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Acknowledgments

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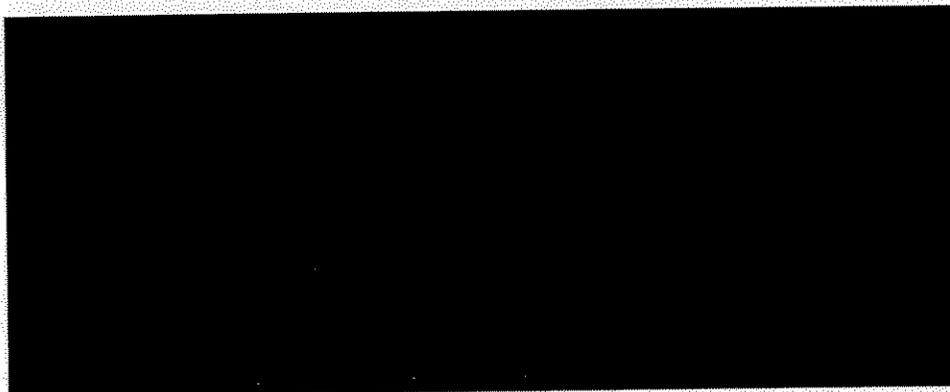
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June 2000

Streamlined Sales Tax Project

Recognizing the need to simplify the state sales and use tax system, states have begun a project called the "Streamlined Sales Tax System for the 21st Century." The project – comprised of state governments with input from local governments and the private sector – is intended to overhaul the existing sales and use tax system to better accommodate interstate commerce, especially the changes presented by the growth of electronic commerce. The project is aimed at developing a substantially simplified sales and use tax system that employs emerging technologies to remove or reduce the burden on sellers for collecting the taxes, with the states contributing substantially to the financing of the streamlined system. The project is an outgrowth of a proposal made by the National Governors' Association, the National Conference of State Legislatures and other state and local organizations to the ACEC in December 1999.

Project Meetings and Participants. The Project has held four meetings, and monthly meetings are planned throughout the summer. It is pursuing two immediate goals: (1) To develop a package of structural and legal simplifications by Fall 2000 which, after a substantial period for public comment, can be presented to state legislatures in 2001; and (2) To develop one or more pilot or test projects that can be deployed in Fall 2000 to evaluate various technological and related aspects of the system. Project meetings to this point have focused on organizing and developing rules for operation of the project, identifying the issues to be addressed and organizing work groups to address them, and beginning the analysis of the issues and development of alternative approaches to address them.

Project meetings are routinely attended by about 60-65 government representatives from roughly 30 states. The project is directed by a Steering Committee of state tax agency representatives. The Steering Committee is co-chaired by Diane Hardt of Wisconsin and Charles Collins of North Carolina. Other members are Nancy Taylor of Michigan, Jack Kopald of Tennessee, Scott Peterson of S. Dakota, Carol Fischer of Missouri, and Johnnie Burton of Wyoming. To address the issues identified, the project has formed four work groups: Tax Base and Exemption Administration; Tax Rates, Registration, Returns and Remittances; Technology, Audit and Privacy; and Sourcing and Other Simplification Issues.

Direct participation in the project is limited to states, broken down into two groups, "participating" states and "observer" states. Participating states, now numbering approximately fifteen, are those whose legislatures have enacted legislation enabling the states to participate in the project or whose governors have issued an executive order or similar authorization for commitment to the project. Observer states, now at about fifteen also, are those who wish to participate in the work done by the project, but have not made the formal commitment to the

project indicated by the participating states. Representatives of observer states may participate in the working groups, but voting is limited to participating states.

The project has encouraged input from the private sector. Each meeting of the project (i.e., those portions involving all participants) has a period for public comment, during which anyone is free to comment on the workings of the project. The private sector has also been used as a resource for deliberations of the work groups even though work group meetings themselves are not public, open meetings. And, the private sector has been invited to provide demonstrations of technologies that might assist in reducing the burden on sellers for collecting and remitting sales and use tax. In coming weeks, the project will develop a roster of resource persons for the work groups to consult with on an ongoing basis.

Further information on the Project is available at its Web site <www.streamlinedsalestax.org>.

Project Principles and Activities. The guiding principles of the project are substantial simplification of the state sales and use tax system, deployment of new technologies to ease the burden on sellers for collecting and remitting the taxes, and substantial state financing of the system. Other principles integral to the project are that the privacy of consumers be protected and that participation by sellers be voluntary.

Simplification. The project has committed itself to the simplification of all aspects of the states' sales and use tax systems, including, but not limited to, the following major areas:

- **Tax base.** The project is focusing on developing definitions for key parts of a sales tax (e.g., sales price, tangible personal property) as well as for certain commonly exempted items (e.g., food and clothing).
- **Exemption administration.** The project is attempting to reduce the burden of exemption administration by examining the ability to provide sellers with access to a data base of exempt purchasers (where available) to verify an exemption certificate and shifting responsibility for policing exemptions to the states where the seller accepts a properly completed certificate.
- **Tax rate administration.** The project is examining various methods for simplifying local sales and use tax rate structures as well as easing the burden for sellers when varying local option use tax rates are utilized. It is particularly examining the ability of various software systems to deal with the complexity of local rates and the use of safe harbors to protect sellers making a good faith effort to determine applicable local tax rates.
- **Centralized registration and simplified returns and remittances.** The project is analyzing various means of simplifying the registration process through a uniform registration form or a centralized approach that would meet the needs of all states. The project is also examining the potential for developing a uniform sales and use tax return and standardized remittance procedures. It is also examining the appropriate structure of due dates for returns and remittances.
- **Sourcing and Other Simplifications.** The project intends to develop uniform rules by which all participating states would source sales, i.e., assign transactions to particular taxing

jurisdictions for tax purposes. The project is also examining such issues as a uniform bad debt rule and uniform rounding rules.

Employment of technologies to be certified by the state. A second principle of the project is the use of emerging technologies to reduce the burden on sellers. A key component will be certification of the services provided by software and service providers by the states involved in the project. The project intends to develop a mechanism for evaluating and certifying that a tax calculation service or software functions at a level adequate to be relied upon by sellers. If a seller employs a certified tax calculation service, it would be held harmless for – i.e., not subject to audit and assessment – tax due as a result of mistakes made by that certified service. The level of “safe harbor” will vary with the type of certified service employed by a seller.

Paying for the system. While it is currently too early in the process to know with any certainty what kind of costs participation in this streamlined system might require of sellers or, for that matter, states, the project is committed to financing as much of the system as it reasonably can. It is anticipated that the primary method of financing sellers’ participation in the system will be through vendors’ compensation – i.e., allowing sellers, or their tax service providers, to retain a portion of the sales and use tax collected -- as is currently employed in many states -- but other mechanisms are also being considered.

Privacy concerns. Provisions will be included in all aspects of the project’s work to ensure that personal information is not unnecessarily gathered and is not improperly used by persons acting on behalf of the states. Tax administration agencies will not come into possession of personal identifying information for an individual paying tax at the time of a transaction. All that will be necessary to source a transaction will be an indication of the lowest level of taxing jurisdiction applicable – e.g., county, municipality, etc. – and tax calculation service providers will be prohibited from using personal information for any non-tax-administration purpose.

Voluntary participation of sellers. The Streamlined Project is being developed under a framework that neither requires nor anticipates any change from the current constitutional nexus requirement of a physical presence in a state. A seller’s participation in the project would be entirely voluntary – which leads to the question of why a seller that is not currently collecting sales and use taxes on its sales into a state might now voluntarily take on that responsibility. The project believes that such sellers would have a variety of incentives to join the project, including the following:

- ***Impact on business decisions.*** As electronic commerce expands, sellers appear to be moving toward a combination of electronic and “bricks and mortar” operations. Reducing the burden of use tax collection should reduce the influence of tax factors in locating facilities and other business decisions.
- ***Tax amnesty.*** The project is currently considering a variety of options of incentives beyond vendor compensation, such as an amnesty from potential assessments resulting from the assertion of nexus by the project states.
- ***No nexus for other taxes.*** Any legislation produced by the project will stipulate that a seller’s registration, collection and remittance of tax as part of the project will have no impact on a determination of nexus for the purposes of any other tax.

Next Steps

The project anticipates continuing its monthly meetings throughout the summer to continue developing approaches to simplification. The schedule calls for the release of a package of recommended simplifications for public and state comment by Fall 2000. Following comment and refinement, model legislation will be developed for the 2001 legislative sessions. In addition, several states anticipate entering into one or more pilot or test projects with interested software providers and retailers in Fall 2000. Results of the tests will educate future decisions and deployment of the project.

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June 2000

Electronic Commerce Activities ACEC and Federal Legislative Matters

Advisory Commission on Electronic Commerce

The Internet Tax Freedom Act established an Advisory Commission on Electronic Commerce that will consist of 19 members, including the Secretaries of Commerce and Treasury and the U.S. Trade Representative. There are eight representatives of state and local government and eight representatives of the electronic commerce industry. Members were appointed by the congressional leadership.

The Commission was formed to study various aspects of the taxation of electronic commerce as well as other comparable intrastate, interstate and international sales activities. The subject matter may include: (a) trade barriers in international commerce; (b) the impact of voice transmission on telecommunications excise (federal) taxes; (c) model State legislation to promote uniformity and simplification of state and local sales taxes; (d) administration of consumption taxes in other countries; (e) other aspects of state and local sales tax administration; and (f) simplification of telecommunications taxes.

The Commission issued its report (amid much rancor and controversy) April 2000.

General Assessment. Over the course of its work, the Commission became deeply divided into four factions: a "no tax" group of 5 people; a "simplify and collect tax" group of 5 people; an "unaligned" business group of 6 people; and the 3 Administration representatives. The Commission became essentially dysfunctional and was not capable of pushing any consistent agenda of research or action forward. There was a lack of a required 2/3 majority support for any substantive recommendations regarding collection of state and local sales and use taxes. The lack of consensus traces to several factors: (1) The amount of authority (minimizing any review of state simplification results) sought by the "simplify and collect" group (with supposed support from the Administration) was more than any other group was willing to give; (2) There was skepticism about the degree to which states would ultimately simplify the sales tax; (3) There was a desire to see the simplifications first and then an expressed interest in considering collection of the tax; (4) The "unaligned business" group desired to couple any potential increased collection of use tax with limitations on the jurisdiction (nexus) of states to tax; and (5) The "no tax" group was not able to push a "pure" no tax agenda, but became most interested in placing hurdles before any expanded use tax collection as well as limiting state jurisdiction to tax.

In the end, the Commission represents, in my estimation, a substantial missed opportunity, not only on the remote sales issue, but also in its inability to move the ball forward in a substantive way on understanding some of the complexities of telecommunications and electronic

commerce taxation. In terms of accomplishments, it did crystallize the issues and really focus the use tax collection debate as well as the interests of many in restricting state jurisdiction to tax. It also demonstrated the political and practical need to simplify sales and use taxes and did much to highlight some of the technology available for sales tax administration. It should also be given credit for serving as a galvanizing force for efforts to repeal the 3 percent federal telecommunications excise tax.

Final Report. The Commission issued its final report in April 2000, despite the fact that most of the proposals it considered failed to receive the 2/3 majority required by the Internet Tax Freedom Act in which the Commission was created. By ruling of the chair, it was determined that the few items receiving a 2/3 majority would be termed "formal recommendations" while those receiving lesser support, would be termed "majority" recommendations.

By a vote of 11-1-7, the Commission adopted the "Business Caucus"¹ proposal put forward in February as a purported compromise as the bulk of its "majority" recommendations.² While billed as a "compromise" proposal, the proposal was viewed by most in the state and local sector (as well as among some business interests) as negative to the positions taken by the state and local organizations. Key features of the proposal include:

- Permanent ban on taxes on Internet access charges, including for "grandfathered" states.
- Extension of the current ITFA moratorium (other provisions) for a minimum of 5 years.
- Exemption of digital products and (in the interests of neutrality) their tangible counterparts.
- Delineation of a series of factors that could not be considered in determining whether an entity had nexus for sales and use taxes and business activity taxes. Factors listed included the presence of affiliates in the state; use of an ISP or telecommunications provider in the state; use or ownership of intangible property in the state; acceptance of in-store returns originally sold by an out-of-state affiliate; and use of 3rd party to perform warranty repair work.
- A 5-year period for states to develop a simplified sales tax administration system meeting certain (potentially) rigorous criteria at which time another advisory commission (unspecified composition) would evaluate the system and make any recommendations to Congress regarding a potentially expanded duty to collect. States not joining the simplified system would face considerable penalties.
- A mandatory program of telecommunications tax simplification with penalties for not simplifying.
- Repeal of the federal telecommunications excise tax.

¹ Representatives of America Online, Time Warner, MCI WorldCom, AT&T, Charles Schwab and Gateway.

² While billed as a "compromise" proposal, the proposal was viewed by most in the state and local sector (as well as among some business interests) as negative to the positions taken by the state and local organizations. There were several efforts between its release and the final session of the ACEC to negotiate an agreement that would be more acceptable to state and local governments and that could potentially achieve the 2/3 majority level. In the end, those efforts were unsuccessful.

State and Local Reaction. The ACEC Report was greeted negatively by most state and local officials as well as some other observers. Forty-two governors eventually wrote to congressional leaders recommending that the report be rejected; other groups of state and local elected officials adopted positions in opposition to the report. In addition, a group of over 100 academic economists joined a statement rejecting the recommendations of the report as violating principles of sound tax policy. Stanford's Charles McLure explained the letter as "saying that the thing that came out of Dallas is horrible. This is not a compromise. This is what happens when you think you have the votes. It is called tyranny of the majority, which of course is the reason the original Internet Tax Freedom Act required a two-thirds vote."

The objections to the report were founded on several grounds: (1) The recommendations did not receive the 2/3 majority support required by law; (2) The recommendations were not "tax and technologically neutral"; (3) The recommendations did not deal with the collection of tax on remote sales or telecommunications tax reform in a meaningful fashion; and (4) The recommendations would substantially disrupt state and local tax systems and revenue streams. With respect to the latter, there was concern about the exemption for digital goods and their tangible counterparts as well as the extent to which the nexus provisions would allow an e-commerce seller to engage in activities in the state without incurring a use tax collection responsibility.

Minority Report. Commissioners Kirk, Leavitt, Lebrun, Locke and Jones issued a Minority Report (not accepted as part of the ACEC Report). The Minority Report recommends development of an Interstate Sales and Use Tax Compact that would include a simplified, uniform sales tax administration system. States joining the Compact would be authorized to require remote sellers to collect use tax on sales into the state. It also included other features such as a prohibition of new taxes on Internet access, cooperative efforts to simplify state and local telecommunications taxes, and an extension of the ITFA moratorium on multiple and discriminatory taxes.

The ACEC Report and the Minority Report are available on TaxExchange.

Federal Legislation

Finalization of the ACEC report led to a flurry of activity in the Congress to address certain of the issues raised by the Commission. Gov. Gilmore presented the report to the Republican leadership of the House and Senate on April 12. Both Speaker Hastert as well as Majority Leader Armey and Senate Leader Lott took advantage of the occasion to pledge to pass legislation that would extend the current moratorium, repeal the grandfather clause for certain taxes on Internet access charges, and repeal the federal telecommunications excise tax this year.

House Floor Action on Moratorium. The House Judiciary Committee was the first to act, on May 4 passing H.R. 3709 to extend the Internet Tax Freedom Act moratorium for five years beyond the initial expiration date (i.e., until 10/21/2006). The Judiciary bill also repealed the "grandfather clause" that protected state and local taxes on Internet access charges that were in effect on passage of the ITFA. The Judiciary Committee mark-up was done without any hearings and was scheduled with less than 24 hours notice.

Meanwhile, in one of the few bright moments from the government perspective, the Congressional Budget Office (CBO) ruled that a bill that would repeal the grandfather clause represents an unfunded mandate. CBO noted that the repeal of the grandfather clause affected the tax revenues of some states and that, while it could not provide a precise estimate of the impact on the states, CBO was confident that the impact would exceed the \$55 million threshold of the Act.

The House passed Judiciary Committee's moratorium extension on May 10 by a vote of 352-75, although the Unfunded Mandates Act decision forced a separate vote to proceed with a mandate (passed 271-129) and also muddied the debate throughout the floor deliberations. Two amendments failed: to make the moratorium permanent failed by a 90-336 vote, and to provide for a two-year extension and leave the grandfather clause in place failed 208-219. A non-binding resolution was passed 289-138 that said the states should adopt a streamlined sales tax system for Internet commerce.

House Floor Action on Federal Excise Tax. Before leaving on a Memorial Day recess, the House of Representatives approved (with only two negative votes) a phase-out of the 3 percent federal excise tax on telecommunications services. The phase-out would occur over three years. The annual cost to the Treasury when phased-in is about \$5.0 billion per year. The bill was championed by Rep. Portman (R-Ohio) and had a number of co-sponsors.

Other House Action. In addition to the floor action, the House Judiciary Committee has introduced bills containing the "Majority Recommendations" of the ACEC and the "Minority Report" of the Commission (H.R. 4267 and H.R. 4460, respectively). They have also held hearings on the bills at which they heard testimony from several members of the ACEC. In addition, the House Ways and Means subcommittee on Oversight held a hearing in mid-May featuring a variety of witnesses representing academics, government, and "clicks-and-mortar" businesses. Finally, Rep. Spencer Bachus (R-Ala.) has introduced legislation that would authorize formation of an Interstate Sales and Use Tax Compact through which states could be authorized to require remote sellers to collect use tax if they enacted a uniform, simplified sales tax (H.R. 4462).

No action on any these measures is expected this year. The hearings were, however, somewhat instructive. Discussion focused almost exclusively on the use tax collection issue, and considerable sympathy was expressed for the "level playing field" argument.

Senate Activity. The Senate has taken no final action on any electronic commerce to this point, despite the fact that Majority Leader Lott has announced an intention to pass a 5-year extension of the ITFA moratorium. The Senate Commerce Committee held a hearing on a bill introduced by its chairman, Sen. John McCain (R-Ariz.) that would extend the ITFA moratorium until October 2006. Several members of the committee objected, however, in large part due to lobbying by the retail industry, and Sen. McCain pulled the bill from consideration before it could be voted on. These members took the position that the Congress should deal with the use tax collection issue if they are to extend the moratorium this year.

Acting on this sentiment, Senator Dorgan (D-N.D.) has worked with state and local governments and the retail industry to develop a bill to authorize formation of an Interstate Sales and Use Tax Compact through which states could be authorized to require remote sellers to collect use tax if they enacted a uniform, simplified sales tax. It is expected that the bill will be introduced shortly after the Memorial Day recess. There is, however, a trouble spot with the bill. Sen. Dorgan believes that to be passed, any bill of this nature must require that states adopt single use tax rate for all remote sales into a state. This provision, if included in the final bill, is likely to cause some groups (NCSL, USCM and NACO) to oppose the bill (or at least not support it).

In a related area, Sen. Judd Gregg (R-N.H.) and Sen. Herb Kohl (D-Wisc.) introduced the "New Economy Tax Simplification Act" (S. 2401). The bill would amend P.L. 86-272 to establish a new nexus standard in federal law for all business activity taxes as well as the collection of sales and use taxes. The bill has been characterized by supporters as codifying the standard set forth by the U.S. Supreme Court in *Quill v. North Dakota*.

In reality, the bill establishes a requirement that a business have a "substantial physical presence" in a state before it could be subjected to a business activity tax or use tax collection obligation. In addition, the bill establishes 10 special conditions that would be deemed not to meet the substantial physical presence requirement. The "carve-outs" include: solicitation of orders for tangible or intangible property; presence or use of intangible property in a state; use of the Internet to create or maintain a web site accessible by persons in the state; use of an Internet service provider to maintain, take, or process orders via a Web site on a computer that is physically located in the state; use of a service provider to transmit communications (including cable, satellite, radio and telecommunications); and affiliation with a person in the state who is not an agent of the company. The legislation is based on a proposal made to the Advisory Commission on Electronic Commerce last year by California Board of Equalization Chairman Dean Andal. Some of the nexus carve-outs were recommended by a majority of that body.

Prognosis. The outcome of this issue is, of course, in doubt. A betting person, however, would likely put pretty good odds on some extension of the ITFA moratorium passing in this session of Congress. The Republican leadership of both houses has announced its intent to pass a 5-year extension. In addition, Senate Minority Leader Daschle has indicated that it should be expected that the Senate will vote on an extension bill this session (i.e., it is not likely that the rules can/will be used to prevent the bill from being considered). If a vote is taken, an extension will most likely pass in my estimation.

State and local governments (and fixed-base retailers) are attempting to affect this outcome. They have several potential objectives: (1) passage of a Dorgan-like bill in the Senate; (2) limiting any extension to some shorter period (e.g., two years); and (3) preventing consideration of any extension. Given that any House-Senate conference committee is likely to contain a majority of Members that support the leadership position, holding any extension to two years would be a major "victory" and will in all likelihood require extensive use of Senate rules.

Repeal of the grandfather clause is also an issue. It seems likely that if moratorium is extended this Congress, that the grandfather clause will be repealed. Most members of Congress

consider it an important step to take (despite any federalism concerns they may or may not have) and the degree of opposition from state and local elected officials is not great.

Issues in Extending the Moratorium. As Congress considers an extension of the moratorium, state and local governments have argued that there are certain issues that should be considered carefully. These include: (1) bundling or what is the effect of a federal prohibition on taxation of Internet access as more and more services (e.g., cable TV) and more content (e.g., AOL-Time Warner merger) get bundled with access; (2) Internet telephony or what is the effect of a prohibition on the taxation of access as an increasing number of services are able to offer telephonic communications as part of the access; and (3) nexus, or the fact that there are certain provisions of the ITFA that, if extended, for the long term could be used to argue that the law limits the jurisdictional reach of the states.

Internet telephone-related fees. In a somewhat related move, the House has passed a bill that would block the Federal Communications Commission from imposing fees for using the Internet. H.R. 1291 would forbid the FCC from charging consumers "per-minute" Internet access fees on top of what subscribers already pay Internet service providers. (The FCC had neither proposed nor considered such a fee.) Also, four leading House Commerce Committee members introduced H.R. 4445 to exclude Internet-generated calls from a payment mechanism used by local phone competitors that exchange traffic.

This fledgling battle is one to watch since it carries many of the same "level playing field" characteristics as the use tax collection issue, ultimately pitting traditional telephone service providers against Internet phone service providers. It also begins to bear on the issues involved in the evolution of "Internet access" to include content, telephony and other things as well as access to the Internet and Worldwide Web. Interestingly (and somewhat frighteningly), H.R. 1291 is the result of an Internet hoax. An e-mail, patently false, was circulated claiming Congress was on the verge of imposing such a surcharge. E-mail fans responded with vicious speed and outrage, prompting the House to pass a bill with equal swiftness "to extinguish this cyber-myth once and for all." The more traditional industries that may eventually be disadvantaged by this legislation apparently did not recognize any potential danger quickly enough to make their positions heard or at least were unable to change the outcome.

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Internet Taxation and State Sales Tax Simplification



Scott Mackey
Chief Economist

**National Conference of State
Legislatures**
June 2, 2000

Overview of Presentation



- Old problem / new urgency
- What is Congress doing?
- What are the states doing?



Legal summary

- **Henneford -- 1937**
 - ◆ **Use tax is constitutional**
- **Bellas Hess -- 1967**
 - ◆ **Collection is undue burden on remote seller**
- **Quill -- 1992**
 - ◆ **Congress may legislate a solution**

Why the New State Urgency?



- Threat to state revenue
 - ◆ Electronic commerce projections
 - ◆ Dot.com subsidiaries
- Federal preemption

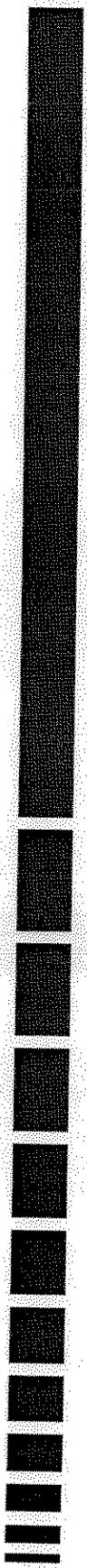
E-Commerce Projections



- **Business to consumer**
 - ◆ 1997 -- \$3 billion
 - ◆ 1998 -- \$8 billion
 - ◆ 1999 -- \$18 billion
 - ◆ 2003 -- \$140 billion

- **Business to business**
 - ◆ 2003 -- \$1.3 trillion

Sales Tax Revenue Implications



- **Professor Fox (Tennessee) -- Feb. 2000**
 - ◆ \$10.8 billion by FY2003 (E-Commerce only)
 - ◆ \$20 billion by FY2003 (All remote sales)

- **Moody's Investor Service -- April 2000**
 - ◆ \$10 billion by FY2003
 - ◆ "Severe long-term effect on sales tax dependent states"

State Sales Taxes



- **One-third of state revenue**
- **Over half of revenue in 6 states**
- **Only major US consumption tax**
 - ◆ **Unlike OECD, no federal tax**

State Revenue Implications



- **Pressure on income & property taxes**
- **Sales taxes ‘least unpopular’**
- **Growing source of urban ‘amenity’ financing**

Impact on ‘Main Street’



- **Competitive disadvantage**
- **Real estate values / property taxes**
- **Impact magnified in certain sectors**
 - ◆ **Books, music, consumer electronics**
 - ◆ **Pressure to exempt vulnerable items**

Major Proposals in Congress



- **Extend moratorium on access taxes**
- **Nexus “carve outs”**
- **Full ACEC proposals**
 - ◆ **Digital goods & “equivalent” preemption**
 - ◆ **Nexus carve outs**
 - ◆ **Permanent moratorium**

What is Congress Doing?



- **US House**
 - ◆ Voted on May 9 to extend moratorium
 - ◆ Hearings on sales tax & nexus carve outs
- **US Senate action uncertain**
 - ◆ Sen. McCain markup on moratorium postponed

What are States Doing?



- **Opposing federal preemption**
- **Multistate discussions on sales tax simplification**

Streamlined Sales Tax System



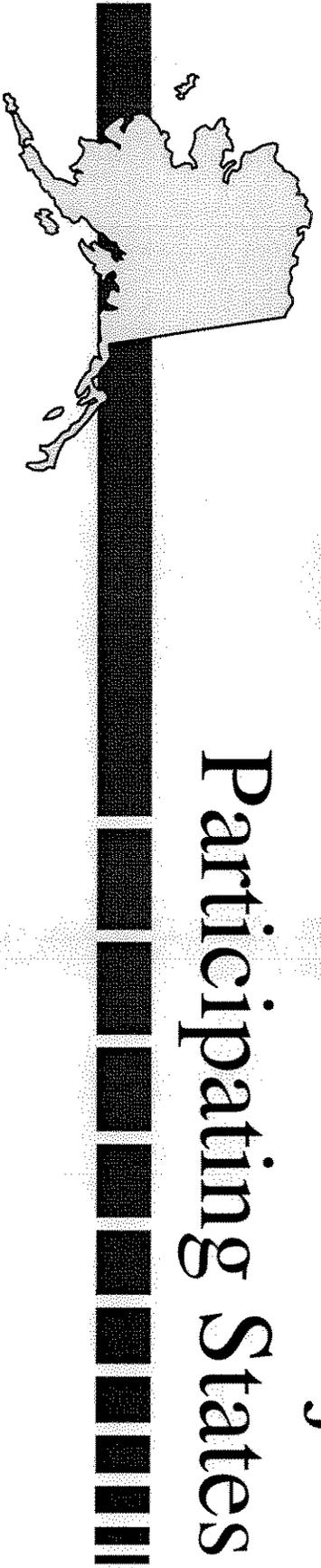
- **Proposed in December**
- **Outgrowth of National Tax Association project**

Overview of Streamlined System

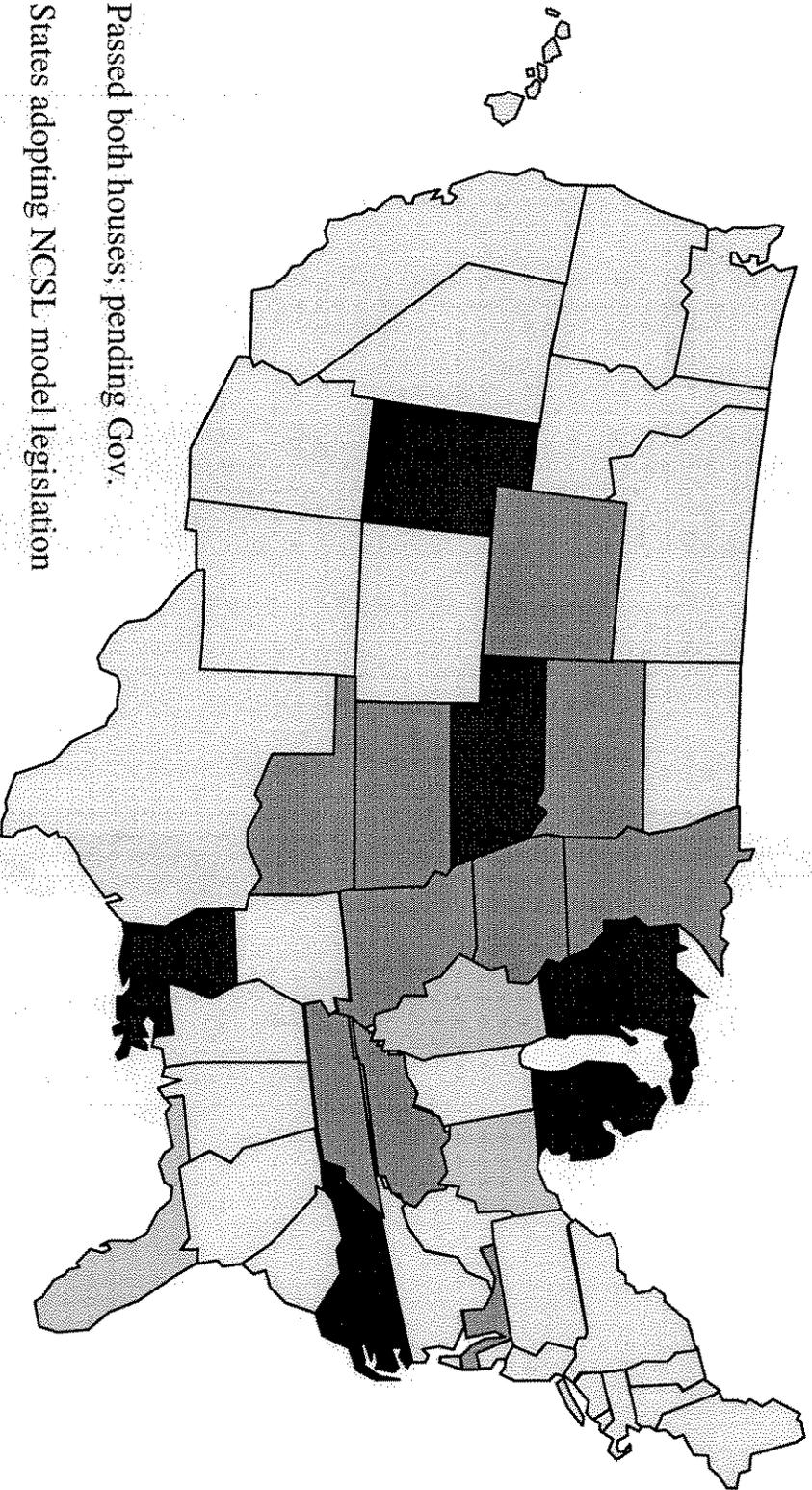


- Major state simplification
- Use of technology to minimize or remove burden of collection on sellers
- Voluntary for sellers and states

Streamlined Sales Tax Project Participating States



- Passed both houses; pending Gov.
- States adopting NCSL model legislation
- States participating through executive actions



Timetable for Multistate Effort



- **Draft legislation -- September**
- **Review / comment / revision -- Oct./Nov.**
- **Final proposal -- end of December**
- **Legislative action -- 2001 session**

Major Simplification Issues



- **Rate issues**
 - ◆ **Local rate simplification**
 - ◆ **Frequency of changes**
- **Sourcing rules**
- **Privacy protection for buyers**

Simplification Issues (continued)



- **Role of “tax calculation service”**
- **Software certification**
- **Uniform definitions**
 - ◆ **of products**
 - ◆ **other terms -- “sale for resale”, etc.**

Policy Issues (continued)



- **Paying for the system**
- **Audit relief**
- **Exemption processing / administration**

State Actions Necessary



- Authorize multi-state discussions
- Adopt simplification model statute
- Provide database
 - ◆ Rates
 - ◆ Exemptions

Why is This Issue an NCSL Priority?



- States controlling our own destiny
- Fairness for local businesses
- Long term: Preventing tax shifts to unpopular sources

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Report: Economy Has Peaked Reuters

10:40 a.m. Jun. 12, 2000 PDT

NEW YORK -- The longest U.S. economic expansion, now in its 10th year, has peaked as business and consumers begin to feel the effects of a battery of interest rate hikes by the Federal Reserve, the Conference Board said on Monday.

The research group said in an analysis that the first quarter of 2000 is expected to be the fastest growing period of the year with Gross Domestic Product rising by 5 percent on a year-to-year basis. But that growth in year-to-year GDP is forecast to ease to 4.4 percent by the fourth quarter, the Conference Board said.

REUTERS

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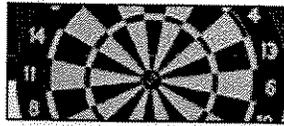
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"Even at these growth rates, the Federal Reserve Board will be disposed to raise short-term interest rates for the foreseeable future," said Gail Fosler, Conference Board senior vice president and chief economist, in the latest issue of her monthly newsletter *StraightTalk*. "In this environment, business will encounter both top line and bottom line pressure, with the negative impact on profitability showing up in the second half of the year."

The Fed, in its bid to keep inflation out of the go-go U.S. economy, has raised the federal funds rate by 1.75 percentage points since June 1999.

Fosler called "more significant" a

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Editorial

From The Business Journal

Comment

Federal Internet sales tax would be disaster

On Internet Tax Gary Edgar

Governments are always looking for new ways to collect taxes, and taxing sales has traditionally been a fairly painless way of going about it.

While there's nothing inherently wrong with taxing sales, differing tax rates among counties and states create distortions. Residents of Biloxi, Miss., for instance, are likely to make the short drive into Louisiana or Alabama for any big ticket purchases in order to avoid paying an additional 3 percent sales tax in their home state. That's a \$600 difference on a \$20,000 car.

The advent of e-commerce greatly exacerbates this distortion. A Wisconsin resident buying an item over the Internet from a local company must pay the 5 percent Wisconsin sales tax. But if they make their Internet purchase from an out-of-state firm, they pay no sales tax. On the same \$20,000 vehicle, that would mean a difference of \$1,000.

The reason for the discrepancy is constitutional in nature. The U.S. Supreme Court has ruled that imposing state sales tax on out-of-state transactions interferes with interstate commerce and is therefore unconstitutional. So the only way to tax Internet commerce fairly is through a standardized (i.e. federal) sales tax. As ugly as that sounds, that's exactly what they're working on right now.



Just for kicks, let's say Congress actually passes a federal sales tax bill a few years from now. Will that fix the problem? The answer is no. It will make things indefinitely worse. If Internet commerce is only taxed within the United States, consumers will simply make their purchases from Web sites located in other countries. After all, the Internet knows no borders.

U.S. firms would therefore be forced to perform legal contortions to set up their own e-commerce sites offshore in a manner which exempts them from charging the tax. One glance at the difficulties of regulating offshore banking tells us that such a thing is done easily enough.

According to International Data Corp., 67 percent of worldwide electronic commerce in 1999 occurred within the United States. We are far and away the world's leader in this new technology, and it's enabling us to make huge strides in productivity. This is one of the principal reasons we are currently experiencing the longest economic boom in U.S. history.

Are we really going to shoot ourselves in the foot now by creating a barrier to e-commerce in the United States? Of course not.

Since we're having so much fun, let's continue in our fantasy world by imagining that, in the future, e-commerce is indeed only taxed within the United States, and then take it to its logical conclusion. How would you go about solving such a problem? Why, a standardized, international sales tax, of course! Must I go on?

Let's face it. Government should stop concerning itself with passing laws that are destined to become completely unenforceable. By doing so, they merely waste time, waste money, miss opportunities, miss the point and make life difficult for all of us.

Gary Edgar is president Heartland Software Development Inc. in Wauwatosa.



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106th Congress

Sales Tax Simplification

NGA's Position

At the 1999 NGA winter meeting, policy EC-12, Streamlining State Sales Tax Systems, was adopted. The policy calls for joint industry/government development of a simplified sales tax system, including one sales tax rate per state, streamlined administration and audit requirements, and uniform definitions of the goods and services that may be taxed. States retain the authority to determine what is taxed and at what rate. The policy establishes incentives for states to streamline and simplify their sales tax systems by calling on the federal government to restore fairness in the sales tax by requiring remote sellers to collect sales taxes for states that simplify their taxes. A minimum level of sales would be established; companies that made sales in the past year above that *de minimus* level would be required to collect and remit the

The Issue

With the rapid growth in retail sales over the Internet, Governors and other state and local elected officials became concerned about the impact of shifting sales from local retail stores to Internet vendors on sales tax revenues. States are not able to require remote sellers (retailers, including Internet sellers, without a physical store or warehouse or other presence in that state) to collect sales tax on sales into that state based on the 1967 *National Bellas Hess* Supreme Court decision and the 1992 *Quill* decision. Today, mail order sales are subject to these rulings, and while the purchaser owes the tax on the product (if that state has a sales tax on that product), the tax itself is rarely collected. Increasing sales over the Internet threaten to significantly compound this revenue loss for states and localities.

To address this issue, the National Governors' Association adopted policy in February 1998 and amended that policy again in February 1999 (EC-12). The Supreme Court's decision in *National Bellas Hess* was based on the complexity of the various state and local sales taxes, calling the complexity a barrier to interstate commerce. The decision in *Quill* was based on the fact that the mail order industry had not had to collect the tax for 25 years. However, the *Quill* decision also stated that technology was available today to solve the complexity issue, and the court specifically cited Congress' authority to legislate in this area. Thus the Governors adopted a policy to express their willingness to simplify their sales taxes with the expectation that, in exchange, the federal government would provide these states with the authority to require larger remote sellers, including Internet vendors, to collect this sales tax for the states.

Internet Tax Freedom Act

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sales tax to qualified states.

NGA Actions

April 12, 2000, testimony by Governor Michael Leavitt, Utah, before the Senate Commerce Committee on legislation to amend the Internet Tax Freedom Act.

April 7, 2000, letter by Governor Michael Leavitt, Governor Parris Glendening, Representative Paul Mannweiler (NCSL President) and Senator Jim Costa (NCSL President-elect) to all Senators opposing any permanent extension of the three-year moratorium set by the Internet Tax Freedom Act.

February 2, 2000 testimony by Governor John Engler, Michigan, before the Senate Budget Committee on Internet Taxation in the New Millennium.

November 15, 1999 letter (from NGA; NCSL, CSG, NACo, USCM, and ICMA) to the Advisory Commission on Electronic Commerce urging consideration of the state and local proposal for Streamlining the

When Congress passed the Omnibus Appropriations Act for fiscal 1999, it included an improved version of the Internet Tax Freedom Act (ITFA). The version adopted sets no restrictions on whether states can tax sales over the Internet. Instead ITFA only prohibited states and local governments during a three-year moratorium (October 1, 1998-October 1, 2001) from adopting *new* taxes on Internet access charges. Currently Internet vendors that sell to individuals in a state in which they **have** a physical presence (nexus) collect any sales tax due. That has not changed with ITFA. During this three-year moratorium, ITFA established an Advisory Commission on Electronic Commerce to look at issues involving taxation of the Internet and telecommunications. The commission, created by Congress as part of the Internet Tax Freedom Act, was composed of three federal, eight private, and eight state and local representatives, including Governors Gilmore, Leavitt, and Locke. The commission completed and sent its report to Congress on April 12, 2000, but failed to reach the required supermajority to make findings and recommendations. The commission held its final meeting by teleconference on March 30, 2000, when it adopted its final report and refused to accept a minority report from Governor Michael Leavitt.

The Advisory Commission on Electronic Commerce was intended to develop findings, recommendations, and a final report on a wide range of resolutions developed by various commissioners on state and local sales and use taxes on Internet transactions, Internet access fees, and telecommunications taxes and fees. The commission failed to approve any comprehensive proposal by the two-thirds majority required by statute or the commission's own rules.

Business Caucus Proposal

The commission adopted a final report on a 10-8 vote on March 30, 2000, adopting the "Business Caucus" proposal. The proposal was put together by staff for commissioners Armstrong (AT&T), Pottruck (Charles Schwab), Sidgmore (MCI), Pittman (AOL), Parsons (Time-Warner), and Waite (Gateway). The proposal was characterized as a "compromise" that tried to "bridge the

Sales Tax for the 21st Century.

October 7, 1999, letter (from Governor Leavitt and Governor Glendening) to Senator Lott and Senator Daschle opposing any efforts to extend the duration or expand the scope of the moratorium imposed by the Internet Tax Freedom Act.

July 29, 1999, letter (from Governor Carper, Governor Leavitt, State Rep. Mannweiler, and State Senator Costa) to all Senators opposing any amendment to the Senate version of the tax bill to extend the three-year moratorium set by the Internet Tax Freedom Act last October.

May 25, 1999, letter from the executive directors of the "Big Seven" state and local government organizations to members of the Advisory Commission on Electronic Commerce offering suggestions on the scope of the commission's work

NGA Policy Reference

EC -12,
Streamlining State Sales Tax Systems

gap" between the anti-tax and pro-tax camps. The proposal would preempt in excess of \$30 billion of existing state and local sales, property, business activity, and income taxes annually. It proposes a six-year extension of the moratorium and would mandate significant simplification by states of state and local sales tax systems. After that, it proposes creation of another congressionally-appointed commission to determine if states had complied with the mandate. If, and only if, the commission so determined, then Congress would determine whether the simplification complied with the mandate and whether the compliance was sufficient for Congress to *consider* whether to permit states to require remote sellers to collect and remit use taxes owed by consumers. It also contains a preemption of all taxes on all Internet access charges, including those grandfathered under current law, preemption of sales and use taxes on "digital goods" and their "tangible counterparts" (which would cover all books, CD's, information data publications, movies, games, etc.) a lengthy series of nexus limitations or "carve-outs" for both income and sales taxes, and a series of federally mandated telecommunications reforms. The business members generally spoke to the perceived reasonableness of the proposal. Other supporters argued they had moved off a position of "no Internet taxes" to supporting this resolution in the interests of an agreement.

Members of the government caucus generally spoke against the proposal as providing special interest tax breaks for selected industries (including those that had put it together). They also argued it was overreaching in several regards and did not address the central issue (as they saw it) of a "level playing field" or potential collection on remote sales. They noted that the proposal would reduce current state and local revenues by an estimated \$25-30 billion per year (a figure based in part on estimating work done by a number of states.)

The Business Caucus proposal was approved on an 11-8 vote, two votes short of the two-thirds majority required to constitute a finding or recommendation.

NGA Contact

Frank Shafroth,
202/624-5315

Streamlined Sales Tax Project

Eighty-two registrants—sixty-four from states and local government and eighteen members from the media and private sector—met in St. Louis last week on behalf of some thirty states as part of the ongoing cooperative effort to continue discussions focusing on the implementation of a revolutionary streamlined sales and use tax system. The *Streamlined Sales Tax System Project* is a comprehensive undertaking in direct response to the widespread call for simplifying the sales tax. The states have enthusiastically embraced this unique opportunity to attain the fundamental simplification measures needed to maintain a viable sales tax system.

The states embarked on this mission in September 1999, by initiating discussions to develop and implement a simplified sales tax system. Three subsequent meetings were held prior to this most recent St. Louis meeting and continuing discussions are being conducted to resolve integrating the design elements of the new system. It is anticipated that a pilot project of the new system will be in place in Fall 2000.

At the St. Louis meeting, the project states heard suggestions from a series of business associations on ideas about how to adopt the most effective changes in state sales and use tax systems and how the work could best be coordinated with the private sector. In addition, the project states begin to focus on how to coordinate the work product of the four work groups established and charged with addressing a multitude of issues essential to successfully implementing the new system. The work groups are:

- Paying for the System, Technology, Audit, and Privacy Issues;
- Sourcing and Other Simplification Issues;
- Tax Rate, Registration, Returns, and Other Remittances; and
- Tax Base and Exemption Processing.

The key issues the participants are focusing on include ensuring that the use of technology does not breach the basic tenets of consumer privacy while simultaneously

establishing a new benchmark of security measures designed to preserve the integrity of transactions; implementing the use of existing technology that provides for the accurate mapping of tax rates to the appropriate taxing jurisdiction; and drafting uniform definitions, standardizing exemption processing procedures for use- and entity-based exemptions, and arranging for the use of a product coding mechanism that will provide a bridge between the tax base and the use of technology.

The project states are expanding efforts to seek the input of both public and private sector groups, in addition to those companies and individuals willing to provide technical assistance to the work groups. A public comment period will be provided at each project meeting during which interested parties may comment on the project's design initiatives and accompanying issues with the project states.

A website has been established for the project to provide information regarding the mission of the project, the overall structure and rules governing participation in the project, and the ongoing activities of the project, including meeting dates and periodic project reports. The next meeting of the Streamlined Sales Tax System Project is scheduled for May 25-26 (Th./Fri.) in Chicago, Illinois.

Current Status

On February 2, Sen. Ron Wyden (D-Ore.) and Rep. Christopher Cox (R-Calif.) offered legislation (S. 2028) to permanently extend the moratorium or prohibition of state or local taxes on Internet access established by the Internet Tax Freedom Act. Both the House and Senate Commerce Committees held hearings on the issue on April 12. The Senate Commerce Committee scheduled a markup on S 2028 on April 13, but the bill was pulled for lack of sufficient support.

On May 10, the House passed and sent to the Senate H.R. 3709, the Internet Nondiscrimination Act, which would extend the moratorium set by the Internet Tax Freedom Act—not set to expire under current law until October 21, 2001—until October 21, 2006 and violate the Unfunded Mandates Act by preempting the grandfathered states

protected under current law. The bill—considered and adopted without any hearings—would eliminate Internet access taxes and fees in Texas, Wisconsin, Tennessee, South Dakota, Ohio, New Mexico, North Dakota, Montana, New Hampshire, and Washington. The action came after the House voted 271-129 against the point of order that the bill violates the Unfunded Mandates Act.

The legislation faces an uphill battle in the Senate, where a number of bipartisan Senators have made clear they will oppose any effort to act on an extension this year. The White House yesterday threatened a veto.

During debate, the House voted 336-90 to reject an amendment by Rep. Steve Chabot (R-Ohio) to make the moratorium permanent, and then narrowly rejected (218-209) an amendment by Reps. John Thone (R-S.D.) and Rep. William Delahunt (D-Mass.) to remove the preemption of the grandfathered states and to reduce the length of the moratorium from five to two years.

On a vote of 289-138, the House adopted a sense of the House resolution proposed by Rep. Ernest Istook (R-Okla.) laying out the criteria for the development of a streamlined state and local sales and use tax system and urging states and localities to work together to develop a non-multiple and non-discriminatory tax system on electronic commerce.

A limited time period for the moratorium was one of the most intensely debated provisions of the Internet tax Freedom Act. All parties agreed to the three-year moratorium. During the three-year period, the Advisory Commission on Electronic Commerce, chaired by Virginia Governor Jim Gilmore, was supposed to meet and make recommendations to Congress with regard to state and local tax and revenue policies on the Internet, as well as telecommunications and international issues.

On September 22, Sen. Majority Leader Trent Lott (R-Miss) introduced a bill (S. 1611) on behalf of Sen. John McCain (R-Ariz.), Chairman of the Senate Commerce

Committee, to expand the moratorium in the Internet Tax Freedom Act to prohibit the imposition of any sales or use tax on any goods or services purchased using electronic commerce—whether the sale is from an in-state or remote electronic seller. House Budget Committee Chairman John Kasich (R-Ohio) has introduced similar legislation (H.R. 3252). The bills would also make the expanded moratorium permanent. According to some in the Senate, Sen. McCain may try to offer his bill as an amendment or rider on legislation in this session of Congress in order to permanently outlaw any future attempts to impose a sales tax structure on Internet sales. The proposals come more than a year before the panel appointed by Congress to study whether and how to tax Internet sales is to complete its report and make recommendations to Congress.

S. 2330, a bill to repeal the federal excise, was introduced by Sen. Roth and eight others. It has been referred to the Finance Committee, and Sen. Roth has indicated he plans to hold hearings on telecom and Internet issues later this year. A companion bill (H.R. 3916, has been introduced in the House by Reps. Rob Portman (R-Ohio) and Robert Matsui (D-Calif.).

S. 2401 has been introduced by Sen. Gregg (R-N.H.) and Kohl (D-Wis.). The Gregg-Kohl bill is the "Andal proposal" to amend P.L. 86-272 to establish a "substantial physical presence" nexus standard for both sales and use taxes and "business activity" taxes. It would also list a number of activities (most related to Internet activity) that would not be considered to constitute "substantial physical presence." No hearings have been scheduled to this point.

H.R. 4202 was introduced by Rep. Erlich (R-Md.). The bill would ban FCC access fees on Internet service providers. It would also extend the Internet Tax Freedom Act moratorium for five years until October of 2006.

Rep. Hyde, Chair of the House Judiciary Committee (that has jurisdiction over state and local tax matters in the House), has introduced a bill, H.R. 4267, that incorporates the ACEC 'majority' recommendations'. Sens. Byron Dorgan (D-

N.D.), Slade Gorton (R-Wash.) and some others are drafting (and expect to introduce) legislation that would incorporate the substance of the 'minority' report.

Currently, Governors, in addition to the NGA commitment to develop a voluntary, zero burden sales tax simplification proposal, are working with two different groups to achieve the goals of this policy:

The Advisory Commission on Electronic Commerce

Governor James Gilmore was the chairman of the commission. The commission met in Williamsburg, Va.; New York City; San Francisco; Dallas; and by teleconference for its final meeting. The legislation establishing the commission only provided for an 18-month commission. The membership of the commission was as follows:

Federal Government

members: Secretary of the Treasury and Commerce Departments and the United States Trade Representative;

State and Local Government

members: Gov. James Gilmore, (R) Virginia; Gov. Michael O. Leavitt, (R) Utah; Gov. Gary Locke (D) Washington; Delegate Paul Harris, (R) Charlottesville, Virginia; Dean Andal, (R) Chair, California Board of Equalization; Mayor Ron Kirk (D) Dallas, Texas; Gene Lebrun, (D) Former South Dakota state legislator, President, National Conference of Commissioners on Uniform State Law; and Delna Jones, County Commissioner, Washington County, Oregon.

Industry members: Richard Parsons, President, Time Warner; David Pottruck, President and Co-CEO, Charles Schwab; John Sidgmore, MCI/WorldCom; Robert Pittman, President and COO, America Online; C. Michael Armstrong, Chairman of the Board and CEO, AT&T; Theodore Waitt, President and CEO, Gateway Computers;

Stan Sokul, Association for Interactive Media (a subsidiary of the Direct Marketers Association); and Grover Norquist, President, Americans for Tax Reform, and a registered lobbyist for Microsoft.

National Tax Association

In the fall of 1986, before ITFA was introduced, the National Tax Association (NTA) decided to address the issue of taxation of electronic commerce and telecommunications. The NTA is a professional association of tax practitioners employed in the private sector, in government, and in academia. The Communications and Electronic Commerce Taxation Project completed and adopted its final report in September of 1999. It addresses the major issues of tax simplification. Current representatives of NGA are Fred Kiga, Commissioner of Revenue, Washington, and Tim Sheehan, Office of Governor Michael O. Leavitt, Utah. Information on the project can be found at their [web page](#).

Northwestern States Sales Tax Pilot Project

In mid-1998, three western states (Idaho, Utah, and Washington) initiated an effort to simplify and coordinate their sales taxes for businesses doing business in all three states. This Northwest Regional Sales Tax Pilot Project is under the direction of the tax administrators of those three states. Meetings have been held that included business representatives and elected officials, focusing on needed simplification. This pilot project has developed working groups focused on simplifying the tax base, easing administrative requirements, and easing the burden on business of knowing local sales tax rates. The group hopes to develop proposed legislative solutions for action during the 2000 legislative sessions in the respective states.

May 11, 2000

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