

California Tax Policy and the Internet:

Supplements

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SUPPLEMENT A

GENERAL DESCRIPTIVE INFORMATION ABOUT THE INTERNET

DEVELOPMENT OF THE INTERNET

The Internet had its beginnings in the late 1960s as part of a project by the Advanced Research Projects Administration (ARPA) of the U.S. Department of Defense (DOD). The project's purpose was to provide an alternative communication system based on a standard protocol linking government agencies, university research facilities, and high technology defense contractors. In 1967, the DOD distributed a plan to link four sites—University of California Los Angeles, Stanford Research Institute, University of California Santa Barbara, and University of Nevada. The ARPAnet, as it was called, was designed to be a self-maintaining and decentralized communication network, capable of transmitting packets of data automatically, with the ability to reroute communication if one or more individual links became damaged or unavailable.

The ARPAnet was based around various equipment installations made by the military, as well as existing telecommunications infrastructure. In the 1980s, however, the National Science Foundation (NSF) created NSFnet. This was a high-speed, high-capacity network “backbone” created to provide connectivity between university- and government-based supercomputer centers, and to provide other general services. The NFSnet supplanted the military system by 1990 and gradually expanded outside of government and education to include the public at large. The NSFnet was phased out beginning in 1994, although it still plays a role in the development of regional networks and access points for Internet service providers (ISPs).

The current ownership of the Internet backbone is primarily comprised of large companies. Some of the most prominent of these are AT&T Networked Commerce Services, Apex Global Information Services, IBM Global Services, MCI WorldCom, GTE Internetworking, PSInet Inc., and Sprint IP Services. Some of their services are overlapping and provide “back-up” capacity to the system.

GAINING ACCESS TO THE INTERNET

Individuals gain access to the Internet by contracting directly with an ISP, or through an institution which contracts with an ISP or has its own connection to the Internet. Connections to the ISP may be made through regular telephone lines, dedicated telephone lines (such as direct subscriber lines), cable connections, or wireless technology. The ISPs may offer Internet services through any or all of these methods.

Links to web sites, e-mail to individuals, and other uses of the Internet go through the ISP, which uses routing and switching equipment—essentially computers—to direct

the communication to the correct address or uniform resource locator (URL). Most of the network “hardware” (that is, tangible items) that comprises the Internet are communication lines, routers, and switches. In the regional and backbone networks, the lines are often leased telephone trunk lines, and are increasingly fiberoptic. The routers and switches are largely owned and maintained by ISPs or telecommunications companies.

TECHNICAL AND ECONOMIC CHARACTERISTICS OF THE INTERNET

Technical Characteristics

The Internet shares certain characteristics with traditional telephone technology but also has some fundamental distinctions. Most backbone and regional network electronic “traffic” moves over telephone lines using routers and switches, so at a basic level the technology of the two activities is the same. The fundamental differences relate to how the physical infrastructure is actually used. Telephone communication is based on “circuit switching” technology, which means that a direct dedicated connection is made between the two end points. A fixed share of the network is reserved for this call and no other telecommunications connection can use those resources until the call is completed and the connection broken.

The Internet, on the other hand, uses what is known as “packet-switching” technology. This means that no direct connection or circuit is made between the origination and destination points. Instead the data stream is broken up into so called “packets” which are then sent out on different routes through the Internet. They are each identified with a “header” which contains information regarding the destination of the packet. The header allows the packet to be combined with other packets or broken up into smaller packets. A packet may go through as many as 30 to 40 different routers before it reaches its destination. Once the packets reach their destination computer, the headers allow them to be reassembled.

Economic Advantages

The Internet offers significant economic advantages as a communications medium because its packet-switching technology allows for more efficient use of existing telecommunications resources. Packets from many different sources and with different destinations can use the same telecommunication lines at the same time, allowing for efficient use of existing capacity. No direct and dedicated connection needs to be maintained between communication points.

In addition, the Internet’s packet-switching technology exploits recent trends in the relative costs of using different elements of telecommunications infrastructure. This is because while the cost of both routers and telephone line capacity has dropped exponentially in recent years, the cost of routers (a type of computer) that the Internet

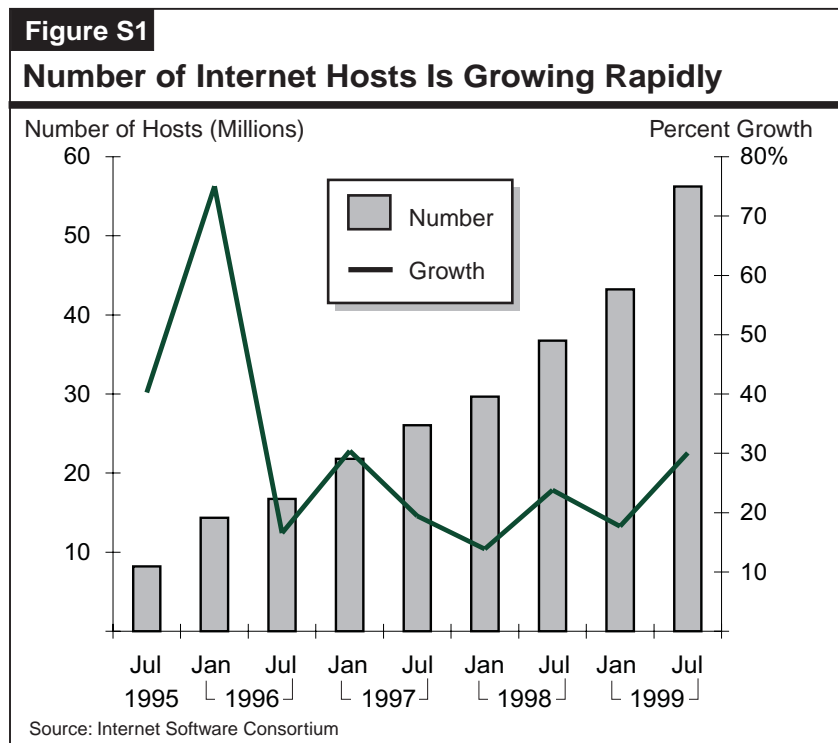
heavily relies on has declined more steeply. With this change in relative prices, packet-switching technology has become more economical.

HOW EXTENSIVE IS THE INTERNET AND E-COMMERCE?

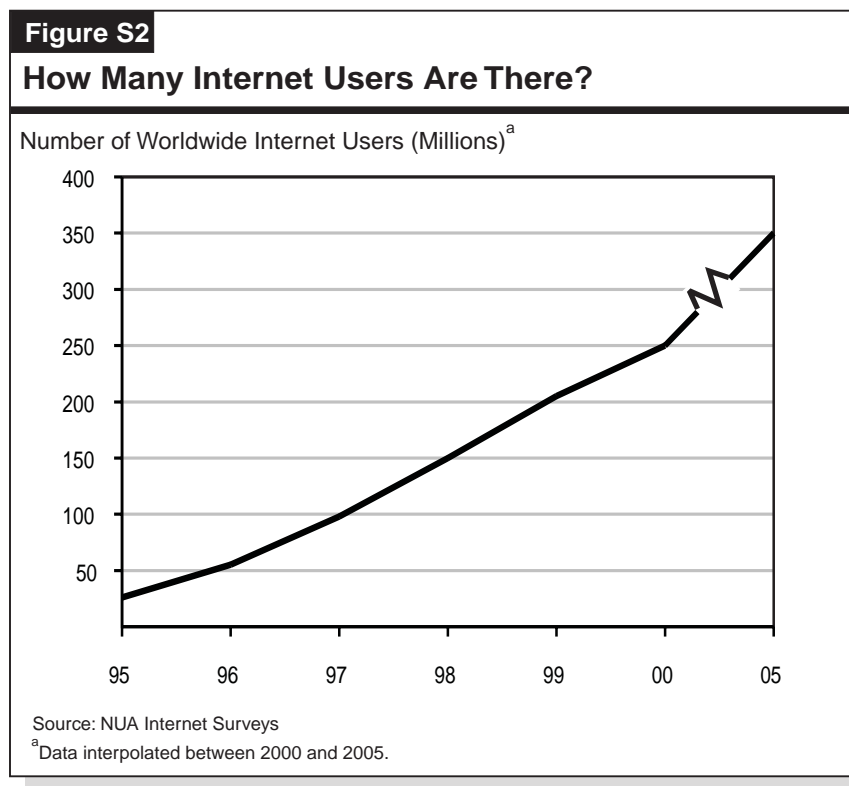
Internet activity is increasingly pervasive and has grown dramatically in the past several years. As yet, however, no official U.S. data on Internet usage or e-commerce are available. As a result, the exact magnitude of Internet activity is not currently known. The U.S. Department of Commerce (DOC) plans to release data on e-commerce activity for the first time in 2000. However, while there is a lack of official Internet-related data, there have been a number of studies on the topic conducted by consulting firms and industry groups that essentially confirm the rapid growth of Internet activity and e-commerce.

Internet Activity

Two of the most common measures of Internet activity are (1) the number of *domain names* (that is, names that represent a record within the domain name system), and (2) the number of *hosts*, (that is, computers that are connected to the Internet). The number of domains is currently estimated to be approximately 6.7 million, up from an estimated 1.3 million in 1997. The number and growth of Internet hosts provides a rough estimate of the minimum size of the Internet and the pace at which it is expanding. Figure S1 presents estimates of this measure of Internet activity.



In terms of Internet use, one recent study concluded that between 1998 and 1999, the number of users increased worldwide by 55 percent, the number of Internet hosts increased by 46 percent, the number of web servers increased by 128 percent, and the number of new web address registrations increased by 136 percent. Likewise, the DOC has estimated that the number of Internet users in the U.S. had increased from fewer than 5 million in 1993 to over 62 million in 1997, and to approximately 80 million by 1999. Currently, the number of worldwide users of the Internet is estimated to be approximately 200 million, with the greatest amount of Internet penetration in the U.S. (37 percent), Canada (36 percent), the Nordic countries (33 percent), and Australia (31 percent). Figure S2 displays the estimated number of worldwide Internet users.



The Volume of E-Commerce

Along with the use of the Internet has come a rapid increase in e-commerce—that is, business conducted over the Internet. One indicator of such commercial activity is the rise in the number of *commercial* domain names, which according to one study, increased from 27,400 to 764,000 between January 1995 and July 1997. In 1998, the DOC noted that studies indicated that business-to-business e-commerce would rise to \$300 billion by 2003. By late 1998, however, most forecasting firms considered this to be

too low, with one source suggesting that a more realistic estimate would be on the order of \$1.3 trillion. More recent estimates have indicated even higher volume.

Retail transactions are also expected to grow rapidly. Estimates of retail e-commerce were in the \$10 billion range in 1998, with firms forecasting online retail sales in excess of \$100 billion by 2003. Recent estimates for 1999 retail sales are from \$20 billion to \$36 billion, suggesting a larger volume by 2003 than previously forecast. Even with this rapid growth, the Internet share of total retail sales currently is still relatively small. The National Retail Federation estimates retail sales during the 1999 Thanksgiving through December shopping period was \$186 billion, of which only \$3 billion to \$5 billion was in Internet sales.

Regardless of the exact magnitude, Internet and e-commerce activity is showing considerable growth, with little if any end in sight as this new technology continues to evolve and spread.

SUPPLEMENT B

SELECTED INTERNET TAX POLICY ADVISORY GROUPS

In addition to the Advisory Commission on Electronic Commerce (discussed in Supplement C) that was established under the federal Internet Tax Freedom Act (ITFA), there exist several other organizations that are involved in addressing issues regarding Internet tax policy. A selection of the leading ones is presented below along with their web addresses.

Organisation for Economic Cooperation and Development

The Organisation for Economic Cooperation and Development (OECD), which is comprised of the United States and 28 other countries which generally subscribe to the principles of a market economy and pluralistic democracy, is actively working on taxation issues related to e-commerce from an international perspective. The OECD's Committee on Fiscal Affairs has adopted principles in the areas of tax treaties, consumption taxes, tax administration, and taxpayer services, and is involved in investigating the means by which to apply these elements of the tax system to e-commerce. The OECD is also engaged in an ongoing effort to involve businesses as well as non-OECD nations in the Internet tax policy discussion (<http://www.oecd.org>).

National Tax Association

The National Tax Association (NTA) is a professional organization of government officials, tax practitioners, business representatives, and academicians which is focused on examining a wide spectrum of public policy aspects of taxation. The NTA's Communications and Electronic Commerce Tax Project was organized to bring together representatives of these diverse groups in order to identify possible solutions to the state and local tax issues raised by e-commerce (<http://www.ntanet.org>).

The NTA's final report was issued in September 1999 and consists of analysis and recommendations in several areas of tax policy. Regarding the sales and use tax (SUT), for example, the NTA's Communications and Electronic Commerce Tax Project:

- Recommended that states adopt a single SUT *rate* in order to simplify the tax reporting process.
- Could not reach agreement on recommendations for a uniform SUT *base*.
- Recommended that sales transactions be sourced for tax purposes only to the state (versus substate) level of destination.

- Addressed various tax simplification issues, but made no specific recommendations regarding such simplification or how it might be accomplished.

The NTA's committee was not able to reach agreement with respect to the subject of telecommunications taxes. In fact, no agreement was reached even regarding the definition of "telecommunications," thereby making it impossible to make progress on the broader issue of state and local telecommunications tax policy and potential reform.

Electronic Commerce Advisory Council

The Electronic Commerce Advisory Council (ECAC) was created by California Governor Pete Wilson for the purpose of recommending how governments at the local, state, and federal levels should further promote the development of e-commerce by clarifying, modifying, and/or removing certain existing policies and practices, and/or implementing new policies and practices. The council considered a number of Internet-related topics, including tax policy issues and released a report addressing these items in November 1998 (<http://www.e-commerce.ca.gov>).

The ECAC put forth a series of recommendations on various tax topics, including the following:

- Certain basic tax policies—including neutrality, low rates and broad base, transparency, certainty, and ease of administration—should be adhered to in any tax regime considered.
- Tax rules for income, property, and consumption taxes should be rationalized and harmonized to reduce compliance costs and avoid multiple levels of taxation by different jurisdictions.
- A multistate agreement should be crafted regarding collection of SUTs by out-of-state sellers.
- The "status quo" should be maintained regarding the application of the SUT only to tangible (versus intangible) personal property.
- The State Board of Equalization (BOE) should consider exempting from the SUT tangible forms of software, music, books, magazines, and other such goods.
- If and when a system for the taxation of interstate sales is in place, California should consider lowering its tax rate to make the overall net revenue effect of any base-broadening steps neutral.

Joint Venture: Silicon Valley Network

The Joint Venture: Silicon Valley Network (JVSVN) is a nonprofit organization of individuals from the business sector, government, education, and the local communities and is focused on economic and social issues in the Silicon Valley. The JVSVN formed the Council on Tax and Fiscal Policy in order to address issues which are tax related. The Internet Tax Task Force of the council was formed in September 1997 in order to focus on Internet-related tax policy issues. The task force has released a draft of a white paper laying out the council's initial positions, and expects to release a final version of the study (<http://www.jointventure.org>).

In addition to the above-cited entities, there are many other organizations involved in the general area of Internet tax policy. For example, many states have their own task forces which are looking at the various tax issues involved, and numerous state and substate regional consortiums likewise exist of business and government representatives. Many tax economists and public finance analysts associated with governments, academia, and independent organizations have also "weighed in" on the subject and numerous manuscripts, papers, and reports have been published on the topic.

SUPPLEMENT C

SELECTED PROVISIONS OF THE FEDERAL INTERNET TAX FREEDOM ACT

Taxes Prohibited by the Federal Internet Tax Freedom Act

The federal Internet Tax Freedom Act (ITFA) prohibits Internet access taxes and multiple or discriminatory taxes on Internet activity. Prohibited *multiple* taxes include those imposed by a state or other jurisdiction on the same e-commerce activity that is also subject to taxation by another jurisdiction. Prohibited *discriminatory* taxes are defined as those:

- Not generally imposed and legally collectable on transactions involving similar goods or services accomplished through other means or not imposed at the same rate.
- Imposing an obligation to collect or pay the tax on a different person or entity than in the case of transactions involving similar goods or services accomplished through other means.
- Establishing a classification of Internet access service providers or online service providers for purposes of establishing a higher tax rate than the tax rate generally applied to all other similar providers.

Prohibited taxes would include Internet access taxes (such as those levied on the monthly fee paid to ISPs) or the “bit” tax (a tax based on the amount of information conveyed over the Internet). Discriminatory taxes might also include—depending upon how they are applied—certain telecommunications taxes, utility user taxes, and franchise fees. Discriminatory taxes would generally *not* include the SUT, since this tax is collected by other businesses engaged in selling the same products through other means.

Reporting Requirements of the Advisory Commission on Electronic Commerce

The Advisory Commission on Electronic Commerce (ACEC) established by ITFA is to study Internet tax policy issues and report to Congress as to whether Internet activity and e-commerce should be taxed and, if so, what the appropriate taxation method would be. The ACEC is comprised of three federal officials, eight state and local government representatives, and eight representatives from the e-commerce industry, telecommunications carriers, local retail businesses, and consumer groups. By April 2000, the commission is to deliver its report to Congress, which is to examine and evaluate:

- Barriers imposed in foreign markets on e-commerce and their impacts on the U.S.
- Consumption taxes on e-commerce in the U.S. and in other countries.
- The impact of the Internet and Internet access on the revenue base for telecommunications taxes.
- Model state legislation that would treat e-commerce in a tax-neutral and technologically-neutral manner relative to other forms of remote sales.
- The effects of taxation and the absence of taxation on all interstate sales transactions, including the Internet transactions, local retail sales, and state and local governments.
- Ways to simplify federal, state, and local taxes imposed on telecommunications services.

The ACEC has held three meetings thus far in its consideration of Internet tax policy. The first was held on June 21 and 22, 1999 in Williamsburg, Virginia; the second occurred in New York, New York on September 14 and 15, 1999; and the third was held in San Francisco, California on December 14 and 15, 1999. The fourth and final meeting is scheduled for March 20 and 21, 2000 in Dallas, Texas.

SUPPLEMENT D

ADDITIONAL INFORMATION REGARDING THE SALES AND USE TAX

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SUPPLEMENT D-1

ALLOCATION OF SUT REVENUES AMONG LOCAL GOVERNMENTS

The procedures for allocating local SUT revenues are complex and governed by numerous detailed regulations, which can have important effects on local jurisdictions. The sales tax component and the use tax component of the SUT are allocated among local governments using somewhat different methods.

Allocation of the Sales Tax

The state receives revenues from its 6 percent share of the basic 7.25 percent state-wide tax rate. Generally, the local SUT portion (based on a 1 percent rate) is allocated to the assigned tax area code for the seller's principal place of business or place of sale, while the remaining 0.25 percent local share (the transportation tax) is allocated to the corresponding county. If the retail sale cannot be identified with a permanent place of business (in the case of contractors, for example), the tax is allocated to local jurisdictions through a countywide (or statewide) "pool." Revenue in these pools is allocated based on the proportion that the identified tax for each geographic area bears to the total revenues identified for the county as a whole. For sellers with multiple geographic locations, the tax is allocated to the location of the principal sales negotiations, even if the item is shipped from elsewhere in the state. For sellers with only one place of business in the state, all sales (and the local portion of the sales tax) would be attributable to that county and its tax areas. Collection of local-option taxes by sellers depends on whether the goods are being delivered or sold inside or outside of an area having an optional tax rate, and whether or not the seller has enough business presence in the tax area to require it to collect the tax.

Allocation of the Use Tax

The state also receives revenues from its 6 percent use tax rate. Since the use tax component of the SUT is by nature not identified with a particular place of business, the local portion of the tax is generally allocated to local jurisdictions in the county of use through the countywide pool. The category of sellers generally collecting and remitting use taxes would include construction contractors whose place of business is a job site, out-of state sellers who ship goods directly from a location out-of-state, and in-state sellers who ship goods from an out-of-state location. Use taxes collected from purchasers (for example, automobiles purchased from private parties) are generally allocated to the location of the purchaser's residence.

SUPPLEMENT D-2

FACTORS AFFECTING SUT GROWTH AND BASE EROSION

There are a number of different factors that appear to have contributed to the SUT not keeping pace with California's overall economic growth over the past couple of decades, as measured by statewide personal income.

- *First*, services—which are generally nontaxable—have become a much more dominant share of the economy. For example, while services comprised roughly 45 percent of personal consumption expenditure in 1970, they accounted for over 58 percent of consumer expenditures by 1996. Compared to many other states with a SUT, California taxes relatively few services.
- *Second*, the growth of catalog sales, telephone sales, and Internet sales by out-of-state companies which are not required to collect the state's SUT has created further erosion of the tax base. This type of retail consumption has increased over recent decades and, given the increasing integration of national and international markets, the trend is likely to continue.
- *Third*, the state's housing construction sector—which is closely linked to SUT performance—has not returned to the levels of activity that were prevalent in the 1970s and 1980s. During those two decades, residential housing starts averaged in excess of 200,000 annually. For the 1990s, in contrast, the annual average declined abruptly to 110,000 units. This is important because the construction of new homes and the furnishings that are acquired for them provide significant stimulus to SUT collections.
- *Fourth*, the component of personal property that is basically informational in nature can be transformed into an intangible form and not be subject to taxation under the SUT. The Internet has increased the opportunities for such transformations to occur. For example, computer software or a database which is sold in prepackaged form and purchased at a store *is* subject to the SUT. However, the same program or data if downloaded over the Internet would *not* be taxed.

SUPPLEMENT D-3

ESTIMATING THE REVENUE IMPACTS OF E-COMMERCE IN CALIFORNIA

Reliably estimating the revenue impacts of Internet activity and e-commerce is difficult and subject to considerable error. Thus, although consensus exists that e-commerce is a rapidly growing sector of the economy, estimates of its size vary considerably and are subject to frequent revision. The DOC will release its estimates of e-commerce for the fourth quarter of 1999 in March 2000. Additional estimates of e-commerce will not be released by the DOC until later in the year. Despite the lack of official estimates, it is helpful to look at some of the independent estimates that have been forthcoming for illustrative purposes.

Volume of E-Commerce

Recent estimates have pegged total e-commerce volume in excess of \$100 billion for 1999. Estimates of the business-to-consumer retail segment of this total amount range from \$20 billion to \$36 billion. Based on these figures, we estimate that the 1999 volume of retail e-commerce in California could be on the order of \$3 billion to \$5.5 billion. Growth estimates also vary considerably, depending on the assumptions used, and tend to be revised frequently as the Internet's development continues to exceed expectations. Annual growth rate estimates for business-to-consumer e-commerce for the next five years range upwards of 100 percent to 200 percent. While the latest independent estimates vary depending on the methodology used, generally they result in sales volume forecasts for retail e-commerce well in excess of \$100 billion by 2003.

Revenue Implications

In estimating potential SUT revenues associated with e-commerce, it is important to note that only a portion of total e-commerce is potentially subject to the SUT. The OECD estimates that roughly 80 percent of the volume of e-commerce transactions is business-to-business in nature. Most of these purchases would not be taxable since they would (1) represent the purchase of intermediate goods, or (2) involve the purchase of nontaxable business services. Of the portion that *would* be subject to the SUT, this would generally be paid as a use tax by the business if the sales tax were not required to be collected by the seller. However, as we indicate in the report, businesses which are *not* registered sellers would typically not remit the use tax on their purchases.

With respect to business-to-consumer retail sales, some consumer purchases over the Internet would not be taxable because they are either (1) not part of the taxable base or (2) statutorily exempted. In addition, there would be some displacement of catalog or telephone order sales which do not now result in SUT payments, and therefore would

not represent a loss in SUT revenues compared to current collections. Finally, businesses with nexus in the state generally *would* collect the SUT on transactions conducted through the Internet. What remains is the portion of Internet sales of tangible goods that otherwise would have resulted in the remittance of the SUT, and intangible goods that otherwise would have been purchased in a tangible (taxable) form.

Based on these factors, it is estimated that over \$1 billion but less than \$3 billion of business-to-consumer sales in 1999 would otherwise have resulted in the payment of the SUT if not for Internet activity. Using the average SUT tax rate of 7.9 percent results in a potential total revenue loss to state and local governments in California in the high tens of millions of dollars to the \$200 million range. These estimates do not account for (1) taxes that would have been collected on the sale of a tangible good that was instead purchased in intangible form using the Internet, or (2) purchases by (nonregistered seller) businesses that would otherwise have resulted in the payment of the SUT. In addition, these estimates do not consider an off-setting increase in other new tax revenues because of expanded commercial activity associated with the Internet itself.

As noted in the text, these revenue-loss estimates do not constitute a large percentage of California's total SUT revenues. They are dwarfed, for example, by potential revenue losses from telephone and catalog remote sales. What is more of a concern to analysts, however, is that the growth of e-commerce could result in major adverse revenue effects on state and local governments in the future. For example, if Internet retail activity continues to expand at its present rate, forgone Internet-related SUT revenues could represent as much as 2 percent to 4 percent of total SUT revenues by 2003. Thus, it is the prospect of these future effects that makes the issue of so much interest today.

SUPPLEMENT D-4

CONSTITUTIONAL ISSUES AND LEGAL STATUS REGARDING NEXUS

Constitutional Standards

Whether or not a state can require a company to collect the sales tax hinges on two Constitutional principles—the *due process clause*, set forth in the 14th Amendment to the U.S. Constitution, and the *commerce clause*, set forth in Article I, Section 8, of the U.S. Constitution:

- ***Due Process Clause.*** This clause sets forth guarantees regarding the treatment of parties by the states. With respect to taxation, its standards are concerned with the fairness of the tax burden and whether the taxpayer has minimum contacts with the state that is levying the tax. The due process clause states: “. . . No state shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States; nor shall any State deprive any person of life, liberty, or property, without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws.”
- ***Commerce Clause.*** This clause balances a state’s right to tax against the burdens placed on interstate commerce due to such taxing. The commerce clause reads, “(The Congress shall have the power) To regulate commerce with foreign nations, and among the several states, and with the Indian tribes.” The commerce clause is also known as the “dormant” commerce clause, since it does not specifically limit state activities but simply reserves to Congress the power to regulate interstate commerce.

The *Quill* Case

The current legal framework regarding SUT nexus was set forth in a series of Supreme Court cases, the most recent being a 1992 case entitled *Quill Corporation vs. State of North Dakota* (hereafter referred to as *Quill*). The case involved the Quill Corporation, an office supply company headquartered in Delaware, and the State of North Dakota. The Quill Corporation advertised by catalog and telephone in North Dakota, and delivered its products within the state using mail or common carrier, but had no physical presence in the state. North Dakota sought to require the Quill Corporation to collect the SUT on sales orders delivered to North Dakota residents.

In its ruling, the court found that North Dakota could not require the Quill Corporation to collect the SUT, and addressed the two salient constitutional questions raised by the due process clause and the commerce clause:

- For *due process* purposes, the court loosened the standard established in a previous case (*National Bellas Hess vs. Department of Revenue of Illinois*) that some minimum physical presence was necessary for a state to require a business to collect the tax. In *Quill*, the court stated that this earlier requirement was too formalistic and instead adopted a more flexible standard that allows nexus with respect to the due process clause if the seller's business contacts with the state make it reasonable for the state to require collection of the SUT. Under this test, a business which purposefully avails itself of the benefits of the economic market in a state would meet the due process nexus requirements.
- With respect to the *commerce clause* requirement, the court applied a test established in an earlier case (*Complete Auto Transit Inc. vs. Brady*) and retained the "bright line" physical presence nexus requirement with respect to the SUT.

What Does This Mean for States?

While the *Quill* decision still requires physical presence to establish nexus, it does so only with respect to the *commerce clause*. The *due process clause* nexus requirement could be satisfied through something other than physical presence. What this means is that should it so choose—since it regulates interstate commerce—Congress could approve legislation that would allow states to require the collection of the SUT by out-of-state businesses. Some legal observers in fact believe that the court ruled in this manner as a means of encouraging Congress to take legislative action along these lines. To date, however, it has not done so.

The existing legal guidelines requiring physical presence to establish nexus are quite relevant to e-commerce. The *Quill* decision creates obvious problems for states attempting to require that remote sellers collect the SUT. The court noted that a substantial amount of business is transacted solely by mail and telephone (and now Internet), thus obviating the need for physical presence within a state. While some states have sought to broaden the definition of nexus such that more companies would meet the test, absent Congressional action, it will be difficult for states to require collection of the tax by out-of-state businesses.

SUPPLEMENT D-5

TRANSFORMATIONS VIA THE INTERNET

One of the major features of Internet technology is its ability to transform vast quantities of information from physical into digital form. The result of this technological capability is that virtually anything whose nature consists of information rather than physical characteristics, can be sold, transferred, or conveyed through the Internet. The process of reducing the item to pure information is referred to as “digitizing” the product, signifying that it is being transformed from a tangible good, which generally would be subject to the SUT, into an intangible good, which is not subject to taxation.

Internet Activity Has Accelerated the Conversion to Intangibles

The process of reducing goods to their pure informational form is not new. Earlier telecommunications-based technologies are used to transform information from physical to digital form. For example, facsimile machines can be used to deliver or sell certain types of information including reports or similar items. However, the development and continued improvement in Internet technology has vastly expanded—in terms of volume and complexity—the ability to engage in such digital conversions.

A Wide Variety of Transformations Are Possible

The process of digitizing has occurred and will continue to occur across a number of different industries. In each case, the intangible, or digitized form, is not subject to the SUT. For example:

- Consumers currently have the ability to purchase music in various digital forms through the Internet. The tangible equivalent of these musical purchases—such as compact discs or audio tapes—would, under normal circumstances, be subject to taxation.
- Computer software and graphics may be purchased over the Internet on a broad basis. The prepackaged equivalents of this software would be taxable under most circumstances.
- Books and other written material may be downloaded through the Internet to individuals or directly to binding companies, in most cases without being fully subject to the SUT.
- Movies and other graphics can be obtained and played directly through the Internet. This use will expand as the technological capabilities of the Internet continue to improve. These would be taxable if purchased in physical form.

- Large-scale databases compiled by businesses, for use by other businesses and individuals, are becoming available through the Internet as the technological capabilities of the medium improve.

It is difficult to ascertain the scope of such product and service transformation. It is also far from clear at what speed such a transformation of many products will occur. Clearly, much of the transformation of many of the products is reliant not only on the technological capabilities of the Internet—for example, the continued development of Internet “broadband” capacity—but also on the willingness of consumers to convert from traditional to new product forms. It is likely, however, that the Internet—and the ongoing improvements to it—will speed up the process of conversion of information-based products to digital forms. As this occurs, many argue it could result in an acceleration in the erosion of the SUT base.

New Tax Administration Challenges Will Have To Be Addressed

The increased use of digitization is likely to require additional regulatory and interpretive actions on the part of the BOE, regarding whether or not products delivered over the Internet are taxable or not taxable. This issue would be raised, for example, if the product being delivered has an exact counterpart in the physical realm. Another manner in which the issue would be joined is if the product delivered were simultaneously accompanied by a physical copy—for example, a software program. Would both be taxed? Would neither be taxed? Or, would only the physical one be taxed?

SUPPLEMENT D-6

TAX-POLICY PRINCIPLES AND INTERNET-RELATED TAX ISSUES

There are several key tax-policy principles that economists and public finance experts typically suggest should be recognized when dealing with tax-policy issues. In the case of Internet-related tax issues, these principles, which include both economic and tax-administration considerations, are among those that can help to guide legislators as they consider and debate various policy options.

Efficiency and Neutrality

This principle holds that taxes should generally be structured in a manner that minimizes their interference with economic decision making. For example, the broader-based a tax is, the lower the tax rate that can raise a given amount of revenues, and thus the fewer the distortions that will stem from its imposition. This principle would suggest that taxes be applied equally to all similar goods, regardless of the means by which they are purchased.

Equity

The equity principle has to do with the relative amounts of taxes paid by different taxpayers having different characteristics, such as their economic well being as measured by income or wealth. Both “vertical” and “horizontal” equity are involved. The former considers the tax treatment of taxpayers in *different* economic circumstances, whereas the latter considers *similarly* situated taxpayers. With respect to vertical equity and the Internet, one consideration is the fact that lower-income individuals do not generally have the same access to the Internet as do higher-income individuals, and thus, to the extent that Internet buyers avoid paying the use tax, low-income individuals would be at a comparative disadvantage.

Revenue Sufficiency

This principle involves such basic features of a tax as the adequacy of the revenues it generates, the growth in these revenues over time, and volatility of its revenues over the course of the business cycle. Also involved are the balance and diversity which a tax brings to a state’s overall revenue portfolio.

Administrative Feasibility

From an administrative standpoint, the best taxes are those which impose minimal compliance costs on taxpayers, and minimal enforcement, collections, and other administrative costs on tax agencies. Such taxes tend to be relatively simple, visible and transparent, and ensure that a high degree of compliance and accountability can be attained.

SUPPLEMENT D-7

IMPOSING THE SUT ON INTANGIBLE PROPERTY

Increased use of the Internet by consumers and businesses, and its increasingly sophisticated technological features, have heightened awareness of issues related to the tangible versus intangible classification of property for SUT purposes. Currently, certain products are subject to the SUT when purchased in tangible form, but exempt when purchased in intangible form—such as when the product is delivered electronically through the Internet. This occurs, for instance, with music, written products, and graphics.

If an effort were made to make the SUT neutral in its application with respect to tangible or intangible manifestations of the same product, either both forms should be taxed or neither should be. Broadening the tax base to include the taxation of intangibles presents quite complex administrative issues. Many of these relate to inability to determine the place of delivery or use of the product for the purpose of assessing the tax and distributing its proceeds. With respect to the sale of intangible goods over the Internet, the seller does not need to know—for purposes of delivery—the location of the purchaser, the location of use, or the number of locations where the goods will be used.

Implementation and Administrative Issues

While taxing intangibles purchased in-state could be accomplished without conflicting with the *Quill* decision (see Supplement D-4), interstate commerce taxation would require that Congress address the commerce clause issue. In addition, taxing intangibles could entail rather intrusive auditing procedures by the BOE unless the state were to rely on purely voluntary participation by purchasers. Since no geographic destination needs to be specified on the delivery of intangibles purchased through the Internet, a voluntary approach would result in an incentive for taxpayers to indicate a purchase site in a low- or no-tax location.

This compliance issue could be dealt with through the use of “digital certificates,” which provide evidence of the owner's identity during a given transaction in the form of a statement signed by an independent third party. In this manner, a digital certificate allows a vendor and officials from a taxing jurisdiction the ability to determine the correct tax rate. Alternatively, instead of assessing the tax based on the place of delivery, the tax could be assessed based on the billing address of the purchaser. This method would be suitable for credit card or similar purchases, even though it would not necessarily mesh with the actual point of consumption and use. In addition, it would not be effective for purchases using untraceable payment means, such as “cybercash”—an Internet form of physical currency. Using such means of payment would require additional information provided by a firm acting as the financial intermediary for the

transaction—a requirement which would raise a number of privacy and administrative issues.

A Fallback Alternative

One proposal to deal with the sale of intangible goods where the purchasers' location is unknown, is to default to a single basic SUT rate (for example, a national minimum tax rate), where the tax proceeds would either be (1) "thrown back" to the seller's location or (2) "thrown around" to all other states in proportion to their share of purchases with known destinations. This approach does raise issues with respect to state sovereignty given that states have independently chosen different SUT rates or may not even have a sales and use tax.

Any attempt by states to broaden the SUT to encompassing intangible products would need to address these significant administrative issues, and probably would require federal legislation unless the system were to be voluntary.

SUPPLEMENT D-8

SELECTED ALTERNATIVE APPROACHES TO ADDRESSING INTERNET-RELATED SUT ISSUES

Approaches to Internet-related SUT issues range from declaring the Internet a “tax-free zone,” to abandoning the SUT altogether in favor of a broad-based tax on all consumption. In this supplement, we focus on approaches which leave the SUT basically intact. Options for addressing Internet-related tax issues may be either undertaken by California alone—the state specific approach—or in conjunction with other states—the cooperative approach.

THE STATE SPECIFIC APPROACH

There are four primary ways the state might wish to address Internet-related SUT issues on its own.

Option: Focus Efforts on Expanding Nexus

Current law requires a seller to have physical presence in a state before the state can require it to collect the SUT. California could use one or more of several legal theories in order to justify expanding the definition of nexus. These include the theories of agency, affiliation, economic presence, and presence of intangibles.

Agency Theory. This approach would allow the state to assert nexus over an out-of-state seller based on the in-state activities of the seller’s agent. Some states have used this theory to assert nexus over out-of-state ISPs that use “server farms” within the state. Some have further argued that ISPs act as agents for those whose web sites they carry. Under this view, firms would have nexus wherever their ISP had a physical presence. Some continue this line of reasoning to argue that telecommunications firms act as agents for ISPs, implying that *all* firms doing business over the Internet would have nexus in all states. Generally, agency theory has met with limited legal success. Even if the approach met with legal success, however, as a practical matter the ease with which agents could move from state to state would likely make it ineffective as a long-term solution.

Affiliation Theory. This theory of nexus involves linking out-of-state sellers with in-state affiliates and subsidiaries based on the dominance or control exercised by the out-of-state seller. As a result of such relationships, the in-state affiliate is deemed to be part of the out-of-state corporation. This approach has generally met with limited success, although it may be successful in narrow situations involving holding companies and “dot-com” subsidiaries.

Economic Presence Theory. This theory of nexus is based on the regular and systematic direction of business efforts to a state where it has no physical presence. In the *Quill* case (see Supplement D-4), the economic presence argument was unsuccessfully used by the State of North Dakota to establish nexus, so its future effectiveness is questionable.

Presence of Intangibles Theory. This approach would base nexus on the existence of intangible property (such as stocks or trade names) within the state. This approach was validated in an *income* tax nexus case, and states could push to have this approach applied to the SUT. Here again, however, the likelihood of fundamentally altering the legal framework is remote.

Option: Encourage Use-Tax Compliance

Purchasers who buy goods from an out-of-state vendor are technically required to calculate and remit the appropriate use tax on these purchases, which is levied at the same rate as the sales tax would have been had the purchase been made from an in-state seller. The use tax is self assessed and, as a consequence, generally goes uncollected except in cases (1) where a registration requirement exists or (2) if the purchaser is a registered seller with the BOE. Currently, registration requirements are limited to automobiles, boats, trailers, and selected other categories of items. In addition, only retail businesses and selected other concerns are registered sellers. As a consequence, the SUT is typically not collected on a large number of purchases.

Auditing Will Not Solve the Problem. All states with a *sales* tax have an accompanying *use* tax (although it is not always levied at the same rate). The use tax is intended to establish tax equity between goods purchased in-state and those purchased out-of-state. While the rationale for the use tax is theoretically sound, the practical limitations with respect to enforcement have largely compromised the tax's underlying policy goal. Although audits can provide a cost-effective means of encouraging compliance, these are only cost-effective in particular cases involving easily identifiable and expensive items. Since most of the noncompliance associated with the use tax is a result of a large number of purchases by the broad general population, audits are neither a practical nor politically palatable alternative to comprehensively dealing with the SUT compliance problem.

Piggy-Backing on the Income Tax Form Could Be Tried. To make the SUT a more reliable revenue source for local governments and yet still maintain simple and inexpensive collection methods for sellers, California could focus on increasing use-tax compliance by heightening consumers' awareness of their use-tax liabilities. This increased awareness could be achieved by incorporating a provision for use-tax payments into California's personal income tax return. A few states, including Connecticut, Idaho, Indiana, Kentucky, Maine, and Wisconsin already employ such an approach. For example:

- In Maine, the state personal income tax return (Form 1040S-ME) instructs the filer as to how to determine use-tax liability, either by applying the use-tax rate to the amount of purchases for which sales tax was not paid (if this amount is known), or by multiplying Maine adjusted gross income by a certain percentage.
- In Kentucky, the state personal income tax return (Form 740) instructs the filer to apply a 6 percent rate to out-of-state purchases of tangible personal property. The Kentucky Revenue Cabinet routinely conducts use-tax compliance programs as well.

Option: Simplify the SUT Structure by Changing to an Origin-Based Tax

Under this scenario, California could significantly simplify its current SUT structure by specifying that all sales be taxed according to their origin (or source), as opposed to their destination. An origin-based SUT would mean that out-of-state purchases by Californians would be taxed at the applicable rate according to where the sales originated (if the origin state had such a tax). In addition, California would tax all sales of products originating in-state, even if they were shipped out-of-state. (For additional discussion relating to this option, see Supplement D-9.)

Option: Create a Web-Based Tax System to Facilitate SUT Collections

Under this option, the state would use Internet technology to facilitate use-tax collection and ease the cost of taxpayer compliance and BOE enforcement. For example, the state could choose to become an on-line use tax collection agency. To accomplish this, California might have the “order page” of sellers’ web sites link with the appropriate state site. The state’s site would then calculate and collect the tax from the buyer, using the same payment mechanism the buyer uses for his/her purchase. Other alternatives exist under this option, as well.

Under the State Specific Approach, What Should California Do?

Regarding the first, second, and third options, they would either be generally ineffective or result in potential economic disruption. The first option would require a significant expenditure of resources with very little guarantee of a substantial return. Efforts to expand the application of nexus would be likely to be effective only in marginal cases. The second option—encouraging purchaser compliance with the use tax—is unlikely to have a material effect on SUT revenues. Changing to an origin-based SUT, as the third option suggests, would bring with it potential economic distortions. It would transform the SUT from a quasi-consumption tax to a quasi-production tax, thereby potentially causing business relocations.

The state-specific action that the state may wish to investigate is an Internet-based tax collection system. Although it would not directly address nexus issues, it would ameliorate some secondary issues associated with the SUT. Among other things, this approach could: (1) lessen the administrative costs on sellers; (2) sidestep the complexities associated with nexus issues; and (3) result in a fairer, more economically neutral application of the SUT. Even with this system, tax neutrality and equity concerns would likely persist, since out-of-state retailers would not be *obligated* (under existing law) to collect the tax, but “main-street” retailers still would be required to do so.

THE COOPERATIVE APPROACH

Under this second general approach, the state would attempt to enter into agreements either with other states, the federal government, or both. There are three basic versions of this policy approach.

Option: Establish a Federal Collections Function

This option would require a rather dramatic administrative restructuring of the SUT by specifying a federal agency to collect the tax. Under its constitutional ability to regulate interstate commerce, federal legislation could require that sellers of products across state lines collect and remit to the federal government the SUT. These revenues could then be allocated back to individual states. For the sake of simplicity, agreements would likely need to be reached regarding definitions of products, products to be taxed, the rate of tax to be used, as well as other administrative issues.

Option: Reciprocal Agreements Between Individual States

This approach would call for California to establish cooperative agreements with individual states that would require companies operating in them to collect the appropriate SUT taxes on shipments to California, and visa versa. For example, California companies shipping goods to New York would be required by California to collect New York’s SUT. This would in turn be remitted to California and netted against the SUT paid by New York sellers of goods shipped to California. This approach would avoid the tax-generated movement of production associated with the origin-based tax.

Option: A Multistate Agreement

Under this alternative, California would develop with other states a multistate agreement that would establish a means to facilitate collection of the SUT by out-of-state sellers. The states participating could initially develop a voluntary collection and remittance system. An effective agreement that did not interfere with interstate commerce activities could encourage Congressional action to resolve the out-of-state sales issue. As part of this process, efforts should be made to minimize SUT collection and compliance burdens on sellers. This approach to Internet-related SUT revenues would

enable California to streamline its SUT collections activities, encourage compliance in a cost-effective manner, as well as manage the overall multistate SUT structure. It also would avoid reliance on the federal government in dealing with SUT revenue issues.

Under the Cooperative Approach, What Should California Do?

In our view, the multistate agreement makes the most sense here. With respect to the other alternatives, pursuing a federal collections approach would involve a significant sacrifice of state sovereignty, and state-by-state agreements would not be all inclusive, and therefore not fully address the problem.

The focus of the multistate approach should be to: (1) establish one SUT rate per state or develop a means to track SUT rates, (2) standardize definitions of taxable and nontaxable items, and (3) establish exemptions for small sellers, as discussed below. Generally, this approach would involve simplifying and minimizing variations in existing SUT systems and coordinating collection efforts. A voluntary system along these lines has been proposed by the National Governor's Association and National Conference of State Legislatures and endorsed by other state and local government associations.

- ***Establish One SUT Rate Per State or A Tax Rate Tracking System.*** There are about 6,500 individual SUT taxing jurisdictions nationally. Vendors find it difficult and expensive to keep track of all of the different SUT rates their buyers represent, since they can frequently change and vary according to the city and county involved. Given this, one approach could be to establish one SUT rate per state, at least for out-of-state sales. Alternatively, states could develop a tax tracking system which would allow for local variation in tax rates, but place limitations on the frequency with which rates could change.
- ***Establish Uniform Product Definitions.*** Many states exempt from the SUT certain categories of goods. However, there is no consistent product definition for these goods among the states. Establishing consensus product definitions among states could lead to increased compliance and would reduce administrative costs.
- ***Establish Rules for Special Sales.*** States have varying SUT requirements for sales to exempt organizations and sales for resale. As part of the process to standardize treatment of sales by different states, any agreement should result in a process that adequately simplifies these varying administrative rules. There could also be exemptions for small businesses with annual sales less than a threshold amount.

Of course, there would be some drawbacks associated with the cooperative approach. For example, participation in a multistate agreement could mean that California

would lose some degree of state sovereignty. It also is open to question whether such an approach can function effectively, given the high degree of interstate cooperation required. Some states, for example, may have incentives not to cooperate because they want to attract business by not enforcing the SUT. There may also be cost considerations, since it would be important that the amount of additional SUT revenues collected cover the cost of administrative and collection activities.

SUPPLEMENT D-9

ORIGIN-BASED VERSUS DESTINATION-BASED SUT

Sales and use taxes are collected on the basis of either product origination, called the *origin basis*, or on the basis of the destination of the goods (or location of the purchaser), known as the *destination basis*. Under the former system, exports for a geographic region are taxed while imports are exempt. Conversely, under the latter system, imports are taxed while exports are exempt. In California, as in virtually all states with a sales and use tax, the tax generally is a destination-based tax, with the tax being assessed according to the rate in effect where the goods are delivered. In practice, however, although the tax is conceptually intended to be purely destination based, the tax is usually levied based on the place of purchase or delivery rather than the place where it is actually used or consumed.

The application of the destination principle to the SUT varies somewhat for the purposes of interstate and intrastate commerce.

The Case of Interstate Sales

The “destination basis” means that for goods shipped *from* California *to* other states, no California SUT is collected. This is because the goods are not delivered in the state (although a tax may be collected by the destination state). For those goods shipped *from* other states *to* California, the destination basis would result in a California use tax liability. However, as discussed elsewhere in this report, the ability of states to require out-of-state sellers to collect and remit the tax is generally limited by law to certain situations, and voluntary remittances by purchasers are seldom made. As a result of these constraints, for many goods purchased from out-of-state, no SUT is collected.

The Case of Intrastate Sales

For commerce that occurs *within* the borders of California, the SUT is generally (but not strictly) destination based. Purchases made in one county are taxed based on that county’s rate and the taxes allocated to that county. On the other hand, purchases made in one county but delivered to another county are taxed based on the county rate where the sale is made, even though the goods are delivered elsewhere. Certain other inconsistencies occur as well, depending upon the location of the sale and the business structure of the seller. For example, for sellers with one place of business in California, all sales are considered to occur at this location, even if they are shipped elsewhere in the state (thereby suggesting an origin basis for the tax). The determination of where a sale occurs (that is, its “situs”) affects both the rate of tax as well as which local jurisdiction receives the associated tax revenues.

The Rationale for Destination Basis

The destination basis for the SUT is linked to the rationale for SUT itself. The tax was originally conceived of as a levy on the *purchase* (or use) of a good, rather than its *production*, since private consumption was deemed to be a better proxy for consumption of the benefits of public services than was production. On this ground, the destination basis of the tax is generally perceived by taxing authorities as a more appropriate model for taxation than an origin-based one. An origin-based tax, in contrast, is effectively a tax on production rather than consumption. One ramification of the destination basis is that it can result in favorable revenue effects for retail-based relative to manufacturing-based economic areas and taxing jurisdictions.

SUPPLEMENT E

ADDITIONAL INFORMATION REGARDING TAXATION OF TELECOMMUNICATIONS

OVERVIEW

Many telecommunications taxes were structured for an industry that has changed significantly in recent years in terms of its technology and competitive characteristics. These taxes have neither evolved sufficiently to mesh with the current industry structure, nor do they possess the flexibility to accommodate future changes in telecommunications technology. A number of the features of telecommunications taxes may no longer be justified in an economic or policy sense. Some of the outmoded features of the tax system relate to (1) an industry typified by monopoly, (2) special rights and privileges that were granted to the industry, and (3) efforts to provide an integrated telecommunications network with universal access. Some of these concerns or industry features are no longer present, while others have changed significantly in composition or magnitude.

The technologies involved in telecommunications—telephone, television, radio, and Internet—while still distinct in some respects, are rapidly beginning to blend and overlap. This process has made many tax distinctions between the different media difficult to justify in economic terms, and has resulted in inefficiencies and unfairness. Many features of the Internet are similar to those embodied in television, radio, and telephone communications, while others remain distinct. This blending and overlap of technologies—or “convergence”—can result in an inconsistent and uneven application of taxes which benefit or hinder particular industries or sectors. This can result, for example, when one particular activity is treated differently by the tax system simply because it uses a different technology or transmission system.

CURRENT TELECOMMUNICATIONS TAXES IN CALIFORNIA

Telephone-Service Taxation

The telecommunications industry has been treated differently than other businesses with respect to taxes, based on its market structure, economic characteristics, and particular social goals. Telephone service was perceived as a natural monopoly (based on its technology and access to scale economies), and was designated by states—including California—as a “common-carrier” industry. On the basis of the special privileges that were accorded to it (such as local rights-of-way) and its monopoly position, the industry was treated separately and uniquely for tax purposes, resulting in an exemption from local franchise fees, and different treatment with respect to property taxes and certain other business taxes. State regulation allowed telephone charges to be set at levels that

provided for subsidized rates for certain parties and geographic areas, helping to further the goal of universal service and establish a telecommunications network. These subsidization measures were motivated by a belief in the essential nature of telephone service and the economic benefits of universal access. As the industry became more competitive (and direct-rate subsidization became infeasible), the levying of surcharges allowed states to continue to fund universal telephone access as well as certain other programs.

There are currently a number of charges placed on local and long-distance telephone service in California, with most other states having similar charges. In addition to the state surcharges and local taxes on telephone service outlined below, surcharges are also imposed by the Federal Communications Commission (FCC) for network access for interstate calling, regulatory charges are levied by the FCC and Public Utilities Commission (PUC) in order to fund the oversight of the industry, and excise taxes are levied by the federal government. Current levies include:

- *Universal Lifeline Trust Surcharge*—this is imposed by the PUC in order to provide discounted local telephone services to low-income households.
- *California Relay Service and Communications Devices Surcharge*—this is imposed by the PUC in order to provide telecommunications equipment and relay telephone service for deaf or otherwise disabled individuals, and to place similar equipment in buildings and public places.
- *California High-Cost Fund Surcharge*—this is imposed by the PUC for the purpose of subsidizing basic local telephone service to residential customers in high-cost areas.
- *California Teleconnect Fund Surcharge*—this is imposed by the PUC in order to provide discounted telecommunications services to qualified entities.
- *Emergency Telephone Users' Surcharge*—this is imposed by the PUC for the purpose of funding emergency telephone service (911) in California.
- *Utility-User Tax*—this may be levied by local governments on a gross-proceeds basis on local and long-distance telephone service as well as wireless telephone service.

Cable Service Levies

Cable service in California is subject to direct local taxation based on the rationale of the use of public rights-of-way and being granted a local monopoly. Cable service is regulated by the federal government and the State of California, and is subject to a regulatory fee levied by the FCC. In California, two principal fees and charges are levied on cable television connections.

- **Franchise Fees**—these are paid to local governments by privately-owned cable companies for the privilege of using local government property and rights-of-way. Federal law prohibits franchise fees from exceeding 5 percent of gross receipts, while state law also limits franchise fees to a percentage of gross receipts. State and federal law also prevent companies from providing cable services without acquiring a franchise. California has delegated to cities and counties the franchising authority over cable companies, whose fee payments represent an unrestricted revenue source.
- **Utility-User Tax**—this is a gross proceeds tax levied by some local governments on cable television services, and other utilities such as telephone, gas, and electric services. Tax rates generally range from 5 percent to 7 percent and represent an unrestricted revenue source for local governments.

Internet Service Charges

California does not have any state or local taxes levied directly on Internet access (that is, the monthly fee that subscribers pay to an ISP to provide access to the Internet). Several states and local governments *do* have such taxes on Internet access, however, and prior to the adoption of California's Internet Tax Freedom Act, such taxes were apparently contemplated by some local governments.

Despite the lack of direct taxes, Internet access may be subject indirectly to telephone surcharges or other taxes. To the extent that the Internet user connects to an ISP through telephone lines, this telephone connection would be subject to various telephone surcharges and (in some localities) utility user taxes. In addition, the ISP could be subject to taxation on the use of telephone lines to connect the subscriber to the Internet trunk lines. These taxes would be incorporated in its business costs, and to the extent possible, passed along to the Internet subscriber. If, on the other hand, Internet access were achieved through cable connections, franchise fees and utility user taxes could be levied.

TECHNOLOGICAL CONVERGENCE IN TELECOMMUNICATIONS

The complexity of the existing telecommunications tax structure makes it difficult to apply to even *standard* technologies in an even handed and consistent fashion. Adding to the existing complexity is the trend towards convergence of telecommunications technologies—the set of technological changes that results in a blurring of the formerly distinct divisions that existed between and among television, telephone, radio, and Internet service. Until relatively recently, television, radio, and telephone service were separate technologies. Even the Internet, prior to its availability to the public, largely existed as a distinct system. As a result of this technological separation, the tax system—while it did suffer from inefficiencies and inconsistencies—generally treated simi-

lar activities in a similar fashion. Taxes were unlikely to alter behavior in choosing one particular medium over another since they served different purposes.

This situation is changing rapidly. Convergence has made these technologies increasingly similar with respect to basic operating principles and use. As a result, similar activities are being conducted over different mediums or systems. Many examples of this currently exist, and they are increasingly likely to occur as the Internet develops. These “cross-technology” activities include electronic Internet telephony (voice communication using the Internet instead of telephone lines), and the use of greater Internet band widths—in conjunction with special software—to yield Internet access to radio and television stations, as well as other technological advances. In addition, company ownership is evolving to include the integration of different types of systems.

CONVERGENCE AND TAXATION

Technological convergence has generally outpaced laws, court opinions, and regulatory treatment—all of which tend to treat the telephone companies and cable providers as *separate* entities and technologies. The *tax system* in the telecommunications area is equally dated and unable to account for the degree of technological change that has occurred in recent years.

California's two basic alternatives in this area are to (1) study existing telecommunications taxes in order to initiate a basic restructuring of the tax system, or (2) accept the telecommunications tax structure as it now stands and attempt to make its application more fair. We suggest that the state pursue the first of these two options, the details of which are further discussed in the text. In undertaking a study of the telecommunications tax area, the potential effects on local government revenues and specific state programs would need to be taken explicitly into account and addressed.

SUPPLEMENT F

ADDITIONAL INFORMATION ON CORPORATE INCOME TAXATION

The principal tax-related issues that arise from Internet activity involving the Bank and Corporation Tax (BCT) are nexus and income apportionment.

- *Nexus.* In order for a corporation to be subject to the California BCT, the corporation must be considered to have “nexus”—or sufficient contact—with the state. Internet activities raise complex issues regarding whether or not certain activities meet the nexus threshold.
- *Apportionment.* California’s BCT law requires that income be apportioned across state jurisdictions to reduce the possibility that the income is either taxed more than once, distributed between states unfairly, or not taxed at all. Internet activity makes it more difficult to calculate the factors included in California’s apportionment formula.

The BCT issues that are raised by Internet activity can be quite technical in nature. For this reason, the basic principles of the tax are provided below prior to addressing the Internet-related tax policy questions.

BASIC CHARACTERISTICS OF THE BCT

For a corporation to be taxable in California, it must be considered to have nexus in the state. Corporations that have nexus in the state and earn income derived or attributable to California sources are subject to California’s BCT. Most California corporations are subject to the *franchise tax*, which is levied for the privilege of conducting business in California, generally at a flat 8.84 percent tax rate. Corporations that derive income from California sources but do not have a substantial enough presence to be classified as “conducting business” in the state are subject to the *corporate income tax*, which is levied in a manner similar to that of the corporate franchise tax.

CALCULATION OF INCOME FOR MULTISTATE AND MULTINATIONAL CORPORATIONS

Sources of Income

If a corporation derives *all* of its income from California sources, the entire nonexempt portion of income is used in the state BCT liability calculation described above. However, if the corporation has multistate or multinational operations and has business income attributable to non-California sources, then the corporation must *apportion* the amount of its business income attributable to its California operations.

Before apportioning income, the corporate taxpayer must first identify and then combine the income from the corporation or group of corporations operating as one integrated business. The taxpayer may elect to combine either (1) its *worldwide* income or (2) its income *within* the U.S. The former method is known as the “worldwide” basis and the latter as the “water’s-edge” basis. Once this election is made, formula apportionment (see below) is used to determine the portion of income attributable to California for tax purposes.

Formula Apportionment

California’s apportionment formula is generally based on a multistate agreement called Uniform Division of Income for Tax Purposes Act (UDITPA), which measures a firm’s average ratio of corporate activity in California relative to its total corporate activity (either on a worldwide basis or water’s-edge basis) for three factors: property, payroll, and sales (the sales factor being generally double-weighted in California). The average computed ratio is then multiplied by the total net corporate income to arrive at the amount of income attributable to California. This amount is then used in the calculation described above to arrive at state BCT tax liabilities.

THE INTERNET, NEXUS, AND INCOME APPORTIONMENT

The areas most in question with respect to the application of the BCT to Internet-related business activity have to do with (1) threshold requirements for establishing nexus in the state, and (2) determining the sales component used in the income apportionment formula.

Current Nexus Status

The issues raised in establishing nexus for BCT purposes are similar to those raised with respect to the SUT in the text and Supplement D—namely, how much taxpayer presence is required before a state can collect the use tax? In contrast to the SUT nexus issue (which requires a physical presence in the state), the nexus requirement with respect to the BCT is less clear. In the *Quill* decision (described in Supplement D-4 in the SUT discussion), the Supreme Court did not extend the physical presence requirement to taxes other than the SUT, including income taxes. As a consequence of this and other court decisions, the level of activity required before other types of taxes can be collected has been left somewhat undefined.

A number of state court cases have led to decisions which specifically hold that physical presence is *not* necessary for a corporation to be subject to corporate income taxes. For example, the South Carolina Supreme Court found in *Geoffrey vs. State of South Carolina* that “purposeful direction” of business activities and the presence of intangibles constituted sufficient nexus for due process clause purposes. In addition, it found that physical presence was *not* necessary to establish nexus for corporate income

taxes on commerce clause grounds. On the basis of this and other court decisions, some states have taken steps to simply *assert* nexus for corporate income purposes in the absence of physical presence. California, however, has not taken such an aggressive stance with respect to nexus.

Internet Activity and Nexus

The development of and growth in Internet activity raises important issues regarding what constitutes nexus for BCT purposes. This is particularly true, given that the necessary threshold itself has not been sufficiently refined for even traditional business activities—and Internet activity adds an additional layer of complexity.

Some of the issues involved are similar to those raised by traditional forms of telecommunications. For example, primary information providers such as ISPs may use local telephone companies for access to subscribers as well as own their own equipment (such as modem connection points or “nodes”) in the state. This arrangement could be sufficient for nexus. On the other hand, ISP connections made through satellite or third-party arrangements may not result in sufficient contact for nexus purposes. Similarly, providers of information over the Internet through third parties (like cable television companies or ISPs), may not have any physical presence in the state. In either of these cases, the lack of physical presence would result in the state having to rely on more uncertain, nonphysical presence in order to assert nexus.

Generally, the continued growth of the Internet and the adaptations that businesses will use in order to avail themselves of Internet technology could result in a relative decline in the presence of tangible property in the state, and make it somewhat more questionable for the state to assert nexus in “borderline” situations. This could result in adverse effects on state revenues as companies shift their points of operation out of state, or as more product is delivered through the Internet using third parties.

Apportionment Issues

Even if a company has nexus in California, this makes no difference from a revenue standpoint unless a portion of the businesses income is assigned to the state under BCT apportionment rules. The largest source of concern with respect to the apportionment formula and Internet activity has to do with the attribution of the sales factor, which differs substantially for tangible and intangible property. For tangible products, the sale is sourced (that is, attributed) to the destination point. For intangible products, on the other hand, all of the sale is sourced to the location with the greatest income-producing activity. This means that a state in which a significant amount of income-producing activity occurs can be completely disregarded if another state has slightly more. This could become increasingly the case for e-commerce businesses engaged in the sale of intangible products from outside California.

Under UDITPA—to which California generally adheres—as well as the California Revenue and Taxation Code, income-producing activity must be related to direct costs of performance. With Internet activities—like telecommunications activities—direct costs are quite difficult to determine. Telephone and Internet activities are routed through a complex system of microwave transmissions, fiber optics, satellites, and cables which make the tasks associated with identifying the direct costs associated with a particular transmission financially prohibitive. In addition, there is some difficulty in defining direct costs as distinct from indirect costs.

In addition, under this approach to attributing sales, certain biases exist in the tax treatment of similar types of businesses. For example, resellers of telecommunications or Internet providers might have little or no physical property of their own used in placing a call or connection, and no associated direct costs. In contrast, other companies engaged in similar telecommunications activities would incur such direct costs based on their ownership of property. The use of property without a jurisdictional home (such as satellite and undersea cables) by Internet providers also could present a problem. Finally, information providers may have data banks located in a single state, while the compilation of such information may occur in several jurisdictions. Under current rules, the state with the largest concentration of income production activities would receive the assignment for tax purposes to the exclusion of other states.

POTENTIAL OPTIONS AND ADMINISTRATIVE SOLUTIONS

Regarding nexus, the uncertainty of the “presence” threshold required for tax purposes suggests either court decisions or national legislation likely will be required in order to establish a firm operational rule for Internet-related activities. Aggressive approaches by the state in nexus issues is likely to run counter to trends in Internet business evolution, and could result in either compensating policies being adopted by other states, and/or negative economic repercussions associated with business decisions. Apportionment questions, in contrast, are best dealt with by continuing efforts to achieve consensus based on state cooperation.

The development of Internet-centered business activity raises distinct challenges for the application of the BCT. As businesses shift their methods of operation toward Internet activity, this could result in an alteration in the number of states where nexus occurs under current definitions. In addition, the growth in the amount of sales of intangible products could result in a shift in the apportionment of income. California should continue to pursue multistate agreements in order to address these issues.