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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.

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 Responsibilities
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.

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.

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 does not 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. NRF's position supporting equal collection obligations for retailers across all channels does not constitute support for new taxes on the Internet.

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.

NEWS RELEASE

FROM THE NATIONAL RETAIL FEDERATION

For Immediate Release
Contact: Pamela Rucker / Scott Krugman (202) 783-7971

NATIONAL RETAIL FEDERATION ANNOUNCES SUPPORT FOR EQUITABLE APPLICATION OF EXISTING SALES AND USE TAXES

New York City, January 19, 2000 – The Board of Directors of the National Retail Federation (NRF) has approved a policy position calling for state sales and use tax equity across all retail channels.

NRF believes all retailers, regardless of the channel or channels in which they do business, be treated equally with respect to collection obligations currently required by existing state sales and use tax laws. 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.

"Consumers today have an unprecedented range of choices about how to make purchases, from visiting stores to browsing catalogues to e-shopping," noted NRF President and CEO Tracy Mullin. "Exempting some catalogues and electronic merchants from collecting sales taxes amounts to an unfair subsidy that penalizes brick-and-mortar merchants, as well as state and local communities that rely on sales tax revenue."

"NRF believes tax policy should be channel neutral", added Mullin. "Providing equal collection obligations (i.e. requiring retailers to collect state sales and use taxes that already exist) for all retail distribution channels merely levels the playing field for retailers and their customers."

"While expanding retailers' collection obligations, states must educate taxpayers about the responsibility to remit use taxes under current law," added Mullin. "In addition, retailers must be adequately compensated for collecting and remitting sales and use taxes for the states." Currently, retailers are forced to absorb significant compliance costs and other burdens as they attempt to collect sales and use taxes on behalf of the states.

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 $3.0 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.

For more information about NRF, visit our Website at www.nrf.com.

NATIONAL CONFERENCE *of* STATE LEGISLATURES

The Forum for America's Ideas

June 13, 2000

Paul S. Mannweiler
House Republican Leader
Indiana, President, NCSL

John B. Phelps
Clerk of the House
Florida House of Representatives
Staff Chair, NCSL

William T. Pound
Executive Director

The Honorable Scott Jensen
Assembly Speaker
Wisconsin State Assembly
State Capitol, Room 211 West
P.O. Box 8952
Madison, Wisconsin 53708-8952

Dear Speaker Jensen,

Thank you for you letter regarding the National Conference of State Legislatures' efforts to oppose congressional attempts to extend the current moratorium on Internet access taxes, which does not expire unti October 21, 2001. We share your concern about higher taxes and as the chairs of our legislative chambers' fiscal committees, we have endeavored to ensure that our states only raise the revenues needed to function and whenever possible have returned surplus funds to our constituents.

First, let us make clear that NCSL has not taken, nor will take a position on whether or not states should impose a tax on Internet access. As you know our primary responsibility is to protect each state's constitutional and traditional authorities. In the case of the moratorium, NCSL's position is that the right of sovereign states to set their own tax policy is one of the key tenets of federalism, and therefore **only the state legislatures should be making policy on state taxation.**

The federal legislation passed by the House of Representatives, whose votes we distributed, would in effect make Wisconsin's vote to repeal the transaction tax on Internet access meaningless. NCSL is not advocating that there should be a tax on Internet access, rather that each state should be able to exercise its sovereign right to decide whether or not to institute such a tax, as the Wisconsin Legislature has done. Furthermore, allowing Congress to dictate state sales tax policy may well be an open invitation for further congressional interference.

As for H.R. 3709 itself, the bill would not only preempt state authority, but it would employ strokes so broad it could easily cause unintended negative consequences. The principal problem with a 5-year extension of the moratorium on state Internet access taxes, is that technologies are converging with such speed that in a short time consumers will likely be able to receive cable television and make long distance telephone calls through the Internet. Under H.R. 3709, Internet Service Providers would be able to package all of those services as "Internet access," making transactions on which many states now impose a tax, exempt. Such a system would put traditional phone companies at a serious competitive disadvantage, and would dramatically reduce revenues currently collected by the states.

Moreover, H.R. 3709 would repeal the grandfather clause in the original Internet Tax Freedom Act, which protected taxes already in place in 11 states, such as Wisconsin. The repeal of the grandfather clause was a major factor in the Congressional Budget Office declaring H.R. 3709 an unfunded mandate under the provisions of the Unfunded Mandate Relief Act of 1995.

Certainly each state is in a unique financial position to deal with potential loses of current revenues. While many states are running surpluses, there are others that are not able to forgo incoming revenue and maintain core services. Indeed there are states that are heavily dependent on sales taxes that are already in risk of a deficit situation. For example, under H.R. 3709 Tennessee would lose $12.5 million this year and $20 million the following year, which would precipitate a budget deficit. In such cases, H.R. 3709 could have the unintended impact of forcing states to raise other taxes to offset the loss in revenue. NCSL will continue to argue that the state legislators, fully accountable to their constituents, should be the only ones making decisions on state taxes.

We would all welcome further discussion with you on this issue. We can appreciate your desire to craft tax policy that is in the best interests of Wisconsin voters, and we hope that you can appreciate NCSL's policy to ensure state legislators have ability to continue to do the same.

Sincerely,

Senator Joanne Emmons
Chair, Michigan State Senate Finance Committee
Chair, NCSL AFI Commerce and Communications Committee

Senator Steven Rauschenberger
Chair, Illinois State Senate Appropriations Committee
Co-Chair, NCSL Executive Task Force on State and Local Taxation of Telecommunications and Electronic Commerce

Representative Matthew Kisber
Chair, Tennessee State House Finance and Way & Means Committee
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Collectors of taxes fret over online loophole

But report says impact of e-commerce on states isn't as drastic as feared

By Doris Hajewski
of the Journal Sentinel staff

Last Updated: July 6, 1999

Buy a $1,000 necklace from a local jeweler, and you'll pay an extra $56 in Wisconsin and Milwaukee County sales tax.

Find the same necklace on the Internet and you'll pay a shipping charge, but if the seller doesn't have a physical presence in the state, you'll save that $56 in taxes.

As Internet commerce grows in popularity, tax collectors are worrying that more and more people will take advantage of that loophole. If that happens, state tax coffers will shrink in direct proportion to the boom in e-commerce, they say.

"This one's a biggie," says Wisconsin Revenue Secretary Cate Zeuske.

Last month, state officials from across the country met in Williamsburg, Va., to start figuring out how to head off the expected drain on their tax bases.

Gov. Tommy G. Thompson has estimated - and he admits he was just guessing - that Wisconsin could lose up to 40% of its sales tax base to Internet commerce. Zeuske says there's no way to tell how much our state would have collected if everyone who bought something on the Internet from an out-of-state company in 1998 had 'fessed up and paid Wisconsin the taxes due on the transactions.

These purchases, the same as with catalogs, are not tax-free. There's a line on Wisconsin's income tax form that asks filers to report what they bought from out-of-state sellers and to pay what is called a "use tax."

But tax collectors acknowledge that this sales tax honor system has never brought Wisconsin, or other states that operate the same way, their due in use taxes.

In an effort to quell the Internet tax frenzy, Congress last year passed the Internet Freedom Act, imposing a three-year moratorium on new Internet taxes while a commission studies the question.

It took months for the first meeting in Williamsburg to happen, because of bickering and jockeying for places on the new panel. The National Retail Federation, the retail industry's Washington-based professional and lobbying organization, sought a seat on the commission, but neither the NRF nor any retailer was included.

The NRF has protested the snub but isn't taking a position on whether the federal government should get involved in collecting sales tax on Internet transactions. NRF members, many of whom are traditional brick-and-mortar retailers also selling online, have divergent opinions on the question, the NRF says.

Lands' End, which got $61 million of its $1.4 billion in total sales from the Internet last year, believes the government should treat e-commerce the same as other selling channels, said Thane Ryland, a spokesman for the catalog retailer.

Avoiding the Tax

In many ways, the Internet tax issue is nothing new. For years, catalog shoppers who buy from companies that have no operations in their state have avoided paying taxes on their purchases.

Wisconsin residents, for example, will pay sales tax if they buy a turtleneck from Lands' End, which is based in Dodgeville. If they buy the same item from L.L. Bean, the Maine cataloger won't attempt to collect a tax for Wisconsin. The same would be true for a Maine resident buying from Lands' End.

States know that they've been losing tax revenue from catalog shoppers for years, but they haven't been particularly militant in trying to collect it. It's different when it comes to the Internet, they say.

"The amount and rapid explosion of Internet commerce just shines a very bright spotlight on this issue that's been around for 30 years," said Harley Duncan, executive director of the Federation of Tax Administrators in Washington, D.C.

But a major national accounting firm says that so far, those fears are overstated.

In a report last month called "The Sky Is Not Falling," economists from Ernst & Young maintained that "a revenue crisis is not at hand." They estimated the sales and use taxes not collected in 1998 from the increase in out-of-state sales due to the Internet at $170 million, or only one-tenth of 1% of total state and local government sales and use tax collections. The Ernst & Young study was commissioned by the e-Commerce Coalition, which includes America Online Inc., Anderson Consulting, Cisco Systems, First Data Corp., Intuit, Microsoft, Time Warner and Wal-Mart.

The study found that an estimated 80% of current e-commerce is business-to-business sales that are either not subject to sales and use taxes or are effectively subject to use tax payments by in-state business purchasers.

About 63% of Internet business-to-consumer sales are intangible services, such as travel and financial services, or exempt products, such as groceries and prescriptions drugs, which are not subject to state and local sales and use taxes. Business-to-consumer (retail) sales over the Internet were estimated at $20 billion in 1998, less than three-tenths of 1% of total consumer spending.

Some current e-commerce sales result in sales and use taxes from sellers, who remit sales tax to states where they have a physical presence, and some buyers comply with use tax rules and actually report their purchases.

Ernst & Young concluded that only about $2.6 billion, or 13%, of all Internet retail sales have potential sales and use tax collection issues.

E-commerce Worries States

Wisconsin gets one-third of its general purpose revenue from the sales tax, which totaled $3 billion in 1998. With the strong economy, sales tax revenue has increased in recent years, but the rate of increase is slowing, Zeuske said.

States that rely more heavily on the sales tax, Florida, for example, where 70% of the state budget is funded with its sales tax, have more worries about the Internet.

And even though the lost revenue is slight now, with the growth of the Internet, there is reason for states such as Wisconsin to be concerned.

As technology advances and it becomes cheaper to go online, more households will do so, Zeuske said. Now, only about 25% of the households in the United States have access, according to recent studies.

That gives e-commerce more growth potential than catalogs, Zeuske said, because consumers will be able to order from a huge number of retailers without having a catalog in their homes.

The Internet also adds complexity to the sales tax issue, said John Healey, managing director of the Deloitte & Touche Center for Multi-State Taxation at the University of Wisconsin-Milwaukee.

"The sales tax has been geared to tangible personal property," Healey said. But consumers can download software products directly from sellers, via the Internet. If a traveler downloads something to a laptop computer, it's uncertain which state has the right to tax the transaction, he said. Is it the state where the traveler was staying, or the person's home state, or perhaps a third destination, where the product will be used?

When the Federation of Tax Administrators met in Milwaukee last month, it came out in favor of expanding the duty of retailers to collect sales tax from their customers, even when the retailer has no presence in the customers' states.

The administrators acknowledged that, in order for this to happen, more uniformity would be needed in sales taxes. Now, with so many counties and municipalities levying their own sales taxes on top of their state sales taxes, a national retailer such as Lands' End could have as many as 30,000 different tax rates to deal with.

One thing that everyone seems to agree on is that there won't be a quick or easy answer to the tax question. Most experts expect the three-year moratorium will be extended while legislators try to figure it out.

In the meantime, Mark Nachbar, partner in charge of Deloitte & Touche's interstate tax group in Chicago, recommends that businesses prepare for the potential that they will be asked to do more to help the tax man get his due.

Appeared in the Milwaukee Journal Sentinel on July 7, 1999.

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Talk of online sales tax premature

From the Journal Sentinel

Last Updated: Dec. 6, 1999

Worried that Caesar might not be getting his due and that consumers might be keeping more money in their pockets, state government officials nationally are in a tizzy over the possible loss of sales tax revenue as a result of growing e-commerce on the Internet.

"This one's a biggie," says Wisconsin Revenue Secretary Cate Zeuske. Former fiscal conservatives Gov. Tommy Thompson and Rep. Scott Jensen (R-Town of Brookfield) apparently agree and have come up with a plan for a state Internet sales tax. Their time would have been better spent coming up with a plan to draw more high-tech commerce to the state.

It turns out that Internet sales are nowhere near the levels needed to drain government coffers of sales tax revenue, and most sales are of a kind that wouldn't be generating sales taxes anyway, according to a recent study, appropriately titled "The Sky is Not Falling." The money that's being missed is insignificant.

And while more people probably will buy online eventually, they will also continue to buy in stores, where they can see and feel the product, talk to a human clerk and enjoy the social experience of shopping. In fact, online sales could drive up sales across the board, and that makes for a healthy economy and greater wealth for everyone.

In addition, there are some real problems with creating a fair tax system on an enterprise as new and far-flung as the Internet, which crosses state and national boundaries at the click of a mouse.

Until there's a real revenue gap, maybe it's best to keep things as they are and even extend the national three-year moratorium on an Internet sales tax until lawmakers can figure out a rational and fair system - if that's possible.

State fears losing money on e-sales

Thompson backs plan for taxing online sales

By Dennis Chaptman
of the Journal Sentinel staff

Last Updated: Nov. 27, 1999

Madison - The threat to Wisconsin's treasury from the point-and-click explosion of Internet commerce has Gov. Tommy G. Thompson lining up behind a new plan to collect sales taxes from online sales.

Christmas shopping season, once limited to the post-Thanksgiving running of the bulls in shopping malls, is increasingly a matter between man and mouse. That has government officials like Thompson quaking as they look for ways to cut their losses.

"I am so worried about this e-commerce and what it could mean for the state," Thompson said. "About 30% of our revenues come from sales taxes. We could be decimated. We're losing about $100 million right now, we think, from e-commerce."

While convenient for shoppers, e-commerce poses a direct threat to Wisconsin sales tax collections, which annually amount to nearly $3.3 billion. Every button-down shirt, snowboard and compact disc sold on the Internet can deprive Wisconsin of its 5% sales tax on purchases.

Nationally, a split has developed over how - or whether - to tax online transactions.

Thompson is lending support to a plan by Utah Gov. Mike Leavitt to create a simplified e-commerce tax system using a third party to collect the taxes. Leavitt will propose the system next month at a meeting of the National Advisory Commission on Electronic Commerce in San Francisco.

"I signed on because there was nothing else out there," Thompson said. "This is a stopgap measure to try to prevent the kind of landslide that's coming from all of the people who want no tax at all on e-commerce."

Department of Revenue Secretary Cate Zeuske said the debate could have profound consequences for state and local government financing.

"States can't sit back and do nothing while e-commerce grows at warp speed," she said. "If we lose $100 million this year and multiply that a few years out, you start to threaten things state government has provided for. There will be tough choices down the road."

Zeuske noted that the direction of tax policy would be felt locally, because 53 Wisconsin counties levy their own half-percent sales tax.

U.S. Supreme Court rulings say states cannot compel remote sellers - catalog and Internet retailers without a physical presence in the state - to collect sales taxes.

That means that retailers such as Lands' End, based in Dodgeville, have to collect the tax from Wisconsin residents, but outfits such as etoys.com do not. Technically, shoppers are responsible for declaring taxes on their purchases from remote sellers, but few do.

Congress in 1998 slapped a three-year moratorium on new Internet taxes while the advisory commission studies the issue. That study is resulting in a national split.

Virginia Gov. Jim Gilmore, the commission chairman, wants to prohibit sales taxes from being levied on e-commerce to promote the growth of the industry. Taxation opponents claim that the Internet could be vulnerable to about 30,000 taxing authorities in the United States alone.

Collecting and administering taxes for that immense patchwork of states and localities - many with overlapping and often changing taxes - would create a vast nightmare, they say. In making his proposal this month, Gilmore said government should promote the growth of the Internet.

"It is the most transforming technological development since the Industrial Revolution, and its growth must not be thwarted by taxation," Gilmore said. His plan also calls for federal help for states to compensate them for lost sales taxes. It would give $1.7 billion to states in the first year, increasing to $3.4 billion in 10 years.

Those who favor taxation argue that if a company can fit you with a pair of pants of a certain size, color and style, it can also identify your tax district and how much to charge.

Leavitt wants a third-party administrator to collect and distribute taxes on Internet purchases.

The administrator, for a fee, would calculate the taxes in the locality where the goods would be delivered and make sure governments were reimbursed for the taxes due.

"Free trade means level playing fields, not special advantages," Leavitt said. "The prohibitionist campaign is an effort to give an unfair competitive advantage to one group of sellers. It is protectionism cloaked as free trade."

In a letter to the national commission, two state legislators who are studying the issue urged a simplified tax system that would safeguard state coffers.

"Creating a tax-free zone on the Internet would be the beginning of the end of the state and local sales tax," wrote Matt Kisber, a Democrat who is chairman of the Finance Committee in the Tennessee House, and Illinois Senate Appropriations Committee Chairman Steven Rauschenberger, a Republican.

Instead, they urged a plan that would minimize the administrative burden on sellers, eliminate tax audit exposure for firms using certified software to impose the tax, and establish uniform definitions of goods and services that sellers could rely on.

"The most viable option for states to preserve the sales and use tax is for the states to simplify and modernize their tax structure," they wrote.

Zeuske said tax simplification might involve a nationwide rewrite of a knot of sales tax codes. For instance, Minnesota does not tax clothing, but Wisconsin does. And New York state doesn't tax clothing that costs less than $100, except shoes.

If states cannot protect their sales-tax revenue, some worry that the income tax might have to pick up the slack, which could result in a decline in the national savings rate. And if the federal government steps in to levy an across-the-board tax, states might also object.

"As a citizen, I feel that is threatening to states' rights," said Zeuske. "Some things are better left to states to decide what to tax."

The issue has seeped into the presidential campaign.

Siding with Gilmore is U.S. Sen. John McCain (R-Ariz.), a White House hopeful who was instrumental in pushing for the three-year moratorium. Republican presidential front-runner and Texas Gov. George W. Bush says he is willing to consider the panel's recommendations.

The University of Texas recently reported that the Internet generated more than $300 billion in U.S. revenue in 1998, a third of which was e-commerce related. That makes the U.S. Internet economy larger than the entire economies of most countries. In fact, when compared to other nations, the Internet economy would be the 18th largest in the world.

No one questions the explosive growth in online commerce.

Lands' End, the Dodgeville clothing seller, did $61 million in Internet sales during the fiscal year that ended last January, up from $18 million the previous year.

And, if Lands' End is able to maintain its current sales pace, the firm could do $152 million in Internet sales in the year that ends this coming January.

"Our sales are growing rapidly," said Charlotte LaComb, Lands' End director of investor and financial relations. "We would hope the regulations stay the same for Internet taxation as they are for catalogs."

If that cannot be done, LaComb said, a simplified tax is preferable.

"If they have multiple tax policies and tax rates, it can be very complicated," she said.

Assembly Speaker Scott Jensen (R-Town of Brookfield) hopes the commission will establish a way to fairly tax Internet purchases.

"Whether a sweater is sold in a store, a catalog, or over the Internet, there should be the same level of taxation," Jensen said. "We need to create a level playing field that treats all retailers the same."

He stressed that government should not push a punitive tax on e-commerce that would stunt development of the industry. But he is also concerned with conventional small businesses.

"I am more concerned with the impact on Main Street businesses than I am with the impact e-commerce will have on state revenues," Jensen said. "If some giant Internet retailer has the ability to buy larger quantities and offer lower prices and not be taxed, they will have a huge advantage."

Appeared in the Milwaukee Journal Sentinel on Nov. 28, 1999.

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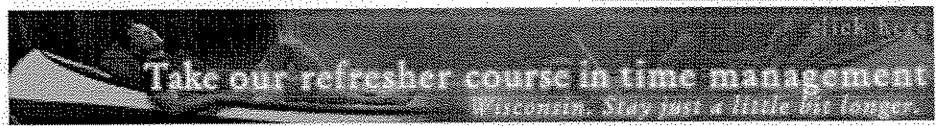

Thompson warns Internet will cut sales tax revenue

By Craig Gilbert
of the Journal Sentinel staff

May 06, 1999

Washington -- Appearing before a Senate panel, Gov. Tommy G. Thompson said he feared the growth in Internet commerce would cost Wisconsin and other states a fortune in uncollected sales taxes.

"It's going to get worse," Thompson said. "We are so fearful of a situation where states have to go to the federal government to get all our revenue."

On the second day of a two-day Washington trip, Thompson testified before the Senate Governmental Affairs Committee on the subject of federalism.

During his testimony, he brought up the subject of Internet commerce and its impact on state revenue. It was something, he said, "that has really bothered me."

Internet taxation is a hotly debated issue. Congress last year passed a three-year moratorium on new Internet taxes while a new commission studies the question.

After the hearing, Thompson suggested states ultimately could lose up to 40% of their sales tax base to Internet commerce, although he admitted the figure was a guess. In Wisconsin, sales taxes account for roughly a third of the state's tax revenue, according to the Wisconsin Taxpayers Alliance; in most states the figure is higher.

He said the government may have to come up with revenue-sharing arrangements among states on Internet commerce. He said governors themselves were divided on the issue but that any fair solution will transcend state boundaries and require federal action.

Wisconsin Counties Association

MEMORANDUM

TO: The Honorable Joint Committee on Information Policy

FROM: Allison Kujawa, WCA Legislative Associate

DATE: June 14, 2000

RE: Sales Tax and the Internet

The Wisconsin Counties Association (WCA) has serious concerns regarding the future of the sales tax as a viable revenue source for state and county government in Wisconsin.

Consumer purchasing of goods by way of the Internet, phone and mail order has literally brought the goods and services of the world to the homes of consumers. Americans are taking advantage of these convenient ways of shopping in record numbers. According to the U.S. Department of Commerce, Internet traffic alone is doubling every one hundred days. In addition to the explosion in Internet use, electronic commerce has grown more than 700% over the past five years. The proportion of retailers selling on the Internet tripled in just one year, from 12% in 1997 to 30% in 1998.

This tremendous shift in purchasing from traditional brick and mortar retailers to remote sales creates serious problems for state and local governments. To date, 53 Wisconsin counties have elected to impose a one-half percent sales tax. The sales tax comprises about one-third of the State of Wisconsin's General fund. Past history has indicated that when the state has experienced significant strains on its budget, the result has been a reduced commitment to county government funding. If sales tax collection is hampered, it is likely that all local governments in Wisconsin will experience reduced state aid.

The current system of state and local tax administration is complex and burdensome. Differences in tax law among the states, coupled with the extensive use of the tax by local governments in many states, impose a significant compliance burden on multistate sellers, a burden for which they are not compensated in many instances. Substantial changes are necessary if the sales tax is to continue as an integral part of the state and local revenue system.

Under current law, the State of Wisconsin must have "nexus" with a business in order to require that business collect sales tax. Wisconsin nexus rule states that retailers engaged in business in the state, unless otherwise limited by federal statute, for purpose of the sales tax, requires retailers to register and collect a state tax if the retailer is subject to the state's jurisdiction. Due process requires some definite link, some minimum connection

100 River Place, Suite 101 ◆ Monona, Wisconsin 53716 ◆ 608/224-5330 ◆ 800/922-1993 ◆ Fax 608/224-5325

Mark M. Rogacki, Executive Director

Mark D. O'Connell, Chief of Staff
Craig M. Thompson, Legislative Director

Darla M. Hium, Deputy Director
Lynda L. Bradstreet, Administrative Director

between the state and the person, property or the transaction to seek a tax. If this minimum connection, nexus, is established out-of-state sellers are required to collect tax.

The federal government has imposed a moratorium on Internet taxes because of the complex and burdensome local tax system. Various legislative proposals affecting Internet sales could significantly reduce state and local government ability to collect sales taxes. Substantial changes are necessary if the sales tax is to continue as an integral part of the state and local revenue system. Sales tax laws must be made significantly more uniform across the states, and the administration of the tax must be substantially overhauled and simplified.

While the WCA Board of Directors will not take an official position on Internet Sales Tax until its June 23, 2000, the WCA Taxation and Finance steering Committee has examined the issue and made the following recommendation to the WCA Board of Directors:

1. Support legislation that would require all sales transactions are treated the same as a transaction that is carried out in person, on the phone, by mail, or on the Internet.

2. Support federal legislation that would permit the collection of state and local taxes on remote sales conducted at the point of purchase.

3. Oppose legislation that would preempt state and local authority to make fundamental decisions about tax structures.

4. Support legislation that would require technology to be utilized, which can administer even the most complex tax systems with ease and efficiency.

It is also important to note that the National Association of Counties, the National league of Cities and the US Conference of Mayors agree on the above four general principals.

WCA urges the State of Wisconsin to cooperate with other states to develop a simplified, more uniform sales tax structure in an effort to better prepare for possible implementation of a nation-wide system for sales tax collection that also preserves state and local sovereignty.

If you have any questions please do not hesitate to contact me at 1-800-922-1993.

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35%–75% off retail prices. The assortment of clothes, lingerie and accessories – from top names like Prada, Perry Ellis, Yves Saint Laurent and Paul Stuart – is updated every two weeks. This smart site lets you search for gifts by price range (starting at under $25), and everything's "guaranteed without reservation."

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Designers Direct
www.designersdirect.com

Discounted "stylish designer clothing for today's casual lifestyles" is Designers Direct's motto. Emphasizing menswear, this site has offerings from Tommy Hilfiger, Ralph Lauren, Calvin Klein, DKNY, Guess, Nike and more. All merchandise is first quality, with both retail and discount prices marked. Although items are "100% satisfaction guaranteed," returns must be authorized by phone and made within two weeks of receipt of your purchase. Another caveat: Delivery and credit card addresses must be the same.

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Dockers
www.dockers.com

America's having a love affair with the casual, comfortable fit of khakis, and Dockers is perhaps the place to shop for pants and coordinated shirts for men and women. Here, khakis are available in a wide range of colors, sizes and styles, including the new "K-1" made from authentic 1932 U.S. Army fabric. The "fit calculator" and full guarantee help make gift buying more relaxing.

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www.eddiebauer.com

Since its beginnings in the Northwest in 1920, Eddie Bauer has grown from just outdoor wear into an impressive empire including men's and women's dress, sports and activewear, often in sizes petite to XXL. Site features include: a quick "Gift Finder" search by price range, clothing coordination suggestions, online/offline gift certificates and returns, complete guarantees and tell-Santa-to-give-me "wish list" forms for loved ones to fill out.

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Esprit
www.esprit.com

Looking for women's clothing, accessories and footwear that have a modern and fresh spirit? Your search is over. Sizing and color guides, "web deals" from past lines and the very handy "product finder" (that lets you search the collection by price, style and color) are cool tools. While the site is fairly slow and onsite customer service is somewhat weak, Esprit is very responsive to e-mail questions.

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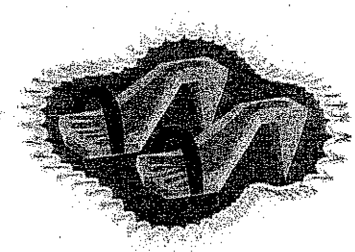
Fashionmall.com
www.fashionmall.com

Living up to its name, here's a collection of dozens of famous fashion retailers for men, women, teens and kids under one virtual roof. While many mall tenants also have their own .com shops, it's timesaving to make all purchases through one checkout process. Just like an offline mall, store policies are determined by the individual retailers. Link to their Outlet Mall for discounts.



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The Taxing Question

If you've ever driven across state lines to avoid paying sales tax, you will love shopping online. The amount of sales tax applied to a purchase varies widely from state to state, and, with judicious shopping, you can save as much as 10% on every item you buy.

A vendor is required to collect tax on any sale made to customers who reside in the same state (or states) in which the company has some physical presence. (Remember, it's not unusual for an online merchant to have its main office in one state and a distribution center in another.) Companies use your billing address rather than your shipping address to determine if your purchase is taxable.

How can you tell whether you'll owe sales tax or not? The most direct way is to almost complete your online order. Most Web stores display the total amount due, including shipping and sales tax, just before you click the button that submits your order for processing. Don't be afraid to abort your purchase (by clicking the browser's Back button or going to another web site) if you don't like what you see. Many companies also list which states charge sales tax under "Customer Service." —JOSEPH LOWERY

Gap Online
www.gap.com

Why face crowded malls when you can easily shop at Gap Online? From loungewear to outerwear, socks to jeans, this extensive site offers the casual clothes the world has come to associate with the Gap. Here, gift giving's a snap with "gift central" prepackaged sets, complimentary gift boxes, "gift reminder" e-mail notification and an onsite address book. Best of all: Returns can be made at your favorite neighborhood Gap store.

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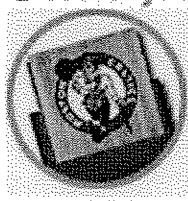

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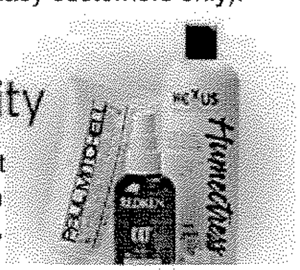

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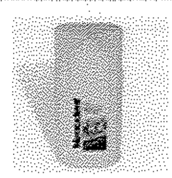

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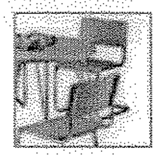

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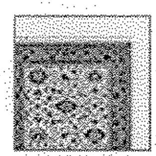

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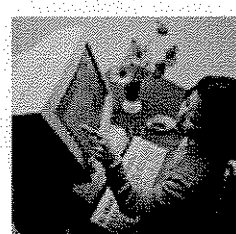

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Editorial Reviews

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DATE: June 14, 2000

TO: MEMBERS OF THE JOINT COMMITTEE ON INFORMATION POLICY AND TECHNOLOGY

FROM: John Stolzenberg, Staff Scientist

SUBJECT: Introduction to the Sales and Use Taxation of Electronic Commerce

This memorandum, prepared at the request of Senator Robert Jauch, cochair of your committee, provides an introduction to the ongoing national policy debate associated with the application and collection of sales and use taxes on electronic commerce. The memorandum was prepared in conjunction with your committee's hearing on June 14, 2000, relating to the effect of electronic commerce upon other businesses and upon sales tax revenues.

A. ISSUES

Currently, 45 states impose a sales or use tax on goods or services purchased or consumed in the state. These taxes make up between 21% and 58% of the state's total tax revenues, with the higher percentages being in states that do not have a state income tax.

The advent of interstate sales to the public by national retail chains and mail order sales in the 1950s and 1960s raised a number of policy and legal issues which culminated in two U.S. Supreme Court decisions (*National Bellas Hess v. Illinois Dept. of Revenue* (1967) and reaffirmed in *Quill Corp. v. North Dakota* (1992)) that held that a state cannot compel a mail order business to collect sales taxes from the business's customers located in the state unless the business has a physical presence (such as sales personnel) or "nexus" in the state. These rulings do not prevent a state from imposing a use tax on its citizens and businesses on goods and service purchased from out-of-state firms, as the rulings address collection of the tax. In Wisconsin, except for motor vehicles and certain other items for which proof of sales tax payment is required as a condition of registration, individuals are required to account for and pay their use taxes on their state income tax returns. While this method of collecting use taxes may be legal, due to the expense and impracticality of extensive auditing of returns, it is difficult to effectively collect use taxes, especially for sales to individuals.

The dramatic growth of electronic commerce through the Internet, and projections that this growth will continue at a high rate, have raised a number of concerns relating to whether states should be able to collect sales or use taxes on electronic commerce sales, and if so, how. These concerns include:

- ***Tax fairness*** between businesses and between customers. Businesses that have to collect sales taxes, such as those with retail stores in a state, are placed at a competitive disadvantage with a firm that sells the same goods remotely via the Internet because the tax makes the total cost of the goods more expensive and administrative expenses associated with the tax collection may not be reimbursed completely by the state. Also, customers with on-line access have an advantage over those that do not in being able to purchase goods or services for which the seller does not collect the tax.

- If sales and use taxes are not collected on electronic commerce, the potentially significant ***decrease in state and local government tax revenues***, especially as electronic commerce continues to grow.

- The ***high administrative burden*** placed on a business selling nationwide in complying with the present patchwork of state and local sales and use tax systems with conflicting applicability, inconsistent rates and varying reporting requirements.

- The ***effect on the Internet as a marketplace*** of the imposition and collection of the sales tax. Some argue that application of the taxes to electronic business will increase their expenses and the accompanying regulations will stifle the growth and open nature of electronic commerce on the Internet.

- In light of the booming national economy, ***whether states and local governments need the additional revenues*** that would arise from collecting sales and use taxes on electronic commerce, especially given the potential growth in revenues from other taxes.

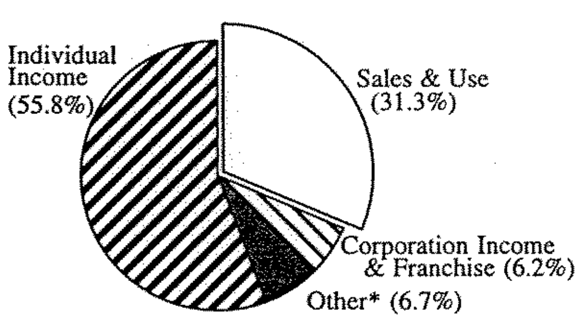
Another issue that is often raised in discussions on the application of sales and use taxes to electronic commerce is the application of these taxes or state telecommunications taxes to Internet access services (for example, America OnLine's service that links a personal computer to the Internet).

B. WISCONSIN SALES TAX COLLECTIONS

According to the Department of Revenue (DOR), of the $9.7 billion collected by the state in general purpose revenue taxes between July 1999 and April 2000, about $2.5 billion, or 31% of the total, was sales and use tax receipts. See Figure 1. During this period, counties and local stadium districts collected an additional $153 million in sales taxes.

The DOR estimates that in 1999 Wisconsin consumers purchased between $290 million and $386 million in goods and services via electronic commerce. The department currently projects that in five years, that is in 2004, these sales will expand to between $4.3 billion and $5.8 billion. The DOR also estimates that in 1999 there were about $2.1 billion in sales to Wisconsin businesses through electronic commerce and that this figure will grow to $30.7 billion in 2004. These electronic commerce sales, the DOR estimates, reduced Wisconsin sales tax revenues by $9 to $14 million in 1999.

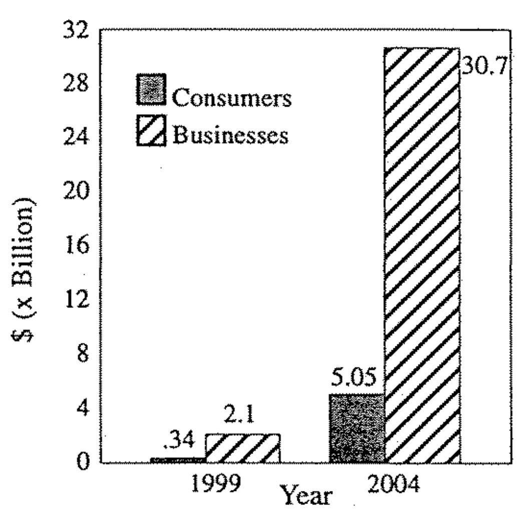
Figure 1. Sources of State Tax Receipts



*Public Utility (2.0%), Excise (2.8%), Estate (1.5%) and Real Estate Transfer Fee (0.4%)

Source: "Wisconsin Economic Outlook" (May 31, 2000), Department of Revenue, based on collections between July 1999 and April 2000.

Figure 2. Estimated Electronic Commerce Sales to Wisconsin Consumers and Businesses



Source: Personal communication, Department of Revenue (June 2000).

C. CONGRESSIONAL ACTIONS

The Federal ***Internet Tax Freedom Act*** was enacted on October 21, 1998, as part of P.L. 105-277. The Act did all of the following:

- Imposed a ***three-year moratorium*** ending October 21, 2001 on the ability of local and state governments to impose new taxes on Internet access services and any "multiple or discriminatory taxes on electronic commerce." The first prohibition does not apply to the sales tax that Wisconsin imposes on Internet access services as Wisconsin's tax existed prior to enactment of the Act. The second prohibition does not apply to or limit the application of general sales taxes to electronic commerce transactions.

- Expressed Congress's position through a "sense of Congress" that ***no new federal taxes*** should be placed on the Internet or Internet access during the moratorium and that the President should seek bilateral, regional and multilateral agreements to remove barriers to global electronic commerce.

- Created the ***Advisory Commission on Electronic Commerce*** and directed it to study the federal, state, local and international taxation or tariff treatment of transactions using the Internet and Internet access and related issues. The Commission presented its final report to Congress on April 12, 2000. However, the Commission was not able to reach the required 2/3 majority to make formal recommendations relating to the sales and use taxation of electronic commerce.

A number of bills have been introduced into the current session of Congress relating to Internet taxation. These include the House Approved H.R. 3709, which extends the current tax moratorium for five years while removing the grandfather protection for previously established Internet access taxes.

D. STATES' EFFORTS

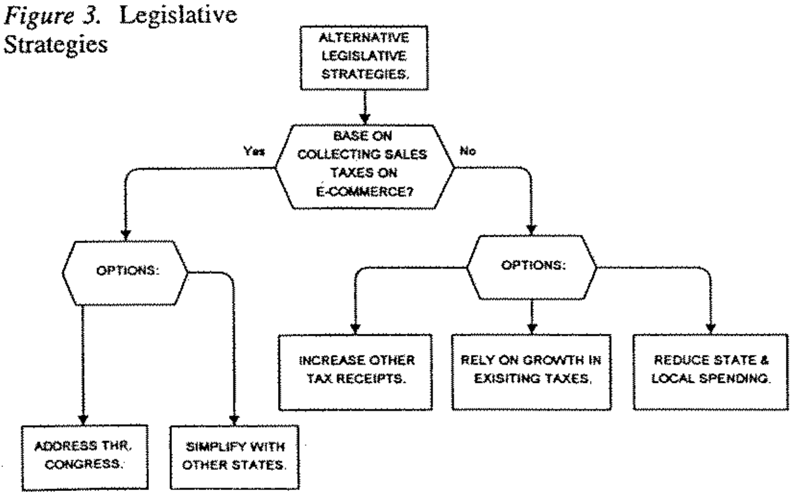
A number of national organizations that represent or assist various state officials are presently addressing issues relating to the sales and use taxation of electronic commerce. Both the National Governors' Association (NGA) and the National Conference of State Legislatures (NCSL) have endorsed the creation of a streamline sales tax administration system with voluntary participation by sellers.

Currently, 16 states are participating in the ***Streamlined Sales Tax Project*** which is developing model legislation to implement the streamlined sales tax administration endorsed by NGA and NCSL. These states are assisted by 16 additional "observer states" and other interested parties, including business representatives. The DOR is actively participating in this project, as Diane Hardt, Administrator, Income, Sales and Excise Tax, DOR, is a project cochair.

E. ALTERNATIVE LEGISLATIVE STRATEGIES

Figure 3 depicts the basic alternative strategies that the Legislature could pursue in addressing the taxation of electronic commerce. Some of these strategies may be pursued simultaneously.

Figure 3. Legislative Strategies



F. FURTHER INFORMATION

The following Internet sites contain additional information relating to the sales and use taxation of electronic commerce:

- Advisory Commission on Electronic Commerce: *http://www.ecommercecommission.org/index.htm*
- e-Freedom Coalition: *http://www.e-freedom.org/*
- Fight Internet Taxes, a campaign of the Heritage Foundation: *http://www.fightnettax.com/*
- NCSL's Task Force on State and Local Taxation of Telecommunications and Electronic Commerce: *http://www.ncsl.org/programs/fiscal/tctelcom.htm*
- NGA: *http://www.nga.org/Internet/equality.asp*
- National Tax Association Communications and Electronic Commerce Tax Project: *http://www.nhdd.com/nta/ntaintro.htm*
- No Net Tax, a project of Max Tax, sponsored by the Committee for New American Leadership: *http://www.nonettax.net/*
- Streamlined Sales Tax Project: *http://www.geocities.com/streamlined2000/*

If you have any questions relating to the sales and use taxation of electronic commerce, please feel free to direct them to me at the Legislative Council Staff offices.

JES:tlu:rv;wu;ksm

WISCONSIN LEGISLATIVE COUNCIL STAFF MEMORANDUM

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DATE: June 14, 2000

TO: MEMBERS OF THE JOINT COMMITTEE ON INFORMATION POLICY AND TECHNOLOGY

FROM: John Stolzenberg, Staff Scientist

SUBJECT: Additional Background Information on the Sales and Use Taxation of Electronic Commerce

The June 14, 2000 Legislative Council Staff Memorandum to you, entitled *Introduction to the Sales and Use Taxation of Electronic Commerce*, includes the addresses of Internet sites that provide information on the policy issues associated with the collection of sales and use taxes on electronic commerce. Attached to this memorandum are the following reports by the Congressional Research Service which provide additional information on these issues:

1. "Internet Transactions and the Sales Tax," Order Code RL30431 (updated May 3, 2000).

2. "State Sales Taxation of Internet Transactions," Order Code RS20577 (May 10, 2000).

JES:rv;ksm

Attachments

Order Code RL30431

CRS Report for Congress

Received through the CRS Web

Internet Transactions and the Sales Tax

Updated May 3, 2000

Steve Maguire
Analyst in Public Finance
Government and Finance Division

ABSTRACT

The purpose of this report is to describe state sales and use taxes and the potential effect of Internet transactions on the administration and revenue generation of the tax. Pending legislation will not be reviewed in depth. Topics covered include state and local tax rates, state tax base, efficiency and equity of differential sales taxes, and sales tax revenue data for the fifty states and the District of Columbia. The moratorium on new Internet taxes as part of the Internet Tax Freedom Act of 1998 (ITFA) is discussed briefly as is the proposed extension and expansion of the legislation. The Advisory Commission on Electronic Commerce, formed as a part of ITFA, is a source of additional information on the taxation of electronic commerce. This report will be updated as legislative events merit.

Internet Transactions and the Sales Tax

Summary

The creation and subsequent activities of the Advisory Commission on Electronic Commerce has focused attention on the issue of Internet taxation. The debate generally focuses upon the administration of the sales tax and electronic commerce. Under present law, interstate vendors that do not have 'substantial nexus' in the state of a purchaser's residence are not required to collect the sales and use tax on Internet transactions. In most cases, the state requires the purchaser to voluntarily remit a use tax to their home state. However, voluntary compliance with this requirement is quite low. Thus, states feel that the growing share of Internet transactions relative to traditional retail transactions will lead to a deterioration of their tax base and thus revenue. This report examines the sales and use tax in general, provides state by state sales tax revenue reliance estimates, and lists state and local sales tax rates. This report will be updated as legislative events merit.

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Internet Transactions and the Sales Tax

Introduction

This report serves as an introduction to the economics of the sales and use tax and the growth of electronic commerce. Presently, forty-five states (and the District of Columbia) require that retail outlets add a fixed percentage to the sales price of all taxable items (inclusive of federally imposed excise taxes). In addition to the states, there are numerous localities and special taxing jurisdictions comprising an estimated 6,400 different sales tax rates in the United States.[1] For transactions physically taking place at the store or retail outlet, collection of the sales tax is straightforward. The vendor simply applies the appropriate tax rate. However, with the expanding acceptance of the Internet as an alternative to traditional retail transactions, the collection of the sales and use tax has become an issue of significant importance to vendors, sub-national governments, and consumers.

There are currently seven bills addressing the taxation of Internet based commerce awaiting congressional action.[2] Three of the bills would extend the moratorium (generally for five years after the current moratorium expiration in October of 2001) on multiple or discriminatory taxation of internet sales: S. 2255 (McCain), S. 2028 (Wyden), and H.R. 3709 (Cox). A fourth bill, H.R. 4267 (Hyde), extends the moratorium and incorporates most of the recommendations of the Advisory Commission on Electronic Commerce. Yet another bill, H.R. 3252 (Kasich and Boehner), makes the moratorium permanent. A sixth bill, S. 2401 (Gregg and Kohl), codifies nexus standards which are currently defined primarily by Supreme Court rulings. And a final bill, S. 1433 (Hollings), introduces a federal sales tax of 5% on all Internet and mail order sales. The proceeds from this tax would be collected by the federal government then redistributed to the states by an apportionment formula loosely based on population and poverty rate. For a more in-depth review of pending legislation, see CRS Report RL30412, *Internet Taxation: Bills in the 106th Congress.*

The first section explains the operation of the sales tax from the tax administrator's point of view. The second section provides an overview of the economic aspects of sales taxes and how Internet transactions, or 'Internet taxes,' have changed the role of the sales tax in state and local government finance.

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[1] Goolsbee, Austan and Jonathan Zittrain, "Evaluating the Costs and Benefits of Internet Transactions," *National Tax Journal,* vol. 52, no. 3 (September, 1999) p. 413-428. In addition, research by *Vertex Inc.*, a private company that collects and sells jurisdiction tax data to vendors, found that over the last six years an average of 639 jurisdictions implemented tax rate changes a year.

[2] The probability of additional bills being introduced after the publication of this report is relatively high.

The Administration of the Sales and Use Tax

State and local governments that impose a general sales tax on transactions typically calculate the tax as a fixed percentage of a retail good's purchase price. In theory, the sales and use tax is seen in part as a benefits received tax on businesses and consumers for state and local expenditures such as fire protection, road maintenance, education, and police protection. Most states require monthly remittance of the sales tax and often offer discounts to businesses that pay early or have total sales exceeding a given amount.[3] Many states require that vendors with a substantial nexus maintain an active sales tax revenue account with the state revenue department.[4]

Sales Tax Pyramiding. However, not all transactions are taxed. Business to business transactions are in some cases not subject to the retail sales tax with the understanding that the purchaser is using the good as an input to production. Including business to business transactions leads to 'pyramiding' of the sales tax. For example, a coffee shop that pays a retail sales tax on the purchase of their wholesale coffee beans, then imposes a retail sales tax on coffee brewed for the final consumer, the total sales tax paid for the cup of coffee would exceed the statutory rate.

In addition to some business purchases, many individuals and organizations are exempt from the sales tax. Entities wishing to claim the sales tax exemption are often issued a certificate indicating their tax-free status and are required to present their verification at the point of transaction. Non-profit organizations, such as those whose mission is religious, charitable, educational, or promote the public health, are often the beneficiaries of sales tax-exempt status.

Substantial Nexus. Out-of-state businesses without substantial nexus in the taxing state are not required to collect state and local sales taxes on transactions involving customers in the home taxing state. The United States Supreme Court has held that a state has no jurisdiction to require a vendor to withhold that state's sales and use taxes unless the vendor has a "substantial nexus" with the taxing state.[5] The residence of the purchaser is not a sufficient nexus. However, the Court has also held that Congress, under its power to regulate interstate commerce, could grant jurisdiction to the states to require the collection of use taxes.

Because interstate Internet transactions do not have the sales and use tax added to their price by out-of-state vendors, Internet retailers and catalogue retailers are thought to have a competitive advantage over traditional 'bricks and mortar' vendors who are required to collect the tax. The equitable treatment of all vendors is the

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[3] Seventeen of the forty-five states with a sales tax do not offer a vendor discount. A gross receipts tax is similar to a general sales tax.

[4] Generally, substantial nexus means physical presence.

[5] There are two decisions that clarified the taxation of out-of-state vendors. In *National Bellas Hess v. Illinois Department of Revenue* (1967) the court established the substantial nexus argument. In *Quill v. North Dakota* (1992) the court upheld the nexus argument and further specified the physical presence standard for substantial nexus.

objective of many of the proposed changes to the administration of the sales and use tax.

In short, the sales and use tax is collected by vendors if the vendor has substantial nexus in the (non-tax-exempt) purchaser's home state. Usually, the vendor must remit all sales taxes monthly and often receives a discount for timely payment. Or, in the case of very large retailers, a rebate is offered to encourage accurate and timely reporting. If the vendor does not have substantial nexus the *consumer* is required to remit a 'use tax' to their state government. All states with a sales tax also impose a use tax though compliance is very low. Thus, contrary to what some observers say, Internet purchases are not 'tax free.'[6]

The Economics of the Sales and Use Tax

In 1932, Mississippi was the first state to impose a general state sales tax.[7] During the remainder of the 1930's, an era characterized by declining revenue from income and corporate taxes, twenty-three other states followed suit and implemented a general sales tax to compensate for the lost revenue.[8] At the time, the sales tax was relatively easy to administer and could raise a significant amount of revenue with a relatively low rate.[9] Given the relative success of the sales tax, almost all other states added the sales tax to their tax infrastructure by the late sixties. Use taxes are in practice analogous to the sales tax though the tax is on the *use* of the product purchased rather than the transaction. The last of the forty-five states to enact a general sales tax (along with a use tax) was Vermont in 1969.

The revenue a sales tax generates depends upon the chosen rate and the base to which the rate applies. The more narrow the base the higher the rate must be to raise an equivalent amount of revenue. States often have somewhat similar consumption expenditures included in their tax base, however, they are far from uniform. Tax rates also vary considerably from state to state depending in part on their reliance on other revenue sources. Following is a brief economic analysis of the sales tax and the challenges electronic commerce poses for the administration of the tax.

Efficiency. A commonly held view among economists is that a 'good' tax (or more precisely, an efficient tax) is one that does not significantly distort behavior. Broadly speaking, individuals should make the same relative choices before and after

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[6] The much discussed moratorium on Internet taxation applies to any multiple or discriminatory taxes targeted explicitly at Internet retailers. The sales and use tax is not a new tax.

[7] The *use* tax, the companion to the sales tax, was added in 1938. In the early years of the sales tax, states began with general sales then added the use tax to capture revenue from sales made out-of-state. Eventually, states adopting a sales tax included the use tax in the initial legislation.

[8] Fox, William F., ed., *Sales Taxation: Critical Issues in Policy and Administration, Sales Tax Trends and Issues*, by Ebel, Robert and Christopher Zimmerman (Westport, CT: Praeger, 1992), p. 3-26.

[9] The highest rate in 1934 was 3%. At the time the 3% rate was considered quite high.

a tax is imposed. The greater the distortions in behavior, the greater the economic welfare loss.

Products purchased over the Internet, which escape use taxation (i.e., the consumer does not remit the required use taxes), are generally preferred to the products offered at traditional retail outlets that are required to collect the tax. However, if the transaction costs associated with the Internet purchase, e.g. shipping and internet access, exceed the sum of the traditional transaction costs (time and transportation) and the applicable sales tax, the consumer will choose the traditional means of transaction. Note that the shipping costs added to Internet purchases are analogous to the transactions costs associated with traditional 'main street' shopping, not to the sales taxes imposed.

Equity. The sales tax has often been criticized as a regressive tax, or a tax that disproportionately burdens the poor.[10] Assuming the Internet shopper is relatively better off and does not remit use taxes as prescribed by state law, they can avoid paying tax on a significant portion of their consumption expenditures.[11] Those without Internet access at home or work, on the other hand, are not afforded the same opportunity to 'evade' the sales and use tax. In this way, electronic commerce may actually exacerbate the regressiveness of the sales tax, at least in the short run.

Tax Base. In theory, the base of a comprehensive consumption tax should include all income that is not saved.[12] The sales tax, which is often thought of as a consumption tax, is perhaps better identified as a transaction tax on tangible personal property. Most states only tax tangible goods purchased at the retail level. Services, such as legal and medical, are expenditures often omitted from the sales tax base.[13]

Ideally, the sales tax base is broad enough to avoid drastic fluctuations in the revenue stream. Given that state budgets must be balanced annually, a consistent revenue stream is important for fiscal stability engendered by a broad base sales tax. With the shift in the United States from an economy based on transactions of tangible personal property to intangible products and services, the sales and use tax base will continue to narrow.[14] It is then likely that sales tax revenue will also begin to show greater volatility.[15] However, the move from arms-length transactions to Internet

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[10] A regressive tax collects a smaller percentage of personal income as income increases.

[11] Goolsbee and Zittrain (1999) found that the average Internet user had on average two more years of education and $22,000 more in family income than non-Internet users.

[12] A common identity in the economics of income accounting is the following: $C=Y-S$. Or, consumption (C) equals income (Y) less saving (S).

[13] Only two states tax medical services, Hawaii and New Mexico.

[14] Bruce, Donald and William Fox, "E-Commerce in the Context of Declining State Sales Tax Bases," (February, 2000). Mimeo, University of Tennessee, Knoxville.

[15] States without groceries in the sales tax base, considered a relatively constant expenditure, are more vulnerable to cyclical shocks to the sales tax base.

transactions for services, such as financial, legal, or medical services, does not portend a large loss in state and local sales tax revenue.[16]

Table 1 presents a rough estimate of the *potential* sales tax base for the fifty states, their localities, and the District of Columbia.[17] Unfortunately, reliable estimates of consumption expenditures at the state level are not available. Thus, we offer state personal income in 1998 as a proxy for the potential base of the consumption tax. The last column is the tax rate on unadjusted personal income (in addition to any existing personal income taxes) that would be necessary to achieve the revenue produced by the current state sales tax.

Tax Rate. Sales tax rates low enough to avoid altering consumer behavior create fewer distortions than do high rates. However, state sales tax rates vary considerably as do the local rates piggy-backed onto the state levy. Mississippi and Rhode Island have the highest state sales tax rate of 7%. Oklahoma and Louisiana have the highest potential combined state and local rate of 9.5%. The higher rates in these states create and even larger wedge between those that must collect the sales tax and those that do not. Clearly, residents in the high sales tax jurisdictions gain more from Internet purchases (and tax evasion) than do those in small low tax states.

Table 2 presents the sales tax rates for the fifty states, their localities, and the District of Columbia. Also reported in Table 2 is the reliance on the states on the general sales (and gross receipts) tax (as measured by CRS). The Bureau of Economic Analysis (BEA) also collects data on excise taxes and selective sales. We do not report these receipts because they are typically collected at the wholesale stage, not at the point of retail transaction. For example, the gasoline excise tax is typically paid by the carrier (tanker truck) at the point of collection (the end of the pipeline), not retail sale. Even though gross receipts taxes have more in common with traditional business taxes, the BEA combines them with general sales taxes. Six states, indicated by italics in Table 2, identify their retail sales tax as gross receipts or general income tax. The base of the gross receipts is sometimes broader than the retail sales tax. Depending on the vendor, revenue generated by Internet transactions with out of state purchasers may or may not fall under the gross receipts tax.

Sales Tax Reliance. Based upon our calculations, the states most reliant upon general sales and gross receipts taxes, with over 57% of total revenue derived from the tax, are Tennessee, Washington, and Florida. This result is not surprising: these states do not have a personal income tax. In fact, the top six states in terms of reliance upon the general sales tax do not have a personal income tax.

States without a personal income tax are identified in italics. Alaska is dissimilar from all other states given the absence of personal income taxes and sales and use taxes. States without a sales and use tax are represented in bold. Ordinal rankings in terms of reliance appear in the last column of Table 2.

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[16] According the Boston Consulting Group, sales of financial services were second to sales of computer goods in the first six months of 1998. Goolsbee and Zittrain (1999).

[17] Assuming all states had a uniform base, which they do not.

A permanent ban on sales and use taxes on Internet sales would affect states proportionately to their reliance on the sales and use tax for revenue. States that rely heavily on the sales tax also have generally higher rates which exacerbate the difference between the after sales tax retail price and the Internet price. Alternatively, states with low rates (and in turn less reliance) would tend to have a smaller 'wedge' between the two means of transaction. Returning to the efficiency discussion earlier, residents in the high rate-high reliance states would tend to recognize the greatest welfare loss given their expected change in behavior.

If sales taxes were eliminated entirely, states may turn to an additional tax on personal income to help balance their budgets. Assuming this course of action is pursued, i.e total elimination of the sales tax, Table 1 offers the minimum personal income tax rate necessary to yield equal revenue. The calculation also assumes that all personal income is included in the income tax base.

Conclusion

The Advisory Commission on Electronic Commerce submitted their final report to Congress in early April of 2000. The final report included three recommendations or findings: 1) to close the digital divide, 2) to explore internet privacy issues, and 3) to support making permanent the international tariffs at the earliest possible date. However, the commission did not arrive upon the necessary two-thirds vote for six additional 'policy proposals'. The six 'policy proposals' included a five year extension of the moratorium on multiple and discriminatory taxes and clarification of nexus rules.

Ultimately, eliminating the sales and use tax on a select type of transactions and not others will likely lead to distortions in consumer behavior. These distortions would be minimized by taxing all transactions, regardless of mode, at the same rate (perhaps even zero). Whether this can be achieved with the current sales and use tax structure is an open question.

Table 1. Potential Sales and Use Tax Base of the Fifty States

State (*italics* =no personal income tax) (**bold**=no sales tax)	GSGR[a] State Tax Revenue 1998 ($000's)	Clothing in Base (in 2000)	Groceries in Base (in 2000)	State Personal Income 1998 ($000's)	GSGR Tax as Percent of Personal Income 1998
(a)	(b)	(c)	(d)	(e)	(f)
Alabama	1,570,650	Y	Y	93,566,943	1.68%
Alaska	0	n/a	n/a	15,823,391	0.00%
Arizona	3,050,111	Y	N	108,086,511	2.82%
Arkansas	1,513,673	Y	Y	51,762,820	2.92%
California	21,301,860	partial	N	900,899,903	2.36%
Colorado	1,530,832	Y	N	114,449,124	1.34%
Connecticut	3,031,699	partial	N	123,430,960	2.46%
Delaware	0	n/a	n/a	22,257,563	0.00%
District of Columbia[b]	855,000	Y	N[d]	19,525,661	4.38%
Florida	12,923,644	holiday	N	386,654,430	3.34%
Georgia	3,993,493	Y	N	191,864,830	2.08%
Hawaii	1,425,352	Y	Y	31,268,323	4.56%
Idaho	652,843	partial	Y	25,901,148	2.52%
Illinois	5,596,046	Y	Y[e]	349,029,419	1.60%
Indiana	3,166,706	partial	N	143,362,349	2.21%
Iowa	1,528,824	Y	N	68,719,683	2.22%
Kansas	1,619,246	Y	Y	65,854,217	2.46%
Kentucky	1,981,290	Y	N	84,833,878	2.34%
Louisiana	1,981,231	Y	Y[f]	93,429,786	2.12%
Maine	830,758	Y	N[d]	28,619,679	2.90%
Maryland	2,161,233	Y	Y	154,163,998	1.40%
Massachusetts	2,962,535	partial	N	202,252,119	1.46%
Michigan	7,572,789	Y	N	255,038,802	2.97%
Minnesota	3,243,611	partial	N	130,736,634	2.48%
Mississippi	2,034,804	Y	Y	52,283,212	3.89%
Missouri	2,627,839	Y	Y[e]	132,955,487	1.98%
Montana	0	n/a	n/a	17,826,735	0.00%
Nebraska	919,750	Y	N	41,211,643	2.23%
Nevada	1,771,955	Y	N	47,794,729	3.71%

State (*italics* =no personal income tax) (**bold**=no sales tax)	GSGR[a] State Tax Revenue 1998 ($000's)	Clothing in Base (in 2000)	Groceries in Base (in 2000)	State Personal Income 1998 ($000's)	GSGR Tax as Percent of Personal Income 1998
New Hampshire[c]	0	n/a	n/a	34,625,867	0.00%
New Jersey	4,766,195	partial	N	275,531,478	1.73%
New Mexico	1,454,913	Y	Y	24,753,112	5.88%
New York	7,615,370	holiday	N	575,767,817	1.32%
North Carolina	3,272,774	Y	Y	182,035,666	1.80%
North Dakota	309,139	Y	N	13,854,813	2.23%
Ohio	5,531,207	Y	N	282,920,265	1.96%
Oklahoma	1,328,295	Y	Y	70,469,389	1.88%
Oregon	0	n/a	n/a	81,309,693	0.00%
Pennsylvania	6,313,056	partial	N	322,705,796	1.96%
Rhode Island	525,672	partial	N	26,614,157	1.98%
South Carolina	2,162,858	Y	Y	82,039,415	2.64%
South Dakota	442,549	Y	Y	16,388,045	2.70%
Tennessee[c]	4,027,787	Y	Y	128,244,293	3.14%
Texas	12,474,161	holiday	N	494,543,763	2.52%
Utah	1,277,126	Y	Y	44,297,177	2.88%
Vermont	194,501	Y	N	14,309,450	1.36%
Virginia	2,225,021	Y	Y	186,685,782	1.19%
Washington	6,909,239	Y	N	159,673,674	4.33%
West Virginia	856,276	Y	Y	35,086,721	2.44%
Wisconsin	3,047,406	partial	N	131,546,684	2.32%
Wyoming	335,383	Y	Y[g]	11,169,256	3.00%

Sources: Columns (b) and (e): Bureau of Economic Analysis. Columns (c) and (d): State Tax Handbook 2000. Column (f): author's calculations.

Notes: [a] General sales and gross receipts tax (GSGR). [b] General sales and gross receipts data are from the annual report of the District of Columbia municipal government which is not directly comparable to the other states. [c] Only capital income is included in the personal income tax. [d] Snack food excluded from exemption. [e] Subject to a reduced rate. [f] Exemption is partially suspended. [g] Some snack foods are taxable.

Table 2. Reliance of State and Local Governments on the Sales and Use Tax

State (*italics*=gross receipts tax) (**bold**=no local tax)	State Rate 2000	Total Potential State & Local Combined Rate 2000	Total State Tax revenue 1998 ($000's)	GSGR[a] State Tax Revenue 1998 ($000's)	GSGR Tax as Percent of Tax Revenue	Reliance Rank
(a)	(b)	(c)	(d)	(e)	(f)	(g)
Alabama	4	5 to 8	5,734,128	1,570,650	27.39%	37
Alaska	0	0	1,186,235	0	0.00%	47
Arizona	5	5.5 to 6	6,949,270	3,050,111	43.89%	9
Arkansas	4.625	6.125 to 8.125	4,056,582	1,513,673	37.31%	13
California	6	7.25 to 8.25	67,713,433	21,301,860	31.46%	27
Colorado	3	4 to 6.75	5,898,349	1,530,832	25.95%	39
Connecticut	6	6	9,393,604	3,031,699	32.27%	23
Delaware	0	0	1,981,473	0	0.00%	48
District of Columbia[b]	5.75	5.75	2,444,800	855,000	34.97%	16
Florida	6	6 to 7.5	22,513,115	12,923,644	57.41%	3
Georgia	4	5 to 7	11,589,495	3,993,493	34.46%	20
Hawaii	4	4	3,176,246	1,425,352	44.88%	8
Idaho	5	5 to 7	2,057,378	652,843	31.73%	26
Illinois	6.25	7 to 8.75	19,771,284	5,596,046	28.30%	34
Indiana	5	5	9,747,426	3,166,706	32.49%	22
Iowa	5	6	4,802,531	1,528,824	31.83%	25
Kansas	4.9	5.9 to 7.4	4,647,921	1,619,246	34.84%	19
Kentucky	6	6	7,115,149	1,981,290	27.85%	36
Louisiana	4	7 to 9.5	6,082,026	1,981,231	32.58%	21
Maine	5*	5	2,369,820	830,758	35.06%	15
Maryland	5	5	9,190,482	2,161,233	23.52%	42
Massachusetts	5	5	14,488,496	2,962,535	20.45%	45
Michigan	6	6	21,692,742	7,572,789	34.91%	18
Minnesota	6.5	6.5 to 7.5	11,503,928	3,243,611	28.20%	35
Mississippi	7	7	4,343,435	2,034,804	46.85%	7
Missouri	4.225	4.725 to 7.475	8,222,326	2,627,839	31.96%	24
Montana	0	0	1,331,895	0	0.00%	49
Nebraska	5	5 to 6.5	2,633,216	919,750	34.93%	17
Nevada	6.5	6.5 to 7	3,228,206	1,771,955	54.89%	4

State (*italics*=gross receipts tax) (**bold**=no local tax)	State Rate 2000	Total Potential State & Local Combined Rate 2000	Total State Tax revenue 1998 ($000's)	GSGR[a] State Tax Revenue 1998 ($000's)	GSGR Tax as Percent of Tax Revenue	Reli-ance Rank
New Hampshire	0	0	1,008,518	0	0.00%	50
New Jersey	6	6	15,604,971	4,766,195	30.54%	30
New Mexico	5	5.125 to 6.9375	3,574,537	1,454,913	40.70%	10
New York	4	7 to 8	36,154,533	7,615,370	21.06%	44
North Carolina	4	6	13,869,426	3,272,774	23.60%	41
North Dakota	5	6 to 7	1,078,375	309,139	28.67%	32
Ohio	5	5.5 to 7	17,642,836	5,531,207	31.35%	28
Oklahoma	4.5	5 to 9.5	5,300,829	1,328,295	25.06%	40
Oregon	0	0	4,999,091	0	0.00%	51
Pennsylvania	6	6 to 7	20,629,483	6,313,056	30.60%	29
Rhode Island	7	7	1,783,913	525,672	29.47%	31
South Carolina	5	5 to 6	5,683,148	2,162,858	38.06%	12
South Dakota	4	5 to 8	833,662	442,549	53.08%	5
Tennessee	6	7 to 8.75	6,996,120	4,027,787	57.57%	2
Texas	6.25	6.75 to 8.25	24,629,000	12,474,161	50.65%	6
Utah	4.75	5.75 to 7.5	3,457,679	1,277,126	36.94%	14
Vermont	5	5	957,656	194,501	20.31%	46
Virginia	3.5	4.5	10,542,966	2,225,021	21.10%	43
Washington	6.5	7 to 8.6	11,806,170	6,909,239	58.52%	1
West Virginia	6	6	3,011,990	856,276	28.43%	33
Wisconsin	5	5 to 5.5	11,149,754	3,047,406	27.33%	38
Wyoming	4	4 to 6	855,716	335,383	39.19%	11

Sources: Columns (b) and (c): Federation of Tax Administrators. Columns (d) and (e): Bureau of Economic Analysis. Column (f) and (g): author's calculations.

Note: [a] General sales and gross receipts tax (GSGR). [b] General sales and gross receipts data are from the annual report of the District of Columbia municipal government which is not directly comparable to the other states.