

The Race to Cyberspace: Internet Taxation and State Tax Competition

NTU Policy Paper 103

November 21, 2000

By Paul J. Gessing

The coming Thanksgiving holiday marks not only the start of the Christmas shopping season, but also a turning point in the history of Internet commerce. While the ongoing collapse of many dot-coms makes this season essential to their bottom lines, the upcoming debate in Congress over a five-year extension of the Internet Tax Moratorium may be of greater importance to e-commerce's long-term viability. Legislation extending the Internet Tax Moratorium will be among the first items considered by the 107th Congress. Debate over this proposal will be a good indicator of how the newly convened Congress may be inclined to deal with Internet-related issues.

The main purpose of the Internet Tax Moratorium is to prohibit state and local governments from taxing monthly fees paid by Internet subscribers. The moratorium and any extension thereof have no impact on states' ability to charge sales taxes on products bought over the Internet. Yet, the issue is important because failure to extend the moratorium, or even a particularly acrimonious battle over its extension, could be a troubling sign that pro-taxation forces have gained the upper hand in Congress. As the pro-tax Center on Budget and Policy Priorities explains, "If Congress extends the moratorium for five additional years now, without addressing the Internet sales tax issue, it could send a signal to retailers that Congress is not willing to assist the states in their efforts to devise and implement a workable system that allows even-handed sales taxation."¹ Clearly, this is a call for those in Congress who favor taxing e-commerce to hold up renewal of the Internet Tax Moratorium in exchange for legislation allowing the states to set up an e-commerce taxation regime. This threat should not be taken lightly.

The debate over e-commerce taxation will test modern interpretations of federalism and our leaders' views on interstate commerce. This paper explores the competing proposals and their attempts to define the proper relationship between government and the Internet.

Background

When discussing taxation and the future of e-commerce, it is important to clarify that the Federal Internet Tax Moratorium has nothing to do with prohibiting taxation of Internet

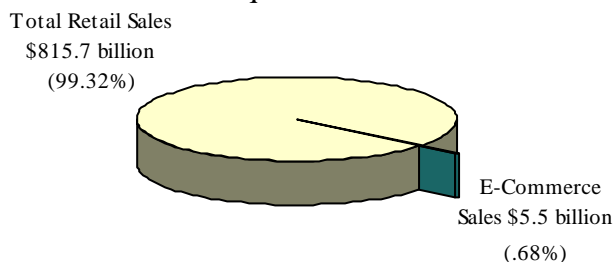
commerce across state lines. The Supreme Court decision, *Quill vs. Heitkamp* actually outlines when states can and cannot tax interstate commerce. The Court ruled that “a seller whose only connection with customers in a given State is by common carrier or the . . . mail” lacked the requisite minimum contacts with the state to require collection of sales or use taxes.² In practice, this means that if a consumer purchases a product from a company in another state that has no personnel, inventory, or showrooms in his own home state, he does not pay sales taxes to that state.³ For example, if a person from New Jersey purchased an item by mail or over the Internet from a vendor whose only location was in Virginia, the seller is not responsible for collecting sales taxes.⁴ The customer is theoretically responsible for remitting the unpaid “use tax” to his or her home state; however, enforcement is nearly impossible and these taxes are rarely paid.

Many states and localities claim that their inability to collect sales taxes on certain types of interstate transactions will plague them with budgetary problems in the near future. This hypothesis is questionable. Mail order, an industry analogous to Internet commerce, has never accounted for more than 3% of all retail sales and as shown by the following graph, e-commerce accounts for less than 1% of all retail sales.⁵

Figure 1.

Internet Commerce is No Threat to Main Street or State Budgets

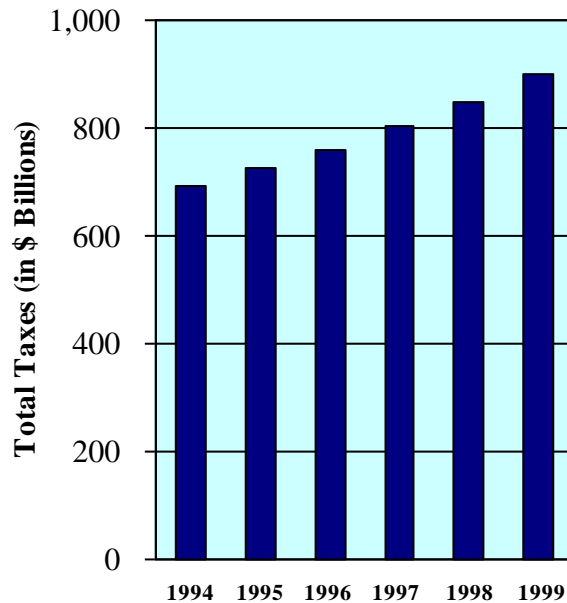
E-commerce sales as a percentage of total retail activity -
2nd quarter 2000



Data: U.S. Department of Commerce, See: <http://www.census.gov/mrts/www/current.html>

A study by the Forrester Research Group found that states collected \$140 million in sales taxes from e-commerce while they were unable to collect a total of \$525 million in 1999.⁶ Although \$525 million may sound like a lot of money, it amounts to less than .06 percent of all 1999 state and local tax receipts.⁷ Instead of doing harm to the states’ bottom lines, Internet commerce has been a leading contributor to recent economic growth. This growth and the state and local governments’ ever-growing thirst for taxpayer dollars has caused state and local government tax receipts to increase by over 30 percent between 1994 and 1999, as shown in the following chart.⁸

Figure 2. State & Local Government Tax Receipts



While e-commerce is certain to grow in coming years, the recent spate of dot-com failures is a clear indicator that traditional, face-to-face commerce remains strong. While many state officials may desire extra money in their coffers, the inability to collect taxes on certain types of e-commerce should not be cause for alarm.

Listed below are the various plans for dealing with Internet commerce. Each plan is discussed within the context of its constitutionality, and how implementation would impact taxpayers.

Option #1: A Streamlined Sales Tax

The National Governors Association and the National Council of State Legislatures have proposed a plan that is essentially a quid pro quo to let states tap tax revenues generated over the Internet. The twenty-six states that currently support the Simplified Sales Tax essentially want to trade simplification of sales tax collection and compliance rules for merchants' "expanded duty to collect" sales taxes.⁹ Although supporters of the Streamlined Sales Tax are correct in arguing that such a plan would not create "new" taxes on the Internet, the plan actually expands states' existing powers of taxation. This is so important that the U.S. Constitution specifically requires Congress's approval for such an expansion of power. On its web site, the National Governors Association outlines its proposal:

- A. One sales tax rate may be applied per state. States that charge a sales tax would need to establish a method of distributing the appropriate share of revenue to local jurisdictions because sales taxes formerly imposed by cities and counties would now

- be reimbursed from the state. States would continue having the option of not imposing sales taxes.
- B. Definitions of goods and services subject to taxation must be uniformly established across state lines. States will be able to choose whether or not to tax specific items.
 - C. The most probable approach to administration of sales taxes under this system would be to encourage the establishment of a network of independent third-party organizations responsible for remitting taxes to the states. Vendors would use a software package pre-approved by the states to calculate taxes due from purchases based on the tax rate of the state where the item is to be sent. These so-called “Trusted Third Parties” would then electronically remit collected taxes to each state’s collection agency.¹⁰

The basis for determining the appropriate tax rate would likely be the 9-digit Zip Code. One or more organizations (such as credit card networks) could potentially assume the role of “Trusted Third Party.” By assigning the appropriate tax rate to each 9-digit Zip Code, tax rates would adjust both for state collection purposes and for remission to local jurisdictions. This would ensure that cities and counties get their share of sales taxes.

From the taxpayers’ perspective, the Streamlined Sales Tax would be the worst possible approach to e-commerce taxation. This plan would tax all forms of e-commerce and inevitably lead to a de facto national sales tax imposed by a state-run cartel. By allowing states to tax their residents’ out-of-state purchases, the Streamlined Sales Tax, if imposed, would also undermine interstate competition by making it impossible for consumers to escape bad tax policy by shopping in jurisdictions with lower sales taxes.¹¹ This would give lawmakers carte blanche to raise sales taxes with the knowledge that consumers are unable to “vote with their feet.”

A potential byproduct of the Streamlined Sales Tax could be the replacement of healthy tax competition among the states with an unhealthy form of interstate tax warfare. By allowing states to tax out-of-state vendors while exempting their own companies from sales taxes on goods or services exported out of state, lawmakers would have the incentive to engage in malicious tax warfare by offering tax breaks to in-state businesses while simultaneously ratcheting up taxes on out-of-state products.

The Streamlined Sales Tax represents a shift back to interstate commerce as it prevailed under the Articles of Confederation. Instead of maximizing the benefits of free trade, loosely tied states engaged in tax warfare. The U.S. Constitution was created in large part as a response to this problem, as the Founding Fathers wisely placed interstate commerce under federal jurisdiction.

There are many specific passages within the U.S. Constitution that directly assert federal control over interstate commerce. These passages appear to prohibit a multi-state compact as proposed under the Streamlined Sales Tax. Among them are the “Commerce Clause” (Article 1, Section 8) which gives Congress the power to regulate commerce among the states and Article 1,

Section 10, which explicitly outlaws multi-state compacts unless they receive specific approval from Congress. In addition, because the plan authorizes states to levy taxes on items imported into that state, Article 1, Section 9, which states that “no tax or duty shall be laid on articles exported from any state,” is violated. With an array of direct violations of the U.S. Constitution, one might think that the states’ ambitious plan would be doomed to failure. Perhaps that may be the eventual outcome; however, the forces behind expanding government can never be underestimated.

The final aspect of the states’ plan that should concern taxpayers is its reliance on “Trusted Third Parties” in the collection and distribution of sales tax revenues. Most notably, in order to collect and levy taxes, consumers would have to give out personal information that is not currently collected in routine retail transactions.¹² If the Simplified Sales Tax were adopted for e-commerce, fairness would dictate that the same system be applied to all retail purchases. In that case, merchants would be forced to determine the buyer’s place of residence in order to charge customers at the correct tax rate. It is unclear how this plan would apply to foreign citizens or cash transactions, but it is obvious that this radical plan for overhauling the sales tax is not very “simplified” at all.

Option #2: Maintain the Status Quo

As John Berthoud of the National Taxpayers Union stated in his testimony before the U.S. Senate Committee on Commerce, Science, and Transportation, “government should not act unless there is a clear and compelling reason to do so.”¹³ States are not losing money because of their inability to tax out-of-state Internet sales – tax collection at the state level has grown at almost twice the rate of inflation and population over the past six years.¹⁴ Although many Internet taxation proponents argue that it is unfair some forms of e-commerce go untaxed, these businesses, like most others, are already overtaxed. After having paid corporate income taxes, personal income taxes, sales taxes, property taxes, and hundreds of fees and levies, no business goes untaxed, let alone under-taxed.

States clearly have the ability to tax items purchased over the Internet when the buyer and seller are both located in the same state or when the seller has a significant physical presence in that state. Many states have actually chosen not to do so. This past August, the California State Assembly passed legislation that, if signed, would have forced any retailer with stores in California to collect sales taxes on products sold over the Internet to California residents.¹⁵ Governor Davis vetoed the legislation because he felt that it would harm California businesses. This is an example of how interstate tax competition forces legislators to weigh their tax and spending urges against their desire to remain business-friendly.

Option #3: Exempt e-commerce from sales and use taxes nationwide

Exempting e-commerce from sales and use taxes would either require a federally legislated prohibition, as proposed in the 106th Congress by Representative John Kasich, or state-by-state legislation banning Internet taxation. Such legislation is not likely to originate at the

state level because many state legislators and governors are among those pushing the Streamlined Sales Tax. These officials have no desire to see their ability to tax e-commerce restricted further.

This leaves Congress to propose legislation specifically exempting e-commerce from sales taxes. Unfortunately, a federally legislated ban on e-commerce taxation is likely to run aground on constitutional issues. This is the flip side of the constitutional impediment to the states' plan for a sales tax cartel. Any ban on taxation of Internet commerce emanating from Congress would surely be challenged under the Commerce Clause, Article I, Section 8 because it prohibits states from collecting taxes on sales made within their own borders.

Option #4: Retain and strengthen current nexus rules (Gregg-Kohl Bill)

This proposal is frequently referred to as the “Andal Plan” because it was originally submitted to the Advisory Commission on Electronic Commerce by one of its members, Dean Andal of the California State Board of Equalization. Senators Judd Gregg and Herb Kohl introduced legislation based on Andal’s proposal in the 106th Congress. This legislation amounts to a specific enumeration of the types of Internet transactions that *cannot* be taxed. By following the Supreme Court’s suggestion in *Quill*, Gregg-Kohl fleshes out and clarifies nexus by defining activities that *do not* achieve nexus. This legislation would codify that without a significant physical presence in a particular state, companies should not be forced to collect taxes within the particular state. Gregg-Kohl would also codify that residents of a state should not be forced to pay another state’s sales taxes. Fairness and equity would be maintained by allowing states to require tax collection by companies with a significant presence in their state.¹⁶

The nexus clarifications contained in this legislation would benefit consumers and help clarify aspects of e-commerce. Unfortunately, it is unlikely that the nexus issue will be able to rally consumers to defeat powerful state interests that have allied against any plan that prohibits them from dramatically increasing the amount of taxes collected on e-commerce. Aside from the “do nothing” option, this appears to be the most viable.

Option #5: Adopt an origin-based system of sales tax collection

This is a viable alternative for simplifying nexus issues, and it accomplishes the task by allowing sales taxes to be imposed only at the point of sale. This would, in essence, be the “ultimate form of nexus simplification.” Instead of creating a list of circumstances that fail to achieve nexus, it would simply call for the same in-state tax system and tax rate to apply whether the item is purchased in the traditional manner or online. The payoff of such a plan for taxpayers and small businesses would be twofold:

1. Use taxes would be eliminated and extraterritorial taxation would no longer exist.
2. Interstate competition would be promoted as states attempt to tailor their tax policies to wooing businesses to locate in their jurisdictions and keeping taxes at a reasonable level.

One area of contention will undoubtedly arise between states with a large presence of e-commerce and those states that could be defined as “technology-poor.” While Washington State, California, and Virginia would benefit due to the presence of technology firms within their borders, Mississippi, Alabama, and others will not be so enthusiastic about seeing their constituents pay sales taxes to other states. It is also unclear exactly which “origin” is referred to. If Amazon.com (headquartered in Seattle, Washington) decided to open a branch office in Delaware, which has no sales tax, how would the “point of origin” be determined? Surely, Amazon.com and any other store that operated under such a plan could argue that their “point of origin” was in the lower-taxed jurisdiction and therefore should not be subject to sales tax collection.

Although an origin-based system would be good for taxpayers in many ways, it is unclear where the necessary political support will come from in order to transform this concept into law. Support is not likely to come from technology-poor states and it is unclear whether the public would support such a shift since consumers have grown accustomed to purchasing items over the Internet on a tax-free basis. It will be a difficult task to gather support for raising taxes on Internet purchases while not satisfying those calling for blanket taxation of the e-commerce.

Conclusion

Although the states have focused the argument over e-commerce taxation through the dual lenses of fairness and revenue, taxpayers should not let this obstruct other views. Constitutional issues need to be addressed as well. States have recently seen sales tax revenues grow at an exponential rate. Instead of using the current prosperity to reform their tax bases and reduce non-essential programs, spending has increased rapidly. Current economic strength will not last forever, but that should be no excuse for a massive expansion of sales tax collections with the side effect of destroying federalism as designed by our Founding Fathers. Instead, state and local officials must reform their revenue collection systems within a constitutional framework.

Because Internet taxation issues are predominantly constitutional, Congress’s role in resolving this debate should be limited. Ambitious new taxation systems are unnecessarily complicated, are of dubious constitutional footing, and would be harmful to Internet commerce. Extending the Internet Tax Moratorium and making it permanent as soon as possible are immediate steps Congress can take to ensure that Internet commerce is allowed to develop and that constitutional integrity is maintained. Leaving e-commerce alone is certainly a valid option for the future; however, Congress should explore the option of refining nexus by passing Gregg-Kohl.

Paul Gessing is a Policy Associate with National Taxpayers Union.

¹ Michael Mazerov, "A Five-year Extension of The Internet Tax 'Moratorium' Would Further Erode The Tax Base of States And Localities," May 12, 2000, <http://www.cbpp.org/5-8-00tax.htm>.

² U.S. Supreme Court, *Quill vs. Heitkamp*, 504 US 298 (1992), <http://caselaw.findlaw.com/scripts/getcase.pl?court=US&vol=504&invol=298>.

³ Nathan Newman, "The Great Internet Tax Drain," *Tech Review*, May-June 1996, <http://www.techreview.com/articles/mj96/newman.html>.

⁴ Testimony of Iris J. Lav, Deputy Director, Center on Budget and Policy Priorities, before the Committee on the Budget, U.S. Senate, February 2, 2000, http://www.senate.gov/~budget/republican/about/hearing_2000/lav.htm.

⁵ U.S. Department of Commerce, Economics and Statistics Administration, <http://www.census.gov/mrts/www/mrts.html>.

⁶ Heather Greenfield, "Fairness and Simplicity Key Issues in Net Tax Debate," *TechWeek*, April 17, 2000, <http://www.techweek.com/articles/4-17-2000/digitdc.htm>.

⁷ Office of Management and Budget, *Historical Tables of the Budget of the United States Government – Fiscal Year 2001*, Table 15.1.

⁸ *Ibid.*

⁹ Testimony of Iris J. Lav, Deputy Director, Center on Budget and Policy Priorities, before the Committee on the Budget, U.S. Senate, February 2, 2000, http://www.senate.gov/~budget/republican/about/hearing_2000/lav.htm.

¹⁰ "Streamlining Sales Tax Systems," National Governors Association, <http://www.nga.org/Pubs/Policies/EC/ec12.asp>.

¹¹ Daniel J. Mitchell, "Stalked by the Sales Tax Cartel," *The Washington Times*, July 24, 2000.

¹² Adam Thierer, *The Heritage Foundation Backgrounder # 1343*, "The NGA's Misguided Plan to Tax the Internet and Create a New National Sales Tax," February 4, 2000, <http://www.heritage.org/library/backgrounder/bg1343.html>.

¹³ Statement of John Berthoud, Ph.D., before the U.S. Senate Committee on Commerce, Science, and Transportation, April 12, 2000.

¹⁴ *Ibid.*

¹⁵ "Governor Davis Expected to Veto Sales Tax on Web-Site Sales," *San Jose Mercury News*, August 31, 2000.

¹⁶ Eric V. Schlecht, Director of Congressional Relations, National Taxpayers Union, letter to Senators Judd Gregg and Herb Kohl, <http://www.ntu.org/leg/Ls2401.html>.