IRJC
International Journal of Marketing, Financial Services & Management Research
Vol.1 Issue 10, October 2012, ISSN 2277 3622

TAX ON ECOMMERCE: A RECENT DISPUTE IN THE U.S. MARKET

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ABSTRACT

This study primarily investigates the taxation issues on ecommerce; how tax can be imposed on ecommerce, why it is important to implement, how the total system of taxing ecommerce can be operated in the real market situation, what are the economic impacts of imposing it and so on. Secondarily, the paper emphasizes which legal issues are creating disputes in imposing and collecting tax from on line customers and traders especially in the context of inter-state tax collection. This paper focuses on the United State's market because the idea of taxing ecommerce and different disputes have been managed here by proper process and sometimes with the help of federal court as a pioneering role in this issue. Other countries including Bangladeshi on-line customers, traders, and Government can learn different aspects of tax and ecommerce and they can practice it in their own country.

INTRODUCTION

Federal taxes are rarely questioned on their constitutionality any more, but state tax laws are still challenged, and sales tax on ecommerce is one of the most disputable topics today in the tax arena. Ecommerce can be defined as buying and selling of products or services through electronic communication. The volume of ecommerce is increasing day by day, especially sales made through the internet. Popularity of ecommerce has massively grown over the last decade with the availability of internet access and development of electronic data exchange throughout the world. The growing popularity of ecommerce is not only due to the increased use of it by customers but also due to its use by the retailers. For retailers, they do not need to invest large in infrastructure to start a business online, and for most customers, shopping online saves them from the burden of paying sales taxes. A sales tax is applied whenever someone buys any product or services from a store, but the rule is a little bit complex for sales made through the electronic means or internet. Internet commerce has been set almost completely free of sales tax from the beginning of its progress. However, not all internet transactions are exempt from sales taxes. Several states are now looking forward to finding ways to tax ecommerce as the volume of internet business has increased significantly over the last decade. It is not only the large amount of tax revenue that is at stake for state and local governments, but also the fairness between the traditional retail store and the internet based businesses is at stake. Sales tax is the major source of revenues for most states. Approximately, one third of most states' revenue comes from sales tax (Fox and Murray, 1). State and local governments are critically looking forward to put sales tax in effect for the internet transactions, as most states are running budget deficit every year. "Internet sales reached $165 billion last year and have been growing by nearly 15% annually" (The Internet Tax Mirage, 2011).

Large portions of ecommerce involve interstate transactions, and that creates the complexity in determining which government has the right to charge and collect sales taxes. Sales tax is a state tax, and there are many taxing jurisdictions in United States. As a result, more than one jurisdiction can overlap with one another on a single interstate transaction, and most likely that single transaction will be taxed multiple times. The issue on ecommerce taxation is not a new dispute, but its importance and complication are expanding day by day. Today, the debate is not over whether to tax ecommerce or not, but over which state should collect the sales or use taxes. Moreover, the growing large volume of internet transactions makes it difficult to track all the transactions for tax purposes. Furthermore, there are many state and local governments who are claiming sales or use taxes on the same sale. The battle on ecommerce taxation places brick and mortar retailers against online buyers and online retailers such as Amazon.com and Overstock.com.

There has to be a relationship established, known as "nexus", between the state and the business before state can collect sales tax from the businesses. Under United States Constitution, a state government cannot ask a retailer to collect sales tax from a buyer if the retailer does not have minimum physical presence in the buyer's state. Internet has made it complicated what is considered as sufficient nexus for the business for the state to collect sales taxes. Merely online presence of an online retailer does not give state the authority to collect taxes. The internet freedom Act of 1998 set the internet commerce free of taxes. There are few federal clauses that provide guidelines on applying sales and use tax on interstate transaction, and these are Supremacy Clause, Commerce Clause, Due Process Clause, Equal Protection Clause, and Privileges and Immunities Clause. Moreover, there are several Supreme Court case rulings, such as National Bellas Hess v. Department of revenue of Illinois and Quill Corp. v. North Dakota, which are used to resolve disputes over sales and use tax involved in interstate ecommerce. Recently, State of New York passed "Amazon Tax Law" to collect sales and use taxes from out-of-state sellers. Many online retailers are claiming "Amazon Tax Law" as unconstitutional. Most remarkably, there is a billion dollar law suit going on right now against the giant online retailer, Amazon.com, LLC, regarding collection of sales tax and use taxes on internet transaction. Congress is working on projects to come up with uniform sales and use tax laws for internet commerce so that the right government gets the authority to collect sales or use taxes on the right transaction at the right rate, and states do not lose billions of dollars in sales revenue every year. Governments are working on Streamlined Sales Tax project to find better ways to collect taxes on internet commerce.

SALES TAX AND USE TAX

Almost all states have both sales tax and use tax. The sales tax is very significant source of revenue than income tax for the sates. Mississippi introduced the first state sales tax in 1932 and New York City first adopted a local sales tax in 1934. From its inception, sales tax grew rapidly in importance and has been the largest single source of state tax revenue since 1970 (Fox and Murray, 1). Generally, businesses who sell products and services are required to collect sales tax from the customers on the behalf of the state in which they have business. Sales tax rate is applied to the price of a sale at the point of purchase. While customers are responsible for paying the sales tax on a transaction, the constitutional burden of collecting sales tax falls upon the sellers. Then the sellers later on remit the total sales tax collected to the right government entity. Usually, sales tax is a state tax. Most States have a sales tax and allow local municipalities to add their own separate rate to the sales tax. A state is in charge of collecting sales tax from the businesses located within its jurisdictional borders. Currently, forty-five states and the District of Columbia impose a general sales tax upon purchases. The only states that do not have a sales tax, or a use tax for that matter, are Alaska, Delaware, Montana, New Hampshire and Oregon. In Alaska, however, municipalities have the statutory authority to impose both sales and use taxes (Fox and Murray, 1). In United States, states are not allowed to tax any out-of-state sales, unless the seller has sufficient nexus with the state. This is why interstate online sales are not taxable. Usually, brick-and-mortar retailers collect sales taxes on a transaction based on where their stores are located, but not based on where their customers live. On the other hand, state governments want online retailers to collect sales taxes based on where their customers' residences are.

Use tax is applied to a sale when a sales tax cannot be charged, it usually involves interstate transactions. In case of an out-of-state sale, a use tax is applied by the residing state of the buyer for storage, usage, and consumption of goods purchased from out-of-state. Use tax rate is usually the same rate as the sales tax rate of the buyer's residing state. Unlike sales tax, use tax is paid by the buyer at a later time. Use tax gives right to the buyer's residing state to collect tax on transactions that occur outside that state. Use tax gives a state the protection against losing revenue in sales taxes if residents of the state buy products from out-of-state just to avoid paying sales taxes. However, the biggest problem with use tax is that the duty of remitting tax is upon the residents of the state, and very few residents voluntarily pay use taxes to the state government. As a result, states lose giant amount of revenue from use taxes on immensely growing interstate online commerce. Now, in this era of internet transactions, states want to impose the burden of collecting use taxes on the sellers. Nonetheless, the sellers have to have minimum physical contact with the state to be able to collect use taxes from that state's residents.

In summary, a sales tax is applied to an inside state transaction, and use tax is applied to an out-of-state transaction.

ECOMMERCE AND TAX ISSUES

Ecommerce business model presents boundless opportunities for economic growth. People of this country are reaping the advantage of this ecommerce through the advanced technology and internet. However, it ecommerce is creating tax complication for the taxing jurisdictions. Below are some of the main reasons that raise tax issues.

LOCATION: Sales tax is generally applied based on where the retailer is located. In ecommerce era, retailers can be situated in just one state and can sell goods and services throughout the world. Moreover, nowadays, there is more demand for customized products than ever. As a result, it reduces the necessity of having much storage for the businesses. Therefore, it reduces the probability of having physical presence of businesses in many states. Moreover, many productions today are outsourced, and that raises the question of whether the suppliers create nexus for the business with suppliers' states.

NATURE OF PRODUCTS: Many products and services that are involved in ecommerce are digitized, such as e-books, music, newspaper, tax services and so on. Sales tax is applied on tangible products. Now the question is whether an e-book is considered tangible product for tax purposes. However, in case of an e-book, the answer is easy to find. An e-book is considered tangible taxable product because it is an electronic version of a book on paper. Nonetheless, the answer can get tricky when it involves sale of computer software and so on.

MARKETING TECHNIQUES: Today retailers do not need to send salesmen door to door or mail out flyers to advertise their businesses. They can now advertise their business on their own websites and their affiliates' websites, where affiliates receive commission on any sales made through affiliates website. Moreover, individuals can go on auction websites, such as e-bay, to sell any kind of products. These factors make it hard for government to track all these transaction to collect taxes.

REMOTE WORKFORCE: Employees of online companies may be spread throughout the country and might work from their own home, instead of coming to a work location. Therefore, it raises the tax issue whether the presence of these remote employees create nexus in that state.

All these above factors feed into the complication of collecting taxes from ecommerce transactions.

INTERNET FREEDOM ACT OF 1998

From the beginning of internet through 1990s, internet access was free from government regulations. As the uses and application of internet surge, state and local governments started to plan to tax internet commerce as they saw it as great source of revenue. Then the enactment of Internet Freedom Act stopped governments from taxing internet commerce. In 1998, Congress realized that redundant and extreme taxation could hamper the growth of internet and lessen the benefits of a digital economy. The Internet tax freedom act of 1998 was signed into law in October 21, 1998. The law was signed by President Bill Clinton to promote business over the internet and to encourage economic growth. The rationale behind enacting this law was to prohibit multiple taxations on the electronic commerce, while it was at its infancy stage. This law imposed a temporary three year moratorium at that time through October 21, 2001 on the state and local taxes on electronic commerce (Maguire & Noto, 2008). Moreover, the law was enacted to give government some time to study and analyze internet commerce so that more uniform policy can be applied to ecommerce. The Internet Commerce Act also established Advisory Commission on Electronic Commerce. Three main features of this Act were:

- This Act applied to only new taxes - it did not ban existing taxes on internet access.
- It excluded telecommunication from the definition of "Internet Access".
- This temporary act was enacted in order to give congress and tax jurisdictions some time to address the new taxation issues more effectively and efficiently that arose from development of technology

However, this law did not make electronic commerce totally tax free. If the goods are sold in the same state as the business, then the customer has to pay taxes on that sale. It does not prohibit states from requiring out-of-state sellers with a substantial physical presence in the state to collect and remit sales taxes. The Internet Tax Freedom Act prohibit state and local governments from imposing three types of taxes: Internet access taxes, multiple taxes on online transactions, and discriminatory taxes on online transactions. First, the Act prohibits taxes on all methods of Internet access, including dial-up, cable, digital subscriber line (DSL), satellite, and wireless. Second, the Act prohibits multiple taxes on online transactions from multiple jurisdictions. For example, the law prohibits two states from charging sales tax on a single purchase unless credit is given for taxes paid in the other jurisdiction. Third, the Act prohibits discriminatory taxes on online transactions that treat electronic commerce differently than other types of commerce. For example, the Act bars taxes that would only apply when a product is online. It also prohibits states from imposing a different tax rate when a product is sold online (Atkinson & Castro, 2007).

Original moratorium, enacted in 1998, expired in 2000, and then it was extended through November 1, 2003. The moratorium was extended again for another four years through November1, 2007. Again, on October 31, 2007, the Internet Freedom Act was extended through November 1, 2014. Issues that need to be addressed before this temporary moratorium expire in 2014:

- Should this Internet Freedom Act be extended again? If so, permanently or temporarily
- If Moratorium is extended, should the grandfather clause protection given to states be extended
- Should states be given authority to impose duty of collecting sales and use taxes on an interstate transaction on the remote sellers
- How should the "nexus" be defined in this age of internet

TEMPORARY OR PERMANENT EXTENSION OF MORATORIUM: If this moratorium is permanently extended, then Congress does not have to reconsider the issue of

IRJC
International Journal of Marketing, Financial Services & Management Research
Vol.1 Issue 10, October 2012, ISSN 2277 3622

internet commerce again. Moreover, it would give businesses and consumers a certainty about taxation. Furthermore, government should keep the cost of internet access low so that people of the country do not fall behind in seizing the opportunity that global digitalized economy provides. On the contrary, supporters of temporary extension of the moratorium argue that temporary extension would give Congress time and opportunity to reassess future issues that will result from further development in technology. The opportunity to periodically visit this issue will protect governments from losing revenue in sales and use taxes. Temporary extension is the best way for Congress to avoid any unintentional consequences that may arise from permanent moratorium. Moreover, state governments do not like federal government's interference in state systems because they think that it undermines state's sovereignty (Maguire & Noto, 2008).

GRANDFATHERING OF EXISTING ACCESS TAXES: The Internet Tax Freedom Act does not apply to those states that used to tax internet access prior to October 1, 1998. Before the enactment of Internet Freedom Act, 10 states and the District of Columbia were collecting sales taxes on Internet access services. Subsequently, Connecticut, Iowa, Tennessee, and the District of Columbia eliminated their sales tax on Internet access, and South Carolina has not enforced the collection of its tax during the federal moratorium. These developments left six states imposing a sales tax (or equivalent tax) on Internet access as of January 2006: New Mexico, North Dakota, Ohio (on commercial use only), South Dakota, Texas (on monthly charges over $25), and Wisconsin. In addition, Hawaii levies its general excise tax, New Hampshire its communications services tax (imposed on all two-way communications equipment), and Washington State its business and occupation tax (a gross receipts tax levied on business) on Internet access. The Congressional Budget Office believes that several local jurisdictions in Colorado, Ohio, South Dakota, Texas, Washington, and Wisconsin also are collecting taxes on Internet access. According to Congressional Budget Office, the prohibition of taxes on Internet access in these grandfathered states would cost these jurisdictions approximately $80 million to $120 million per year (Maguire & Noto, 2008). These states then have to find some other ways to balance this deficit, and might lead these states to cut down on services for their residents.

CONSTITUTIONAL CLAUSES THAT RELATES TO ECOMMERCE

SUPREMACY CLAUSE: This clause sets forth the winner when a federal law and a state law are in conflict. The supremacy clause provision in the federal constitution confers superiority to federal laws over state laws. Federal laws are considered as the supreme law of the land. If a state's constitutional provisions or laws are in conflict with a Federal law, the state provisions are invalid. Usually, the supremacy clause is applied to tax conflicts involving the federal commerce clause (Raabe, Sanders & Whittenburg, 313).

COMMERCE CLAUSE: The commerce clause states that Congress has the power to regulate commerce with foreign nations, among states, and with Native American tribes. This clause contains the most significant Federal limitation on a state's capacity to impose taxes on interstate commerce. It grants powers to Congress and places constraints on the state's ability to tax interstate trade. The commerce clause has a long history of Supreme Court actions. The interpretation of this clause is based on the Supreme Court case Complete Auto Transit Inc. v.

Brady (Raabe, Sanders & Whittenburg, 313). In this case, State of Mississippi imposed tax on an out-of-state motor carrier companies for the privilege of engaging in interstate commerce in the state. Supreme Court of Mississippi ruled in favor of the State saying that the company engaged in continuing business within the state and enjoyed the facilities provided by the state. Therefore, the motor vehicle company should pay taxes on its gross receipts from the State. Then the motor carrier company appealed the case to the Supreme Court of United States. Supreme Court ruled in favor of the motor carrier company saying that the business was not sufficiently connected with the State to justify the tax and the tax was not fairly apportioned related to the benefits it enjoyed in Mississippi. On unanimously deciding that the tax was valid, the Supreme Court established the four criteria now regarded as controlling as to whether a state may tax interstate commerce without the tax becoming an unreasonable burden. A tax may be imposed if:

- The activity includes a substantial connection (nexus) with the taxing state.
- The tax burden is fairly apportioned
- The tax does not discriminate against interstate commerce
- The tax fairly relates to the services provided by the state.

Thus, businesses involve in interstate commerce should be subject to a tax burden related to their fair share of the state's costs of providing benefits to the taxpayer. Substantial nexus is the keystone of a state's taxing jurisdiction over remote sellers. If substantial nexus does not exist between the state and a remote seller (whether an Internet seller or not), the state may not validly impose tax liability on the remote seller or require it to collect and remit such tax (Trelease & Storum, 2003).

DUE PROCESS: Due Process Clause also play very significant role in interstate ecommerce. The Supreme Court has applied the federal Due process Clause, found in the Fourteenth Amendment, to limit the territorial scope of a state's taxing authority in interstate commerce cases. States have lost cases in two key situations.

- States seek to tax out-of-state businesses whose connections with the state are not sufficient to satisfy the Due Process Clause.
- The tax imposed does not fairly reflect the tax payer's activities in the state (Raabe, Sanders & Whittenburg, 313).

To impose the duty of collecting sales and use taxes on a remote seller, states must prove that the business has more than a de minimis existence within the state. States also have to make sure that the burden of tax on the remote seller includes only amounts fairly apportioned to its activities within the state. The Complete Auto Transit interpretation of the commerce clause also contains these two criterions for successful taxation of interstate commerce. However, the criteria and depth of connection within a state required under the Commerce Clause and the Due Process clause is different.

Moreover, even though these two clauses are based on the level of relationship between the seller and the state, they are directed to two different facts of existence of a business within a state. The due process clause is directed toward the fairness of governmental activities. This fairness is testified when an out of state entity “purposely avails itself of the benefits of an economic market in the foreign State.” The commerce clause, in contrast, is concerned with the effects of state regulations on the interstate economy. Accordingly, the Commerce Clause requires more than existence of customers to rise to the level of a nexus within the state, but a physical presence such as an office is not necessary. For example, presence of salesmen or independent contractor, for the purpose of soliciting business in a state, creates a Commerce-Clause nexus for an out-of-state business. The courts consistently have ruled that out-of-state entities cannot skirt a state’s taxing jurisdiction by contracting with in-state persons to conduct company business that would otherwise create a nexus if the out-of-state company had used its own employees (Raabe, Sanders & Whittenburg, 314).

Finally, the Due process clause does not guarantee that the benefits by an interstate enterprise will have any direct relationship to the amount of taxes paid to that state. The be fairly related to the services provided by a state, the last test from Complete Auto Transit, the tax need only be assessed in proportion to the business activities within the state (Raabe, Sanders & Whittenburg, 314).

UNIFORMITY AND EQUAL PROTECTION: Uniformity and Equal Protection Clause makes sure that all businesses are treated equally in a state for tax purposes. It prohibits states from treating one business more favorably than other business in the state, specially, in case of non-resident or out of state businesses in interstate commerce. This clause grants federal government the authority to interfere with states issues involving inequality. However, state legislature has the supreme authority to make its own taxation system on an equitable and uniform basis (Raabe, Sanders & Whittenburg, 315).

PRIVILEGES AND IMMUNITIES: Federal constitution grants the citizen of each state all privileges and immunities of citizens in every other state. This means that a nonresident business has right to engage in commerce within the state, without being subject to different or greater taxes than resident businesses. This clause applies only to citizens of state, and thus largely protects individuals but not corporations.

NEXUS

In general, nexus means connection. For tax purposes, nexus refers to the level of business activities within a state. If a business has substantial nexus with a state, the state government can impose the burden of collecting sales and use taxes on that business. However, the criterion is different for income tax purposes than sales and use tax purposes. For income tax purposes, a business is obligated to pay taxes on its income to a state if the income is derived from resources within that state. For example, if a business owns or rents a property in the state or has business activities in the state that surpasses “mere solicitation”, then the business is liable to pay income tax to that state. The nexus requirement for sales and use taxes is determined more lightly than income tax (Murray, 2011). Under Commerce Clause, a physical presence is necessary to have sufficient nexus. Due Process Clause requires “minimum contact” with the state through which business avails itself to the benefits that the state provides. Physical presence is not necessary to meet the nexus requirement under Due Process Clause. Below are some examples that create substantial nexus for a business with a state for sales and use tax purposes:

- If the business has physical store, branch, warehouse, distribution center, etc. in the state
- If there are employees in the state who regularly solicit sales
- If there are travelling salesmen or independent contractor in the state who gets paid on commission based on sales.

With the advancement in internet and technology, it is getting complicated to determine what considers substantial nexus under Due Process Clause. For example, does the connection between two computers in two different states create nexus, or does the presence of a website in a state create nexus. In this age of Internet, state governments are trying to establish the presence of an online affiliate in the state is sufficient to create nexus. Affiliates are owner of websites who advertise an online retailer by having a link on their websites. New York, Rhode Island, North Carolina, and Illinois have already adopted laws to collect sales and use taxes from online retailers for sales made through these affiliates. However, online retailers are claiming this law unconstitutional under Commerce Clause, and they are filling lawsuit against states. However, Supreme Court of United States has not made its decision yet regarding affiliates.

THE STREAMLINED SALES AND USE TAX AGREEMENT

The Commerce Clause and Due Process Clause of United States constitution and the past court rulings made it clear that States cannot impose the burden of collecting sales and use taxes on the out-of-state sellers who do not have a physical presence in the state. However, Congress also mentioned that Congress has the power to allow States to collect taxes from remote sellers. The huge increase in online transactions has made governments rethink about the tax position on online sales. Internet transactions were set free of taxes in 1998 through internet freedom Act because of the complexity cross-border transaction. In United States, there are 7500 in total state and local taxing jurisdictions, and these jurisdictions have different tax laws and compliance rules and different tax rates (Yang, 2010). When the Act was passed, it considered that it would be very difficult for the out-of-state sellers to comply with so many tax authorities where the tax system is already complicated by itself. Congress is still undecided about whether to grant states the authority to collect sales and use taxes from the out-of-state sellers.

The Streamlined Sales and Use Tax Agreement was originated in March of 2000 in an effort to find a simplified tax system so that businesses can operate in fair environment. “The purpose of the Agreement is to simplify and modernize sales and use tax administration in order to substantially reduce the burden of tax compliance” (stremlinedsalestax.org). Twenty-three states have accepted the tax measure provided by this agreement. Products and services are defined different ways in different states. A retailer who conducts business in multiple states should know individual states definition for a specific product or service. Under Streamlined tax system, the retailer only needs know whether the product is taxable or tax exempt in a particular sate because this system uses uniform definition for a product in all of its member states. Moreover, under streamlined system, there is only one state sales tax rate and only one local tax rate. Furthermore, the retailer doesn't have to file separate tax return with each tax jurisdiction it has connection with. There will be one center point of administration for all state and local sales taxes. As a result, the retailer does have to keep track of in which state it is making sales. Approximately fourteen hundred retailers collected about seven hundred million in sales taxes in streamlined states (stremlinedsalestax.org). This agreement shows the way how to tax online commerce, and encourages Congress to grant sates the authority to tax out-of-state sellers. However, congress still has to find out how to treat the computers and websites for tax purposes before it grants states power to tax remote sellers.

CONCLUSION

Internet commerce is growing exponentially in today's business world. Its sales volume has increased from $107 billion in 2006 to $134 billion in 2009. It is projected that the internet transactions will reach $224 billion by 2014 (Yang, 2011). State governments are losing billions of dollars in sales and use taxes every year. Moreover, bricks-and-mortar retailers are complaining about the protection against sales and use taxes for online retailers. Sometimes, many customers today choose online retailers over rick-and-mortar retailer because buying goods online saves them from paying any taxes. Thus, the protection for out-of-state sellers is resulting in an unfair business environment for the in-state sellers. For example, giant retailer, Wal-Mart, has physical stores in all fifty states. As a result, all customers, who buy goods form Wal-Mart websites, have to pay sales taxes on their purchases. On the other hand, giant online retailer, Amazon, has physical presence in very few states. Therefore, most of Amazon customers do not have to pay taxes, depending on their state of residency. As a result, many customers choose Amazon over Wal-Mart when they buy something online. Hence, in-state retailers are worried about competition from the online retailers (The internet Tax Mirage, 2011). In this situation, Government needs to redefine the definition of "internet access" and "nexus" to face this challenge placed by advanced technology to create a fair and equal economic market. Redefining "nexus" for sales and use tax purpose's will also create source of revenue for most budget deficit states. Streamlined sales tax sounds very promising in this taxing crisis. However, Government has to be careful in addressing this issue to make sure that it does not hinder the potential growth of ecommerce.

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