Should State and Local Government Sales Taxes Apply to E-Commerce?

by
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EXECUTIVE SUMMARY

Background

Currently, Internet and catalogue merchants do not collect state sales taxes on many sales. This is because the Supreme Court has ruled that retailers cannot be required to collect and remit the sales tax unless they have a physical presence, or “nexus,” in the customer’s state. Moreover, in cases where the retailer is not required to collect the tax, consumers have generally failed to submit the sales tax voluntarily to their home states.

This situation has created several types of inequities. Traditional retailers argue that Internet and catalogue retailers enjoy a price advantage because their sales in many jurisdictions are tax-free. In addition, older people, minorities, and people with low incomes may pay the sales tax more frequently because they are less likely to have Internet access.

State governments are concerned that the loss of sales tax revenue could have an adverse effect on state finances. This could imperil the many state-provided services to seniors and low-income residents. Eventually, states might be forced to seek additional revenues from the property tax, which weighs more heavily on seniors.

On the other hand, anti-tax groups argue that the Internet is a new medium and applying the sales tax could cripple its growth. The sales tax also imposes certain administrative burdens on retailers, who may be required to calculate the appropriate sales tax rate for out-of-state sales and remit the tax receipts to varied state governments.

Purpose

The concern addressed by this paper is whether state and local sales taxes should be applied to e-commerce.

Methodology

The paper provides a detailed description of the current state sales tax system and the surrounding legal framework. The role of the sales tax in state finances is explained using recent data. The balance of the paper presents an extensive literature survey on the subject of the state sales tax and e-commerce. The paper analyzes arguments for and against the sales tax, employing sources on both sides of the debate.

Principal Findings

Currently the sales tax provides about 25 percent, on average, of state and local tax revenues. State governments are concerned that their financial situation will suffer as more and more purchases escape taxation because they are conducted over the Internet.
Although state budgets were generally sound in recent years, this picture could change rapidly during an economic downturn, or as a result of vigorous growth in Internet sales.

Important equity issues arise as a result of the fact that many Internet sales go untaxed. First, identical products may be taxed differently, depending on whether they are purchased over the Internet, through a catalogue, or in a traditional, “mortar-and-bricks” store. Traditional retailers charge that this situation confers a price advantage on catalogue and Internet retailers. A second important equity concern is the fact that older people, lower income people, and certain minorities are less likely to have Internet access. These groups may therefore pay sales taxes more often than other groups. In addition, people with lower incomes are less likely to have credit cards or a secure place to take delivery of goods delivered through the mails, two prerequisites for both Internet and catalogue shopping.

Many arguments have been levied against the existing sales tax system. Some of the criticisms are of dubious merit, such as the argument that the Internet is an “infant industry” that must be protected in order to allow it to develop.

One frequently heard criticism is that the sales tax places an onerous burden on both catalogue and Internet firms, because it requires them to collect the tax under vastly different state sales tax regimes. Currently, the compliance burden facing an Internet or catalogue firm that is required to collect the sales tax in 46 jurisdictions is no different from the compliance burden facing a national retail chain with stores in each of those jurisdictions. Probably the strongest argument to be made against expanding merchants’ duty to collect the sales tax is that the administrative burden could overwhelm the smallest retailers. The very smallest Internet retailers, those run out of households, do not face this burden under current law. But efforts to expand greatly the duty of Internet and catalogue merchants to collect the sales tax on out-of-state sales have the potential to affect even the very smallest household firms. For this reason, most proposals to expand the duty to collect the sales tax contain de minimis thresholds.

In the fall of 1998, Congress passed the Internet Tax Freedom Act (ITFA), which imposed a three-year moratorium on certain kinds of new special, multiple, or discriminatory Internet taxes. The ITFA did not affect the ability of state and local governments to collect the sales tax consistent with current law. The ITFA also established a new panel, called the Advisory Commission on Electronic Commerce (ACEC), to make recommendations on what to do after the three-year moratorium expires. After deliberations that were fraught with contention, ACEC issued its Final Report in April 2000. ACEC issued two formal recommendations in support of an international standstill on Internet tariffs, and for providing needy families access to computers and to the Internet. In a highly controversial move, however, ACEC’s report included some additional proposals that did not win support from two-thirds of the panel as required under the ITFA. One such proposal, which was supported by ACEC members from the telecommunications and publishing industries, would have banned, for five years, sales taxes on digital goods and services (such as digital books, music, and
software downloaded over the Internet) as well as their non-digitized counterparts (such as hardbacks, paperbacks, CDs and shrink-wrapped software).

The question facing policy makers, therefore, is what to do after the temporary moratorium, imposed under the ITFA, expires in October 2001. Congress is predictably divided. In the 106th Congress, many of ACEC’s “majority” proposals were incorporated into a bill introduced by House Judiciary Committee Chairman Henry J. Hyde and others. The views of a minority group in ACEC were incorporated into another bill introduced into the 106th Congress by Senator Byron Dorgan. Under the Dorgan bill, states would have been required to simplify their sales tax regimes dramatically, and Internet and catalogue merchants with gross sales above a de minimis level would have been required to collect the use tax on sales into all states that adopted the simplified sales tax regime. Senator McCain, together with Representative Kasich, introduced a bill in the 106th Congress to impose a permanent ban on all Internet taxes, including the sales tax. A second bill introduced by McCain had more limited aims: it would merely have extended, for another five years, the current moratorium on Internet access and multiple and discriminatory taxes. In April, 2000, the Senate Commerce Committee failed to mark up McCain’s second, more limited, bill in large part because “mortar-and-bricks” retailers improved their lobbying efforts on Capitol Hill.

Members of the 107th Congress have already begun work on this issue. In early February 2001, Senator Bob Smith submitted a bill (S. 246) to extend the ITFA moratorium for another five years. Senator Dorgan has launched a series of meetings with state government officials to coordinate the development of future legislation. Although Congressional action could resolve this issue, another route is being pursued by a coalition of 30 states plus ten additional “observer” states. Under the umbrella of the National Governors’ Association, these groups have drafted a plan called the “Streamlined Sales Tax Project” (SSTP) that could be implemented by the states themselves, that requires no federal action, and in which the private sector could participate on a voluntary basis. In essence, the SSTP would establish a multistate sales tax compact to lessen the compliance burden on vendors through technology and tax simplification.

Conclusions

The Internet sales tax debate has inspired strong opinions and some fairly high-flying rhetoric. One thing seems fairly clear: the current sales tax system, characterized by limited collection requirements, cannot endure because of the inequities that it creates.

As the three-year ITFA moratorium approaches expiration in the fall of 2001, this debate will play out in Congress and among the states. The debate in Congress will likely differ from earlier years, because traditional retailers, who were largely absent during the discussions that lead to the ITFA and ACEC in 1998, built up their lobbying efforts during 2000.
INTRODUCTION

Online retail sales totaled $25.8 billion during 2000, according to the Commerce Department. The launch of this new government statistical series, in March, 2000, was accompanied by more fanfare than usually greets government statistics, and took on almost symbolic overtones. The way that America does business simply does not change very often, and the new figures seemed to signal the changes underway, with more changes to come.

As a percent of all retail sales, $25.8 billion is a small amount – only about 0.8 percent of total retail sales in 2000. Most observers expect this segment of the economy to grow rapidly in the near future, however. Indeed, online retail sales grew 67% from the fourth quarter of 1999 to the fourth quarter of 2000, according to the Commerce Department. A private sector survey found that nearly 20 million households shopped online in December 2000, spending an average of $308 per person. Even larger than online retail sales, however, is the Internet commerce that is conducted between businesses. The first official statistics measuring business-to-business, or “B2B,” commerce will be released in March, 2001.

The growing role of e-commerce raises many policy issues. These policy issues encompass a number of traditional concerns, such as consumer rights, the privacy of consumer information, and tax equity among sellers and consumers. The rapid development of e-commerce also introduces some brand new concerns, such as validating electronic signatures and assuring the security of information transmitted over the Internet.

The concern addressed by this paper is whether state and local sales taxes should be applied to e-commerce. Currently, 45 states impose sales/use taxes, but these taxes go uncollected on many Internet and catalogue sales. This is because the Supreme Court has placed limits on the states’ ability to require certain out-of-state merchants to collect the tax. Moreover, consumers have failed, by and large, to carry out their legal responsibility to submit the sales tax to their home states, although all states that collect the sales tax require their citizens to do so when the retailer has not already collected the tax.

As a result, under the existing system of laws related to the sales tax, identical products may be taxed differently, depending on whether they are purchased over the Internet, through a

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1 Statistical Release, “Retail E-Commerce Sales for the Fourth Quarter 2000 Were $8.7 Billion, Up 67.1 Percent from Fourth Quarter 1999, Census Bureau Reports,” Bureau of the Census, Commerce Department, February 16, 2001. Available at www.census.gov. The economic importance of e-commerce today is almost certainly larger than government figure, which is limited by the government definition of retail sales. The figure of $5.3 billion does not include travel, for example, which the government measures as part of the transportation sector. Nor does it include on-line ticket agencies and financial services, which are classified separately in the services sector.
2 The NRF/Forrester Online Retail Index is available at www.nrf.com. The private sector and government surveys are not directly comparable because they use different product definitions and survey techniques.
3 In some states there is a de minimus level, below which use taxes don’t have to be self-remitted.
catalogue, or in a traditional, “mortar-and-bricks” store. Traditional retailers charge that this situation confers a price advantage on catalogue and Internet retailers.

In addition, an important equity concern arises from the fact that lower income people face certain barriers to Internet shopping and may therefore pay sales taxes more often than higher-income individuals. People with lower incomes are less likely to have Internet access. They are also less likely to have credit cards or a secure place to take delivery of goods delivered through the mails, two prerequisites for both Internet and catalogue shopping.

It is often argued that the sales tax places an onerous burden on both catalogue and Internet firms, because it requires them to collect the tax under vastly different state sales tax regimes. Under current law, this issue does not affect the thousands of family concerns that are run out of someone’s house and that have joined the national market through the Internet (although such firms could be affected if the duty to collect were expanded). Currently, the compliance burden facing an Internet or catalogue firm that is required to collect the sales tax in 46 jurisdictions, because it has a physical presence in each of those jurisdictions, is no different from the compliance burden facing a national retail chain with stores in each of those jurisdictions.

Most of these problems are not new. For over thirty years, state and local governments have been concerned about the revenue impact of uncollected sales taxes due to purchases from out-of-state catalogue and mail order firms. The states have brought numerous court cases to litigate out-of-state merchants’ responsibility for collecting the sales tax, as will be discussed below. Also during the past several decades, catalogue and mail order merchants have fought in the courts against the obligation to collect the sales tax on out-of-state sales.

E-commerce has also created a few unique problems related to sales taxation. For example, digitally-delivered goods are particularly well-adapted for escaping the notice of tax authorities. Yet, to a great extent, the growth of e-commerce has simply magnified existing problems.

**SUMMARY OF RECENT DEVELOPMENTS**

To address these problems, a wide variety of solutions have been offered. Proposals range from abolishing the sales tax to expanding merchants’ duty to collect the sales tax. Simplification of the states’ current sales tax regimes is also a prominent feature of many proposals.

Some of the approaches are compatible and could be implemented jointly. For example, simplification of existing state sales tax regimes has been viewed by some groups as the quid pro quo for an expanded duty to collect. On the other hand, tax simplification has also been combined with proposals to roll back merchants’ existing duties to collect the sales tax.
Some opponents of the sales tax would scrap the system entirely, however. Opposition to applying the sales tax to the Internet is frequently philosophical: it is part of a broader anti-tax agenda that would not be satisfied with administrative reform of the existing sales tax system.

In 1998, Congress decided to give policy makers some breathing space in which to weigh the implications of taxing e-commerce, by imposing a three-year moratorium on certain kinds of new special, multiple, or discriminatory Internet taxes. The resulting law is known as the Internet Tax Freedom Act (ITFA). Discriminatory taxes barred by the ITFA include any new taxes on Internet commerce, or higher tax rates, that would not apply to the same good if sold through a traditional retailer or a catalog. As an example of a discriminatory tax, the Clinton Administration defeated a European effort to impose a bit tax on Internet traffic. The ITFA also bans new Internet access taxes and any new federal taxes on the Internet for the duration of the moratorium, which expires on October 21, 2001. Internet access taxes are taxes on the monthly fee that users pay to companies to connect to the Internet. The ITFA enjoyed the strong support of the Clinton Administration as well as many anti-Internet tax groups.

The ITFA does not affect the ability of state and local governments to collect non-discriminatory sales and use taxes consistent with current law, provided that the tax, and the tax rate, are the same as would be imposed on mail order or telephone commerce. Nor does the law reduce the existing ability of state and local governments to collect normal business income taxes, property taxes, non-discriminatory business taxes, or local franchise fees paid by cable television (even if the cable company is providing Internet service as well).

The ITFA also established a new panel, called the Advisory Commission on Electronic Commerce (ACEC), to study state and local sales taxes and other issues and to make recommendations on what to do after the three-year moratorium expires. The ACEC panel was fraught with contention, with some of the 19 members from industry, the federal government, and state and local governments trading charges that the other participants have acted utterly in their own self-interest. In fact, several weeks before ACEC released its final report, the three federal government representatives issued a scathing condemnation of ACEC’s deliberative processes. ACEC issued its Final Report on April 12, 2000. ACEC issued formal recommendations in support of an international standstill on Internet tariffs, and in support of allowing states to use Temporary Assistance to Needy Families (TANF) funds to provide needy families access to computers and the Internet. These ACEC proposals achieved formal “recommendation” status because they garnered support from two-thirds of the 19-member panel, as required under the ITFA. The ACEC report also related the rather ambiguous conclusion that:

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4 The Internet Tax Freedom Act was included as Titles XI and XII of the Omnibus Appropriations Act of 1998, signed as P.L. 105-277 on October 21, 1998. It is available at www.thomas.loc.gov

It should not be presumed that the collection of sales and use taxes on Internet transactions is an inevitability. There is, however, a need to begin a dialogue that will lead to the substantial simplification and reform of the current tax systems if they are to continue to remain viable in the 21st century.⁶

In a highly controversial move, ACEC’s final report also included some additional proposals that were supported by a simple majority of 11 commissioners, but failed to achieve the two-thirds support required under the law. The so-called “majority” proposal would ban, for five years, the application of the sales tax to digital goods and services (such as digital books, music, on-line newspapers and software downloaded over the Internet) as well as their non-digitized counterparts (such as hardbacks, paperbacks, CDs, newspapers and shrink-wrapped software). This would amount to a roll-back of the existing sales tax on certain items. During the proposed five-year moratorium, states would work out a thorough simplification of sales tax policies. At the end of the five years, a new commission would examine the states’ simplified sales tax program and make recommendations to the Congress concerning merchants’ duty to collect the tax. Additionally, the “majority” proposal would ban permanently all taxes on Internet access, as well as eliminate the three percent federal telecommunications tax.⁷

ACEC’s report was well received by some in Congress. Many of ACEC’s “majority” proposals were incorporated into H.R. 4267, which was introduced by House Judiciary Committee Chairman Henry J. Hyde (R-Ill) and others in the 106th Congress.

Elsewhere the ACEC report was greeted with withering criticism. Forty-two state governors signed letters to Congress opposing the report.⁸ State and local governments claim that various new exemptions contained in the majority proposal, for items such as paperbacks and hardbacks, would cost them upwards of $30 billion annually if enacted.⁹ In the world of academia, Charles E. McLure of Stanford gathered 100 signatures from academic tax specialists in a plea to ACEC to avoid special interest provisions. McLure characterized the academics’ letter as follows: “Basically, we’re saying that the thing that came out of Dallas is horrible.”¹⁰

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⁷ The “majority” proposal can be viewed in ACEC’s final report (ibid). The ACEC web page also contains the original version of this proposal, as submitted by the ACEC Business Caucus, entitled “A Proposal for Internet Tax Reform and Reduction.” The ACEC Business Caucus consisted of Charles Schwab, America Online, MCI Worldcom, AT&T, Time Warner and Gateway. The proposal has been criticized by people who scoff at Time-Warner’s bid for a temporary exemption for printed materials and books (see David Ignatius, “E-Execs in Loophole Heaven,” The Washington Post, March 29, 2000, available at www.washingtonpost.com). The proposal has also been criticized, however, because it could pave the way for ultimate endorsement of the National Governor’s Association proposal to “streamline” the current sales tax system (see Aaron Lukas, “Business Sells Out on Internet Taxes,” February 22, 2000 at www.cato.org).


A minority group in ACEC held quite different views from those contained in the ACEC report, and many of their proposals were incorporated into another bill introduced into the 106th Congress by Senator Byron Dorgan (D-N.D.), S. 2775. Under the Dorgan bill, states would have dramatically simplified their sales tax regimes. Internet and catalogue merchants with gross sales above a de minimis level would have been required to collect the use tax on sales into all states that adopted the simplified sales tax regime.

The failure of the ACEC group to agree on detailed recommendations makes a consensus solution look more difficult. Nevertheless, diverse groups continue their efforts to develop plans that might attract a national consensus.

The question facing policy makers is what to do after the temporary moratorium, imposed under the ITFA, expires in October 2001. The ball is back in Congress’ court, and Congress is predictably divided on the issue of applying sales/use taxes to the Internet. Congress has paid little attention to many of the ACEC “majority report” proposals since their introduction, apart from the recommendations to extend the moratorium and repeal the federal telephone excise tax.

Bills introduced into the 106th Congress ranged from Senator Fritz Hollings’ proposal for federal collection of a five percent excise tax on all Internet sales, with the proceeds distributed to states to fund education (S. 1433), to the McCain-Kasich proposal for a permanent ban on all Internet taxes, including the sales tax (S. 1611 and H.R. 3252). McCain also introduced another bill, S. 2255, which represented a retrenchment from S. 1611 because it merely aimed to extend, for another five years, the current moratorium on Internet access and multiple and discriminatory taxes. The Senate Commerce Committee failed to mark up S. 2255 in mid-April, 2000, at about the same time that ACEC was presenting its final report to the House and Senate leadership. S. 2255 failed in large part because retailers persuaded a sufficient number of Senators on the Commerce Committee that it would be unwise to extend the moratorium without addressing the need to level the playing field between traditional and Internet retailers.

Members of the 107th Congress have already begun to work on this issue. In early February 2001, Senator Bob Smith submitted a bill to extend the ITFA moratorium on special, multiple, or discriminatory Internet taxes for another five years (S. 246). Senator Dorgan has begun discussions with state and local government representatives concerning new legislation.

Although Congressional action could resolve this issue, another route is being pursued by a coalition of 30 states, plus ten “observer” states. Under the umbrella of the National Governors’ Association, these groups have drafted a plan called the “Streamlined Sales Tax Project” (SSTP) that could be implemented by the states themselves, that requires no federal action, and in which the private sector could participate on a voluntary basis. In essence, the SSTP aims to lessen the compliance burden on vendors through new technology and by simplifying state sales tax regimes.

This Issue Brief will explore in detail some of the considerations that must be addressed as policy makers consider whether or not to apply state sales taxes, or other types of taxes, to the
Internet. The following section will outline the current law regarding state and local sales taxes and some of the major policy concerns. Subsequent sections will address some of the proposals for reforming state and local government sales tax systems.

THE CURRENT SYSTEM OF STATE SALES AND USE TAXES

A fundamental issue is whether the existing system of state sales and use taxes is compatible with e-commerce. Historically, the problems that will be described below have existed for over thirty years, and have been debated previously in the context of catalog and mail order sales. E-commerce has only magnified these existing problems, as more and more interstate sales are conducted over the Internet.

Sales taxes are a key element of state finance: they account for about one quarter of all state and local tax revenues. This can be seen in Chart 1. In Florida, Nevada, South Dakota, Tennessee, Texas and Washington, state governments get over 50 percent of their tax revenues from general sales taxes.

<table>
<thead>
<tr>
<th>Chart 1</th>
<th>U.S. State/Local Tax Revenue Sources</th>
<th>1997</th>
</tr>
</thead>
<tbody>
<tr>
<td>General Sales Taxes</td>
<td>25%</td>
<td></td>
</tr>
<tr>
<td>Property Taxes</td>
<td>24%</td>
<td></td>
</tr>
<tr>
<td>Personal Income Taxes</td>
<td>22%</td>
<td></td>
</tr>
<tr>
<td>Other Taxes</td>
<td>29%</td>
<td></td>
</tr>
</tbody>
</table>

Source: U.S. Bureau of the Census

Currently, 45 states plus the District of Columbia levy sales taxes, so readers will sometimes see a reference to 46 jurisdictions. The five states that do not levy a state sales tax are Delaware, New Hampshire, Montana, Oregon and Alaska. In addition, 34 states have authorized their cities and/or municipalities to levy their own sales taxes. About 7,600 local jurisdictions currently do levy sales taxes, out of a potential 30,000 local jurisdictions. In 2000, combined state and local sales tax rates ranged from three to 11 percent, although most fell within a range of five to eight percent. While the sales tax is generally imposed on tangible goods, numerous states also tax selected services such as personal care and repair work.
Retail sales and use taxes are intended to be taxes on the consumers of purchased goods and services. The sales tax applies to sales between a merchant and a consumer who are located in the same state at the time the sale occurs. The use tax is complementary to the sales tax and is applied when the merchant and the consumer are located in different states at the time the sale occurs. Even though the tax is levied on the consumer, it is the merchant who is required to collect the sales or use tax and remit it to the state in which the product was transferred to the consumer. For this reason, many people mistakenly believe that the sales tax is levied on the merchant.

Where the Internet merchant and the customer are located in different states, the situation can become complicated. The Supreme Court decided in 1992, in the case of Quill Corporation v. North Dakota, that a merchant cannot be required to collect the sales/use tax and send it to the consumer’s state if the merchant does not have a “substantial nexus,” requiring physical presence, in the consumer’s state. Quill sells office equipment and supplies. It is incorporated in Delaware, maintains its headquarters in Illinois, and has warehouses in several other states but not North Dakota. At the time of the litigation, Quill had no employees and minimal tangible property in North Dakota. Quill was soliciting business in North Dakota through catalogs and flyers, and through advertisements in national periodicals -- but not through the Internet at that time. The Supreme Court ruled that catalogs and advertisements were not sufficient presence under the Commerce Clause of the Constitution; therefore Quill was not required to collect sales taxes from North Dakota customers. This decision is often referred to as the “Quill Decision” or the “Nexus Rule.”

Quill Corporation v. North Dakota (91-194, 504 U.S. 298 (1992), Supreme Court of the United States, May 26, 1992. The Quill decision reaffirms the Supreme Court’s basic holding in the case of National Bellas Hess v. Illinois Department of Revenue (NBH) in 1967. In NBH, based on facts essentially identical to Quill, the Court held that an out-of-state seller whose only contact was the solicitation of sales through catalogs and shipping goods via common carrier could not be required to collect the use tax. Instead, a “physical presence” was required before a seller could be required to collect the tax. The NBH decision referred to both the Commerce clause and the Due Process clause of the 14th Amendment, but was not clear on which was controlling.

In the opinion delivered by Justice Stevens, Quill reaffirmed the basic holding of NBH, that a physical presence is required before an out-of-state seller can be required to collect the use tax. The Quill decision went further, however, by ruling that there are two nexus tests: a Due Process test that requires a “minimal connection” that is satisfied by soliciting sales on a systematic basis; and a Commerce Clause test that requires a “substantial nexus” with the state and, in the case of use tax collection, a physical presence by the seller. Regarding the “Due Process” clause, the Supreme Court ruled that a physical presence in a state was not necessary to trigger nexus for the sales/use tax, because, “In ‘modern commercial life’ it matters little that such solicitation is accomplished by a deluge of catalogs rather than a phalanx of drummers: the requirements of due process are met irrespective of a corporation’s lack of physical presence in the taxing state…. We therefore agree with the North Dakota Supreme Court’s conclusion that the Due Process Clause does not bar enforcement of that State’s use tax against Quill.” (Id. at 308) The Supreme Court also concluded, however, that “Despite the similarity in phrasing, the nexus requirements of the Due Process and Commerce Clauses are not identical. ….The Commerce Clause, and its nexus requirement, are informed not so much by concerns about fairness for the individual defendant as by structural concerns about the effects of state regulation on the national economy.” (Id. at 312) With respect to the Commerce Clause, the Court concluded that the time had not yet come to renounce the “bright line” test established in earlier litigation, i.e., that a firm must have a “physical presence” in a state before it can be compelled by that state to collect the use tax. Justice Stevens concluded his opinion with what looks like an encouraging nod to the Congress: “This aspect [related to the Commerce Clause] of our decision is made easier by the fact that the underlying issue is not only one that Congress may be better qualified to resolve, but also one the Congress has the ultimate power to
Transactions that do not meet Quill physical presence standards are not tax-free, however. In circumstances where the merchant is not required, under Quill, to collect the tax, the consumer still has the legal responsibility to pay the use tax directly to his or her own state. Individuals who do not pay the sales tax on either Internet or mail-order purchases are supposed to call their state tax authority, ask for a use-tax form, and voluntarily pay the use tax on their purchases. At least 15 states now include a line on the state income tax form that asks residents to total up their out-of-state purchases, including items bought on-line or through a catalogue. In fact, few consumers report out-of-state purchases to their tax authorities, either out of ignorance, neglect, or because they intend to evade the law.

Although sales tax opponents charge that states lack the political will to enforce the use tax, the issue is complicated. States lack information on what their citizens are buying from out-of-state Internet merchants and catalogue companies. In 1997, the Nebraska legislature passed legislation that would have required out-of-state companies with no physical presence in Nebraska to report all sales to Nebraska citizens. Under the legislation, the state of Nebraska would have used that information to collect the use tax directly from its citizens. The bill was vetoed by the governor on privacy and logistical grounds.

A common misconception is that state sales taxes are taxes on merchants, and therefore “taxation without representation” takes place when a merchant from one state is forced to pay taxes to the government of another state. This misconception is expounded even by people who should know better. In fact, the law is clear that the merchant’s role is to collect the sales tax from the customer. For this reason, catalogue and Internet merchants must collect the use tax at the rate that applies in the state where the customer lives (or at least where the product will be delivered), and the merchant remits the collected taxes to the customer’s state. The customer clearly has avenues for achieving political representation within his or her home state, and through these political avenues the customer can influence the state sales tax system and/or the distribution of revenues from the sales tax.12

The Quill decision left open many fertile grounds for controversy. In particular, there has been much litigation over what constitutes a sufficient “physical presence” that would require a merchant to collect the sales tax from out-of-state customers. Does a web page, or the use of an in-state server to maintain a web page, constitute such a presence?13 In 1995, the New York
Court of Appeals ruled that Orvis Co. was required to collect the sales tax on mail-order sales to New York residents, because Orvis employees systematically visited New York retailers in order to persuade them to buy Orvis merchandise wholesale.

An emerging test for the nexus rules is being posed by the web kiosks that several well-known national retailers have begun to install within the walls of their “mortar-and-bricks” stores. In-store web kiosks enable customers to make Internet purchases from the retailer’s web operation, provided that the customer is willing to wait for delivery. Some national retailers are taking the position that their web operations are “unaffiliated” with their “mortar-and-bricks” operations. As a result, the web operations collect the use tax in only those states where the web operation itself has a physical presence. Thus, web kiosks offer customers the potential advantage of a tax-free purchase. This is controversial, and raises many questions, such as the extent to which the website benefits from advertising conducted by the retail chain.

According to a recent survey by Forrester Research, Inc., retailers see numerous benefits to in-store web kiosks, such as selling out-of-stock merchandise, or product lines that the particular store does not carry. Forrester surveyed 30 firms and found that 80 percent planned to roll out web kiosks by 2002, and one-third planned to introduce web-enabled cash registers. Fifteen percent of Forrester’s survey respondents planned to introduce by 2002 a handheld bar code scanner that would allow consumers to “zap” their purchases onto an electronic shopping list.14

In the Quill majority opinion delivered by Justice Stevens, the Supreme Court pointed out that “our law in this area is something of a ‘quagmire.’ ” The opinion also extended an invitation to the Congress to take action, noting that “Congress may be better qualified” than the Judicial branch to resolve the underlying issues.

**Policy Concerns**

Sound policy needs to achieve a balance between the potential burden on technological growth, the revenue needs of state and local governments, the continued viability of traditional retailers, and equity concerns over access to the Internet. Policy makers also need to keep in mind the traditional set of tax policy concerns: a tax system should be neutral, non-discriminatory, administrable, simple, yet flexible.

Certainly there is broad consensus today, among businesses and government at all levels, that Internet merchants should not face higher taxes than traditional bricks and mortars businesses. For this reason, several groups and panels have championed the principle that there

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should be no discriminatory, multiple, or special taxes on Internet commerce. ACEC and the Clinton Administration both spoke out against discriminatory and multiple Internet taxes. The Clinton Administration also successfully opposed imposition of an international bit tax based on information volume. At this early date in 2001, the Bush Administration has not yet taken action on the taxation of e-commerce.

The debate over state and local sales taxes has given rise to numerous additional points of view and concerns, which are summarized here.

State Finances. The fact that sales taxes often go uncollected on Internet sales raises serious concerns about state and local government finances. According to one recent estimate, states lost $525 million in sales taxes in 1999 because of consumer purchases over the Internet. The study showed that state sales taxes were applied to only about 20 percent of the $13 billion in taxable retail goods that were sold online in 1999, with California, Texas, Illinois, Florida, and New York losing the most revenue. Separately, California’s Board of Equalization reported that nearly 27 percent of revenues that resulted from audits of the sales and use tax were associated with purchases made from out-of-state vendors without payment of the use tax.

The GAO estimated that in 2000 states lost less than two percent of their aggregate sales tax revenues because of Internet sales. That same year, the size of the loss from all remote sales (catalogue as well as Internet) was under five percent of aggregate sales tax revenues, under a variety of scenarios. For 2003, the GAO found that Internet sales could lead to losses ranging from under one percent to about five percent, and that all remote sales could lead to sales tax losses ranging from about one percent to about eight percent of aggregate sales tax revenues.

The drain on state and local finances will surely intensify as e-commerce grows over the next few years. The CBPP estimated that state and local governments could lose as much as $10 billion annually by 2003, if Internet retail and business-to-business purchases remain effectively tax exempt.

One alternative study puts the annual loss in sales tax revenues at below two percent of total collected state sales tax revenues, in every year from 1998 to 2003. This calculation is based on an assumption that online retail spending grows 70 percent per year. (As noted at the beginning of this paper, online retail sales grew 67% from year-end 1999 to year-end 2000.) The

authors also conclude that, at 70 percent growth per year, revenue losses would amount to ten percent of total collected sales tax revenues by 2007.20

States and localities need to have a solid, stable revenue base in order to provide the services on which their citizens depend, such as education, police, fire protection.21 Dallas Mayor Ron Kirk has joked that citizens who enjoy the tax-free “virtual” world of the Internet should not be surprised if they dial 911 and find that a “virtual” firefighter or policeman shows up at their door.22 From another perspective, the sales tax is one of several revenue sources that helps to preserve states’ sovereignty in many local decisions.

If sales tax revenues were to fall dramatically, states and localities might have to reduce services such as education, police or fire protection. Alternatively, states and localities could increase the sales tax that still applies to conventional retailers; or, states and localities could increase other taxes, such as the property tax. Some of these solutions could have regressive distributional consequences, and none is likely to receive local political support.

State governments point out that Internet merchants may receive benefits from states in which they make sales, even when they have no physical presence. Governments protect copyrights and trademarks, provide various types of infrastructure, and dispose of tons of catalogues and flyers mailed into the state every year.

Opponents of a wider application of state and local sales taxes to e-commerce argue that state and local taxes are at an all-time high. The Cato Institute reports that state budgets grew by 5 percent in FY97 and 6 percent in FY98, and that state tax collections have exceeded expectations by about 25 billion over the past four years.23 Hence, applying sales taxes to Internet sales could “slay the goose with the golden egg.”24 because much of recent economic growth may be due to the expansion of the high-tech sector.

The recent rosy picture of state finances was rooted in the long-running economic boom that began in the nineties. State and local governments are concerned this picture could change rapidly, in the event of an economic downturn, or as a result of the projected astronomical growth of Internet sales. In 2001, some states had begun to experience budget woes.

20 Goolsbee, Austan, and Jonathan Zittrain, “Evaluating the Costs and Benefits of Taxing Internet Commerce,” May 20, 1999, available at www.ecommercecommission.org. Goolsbee and Zittrain also calculated that the lost sales tax revenue could reach the benchmark of 10 percent of total collected sales tax revenues by as early as 2004, under an alternative growth assumption that online sales will double in every year.

21 Study conducted by the University of Tennessee, as quoted by the National Governors’ Association. A summary of the study is available at www.nga.org/Internet/Overview.asp.


Equity Among Socio-Economic Groups. People without Internet access, who tend to be poorer, have to pay sales taxes on the products that they buy from a traditional retailer. By contrast, an online household, which is likely to be richer, can buy the same product over the Internet and avoid paying the sales tax.

At the end of 1998, over 40 percent of American households owned computers, and \( \frac{1}{4} \) of households had Internet access. Yet urban households with earnings over $75,000 were more than twenty times as likely to have access to the Internet as rural households with incomes under $10,000. Whites were more likely to have home Internet access than Blacks or Hispanics from any location.\(^{25}\)

Even if falling computer prices make Internet access more affordable for all income groups, some believe that the digital divide will persist due to differences in education and computer skills. The Commerce Department found evidence that households headed by someone with a college education were three times more likely to have Internet access than households headed by someone with a high school education, and sixteen times more likely to have Internet access than households headed by someone with an elementary school education. Additional barriers to Internet access include lack of credit and lack of a secure place to take delivery of mailed goods. Many of these barriers also exist for catalogue shopping.

Equity Between Traditional Retailers and Internet Retailers. Traditional, “mortar-and-bricks” retailers complain that the sales tax situation confers an advantage on Internet retailers, by reducing the total cost of a book sold over the Internet as compared to the same book sold by a bookseller on Main Street. (Implicit in this argument is an assumption that customers are indifferent about the shipping and handling charges that are added to Internet purchases, because they have saved time and money by not traveling to a retail store.)

This situation also violates the traditional neutrality concerns of tax policy, under which a product should not be taxed differently depending on whether it is sold over the Internet or in a traditional store.

Traditional retailers were largely silent in the Congressional debates of earlier years. In the 2000 debate, however, they were represented by the International Mass Retail Association, the National Retail Federation, the International Council of Shopping Centers, an umbrella group called the e-Fairness coalition, and others.

Recent studies have documented that consumers are indeed sensitive to the Internet’s tax advantage. A survey by Forrester Research of 8,900 online purchases found that 22 percent of survey respondents shopped around to avoid paying sales taxes online.\(^{26}\) The price handicap that results may fall more heavily on certain types of traditional merchants, such as book and clothing sellers.


A study by Austan Goolsbee, of the University of Chicago, found that applying sales taxes to the Internet might reduce the number of online buyers by 24 percent, or even more. Using different model specifications, Goolsbee calculated price elasticities of between 2.3 and 4.3 percent. Goolsbee notes that his results are compatible with empirical studies of consumer behavior in communities that lie on the border between states with high and low sales taxes. In those studies, elasticities of as high as 5 or 6 percent have been found.\(^{27}\)

Certain well-known, national retailers are taking advantage of this customer savvy, by establishing wholly separate web operations that have a much more limited physical presence. These web sites are collecting and remitting sales taxes only in states where the dot.com affiliate has a physical presence.\(^ {28}\) The fact that “clicks and mortars” retailers are taking pains to make their Internet sales tax-free is an indication that retailers believe that offering tax-free shopping to their customers confers a competitive advantage.

These findings have two related implications: (1) the tax-free status of many Internet sales does take business away from conventional retailers; and (2) if more Internet sales were subject to the sales tax, then Internet merchants could lose some revenues as business returned to traditional retailers.

Some sales tax opponents argue that the playing field could be leveled if the states compelled their own citizens to file the use tax. Under the law in most states, if the Internet merchant does not collect the sales tax, then the customer is required to file the sales tax with his or her state. The other side of the coin, of course, is that in many cases the customer is either unaware of the obligation to remit the corresponding use tax, or has no intention of paying it. Prospects for improving enforcement of the use tax are poor, because states lack information on what their citizens buy over the Internet.

While some observers do not dispute that the Internet enjoys a de facto (if not de jure) tax advantage, they argue that this is good public policy. James Gilmore III, who was the Chairman of the ACEC group and is also Virginia’s current governor, wrote that “To the extent tax-free treatment is viewed as a preference or subsidy of the Internet, American public policy should embrace it in order to realize the Internet’s tremendous social and economic potential. Tax preferences and public subsidies of certain business sectors are preceded, especially where

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\(^{28}\) Advisory Commission on Electronic Commerce, “Report to Congress,” April, 2000, page 14. Available at www.ecommercecommission.com. A part of ACEC’s “majority proposal” would clarify the nexus rules so that an Internet merchant’s affiliation with a second taxpayer that had physical presence in a different state would not, by itself, be sufficient to establish nexus requirements for the Internet merchant (see page 19 of ACEC’s Report). This proposal was reportedly forwarded by the chairman of Gateway.com; a key Gateway rival, Dell Computers, reportedly doesn’t collect use taxes in most states because it does not have a network of stores around the country (see David Ignatius, “E-Execs in Loophole Heaven,” Washington Post, Wednesday, March 29, 2000). As noted earlier, the “majority proposal” attracted support from 11 of the 19 panel members, including ACEC’s business members, but failed to win the two-thirds consensus that is required under the ITFA to achieve the status of “recommendation.”
public benefits as great as those generated by the Internet can be obtained.”

Chairman Gilmore went on to cite the tax advantages and public subsidies that are provided to sports teams, shopping malls, and even to “Main Street” retailers in the form of “enterprise zones.”

Sales Tax Administrative Burden on Internet Merchants. The discrimination argument is used on both sides of the debate, however, and some argue that Internet merchants are the real victims of the Quill rules. This is because Internet merchants may be required to calculate sales taxes in multiple states, depending on where they have a physical presence, such as a retail store or a warehouse. Internet retailers argue that “mortar and bricks” retailers do not face this administrative burden, because they calculate all sales taxes at the single rate applicable in the retailer’s own jurisdiction. The more extreme version of this argument is that taxing Internet sales is a form of “protection” that burdens e-commerce in order to shelter traditional retailers.

E-commerce firms with multi-state nexus may have to navigate sales tax systems in up to 45 states and 7,600 local jurisdictions that levy the sales tax. Many of these jurisdictions have different tax rates, different exemptions for goods, such as food or clothing, and different procedures for remitting the tax and conducting audits. Even where the tax base has been harmonized among localities within a state, such as in California, complexity can persist. For example, in California, the difference between taxability and non-taxability turns on distinctions such as those between a sport drink and a sport energy drink, or between an herbal tea and a medicinal tea.

Under current rules, the compliance burden is essentially the same for an Internet seller with nexus in multiple states as compared to a national chain with retail locations in many states. For example, an Internet merchant that has nexus in ten jurisdictions faces a compliance burden that is identical to that of a national retail chain with retail outlets in the same ten locations. Both the Internet merchant and the retail chain are required to collect the use tax on behalf of the ten jurisdictions, and remit the tax to the ten state governments. The difference is in the implementation: the Internet seller has to determine the applicable sales tax rate from the customer’s delivery or billing address, and makes the tax calculation using software housed at the website’s offices. By contrast, the national retail chain calculates the sales tax within the store making the sale, although other administrative functions associated with the sales tax may be performed at another location such as corporate headquarters.

32 An Internet merchant with nexus in multiple jurisdictions could have retail affiliates or warehouses in these jurisdictions. Note that some national retailers have started to claim that their websites operations are not affiliated with their retail operations. Although controversial, the web operations do not collect the sales tax even in those jurisdictions where the retail merchant has a physical presence such as a store.
The degree to which tax collection costs may or may not be different for remote sellers is not known, and deserves further study, according to a project sponsored by the National Tax Association. All types of vendors do face some administrative costs relating to the sales tax system. Studies of the cost to “mortar and bricks” vendors of administering the sales tax range from one to three percent of sales, on average.

Specialized software that minimizes the tax administration burden is used by thousands of large catalogue and Internet merchants that have nexus in multiple states. While some catalogue and Internet merchants have developed their own in-house tax software, such software can also be purchased from at least two providers. On-line order forms can prompt customers for the necessary data concerning delivery and billing addresses, and the software can figure out the appropriate tax rate.

A combination of tax simplification and specialized software is often regarded as the essential quid pro quo among the current proposals to expand merchants’ duty to collect the sales tax. Tax simplification also features in proposals that would roll back the current nexus rules.

The burden of navigating multiple state sales tax systems does not currently fall on the very smallest Internet businesses, which are run out of homes. This is because household businesses, by definition, do not have nexus in any other state (unless they have representatives in other states), and so are not required to collect sales taxes in other states.

An expansion of the nexus rules could extend responsibility for collecting the sales tax to household firms and other very small Internet businesses. This could happen, for example, if Congress required Internet merchants to collect the sales tax on all sales, not just on sales to states in which they have a substantial nexus. The specialized tax software is expensive and could be out of the reach of the smallest Internet merchants. For this reason, most proposals to expand the duty to collect provide an exemption for sellers below some sales threshold volume.

**Infant Industry Arguments.** The case is often made that the Internet is an “infant industry” and that it should be protected from taxes, in order to allow it to develop. According to the Heritage Foundation, taxing the Internet could “kill this revolutionary medium in the cradle.” John Boffa, executive director of the Internet International Trade Council, has said, “We are not saying, ‘Don’t ever tax the Net.’ We are saying that the Internet is a child, and when you have a child, you don’t impose a lot of rules and regulations on it until it has a chance to define itself.”

It is not often clear whether the “infant industry” argument is being applied to specific Internet firms, or to the medium as a whole. Certainly, new firms enter the web every day, just as

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new “mortar-and-bricks” retailers put up signs every day. There is an enormous variety among e-commerce merchants, in terms of the products and scale of operations, and it is not clear that some or all of them would need protection to thrive.

There are good arguments to be made that the Internet as a whole becomes more useful, and attracts more users, after a critical mass of vendors and information providers have established web pages. A “virtuous cycle” is created, wherein a shopper is more likely to turn to the Internet to search for a given product, and more vendors begin to set up web pages. It would be nearly impossible, however, to pin down where exactly this critical mass is located on the trajectory of Internet growth. Moreover, for the Internet as a whole, it is not clear that the medium is still in its infancy. According to the e-Fairness Coalition, the Internet reached 50 million people in four years, compared to radio and TV, which took 38 and 13 years respectively to reach the same number of users.36

Economists generally argue that the infant industry theory applies only when the industry in question is characterized by exceptionally high start-up costs, such as intensive investments in R&D, plant, or equipment that may not pay off for a long period of time. This is the rationale behind patent protection. The reasoning goes that the exceptional economic structure of the company means that the investment would not happen without government protection that allows the firm to earn profits sufficient to pay off the large initial investment. Economists also insist on a second condition to justify infant industry protection: the ultimate payoffs to the broader economy must be higher than the cost of the initial protection.37

One thing to consider is that, if Internet merchants’ initial investment is not considered to be unusually high, then the Internet’s tax-free status provides a tax advantage over “mortar-and-bricks” firms. If removing this tax advantage killed Internet growth, then one would have to conclude that the Internet could not compete on a level playing field. For this reason, economists often frown on protecting “infant industries,” and the federal government, with some notable exceptions, has generally refrained from subsidizing inefficient industries.

It is more likely, however, that e-commerce has many other advantages that will ensure that it continues to thrive, even if the playing field is leveled with respect to taxes. These advantages include the convenience of shopping at home, the ease of comparison shopping, and the economies that Internet retailers can achieve by using warehouses instead of small retail shops in multiple neighborhoods or cities.

**Privacy Issues.** Application of the nexus rules requires that merchants collect the customer’s address for every sale. The customer’s address is necessary to determine: (1)

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37 The infant industry argument should be analyzed separately from arguments that Internet growth is slowed by the administrative burdens imposed on firms that have to administer the sales tax. The argument concerning administrative burdens does not rely on claims that the birth of an Internet company is surrounded by special circumstances, such as intensive investments in R&D. Moreover, to the extent that the sales tax may be administratively burdensome, it would slow the growth of both infant and mature Internet companies.
whether or not the merchant is required to collect the sales tax (i.e., does the merchant have nexus in the customer’s state?); and, if so, (2) the appropriate sales/use tax rate for the customer’s state and locality.

During most Internet transactions for tangible goods, there is no privacy issue. The customer normally provides his or her mailing address during transactions for tangible goods and services that are delivered through the mails. Another avenue is the customer’s credit card information: credit card verification generally depends on whether the merchant can verify the cardholder’s billing address. If the merchant fails to get billing information, and the credit card turns out to be stolen, the merchant may be liable for a charge-back and/or penalty from the issuing bank.

Customer privacy becomes more thorny in the case of goods that are delivered digitally over the Internet, such as digital software or music. In these cases, no mailing address is necessary, because the customer provides only an email address. For the moment, digital goods are generally purchased with a credit card, which offers the retailer an opportunity to refer to the customer’s billing address. Yet when digital goods are delivered over the Internet, it would be relatively easy for the customer to evade the sales tax by lying about his or her mailing address (if the merchant asks the question directly, and if the merchant doesn’t compare the answer to the billing address on the customer’s credit card), or by having the merchant bill and deliver the digital product to a friend in another state, who then forwards it with a click of the mouse.

Internet merchants are concerned that they may be liable for uncollected taxes, in the event that the customer refuses to provide an address, or provides an incorrect address. State governments and others have suggested that when sufficient information is not available to determine the jurisdiction to which a sale should be sourced, there should be a default rule for the seller to follow. For example, under a “throw-back” type of default rule, the merchant would charge the sales tax rate applicable to its own jurisdiction. Following the default rule would relieve the seller from liability related to the sales tax on that particular sale.

The extent to which customers are concerned about privacy is debatable. Purchasers of pornography are probably concerned about anonymity. Yet the person who downloads software from the Internet may want the seller to know his identity, so that he can get help if the software doesn’t download or function properly.

In the future, the development of non-credit card, micropayment systems such as Cybercash and Echarge would seem to increase the anonymity of Internet purchases. As long as there is a centralized payment point, however, it might still be possible for the merchant or the government to learn the customer’s state of residence, in order to calculate the appropriate sales tax rate. Some Internet start-ups hope to go even further, however, by establishing a way to store value on a person’s own computer. This would reduce the current practice of sending a credit or cash card number over the Internet (or paying by telephone), and it would also eliminate the middle man -- the bank that sponsors the credit card or the dot.com that sponsors the micropayment system. For this to happen, encryption services would need to be developed to protect the privacy of money transfers. Encryption would increase the anonymity of e-commerce
transactions, further impairing the Internet merchant’s ability to establish the customer’s location for sales tax purposes (not to mention increasing the customer’s ability to engage in tax evasion or even money laundering). For these reasons, encrypted transactions that transfer stores of value between computers may be a long way from reality.

**Policy Options**

Current policy proposals vary greatly in their approach. During the 106th Congress, several proposals would have prohibited the application of the state sales tax to Internet sales. Other proposals would reform the current system, however, for example by expanding merchants’ duty to collect the sales tax. Simplification of the states’ current sales tax regimes is also a prominent feature of many proposals.

Some of the approaches are compatible and could be implemented jointly. For example, simplification of existing state sales tax regimes has been viewed by some groups as the quid pro quo for an expanded duty to collect.

*Proposals to Abridge the Nexus Rules.* One prominent proposal to roll back the nexus rules was tabled by Dean Andal, who is Vice Chairman of Califorina’s Board of Equalization, a member of ACEC, and an outspoken opponent of new Internet taxation. Andal’s plan would establish a “substantial physical presence” standard as the nexus rule for both sales and use taxes and business activity taxes. The phrase “substantial physical presence” does not appear in the *Quill* decision and is not currently the standard. While the Andal proposal does not define the term “substantial physical presence,” it does establish a negative list of activities within a state that would *not* constitute a “substantial physical presence.” For example, under the Andal proposal, “substantial physical presence” would not be established by a merchant’s web pages, the use of a server in the customer’s state, or sending a sales force into another state.38

Certain of Andal’s proposed exclusions would roll back existing case law concerning nexus. For example, sending sales people into a state to solicit business had been determined by case law to constitute nexus in a state.

Many of Andal’s proposals were included in a bill introduced into the 106th Congress (S. 2401) by Senators Judd Gregg (R- N.H.) and Herb Kohl (D-Wisc.) This bill, which incorporated much of the language from Andal’s original proposal, made no progress towards defining the term “substantial physical presence.” For this reason, the bill could have resulted in additional litigation instead of the clarification that it was purported to supply. The bill included the same exclusions from nexus that were suggested in the Andal proposal.

The Gregg-Kohl bill also sanctioned the “entity-isolation” strategies being pursued by companies that claim that their web operations are unaffiliated with their retail operations. Under the Gregg-Kohl bill, a retail chain could have incorporated its web and retail operations

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separately, and the web operation would have had a use tax obligation only in those states in which the web operation itself had a physical presence. Furthermore, the company could place Internet kiosks in its “mortar-and-bricks” retail stores, and offer tax-free shopping on any purchase that the consumer was willing to wait to have delivered. Difficult questions might arise regarding agency relationships, and additional litigation could result. For example, the role of the retailers’ sales staff in making the sales pitch before consummation of the Internet purchase might be excluded under the bill’s safe harbor for out-of-state sales forces. But how would sales commissions enter into the picture, or advertising by the “mortar-and-bricks” entity with the same name?

Traditional retailers oppose the Andal proposal and S. 2401. Although the Andal proposal and S. 2401 have been characterized by their supporters as freezing and “clarifying” the existing nexus rules, it is clear that the larger goal of such proposals is to roll back existing nexus requirements.

Proposals to Eliminate All Sales Taxes on E-Commerce. A more ardent group of anti-tax lobbyists has urged Congress to ban all types of Internet taxes, including the existing sales and use taxes. This would amount to rolling back the existing nexus rules that were established by the Supreme Court.

Congress could ban the application of the sales tax across state borders, because Congress has authority to regulate interstate commerce under the Commerce Clause of the Constitution. In fact, in the Quill decision, the Supreme Court reasoned that Congress was ultimately better qualified than the Court itself to resolve the issue at hand, i.e., under what circumstances a corporation in one state should collect the sales tax for sales made in another state (see footnote 11). It is debatable, however, whether Congress could prevent states from attempting to impose sales taxes in their own jurisdictions, although this is clearly the goal of some of the anti-sales tax legislation.

In the 106th Congress, Senator John McCain and Representative John Kasich (R-Ohio) introduced similar bills to make permanent the current three-year ban on new, multiple, or discriminatory Internet taxes bills (the McCain and Kasich bills were S. 1611 and H.R. 3252, respectively). These bills would also have prevented states from imposing any sales or use taxes on any goods acquired over the Internet – possibly even intra-state Internet purchases.

State governors James Gilmore of Virginia, who served as the chair of ACEC, and Massachusetts Governor Paul Cellucci are also strong opponents of Internet sales taxes, although they are in the vast minority among their peers. Governor Gilmore has issued a proposal to ban all sales taxes on remote retail sales, and to abolish the federal 3 percent excise tax on telephone service. (The term “remote sales” was undefined in the proposal, and at the time the Governor

40 S. 1611 is available at www.thomas.loc.gov. Additional information on the McCain bill is available at www.senate.gov/~mccain/taxfree.htm.
41 H.R. 3252 is available at www.thomas.loc.gov.
said that it could mean “anything we want it to.” It probably refers to all Internet sales.) In return, the federal government would give states $1.7 billion each year, and $3.4 billion ten years from now, to make up for the lost revenue. Governor Gilmore also proposes to reduce the “digital divide” between rich and poor by permitting states to use surplus welfare funds to buy computers and Internet access for the poor. This aspect of the governor’s plan was incorporated into the “majority proposal” of the ACEC Commission, which Gilmore chaired.42

Thus, under the McCain, Kasich, and Gilmore proposals, a person in the market for a new car could do his or her comparison shopping in the showroom, but avoid the sales tax by placing the actual order over the Internet. Currently, the customer’s home state is able to collect the use tax on out-of-state auto sales, because registering the vehicle notifies the state that a taxable purchase has been made; the McCain and Kasich proposals would preclude the use tax in all Internet sales.43 The Center on Budget and Policy Priorities (CBPP) points out that many traditional retailers could easily restructure their operations so as to re-characterize their in-store sales as Internet sales, simply by installing an Internet-linked computer on the store’s own premises and arranging for delivery to the customer’s home – possibly even within the same state.

Another anti-sales tax group has gathered under the umbrella of the e-Freedom Coalition, which represents conservative groups such as Americans for Tax Reform and the Heritage Foundation. The e-Freedom Coalition has proposed a ban on sales taxes on e-commerce, and repeal of the 3 percent federal excise tax on telecommunications. If sales taxes are to continue, and to be collected online, the e-Freedom Coalition would support a proposal that rolls back the current nexus rules, along the lines of Andal’s proposal, and that preserves privacy rights.44

ACEC’s unofficial, “majority” proposal could be interpreted by skeptics as a plan to undermine the existing sales tax system. As noted earlier, a group of the 11 panelists in ACEC approved a proposal calling for a five-year moratorium on all taxation of “digitized goods and products and their non-digitized counterparts.” This means that all hardback books, paperbacks, CDs and shrink-wrapped software, as well as their digitized counterparts, would be exempt from all sales taxes during the moratorium. This would amount to a roll-back of existing law. During the five-year moratorium, state and local governments would be required to work together to develop a simplified sales tax structure, featuring one sales tax rate per state, uniform tax base definitions, and simplified filing and audit procedures. (In fact, even before the ACEC “majority” proposal, state and local governments had begun work on a simplified, technology-driven structure, as will be discussed below.) When completed, the simplified system would be evaluated by another commission that would subsequently make a recommendation concerning nexus to the Congress. Meanwhile, the simplified sales tax regime could be imposed at the end

of the five-year moratorium and after the second commission had completed its review – that is, unless a great roar from consumers made it impossible to re-impose the sales tax on tangible books, CDs, software and their digital counterparts.

The prospects that Congress will impose an outright ban on Internet sales taxes have diminished over the past year, as the Congressional debate has been transformed. Traditional retailers, who were largely silent during the past few years, have rallied their forces and begun to lobby their cause more effectively. In mid-April, 2000, for example, traditional retailers influenced the Senate Commerce committee to defer a more temperate bill from Senator McCain (S. 2255) that would merely have extended the ITFA moratorium on access taxes and discriminatory taxes for another five years. The retailers managed to persuade the legislators that it was unwise to extend the moratorium without addressing the issue of inequality between traditional and Internet retailers.

**Expanding Internet Merchants’ Use Tax Collection Duties.** Many in government, and even some in industry, believe the duty to collect the use tax should be expanded, rather than restricted or abandoned. Along these lines, a group of 170 academic specialists in tax policy cosigned a letter to ACEC urging that the Commission adhere to several principles, including the following: “Remote sales should, to the extent possible, be taxed by the state of consumption, regardless of whether the vendor has a physical presence in the state.”

Proposals to expand merchants’ duty to collect the use tax generally take a two-pronged approach. The first prong is to increase or expand the duty of Internet merchants to collect the sales tax. The essential political tradeoff, and the second prong, is that the states would work together to harmonize and drastically simplify their sales tax systems.

A bill introduced into the 106th Congress by Senator Dorgan (S. 2775) would have required Internet and catalogue merchants to collect the use tax on sales to all states that adopted a simplified sales tax system. States that did not adopt the system would have been unable to require remote merchants to collect the use tax. So as not to overburden small firms, under the Dorgan bill, all remote sellers falling below a de minimus threshold of five million dollars in gross annual sales would have been exempted from the requirement to collect the use tax.

The North American Retailers Association submitted a proposal to the ACEC that would expand the nexus rules, in return for which states would simplify their sales tax system. The retailers’ proposal would authorize states to require sellers with no physical presence in a state to collect sales taxes, but in turn the states would have to establish uniform definitions of taxable transactions, and establish a single rate per state. This could include establishing a mechanism

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45 “Appeal for Fair and Equal Taxation of Electronic Commerce,” letter to the Advisory Commission on Electronic Commerce, signed by 170 academic specialists in tax policy, December 15, 1999. Available at www.nga.org/Internet/EconAppeal.asp. This letter to ACEC was organized by Charles E. McLure Jr., of Stanford’s Hoover Institution, who also organized a separate letter arguing against special interest provisions for electronic commerce.
by which local governments would share in the tax revenues that were collected and remitted at the state level.46

Robert Strauss of Carnegie-Mellon University has suggested several possible mechanisms through which the federal government could help states to enforce an expanded duty to collect the use tax on remote sales.47 Strauss’ plan also envisages action by state governments to simplify their use tax regimes. Under one mechanism, the federal government could impose a 10 percent levy, which could be structured either as an excise tax or a penalty, on catalogue and Internet vendors that did not agree to collect and remit use taxes on remote sales. Under another mechanism suggested by Strauss, remote merchants would be unable to take the historical credit for state unemployment taxes against the federal unemployment tax, unless they demonstrably agreed to collect and remit use taxes on remote sales. This second scheme relies on the fact that remote sellers of any consequence have employees and are hence required to participate in both state and federal unemployment compensation programs.

As proposed by Strauss, the government would use one of these mechanisms to enforce use tax collection only on behalf of states that had simplified their use tax regimes. This would ensure implementation of the political trade-off involving the expanded duty to collect in return for state use tax simplification. This would also enable all non-sales tax states to remain sales tax free. Also under the Strauss plans, the federal government would function to enforce the system of state and local sales taxes, but it would not collect tax monies itself or be involved in transferring it back to the states. The various Strauss plans should be distinguished from a national sales tax. Strauss is concerned that the Hollings mechanism could put extreme pressure on the states to adopt a uniform tax rate of 5 percent.

It seems unlikely that the current Congress will take steps to expand greatly a merchant’s existing obligations to collect the sales tax. The chances would be improved, however, if states were to take substantial measures to simplify and harmonize the diverse state and local sales tax regimes.

Using Technology to Reduce the Burden on Merchants. One way to reduce the administrative burden that the current system places on Internet, catalogue and national retailers is to employ technology. It is even possible to design tax collection technology that interfaces seamlessly with the website’s credit card processing system, so that the customer does not know that it is there.

The National Governor’s Association (NGA) has developed a plan that would combine technology with tax simplification.48 Developed by Utah Governor Leavitt and others, the

NGA’s “Streamlined Sales Tax System” would retain the existing nexus laws governing sales taxes, and hence would not impose new sales tax collection responsibilities on merchants. Under Governor Leavitt’s plan, the states would devote 6-7 years to an effort to harmonize and adopt the same product definitions and audit procedures. (The NGA proposal does not extend to harmonizing sales tax rates, or lists of taxable goods and exempt goods, either within states or across states. The frequency of tax rate and tax base changes would be restricted to once a year, however.) A “consensus board” of state representatives would review any proposals for changes to a state’s tax regime. Presumably, these requirements relate to the need to keep the tax software current.

There would be no need for Congressional action, because of the voluntary nature of participation by sellers and states. States that did not adopt the simplified system would not have the ability to collect taxes on remote sales.

As originally proposed, the NGA proposal would relieve the merchant from all duties involved in collecting either the sales (in-state) or use (out-of-state) taxes. Instead, merchants could choose, voluntarily and free of charge, to transfer all responsibilities for calculating, collecting, reporting, and paying the sales and use taxes to a “certified service provider” (“CSP”). The only obligation imposed on participating sellers would be to integrate their computer systems with that of the CSP. The seller would not be responsible for determining the taxability of a transaction, or handling tax monies, and thus the seller would not be subject to audit. The CSP would perform the sales tax calculations contemporaneously with the transaction, so that the buyer would be informed of the tax collection before completion of the transaction. States would assume all of the costs of this system, contracting with the private sector CSPs to develop the necessary software. The way that states and localities reimburse CSPs could be negotiated – i.e., as a flat per transaction rate, a percentage rate, or a combination.

Opponents of the NGA proposal object that the CSPs could potentially accumulate extensive personal information about the shopping behavior of Internet users. In addition, some merchants could be reluctant to turn over proprietary sales information to a CSP, because the CSP could leak the information to competitors. To address privacy concerns, the NGA’s proposal stipulates that a CSP would never possess a customer’s personal identifying information, such as name, address or credit card number. While the tax rate assignment would be based on an individual street address, the merchant’s server would convert the buyer’s address to a taxing district identifier before the information was transmitted to the CSP.

Partly in response to privacy concerns, the Streamlined Sales Tax Project has expanded the scope of its proposal to consider four technical models for sales tax collection. CSPs were included in the testing stage of a pilot software project that began in the fall of 2000 in North Carolina, Kansas, Michigan and Wisconsin. A second model under consideration would still transfer responsibility for calculating the tax rate to a state-certified software provider, but the merchant would continue to file and remit the sales tax to the appropriate jurisdictions. Third, for large retailers who already employ sales tax software, the Project is considering a certification process under which the merchant could continue to use its own software. Fourth and finally, the Project is exploring the treatment of merchants who do not use certified tax collection software.
Unlike merchants under the first three plans, merchants without certified software would continue to be held liable for mistakes in collecting the sales tax. Non-participating merchants would, however, enjoy other benefits from the Streamlined Sales Tax system, such as uniform tax base definitions.

Opponents of the NGA plan also allege that the idea amounts to a national sales tax, because changes in state sales tax regimes would be subject to the approval of a “consensus board,” which would encourage the harmonization of sales tax rates, product bases, and exemptions. Additionally, all states would be compelled to participate in the CSP system. It is also charged that CSPs might even begin an evolution towards imposing higher taxes on “bad” products, or products from “bad” nations. Critics also charge that if this system were imposed on all sales, including those in traditional stores, then shoppers would no longer be able to drive to neighboring states to seek out lower tax rates, removing what some view as an important constraint on state taxing authorities. Some of these criticisms may be unjustified, as the NGA plan is explicitly designed to accommodate the existing system of multiple tax rates and taxable goods.

Many opponents of the NGA proposal, however, do not give a reason for rejecting it, and this may be a measure of the proposal’s strength. Surprisingly, ACEC’s Final Report does not even mention the NGA proposal, although ACEC did consider the proposal. The e-Commerce Coalition simply states, without saying why, that “merely shifting the burden for collection from the vendor to any other party to the transaction is not a viable solution.”

As of February, 2001, 30 participating states had signaled their intent to participate in the Streamlined Sales Tax Project through either legislation or executive order. An additional 8 “observer” states were participating in project discussions. Several working groups have begun to address issues such as sales tax bases, exemptions, and sourcing rules. In December 2000, the members of the Project agreed to forward the project’s model legislation to the states for the 2001 legislative session. The model legislation authorizes state governments to participate in the Project, and also contains some sourcing rules and uniform definitions for food and clothing. The Project still has work to do in developing definitions and resolving issues regarding implementation.

**Simplifying and Harmonizing State Sales Tax Systems.** There is enormous potential for simplifying the existing system of state and local sales and use taxes, in order to make it less onerous to merchants. Work has been underway on tax simplification within several groups.

 Often, simplification of the sales tax system is discussed in tandem with proposals to expand the duty to collect. Simplification has also been discussed as an element of technology-based proposals.

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Sales and Use Tax Rates. The National Tax Association sponsored an in-depth study of the issue of sales tax reform. That group reached a tentative conclusion that:

There should be one tax rate per state which would apply to all commerce involving goods or services that are taxable in that state. Provision must be made to ensure protection and equitable distribution of revenues to local jurisdictions.51

(None of the National Tax Association project’s recommendations is to be considered final, because the group did not agree on a broad package of reforms.)

A single sales tax rate per state would minimize the burden on sellers, and recognize that only limited address information may be available in some cases, such as digital books or music. Instituting a one-state, one sales tax rate system would probably not be easy, however. Many issues would arise, such as revenue neutrality and equity between communities within the same state. In addition, there could be potential windfalls or shortfalls to local communities after the state divvies up the proceeds.

Harmonizing the Base of Goods Subject to the Sales/Use Tax. An obvious way to relieve the administrative burden on retailers would be to ensure that the same lists of goods were taxable, or exempt from taxation, in every state. This would greatly simplify the task facing merchants.

Most restructuring proposals would not go this far, however. This is because the issue of what products to tax is wrapped up in the fundamental debate over states’ rights and fundamental policy choices states have made to mitigate the regressivity of their sales taxes (e.g., by exempting food). For this reason, the NTA and other groups have taken the view that the states will continue to tax, and exempt, different lists of products.

The most prominent harmonization proposals would start with states making a concerted effort to harmonize, across all states, the definitions of goods that are taxable. This is the starting point of the NGA plan, which would require states to agree on and adopt the same classifications systems, product definitions, and audit procedures, within 6-7 years. The NTA focused on ways to create a uniform “menu” of goods and services that all states would use to define products for sales tax purposes. The NTA examined various possibilities for developing this menu, including the new United Nations Central Product Classification System.

The Multistate Tax Commission, an umbrella group of 21 state government members and 23 associate state government members, is also working on a project to harmonize aspects of the states’ sales tax regimes. For example, the MTC is considering the possibility that all jurisdictions within the state use the same taxable base and exemptions as the state.52

Establishing the Customer’s State and/or Locality. Before an Internet merchant can apply the appropriate state tax rate – even before the merchant can decide whether the nexus rules apply to a particular sale – the merchant must learn the customer’s address. When tangible goods are purchased over the Internet, the address is always known because it is the customer’s delivery address. When software or other digital goods are purchased, the customer doesn’t need to provide a delivery address, although he or she generally provides a credit card billing address.

One option that has received some press play would involve sourcing a sale to the customer’s zip code. This would help to preserve sub-state taxes. Unfortunately, zip codes do not always correspond with the boundaries of local tax jurisdictions.

Under a one-tax-rate-per-state system, sourcing an Internet sale to an individual city or county would not be required. The merchant would only need to know the customer’s state, and customers might not view this request as an intrusion on their privacy.

In the case where address information is missing, the NTA discussed the development of default rules, to ensure that there is a set of rules applied to each sale. For example, in the absence of a shipping address, the Internet merchant could default to the billing address of the buyer’s credit card or, failing that, to a “throw-back” rule that sources the transaction to the state of sale.

Simplification of State Tax Administration. Tax administration includes registration, filing returns, tax remittance and audits. The NGA proposal would employ special software to transfer all responsibility for these functions from the Internet merchant to a “Certified Service Provider.”

In contrast, the NTA panel reached the tentative (in the absence of broad agreement among panel members on other reforms) conclusion that it was more realistic, at least in the short term, to assume that Internet merchants will continue to interact directly with different state tax administrations. The NTA therefore focused its efforts on improving the quality of that interaction. The NTA saw a number of potential areas for reform, including:

- harmonizing states’ sales and use tax return forms;
- improving merchants’ ability to file state sales and use tax returns electronically;
- decreasing the frequency with which state sales and use tax returns are filed (currently, many states require monthly returns); and
- establishing simplified audit, assessment, and appeal procedures for multistate sellers.

There was widespread agreement in the NTA project that vendors should be compensated for administering the sales tax. Currently, 27 states provide an allowance to vendors for collecting the sales tax. What share of the costs should be assumed by government was not agreed. As noted earlier, studies of the cost to vendors of administering the sales tax range from 1.02 percent to 3 percent of sales, on average.
Another proposal considered by the NTA involves “base state tax administration,” which is the approach that has been successfully implemented by all states for the fuel tax on interstate motor carriers. The Internet merchant would be responsible for collecting tax on its sales to any state in which it had nexus, but the merchant would file a single tax report only with its base state. The tax authority in the base state would be responsible for distributing the revenues to all other interested jurisdictions. Opponents argue that state sales taxes are much more complex than the fuel tax, and that state tax administrations are not equipped to handle these complexities.

The Source-Based Sales Tax. Under a source-based sales tax, the sales tax would be imposed at the point of sale, rather than at the point of consumption. The sales tax rate in the merchant’s state would apply to the sale. Thus, a purchase from Amazon.com would be assessed sales taxes for the city of Seattle and the state of Washington.

Traditional retailers and state and local governments have generally been reluctant to accept a source-based tax as a replacement for the current, consumption-based sales tax system. Critics charge that a point-of-sale tax would amount to a tax on production and exports, and could lead to economic distortions favoring sellers that located in a jurisdiction without the tax. Some academics even believe that a source-based tax would encourage a “race to the bottom,” as states competed to lower their tax rates, and eventually eliminated them altogether.

Not everyone views tax competition as a problem, however. The Heritage Foundation, which has endorsed the source-based sales tax as a second-best solution, if the sales tax is not abolished altogether, writes that “Such a system would provide a check on excessive taxation by encouraging vigorous interstate tax competition, since companies could ‘shop around’ for more hospitable tax locales if their current jurisdictions became over-zealous tax collectors.” The Cato Institute also supports a source-based tax.

Some groups see benefits to a limited use of a source-based tax. As noted earlier, the project sponsored by the National Tax Association considered using the source-based tax as a default rule for cases where a merchant could not obtain the customer’s address. Under this so-called “throw-back” default rule, the merchant would apply its own state’s sales tax rate to the purchase.

Replacing the Sales Tax with a Value-Added Tax. The sales tax and the value-added tax are both forms of consumption taxes. A value-added tax on consumption, properly administered,
The value-added tax may be applied to the incremental increase in the value added, at every stage of production, to a consumer product. The base of a consumption-based value-added tax is defined as the firm’s gross receipts minus the value of all its purchases of intermediate products (such as materials and goods in process) as well as its expenditures on capital goods, such as plant and equipment. Because each firm can deduct the cost of capital expenditures and intermediate goods, the tax base becomes the value of consumer goods that the firm has produced. Additionally, a value-added tax system could avoid sales taxes on business-to-business sales, which is a goal of current state sales tax regimes. To date, Michigan and New Hampshire are the only states to administer a state-level value-added tax.

One drawback of a credit-invoice method value-added tax, however, is that it could be very complex to administer on an intra-state basis. It requires careful recordkeeping and administration, and moving money between the states could also become more complicated. In addition, replacing the current sales tax with a value-added tax would do nothing to resolve the existing issues concerning nexus.

Hal Varian, who is the Dean at U.C. Berkeley’s School of Information Management and Systems, has proposed replacing all state and local sales taxes with a revenue-equivalent state income or consumption tax. Most states already levy an income tax, so the administrative infrastructure is already in place in these jurisdictions for a supplemental tax on income. If it is seen as particularly desirable to tax consumption, rather than income, then states could offer taxpayers a deduction for their measured savings. Because consumption equals income minus savings, this would be equivalent to a very broad-based sales tax. Varian argues that there would be little difference in incidence between a state income tax and proposals to tax Internet sales, because both are generally based on the place of residence. (There might, however, be a difference for people who regularly travel to a mortar-and-bricks store in another taxing jurisdiction.)

A National Sales Tax. Senator Fritz Hollings (D - S.C.) proposed a radical reform of the current sales tax system in the 106th Congress (S. 1433). Hollings’ bill would have imposed a five percent federal sales tax on all retail sales made through the Internet, by catalog, or by direct sales other than a traditional, storefront merchant. State and local jurisdictions would have continued to administer their own sales taxes; an exemption from the five percent federal sales tax was provided for the case where an Internet merchant collected the sales tax for a customer in the same taxing jurisdiction. The U.S. Treasury would have distributed the revenues from the federal sales tax back to each of the 50 states, the District of Columbia, and Puerto Rico, according to a formula based in part on poverty and school-age population.

Opponents of a single, uniform sales tax at any level of government argue against a national sales tax on the grounds that “Electronic commerce empowers consumers to take advantage of competitive tax rates in other jurisdictions and thus serves as a necessary constraint

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on excessive government. The flexibility in moving capital and economic activities around the globe offered by the Internet at last makes it possible to sharpen those disciplining influences.⁶⁶⁰

CONCLUSIONS

Clearly there is a wide gap that needs to be bridged between the opponents of any type of sales tax on the Internet and the forces for retaining but restructuring the current system of state and local sales taxes. The ACEC panel failed in this task, and instead produced a very divisive report that was denounced by ACEC’s three members from the Clinton Administration.⁶¹ ACEC’s final report did not even mention one leading policy option, the widely-known NGA proposal for a Streamlined Sales Tax system.

Congressional action may be needed to resolve this issue, as the Supreme Court suggested in the Quill case. On the other hand, the proposal from the NGA, which is supported by many state and local governments, could be implemented by states and merchants on a voluntary basis, and without any Congressional action.

In some cases, the opposing views have deep, philosophical roots. Many critics of the sales tax are pursuing a broader anti-tax agenda. For supporters of the sales tax, the key issue is the need to preserve state and local sovereignty by defending state and local sources of revenue. This divergence of views has given rise to some fairly high-flying rhetoric.

It seems clear that the current sales tax system, characterized by limited nexus requirements, cannot endure. Perhaps the most pressing argument for change is that the current system has created two types of inequities, and these inequities are deepened each day as the Internet continues to grow. First, people without Internet access, who tend to be poorer and less well-educated, are unable to avoid the sales tax on goods. By contrast, their wealthier peers can avoid sales taxes by shopping on the Internet (often, these shoppers have no intention of paying the complimentary use tax).

The current system has also created inequity between “mortar and bricks” retailers and Internet retailers, where the latter can offer goods at prices that do not reflect the sales tax. If nothing is done to reform the current sales tax system, the sales tax could begin to resemble a tax on poorer people that is collected by traditional merchants.

States’ argument that their financial situation will suffer as a result of untaxed Internet commerce also seems compelling. Although state budgets were by and large sound in recent years, this picture does not reflect the tremendous potential for growth in Internet sales, nor does it reflect the potential for an economic downturn. To the extent that state and local government sovereignty continues to be an important goal, steps must be taken to ensure the continued financing of state and local governments.

Many arguments have been levied against the existing sales tax system. Some of the criticisms are unjustified, for example the charge that the sales tax amounts to “taxation without representation.” Other criticisms are of dubious merit, such as the argument that the Internet is an “infant industry” that must be protected in order to allow it to develop. Probably the strongest argument to be made against applying state sales and use taxes to the Internet is that the administrative burden could overwhelm small retailers. The very smallest Internet retailers, those run out of households, do not currently face this burden because they do not have a “substantial nexus” in more than one state. But efforts to redefine the concept of physical presence to include a web page, or other efforts to expand the nexus rules, have the potential to affect even the very smallest household firms. For this reason, most proposals to expand the duty to collect the sales tax contain *de minimus* thresholds.

The administrative burden facing Internet retailers could be greatly reduced through a combination of technology and a dedicated effort on the part of states to reform their systems. This two-pronged strategy has the backing of numerous state and local governments, as well as some well-known commentators like Henry Aaron. Skeptics counter that the states are unlikely to agree on the necessary reforms. Whether this skepticism is justified remains to be seen. Several umbrella groups that include state participants, such as the National Governors Association, the National Tax Association, and the Multistate Tax Commission, have already identified many areas of potential reform. Moreover, states may be driven to compromise on reforms by the compelling need to preserve their own tax bases.

Writing that, “There is a point in the life of every problem when it is big enough to see and small enough to solve,” Utah’s Governor, Michael Leavitt, believes that the current early stage in the changing retail model is a good point at which to begin implementing the NGA’s plan for a streamlined, technology-based tax system. Of course, some opponents of the NGA’s plan see another solution in abolishing the sales tax altogether.

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# TAXONOMY OF LEADING PROPOSALS

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<tr>
<th>Taxonomy</th>
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<td>Allow states to use TANF funds to provide computers and Internet access to needy families.</td>
<td>No Internet tariffs.</td>
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<td>ACEC “majority” proposal</td>
<td>Five-year moratorium on sales tax on digital goods and services (digital books and software), as well as their non-digital counterparts (hardbacks, paperbacks, CDs).</td>
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<td>States can use the five-year moratorium to agree on reforms. A Congressionally-appointed panel would review the states’ reform plans and make recommendations on nexus.</td>
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<td>Andal, Dean (ACEC member and Vice Chairman of the California Board of Equalization)</td>
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<td>Establish a “substantial physical presence” (undefined) criterion for nexus. Enumerated exemptions from nexus would in some cases roll back existing case law.</td>
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<td>Consumption-based Value-added Tax (e.g., Michigan)</td>
<td>Abolish sales tax. Seller pays value-added tax on value of gross receipts less intermediate inputs and investment in plant and equipment.</td>
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<td>Abolish sales tax. Individuals pay tax on the difference between income and saving. Tax</td>
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<td>Consumption tax (Hal Varian proposal)</td>
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<td>Dorgan bill (106th Congress, S. 2775)</td>
<td>is collected through state income tax forms.</td>
<td>States would dramatically simplify their sales tax regimes. Internet and catalogue merchants with gross sales above a de minimis level would be required to collect the use tax for sales into all states that adopted the simplified sales tax system.</td>
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<td>E-Freedom Coalition</td>
<td>Ban sales taxes on e-commerce.</td>
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<td>If sales taxes are collected on-line, move from consumption-based sales tax to source-based sales tax (levied at the point of sale).</td>
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<td>Gilmore, James Governor of Virginia and Chair of ACEC</td>
<td>Ban all out-of-state sales taxes on Internet transactions.</td>
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<td>Allow states to use TANF monies to provide computers and Internet access to poorer citizens.</td>
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<td>Gregg-Kohl bill (106th Congress, S. 2401)</td>
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<td>Incorporates much of the language of Andal proposal concerning a “substantial physical presence” requirement for nexus and related exemptions (see above). Sanctions entity-isolation strategies under which a national</td>
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<td>Action</td>
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<td>Abolish Sales Taxes on Internet Sales</td>
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<td>retailer’s unaffiliated web operations have nexus only in those states in which the web operation has a substantial physical presence.</td>
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<td>Heritage Foundation</td>
<td>Ban sales taxes on e-commerce.</td>
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<td>Hollings bill</td>
<td>5 percent federal excise tax on all Internet sales, with the proceeds allocated among the states.</td>
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<td>Kasich-McCaIn bills</td>
<td>Permanent ban on all Internet taxes, including the sales tax.</td>
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<td>McCaIn bill</td>
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<td>Multistate Tax commission</td>
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<td>National Governors Association</td>
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<td><strong>(this proposal is also supported by the e-Fairness Coalition of traditional retailers)</strong></td>
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<td>software to aid in collection. “Trusted Third Parties” perform all tax collection duties (other technological mechanisms are also being explored).</td>
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<td>North American Retailers Association</td>
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<td>Expand the nexus rules to require all out-of-state merchants to collect the sales tax, regardless of physical presence. In return, states simplify their sales tax regimes, including a single tax rate per state.</td>
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<td>Robert Strauss, Carnegie-Mellon University</td>
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<td>In return for state action to simplify sales tax regimes, duty to collect would be expanded. The Federal government would assist in collecting use taxes from remote sellers under several possible mechanisms.</td>
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