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TAX IMPLICATIONS OF USING OUT-OF-STATE COMPUTER SERVERS

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ABSTRACT

The majority of companies represented on the Internet rent third-party computer servers to host their web site and conduct e-commerce. Since the location of the server could be anywhere, states are losing sales and use tax revenue due to the increase in e-commerce from out-of-state companies. Hence, states are looking for ways to replace their lost revenue. In *Quill Corp. v. North Dakota*, the United States Supreme Court held that minimum contacts were no longer sufficient to establish nexus for purposes of local taxation, but instead required physical presence in the state. Renting electronic space in-state does not constitute physical presence or substantial nexus by an out-of-state company. The current Congressional resistance to taxing the Internet and the ease of switching to another computer server in another state or country to host a web site or conduct e-commerce will prevent states from being able to establish sufficient nexus to tax out-of-state companies renting in-state computer server space.

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INTRODUCTION

<1>

Among the primary uses of a computer server for a business are: 1) hosting its web site, 2) conducting e-commerce transactions, 3) storing large amounts of data for the business, and 4) operating the company Intranet. Ninety percent of web sites on the Internet do not conduct e-commerce in the sense of concluding transactions for the purchase of goods or services. More than 60 percent of web sites are considered "small" since they have fewer than 20 pages, and nearly half are merely "brochureware,"[2] with only static pages and no interaction capability.[3] Most companies in the United States do not require an entire server, either because of the amount of e-commerce transacted, the amount of data stored, or because of the small size of the company Intranet. Consequently, many businesses choose to outsource this service by "renting" space on a third-party server. In addition to size requirements, businesses may outsource this service for other reasons including better physical or cyber security, more efficient management of resources, or lower cost.

<2> The location of the server is usually irrelevant to the company renting space, but not to the local taxing authority. States are losing sales and use tax[4] revenue due in part to the exponential growth of e-commerce, and the fact that mail-order sales and direct marketing encourage consumers to purchase goods from out-of-state vendors.[5] States need to replace these traditional revenue sources. One potential source is taxing web site hosting and/or e-commerce transactions conducted on in-state computer servers by out-of-state companies. This revenue will be difficult for states to acquire, however, due to Congress' and some states' interest in allowing the Internet to grow without taxation and the current constitutional requirement for substantial physical nexus under the Commerce Clause.

<3> Advanced industrialized nations of the European Union are facing the same situation. E-commerce across international borders is successfully evading value-added taxes, which along with "other consumption taxes make up on average nearly one-third of the tax base."[6] These countries, through the Organization for Economic Co-operation and Development ("OECD"), use a concept called a "permanent establishment" to "address the importance of computer servers and Web sites in generating income."[7] This concept will be discussed further in the next section.

FORMS OF NEXUS FOR LOCAL TAXATION

<4> Two constitutional requirements must be satisfied when states seek to tax non-residents and interstate commerce: the Due Process Clause and the Commerce Clause.[8] The seminal cases for these topics are *International Shoe Co. v. Washington*[9] and *Quill Corp. v. North Dakota*.[10]

Minimum Contacts

<5> In *International Shoe*, the issues were (1) whether a foreign corporation with salespeople living and working in Washington State had

rendered itself amenable to suit in the state courts "to recover unpaid contributions to the state unemployment compensation fund exacted by state statutes" and (2) "whether the state can exact those contributions consistently with the due process clause of the Fourteenth Amendment."[11] The Court held that minimum contacts were required for a state to have *in personam* jurisdiction over a defendant to maintain a suit. International Shoe's employees within the state constituted systematic and continuous business activities and subjected the corporation to contributing to the state unemployment compensation fund. While *International Shoe* did not deal with sales and use tax, its holding and reasoning have become precedent in a wide variety of contexts when determining Due Process Clause requirements, including sales and use tax cases.[12]

Physical Presence

<6> Forty-seven years after *International Shoe*, the U.S. Supreme Court used *Quill Corp. v. North Dakota* to draw a clear distinction between the Commerce Clause and Due Process Clause nexus requirements for state tax purposes. Quill sold office equipment and supplies exclusively through mail-order. It advertised using mailed catalogs, print advertisements in national publications, and telemarketing. It did not have any physical presence in North Dakota since it had no employees located there and it did not own or use any property in the state.

<7> The Court held that Quill had sufficient minimum contacts required by the Due Process Clause to impose the collection and remittance of state use tax, but it lacked the "substantial nexus" required by the Commerce Clause. Requiring Quill, or similarly situated companies, to collect and remit the state use tax placed an unconstitutional burden on interstate commerce. A finding of "substantial nexus" requires physical presence that is more than *de minimis*. The Court noted its earlier rejection of a "slightest presence" standard of constitutional nexus from *National Geographic Society v. California Board of Equalization*,[13] and stated that "a few floppy diskettes to which Quill holds title" from licensing software to customers to place orders and check inventory did not meet the "substantial nexus" requirement of the Commerce Clause.[14]

The International Requirement of a "Permanent Establishment"

<8> The OECD uses the concept of a "permanent establishment" ("PE") for determining the nexus/threshold for taxing business profits of non-residents for international transactions. A PE is the international analogy to physical presence or substantial nexus and is currently defined as "a fixed place of business through which the business of an enterprise is wholly or partly carried on."[15] The OECD has clarified how it considers a PE should be applied to e-commerce operations. It concluded that neither web sites, nor web site hosting, nor an Internet service provider will typically constitute a PE for the enterprise using those services.[16]

<9> The Technical Advisory Group ("TAG") of the OECD proposed a modification of the PE definition to provide that a computer server cannot, in itself, constitute a PE. The rationale is that these activities do

not involve human intervention by personnel. They explained that "[t]he importance of the human contribution to the setting up, operation and maintenance of the business will be greater and the contribution of the places where the automated equipment is located will be smaller."[17] There is support for this modification, especially for servers conducting e-commerce,[18] but "[t]he conclusion reached by the TAG is that while this option should not be pursued at this time, the application of the current rules to functions performed with the use of servers and software should be monitored to determine whether it raises practical difficulties or concerns, which could lead to further study of these alternatives or combinations or variants thereof."[19]

THE HANDS-OFF APPROACH OF CONGRESS TAXING THE INTERNET

<10> The Internet Tax Freedom Act[20] was designed to allow e-commerce to grow unburdened by not allowing any tax on Internet access, unless the tax existed prior to the Act's enactment, and relieving online out-of-state sellers from collecting and remitting sales and use taxes for the 45 states and more than 7500 municipalities that have them.[21] The Act permits shoppers to buy online from out-of-state companies and avoid paying sales tax, the same way they can with interstate catalog and mail order companies.

<11> On December 3, 2004, President Bush signed the bill extending the Internet Tax Freedom Act until 2007.[22] Since the original 1998 Act expired in November 2003, states were permitted to tax Internet access services, but few implemented such legislation, instead choosing to wait for Congress to decide whether it would ban Internet taxes permanently. During this time, California and Hawaii passed their own Internet Tax Freedom Acts that mirror the federal Act.[23] The Internet Tax Freedom Act renewal will continue to curb any taxation on Internet access and interstate e-commerce, but a permanent ban is unlikely if states continue to suffer revenue declines.

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<12> A few states have enacted statutes to specifically protect forms of Internet activity from taxation. For example, New York will not tax an out-of-state company if only its advertising is stored on a server located in-state, or if its advertising is "disseminated or displayed on the Internet by an individual or entity subject to tax" in New York State.[24] Washington State does not tax web site hosting or e-commerce conducted on an in-state computer server for an out-of-state company as long as the company, or an affiliate, does not own the server.[25] Vermont will not tax an out-of-state company if its activities are limited to using in-state computer servers for e-commerce or maintaining a web site, including owning the server.[26]

<13> Tax laws can change quickly. An important feature of Washington State's statute is that it will automatically expire when the U.S.

Congress or a "court of competent jurisdiction, in a judgment not subject to review" grants individual states the authority to impose sales and use tax collection duties on remote sellers.[27] It is critical to know when the status of the tax law changes in the jurisdiction where a web site or e-commerce transactions are hosted.

Renting Computer Server Space

<14> Generally, a business renting server space does not care where the server is located as long as it works and qualified people are maintaining it. Computer server space is compact and mobile. For that reason, it seems logical that the more interested a local jurisdiction is in taxing it, the less likely customers will rent space in that jurisdiction, preferring instead to use servers in more taxpayer-friendly jurisdictions.[28]

<15> However, the e-commerce industry is in an early stage where businesses buy more than a commodity of computer server space. They buy a business relationship, reliability, price, security, etc. Nevertheless, if the price becomes too high, or if local jurisdictions impose a tax on this service, not only will businesses contract for the service in another state, they could eventually move it out of the country. A United Nations policy study suggests that developing countries could negotiate bilateral treaties for e-commerce taxation that give them a competitive edge.[29] The study uses computer servers as an example of the low cost for setting up or moving, which allow companies to respond quickly to tax incentives by governments and move a web server to a developing country. Companies could respond just as quickly to tax disincentives.

<16> Unless companies want total control of the server(s) within their home state or some other location where they have other activities or physical presence, computer server farms could develop where tax exemption is the most beneficial.

Owning a Computer Server in Another State

<17> Usually if a business owns a server that is located in another state that is enough to establish substantial nexus over the business and allow the state and local jurisdictions to tax any sales in that state.[30] The server is property owned by the business and it constitutes physical presence in that state, unless there is a designated exemption by the state, as in Vermont.[31]

Agency Nexus

<18> Agency nexus (aka attributional nexus) exists when an out-of-state company has agents acting on its behalf in a jurisdiction without any other physical presence.[32] The taxing jurisdiction "attributes" the presence or activity of the agent to the remote company. For purposes of establishing agency nexus, the holding in *Tyler Pipe Industries, Inc. v. Washington State Department of Revenue* requires that a third party intermediary perform in-state activities that are "significantly associated with the taxpayer's ability to establish and maintain a market in" that state for the sales of the taxpaying company.[33]

<19> When an out-of-state vendor rents space on a third-party computer server, the server is merely a conduit for information. It connects consumers with vendors via web sites. The third party does not do anything differently for the specific jurisdiction that could not be done by another server located in another state or another country. California and Oklahoma adopted regulations, and New York issued a legal ruling clarifying that agency nexus is not created when an out-of-state company uses an in-state computer server to either host its web site or transact e-commerce.[34] While most states have not taken a position, it seems unlikely they would want to discourage out-of-state companies from contracting with in-state servers.

CONCLUSION

<20> For now, Congress has renewed the Internet Tax Freedom Act to allow its continued growth without taxing Internet access or e-commerce transactions that cross state lines. This will continue the loss to states of sales and use tax revenue from the increase in e-commerce and the decrease in the physical presence of companies in their jurisdictions. Due to the portability of computer servers and their evolution towards becoming a commodity, companies will seek to locate them in the most taxpayer-friendly jurisdictions. To recoup the lost tax revenue, states will have to restructure their taxes based on the consumer's location rather than the vendor's location.

PRACTICE POINTERS

Here are some ideas to keep in mind when discussing the sales and use tax implications of renting space in computer server facilities:

1. If a company chooses to own and maintain its own server facilities for e-commerce transactions, locate them in a state where substantial nexus already exists, e.g., where company headquarters or a manufacturing facility is located, or where the jurisdiction will not tax the company if the only activity in that state is ownership of the server, e.g., Vermont.
2. If a company decides to contract with a third party for server services, make sure there is no agency nexus: the server company does not do anything special in its state that could not be done by a server company in another state.
3. When renting out-of-state server facilities, select a state that does not tax computer server services, e.g., California, New York, Oklahoma, Vermont, or Washington.
4. If a company rents space on or owns an out-of-state computer server, keep apprised of the tax status for that jurisdiction, as it could change quickly.
5. As a backup measure, if there are a lot of e-commerce transactions conducted over a rented servers, consider hiring more than one server in more than one state or country,

with remote control applications which enable a shift of business activities from one computer server to another. The company's e-commerce transactions will continue uninterrupted in the event of downtime due to maintenance, catastrophe, or changing state or federal law that could start taxing computer server services.

6. If a company conducts e-commerce, make sure there is a choice of forum clause in the online sales agreement identifying the state the company chooses to resolve any legal disputes.

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FOOTNOTES

1. Paula K. Royalty is a member of the University of Washington School of Law Class of 2005. She is deeply grateful for the help she received on this article from Reid S. Okimoto, Ada Ko, and Henry L. Judy. Royalty can be reached at royalty@u.washington.edu.

2. One definition of "brochureware" is "[a] Web site that is merely information placed on a page and is not commerce enabled. Similar to a brochure, these sites are simply electronic marketing pieces with no ability to perform transactions." eStoreReady, *Glossary, at* http://www.estoreready.com/glossary.html (last visited Jan. 4, 2005).

3. Netvention, *Web Statistics, at* http://www.netvention.com/webstats.php?source=google (last visited Jan. 4, 2005).

4. Use tax is defined as "[a] tax imposed on the buyer for the in-state use of items purchased from out-of-state suppliers." Ariz. State Univ., *PCS 004: Definitions, at* https://www-sec.asu.edu/aad/manuals/pcs/pcs004.html (last visited Jan. 4, 2005). Use taxes are rarely paid by consumers, which is a large part of the problem of collecting this revenue by taxing jurisdictions.

5. Donald Bruce & William F. Fox, *State and Local Sales Tax Revenue Losses from E-Commerce*, Center for Business and Economic Research, *at* http://cber.bus.utk.edu/ecomm/ecom0901.pdf (Sept. 2001); U.S. Conference of Mayors, *Impact of E-Commerce on Cities and Their Residents, at* http://www.usmayors.org/uscm/wash_update/documents/impactecommerce.h (last visited Oct. 10, 2004).

6. Karl Frieden, Cybertaxation 52 (2000).

7. *Id.* at 54.

8. For a thorough discussion of these topics and their impact

on Internet sales see Ada Ko, *A National Sales Tax After* Quill*? A Proposal for State and Local Taxation of the Sales of Goods and Services on the Internet*, at http://www.lanepowell.com/pressroom/publications/pdf/koa001.pdf (1999).

9. 326 U.S. 310 (1945).

10. 504 U.S. 298 (1992).

11. 326 U.S. at 311.

12. *See, e.g.*, Miller Bros. Co. v. Maryland, 347 U.S. 340 (1954); Scripto, Inc., v. Carson, 362 U.S. 207 (1960).

13. 430 U.S. 551, 556 (1977).

14. *Quill*, 504 U.S. at 315 n.8.

15. Articles of the Model Convention with Respect to Taxes on Income and on Capital, art. 5(1) (Org, for Econ. Cooperation and Dev. 2003), at http://www.oecd.org/dataoecd/52/34/1914467.pdf.

16. Technical Advisory Group on Monitoring the Application of Existing Treaty Norms for Taxing Business Profits, *Are the Current Treaty Rules for Taxing Business Profits Appropriate for E-Commerce?* para. 15 (Public Discussion Draft 2003) (on file with Shidler Journal of Law, Commerce & Technology).

17. *Id.* para. 150.

18. *Id.* para. 144.

19. E-mail from Jacques Sasseville, Org. for Econ. Cooperation and Dev., to Paula Royalty, author (Apr. 21, 2004) (on file with Shidler Journal of Law, Commerce & Technology).

20. 47 U.S.C. §§ 1100-1104 (1998).

21. Frieden, *supra* note 6, at 57.

22. *Bush Signs Bill Extending Internet Tax Moratorium*, OMB Watch, Vol. 5, No. 25, Dec. 14, 2004, *at* http://www.ombwatch.org/article/articleview/2560/1/306/ (last visited Jan. 5, 2005).

23. Cal. Rev. & Tax. Code § 65002 (Deering 2004); Haw. Rev. Stat. Ann. § 231-8.6 (2003).

24. N.Y. Tax Law § 12 (2003).

25. Wash. Rev. Code § 82.04.424(1), 82.08.050(5), 82.12.040(5) (2004).

26. Vt. Stat. Ann. tit. 32, §§ 5811(15)(C)(ii), 9701(9)(H) (2003).

27. Wash. Rev. Code § 82.04.424(2), 82.08.050(6), 82.12.040(6) (2004).

28. Frieden, *supra* note 6, at 154, 220, 241, 308.

29. Susanne Teltscher, Tariffs, Taxes and Electronic Commerce: Revenue Implications For Developing Countries 14 (United Nations 2000).

30. Frieden, *supra* note 6, at 289.

31. Vt. Stat. Ann. tit. 32, §§ 5811(15)(C)(ii)(II) (2003).

32. Frieden, *supra* note 6, at 289.

33. 483 U.S. 232, 250 (1987).

34. Frieden, *supra* note 6, at 308.

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