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NCSL Executive Committee Task Force on State and Local Taxation of Telecommunications and Electronic Commerce

NCSL Adopts Model Legislation To Simplify Sales Tax Collection

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WASHINGTON, DC - State legislatures have taken a significant step toward ensuring a fair and equitable solution to the e-commerce issue.

The Executive Committee of the National Conference of State Legislatures (NCSL) has unanimously endorsed model legislation as the first step in ensuring tax equity and fairness between "Main Street" businesses and remote sellers, including Internet retailers. The intent of the draft legislation is to allow states to participate in discussions with other states on developing a voluntary, streamlined, multi-state system for the collection and administration of existing sales and use taxes. The model legislation incorporates the Streamlined Sales Tax System for the 21st Century proposal that has been developed by NCSL and the National Governor's Association.

NCSL's Executive Committee Task Force on State and Local Taxation of Telecommunications and Electronic Commerce has worked for the last year to address how states can modernize their state-local sales and use tax systems to accommodate the rapid changes in technology and the explosion of Internet commerce. The sales and use tax currently generates over $150 billion for states, almost one-third of state budgets, with much of the revenue used to fund K-12 education and public safety.

"NCSL's model legislation is a bold step in preserving the vital services that state governments have a moral responsibility to provide such as education and crime prevention," stated Tennessee Representative Matthew Kisber, co-chairman of the Task Force.

"This proposal has nothing to do with creating new taxes. It merely provides states with the opportunity to develop a more simple, uniform and fair system of state sales and use taxation without mandates or interference from the federal government," declared Task Force co-chairman Illinois Senator Steven Rauschenberger.

The NCSL Executive Committee will submit the model legislation to each of the state legislature's legislative leaders. It is expected that several states will enact the legislation this year. It is NCSL's hope that this first group of states will lay the groundwork for the Streamlined Sales Tax System for the 21st Century and for the other states to follow over the next two to five years.

NCSL is a bipartisan organization that serves the legislators and staffs of the nation's 50 states, its commonwealths and territories and the District of Columbia. NCSL provides research, technical assistance and the opportunity for policymakers to exchange ideas on the most pressing state issues. NCSL also is an effective and respected representative for the interests of state governments before Congress and federal agencies.

The model legislation is here.

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NCSL Executive Committee Task Force on State and Local Taxation of Telecommunications and Electronic Commerce

Minutes from the Seventh Meeting, in Denver, Colorado

Denver, CO
April 1, 2000

Contents:

Members Attending:

Representative Matt Kisber, TN, Co-Chair
Senator Larry Borst, IN
Senator Joanne Emmons, MI
Representative Dave Ennis, DE
Senator Dick Finan, OH
Assemblyman David Goldwater, NV
Senator Bob Jauch, WI
Representative Philip Travis, MA
Representative John Hines, WY (new member)

Legislative Staff:

Dave Crotts, NC Fiscal Research Division

NCSL Staff:

William Pound, Executive Director
Scott Mackey, Chief Economist
Gerri Madrid, Committee Director
Neal Osten, Senior Committee Director
Graham Williams, Senior Staff Assistant

Saturday April 1, 2000

Rep. Kisber called the meeting to order and welcomed the Task Force to Denver. He explained his co-chair, Sen. Steve Rauschenberger, was unavoidably detained in session in Illinois. Rep. Kisber asked the group to introduce themselves and the meeting commenced. Rep. Kisber asked the staff to give brief updates on what had been going on with the Advisory Commission, in Congress and in the states.

Scott Mackey explained what had transpired at the final Advisory Commission on Electronic Commerce in Dallas. Mr. Mackey recounted that Governor Leavitt, who had taken the lead for the state and local group, was willing to compromise and in fact looked for a deal around which to build consensus. However, Governor Gilmore, the Chairman of the Commission, had the tax-free zone faction and the business caucus firmly allied with him so no 2/3 recommendations could be reached. Mr. Mackey asserted that this might have been the best possible outcome for the state and local groups because any compromise would have required giving away too much. Further a report from a slim majority would be easier to fight in Congress. Mr. Mackey went on to say that the greed of the business caucus may have shifted public support to the state and locals as the business caucus proposal was increasingly being viewed as a group of special interest tax giveaways.

Neal Osten presented a short review of possible congressional action on Internet taxes. Mr. Osten mentioned that Governor Gilmore would likely testify at hearings of the House Commerce Committee on April 5th and before the Senate Commerce Committee April 6th. The hearings would generate a lot of press, and any attempts to call the Commission's report into question might be muted by a letter sent to Gov. Gilmore from Sen. Lott and Speaker Hastert saying that a majority recommendation would satisfy them. Mr. Osten explained that it was possible Congress would try to extend the current moratorium. He remarked that there were several different vehicles available in Congress to do so. Sen. McCain had introduced a new bill, which is a simple five-year extension of the current moratorium, as well as authored a separate permanent extension including sales taxes. Sen. Wyden and Rep. Cox had also introduced legislation to permanently extend the current moratorium.

Mr. Osten detailed plans for an NCSL Internet Tax Lobby Day on May 4th, to kick off the Spring AFI Meeting in Washington, DC. According to Mr. Osten, the Lobby Day will include a lunch update on how the issue is unfolding on its various fronts from the Co-Chairs of the Task Force, Rep. Kisber and Sen. Rauschenberger. Then the group will then walk to the Hart Senate Office Building for a rally and briefing with Sen. Bob Graham (D-FL) and Sen. Kay Bailey Hutchison (R-TX). After the rally the group will split up to meet with their individual congressional delegations. Mr. Osten suggested the message should be that Congress should not rush to judgment on this issue, especially as there are 17 more months left under the current moratorium.

Sen. Finan asked if the real danger with McCain's newer bill was the possibility of amendments on the floor. Mr. Osten and Mr. Mackey agreed that the simple extension of the moratorium would be a perfect vehicle for other more onerous provisions. Rep. Ennis said that he would be happy to contact Sen. Roth (R-DE) and ask him to hold a hearing on the same day as the NCSL Lobby Day. He felt that even though Delaware does not have a sales tax, Sen. Roth might be a valuable ally if the issue was framed in the context of states' rights.

The discussion shifted to materials that might help Task Force members lobby in their own states and in Washington. Rep. Kisber asked if it was possible for NCSL staff to prepare a one-page list of taking points specific to the Commission Report, specifically pointing to the loopholes added to the business caucus proposal. He felt that would be a valuable tool to have when discussing the Commission and legislation with his delegation. Assemblyman Goldwater and Sen. Jauch each reiterated the need for continued economic studies to produce hard data. Assemblyman Goldwater asked if NCSL had done any work specifically on studies that took a more macro-economic approach the state revenue losses in the context of an expanding economy. He explained he thought such a study if not already underway would be helpful.

Graham Williams then gave a short update on action in the states to enable multi-state discussions on the "Streamlined Sales Tax System." To that point 26 states had either taken action legislatively or though executive action, or were considering action. Mr. Williams referred the Task Force to a chart in their binders tracking all action in the states. With ten states already committed and 6-10 more possible, the results had already exceeded the hope that 6-8 total states would participate in the discussions.

Streamlined Sales Tax Project

Charles Collins and Dianne Hardt, Co-Chairs of the Streamlined Sales Tax Project, then gave their report to the Task Force on their meeting held in Denver March 30-31. They explained their mission was to design, test, and implement a system that radically simplifies sales and use taxes. Mr. Collins and Mrs. Hardt explained the membership consisted of two groups, "Participating States" and "Observing States." Mr. Collins told the Task Force that there were ten "Participating States," states who had already committed to the process through legislation and/or executive order. He went on to point out that there were 19 "Observing States" who agreed with the mission but either had yet to, or could not officially commit to working to fulfill the project. Mrs. Hardt explained the steering committee had been elected and was comprised of nine representatives from member states. In the Denver meeting, which was the second such meeting, the group split up into five work groups:

- Tax base Uniformity and Exemption Administration
- Technology, Audit and Privacy Issues
- Tax Rate and Registration, Returns and Other Remittances
- Sourcing and Other Simplification Issues
- Paying for the System

The Co-Chairs of the Streamlined Project continued that they were still working on a timeline, and hoped to have a pilot project up and running by late 2000. According to the Mr. Collins and Mrs. Hardt, the next meeting of the Streamlined Project will take place April 26-27 in St. Louis, and the following meeting will likely take place May 24-25 in Dallas. The presenters also informed the committee that the progress of the "Project" could soon be followed on the web at www.streamlinedsalestax.org.

The Task Force had several questions for the representatives of the State Tax Departments. Sen. Finan noted the timeline for constructing a system was very ambitious, but applauded the administrators for working so diligently. Sen. Finan cautioned Mr. Collins and Mrs. Hardt not to "let the perfect be the enemy of the good" since it was so important that the tight timeline be kept. Mr. Collins thanked the Task Force for its support and replied that his group was working really hard to meet the timetable. Rep. Travis noted the change in emphasis away from the TTP to a technology solution. He asked if this shift meant that the structure of the system would be different? Mrs. Hardt replied that there were several options still on the table. The first would be the old TTP structure with a number of certified third parties collecting and remitting the taxes. The second option would be a certification process for systems currently in use by large retailers. Lastly there might be a combination of the two.

Rep. Travis followed up asking if the members of the Streamlined Project were confident that the technology could work. Mr. Collins said that the group was confident that technology could facilitate the process and the group was planning to issue and RFI (Request for Information) from the various technology companies in May or June.

Sen. Jauch commented that he was impressed with the Streamlined Project members' work and effort and asserted that all the hard work would pay off as the results would lead to a domino effect of interested states. Maureen Reihl, a representative of the National Retail Federation, cautioned that the process should not be perceived as closed, as that might impair the credibility of the final result. Mr. Collins and Mrs. Hardt, agreed and noted that at each of the meetings there has been a morning session scheduled solely for public comments. Further the project would soon be inviting in representatives from various industries to get their perspectives. Rep. Kisber thanked the group again for their dedication and their leadership.

Retailers Perspective

David Bullington, Executive Vice-President in Charge of Taxes for Wal-Mart Stores, addressed the Task Force on the retailers' perspective on the Internet tax issue, and how best to advance their common positions with the state and local groups. Mr. Bullington started out by acknowledging that the retail community was "asleep at the switch" throughout the debate on the Internet Tax Freedom Act two years ago. He offered several realizations that he has come away with from his involvement with the issue over the past year. First, keeping the various groups with common interests on the same page had been very difficult. Second, he found the state and local groups had been equally stubborn on certain issues as the anti-tax groups. Third, he said that it was clear that the Direct Marketers Association understood the pricing advantage they enjoy and are fighting to protect it. Finally, he noted that in his experience, the groups advocating a level playing field were being outspent by their opponents by as much as 10-1.

Mr. Bullington applauded the Task Force for its hard work on the issue. Furthermore he praised the concept of simplification and technology as a feasible way to reduce the burden on sellers and move toward mandatory collection. He recognized, however, that there were several factors that were evolving that would affect the state efforts. He offered a list of five factors that states would have to understand as they moved forward:

- An extreme urgency in the retail community brought on by e-commerce sales during the last Christmas season.
- Pressure on traditional retailers to cut their loses and move sales online
- Some technology parties are not interested in the streamlined system, as they have worries about new liabilities
- Credit Card Companies/ Financial Institutions/ Delivery Companies
- Trusted Third Party is dead in the water due to public privacy concerns
- Opponents of a level playing field have a lot of money to spend

Mr. Bullington went on to explain that Wal-Mart has called for federal enabling legislation that would provide a roadmap for state simplifications, and triggers for mandatory collection. The simplifications would include meaningful collection allowances. He told the Task Force that more and more people were beginning to warm up to the idea of states receiving mandatory collection on the condition they simplified their sales tax systems. He stressed that the legislation he was proposing would be the cost for any extension of the current moratorium. Finally he explained that the legislation also provided states with an incentive to simplify quickly that would not exist under a purely voluntary system.

Mr. Bullington then answered questions from the Task Force. Senator Borst asked if there was any way this Congress would give states the authority to require collection. Mr. Bullington agreed that it was unlikely in this Congress, but that it was more likely than a favorable decision from the Supreme Court. Rep. Kisber asked who would determine the triggers and whether the states complied or not. Mr. Bullington gave three possibilities: 1) New Commission; 2) Uniform Statute; 3) US General Accounting Office. Mr. Bullington expressed his favor for the GAO to act as judge. Scott Mackey followed up asking why the uniform statute path was not the way to go. Mr. Bullington replied that it would likely take too long, adding that the business community was skeptical that states would simplify without a "stick." He said that he was not unwilling to explore mandatory collection for members of a federally approved compact after a date certain.

Maureen Riehl of the National Retail Federation (NRF) introduced herself to the Task Force and offered her personal commitment as well as the support of the NRF. She told the task force that she looked forward to coordinating support in the members' states and looked forward to working with the Task Force as a whole. She also pledged that NRF would not change its position and oppose state efforts.

Local Perspective on Telecommunications Tax Reform

Margaret Browne from Denver Mayor Wellington Webb's office and Ken Fellman, Mayor of Arvada spoke to the Task Force about their perspectives and concerns about states making tax systems more uniform at the expense of local governments. As an example, Mrs. Browne asserted that if the streamlined sales tax plan were to go into effect in Colorado, and Denver were forced to collect taxes under current state rules, Denver would lose up to a third of its total revenue.

As to telecommunications, Ken Fellman introduced himself as a mayor, a lawyer, and the Chairman of the Local and State Government Advisory Committee to the FCC. He started out by explaining that the focus of the 1996 Telecommunications Act was to remove barriers and increase competition. He agreed that fostering competition is a good thing. At the same time, local governments are charged with managing billions of dollars of limited public rights of way that impact traffic, safety, and beautification. He said he was opposed to state laws limiting local control and cost recovery for public rights of way. He asserted that local government must maintain the right to recover the costs of street degeneration caused by telecommunications companies digging up streets to lay wires and cables.

Mr. Fellman used the City and County of Denver as a test case to assert that local regulations and fees will not necessarily decrease competition. He argued that Denver has the highest telecommunications fees and the most regulation of any city on the Front Range, and yet it still has the highest levels of competition. He posited the tough but correct way to deal with the issue is to acknowledge the role that locals play in the system and to adopt basic principles for administration and taxation of telecommunications companies. Then he said states and local governments should proceed on a case by case basis to find the proper balance. He pointed to the Mobile Telecommunications Sourcing Act as a good example of that method in action. Mr. Fellman went on to explain the position of the National League of Cities. NLC's position is that simplification of regulations is a good step and the cities should be at the table when that occurs. Second, NLC is opposed to ceding rights of way authority to the state.

The Task Force then asked questions of the local representatives. Scott Mackey expressed that local cost recovery seemed to be justifiable, unless the locality also had a gross receipts tax. Mr. Mackey asked if the locals could separate the regulatory issues from the tax issues, as the main push from the industry has been tax simplification? Mr. Fellman pointed out that the different types of telecommunications up to this point had dictated their regulation and taxation (i.e. cable v. phone v. wireless). Mr. Mackey followed up by asking if Mr. Fellman could support a single tax return administered by the state with the money being distributed to the cities based on what would currently be due? Mr. Fellman said that his mind was not closed to the concept. Mrs. Browne replied that she was not confident enough with the state to allow them to administer and remit the taxes to the city. Cameron Whitman, from the National League of Cities, added that it has been her experience that city and local officials trust the federal government far more than they trust their state government.

The Task Force ended the session with a discussion of a set of principles for telecommunications reform. Sen. Rauschenberger has suggested at the last Task Force meeting in Tampa Bay that the Task Force adopt principles to serve as a base for further discussions on the direction of state telecommunications tax reform. The Task Force discussed several principles including specific wording on tax neutrality within the telecommunications industry and fairness in relation to other industries. There was also discussion on the tone of the principles as far as possible mandates on local units of government. Finally, the Task Force discussed reform of disproportionate property taxes on telecommunications companies. The industry clearly had made this issue a top priority, though the Task Force recognized property tax reform would be a more difficult result to achieve politically. The Task Force agreed to defer further action on the principles until Senator Rauschenberger could be present, since he has a strong interest in this area.

The Task Force agreed the next meeting should coincide with the Annual Meeting in Chicago in July.

The meeting was adjourned.

Prepared by Graham Williams, NCSL

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Telecommunications Task Force

Can the Sales Tax Survive Cyberspace?

By Scott Mackey

The explosion of e-commerce is making states very nervous about the future of their sales taxes.

It was a neighbor who first alerted Ohio Senate President Richard Finan that the Internet might pose a threat to the future of his state's sales tax. "A moving van pulled up to his house one day, so I asked if he was moving. He said, 'No, I just bought new furniture over the Internet--and I didn't have to pay any sales tax.'" For years, the Supreme Court has prevented states from requiring out-of-state sellers to collect sales and use taxes legally due from buyers. But now, with many experts predicting that the Internet will revolutionize retailing, states are beginning to get very nervous about the viability of their sales taxes in the electronic commerce environment. Some experts are even questioning whether the sales tax is viable in a 21st century economy. This is a high visibility issue not only in state capitals but in the nation's capital as well, and it has all the elements of high drama. The players are:

- A federal commission chaired by a governor who has questioned the viability of the state sales tax.
- Members of Congress who want to preempt state tax policy without regard for the impact on state finances.
- State legislators and governors who see electronic commerce as a powerful economic development tool, but who also understand that education and infrastructure (often funded by sales taxes) are key building blocks in high-technology growth.
- Consumers who see Internet buying as a way to "beat the system."
- CEOs who must balance the need for skilled workers with the desire for low taxes.

A powerful telecommunications industry with the means to provide candidates with needed cash just as the 2000 election cycle is heating up.

What makes this such a daunting issue is that its ultimate resolution depends on so many interrelated factors: Will electronic commerce grow exponentially, as analysts are predicting? Will electronic commerce revolutionize marketing, distribution and retailing? What will the federal advisory commission studying this issue recommend to Congress? Will Congress act during a presidential election year? Where do the presidential candidates stand? Will governors and legislators pass legislation to reduce the administrative burdens imposed by the sales tax?

Ultimately, the states must live with the consequences of the decisions, many of which they have no control over. "This may be the most important issue that states have faced in a generation," says NCSL Executive Director William Pound. "How Congress and the states resolve it will influence the balance of power between the federal government and the states for decades to come."

NCSL Task Force Develops Policy Principles

NCSL's Task Force on State and Local Taxation of Telecommunications and Electronic

Commerce is charged with the difficult duty of developing recommendations for NCSL policy on modernizing state and local sales and use taxes and how to tax telecommunications providers and services.

Established in November 1998 and headed by Co-Chairmen Tennessee Representative Matthew Kisber and Illinois Senator Steven Rauschenberger, the task force has already influenced NCSL policy. It developed seven principles that will guide lobbying efforts in Washington and with the federal Advisory Commission on Electronic Commerce. These principles were adopted unanimously by the delegates at the Indianapolis Annual Meeting in July. Next on the agenda: recommending state changes in sales and use taxes and telecommunications taxes to prepare tax systems for the 21st century.

These seven principles are:

1. State and local tax systems should treat transactions involving goods and services, including telecommunications and electronic commerce, in a competitively neutral manner.
2. A simplified sales and use tax system that treats all transactions in a competitively neutral manner will strengthen and preserve the sales and use tax as vital state and local revenue sources and preserve state fiscal sovereignty.
3. The Internet and Internet vendors should not receive preferential tax treatment at the expense of local "Main Street" merchants, nor should such vendors be burdened with special, discriminatory or multiple taxes.
4. States should recognize the need to undertake significant simplification of state and local sales and use taxes to reduce the administrative burden of collection.
5. Under such a simplified system, remote sellers, without regard to physical presence in the purchaser's state, should be required to collect sales and use taxes from the purchaser and remit such taxes to the purchaser's state.
6. NCSL should encourage current and future cooperative efforts by states to simplify the operation and administration of sales and use taxes.
7. NCSL will continue to oppose any federal action to preempt the sovereign and constitutional right of the states to determine their own tax policies in all areas, including telecommunications and electronic commerce.

The task force's web site provides more information about itself and its work

An Old Problem...

The origins of the current Internet tax debate can be traced back to another era of major economic change in the United States: the Depression. State and local governments, which relied primarily on property taxes, suddenly faced a collapse of property values across the country. Many states turned to sales taxes to replace the failing property tax. In 1930, Mississippi became the first state to levy a general sales tax. By the end of the decade, 23 other states had followed suit. Today, only Delaware, Montana, Oregon and New Hampshire lack a state or local general sales tax.

These "new" sales taxes were designed in an era when citizens bought goods at the local store. The local merchant could, without much trouble, collect a few pennies on the dollar and send the money to the state once a month. And because retailers were present in the state, there was no question that states had the authority to require them to collect taxes on their behalf.

Fast forward to the 1950s and 1960s. The improvement of our national highway system opened up many opportunities for multistate selling. Major national retail chains emerged; consumers became increasingly mobile and had the ability to shop across state lines.

To protect in-state retailers from competition from out-of-state vendors, states turned to "use" taxes. Use taxes require residents who purchase taxable goods in another state to pay the equivalent of a sales tax in their home state. The use tax preserves a key principle of the sales tax: that the tax is due in the state where the product is used or consumed, not necessarily where it is purchased.

States had a fundamental problem with the use tax, though. For many transactions, they could not collect the tax because they relied on out-of-state merchants--not the state tax department--to collect the money. These merchants balked at becoming tax collectors for hundreds of states and localities, arguing that other states had no jurisdiction over them.

State attempts to enforce this use tax--by requiring out-of-state firms to collect taxes from customers--led to the 1967 Supreme Court decision commonly known as Bellas Hess. In that case, the court ruled that states lack the authority to compel out-of-state firms to collect use taxes unless those firms have "nexus" in the state. Nexus was defined by physical presence--having an office or store, owning property or employing workers in a state.

The Court's decision was rooted in the Commerce Clause of the U.S. Constitution, which gives Congress jurisdiction over issues involving interstate commerce. The Court said that imposing a tax collection obligation on out-of-state sellers would impose an "undue burden" on interstate commerce. This burden stems from the incredible complexity of state and local sales and use taxes--complexity that persists to this day.

For decades, states tried to convince Congress to overturn the Bellas Hess decision, but with no success. Congress had little incentive since all the potential new revenue would flow to state and local governments. A prosperous and powerful mail-order industry made sure Congress knew that it would be blamed for a tax increase if members acted to overturn Bellas Hess.

States also tried to convince the Supreme Court to reverse its decision. But in the 1992 Quill decision, the Court reaffirmed the physical presence standard in Bellas Hess.

With New Urgency

By the mid-1990s, mail-order retailing had become a mature, slow growth industry. A 1994 report by the federal Advisory Commission on Intergovernmental Relations estimated that states lost about $3.3 billion in uncollected use taxes in 1994 on about $58 billion in sales where no tax was collected. The report also pegged the growth in mail-order sales at about 5 percent per year.

Although states were concerned about the revenue loss from mail-order sales, $3.3 billion on a base of $120 billion in state sales taxes was a relatively small problem. And with mail-order sales growing at a slow, stable pace, there was little cause for alarm.

But the Internet has changed all that. Economists and market research firms have been continuously upgrading their projections of how quickly Internet sales will grow in the next five years. Economist Austan Goolsbee in May told members of the NCSL task force studying this issue that sales to cons umers would top $8 billion in 1999--a fivefold increase from actual sales of $1.5 billion in 1998. At the time, Goolsbee's projections were at the high end of the forecasting range.

By October, firms using data for the first three quarters of 1999 projected that Internet sales would top $20 billion. The updated projections were based upon the rapid growth (and success) of "clicks and mortar" retailers--retailers like Gateway, Gap and others that have storefronts where consumers can test merchandise and then place orders on their Web sites right from the store.

What really ought to scare state policymakers are long-term projections of the growth of Internet sales. The mid-range estimates predict sales of $150 billion by 2003. States paying the most attention are those that rely heavily on sales taxes because they do not have income taxes--Florida, Nevada, South Dakota, Tennessee, Texas, Washington and Wyoming.

Tennessee Representative Matthew Kisber, co-chair of the NCSL task force that is studying this issue, points to his home state as an example. "Our revenues are not keeping up with economic growth, so we face a budget shortfall while most other states enjoy surpluses. One reason is that the sales tax base just keeps shrinking. Electronic commerce will only make that problem worse."

But with states enjoying record surpluses right now, it is hard to convince policymakers that the sky is falling. In fact, an industry sponsored study, "The Sky is Not Falling," makes the case that there is very little state revenue loss from Internet commerce right now.

The Tangled Web Of Sales And Use Taxes

At the heart of this issue is the sales tax itself. Over the years, states have created a complex system that truly imposes an enormous burden on multistate sellers. Companies like Sears and JC Penney, which have nexus in most states, spend a lot of money to comply with it. Firms like L.L. Bean and Amazon.com go out of their way to avoid the burden.

Consider a small Vermont firm that decides it wants to sell maple syrup directly to customers through an Internet site. First of all, it must determine if the product is taxable in the purchaser's state. Twenty-eight states exempt food for home consumption from the sales tax. Missouri, North Carolina and Georgia exempt food from the state sales tax, but not local option taxes. Colorado lets cities decide whether or not to tax food--some do, some don't.

But wait--is maple syrup food? States define food differently. Depending upon the statute or administrative interpretation, maple syrup may be considered food in one state and not in another. Once the vendor determines that the maple syrup is taxable, it must determine the applicable state and local taxes based on the customer's address. Thirty-three states allow for local option taxes, so the vendor must either ask the customer what the rate is or use software to determine it.

What if the person ordering the syrup is buying it to use in the annual Boy Scouts fundraising breakfast? The Boy Scouts may qualify for an exemption from all sales taxes because it is a charitable organization. The out-of-state vendor must know whether or not to honor the exemption request based upon another state's laws.

And to top it all off, the vendor who collects the tax becomes subject to audits from each of the state revenue departments (and some local revenue departments, as well). If the vendor makes a mistake--for example, honoring an exemption request from a purchaser who is not entitled to one--it may be liable for payment of the uncollected tax.

This hypothetical example illustrates how burdensome complying with state and local sales and use taxes can be to out-of-state sellers. Every time legislatures pass an exemption, a new local sales tax for stadiums or transit, a one-week sales tax holiday or some other special provision, the burden on national retailers grows.

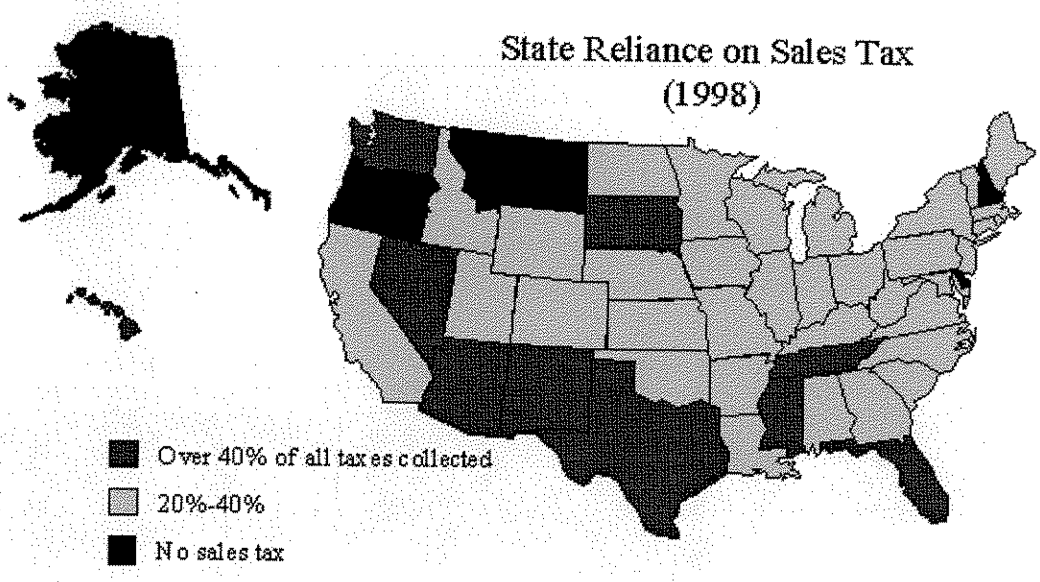
The Fairness Issues

There are two fairness issues wrapped up in this debate. The first is the disparity between the treatment of "Main Street" retailers and Internet sellers. In an era where retail margins can be very small, remote sellers can offer their products for 5 percent to 8 percent less than traditional merchants by not collecting the sales tax. Shipping costs may help minimize the price advantage somewhat, but for computers, electronics and other expensive items the tax savings overwhelm any shipping costs.

An important principle of good tax policy is competitive neutrality--that sellers of similar or identical products be treated the same under state tax laws. The disparity between traditional and remote sellers clearly violates this principle.

Not only sales taxes are at risk. Main Street merchants also pay property taxes and support local charities and civic organizations. If they cannot compete with remote sellers due to disparity in tax treatment, local communities suffer.

The second fairness issue concerns the administrative costs imposed on multistate sellers with nexus. Firms that decide to have storefronts--either traditional national chain stores or the emerging "clicks and mortar" model pioneered by Gateway computers--face a costly administrative compliance burden that their competitors without nexus can avoid. These administrative costs--keeping track of state sales and local sales tax law changes, filing forms, participating in audits and defending against legal actions from state revenue departments--come right off the bottom line.



Simplification

Can the sales tax be "saved" or is it structurally incompatible with the 21st century economy? That is the question that state and federal lawmakers, academics and business leaders are trying to come to grips with. There's no answer yet.

It is clear that if states are ever going to collect taxes from remote sales, they must minimize or eliminate the "undue burden" of collection by simplifying state and local sales taxes.

The dilemma for legislatures is that most simplification options require states to give up some measure of authority over their tax policies. For example, one option is for legislatures to adopt a single sales tax rate per state. Most local governments, although unhappy about the prospect, would probably go along with "one rate per state" if it applied only to remote sales.

But a single rate per state for remote sales means continuing the disparity between Main Street and remote sellers. Remote sales could be taxed at a lower rate in one location and at a higher rate in others. Higher rates for remote sales may run afoul of constitutional prohibitions against states interfering with interstate commerce. Also would companies that have both stores and Internet sales be subject to the "one rate" or the local option rate?

A single rate per state would overcome these problems only if it applied to all commerce. This means the end of all local option taxes as they exist today, a prospect likely to encounter stiff resistance from local governments. No more stadium taxes; no more local transportation or cultural facilities taxes; and no more local autonomy over a major source of local tax revenue in some states. Local governments would have to trust legislatures to make up for lost funds through revenue sharing programs.

Another likely requirement of a simplified system is that states adopt a common set of definitions of products and services subject to the sales and use tax. Right now, the same product may be defined differently depending upon the state. A common set of definitions would allow the development of a database that would tell retailers whether the product they are selling is taxable or exempt in each state.

States would also need to agree on standardized filing, treatment of exempt organizations, and simplified audit and record keeping procedures. Remote sellers are unlikely to agree to any system that subjects them to 50 different state audits.

A Technology Solution?

In the last few months, another simplification option has emerged that would harness the power of technology and the Internet to simplify sales and use taxes. Called the "zero burden system" because it would remove the collection burden from retailers, this idea builds upon current technology that allows retailers to verify credit and debit card purchases in "real time."

The system would create a third-party financial clearinghouse that would maintain a national database of tax rates by jurisdiction and by which products are taxable in each state. When a transaction is processed, the company would supply retailers with the amount of tax to collect. Instead of the retailer collecting the tax and remitting it to the states, the tax would go directly to this third-party clearinghouse and then be remitted to the states.

Under this system, retailers would no longer be burdened with collecting the tax. Of course, states would have to pay for this service--much the same way that vendors pay VISA, American Express and other credit card companies through a small percentage of each transaction.

States would still need to take several steps to simplify their sales and use taxes. One of the biggest problems is the lack of uniformity in how they treat exemptions for nonprofits, charitable organizations, farmers, business purchases and others. A zero burden system would also require standardized exemptions and other steps to simplify the administrative side of sales taxes. But the major policy decisions--whether to tax certain goods and services and at what rate--would remain with the legislatures.

Will legislatures be willing to make such changes to their tax systems, especially at a time when states are boasting of record surpluses? Those segments of the e-commerce industry that are opposed to any taxes on Internet commerce are trying to convince Congress and state policymakers that any efforts to collect existing use taxes are tantamount to new taxes. At a time when states have been cutting taxes, no elected official wants the "tax and spend" label.

There may be ways to sell this issue to the public, however. The fairness to Main Street argument strikes a responsive chord with many citizens. It is also possible that a sales tax modernization effort could be coupled with a reduction in sales tax rates for all consumers. Although Internet shoppers would be forced to pay legally due taxes that previously went uncollected, all consumers would pay less on their Main Street purchases. This would help ensure that citizens at the wrong end of the "digital divide"--generally lower income citizens without computers and Internet access--would get a tax reduction.

States Represented on Federal Board

A state legislator and three governors serve on the federal Advisory Commission on Electronic Commerce, the group charged with advising Congress on whether and how to tax Internet transactions.

Among the 19 members are Delegate Paul Harris of Virginia, and Governors James Gilmore of Virginia (who serves as chair), Michael Leavitt of Utah and Gary Locke of Washington.

The commission, which includes representatives from the technology industry and government, must recommend a national Internet tax policy to Congress by April 2000. Other members are: Dean Andal, California Board of Equalization; Michael Armstrong, AT&T; Joseph Guttentag, U.S. Treasury; Delna Jones, Washington County commissioner, Oregon; Ron Kirk, Dallas mayor; Gene Lebrun, National Conference of Commissioners of Uniform State Laws; Robert Novick, U.S. Department of Commerce; Grover Norquist, Americans for Tax Reform; Richard Parsons, Time Warner Inc.; Andrew Pincus, Department of Commerce; Robert Pittman, America Online;

David Pottruck, Charles Schwab and Company; John Sidgmore, MCI Worldcom; Stan Sokul, Association for Interactive Media; and Theodore Waitt, Gateway Inc.

For more information, go to the commission's web site.

Three Paths

There are three possible outcomes to this debate, at least in the short term: 1) Congress could make the Internet a "tax-free" zone and preempt state and local taxes, creating a major new tax loophole for firms that have both Internet sales and Main Street stores; 2) Congress and the states could maintain the status quo, with Main Street firms continuing to collect sales taxes, and remote sales escaping taxation; or 3) States could simplify the sales tax, perhaps leading to the collection of use taxes on remote sales.

The federal Advisory Commission on Electronic Commerce may play an important role in this debate. Members of the commission appear to be divided, with about a third favoring legislation to preempt state authority, a third favoring sales tax simplification in exchange for collection by out-of-state retailers and a third undecided.

The stakes for the states are enormous. Congressional legislation to codify the Quill decision--or go beyond it--could prevent states from ever resolving this issue on their own through cooperative efforts to simplify sales and use taxes. As University of Georgia at Athens Professor Walter Hellerstein recently commented, legislation to create tax- free Internet commerce, such as the bill proposed by U.S. Senator John McCain of Arizona, would "create a loophole through which not just the truck but the whole caravan could drive." Over time, the sales tax would become less and less important as a state revenue source--strengthening the hand of congressional advocates of a national consumption tax. States might lose the only revenue source fully under their control.

Even if Congress does not act to preempt state taxes, Quill remains the law of the land. State inaction on simplification would lead to the same result as federal preemption--a marginalized sales tax that continues to decline in importance as a state revenue source and imposes heavy administrative burdens on multistate firms with nexus.

The third option is for states to act. "We can no longer rely on a Depression-era sales tax system in a digital, 21st century economy," says Illinois Senator Steve Rauschenberger, co-chair of the NCSL task force. "And we can't expect Congress or the Supreme Court to bail us out of the mess we've created. Cooperative state action to simplify state and local sales taxes may be the only way to save them."

The strong economy may lead some state policymakers to question the need to act right away. But with Internet commerce growing exponentially, state inaction today may prevent states from ever coming to grips with the fundamental flaws in the current sales tax.

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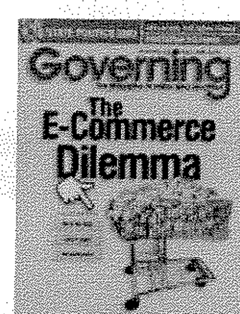
COVER STORY | TAXATION

E-Conomics Problem

With Congress' Internet tax commission deadlocked, governors and mayors are desperately seeking solutions to their e-commerce sales-tax dilemma.

BY CHRISTOPHER SWOPE

As Michigan taxpayers sit down to fill out their tax forms this year, many are in for an unwelcome surprise. When they get to Line 30, they will see something they've never seen before: a space in which to tally their Internet taxes.



By now, a lot of folks in Michigan, as elsewhere around the country, have come to conclude that buying stuff online is tax-free. And with good reason. Most Internet retailers don't bother to collect sales taxes, except in a very few states where they have to. That was OK for a while. In the early days of electronic commerce, the tax revenues that Michigan lost to Internet retail amounted to a pittance.

Not anymore. State revenue experts estimate that Michigan is losing $21 million a year in tax-free Internet sales — and growing fast.

On Line 30, Michigan is asking taxpayers to add up all of the tax-free purchases they made last year, both on the Internet and through mail order catalogs. Then multiply by 6 percent. For the most avid of online shoppers, this could come to hundreds, if not thousands, of dollars. It is likely, however, that most taxpayers will just skip Line 30. After all, there's no way that Michigan can track what they bought.

The 6 percent tax that Michigan is asking residents to pay is not actually sales tax. It is something called "use tax," which for decades residents have ostensibly owed when they buy things from out of state. But like the 44 other states that have use taxes in place, Michigan has never before made much effort to collect it. "We've never had broad compliance from consumers," says Michigan Treasurer Mark Murray.

The point of Line 30 is not, however, to raise cash. It is to prepare taxpayers for a permanent response to the Internet tax problem. Michigan is gearing up to test new technology that would automatically collect sales and use taxes on Internet purchases. And that pilot, which could begin as early as this year in several other states as well, is itself a prelude to much bigger plans to come.

The "Big Seven" associations representing state and local officials, led by the National Governors' Association, are sketching out a sweeping strategy to completely overhaul the way in which state and local governments collect sales and use taxes. The explosion in tax-free e-commerce sales, they say, is putting traditional retailers who do collect sales taxes — on America's Main Streets and in its shopping malls — at a competitive disadvantage. It also threatens the budgets of 45 states and hundreds of cities, which count on sales and use taxes to pay for the essential government services. "Ten years from now, the typical person will be all wired," Dallas Mayor Ron Kirk says, launching into a popular joke. "He'll have his high-speed Internet link, buying everything online. His life will be dependent on computers and the Internet. Then one day, in all that electronic equipment, he'll have a short, and it will start a fire in his house. And when he calls 911, we'll fax him a picture of a fire truck."

The irony, however, is that if technology, through the Internet, is bringing state and local budgeteers' concerns to a crisis point, then it is technology that also may bail them out. State and local officials want Internet retailers to use software that would automatically calculate and charge sales and use taxes. The system would be run by a third party — meaning that collection of sales and use taxes would essentially be privatized. To make the system work, states would probably have to simplify the myriad complexities of their sales-tax codes. In essence, they would be creating a national sales tax, implemented on a state-by-state basis.

This idea is one of several to come out of a commission that Congress appointed in 1998 to study Internet taxes. With one meeting remaining, the Advisory Commission on Electronic Commerce is deadlocked. One faction on the commission, led by Utah Governor Michael Leavitt, generally supports the privatized software solution. On the other side is a group, led by Virginia Governor James Gilmore, that proposes making all online purchases tax-free for consumers. Gilmore disagrees with the notion that making the Internet tax-free would put traditional retailers at a disadvantage. "I just don't start from the assumption that everything in America ought to be taxed," he says. "And therefore, to not tax it is somehow implying some type of privilege."

In Congress, there is a lot of support for Gilmore's position — especially from anti-tax conservatives. But other members of Congress are pushing a national sales tax in which the federal government would pass the revenues back to the states and cities.

The good news for state and local officials, many of whom aren't happy with either approach, is that Congress is likely to be as stalemated as the commission. That means many eyes will be watching the circle gathering around Governor Leavitt. Leavitt insists that the states can put their privatized tax regime in place without Congress' blessing. The approach has the support of at least half of the nation's governors, including high-profile Republicans such as John Engler from Michigan and Wisconsin's Tommy Thompson. This year, perhaps a dozen legislatures will consider proposals to have their states' top revenue officials meet to start pounding out details.

They are in for a monumental undertaking. The effort will require an unprecedented amount of interstate cooperation to keep all the states and cities moving in one direction — while fending off Congress in the meantime.

There is fair reason to doubt that the governors can pull off their gambit. Overhauling all the states' tax codes on a state-by-state basis is bound to be a political mess. Along the way, they will have to do battle with the myth of the tax-free Internet, which is already ingrained in many people's minds. Although the governors are only proposing to collect use taxes already on the books, people will inevitably interpret the move as a tax increase.

Then there is the question of whether this is something the governors should be pursuing. A privatized tax-collection system is enough to make even the most committed privatization advocates nervous. And anything the states try to do on this would likely be challenged in the courts. Critics make a strong argument that the states are wading too far into matters of interstate commerce. "Somebody has to lay down the law here," says Robert Strauss, an economist at Carnegie Mellon University. "And that's Congress."

If this debate has a familiar ring, it is because it is essentially a replay of the feud that states have had for decades with mail-order companies. In both Congress and the courts, state and local governments have fought to make catalog retailers collect taxes for them. And for the most part, they've lost. "This is an old wound aggravated," says David Hardesty, author the book "Electronic Commerce: Taxation and Planning." "They used the debate surrounding e-commerce to reopen this argument."

The main obstacle is a 1992 Supreme Court decision on taxing mail-order sales, known as Quill Corp. v. North Dakota. The Quill decision said that states cannot force catalog companies to collect taxes for them — unless the retailer has a physical presence, or "nexus" in that state. In other words, L.L. Bean, the Maine catalog company with stores in no-sales-tax states, must only collect sales taxes from its customers in Maine. It would be an "undue burden," the court said, for L.L. Bean or any other seller to have to keep tabs on the sales-tax rates in each state and every city, as well as all the numerous exemptions and special rules those jurisdictions impose.

In the wake of Quill and a similar earlier ruling, state and local governments feared that they would lose a lot of revenue. They went to Congress and proposed a bargain: If Congress would make catalog companies collect taxes for them, they would simplify their tax codes to make collection easier. But nothing ever came of it.

So the states and cities learned to live with Quill. Instead of asking sellers to collect taxes, they tried to collect the tax themselves. It wasn't hard on business-to-business purchases, because businesses are audited regularly. But collecting taxes from household consumers was a nightmare. By the mid-1990s, state and local governments were losing as much as $3 billion a year in revenue on tax-free mail-order sales.

Comparatively, electronic commerce is still small, but it is growing exponentially. According to Forrester Research, Internet sales topped $18 billion in 1999, and could reach $108 billion by 2003. Multiply those numbers by, say, a 6 percent sales tax, and the budgetary threat of e-commerce dwarfs the damage that mail order did.

Taxware, a small computer software company, is sitting in the right place at the right time. Since 1980, the company has been developing computer systems that help businesses comply with state sales- and use-tax laws. At Taxware's Salem, Massachusetts, headquarters, a brigade of more than three dozen employees is dedicated to an unconscionably complex task: keeping track of how 7,600 different state and local jurisdictions tax some 1,500 different products.

The state and local strategy for taxing electronic commerce relies heavily on the research and technology produced by companies such as Taxware. A software solution would do more than create technological wizardry. It would help the states circumvent the Quill decision. After all, the court had said it would be too burdensome for remote sellers to keep track of all the different state and local tax rates — but technology could ease that burden for them.

The governors propose making banks or credit-card companies responsible for collecting sales taxes. These so-called "trusted third parties" would embed tax-collection software into the Web sites of e-commerce vendors. When a customer buys a product online, the third party would automatically calculate and charge the proper sales or use tax and then pass the revenue back to the right state or city.

State and local governments would pay for the system through a small fee on each transaction. A profit margin built into that fee would aim to attract private-sector partners.

Should governments be turning over one of their most basic functions — tax collection — to small private shops? Even the conservative Heritage Foundation, which has advocated privatization of everything from adoption services to airports, thinks the NGA plan goes too far. "How trustworthy are the trusted third parties?" asks Adam Thierer, a Heritage scholar who testified before the e-commerce commission. Thierer's main concern is maintaining taxpayer privacy in a system where private parties know what people are buying, where they live, and what their credit-card number is.

Beyond the privacy factor, local-level sales-tax rates sometimes vary from neighborhood to neighborhood. In these places, pegging exactly which tax district a shopper and her computer are in would be no easy task. Spelling errors and other glitches could easily muck things up. "A computer can do a lot of things, but it can't figure out what it is that you really meant to spell," says David Sjoquist, an expert on state and local taxation at Georgia State University.

A bigger problem is that no two states share the same tax base, with different states exempting different products from the sales tax. Unique rules abound. For example, in Massachusetts, the first $175 of an article of clothing is tax-exempt. In Connecticut, only the first $50 is tax-exempt. In New Jersey, clothing is completely tax-exempt. Then there is the question of what constitutes clothing. "The real problem is the varying definitions," says Tennessee state Representative Matt Kisber. "It's difficult writing software that understands whether a scarf is for decorative purposes and is taxable, or if it's clothing intended for warmth and is tax-free."

A diligently programmed software package could handle this. But state and local officials are coming to understand that they need to simplify and harmonize their sales taxes. This year, revenue officials from a dozen or so states are expected to come together to start working out a plan to do just that. "If the system remains as complex and burdensome as it is today, the software will cost a whole hell of a lot of money," says Frank Shafroth, chief architect of the plan at NGA. "The greater the simplicity, the cheaper it will be."

As the simplification debate moves off of dry-erase boards and into state legislatures, it is likely to open a political Pandora's box. Local governments, for one, are skeptical of simplification. Some ideas on the table, for instance, call for one tax rate per state. That would effectively lock cities and counties out of using sales taxes in the future. Given how much local governments rely on sales taxes to fund roads and arenas and to pay off bonds, they will be a powerful force in the debate.

Other special interests could get involved, just as they have whenever sales-tax-base issues have come up. For example, Georgia's sales tax exempts the bait used by its lucrative shrimping industry. The simplification debate could end up a lobbyists' free-for-all as lawmakers unpeel the shrimp exemption and hundreds of others like it.

Some critics fear that, given the complex politics involved, legislatures won't confront the political challenge but will lean on the software solution as a golden crutch. "The NGA proposal leaves a lot of the complexity in place," says Charles McLure, a tax expert at Stanford University's Hoover Institution and a longtime simplification advocate. "It says we'll transfer the costs of that complexity to the trusted third party."

Illinois state Senator Steven Rauschenberger is more optimistic. "The biggest motivating factor for states is that they'll recognize soon that if they don't act to modernize their tax codes and make the system work, they may not have much of a system left to be concerned about."

There is another way that the NGA plan tries to circumvent the Quill decision. The court said that states could not require remote sellers to collect sales or use taxes. But the NGA plan does not demand that merchants play in this elaborate system of trusted third parties. Participation is voluntary.

The big question is: Why in the world would any Internet retailer sign up if they don't have to? "The problem with a voluntary system is that there is a reward for holding out," says Richard Prem, the head of e-business services at Deloitte & Touche. "By joining, businesses would be giving up sales."

The least likely to join would be the pure e-commerce sellers. Take ValueAmerica.com, a company that sells merchandise only over the Internet. Under the current rules, ValueAmerica has nexus only in Virginia, where its headquarters are located. For ValueAmerica to join the third-party system, it would be giving up a big competitive advantage over bricks-and-mortar retailers: tax-free shopping in 49 states.

There are some retailers, however, who would be likely participants, according to Leavitt. The most promising are big national chain stores. By now, nearly every major chain retailer, from big-box stores such as Staples to mall fixtures such as Crate & Barrel, has a virtual store online. But because they have physical stores — and thus nexus — in so many states, they already have to collect taxes for almost every state. Having a third party collect taxes for them would actually relieve a major hassle for these "bricks and clicks" retailers.

But there is a loophole in that logic, one that big chain stores are tearing through like running backs. Look at Wal-Mart. With 2,500 stores in all 50 states, Wal-Mart would be a natural fit for the NGA plan. But in January, Wal-Mart followed the example of its competitor K-mart and others: It created a separate company for its Internet business. Despite close ties to the mother company, the upstart Walmart.com bears more resemblance to ValueAmerica. It has nexus only in California, where its headquarters are, and Arkansas and Utah.

Aware of this problem, the states are planning a number of carrots to try to persuade even sellers such as Amazon.com or Walmart.com to participate. For example, the third parties might offer financial bonuses to retailers who play. In addition, participants would receive a sort of tax amnesty. And there might also be a bureaucratic advantage to joining: Sellers would have to answer to only one state audit, rather than 45 audits by the states that assess sales and use taxes.

There is also one big stick: the courts. The states could do some legal ganging up on Amazon and Wal-Mart in the same way that they went after tobacco companies. They might have a case. Does Amazon create additional nexus for itself when it posts its link on another vendor's Web site? Perhaps not. But these types of questions are as yet largely unsettled, and it might be more expensive for dot-com companies to litigate than to go with the program.

Critics argue that the governors' proposed tactics are too strong-armed. "How voluntary is a system when it offers financial incentives as carrots to get sellers to join?" asks Adam Thierer. "The whole system hinges on two things: Will the trusted-third-party idea mechanically work? And is it really voluntary? If the answer to either of those questions is no, then the NGA plan falls apart."

Besides, the states may have trouble getting merchants to play, despite the incentives. The governors' plan amounts to "fiscal hunting in the dark," says Carnegie Mellon's Robert Strauss. "There has to be federal legislation here," he adds. "There need to be some rules of the game for states to collect use taxes."

Then, again, the system might half work: Some retailers would play, while some wouldn't. But if the result is replacing the current inconsistent patchwork of taxes with another, it wouldn't much satisfy anyone. "If we go down the road of a voluntary system, and we're only partially successful, we will have lost lots of time which we can't replace," says Wade Anderson, who used to be the top tax collector in Texas. "It will make it that much harder to go back and change this later. But I wish them luck."

Written Statement to the Advisory Commission on Electronic Commerce

by

Representative Matthew Kisber, Tennessee
Chairman, House Finance, Ways and Means Committee

Senator Steven Rauschenberger, Illinois
Chairman, Senate Appropriations Committee

Co-Chairs, NCSL Task Force on State and Local Taxation of Telecommunications and Electronic Commerce

on behalf of the
National Conference of State Legislatures

September 15, 1999

Thank you Governor Gilmore and members of the Commission for the opportunity to address the Commission. We speak on behalf of the National Conference of State Legislatures, the bipartisan national organization representing every state legislator from all 50 states, our nation's commonwealths, territories and possessions.

We would like to begin by acknowledging the role that the industries represented on this Commission have played in this incredibly robust economic expansion. Your firms have helped to create the tools that have allowed our businesses - and governments - to be more efficient, more productive, and more responsive to our customers. As a result, our nation has enjoyed phenomenal economic growth - without much inflation. This economic environment has dramatically increased household wealth and left state governments in their best fiscal position ever.

States and Electronic Commerce

Unfortunately, we also need to acknowledge that there is much misinformation being disseminated that state governments view the Internet and Electronic Commerce as a "cash cow" and we, as state officials, are salivating for our prime cut. This is simply not true.

Speaking for our colleagues, we know that they recognize the vital economic force that the Internet and advanced telecommunications services will be for our states and our nation. We also are as concerned as you are about the unintended consequences of obsolete, discriminatory or multiple taxes on this vital new technology.

It also is important to note for the record that no state has enacted any Internet specific taxes. In some states where a tax on Internet access was grandfathered by the Internet Tax Freedom Act, states legislatures have worked to repeal those taxes.

With that said, we need to make clear that state legislatures are equally concerned about the impact that sales tax free electronic commerce transactions will have on state revenues and the unfair competitive burden it will have on small main street businesses in our communities.

We have some additional points to make on this issue:

- State leaders recognize the role that a strong telecommunications infrastructure will play in future economic growth.
- In the last five years state legislatures and governors have reduced taxes by over $25 billion. And as long as the economy remains strong, tax reductions will continue.
- Most states do not tax Internet access charges and the trend is to exempt them. And even in states that do tax Internet access, a 5% to 8% tax imposed on the customer is not going to measurably affect demand for Internet access. AOL increased prices by 10% in 1998 and its revenue base, stock price, and market position remain strong.
- If business is concerned about taxes on the "Internet," they should be talking to Congress. Most of the current taxes on the "Internet" are federal excise taxes, access charges, and other taxes and "fees" on the telecommunications providers that are the backbone of the Internet - not state and local sales and use taxes.

Our concern at the state level is the future of our primary consumption tax - the general sales and use tax. This tax provides about one-third of state revenue - over $150 billion in 1998 - with most of the funds used to finance K-12 education.

Sales Tax Popularity

As we all know, taxes are not very popular. However, if state and local governments are to provide necessary services, like education and public safety, then we need to maintain our ability to levy taxes. In surveys of taxpayers as to which tax of all the major federal, state and local taxes they dislike the least, the surprising answer has been the sales tax.

Voters all over the country have approved local sales taxes to pay for sports stadiums, added police protection, land acquisition for open space, and transportation improvements. The taxpayers of the state of Michigan overwhelming voted to use the sales tax as opposed to property tax as the major source of revenue for education and then the next year, they voted to increase the sales tax. How many federal taxes have been enacted by a direct vote of the people?

As you know, the sales tax is imposed on the customer, not the seller. Sellers collect the tax on behalf of state and local governments and pass this money along to them. Many states pay merchants for this service, typically allowing them to keep between 1 and 3 percent of what they collect to offset the administrative cost.

Sales Tax and Electronic Commerce

The problem states have with the sales tax is that the base keeps shrinking. In the 1930s, when the sales tax was first imposed, consumers bought goods from the local merchant and it was not that difficult for the merchant to collect a few cents on the dollar. Also, most Americans spent very little on services - they spent most of their money on taxable goods. And there were very few "remote sellers."

In the 1970s and 1980s, the share of personal consumption expenditures began to shift from taxable goods to services - things like medical care, health clubs, legal and accounting services. So the sales tax was applied on a smaller and smaller share of tangible products. This was compounded on the goods side by mail order outlets selling goods without collecting sales taxes from their customers - a practice sanctioned by the US Supreme Court in the *National Bellas Hess* case in 1967 and reaffirmed in the *Quill* decision in 1992.

Today, states face a new threat to sales tax revenue, electronic commerce, with the potential to dramatically expand the volume of goods sold to customers without collection of a sales or use tax. The combined weight of the shift to services and the tax erosion due to electronic commerce threatens the future viability of the sales tax.

Let us pose a hypothetical question. What would happen if the federal government allowed customers to avoid paying federal airline ticket excise taxes if travelers purchased their tickets over the Internet, but kept the tax in place on purchases from travel agents? That would give us - and other air travelers - a 10% price discount and provide a tremendous incentive to buy over the Internet. Obviously, travel agents would disappear and federal revenues would dry up in a hurry. To some extent, this is the same situation that state and local governments face with the sales and use tax on Internet purchases.

As state legislators, we recognize that we have been part of this problem. We have created a confusing, administratively burdensome tax system with very little regard for the compliance burden placed on multi-state businesses. The NCSL passed a resolution this summer - written by the Task Force that we chair - acknowledging for the first time that states need to simplify their sales and use taxes and telecommunications taxes for the 21st Century. We recognize that we are a key part of the problem - and the solution.

So the remainder of our comments focus on options for state legislatures and for this Commission. As we see it, there are really only three options.

Option 1 - the Status Quo

Under this scenario, we keep the current system as it is. Remote sellers without a physical presence would continue to be protected from the "undue burden" of use tax collection under the current Supreme Court decisions in *National Bellas Hess* and *Quill*. Sellers that are physically present would continue to have a sales tax collection obligation.

There are two primary reasons to be concerned about the status quo. First, states and local governments would continue to see erosion of the tax base as electronic commerce vendors gain market share. Second, it is just not fair to treat sellers of the same product differently by making one vendor collect a tax while a competitor does not.

We do not support continuation of this unfair system.

Option 2 - the Internet as a Tax Free Zone

Some have suggested that the Internet should be preserved as a tax free zone, with a permanent moratorium on taxes on Internet access as well as a moratorium on sales and use taxes on goods and services sold over the Internet.

We do not support this option.

Creating a tax free zone on the Internet would be the beginning of the end of the state and local sales tax. Entire retail sectors would argue for sales tax exemptions, lest electronic commerce vendors drive them out of business. In essence, Congress would be choosing the "winners" in our economy, choosing e-businesses in competition with other taxpaying interests. This would not be an appropriate role for the federal government to play. States would be forced to either grant these exemptions or watch main street and mall retailers lose market share. Not all retail sectors would ultimately fail, but many would.

With a declining consumption tax base, states would be forced to rely on income taxes, property taxes, and other excise taxes that target specific "captive" goods like gasoline.

Constitutional limitations on the property tax in many states would preclude this as a revenue option, forcing the income tax to shoulder a larger burden. This would have significant implications for savings and investment, potentially reducing our already meager national savings rate. Federal marginal tax rates are already at 40%, not including payroll taxes. Replacing the sales and use tax, just at the state level, would require a doubling of the state income tax burden. This is neither desirable nor economically viable.

Sound state tax policy dictates the broadest possible base, the lowest possible rates, and a diversification of reliance on income, property, and consumption taxes. Taking consumption taxes off the table is just not good policy.

States' Fiscal Requirements

Some people argue that states should just cut spending. But our states' Supreme Courts, and the voters, are saying we need to spend more on education to provide the educated workers that CEOs - some sitting at this table - tell us that our e-commerce firms need to be competitive. Voters are telling us to spend more on our transportation systems so they can get to work - and home to their families - in a reasonable amount of time.

States also must have the fiscal resources to administer the programs, which have been devolved from the federal government to the states by Congress. While the Congress has provided fixed or capped funding formulas to the states to operate some of these former federal programs, states realize that permanent federal funding is not a life time guarantee nor is it always sufficient to meet all the costs associated in the administration of these programs. Should our national economy begin to falter, states may find themselves left holding the bag on all these former federal programs now operated by State Government.

States are very concerned that the decline or demise of the state sales tax as a viable revenue option would lead to a federal sales or consumption tax, like the one proposed by Senator Hollings last month. We think a federal consumption tax would be a disaster for the states - and for our business community. Current state and local sales taxes are only about 2.4 percent of personal consumption expenditures in the US, a relatively modest burden compared to the European Community's value-added taxes.

From a purely administrative perspective, a national VAT or sales tax would be very easy for businesses to comply with. But the tradeoff, in our opinion, would be a higher tax burden. It is much simpler for Congress to raise the tax rate than 50 states and another 6,000 local units of government. And the money would be controlled at the federal level, not the state and local level. Congress would be tempted - as in the Hollings approach - to redistribute sales tax revenues not based on actual consumption but on federal formulas, subject to political manipulation.

So for these and many other reasons, we cannot support making the Internet a tax free zone.

Option 3 - Modernize the State Sales and Use Tax

Another option is for states to preserve the sales tax - by modernizing and simplifying it. The NCSL Task Force that we chair have been working toward the following goals:

- Minimize or even eliminate the administrative burden on remote sellers - or compensate them for it;
- Minimize or eliminate the audit exposure for firms that use certified software;
- Create uniform definitions of goods and services that sellers can rely upon.

Our Task Force will meet in two weeks in Nashville to hear about a proposal that states fund a national, real time database that can be made available to vendors free of charge that will automatically calculate the sales tax due. There are other proposals as well. Before we foreclose our options, we should examine whether technology can be brought to bear on this problem.

These changes will take a few years, but we think states will move to implement them. Therefore, we urge the Commission to avoid recommending actions to Congress that will pre-empt the states and prematurely limit our options to address these very important issues. During the period when states move to modernize their tax systems, Internet vendors will continue to operate under the current *Supreme Court* protections and the provisions of the Internet Tax Freedom Act.

States are beginning to realize that businesses - especially remote sellers - have legitimate concerns about state and local sales tax complexity. Not only must they know the rates of the local jurisdiction, they must make sure that they collect and remit the proper jurisdiction's tax. They can be subjected to audits from multiple local jurisdictions. And if they make a mistake, they are liable for back taxes and possible class action lawsuits from taxpayers. Clearly, if states want remote sellers to take on additional collection responsibilities, we must simplify the system.

This would create a level playing field for all retailers. Sales taxes would continue to be borne by customers, not sellers. And if it turns out that under this level playing field, Internet sellers have a business model that delivers goods to customers at lower cost than the traditional retailers, they will prosper. If not, they will fail.

Ultimately, this is what our free enterprise system is all about. It is not about government-protected advantages in the marketplace.

Telecommunications Taxes

States also need to address the administrative burden on our telecommunications firms, and the fundamental unfairness caused by outdated telecommunications tax systems in some states. It is not fair that two firms selling the same service face different tax burdens based upon the historical classification of one firm or another. Also, the multitude of state taxes and local taxes and fees imposed on our telecommunications providers are administratively costly and burdensome.

Our Task Force will be presenting policy options for states that will build upon two fundamental principles: 1) Competitive neutrality; 2) Reduced administrative burden.

Mr. Chairman, we have attached a copy of the Resolution formulated by our Task Force and approved by NCSL's membership at our Annual Meeting just two months ago. We would urge the Commission to consider these principles and incorporate them into your recommendations to Congress.

On behalf of the National Conference of State Legislatures, we stand ready to assist you and the members of the Commission in your deliberations. We are available to answer any questions you may have as well as discuss with you the role of state legislatures in the process to reform state sales tax procedures and regulations.

We also would like to recognize the participation in our Task Force of two Commission members, our colleague from the Commonwealth of Virginia, Delegate Paul Harris, and a former colleague from the State of South Dakota, Mr. Gene LeBrun. We look forward to their continued involvement with our Task Force.

Mr. Chairman and members of the Commission, thank you again for the opportunity to share our thoughts with the Commission today.

Commerce and Communications Page

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Executive Committee Task Force on State and Local Taxation of Telecommunications and Electronic Commerce

NCSL Endorses Overhaul of Sales Tax System

Updated 6 January 2000

A Task Force of the National Conference of State Legislatures approved NCSL's endorsement of a radically simplified sales tax system to reduce administrative burdens on merchants. This voluntary system would allow merchants in other states to collect sales and use taxes without any new administrative burdens.

The proposal, developed jointly by the National Governors' Association and the National Conference of State Legislatures and endorsed by major local government organizations, would create a system where a third party vendor would be responsible for determining whether items are taxable and what rate of tax would apply. The third party would collect and remit taxes to states, completely removing sellers from any collection or administrative responsibility.

The system would be made available to merchants on a voluntary basis. Under existing US Supreme Court precedent, states may not force remote sellers to collect taxes from customers. Many sellers have said for years that they would be willing to collect the tax if the costly administrative burden was removed.

The NCSL Task Force, chaired by Representative Matt Kisber of Tennessee and Senator Steve Rauschenberger of Illinois, unanimously endorsed the proposal on behalf of NCSL at its Chicago meeting in November. The Task Force was created in early-1999 to ensure that states have a strong voice in the ongoing national debate over the future of state and local taxes on internet-related commerce. It will meet in January in Tampa, Florida to discuss telecommunications tax reform proposals and to develop implementing legislation for states interested in participating in the new sales tax system.

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David Ignatius
Opinion Columnist

E-Execs in Loophole Heaven

By David Ignatius
Wednesday, March 29, 2000; Page A25

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For a depressing demonstration that the old politics of greed and self-dealing apply to the New Economy, consider the recent deliberations of the Internet tax commission, chaired by Virginia Gov. James Gilmore.

The commission was established by Congress 17 months ago to make recommendations about how the Internet and e-commerce transactions should be taxed. The Clinton administration and many independent experts hoped the commission would propose a clear plan to "level the playing field," so that the same tax rules would apply to all retailers. Right now, you have to pay sales tax if you buy a toaster from your local hardware store, but not if you buy it from an online merchant.

But the Gilmore commission is instead on the verge of endorsing a package of tax loopholes that would provide only a vague commitment in principle to future tax equity--and in the short run, would enrich the six companies whose executives serve on the 19-member commission. Even by the standards of Washington politics, this is a shabby story.

Last week, the commission, by an 11 to 8 vote, tentatively approved a proposal by the business members that would include, among other items, the following:

* A new sales tax exemption for online retailers that have brick-and-mortar "affiliates," giving them the same tax break as companies that operate entirely in cyberspace. This provision was supported by commission member Ted Waitt, who's chairman of computer seller Gateway Inc. Waitt recently turned Gateway's network of 240 stores into affiliates, making it easier for him to compete with rival Dell, which doesn't have a similar network around the country and thus doesn't have to collect sales tax. (Under existing law, a retailer must collect taxes in any state where it has a physical presence.)

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The "Gateway Giveaway," as Stanford economist Charles McLure caustically dubbed this provision, would be good for Waitt's company, but it would be bad for America. It would accelerate the rush to create phony "dot.com" sales channels, further undermine traditional brick-and-mortar retailers and gut the local tax base. But wait, there's more mischief . . .

* A new loophole to exempt from taxes all "digitized content" (things that can be sent electronically, such as music, e-books, online games and software) and their old-fashioned non-digitized counterparts. In other words, the commission would create a special tax exemption for books, music, electronic games, magazines and software. Gosh, even newspapers!

And guess who happens to sit on the commission? Why, none other than Robert Pittman of America Online and Richard Parsons of Time-Warner, presidents of two of the most powerful content companies in America--which after their planned merger would probably benefit most from this loophole.

Why should AOL-Time Warner's CDs get a special tax break, but not the Steinway piano or the Fender guitar that made the music? It defies logic--but that has been the pattern with the Gilmore commission. And wait, there's still more . . .

* A new tax break for telecommunications companies and their customers, repealing the 3 percent federal excise tax that's now charged on telephone calls. And who were among the disinterested, public-spririted business leaders who endorsed this tax repeal? None other than Michael Armstrong, chief executive of AT&T, and John Sidgmore, vice chairman of MCI WorldCom. This proposal actually makes some sense--House Democratic leader Richard Gephardt backed it yesterday, for example--but it's undermined by the Gilmore commission's aura of log-rolling. And hold on, there's still more . . .

* A new loophole to exempt the local affilates of online concerns from paying state income tax, as well as sales tax. Among the biggest beneficiaries here would be banks, brokers and other financial companies that make big money through a combination of online operations and local branches. Inevitably, the Gilmore commission included a representative from one such concern--David Pottruck, president of Charles Schwab.

"Six pigs at the trough" is how one frustrated state representative characterized the business members of the Gilmore commission. But as it happens, they're not the most egregious offenders. Even worse have been the politicians, led by Gilmore himself, who have actually tried to dissuade some of the business members from even their vague endorsement last week of eventual tax equity between e-commerce and Main Street. Gilmore's anti-tax absolutism might have made sense when the Internet was in its infancy, but it's so big now it's practically swallowing the Old Economy. It hardly needs special protection.

Gilmore and his allies have been so shameless, in fact, that they're rewriting the commission's rules. Backed by a letter from Republican Senate and House leaders Trent Lott and Dennis Hastert, Gilmore has ruled that the commission can issue its report with a simple majority, rather than the 13-vote "super majority" Congress had originally required when it created the commission in 1998.

The Gilmore commission has a last chance to avoid special-interest ignominy tomorrow, when the members are scheduled to hold a final teleconference. It would be nice to think that sanity might yet win out over greed and anti-tax zealotry, but don't bet on it. When high tech meets low politics, the pols rule.

Letter Sent to Congress on the Internet Tax Freedom Act
On Behalf of the National Governors' Association
and the National Conference of State Legislatures

July 29, 1999

Dear Senator:

The nation's Governors and state legislators strongly oppose any amendment to extend the moratorium established by the Internet Tax Freedom Act beyond the three years provided by the original legislation.

A limited time period for the moratorium was one of the most intensely debated provisions of the bill, and all parties agreed to the three-year moratorium. To change the length of the moratorium before the commission has even had a chance to complete its work or make any recommendations to Congress--including and recommendation about the need for additional time--would be an unreasonable intrusion into its good faith efforts to meet the deadlines set in the law.

As the advisory Commission on Electronic Commerce continues its deliberations, the Congress should be mindful of the balance that the Internet Tax Freedom Act established, and avoid actions that would undercut this balance. If you or your staff have questions, please contact Frank Shafroth at NGA at 624-5309.

We appreciate your consideration of our views.

Sincerely,

Governor Thomas R. Carper
Chairman
National Governors' Association

Governor Michael O. Leavitt
Vice Chairman
National Governors' Association

Representative Paul Mannweiler
House Republican Leader, Indiana
President, NCSL

Senator Jim Costa
California State Senate
President Elect, NCSL

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Wisconsin Merchants Federation

The Voice Of Wisconsin Retailing

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Telephone 608/257-3541
Fax 608/257-8755
E-mail wimerfed@execpc.com

MEMORANDUM

TO: Joint Committee on Information Policy

FROM: Chris C. Tackett, President & CEO
Douglas Q. Johnson, Sr. VP/General Counsel

DATE: June 13, 2000

RE: E-commerce and Internet Sales

Our members (local-state-national) are **increasingly** concerned about e-commerce and Internet sales. In particular mainstreet is concerned about:

1. unfair competition and;

2. erosion of the tax base;

More will follow. Hope you can help.

CCT:DQJ:mb
Enc.

unfcommcomp:rep

NATIONAL RETAIL FEDERATION

POLICY STATEMENT

Taxation of Remote Commerce/Internet Sales

The growth of consumer shopping on the Internet is expanding at a rapid rate. In 1999, almost 40 million Americans shopped online, with the total value of goods and services traded on the Internet expected to reach $300 billion by 2002. The unique nature of the Internet, including the lack of physical stores and the ability to sell intangible goods, will dramatically change the way in which future transactions are conducted.

The Internet does not alter the ability of states to tax, the requirement that retailers collect those taxes, nor the responsibility of consumers to pay the taxes. However, the Internet has made the calculation and collection of taxes more problematic. It has caused disparity in collection obligations for traditional "brick and mortar" retailers and remote retailers. Traditional brick and mortar retailers are required to collect and remit taxes at the point of sale, while online businesses must only collect taxes in states where they have a physical presence, giving remote sellers an unfair tax advantage. In addition, consumers that may not have access to the Internet, predominantly low-income individuals, are also disadvantaged as they are unable to make purchases from sellers not required to collect the tax.

TAX EQUITY/A LEVEL PLAYING FIELD

While NRF opposes the imposition of any new taxes on the use of the Internet or any other channel of distribution, NRF believes all retailers, regardless of the channel or channels in which they do business, should be treated equally with respect to collection obligations required by existing state sales and use taxes. Equity should be ensured regardless of whether the transaction is made in a traditional store, through a traditional store's own website, by a strictly e-commerce retailer or through any other type of remote seller. Tax policy should be channel-neutral.

In moving toward a system in which purchases through all channels of commerce are taxed the same (i.e. tax equity), the following conditions must be met:

Restructuring of Sales and Use Tax Systems
Dramatic restructuring of existing state sales and use tax systems is necessary if collection obligations are to be expanded. This includes simplicity and uniformity in tax administration, definitions, and classifications (e.g. the tax base, uniform tax returns, simplified procedures for audit, bad debt deduction, assessment and appeals, etc). In addition, this system must maintain income tax nexus protections and provide for destination based sourcing.

Collection Allowances for Sellers
The complexity of state sales and use tax systems imposes significant compliance burdens and costs on multistate sellers. States who expect others to collect their taxes for them must provide and maintain mechanisms to compensate others for those efforts.

State and Local Responsbilities
The decision to impose, and the obligation to collect, sales and use taxes resides in the states. Currently, taxpayers are obligated to remit use taxes to their state if sales taxes were not paid on out-of-state purchases at the time of sale. State enforcement of this tax has been negligible. States have a responsibility to inform and educate their citizens about these obligations, in particular, the consumer's responsibility to pay the use tax under current law. States impose taxes, not retailers. Retailers are merely required to collect sales taxes on behalf of the state and local governments.

NATIONAL RETAIL FEDERATION

EQUITABLE COLLECTION OF RETAIL SALES TAXES

An overview

The growth of consumer shopping on the Internet is expanding at a rapid rate. In 1999, 39 million Americans shopped online, up 17 million from 1998. The total value of goods and services traded on the Internet is expected to reach $300 billion by 2002. The unique nature of the Internet, including the lack of physical stores and the ability to sell intangible goods, changes the frontier in which transactions are conducted. Although the Internet has not removed the necessity for governments to tax, for retailers to collect the tax, or the responsibility of consumers to pay taxes, it has made the calculation and collection of taxes more problematic. It has caused greater disparity in collection obligations for traditional "brick and mortar" retailers and electronic retailers. Traditional retailers must collect and remit taxes at the point of sale, while online and catalog businesses must only collect taxes in states where they have a physical presence, giving the online retailer a competitive advantage.

The National Retail Federation (NRF) supports an equity-based tax policy with equal collection obligations across all retail channels, whether the transaction is made in a traditional store, through a traditional store's own Web site, by a strictly e-commerce retailer or through any other type of remote seller.

BACKGROUND

Under current law, 45 states and the District of Columbia impose sales and use taxes on remote commerce on purchases of tangible goods. Due to the complexity of the sales and use taxes, the state and local governments that imposed these taxes require retailers to collect them at the point of sale from consumers. Retailers must then remit these taxes back to the state or local governments immediately.

Under the 1967 U.S. Supreme Court case *National Bellas Hess*, the Court held that a state or local government cannot constitutionally require a retailer to collect and remit use taxes unless the business has "nexus" (a physical presence) within the state. In 1992, the Supreme Court reaffirmed in *Quill* that an out-of-state mail order house without outlets or sales representatives in the state is not required to collect and pay use tax on goods and services purchased for use in the state, reaffirming *National Bellas Hess.* The Court ruling based its decision on due process considerations and reiterated Congress' authority to regulate or change interstate commerce policy.

In October of 1998, recognizing the ability of electronic commerce to influence our national economy, Congress imposed a three-year moratorium on any new or discriminatory federal or state tax on the Internet or electronic commerce. The moratorium gives Congress the opportunity to evaluate state, local, and international taxation of the Internet and electronic commerce. Congress believes "fair and administrable rules" for taxing and regulating the use of the Internet and electronic commerce should be developed. To that end, an Advisory Commission on Electronic Commerce (ACEC) was created and tasked with studying electronic commerce tax issues and recommending to Congress, within 18 months, model legislation that will govern tax treatment of the Internet, electronic commerce, and remote sales. The Advisory Commission is expected to issue its report in April, 2000, while the moratorium sunsets in October of 2001.

HOW CURRENT LAW IMPACTS RETAILERS

Under the current sales and use tax system, traditional brick and mortar stores find themselves at a competitive disadvantage to their Internet and catalog counterparts because they must collect sales taxes on most in-store sales. Obviously, retailers who are not required to collect sales taxes have a price advantage with consumers. With retailers achieving only a modest 2-4 percent net profit on sales, remote sellers who are not currently required to collect sales and use taxes (which average 6-8 percent) have an unfair pricing advantage over their brick and mortar counterparts.

Some retailers have been forced to create separate dot-com subsidiaries in an effort to diminish this competitive disadvantage. This strategy eliminates the requirement for sales tax collection in states where the subsidiary does not have a physical presence. There are many disadvantages to setting up separate subsidiaries and companies who do so are concerned about their tax liabilities.

HOW THIS IMPACTS CONSUMERS

Though consumers are required to remit use taxes on out-of-state sales, historically states have not enforced collection of use tax claiming significant compliance burdens or for political reasons. Given the explosion of Internet sales, states are concerned with future revenue loss as consumers buy more over the Internet. Instead of relying on taxpayers to remit "use" taxes, States want to require retailers to collect sales taxes on out-of-state purchases.

In addition, low-income consumers who do not have access to the Internet are disadvantaged because they cannot make purchases from electronic retailers who do not collect sales taxes. These are often the individuals who can least afford the burden of a tax.

State and local governments also claim that more than $3.3 billion in tax revenue is lost annually from mail order sales and the amount from the Internet may be much greater. This is lost revenue that could be used for funding education, transportation, and law enforcement in the state and local governments.

HOW NRF DEVELOPED ITS POSITION

Historically, the National Retail Federation has remained neutral regarding the taxation of remote commerce following the *National Bellas Hess* and *Quill* Supreme Court cases. The extraordinary growth of Internet sales, coupled with the creation of a Congressional panel to evaluate taxation of the Internet required NRF to reevaluate its position. In developing its position, the NRF first presented the issue to the NRF Taxation Committee, which passed a resolution in support of a level playing field with conditions. Following the action of the taxation committee, the NRF Policy Council addressed the issue and also voted in support of a level playing field. Because of the magnitude of the issue, the General Counsels forum also considered the issue prior to the board vote. The NRF position was overwhelmingly agreed to by the Board of Directors in January, 2000.

NRF'S POSITION

While NRF opposes the imposition of any new taxes on the use of the Internet or any other channel of distribution, NRF believes all retailers, regardless of the channel or channels in which they do business, should be treated equally. Equity should be ensured regardless of whether the transaction is made in a traditional store, through a traditional store's own website, by a strictly e-commerce retailer or through any other type of remote seller. Tax policy should be channel-neutral.

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The **National Retail Federation (NRF)** is the world's largest retail trade association with membership that comprises all retail formats and channels of distribution including department, specialty, discount, catalogue, Internet and independent stores. NRF members represent an industry that encompasses more than 1.4 million U.S. retail establishments, employs more than 20 million people -- about 1 in 5 American workers -- and registered 1999 sales of $3 trillion. NRF's international members operate stores in more than 50 nations. In its role as the retail industry's umbrella group, NRF also represents 32 national and 50 state associations in the U.S. as well as 36 international associations representing retailers abroad.

ShawPittman

PRIMER ON STATE SALES TAX FOR RETAIL SALES MADE OVER THE INTERNET

Jerald A. Jacobs
Karen L. Cipriani

Shaw Pittman
Washington, D.C.

All retailers are subject to sales tax when they sell goods in states that have a sales tax law. Forty-five states and the District of Columbia currently charge sales tax on products and services purchased within the state or purchased out-of-state for use inside the state. While state laws vary, generally a state will impose sales tax on sellers that are considered to have maintained a place of business or engaged in business in the taxing state. "Sales tax" generally refers to a tax imposed on the seller; "use tax" refers to a tax imposed directly on the consumer for the privilege of storing or consuming products in the state. While these taxes are distinguishable, for purposes of this primer they are used interchangeably.

The ability of some states to impose sales tax on Internet-based transactions has been hampered by the Internet Tax Freedom Act ("ITFA"), enacted as part of the omnibus appropriations bill for FY 1999.[1] The ITFA was designed to prevent further taxation of Internet-based sales while Congress and the states take the time to develop a comprehensive policy, and creates a three-year moratorium on the creation and imposition of state taxes that have the effect of discriminating against electronic commerce.

Specifically, the ITFA prohibits state or local governments for three years (until October 21, 2001) from imposing either (1) taxes on Internet access, unless such taxes were generally imposed and actually enforced before October 1, 1998, or (2) "multiple or discriminatory taxes on electronic commerce."[2] For example, a discriminatory tax under the act would include a state tax on retail sales that is not imposed on goods acquired

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[1] Pub. Law No. 105-277, 112 Stat. 2681-725, 1998 (to be codified at 47 U.S.C. 151 et seq.).

[2] Pub. Law No. 105-277, Title XI, Sec. 1101(a). The ITFA defines "electronic commerce" as "any transaction conducted over the Internet or through Internet access, comprising the sale, lease, license, offer, or delivery of property, goods, services, or information, whether or not for consideration, and includes the provision of Internet access." Id. at Title XI, Sec. 1104(3).

through more traditional means. In addition, the law bars any state from considering an Internet service provider to be the "agent" of an out-of-state vendor solely as a result of displaying the vendor's web site information over the Internet or processing orders over the Internet.[3] In many states, then, the ITFA will bar the state from imposing taxes on sales made over the Internet where the retailer has no other connection to the state.

Nonetheless, the three-year moratorium on state taxation of Internet sales does have limits. The ITFA specifically prohibits a state from imposing a tax when the sole basis for finding an out-of-state vendor subject to tax is the ability to access the vendor's web site. However, the ITFA provides that where a tax has already been "generally imposed and actually enforced" by a state prior to October 1, 1998, that state will be exempt from this prohibition against taxing an out-of-state vendor solely on the basis of its web site.[4] States with pre-existing statutes will remain free to tax retailers under the terms of those statutes. While the language of the statute is unclear, it is possible that a state would be required to demonstrate that it had previously taken steps to enforce its pre-existing tax laws against Internet sellers in order for those laws to be upheld under the moratorium. In addition, existing state statutes that tax general Internet access may still be applied to Internet sales. Individual state laws must be examined to determine the applicability of the ITFA to sales of goods over the Internet under that state's sales tax practices.

I. OVERVIEW OF STATE SALES TAX LAWS

To be valid and effective, a statute imposing a tax on the sales of out-of-state retailers must meet certain constitutional tests. Specifically, state tax laws must satisfy the requirements of both the Due Process Clause of the Fourteenth Amendment and the Commerce Clause. In other words, the state must demonstrate that an out-of-state retailer has sufficient economic contacts to the state to justify extending jurisdiction over that retailer ("Due Process nexus"), and there must be sufficient contacts between the retailer and the state, usually evidenced by physical presence in the state, to justify the imposition of tax on the seller ("Commerce Clause nexus").

The 1992 United States Supreme Court case <u>Quill Corp. v. North Dakota</u>[5] currently provides the basis for analysis of any state sales or use tax law. <u>Quill</u> involved North Dakota's attempt to require a Delaware mail-order company that sold office equipment and supplies to collect and pay a use tax on all goods purchased for use within North Dakota. While the company used catalogs, flyers, and telephone calls to solicit business in North Dakota, it had no outlets, warehouses, employees, or sales representatives in the state. The court found that states have authority to exercise jurisdiction over out-of-state vendors consistent with the Due Process Clause if certain minimum contacts have been made in the

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3 <u>Id</u>. at Title XI, Sec. 1104(B)(i).

4 <u>Id</u>. at Title XI, Sec. 1104(B)(i).

5 504 U.S. 298 (1992).

state. In other words, if a retailer were to "purposefully direct" its activities towards the state (for example, by advertising or making sales), then the seller may subject itself to jurisdiction in the state.

However, the court found that even if a state may have the *authority* to tax under the Due Process Clause, the actual *imposition* of the tax may nevertheless be unconstitutional under the Commerce Clause if it impermissibly burdens interstate commerce and the ability of vendors to conduct business in and among the several states. The court clarified that in order to require a vendor to collect and remit sales or use tax, a state must demonstrate that the vendor's activities have a "substantial nexus" with the taxing state.[6] Under Quill, a company must have a physical presence in the state in order for a nexus to exist under the Commerce Clause which triggers the obligation to collect sales and use. While a physical presence is not necessary to establish minimum contacts under the Due Process Clause, physical presence is required to establish a nexus for purposes of the Commerce Clause.[7] In this case the court found that the out-of-state vendor only had a *de minimis* physical presence in the state (it held title to several computer disks in the state), despite making almost $1,000,000 in annual sales to 3,000 customers in the state; therefore, North Dakota could not impose sale tax obligations on the vendor. In particular, the Quill court reiterated its holding in a 1967 case, National Bellas Hess v. Illinois Dept. of Revenue, that vendors whose only connection to a state is through common carrier or U.S. mail are free from state-imposed duties to collect sales and use tax under the Due Process Clause.[8]

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6 See Complete Auto Transit Inc. v. Brady, 430 U.S. 274 at 279 (1977) (State sales tax will survive Commerce Clause scrutiny when it (1) is applied to an activity with a substantial nexus to the taxing State, (2) is fairly apportioned, (3) does not discriminate against interstate commerce, and (4) is fairly related to services provided by the State).

7 Certain lower court cases since Quill have rejected the substantial nexus" test and look instead to the vendor's presence in the state. Under this analysis, a vendor need only have Amore than a 'slightest presence' in the state, which Amay be manifested by the presence in the taxing state of the vendor's property or the conduct of economic activities in the taxing state performed by the vendor's personnel or on its behalf. Orvis Co. v. Tax Appeals Tribunal, 654 N.E.2d 954, 961 (N.Y. 1995) (citations omitted) (finding that Vermont corporation that sold outdoor equipment to New York residents through mail order catalog and periodically sent representatives to New York had a sufficient physical presence in New York to justify the imposition of sales tax). See also Brown's Furniture, Inc. v. Wagner, 665 N.E.2d 795 (Ill. 1996) (finding that only more than a "slightest" presence is necessary for a vendor to be subject to sales tax, which presence was found due to a company's extensive advertising and regular furniture deliveries in the taxing state).

8 National Bellas Hess v. Dep't of Revenue of State of Illinois, 386 US. 753 (1967) (finding that a vendor was not required to pay use tax when it did not have property or representatives in Illinois and its only contact with the taxing state was through its mail order catalog). But see Koch Fuels, Inc. v. Clark, 676 A.2d 330, 334 (R.I. 1996) (finding

Footnote continued on next page

II. APPLICATION TO INTERNET RETAILERS

Many courts and commentators have extended this analysis to equate mail order catalog sales with Internet sales. The United States Supreme Court has not addressed the issue of whether Internet sales can subject a vendor to jurisdiction in a state and, if a substantial nexus exists, to state sales tax. However, it is likely that the Quill requirements for constitutional sales tax statutes will be applied to an analysis of whether sales tax must be collected and remitted on retail sales made over the Internet. Lower court cases since Quill have been split as to whether a company's maintenance of an Internet presence alone may subject that company to jurisdiction in a particular state under the Due Process Clause.[9] However, where a vendor's activities involve more than maintenance of a passive web site, as is the case with retailers that offer products and process orders over the Internet, it becomes more likely that courts will find that a state may properly subject the retailer to jurisdiction in accordance with the Due Process Clause because the retailer has directed its business activities towards state residents.[10]

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that oil shipment by common carrier nonetheless created sufficient nexus when vendor had complete control over and ownership of product during shipment, contract was exclusive, cargo was unique, and sales were consummated in state).

9 See, e.g., CompuServe, Inc. v. Patterson, 89 F.3d 1257 at 1263-1266 (6th Cir. 1996) (finding that continuing transmissions to a network service over the Internet pursuant to software agreement was sufficient to provide State with jurisdiction over out-of-state company); Inset Systems, Inc. v. Instruction Set, Inc., 937 F. Supp. 161 (D.Conn. 1996) (finding that solicitation of business through toll-free number and web site accessible within State allowed for jurisdiction over out-of-state company for purposes of trademark infringement suit). But see Cybersell, Inc. v. Cybersell, Inc., 130 F.3d 414 (9th Cir. 1997) (finding that more than existence of a passive web site accessible in State was required before company could be subject to jurisdiction for trademark infringement suit); McDonough v. Fallon McElligott, Inc., No. 95-4037, 1996 U.S. Dist. LEXIS 15139 (S.D.Cal. August 6, 1996) (finding maintenance of web site by itself did not amount to minimum contacts allowing for exercise of personal jurisdiction over out-of-state advertising agency); Bensusan Restaurant Corp. v. King, 937 F. Supp. 295 (S.D.N.Y. 1996) (finding that State did not have jurisdiction over company whose sole contact with the State was a passive web site that provided information about the company's jazz club).

10 See Zippo Manufacturing Co. v. Zippo Dot Com, Inc., 952 F. Supp. 1119 at 1124 (W.D. Pa. 1997) (in finding that jurisdiction could be extended to an out-of-state Internet news service that had no offices or employees in the state but had subscribers in state, the court suggested that "the likelihood that personal jurisdiction can be constitutionally exercised is directly proportionate to the nature and quality of commercial activity that an entity conducts over the Internet.").

In order to require an out-of-state Internet retailer to pay sales tax, however, the state must be able to demonstrate that the retailer has a physical presence in the taxing state and that there is a "substantial nexus" between the retailer's activities and the state under the Commerce Clause. It is unlikely that a nexus or a physical presence will be found solely by virtue of the retailer's maintenance of a web site. However, it is more likely that a substantial nexus would be found in many or most states if, in addition to offering products through its web site, the Internet retailer also engaged in one or more other activities. Obviously, the more of these and similar activities that the Internet retailer engages in, the more likely it will be that a substantial nexus is found. Some examples include:

- Maintenance of a retail facility, warehouse, plant, or other facility in the state.[11] An Internet vendor may also have one or more retail stores in the taxing state, or own a fulfillment center in the state that warehouses products.
- Maintenance of more than a *de minimis* amount of property in the state.[12] The Internet retailer may have a distribution warehouse, or even property unrelated to the sale of its products, in the taxing state.
- Delivery of goods within the state via means other than common carrier.[13] The Internet retailer may ship goods via its own transportation system or a contract carrier (as

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11 See National Geographic Soc. v. California Bd. of Equalization, 430 U.S. 551 (1977) (finding that although National Geographic's headquarters and mail order business were operated out of the District of Columbia, the company's maintenance of two offices in California to solicit advertising for its magazine was enough to create a sufficient nexus and require National Geographic to collect sales tax in California); Nelson v. Montgomery Ward & Co., 312 U.S. 373 (1941) (finding that sales tax could be imposed on company based on ownership of retail stores in State). See also Quill, 504 U.S. at 315 ("whether or not a State may compel a vendor to collect a sales or use tax may turn on the presence in the taxing States of a small sales force, plant, or office."); Bellas Hess, 386 U.S. at 758 (drawing distinction between "mail order sellers with retail outlets, solicitors, or property within a State, and those who do no more than communicate in the State by mail or common carrier as part of a general interstate business.").

12 See Quill 504 U.S. at 315, n. 8 (mail order catalog company which owned title to a few computer disks in the state did not meet substantial nexus requirement); Cally Curtis Co. v. Groppo, 572 A.2d 302 (Conn. 1990) (finding that limited amount of training video sales, rentals and preview offers in the State did not constitute a substantial nexus to the State).

13 See General Motors Corp. v. Washington, 377 U.S. 436 (finding that State could tax gross proceeds of sales on auto parts shipped by parent corporation to its in-state divisions pursuant to purchase orders); Amway Corp. v. Director of Revenue, 794 S.W.2d 666 (Mo. 1990) (finding State could tax out-of-state vendor where the vendor sold "distributorships" or franchises to individual distributors residing in the State, and sold

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distinguished from a common carrier), or the Internet retailer may offer the customer the opportunity to put goods "on hold" at related stores, or even deliver the goods locally from its store, warehouse, distribution center, or the like

➢ Holding intangible property in the state.[14] The Internet retailer may own trademarks and trade names and license them to an affiliated or non-affiliated business that makes sales in the state. It should be noted that the law is not settled in this regard and mere ownership of intangible property may not be enough to establish nexus in many states.

➢ Hiring employees or independent contractors to solicit sales in the state or otherwise having agents or representatives in the state.[15] The Internet retailer may have employees or contract representatives that make sales calls in the state.

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products to in-state distributors which the distributors then resold to customers or other distributors); Citizens and S. Systems, Inc. v. South Carolina Tax Comm'n, 311 S.E.2d 717 (S.C. 1984) (finding that software program transferred over Internet was delivery of tangible property that could be subject to sales and use tax). But see SFA Folio Collections, Inc. v. Tracy, 652 N.E.2d 693 (Ohio 1995) (finding that allowing occasional returns of mail order merchandise at in-state retail stores of affiliate did not create substantial nexus so as to require company to collect sales tax); Hearst Corp. v. ARI Goldberger, No. 96 Civ. 3620, 1997 U.S. Dist. LEXIS 2065 (S.D.N.Y. February 26, 1997) (finding the State could not exercise jurisdiction over a company that maintained a web site accessible in New York but had not sold any products or services to New York residents).

14 See Geoffrey, Inc. v. South Carolina Tax Comm'n., 437 S.E.2d 13 (S.C. 1993); American Dairy Queen Corp. v. Taxation & Revenue Dep't, 605 P.2d 251 (N.M. Ct. App. 1979) (finding that company could be taxed on gross receipts when its trade name, trademark, and related intangible property were used by franchise operators in New Mexico in exchange for a license fee).

15 See, e.g., Standards Pressed Steel Co. v. Washington Dep't of Revenue, 419 U.S. 560 (1975) (finding that Pennsylvania company's employment of one salesman to maintain regular contact with largest customer in Washington justified imposition of sales tax on sales in Washington); Scripto, Inc. v. Carson, 362 U.S. 207 (1960) (finding that Georgia company's use of independent contractors to systematically and continuously solicit product orders in Florida justified imposition of tax on sales in Florida); Tyler Pipe Industries, Inc. v. Washington State Dep't of Revenue, 483 U.S. 232 (1987) (finding that Washington State could impose a business tax on an out-of-state manufacturer that sold goods in Washington State and had a sales representative located in the State); Orvis, 654 N.E.2d at 961 (finding that sales personnel's direct solicitation of retailers through visits to the State sufficed as a nexus to impose tax).

> Advertising its Internet sales capability in retail stores.[16] The retailer may have posters, order forms, or other materials available in the related retail stores that assist customers in dealing with the Internet retailer, or the store may have a computer terminal kiosk which facilitates customers' direct access to the Internet sales operation.

The courts have been split as to whether the activities of one corporation may justify imposing sales tax on an affiliated corporation. For example, suppose affiliated companies operate one or more retail stores as well as an Internet web site, but the retail chain and the Internet web site are owned by separately incorporated entities. Perhaps the Internet corporation has no property, fulfillment center, or other presence in the state, but the parent retail corporation has one or more stores in the state. In certain states, a nexus will be found based on the fact that the Internet retailer is affiliated with another corporation that has a physical presence in the state.[17] In other states, courts will recognize that the retail seller and the Internet seller are separate legal entities, and will not find that the retail stores' operations in the state amount to a physical presence for the Internet company.[18] In analyzing this issue, courts may use either an "agency theory"[19] (under

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16 See Nelson v. Montgomery Ward & Co., 312 U.S. 373 (1941) (finding that an out-of-state mail order vendor was required to collect use tax where its in-state retail stores advertised the ability to purchase products through the company's mail order service).

17 See Mobil Oil Corp. v. Comm'r of Taxes, 445 U.S. 425, 440 (1980) (finding that affiliated companies' underlying business activities, as opposed to the form of investment, will be the primary consideration in establishing nexus for purposes of state income tax); General Motors Corp. v. Washington, 377 U.S. 436, 447 (1964) (looking at the "bundle of corporate activity," of both the parent and its divisions, in finding a tax on gross proceeds valid as imposed on an out-of-state vendor); Western Acceptance Co. v. Department of Revenue, 472 So.2d 497 (Fla. Dist.Ct.App. 1985) (finding State could impose tax on out-of-state vendor because it was essentially doing business in State through its parent corporation).

18 See SFA Folio Collections, Inc. v. Tracy, 652 N.E.2d 693 (Ohio 1995) (finding that state could not impose tax on mail order company based on affiliate's maintenance of retail stores in state and recognizing that the parent and subsidiary were separate and distinct legal entities); Bloomingdale's by Mail, Ltd. v. Pennsylvania Dep't of Rev., 567 A.2d 773 (Pa. Commw. 1989) (finding that there was no agency relationship between mail order catalog company and parent corporation that operated retail stores in the state, and the state could not impose tax on mail order company).

19 See, e.g., Bellomo v. Pennsylvania Life Co., 488 F. Supp. 744 (S.D.N.Y. 1980) (finding jurisdiction over out-of-state vendor for breach of contract because subsidiaries were agents of parent corporation). Note that several tax cases have arisen based on scholastic book club sales. In these cases, a teacher will take book orders and collect money from students and forward them to the out-of-state book club; the book club then ships the books into the state for the teacher to distribute. The book club generally will have no other property, employees, or retail stores in the state. Courts have varied as to

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which the retail corporation acts as an agent of the Internet corporation in the state) or an "alter ego" theory[20] (under which the retail corporation and Internet corporation would essentially be considered part of the same entity). In either event, a court would likely consider such factors as whether the two corporations shared directors or officers, whether one entity exercised control over the other, whether one entity owned all or most of the stock of the other, or whether the companies held themselves out to the public as the same entity. In this regard, joint advertising of both the retail stores and the Internet web site, whether via mass media, in the retail store, or on the Internet site, could be a significant factor.

III. CONCLUSION

Internet retailers must pay serious attention to state sales and use tax obligations. The law differs from one state to the next. The law is evolving and could be subject in some cases to a three-year federal moratorium. Further, the applicability of the law depends upon many complex factors. In general, a completely passive Internet retailer selling goods to customers in other states probably does not currently have an obligation to collect and pay sales taxes in those other states due to the lack of a substantial nexus. But one or more additional ties to the other states -- such as owning a retail store, warehouse or fulfillment center, employing persons to work in the state, actively servicing the customers' needs in the state, advertising, or conducting similar activity -- may well subject that Internet retailer to sales tax obligations in those other states.

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whether under this scenario the retailer can be taxed because the teacher is essentially acting as the seller's agent in the state. Compare Scholastic Book Clubs, Inc. v. State Bd. of Equalization, 207 Cal.App. 3d 734 (Cal. Ct. App. 1989) (finding agency relationship and imposing tax on retailer); with Pledger v. Troll Book Clubs, Inc., 871 S.W.2d 389, 316 Ark. 195 (1994) (finding that teachers were not agents of retailer and finding that use tax could not be imposed).

20 See, e.g., CIT Financial Services Consumer Discount Co. v. Director, Division of Taxation, 4 N.J. Tax 568 (N.J. Tax Ct. 1982) (finding tax could be imposed on Pennsylvania consumer loan company that worked with two sister corporations in New Jersey, particularly through a computer processing system operated by a common parent; the interaction and structure of the corporations convinced the court that a *de facto* merger had occurred such that the loan company could be subject to tax in New Jersey).

NATIONAL RETAIL FEDERATION

RETAILERS SUPPORT A LEVEL PLAYING FIELD FOR ALL
- OPPOSE ANY NEW TAXES ON REMOTE COMMERCE -

As you know, the NRF Board of Directors adopted a policy position calling for equal sales and use tax collection obligations for all retailer delivery channels on January 18, 2000. NRF believes tax policy should be channel-neutral. NRF feels that all retailers, regardless of the channel, or channels, in which they do business, should be treated equally with respect to collection obligations required by state sales and use taxes.

NRF <u>does not</u> support any new taxes on remote commerce or the Internet. Under current law, 45 states and the District of Columbia impose sales and use taxes on purchases of tangible goods. Due to the complexity of these sales and use taxes, the states and local governments that imposed these taxes require retailers to collect them at the point of sales from consumers. Retailers must then remit these taxes back to the state or local governments immediately.

Based on two separate Supreme Court rulings, the Court held that retailers cannot be required by a state or local government to collect sales and use taxes from the purchaser unless the retailer has a "physical presence" within the state of the purchaser. Although the retailer is not required to collect the sales tax in these instances, the consumer (i.e. the taxpayer) is required by state law to remit a "use" tax (i.e. the sales tax) to their home state. Many states include a line at the bottom of their state income tax returns for taxpayers to disclose if they made any out-of-state purchases. If sales taxes were not paid on these out-of-state purchases at the time of sale, the taxpayer must voluntarily remit these taxes to the state. States use revenue from the sales and "use" taxes to provide government services to its taxpayers.

Though consumers are required to remit use taxes on out-of-state sales, historically states have not enforced collection of the use tax claiming significant compliance burdens or for political reasons. However, given the explosion of Internet sales, states are concerned with future revenue loss as consumers buy more over the Internet. Instead of relying on taxpayers to remit "use" taxes on the backend, States want to require retailers to collect sales taxes on out-of-state purchases on the front end. NRF is only asking that retailers have the same collection obligations regardless of how a product is delivered. <u>NRF's position supporting equal collection obligations for retailers across all channels does not constitute support for new taxes on the Internet.</u>

NATIONAL RETAIL FEDERATION

MYTHS AND FACTS ON INTERNET TAX POLICY

MYTH: Advocates of tax equity support new online taxes.

FACT: No, currently consumers are expected to remit taxes on purchases made on the Internet or by catalog to their home state on state income tax filings each year. The National Retail Federation believes tax equity should be ensured regardless of whether the transaction is made in a traditional store, by an e-commerce retailer or through a catalog. By doing so, consumer confusion is eliminated, and the playing field is leveled for all retailers.

MYTH: Taxation of sales of goods and services online will cause a decrease in consumer purchases on the Internet.

FACT: Studies show consumers shop online for good product selection, competitive prices, and ease of use, not because sales taxes are not collected on these types of purchases. Detriments to buying online include consumer concerns over credit card security and privacy.

MYTH: Congress has imposed a three-year tax moratorium on sales on the Internet.

FACT: In 1998, Congress enacted the Internet Tax Freedom Act prohibiting any new or discriminatory taxes from being imposed online. The Act created an Advisory Commission to study and determine whether access, bit, or sales and use taxes should be applied to the Internet.

MYTH: The Internet is in it infancy and its growth should not be stifled by taxation.

FACT: Consumer shopping online in the United States is growing at a rapid rate. Between 1998 and 1999 the number of shoppers on Web sites increased from 17 million to 39 million. Spending online is expected to reach $300 billion by 2002. At this exponential rate, the Internet will continue to grow regardless of equitable collection of taxes on online sales.

MYTH: State and local governments don't need the additional revenue that would result from taxation on line.

FACT: According to the National Governors' Association, more than 40% of state revenues come from sales taxes. If taxes are not collected by online and catalog retailers, state and local governments could lose more than $10 billion in revenues by the year 2003. Much of sales tax revenue goes towards essential services such as education, law enforcement and transportation which communities benefit from. Without this additional revenue, states have felt the need to raise taxes to fund these programs. The additional revenue may actually allow States to cut taxes.

NATIONAL RETAIL FEDERATION

POLICY STATEMENT

Taxation of Remote Commerce/Internet Sales

The growth of consumer shopping on the Internet is expanding at a rapid rate. In 1999, almost 40 million Americans shopped online, with the total value of goods and services traded on the Internet expected to reach $300 billion by 2002. The unique nature of the Internet, including the lack of physical stores and the ability to sell intangible goods, will dramatically change the way in which future transactions are conducted.

The Internet does not alter the ability of states to tax, the requirement that retailers collect those taxes, nor the responsibility of consumers to pay the taxes. However, the Internet has made the calculation and collection of taxes more problematic. It has caused disparity in collection obligations for traditional "brick and mortar" retailers and remote retailers. Traditional brick and mortar retailers are required to collect and remit taxes at the point of sale, while online businesses must only collect taxes in states where they have a physical presence, giving remote sellers an unfair tax advantage. In addition, consumers that may not have access to the Internet, predominantly low-income individuals, are also disadvantaged as they are unable to make purchases from sellers not required to collect the tax.

TAX EQUITY/A LEVEL PLAYING FIELD

While NRF opposes the imposition of any new taxes on the use of the Internet or any other channel of distribution, NRF believes all retailers, regardless of the channel or channels in which they do business, should be treated equally with respect to collection obligations required by existing state sales and use taxes. Equity should be ensured regardless of whether the transaction is made in a traditional store, through a traditional store's own website, by a strictly e-commerce retailer or through any other type of remote seller. Tax policy should be channel-neutral.

In moving toward a system in which purchases through all channels of commerce are taxed the same (i.e. tax equity), the following conditions must be met:

Restructuring of Sales and Use Tax Systems
Dramatic restructuring of existing state sales and use tax systems is necessary if collection obligations are to be expanded. This includes simplicity and uniformity in tax administration, definitions, and classifications (e.g. the tax base, uniform tax returns, simplified procedures for audit, bad debt deduction, assessment and appeals, etc). In addition, this system must maintain income tax nexus protections and provide for destination based sourcing.

Collection Allowances for Sellers
The complexity of state sales and use tax systems imposes significant compliance burdens and costs on multistate sellers. States who expect others to collect their taxes for them must provide and maintain mechanisms to compensate others for those efforts.

State and Local Responsbilities
The decision to impose, and the obligation to collect, sales and use taxes resides in the states. Currently, taxpayers are obligated to remit use taxes to their state if sales taxes were not paid on out-of-state purchases at the time of sale. State enforcement of this tax has been negligible. States have a responsibility to inform and educate their citizens about these obligations, in particular, the consumer's responsibility to pay the use tax under current law. States impose taxes, not retailers. Retailers are merely required to collect sales taxes on behalf of the state and local governments.