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THE INTERNET, SALES TAXES, & TAX COMPETITION

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With most state lawmakers facing large budget deficits, they have become more aggressive about collecting online sales taxes. And now, Congress is considering blessing a multistate compact that would permit states to impose such taxes on interstate commerce, ending a 15-year long debate. To that end, Senator Dick Durbin (D-IL) recently introduced S. 1452, "The Main Street Fairness Act," which would force retailers to collect sales tax for states that join a formal tax compact.[1]

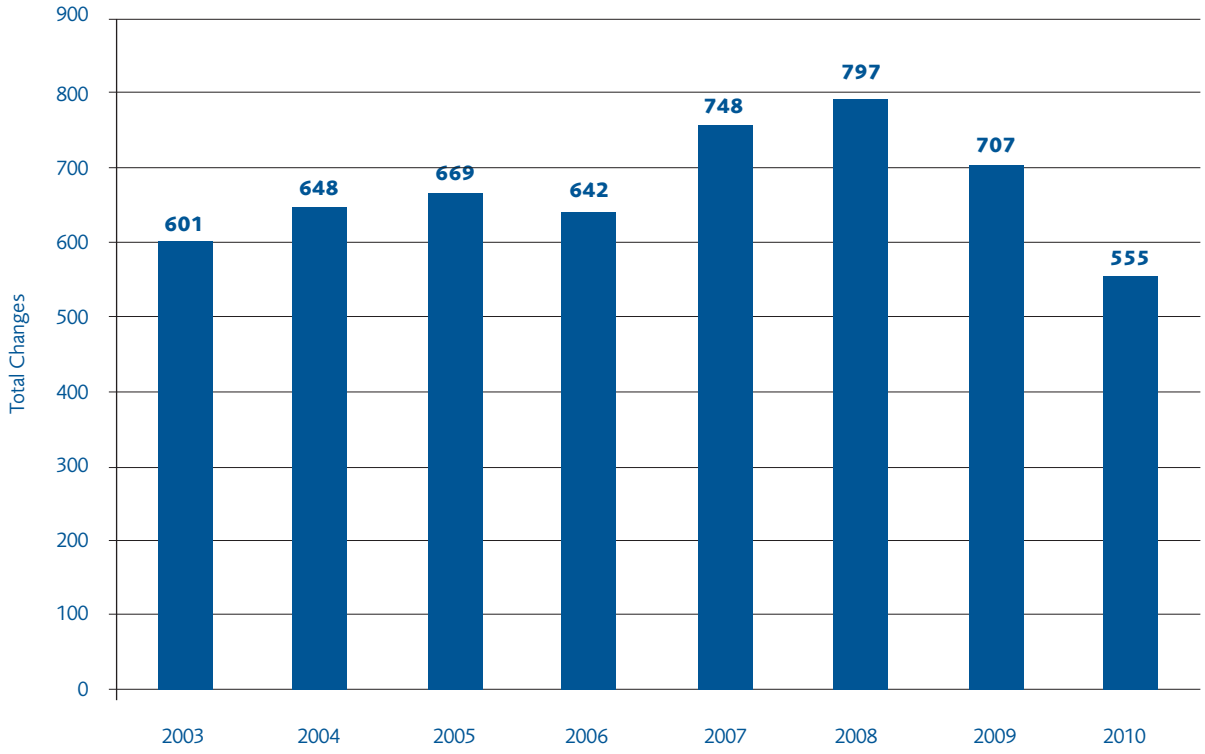
Apart from getting chronic state overspending under control,[2] a better solution to the states' fiscal problems than a tax cartel that imposes burdensome tax collection obligations on out-of-state vendors would be tax competition.[3] Congress should adopt an "origin-based" sourcing rule for any states seeking to impose sales tax collection obligations on interstate vendors. This rule would be in line with Constitutional protections for interstate commerce, allow for the continued growth of the digital economy, and ensure excessive, inefficient taxes do not burden companies and consumers.

BACKGROUND

While the United States does not have a national sales tax, 45 states and approximately 7,400 local jurisdictions impose sales taxes. State and local governments have the power to require retailers within their borders to collect these consumption taxes at the point of sale in the government's name, but they do not have the authority to require businesses outside of their jurisdictions to collect taxes for them.

Starting in the 1960s, a string of Supreme Court decisions restricted state efforts to impose tax collection requirements on interstate, or "remote," mail order and catalog vendors.[4] The Court held that states could only require firms with a

FIGURE 1: SALES TAX RATE CHANGES, 2003–2010



Source: Vertex Inc., Berwyn, PA, vertexinc.com

physical presence—or "nexus"—in their jurisdictions to collect sales taxes on their behalf. Applying the timeless principle of "no taxation without representation," these rulings extended sensible Commerce Clause protections to interstate activities. In addition, the Court has ruled that the complexity of state sales tax laws represents an undue burden on interstate commerce because it would be too difficult for out-of-state vendors to comply with those 7,400 local tax systems.[5]

Though the Court will not let the states collect taxes from out-of-state sellers, it will let them tax in-state buyers through "use taxes." But, because few people voluntarily compute and pay use taxes,[6] states want online retailers to collect the taxes. States then have turned to counting in-state "affiliates" of online retailers as a sufficient nexus to impose sales-tax collection obligations, arguing that the presence of an affiliate in a state is sufficient cause for an Internet company to collect the sales taxes for that state.[7]

Companies, however, are as eager to avoid taxes as states are to impose them. In states that have imposed affiliate taxes, online vendors have canceled commission arrangements, destroying in-state jobs and tax revenues. Amazon.com and Overstock.com recently cancelled affiliate contracts in Connecticut and California, for example, and Amazon has threatened to cut ties with other states. Amazon is also negotiating with states where it has a nexus, such as Texas and South Carolina, for tax-exempt status in exchange for the promise of jobs and investment in those states.[8] If Amazon succeeds in its negotiation, the resulting agreements would not only give the company special treatment compared to other businesses, but it would also would create a vicious cycle in which large companies could get "tax-free" treatment in exchange for promises of jobs, while medium-sized to smaller companies would bear the heavy burden of tax compliance.

COMPLICATED "SIMPLIFICATION"

States are now attempting to circumvent Supreme Court rulings through the "Streamlined Sales and Use Tax Agreement" (SSUTA).[9] The SSUTA seeks to minimize the burden associated with multiple sales tax rates and definitions and, in the process, overcome the constitutional prohibition on the taxation of remote vendors.

Different definitions and exemptions greatly complicate the sales tax codes, as do constant revisions to the sales tax rates (see Figure 1). For example, is a cookie a "candy," which is taxed in most jurisdictions, or a "baked good," which is typically tax-exempt? What type of clothing is "essential" and, therefore, untaxed? When should sales tax holidays be allowed and for what goods? The SSUTA is a good-faith effort to answer such

questions. However, the latest incarnation of this constantly changing "simplification" effort runs over 200 pages. Even if states adopted SSUTA, the sales tax base would remain riddled with definitional loopholes and complexities that could burden vendors, especially mom-and-pop operators.[10]

A 2006 PricewaterhouseCoopers study found that sales tax compliance costs for small retailers (with less than $1 million in sales) equaled almost 17 cents of every dollar they collected for states.[11] Expanded tax collection obligations could increase that economic burden and discourage marketplace innovation and new entry. To remedy that, states have considered a "small seller" exemption, but piling exemption on exemption would undermine the goal of simplifying the sales tax system.

Nonetheless, 24 states already have signed on to the SSUTA. It is unclear whether all states will join the effort, meaning complexity will persist if multiple tax rules remain in place. If all states did join the effort, however, it would be the equivalent of a de facto national sales tax system, led by the states. It would discourage beneficial tax competition among governments and likely lead to increased taxes for consumers.

ON "FAIRNESS"

States insist the SSUTA is needed to "level the playing field" between online and main street retailers. "Main Street" vendors—whether the mom-and-pop retailers or larger companies, such as Walmart or Target—are clearly burdened with significant tax collection responsibilities. The difference in tax treatment is what animates Senator Durbin's "Main Street Fairness Act."

But fairness cuts many ways. Requiring out-of-state vendors to collect sales taxes on behalf of jurisdictions where they have no physical presence remains unfair and unconstitutional, especially when there are other ways states could promote fairness. One way to level the playing field would be to cut or eliminate sales taxes on in-state vendors. Another alternative would be a national Internet sales tax that would avoid the complexity problem by imposing a single rate and set of definitions on all vendors. But that solution opens the door to a new federal tax base, which would grow to be burdensome in other ways at a time when American consumers and companies are already over-taxed.

The third and best option might be to clarify tax sourcing rules by implementing an "origin-based" tax system. In this system, states would tax all sales inside their borders equally, regardless of the buyer's residence or the ultimate location of consumption. Under that model, all sales would be "sourced" to the seller's principal place of business and taxed accordingly.

This is, after all, how sales taxes have traditionally worked. A Washington, DC, resident who buys a televison in Virginia, for instance, is taxed at the origin of sale in Virginia regardless of whether he brings the television back into the District. Each day in America, there are millions of cross-border transactions that are taxed only at the origin of the sale; no questions are asked about where the buyer will consume the good. Policy makers should extend the same principle to cross-border sales involving mail order and the Internet. Under this approach, Internet shoppers would pay the sales tax of the state where the online retailer is based.

An origin-based sourcing rule would have many advantages over the "destination-based" sourcing rule that state officials are pushing. It would eliminate constitutional concerns because only companies within a state or local government's borders would be taxed. An origin-based system would do away with the need for prohibitively complex multistate collection arrangements such as the SSUTA because states would tax transactions at the source, not at the final point of consumption.

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An origin-based system also would protect buyers' privacy rights, eliminating the need to collect any special or unique information about a buyer and to use third-party tax collectors to gather such information. Additionally, it would also preserve local jurisdictional tax authority whereas a harmonization proposal like the SSUTA plans would create a de facto national sales tax system that would exclude local governments.

Finally, because it is more politically and constitutionally feasible, an origin tax may actually maximize the amount of tax collected for states by making compliance easier and incorporating currently untaxed activities.

CONCLUSION

If Congress feels the need to take action on this front, it should implement an origin-based sourcing rule for the taxation of interstate commerce and make it clear to the states that they are free to impose sales tax on vendors whose principle place of business is within their borders, but not on imports from other states. State officials might protest the vigorous tax competition such a sourcing rule would spawn since some companies might locate their business in more hospitable tax environments. But that is real federalism at work. Federal lawmakers should favor it over tax cartels.

ENDNOTES

1. S. 1452, "The Main Street Fairness Act," 112th Congress, July 29, 2011, http://www.govtrack.us/congress/billtext.xpd?bill=s112-1452; See also Mark Hachman, "Democrats Introduce Federal Bill to Collect Online Sales Tax," *PCMag.com,* August 1, 2011, http://www.pcmag.com/article2/0,2817,2389490,00.asp.
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4. *National Bellas Hess, Inc.* v. *Department of Revenue of State of Illinois* 386 U.S. 753 (1967), *Complete Auto Transit, Inc.* v. *Brady* 430 U.S. 274 (1977), and *Quill Corporation* v. *North Dakota* 504 U.S. 298 (1992).
5. Thierer and de Rugy.
6. Nina Manzi, "Use Tax Collection on Income Tax Returns in Other States," Policy Brief Research Department, Minnesota House of Representatives, June 2010, http://www.house.leg.state.mn.us/hrd/pubs/usetax.pdf.
7. This tax is known as the "Amazon tax," after Amazon's popular affiliate program that allows websites—from personal blogs to enthusiast discussion forums—to generate revenue by promoting Amazon products on their sites. See Justin Pratt, "On Sales and Use Tax, Nexus and Affiliates," *Mobile Evolution,* July 10, 2011, http://creativealgorithms.com/blog/content/sales-and-use-tax-nexus-and-affiliates.
8. Ross Ramsey, "Let's Make a Deal, Amazon Tells Texas," *New York Times,* June 23, 2011, http://www.nytimes.com/2011/06/24/us/24ttramsey.html.
9. Streamlined Sales Tax Governing Board, Inc., "Streamlined Sales and Use Tax Agreement," November 12, 2002 [as amended through May 19, 2011], http://www.streamlinedsalestax.org/index.php?page=modules.
10. A lengthy "Library of Interpretations" is also included in the appendix of the Streamlined Sales and Use Tax Agreement (SSTUA) explaining how SSTUA officials answered questions such as what is "food sold with eating utensils?" and "do articles of human wearing apparel suitable for general use that are made from fur or hide on the pelt (i.e., animal skins with hair, fleece or fur fibers attached) constitute 'clothing' within the meaning of the Agreement?" Another debate dealt with the question of whether Jose Cuervo Margarita Mix and other "fruit flavored cocktail mixes" were "soft drinks." In another section, it is determined that "breakfast cereals are not candy because they are not sold in the form of bars, drops or pieces," but "natural or artificially sweetened breakfast bars, Carmel Corn Rice Cakes, and Rice Krispie Treats that do not have ingredient labeling specifying flour and do not require refrigeration are candy." See Ibid., 167–8, 171, 189–90, 193.
11. PricewaterhouseCoopers, *Retail Sales Tax Compliance Costs: A National Estimate,* Joint Cost of Collection Study, April 7, 2006, http://www.bacs-suta.org/Cost%20of%20Collection%20Study%20-%20SSTP.pdf.

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