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CYBERSHOPPING AND SALES TAX: FINDING THE RIGHT MIX

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CYBERSHOPPING AND SALES TAX: FINDING THE RIGHT MIX

WEDNESDAY, AUGUST 1, 2001

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:07 a.m., in room 215, Dirksen Senate Office Building, Hon. Max Baucus (chairman of the committee) presiding.

Present: Senators Breaux, Graham, Lincoln, Grassley, Thompson, and Snowe.

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The committee will come to order.

Today the committee will examine a number of issues involving taxation and the Internet. We have an impressive panel of experts to help us understand these important issues, quite a panel, I might add. There are seven of you there.

I want to thank all of you for appearing and welcome you to the Finance Committee. I deeply appreciate the time and attention you are paying to this extremely important issue. I know how much time you have dedicated to your thoughts and efforts to it, and I thank you for it.

When Congress approved the Internet Tax Freedom Act in 1998, we did two things. We imposed a moratorium on multiple and discriminatory taxes on the Internet and on Internet access taxes. We also set up a National Advisory Commission to examine a long list of issues involving taxation and electronic commerce.

The commission reported back to Congress in April of 2000, but was unable to give us a clear path on how to proceed. So here we are, facing the expiration of the moratorium. We are confronted by a need to act before October 21.

The question is, what should we do? I, frankly, have not made up mind on what is the best way to proceed. It seems, though, that all sides agree on one thing: Congress should do something.

All of our options, however, have consequences. What if nothing is done and the moratorium is allowed to expire? Will States begin to treat the Internet and Internet businesses as "cash cows?" I sincerely hope not.

In Montana, as in most large rural States, we rely on the Internet and the advancements in technology. The Internet enables our residents to take college courses, consult with doctors without leaving home.

Farmers can now go on-line to consult with plant specialists a thousand miles away. Citizens can use the Internet to interact with government agencies, like renewing their car registration, and even their driver's license.

This technology also allows people to shop for things they may not otherwise have access to. The Internet opens up the world to Montana, and Montana to the world. It is truly an essential tool for participating in the new economy.

A recent study by the Bureau of Economic Research states that, of all Montana manufacturers, over 40 percent maintain a web site, and approximately 15 buy supplies and take orders over the Internet.

Governments at all levels should do more to foster, not hamper, the availability of the Internet and particularly to low-income and rural families. I would hope that we keep this in mind as we move forward.

Even though the Internet Tax Freedom Act had nothing to do with the States' ability to collect taxes for on-line transactions, this is the issue that seems to dominate the discussions about e-commerce.

Sales taxes are paid by the consumer, not by the seller. Consumers in Montana do not pay sales tax. Montana does not have a sales tax. That is our choice, just like it is the choice of 45 other States and the District of Columbia to have a sales tax.

The Internet Tax Freedom Act did not affect the ability of those 45 states and the District of Columbia to impose a sales tax on on-line purchases. If someone walks into a store in any State with sales tax and buys an end table for their living room, they will pay a sales tax. That same sales tax, or use tax, would be due if they ordered it by phone or on-line. That is the current law.

What worries the States, it appears, is that the growth of electronic commerce exacerbates the problem that has existed between States and catalog merchants for decades.

I hope our witnesses will help us understand the true magnitude of this problem and the extent to which some of the problem lies in the States' ability, or inability, to enforce its use tax.

There apparently is a problem, or we likely would not be here today. States increasingly are feeling a revenue crunch. Dwindling State revenues threaten funding for essential expenditures on education or health care.

We in Congress are being asked to help them. The States want us to enhance their ability to have out-of-State businesses collect sales taxes on sales made to consumers in their States.

Again, what we do here has consequences. The Supreme Court said it is up to Congress to decide whether States can require sellers to collect sales taxes. Is now the right time? Can businesses of any size and of any location comply with such a requirement if it were imposed on them? What should we require the States to do to minimize burdens on businesses?

I am concerned that we may not be there yet. I am not sure how long it will take us to get to where we need to be. I worry that if we just say to the States, go ahead, make all the businesses collect your sales taxes, then Montana businesses, like TrainNow.net, in

Billings, will be threatened by the reach of tax collectors from all over the Nation, and possibly all over the globe.

I also want to ensure that we move carefully with regard to business activity taxes. If changes are made in the area of sales tax collections, could States use this as an opportunity to say to an out-of-State business that it also owes income taxes? This is an important question for this committee to consider.

Montana does have a corporate income tax and they do not want to make it easier for other States to take tax dollars from Montana businesses. Montana needs those resources to finance State services and provide for its people and its residents.

The States themselves appear to agree that things need to be simpler in order to make this work. I hope we can talk a bit about the progress States are making toward that goal.

I would like to be certain that, if we address the need of the States, we do not crush our small businesses at the same time. There must be balance. We must find the right mix. At a minimum, it makes sense to have clear rules so that businesses can easily be able to understand their responsibilities.

Given the very nature of electronic commerce, we also need to look at whether additional State tax burdens will encourage businesses to locate outside of the United States. There are important international elements to this debate. I know that some of our witnesses will touch upon this subject.

As I said before, I have not yet made up my mind on what is the best way to proceed. I hope today's hearing will provide us with useful guidance. I look forward to hearing from all of our witnesses and working with my colleagues as we address these issues.*

The CHAIRMAN. I think, unless Senators have statements they wish to make, I would like to go straight to the panel.

Senator BREAUX. Mr. Chairman?

The CHAIRMAN. Senator Breaux?

OPENING STATEMENT OF HON. JOHN BREAUX, A U.S. SENATOR FROM LOUISIANA

Senator BREAUX. Mr. Chairman, I think it is very important. I mean, I think that we have struggled with this issue. I would say to our colleagues on the Finance Committee and other committees, principally the Commerce Committee on which I happen to serve as a member, regardless of where we come out on this issue, I think it is clearly, in essence, a tax issue.

I think that this committee should be seriously involved in setting tax policies in these type of instances. I am very pleased that the Chairman has decided to have this hearing to allow the tax-writing committee of the Senate to be involved in the decisions that I think we are going to be facing.

Thank you for that.

The CHAIRMAN. Thank you, Senator.

I would like to proceed. Our panel includes Tom Woodward, who is the Assistant Director for Tax Analysis at the CBO; Frank Shafroth, Director of the Office of State Federal Relations, National

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*For more information on this subject, *see also*, Joint Committee on Taxation staff report, "Overview of Issues Related to the Internet Tax Freedom Act and of Proposals To Extend or Modify the Act", July 30, 2001, JCX–64–01.

Governors Association; David Bullington, vice president of Taxation at Wal-Mart Stores; Frank Julian, vice president and general counsel for Federated Department Stores; Dr. Michael Greve, John G. Searle Scholar for the American Enterprise Institute; the Honorable Steven Rauschenberger, State Senator from Illinois, with the National Conference of State Legislatures; and Jeff Friedman, who is a partner of KPMG.

All right. Mr. Woodward, why don't you begin? We have a five-minute rule here. All of the statements will be included in the record, so you need not ask. I will ask you to summarize your testimony, then we will ask questions afterwards.

Mr. Woodward, why do you not proceed?

STATEMENT OF TOM WOODWARD, ASSISTANT DIRECTOR FOR TAX ANALYSIS, CONGRESSIONAL BUDGET OFFICE, WASHINGTON, DC

Mr. WOODWARD. Mr. Chairman, Senator Thompson, other members of the committee, I am pleased to be here to talk about collecting sales and use taxes on remote purchases such as those that are made on the Internet. I would like to emphasize that my remarks are limited to that issue. They do not address other taxes on Internet use.

Since the written testimony will be submitted for the record, I will limit my remarks to oral summary.

I have three basic points. First, States and localities cannot easily collect taxes on out-of-jurisdiction purchases by their residents. The growth of those purchases and the difficulty of enforcing compliance combine to erode their sales tax bases.

Current estimates suggests that such erosion could be large enough to compel many States to choose between reducing spending or seeking new revenues through higher tax rates or new taxes.

Second, as long as consumers in a State that imposes a sales tax can escape that tax by buying from an out-of-State vendor, tax considerations, rather than economic costs, will, in part, drive decisions about consumption and production, generating economic inefficiency by misallocating resources and causing some output to be lost.

Third, requiring out-of-State vendors to collect and remit sales taxes could impose significant compliance costs on them because States and localities levy those taxes at different rates and include different goods and services in their tax bases.

Compliance costs might be significantly reduced by using computer technology and developing new institutional arrangements for more streamlined tax collection, or by partially harmonizing State sales tax regimes among those States that impose sales taxes.

Extending these qualitative conclusions further is difficult, because these various costs and benefits are poorly quantified. For a variety of reasons, we do not know exactly how much States and localities are losing in revenue because of remote sales. Estimates exist, but they vary. Estimates of losses specifically from e-commerce are even less reliable.

Similarly, we do not know exactly how costly it is for remote merchants to assess, collect, and remit sales taxes to multiple jurisdictions, and we do not know how much streamlining State sales tax administration, harmonizing State sales tax regimes, or using advanced computer software will reduce those collections costs.

We can say that the other issues raised in the sales tax debate do not have as much relevance in terms of economic analysis. In particular, the Internet does not display those characteristics that would lead us to conclude that exempting e-commerce from sales taxation would lead to any significant efficiency or productivity gains for the economy.

Nor would ending the effective sales tax exemption for remote sales appear to create any significant fairness problems. If anything, it may help remedy some of the perceptions of unfairness that come from the exemption.

Similarly, remote collection is not necessary for States to deal with their loss of revenues or with the added regressivity from the effect of exemptions. States can deal with those problems through other changes in their tax regimes, although that may not be their preferred means of doing so.

Aspects of the issue lie outside economics' ability to shed much light. In particular, there is nothing much economic analysis can say that speaks to the concern that requiring remote collection will mean, effectively, raising taxes or that conditioning this authority on sales tax harmonization would interfere with State and local fiscal autonomy.

That leaves us then with the underlying economic issues. The effective tax exemption for remote purchases worsens the inherent inefficiencies of the sales tax. Giving States authority to collect taxes from remote retailers would help lessen those inefficiency costs. But that imposes compliance costs on the sellers with the possibility that those compliance costs can be lessened through a variety of mechanisms.

So, in terms of economics, the debate is fundamentally about whether the compliance costs are significant enough to outweigh the efficiency concerns and how much those compliance costs can be reduced.

Thank you.

The CHAIRMAN. Thank you very much, Mr. Woodward.

[The prepared statement of Mr. Woodward appears in the appendix.]

The CHAIRMAN. Mr. Shafroth?

STATEMENT OF FRANK SHAFROTH, DIRECTOR OF THE OFFICE OF STATE-FEDERAL RELATIONS, NATIONAL GOVERNORS ASSOCIATION, WASHINGTON, DC

Mr. SHAFROTH. Thank you, Mr. Chairman.

The Nation's Governors want to ensure that the country will be competitive in this global economy in which the dominant source of social wealth will be knowledge and information, and no longer manufacturing.

Governors understand that the traditional State local structure of property, sales, and income taxes does not reflect the old concept of borders in this new borderless economy, or the driving knowledge forces of the economy.

They, therefore, recognize that there must be structural changes for a new State local tax structure that matches this information age. This will require cooperation, not just among States, but States with local governments, States with the private sector, and hopefully with your committee. They look forward to your leadership in this effort.

Specifically, the issues that are the most important facing the Governors: what should be taxed in the future as production and consumption becomes disconnected from geography?

How do you create a fair, neutral tax system, as Tom discussed, one that does not discriminate for or against new technologies but that improves productivity and enhances opportunity?

How do you address a growing long-term structural gap between the investment demands of States and local governments and revenues, especially in education and health care, areas where we have a joint agenda with Congress, especially with regard to Medicaid, over the coming decade?

How do we preserve State and local autonomy at a time when the networked economy pushes society towards uniform standards and common protocols?

Two years ago—nearly 2 years ago today—the Governors met privately and discussed whether, given the increasing erosion of the sales tax, they needed to discuss replacing the sales tax with a new tax or whether it could be replaced with a 21st century sales and use tax system that would create much greater efficiency for the national economy.

They determined, and the initial name for it, Tom, was the No Burden Sales Tax System because of that concern about the collection burden on remote sellers.

At the Federal level, the Governors strongly support the legislation co-sponsored by Senators Graham, Breaux, Enzi, and others, S. 512, to provide States with the authority to require remote sellers to collect State and local sales and use taxes, combined with an extension of the Internet Tax Freedom Act.

I would note that 16 States have passed legislation to enable the Streamlined Sales Tax project and to provide for modifying the laws in those States, the two most recent Governors signing those being from Florida and Texas. We are awaiting enactment by three more Governors where the State legislatures have acted on this legislation.

Unlike the report on NPR this morning describing your hearing, Mr. Chairman, the hearing today is not whether sales made over the Internet should continue to be tax-free, since, except to those purchasers in Montana and the four other States without a sales tax, they are not tax-free.

It is a collection question not unlike this committee has faced in the past with regard to dividends and capital gains where, despite the goodness of taxpayers, sometimes a little help is necessary.

So the issue is a collection issue. Forester's most recent report last November indicates that, by the year 2004, Internet sales will reduce State sales tax revenues by $13.7 billion. So it is a substantial number, particularly as we look at the education bill in conference today between the House and the Senate.

One of the key concerns of Governors is inequity. As Congressman Cox's staff director said when I discussed the possibility of exempting airline tickets purchased over the Internet from the domestic and international Federal airline ticket tax, he said, you do not understand.

"If we did that, pretty soon all Americans would only purchase their airline tickets over the Internet. We would have no funds coming into the Airport and Airways Trust Fund and we would not have a balanced Federal budget."

I said, "Well, I do understand that part. What I do not understand is somehow why it is uniquely different for purchasers of products when they can go into a furniture store, test items, order the same items for the same price, without having those taxes collected over the Internet."

So, that will accelerate the erosion. Moreover, as I am assuming Mr. Bullington will discuss, I do not think you can long have a situation where there is a substantial difference or inequity that so discriminates against main street retailers.

So what are the Governors doing about it? As I said, they have initiated the streamlined sales tax project. I think back to 1986 when some of you were involved in trying to streamline and simplify the Federal Tax Code, and what a simple process that was. Now you need to multiply that by 7,500. That is the number of different sales tax systems in the United States.

This is a process which deals with extraordinary details, like how do you have a comparable rounding rule for a sales price, something that consumed days of negotiations? When we first discussed this with the Governors they said, well, just fix it. It should not be a problem.

But the final proposal will reduce revenues to some States by tens of millions of dollars. So trying to work something out this broad has been an exceptional process.

The CHAIRMAN. Go ahead, but do not take advantage of it.

Mr. SHAFROTH. I will not, Mr. Chairman.

So it is fairly extraordinary that, without any certainty whether Congress would actually give the authority to States to require remote sellers to collect and remit on the same basis as, say, Mr. Bullington's stores, that 19 State legislatures have actually passed legislation to enable an interstate compact between the participating States.

It is extraordinary that 38 States have participated for the last 2 years in this process, and I think there is a better-than-even chance that, within 2 years, 2½ more years, 25 States will have enacted very substantial changes to eliminate most of the burden on those remote sellers. I cannot think of any process like this.

The one other thing I would like to say, Mr. Chairman, in closing, is that, number one, I do not think in the end we can reach a level playing field without your involvement.

This is something that is going to involve making sure this system works for the private sector, making sure it works and protects the autonomy of State and local governments, and making sure that you all give us the legal authority to make sure the field is level.

I say this having completed, a year ago, the Mobile Telecommunications Sourcing Act. If you think about wireless phones, cell phones, you make a call. Maybe you are driving down here in the morning. You are crossing through Arlington County, Alexandria, the District of Columbia.

You are on the same phone call, you are in three jurisdictions. To whom do you remit the taxes? We spent 3 years negotiating with the wireless industry and said, it does not make sense any more. You can buy a bucket of minutes from AT&T.

So we agreed, over that period of time, for a new sourcing destination for the taxes so your main place of business or main residence is going to be where the taxes are remitted, no matter where you are making those calls.

That was a difficult process. It was a finite process just dealing with wireless phones. It could not happen without Congressional action. At the end of the day, it passed unanimously in the House and the Senate, and President Clinton signed it.

So I am saying, at the end of the day, I think we can remove the burdens that Tom talked about, we can create a system that is far more efficient for the retail industry in this country, but it cannot be done without a partnership involving you.

Thank you.

The CHAIRMAN. Thank you, Mr. Shafroth.

[The prepared statement of Mr. Shafroth appears in the appendix.]

The CHAIRMAN. Mr. Bullington?

STATEMENT OF DAVID BULLINGTON, VICE PRESIDENT OF TAXATION, WAL-MART STORES, INC., BENTONVILLE, AR

Mr. BULLINGTON. Thank you, Mr. Chairman.

Wal-Mart is a founding member of the E-Fairness Coalition, which includes brick-and-mortar and on-line retailers, realtors, retail and real estate associations, publicly- and privately-owned shopping centers, and several major high-tech-related companies.

Wal-Mart is also a member of the International Mass Retail Association, which represents value-priced general merchandise retailers.

These organizations are committed to the establishment of a level playing field for retailing in which sales of goods are taxed in the same manner regardless of the medium of sale. We all agree that it is simply unfair that brick-and-mortar retailers are required to collect sales taxes, while remote on-line competitors are exempt.

Wal-Mart has participated in the Internet economy for some time now and, like a lot of companies, has modified its approach to online selling as it went. A year-and-a-half ago, we adjusted our corporate structure so that Wal-Mart.com on-line would reside in a separate subsidiary corporation headquartered in California.

One of the reasons for taking this step was so that the site would not have to collect sales taxes for the vast majority of States and, accordingly, we would be more price competitive with other on-line sellers.

This posturing so as not to have to collect sales tax has become prevalent among other major retailers as they strive to compete head-on with their pure-play remote competitors.

At Wal-Mart, we believe the time has come to put in place the mechanism whereby a level playing field can be created so that all large companies participate in across-the-board collection of the existing State and local sales taxes.

I should mention our Arkansas-headquartered Samsclub.com, which does collect sales tax on all its taxable sales due to its close integration with our clubs.

I mentioned Samsclub.com because, on a very tight developmental budget, it put in place the underlying infrastructure and software necessary to collect taxes for all of the 6,500-plus jurisdictional possibilities, a feat that has so often been referred to as an impossibility. If we can do it in Arkansas, it can be done in other parts of the country.

Now back to California-based Wal-Mart.com. It is currently beginning the process of moving its on-line business to one that is fully integrated with the operations of Wal-Mart's physical stores.

As Wal-Mart.com adds interactive kiosks in our stores or undertakes other activities within a State, it will start collecting sales taxes within each State.

The existing sales tax collection loophole discriminates against an important part of our customer base, the lower-income family. This family pays the sales tax day in and day out, but likely has neither the Internet access nor the banking and credit card relationships necessary to order on-line.

Wal-Mart and most other retailers are only seeking equitable tax treatment where a product is taxed the same regardless of how it is ordered or delivered.

As a final matter, I would like to respond to an argument that some opponents of this approach have made in recent months. The argument is that resolution of the sales tax issue is too controversial and complicated for Congress to address at this time, and that the only feasible course, therefore, is for Congress to extend the current moratorium now and resolve the sales tax issue at a later time.

In response, it can fairly be said that most of the interests currently participating in the debate on this matter have developed a consensus on major points involved.

First, there is agreement among most of those who have testified before Congress, including a number of major e-tailers, that there should, in fact, be a level playing field. There is also agreement that substantial sales tax simplification should precede Congressional action to create the level playing field.

And there is agreement on the very large majority of the elements of the simplification that has to be considered as possible components of an acceptable sales tax system.

The very few elements that remain in dispute, we believe, can be addressed quickly and without great difficulty by Congress prior to the expiration of the current moratorium.

Moreover, if the committee should disagree with that assessment, which we strongly hope it will not, we have a related recommendation. In that event, the moratorium should be extended for only so long as it takes for the Congress to resolve whatever issues it cannot resolve by October 21.

While we do not believe the moratorium should be allowed to expire, only simple extensions should be considered that are measured in months and not years. Any longer extension would send precisely the wrong message to the States that are now addressing simplification.

That is the message that Congress is less than committed to addressing the issues identified by the Supreme Court's decision in Quill, less than committed to providing adequate guidance to the States regarding simplification, and less than committed to establishing a level playing field on an expeditious schedule. It is a message that we hope this committee would be reluctant to send.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Mr. Bullington.

[The prepared statement of Mr. Bullington appears in the appendix.]

The CHAIRMAN. Mr. Julian, you are next.

STATEMENT OF FRANK JULIAN, VICE PRESIDENT AND TAX COUNSEL, FEDERATED DEPARTMENT STORES, CINCINNATI, OHIO

Mr. JULIAN. Mr. Chairman, good morning.

The CHAIRMAN. Good morning.

Mr. JULIAN. My name is Frank Julian. I am operating vice president with Federated Department Stores in Cincinnati.

Federated operates over 450 department stores in 34 States under the names of Bloomingdale's, Macy's, the Bon Marche, Burdines, and others, and a significant direct-to-consumer presence with its Fingerhut, Bloomingdale's By Mail, and Macys.com subsidiaries.

I am here today on behalf of the Direct Marketing Association and the Internet Tax Fairness Coalition. We firmly believe that the moratorium against new and discriminatory taxes on the Internet should be extended, and the moratorium against taxes on Internet access should be made permanent.

While there is widespread support for extending these moratoria, many have urged Congress to make collection of sales tax by remote sellers the sine qua non to extending these moratoria. We do not believe that these two issues are so intertwined that the moratoria cannot be extended without addressing the sales tax issue.

The constitution vests in Congress the authority to protect interstate commerce. This is a serious responsibility that Congress should not abdicate to the States.

Thus, to the extent Congress is inclined to address the sales tax collection issue, we believe it is imperative for Congress to require the States to substantially simplify their sales tax systems under parameters which Congress establishes, and then to evaluate the States' simplification efforts before granting them broad tax collection authority.

My written testimony contains a list of 19 simplification parameters that we believe are essential. Of these 19 principles, however, two that are among the most important to businesses are the two that State and local governments have opposed most vigorously. First, only one sales and use tax rate and base per State, and second, bright line nexus standards for business activity taxes.

We also cannot over-emphasize the need to adequately compensate all sellers for collecting sales tax. In our view, S. 288, introduced by Senator Wyden, contains the appropriate simplification standards and we support that bill. The level of simplification called for in S. 512, introduced by Senator Dorgan, in our view is inadequate.

The States have begun simplification efforts through the Streamlined Sales Tax Project, or SSTP. In December, the SSTP released model legislation that it encouraged its member States to adopt.

The SSTP model includes some of the important simplification standards that we believe are essential. Many of the SSTP's simplification provisions, however, do not even become effective until 2006. In the final analysis, this proposal falls into the category of simplification-light.

In January, the NCSL created its own version of a model act. If the SSTP's model is simplification-light, the NCSL's version is, clearly, simplification ultra-light. As a result, there are now competing versions of inadequate tax simplification being considered by various States.

You just heard that 16 States enacted legislation this year. This figure is very deceiving. Only two States enacted legislation that actually simplified their taxes. The others merely agreed to engage in future discussions.

Simply relying on software is not the solution. From first-hand experience, I can tell you that the software that exists today is not capable of successfully navigating the 7,600 different sales tax rates across the country, or the myriad of rules imposed by those 7,600 jurisdictions.

Several members of Congress have been told that sales tax collection can be avoided if an Internet affiliate of a brick-and-mortar store places a kiosk in the store at which customers can place orders for merchandise. This is simply not true.

Under existing law, a seller that has physical presence or nexus in a State through property, employees, or agents, is required to collect sales tax on all of its sales made into that State.

The presence of a remote seller's kiosk in the State would constitute nexus in the State for that remote seller, thus legally obligating that remote seller to collect sales tax in that State.

To the extent there are remote sellers trying to take advantage of this perceived loophole, the remedy is for the State revenue authorities to enforce existing law. It does not require any act of Congress or of the State legislatures.

Mr. Shafroth compared collecting sales tax on remote sales to collecting the Federal Airline Ticket Tax. Such a comparison is not even comparing apples to oranges. It is more like comparing apples to frogs. The ticket tax is a single rate on a single commodity collected for one jurisdiction.

Requiring remote sellers to collect sales tax under the current environment would involve collecting 7,600 tax rates on behalf of 7,600 different jurisdictions on millions of different products.

Congress should act now to extend the moratorium and to permanently ban taxes on Internet access charges. Granting the States the power to require remote sellers to collect their tax should not be made a condition precedent to extending the moratoria.

To the extent Congress is going to address the sales tax collection issue, it must be cognizant of its responsibilities under the Commerce Clause. It must assure that any grant of tax collection authority to the States does not interfere with, or place undue or discriminatory burdens on, interstate commerce.

Mr. Chairman, this committee just passed a $1.3 trillion tax cut that will be a significant boost to our weakening economy. The last thing Congress should do now is to burden a fragile sector of our economy by requiring remote sellers to collect sales tax under a Depression era system.

I thank you very much for the opportunity to testify.

The CHAIRMAN. Well, thank you very much, Mr. Julian. That is very provocative.

[The prepared statement of Mr. Julian appears in the appendix.]

The CHAIRMAN. Dr. Greve?

STATEMENT OF DR. MICHAEL GREVE, JOHN G. SEARLE SCHOLAR, AMERICAN ENTERPRISE INSTITUTE, WASHINGTON, DC

Dr. GREVE. Thank you, Mr. Chairman.

The thrust of my testimony, which has been submitted into the record, is that we should scrap the entire sales tax system which is beyond repair and replace it with a system that is based on the origin of the transaction and not its destination, that is to say, the customer's home State.

All the intractable problems before this committee—compliance costs, definitions, neutrality, nexus, and on, and on—would disappear. Every sale through whatever channel would be taxed once at an equal rate, namely in the State where it came from.

Wal-Mart and the guys from the DMA, who cannot seem to agree on anything, would shake hands and go home. You would no doubt see them again, but not on this issue.

At the same time, I believe that an origin-based system is consistent with Federalism. It is the only solution that, to my mind, is consistent with basic Federalism principles.

There are many good reasons for doing this. What is the objection? Well, there is only one. That is, there would be lots of tax competition under an origin-based system. Everybody would move to Montana and sell from there. There would be zero tax rates everywhere. Senator Baucus likes that, evidently. Unfortunately, that is not going to happen. We have some form of tax competition even now and the sales tax rates are not zero everywhere.

What is true is that you would get intensified tax competition. The question is, is that a good thing or a bad thing?

I will use my remaining two or three minutes to impress upon you three points. First is the point that Chairman Baucus made at the beginning. Even if you think you live in the domestic environment, you cannot ignore that you live an international environment as well.

If you extend the destination principle that we have in the sales tax context internationally, that means you are going to have tax inspectors on American soil, in American companies, in American

States to verify what kinds of sales occurred in Padua, or God knows where in Europe. That, to my mind, is not a good idea.

The second point, is that destination, as a general principle, is absurd. It means that each of hundreds and thousands of jurisdictions gets to dictate what folks in other jurisdictions can and cannot do. No business can operate that way.

The European Community recently threatened, on the issue of consumer privacy protection on the Internet, to move from origin, which it now has, to destination.

American service companies, financial service companies, said, be our guest. Do it. Go right ahead. But we cannot operate in that way. We cannot tailor our products to each of your jurisdictions and its specifications. The difference between destination or origin here is the difference between the stone age and a modern information economy.

So, even if you disavow the origin concept and competition in one case, it seems to me you should do so grudgingly, and with a general acknowledgement that the presumption in the usual run of cases runs the other way.

A related point, and that is my final point. Before the fact, we always underestimate the benefits of competition and always grossly overestimate the costs. To prove it, I brought you a prop. You cannot see it, but you do not have to see it because you all have six of these. It is a credit card. This one is good across the country and carries an interest rate of 0.9 percent.

How did I get a hold of that? The answer is, because the credit card transaction is controlled by the bank's home State's terms and not by mine. Suppose the opposite. Suppose we had a destination principle in that context. Every bank would have to comply with 50 different regulatory regimes.

If that were true, very rich people could still get credit cards, but the rest of us could not. We would all be running around with local credit cards for our local gas station and our local supermarket. There would be no national consumer credit market and we would never know what we were missing.

That was, in fact, the case until two decades ago, roughly, when the Supreme Court decided that the origin principle, rather than the destination principle, applied to credit card transactions. At that point, banks sorted themselves, first into South Dakota and then elsewhere, and consumer credit markets exploded.

No one here, I trust, would dream of shutting those markets down. But had the question been put to legislative consideration in advance at the time, there would have been the same dire predictions that you hear now about defenseless consumers and the States' rights to protect them, and about a race to the bottom, and anyone who would have forecasted the huge expansion and democratization of consumer credit markets would have been laughed out of this body.

Again, that is natural. We always tend to prefer the comforts of a regulated world to the benefits of a more open and competitive world. But the credit card example and many other examples, I think, show that that is a mistake, and we should learn from that mistake.

We should start with the presumption against anti-competitive legislation and, on appropriate occasions, take a flyer and give competition a chance. This is one such chance.

Thank you.

The CHAIRMAN. Thank you, Dr. Greve. Appreciate that

[The prepared statement of Dr. Greve appears in the appendix.]

The CHAIRMAN. Next, is Hon. Steven Rauschenberger, State Senator from Illinois. Go ahead.

STATEMENT OF HON. STEVEN RAUSCHENBERGER, STATE SENATOR FROM ILLINOIS, NATIONAL CONFERENCE OF STATE LEGISLATURES, WASHINGTON, DC

Mr. RAUSCHENBERGER. Thank you very much. I always appreciate following gifted academics. It almost kind of unbalances me. I am a legislator, so my testimony is not quite as formal. I would love, though, to be back when Dr. Greve does an explanation of the Federal income tax and its effect on our economic system.

The CHAIRMAN. He is trying. I can see him right now. He wants to speak to us right now.

Dr. GREVE. I cannot wait, Mr. Chairman.

The CHAIRMAN. I know.

Mr. RAUSCHENBERGER. I have never heard a parallel drawn between regulation of credit cards and the sales tax. It does not go to the issue of whether States have authority over consumer protection, which still applies and it has not crippled the credit card marketplace. So, I have got some work to do on that.

Today, I represent the National Conference of State Legislatures. It is a bipartisan organization representing every legislator from all 50 States, our Nation's commonwealths, territories, possessions, and the District of Columbia.

I want to make one thing very clear. State legislators are not advocating any new or discriminatory taxes on electronic commerce. Our desire is to establish a streamlined sales and use collection system to more efficiently collect the transactional taxes legally imposed by States.

Now State legislature has enacted any Internet-specific taxes. In fact, two have repealed taxes, telecommunication taxes, that affected Internet access in the last 5 years.

The Internet and advanced telecommunications are a vital economic force for the States, and we understand that. State legislators have no desire to be a barrier to that growth of the development of a modern marketplace.

But State legislators are equally concerned about the impact that a sales tax-free electronic commerce environment will have on State revenues and the unfair competitive burden it places on traditional Main Street retailers, which is the life blood of many States and communities.

Sales tax is the primary consumption tax for the States. It provides more than one-third of all State revenues, $150 billion in 1998. Most of the sales tax revenues go to fund education in the States, which is a critical need. Ninety-three percent of all K-12 educational funding in the United States is funded by States and localities which use sales tax as a primary source of revenue. We take that revenue source very seriously.

Sales tax is not an onerous tax. Sales taxes have been overwhelmingly supported in the last five major referendums when it was put to the vote, whether you are talking about the Michigan school reform plan or plans to build stadiums.

When voters are given a choice to choose or select a tax to be raised to do a specific purpose, they have universally, over the last 10 years, selected sales taxes, not property taxes and not income taxes.

Some have argued that requiring remote sellers to collect State and local sales taxes amounts to taxation without representation. That is not true. Sales taxes are imposed on the consumer. They are residents of the States, not the seller.

State legislators have acknowledged that the present sales and use tax system is complex and burdensome, especially for multi-State sellers. States are a key part of the problem and we can be the key part of the solution.

NCSL has resolved that State and local sales tax systems must treat all transactions equally, must be in a competitively neutral manner, and we need to achieve substantial streamlining and simplification.

Last year, NCSL drafted model legislation to authorize States' participation in multi-State discussions to develop a simpler, more uniform, and better system of sales and use tax.

By the end of 2000, 32 States, either by executive branch action or by the action of both chambers of their legislature, have joined what is now called the Streamlined Sales Tax Program. That is Internet speed for the States.

Key features of the streamlined tax system that we are pursuing consensus on and convergence on, is simplification, technology for calculating, collecting, reporting, and paying the taxes, State assumption of the costs of the system so that it is a burden-free system for the sellers.

At this point we are pursuing a voluntary system for both vendors and the States so we do not have a compact, and we are pursuing aggressive audit and exemption reform.

Simplification of the streamline sales tax systems are embodied in Senate bill 512, the Internet Tax Moratorium and Equity Act sponsored by Senator Dorgan and five members of the Commerce Committee.

Overcoming 46 different constitutional schemes and 75 years of modifications to 46 different historical tax systems will not be an easy task. The progress the States have made over the past 2 years, I think, makes clear our commitment to move forward to reform the sales tax, but we need time, forbearance, and support from Congress.

Regarding the Internet tax moratorium that expires, today we believe access means the $21.95 we all pay to get on the net. Convergence of technologies, mergers, and the changes in the industry do not make it clear to us what Internet access will be in the next 5 years.

Consumers may soon be able to make long-distance and local telephone calls through their ISP provider. We expect video-on-demand to be downloadable. People are talking about merging cable and ISP on the same wire.

States need guidance from Congress on the Internet moratorium question as far as defining, so we make sure that we achieve the ends that Congress has regarding the moratorium.

Thank you.

The CHAIRMAN. Thank you very much.

[The prepared statement of Mr. Rauschenberger appears in the appendix.]

The CHAIRMAN. Mr. Friedman?

STATEMENT OF JEFF FRIEDMAN, PARTNER, KPMG, WASHINGTON, DC

Mr. FRIEDMAN. Chairman Baucus, Ranking Member Grassley, and distinguished members of the Senate Finance Committee, thank you for inviting me to speak at today's hearing on Internet taxation. The views I will express today are my own and do not necessarily represent the views of KPMG or its clients.

In my remarks today I am going to discuss some of the international tax developments in Europe and the Organization for Economic Cooperation and Development that could affect U.S.-based businesses doing business over the Internet.

International issues are relevant to our domestic discussions for at least three reasons. First, there are similar tax policy discussions taking place overseas and, as a result, it is helpful to consider, and perhaps benefit, from those ongoing discussions.

Second, as U.S.-based multinational companies are subject to both foreign consumption taxes and U.S. sales and use taxes, many business representatives would like to see taxing authorities make similar tax policy decisions in the hope of simplifying today's taxes.

Finally, some of the difficult issues that have prevented an international compromise on tax reform are also relevant to the domestic sales and use tax debate. By way of background, discussions concerning how to adopt consumption taxes through electronic commerce are taking place at the OECD and the European Commission.

These discussions are focused on how to apply value added taxes and similar taxes to sales of digitized goods and services such as music, software, and information services.

Currently, non-EU vendors do not have to charge VAT on sales of digitized goods and services to EU customers. In June 2000, the European Commission released a proposal for a directive to impose VAT on sales by non-EU vendors of digital goods and services to individual EU consumers.

There have been several iterations of this proposal since June of last year. The most recent version provides that non-EU vendors would be required to register in a single EU member state and to pay VAT only to that member state, referred to as the member state of identification.

However, non-EU vendors would be required to charge VAT based on the tax rate in the customer's jurisdiction. The member state of identification would be responsible for remitting to each EU member state its share of the VAT collected. Only the member state of identification would have audit powers.

The revised proposed directive must be unanimously approved by EU member states in order to go into effect. The revised proposal has received the endorsement of all but one EU member state, the United Kingdom. The new EU president has said that the commission will press ahead on trying to obtain EU-wide agreement on the proposal.

Some U.S. businesses have expressed concern that the revised proposed directive could create a new competitive distortion and place U.S. businesses at a disadvantage vis-a-vis EU vendors.

For instance, current law allows EU vendors in certain circumstances to charge tax based on where they, as opposed to their customers, are located. The proposal would expressly deny this simplified system to non-European businesses.

The revised proposed directive would require non-EU sellers to verify where the customer is located at the time each sale takes place. Many business representatives have said that they often do not know or cannot verify where their customers of digitized goods are located at the time of the sale.

Cross-border sales of traditional goods typically benefit from a diminimus rule that allows sales under a certain threshold—generally around $25—to be exempt from tax. The revised proposal does not provide a similar exemption for digitized goods and services.

The original EC proposed directive would have exempted companies that had less than 100,000 euros in European sales from collecting tax. Proposals in the U.S. to expand sales tax collection often have a similar, albeit higher, small company exemption. The revised proposed directive includes no such threshold and would, therefore, subject even very small enterprises to tax obligations.

The OECD is also working on developing recommendations for implementing a system of VAT collection for remote sales of digital goods and services. The OECD's consumption tax efforts are comprised of OECD member countries, non-member countries, and business representatives. As a result, the OECD's inclusive efforts are broadly supported but are not as far along as the EC process.

In conclusion, international tax developments demonstrate that many nations are grappling with how to adapt taxation systems to electronic commerce, and that there are many competing concerns.

Policy makers here and abroad are correctly seeking input from various stakeholders, including government representatives, the business community, and tax practitioners. Their work will continue and comprehensive answers to some of the most difficult tax policy issues do not necessarily appear imminent.

Thank you for the opportunity to address these issues today.

The CHAIRMAN. Thank you, Mr. Friedman.

[The prepared statement of Mr. Friedman appears in the appendix.]

The CHAIRMAN. Senator Grassley was not here at the opening of the hearing. I will give him, now, an opportunity to make a statement.

OPENING STATEMENT OF HON. CHARLES E. GRASSLEY, A U.S. SENATOR FROM IOWA

Senator GRASSLEY. First of all, Mr. Chairman, I have had a chance to read your opening statement and I associate myself with the remarks that you made, particularly the concern of considering all alternatives and reserving some judgment, as I think you have, on exactly what to do in that area. I have the same reservation.

I have a long opening statement that I want to put in the record, but I would like to highlight a couple of things that I think are important due to our committee's jurisdiction over this issue. My statement deals a lot with that issue. So, I would make a couple of points.

In the late 1960's, early 1970's, there were a number of Senate bills dealing with the topic of State and local taxation. All those bills were referred to the Senate Finance Committee. The Finance Committee established a Subcommittee on State Taxation on Interstate Commerce during the 93rd Congress.

During the time when Senator Warren Magneson was chairman of the Senate Commerce Committee, he introduced a bill "to regulate and foster commerce among the States by providing a system for the taxation of interstate commerce."

Then he specifically designated one Senate committee to evaluate the actions of the States in this area, and Chairman Magneson had chosen the Senate Finance Committee.

So I want to make clear, as I am sure the Chairman would agree, that we understand the long-term precedent of the Senate Finance Committee having jurisdiction in this area.

I will put the rest of the statement in the record.

[The prepared statement of Senator Grassley appears in the appendix.]

The CHAIRMAN. Thank you very much, Senator. I appreciate that statement. This committee does have primary jurisdiction. On the other hand, I think there are other matters that rightfully belong to some other committees. But that is an issue we are going to have to wrestle with here in the Congress.

As I listen to all of you, I am just struck with many different points of view. There is a lot of common ground here. The Internet it here and we have to deal with it. We have complexities that have to be straightened out so that commerce can be encouraged, not impeded.

Also, we want to encourage the development of new technologies, not discourage the development of new technologies, and let the market work in a fair, evenhanded, balanced way.

I do not hear any of you saying, and maybe I did not hear correctly, that we should just let the moratorium expire October 21. Does anyone here think we should let it expire and let States figure this all out among themselves the best they possibly can and let chaos reign for a while, try to encourage States to enforce the resolution?

Mr. Shafroth, do you want to address that?

Mr. SHAFROTH. Just two things. You heard the chairman from Illinois say that the direction, with regard to access, has been away from States or local governments. Tacoma was the only city in the United States that ever enacted a specific Internet access fee. By a narrow 13:0 vote a week later, they reversed their decision. So I am unaware of any municipality.

But the harder issue, is what he also raised. We all read last week that Comcast has proposed to purchase the cable division of AT&T. Should it succeed in that, it will own the largest broad-band

Internet access market in 8 of the 10 largest markets in the United States. So, it will be providing Internet access.

But will that be cable, subject to cable franchise fees? Will it be telecommunications, subject to Federal, State, and local telecommunications taxes? Will it be Internet access?

I do not know if any of us got on our hands and knees and opened up those wires going into homes and businesses, whether we could distinguish the bits and the atoms and say, well, this one is a cable part of the service so it will be subject to cable franchise fees, this part is Internet access so it is exempt from any State or local fees, this part is telecommunications and is subject to Federal, State, and local telecommunications taxes. This part over here is enhanced access. It is sort of like enhanced cable TV that you can get.

The CHAIRMAN. So what do we do about that?

Mr. SHAFROTH. Number one, we get our friend to help us out. I think we need something or somebody to help sort this out for us, because I do not imagine at the Federal level, certainly not at the State level, we want to get into the business where we have tax policies that strongly favor America Online over AT&T, or AT&T over Comcast. We ought to have a neutral system. I do not think any of us yet fully understand convergence and its implications for the United States economy.

The CHAIRMAN. Well, what is the best way to move toward that neutral system?

Mr. SHAFROTH. The best example I have of how clearly we do not know is the most recent Governor of Texas, who signed an Internet access tax into law, but the law only applies after the first $25, because he could not draw that bright line between access and other services.

But it seems to me that the General Accounting Office or CBO ought to be directed to do a study and look specifically at this. You ought to give them, I do not know, Tom, 9 months, 14 days, and 2 hours or so, so that you extend the moratorium for 1 year, and you ask them to come back. What does this mean and how do we deal with this?

The CHAIRMAN. Is there anyone here who is against extending the moratorium for at least a year?

Mr. BULLINGTON. I would like to speak to that.

The CHAIRMAN. Mr. Bullington?

Mr. BULLINGTON. I suggest, in my testimony, that it should be thought of in terms of months. I think 12 months is in the realm, still, of that. But the things relative to the sales tax issue to be resolved, I think, can be resolved yet in a matter of weeks, if not months.

We are close. There are some policy-type things that have to be decided, the direction that has to be given to the States as far as a single rate or multiple rates, a few things like that. So, I think we are extremely close on most of the fronts as far as the basic issues on the sales tax.

I think it is appropriate to extend the moratorium as it relates to access taxes. There are very difficult issues to be sorted out there. A year may be about right.

The CHAIRMAN. In Mr. Julian's statement said, as a fallback, extend until certain conditions occur. I am curious what those conditions would be. In effect, you are somewhat agreeing. So what conditions do you have in mind? What should Congress do and have it solved to enable the moratorium to expire?

Mr. JULIAN. Mr. Chairman, we believe that the moratorium on Internet access charges should be made permanent, and the moratorium on new and discriminatory taxes, I would throw out a period of 5 years. The reason I say that, is if you look at the streamlined sales tax project, several of the simplification provisions in the streamlined sales tax project do not even kick in until 2006, which is 5 years from now.

In addition, the Federation of Tax Administrators, which is the trade association of State Revenue Commissioners, at its annual meeting earlier this year passed a resolution endorsing a 5-year extension of the moratorium.

So if the sales tax simplification group thinks they need 5 years to implement their simplification and the tax administrators think that they need 5 years, who am I to question that?

The CHAIRMAN. Who wants to take the best shot? [Laughter.] Who among you wants to argue against that point, that we need 5 years? If the tax commissioners say 5 years and some of the provisions of the streamlined sales tax project do not kick in for 5 years, who wants to argue that is nonsense? My time has expired, so please be short.

Mr. RAUSCHENBERGER. If the argument is that this moratorium does something, then maybe his argument for 5 years makes sense. But States were not imposing Internet access taxes.

If you properly defined Internet access, you do not need the moratorium. I think it is now widely held and believed by policy makers at the State and local level you do not need a moratorium at all. If you believe the moratorium is a vehicle, a Congressional vehicle that keeps the parties at the table discussing the future of Internet commerce, do a short extension to keep us in dialogue.

The question is hard for me to answer because I do not perceive any effect to the explicit moratorium that I believe your intent is. But, absent the definition reform, there is some real fear by a lot of us that convergence in technology is going to affect what you maybe do not intend. So I would say, a short moratorium is all right, I guess, if it makes you guys feel good.

The CHAIRMAN. What is short?

Mr. RAUSCHENBERGER. A year.

The CHAIRMAN. All right. Thank you.

Senator Grassley?

Senator GRASSLEY. I am going to ask my questions of Mr. Friedman, partly because this committee has jurisdiction over international trade and you talked in your comments about the European Union and the value added tax. I do no want to preclude anybody else from maybe answering subsequently to Mr. Friedman's answer.

But this whole issue is very troubling to me. I think it means that if a small company in my State of Iowa would set up a web site for a digital product, then the EU would try to impose a value added tax on those sales, even if the company and its owners have never stepped foot in the European Union, if I have described that right.

Two questions. How can a U.S. company know where their customers are located when they download a digital product? Two, does the European Union intend to enforce this scheme, and what can they do to our U.S. businesses if they do that?

Mr. FRIEDMAN. Regarding the first question, many business representatives have complained to the European Commission that they do not, in fact, either know or cannot verify where their customers are located in the sale of a digitized good, such as music, movies, or something like that. So that is a question that, frankly, the European Commission has not resolved.

The enforcement mechanism, I believe, was your second question, Senator. There is no enforcement mechanism. Ironically, what the European Commission is proposing—it is proposed, not finalized—in some ways emulates our current use tax collection problem here where we have a tax that is just not being enforced.

Senator GRASSLEY. All right. I also saw in your testimony, and I also heard you speak about it in your summary as well, about the OECD and cooperation of the United States in the international business community working on a plan for how the value added tax should be imposed on digital products.

The EU is a major player, obviously, in the OECD. So since the OECD has taken such a, it seems to be, "go slow" approach to this, I guess I am surprised that the EU will not honor these efforts. It seems to me that EU members have then consequently jumped the gun and should work on these complex issues within the OECD-established process.

Two questions. If the EU schemes go through, do you think that that is a message then for any other countries? Second, does this mean that every country in the world could be requiring U.S. businesses to collect taxes just because a citizen of that country visits a web site and makes a purchase?

Mr. FRIEDMAN. Regarding the first question, you are right, Senator. The European Commission itself, as well as its 15 member countries, are participating within the OECD process.

The OECD process is quite broad. Not only does it include the 30 OECD member countries, but they have included non-member countries in developing nations, as well as representatives from the business community.

I think it does send a message that if the European Commission kind of opts out, let us say, of the OECD process or acts unilaterally, it sends a message to other nations that they, too, can opt out and act unilaterally. It could set a bad precedent in that regard.

Senator GRASSLEY. Your testimony also says that this whole approach would cause U.S. businesses to be at a competitive disadvantage to EU businesses, if I understand this right, an EU vendor imposes the value added tax rate of that vendor's home country, which can be a country with a low rate value added tax.

Under the EU's plan, a U.S. business would impose the value added tax of the EU's customer's home country, which could force the U.S. business to impose a higher value added rate than many other EU vendors.

That is just a statement, but it is also a question. It seems to me to be highly discriminatory and a violation of those trade practices that would prohibit discriminatory treatment.

Mr. FRIEDMAN. The proposal, as written right now, in fact, would lead, or could lead, to those results you describe, where a seller, let us say, based in the U.S. and a seller based in France selling the identical item would be taxed differently. In fact, the U.S. seller could be taxed higher.

Senator GRASSLEY. I do not know the EU's regime about discriminatory taxation. I guess what I have read in the paper is, that they are trying to establish a great deal of uniformity to break down barriers to trade. So would this not be completely contrary to that trend of the European Union within the European Union?

Mr. FRIEDMAN. It could have that effect, yes.

Senator GRASSLEY. Well, you have not read that they see that as a conflict.

Mr. FRIEDMAN. They do not recognize the conflict. They recognize it as a simplified system.

Senator GRASSLEY. All right. I am done, Mr. Chairman. I did not thank you for holding this hearing. I think it is very, very important issue, and obviously something that has to be dealt with by the Congress very shortly. So, it is very timely that you have held this hearing.

The CHAIRMAN. Thank you.

Senator Breaux?

Senator BREAUX. Thank you, Mr. Chairman. Again, thanks for having this hearing. I think it is important that, on this complicated tax matter, that the tax writing committee be involved. I happen to be on the other committee as well, but I think this is important in this jurisdiction.

In the interest of full disclosure, let me tell everybody where I am coming from and make it very clear. I think that States should have the right to require the collection of sales taxes by remote sellers to citizens of their State.

At the same time, I think that, on the business activity taxes, franchise taxes, brick-and-mortar taxes, those type of taxes, that there should be a nexus or physical connection to the State in order for the State to collect those type of taxes.

I think the Quill decision, which talks about physical activity, is the right way to go with regard to business activity taxes.

Mr. Julian, in understanding your testimony, I get that you are not opposed to allowing States to require remote sellers to collect sales taxes to sales within a State, as long as the State is simplifying their tax systems and that Congress agrees that they have achieved sufficient simplification. Would that be correct?

Mr. JULIAN. That is correct, Senator. If Congress establishes the parameters for substantial simplification, the States go out and do it, and then there is a mechanism for Congress to review that simplification, if the States meet the simplification, we do not oppose that.

Senator BREAUX. And Congress would have to affirmatively approve that submission by the States.

Mr. JULIAN. Yes, Senator.

Senator BREAUX. I agree with that.

On the other question, I think we may depart. It seems like on questions, like you are advocating channel neutrality, that you would have to have the same tax on sales of products regardless of whether they are remote or not, I am not sure that Congress can require a State to do that. We cannot pass an act of Congress and say, you have to have this type of sales tax.

I think that we can encourage them to do things of that nature and then approve or not approve what they do, but I do not think that we can affirmatively go forward and design their State sales taxes for them.

Do you think that affirmative approval would allow us to look at these things and have a sufficient authority in that frame?

Mr. JULIAN. Well, Senator, we do believe that, from a fairness standpoint, a sale made from a brick-and-mortar store and a sale made from a remote seller should be taxed at the same rate.

To the extent that you believe Congress does not have that authority, I do not know that I would necessarily agree with that. But, as to the bigger picture of Congressional evaluation of simplification, that is one of many things that Congress should look at.

As many witnesses have testified, this is a very detailed and complicated topic. That is why we think it is important for Congress to evaluate the States' simplification efforts after they are completed, before Congress, pursuant to its constitutional duties under the Commerce Clause, gives them the authority to require remote sellers to collect their taxes.

Senator BREAUX. Well, I appreciate everybody's testimony. I think our colleague, Senator Wyden, had come up with some ideas on this and some suggestions at one point about leaving the rate structure up to the States and requiring that the Federal Government would have to affirmatively approve those decisions. I think that is a good way to go. I think it was a good compromise, and I think that is something that we should be pursuing. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

We are, unfortunately, in the middle of a roll call vote. I understand that Senators Lincoln and Thompson are coming back to ask questions.

I would like to focus a little bit on software and the complexity issue, the 7,600 different jurisdictions. Dr. Greve kind of makes an interesting point about, there is one simple way to solve that one problem, just to not go down that road.

But the momentum seems to be in the direction, at least there is a lot of discussion, that the software might be available, or we may get there soon. We may not. One of you testified that it is virtually impossible, with all the different jurisdictions, laws, and so forth, to put all this together.

So, who would like to talk about how we address the complexity question, that is, all the different jurisdictions?

Mr. RAUSCHENBERGER. Mr. Chairman?

The CHAIRMAN. Go ahead. We have not much time.

Mr. RAUSCHENBERGER. Very briefly, there are 6,500 jurisdictions that do sales tax. A couple of things that I would point out. The biggest single sticking point is States coming together on clear definitions so that anyone can recognize what a product is once we get common definitions.

The question of turning a tax switch on or off can be the States' and their software system. It is very manageable for States, we believe, to do a database so that, by a nine-digit zip code, we can identify the tax rates. There are commercial companies now who prepare those and sell them.

If States were to prepare their own or commission them to be prepared and indemnify sellers, that solves the whole question of rate. If I know the sellers' nine-digit zip code either from billing address or series of defaults, then there is no liability for the seller if he uses the States-approved table because we indemnify.

So the question of being able to solve the rate question is fairly simple. The complexity is really trying to get everybody to agree on common definitions of what is a boot, what is a shoe, what is food, and what is not food.

The CHAIRMAN. All right.

Dr. Greve?

Dr. GREVE. Thank you, Mr. Chairman. I just want to say one brief word. This is not, at bottom, a technical problem. A lot of the things that are the focus of disagreement are real, genuine, political differences. The DMA has, at least over the last 20 years, died on the ramparts for one rate per State. All right.

Now, what that means, in effect, is that you wipe out the tax autonomy of local governments, school districts, and other local entities with tax authority. That is a genuine political dispute. That is not a technical dispute to which there is a technical software solution, if we can just get the guys at TaxWare to design a slightly better vehicle somewhere down the road.

The way in which the SSTP has made progress—and bless their hearts, let them try; I am not for stopping them—is by bracketing all of those problems. That means, in effect, that the current messy system remains in place.

Mr. JULIAN. Mr. Chairman?

The CHAIRMAN. Very, very briefly. I am going to have to run here. Go ahead.

Mr. JULIAN. The week before last, I testified before the House Judiciary Committee on this same topic. One of the other witnesses was a representative of TaxWare, which is one of the two leading software companies.

The CHAIRMAN. Right.

Mr. JULIAN. That gentleman said, in response to a question from Ranking Member Watt, we do not have the technology today to deal with these rates. Simplification has to come first.

So if the software providers are agreeing with me, and we are a company that uses this stuff every day, we have tremendous problems and incur tremendous expenses. It does not work, from a user's standpoint. The software companies are saying they do not have the technology today, that simplification has to be a part of it.

Senator Rauschenberger mentioned nine-digit zip codes. There are scores of nine-digit zip codes in the country right now in which there is more than one tax rate. In the Dallas Ft. Worth Airport alone, there are three different tax rates. Depending upon which terminal you are in, you have a different rate. It should not be that complicated if you are going to require remote sellers to collect this tax.

The CHAIRMAN. All right. I am going to have to go vote. The committee will be in recess until Senator Lincoln returns. She will chair the committee until I return.

The committee, now, is in temporary recess.

[Whereupon, at 11:20 a.m., the hearing was recessed to reconvene at 11:27 a.m.]

Senator LINCOLN. Well, I have the incredible honor of bringing the committee back into order, and I will do that.

I want to take this great opportunity as well to be able to welcome Mr. Bullington, with Wal-Mart Stores. Wal-Mart is a great corporate citizen of Arkansas. They have grown, and grown, and grown, and made us all very proud in Arkansas. We are glad that you are here. Thank you very much.

Mr. BULLINGTON. Thank you.

Senator LINCOLN. I am not sure if any of these questions have been asked in my absence, but I would like to move forward, if I can, and see if I can get a response from you all on these.

In terms of evidence that has come about, has there been any evidence really that citizens in Massachusetts, or perhaps Montana, the other five States that were grandfathered in under the moratorium, have they had any trouble relative to other States in obtaining Internet access due to the taxes on that access?

Mr. RAUSCHENBERGER. I would say there is no evidence whatsoever that grandfathered States have had any problem with people being able to afford or access the Internet.

In fact, I think that AOL's 9 percent price increase is larger than any States' levy they impose on Internet access, I think, by a factor of two. So we do not seem to believe that the grandfather clause affects Internet access in any way. I am a State legislator.

Mr. JULIAN. Senator, one thing that we think, the current prohibition on States imposing taxes on Internet access helps to bridge the digital divide. Mr. Bullington made a comment earlier about lower-income people and their inability to get on the Internet. Well, removing taxation barriers is a way to help lower-income people to gain access the Internet.

Senator LINCOLN. Also, those lower-income people tend to live in rural areas, unfortunately, where they have a great dependence on sales tax, too. So, there is definitely a trade-off in many of those areas.

If the moratorium were allowed to expire in October, and we have talked about that, who is in favor of it and who is not, has there been any indication that one, or any, of the States would move to impose Internet access taxes? Has that been indicated?

Mr. SHAFROTH. No indication whatsoever, Senator.

Senator LINCOLN. If the moratorium were allowed to expire, would there not still be a political calculation that States would have to make? After all, the tax there is on their citizens, who clearly want access to the Internet, too. Perhaps our State legislator would like to comment on that.

Mr. RAUSCHENBERGER. Yes. I think, if you believe that the purpose of the moratorium was to provide a cooling off period so people came to understand Internet access and the Internet better before they acted precipitously and became dependent on revenue, it has achieved its purpose already.

Renewing the moratorium is kind of like redeclaring war. It does not, in my opinion, carry much effect or have much necessity. I think States understand how important the Internet is, and I think localities do, as well.

But I would point out that again that the grandfathering is very important. I think we have nine States in the United States that do not levy income taxes and are much more dependent, on average, than States are with sales taxes.

So those States are materially affected by removing the grandfather clause. Most of that taxation arises under their statutes from before the moratorium because of the Internet's intimate connection with the telecommunication tax statutes they have.

So I would really urge the committee to be very cautious about removing the grandfather clause in the first moratorium as you go forward.

Senator LINCOLN. Dr. Greve, I had a question. I was here for your testimony. You said that companies would not flock to Montana to benefit from their no-income tax environment, perhaps.

I am not a lawyer, but just following what comes in the paper, mostly, is that not exactly what Toys R Us did when they incorporated the portion of their company out of South Carolina?

Dr. GREVE. Senator, some companies undoubtedly will. That is the sort of intensified competition. At the same time, there are lots and lots of things that companies depend on, that companies want from any given location: quality of life for their employees, an educated workforce, sensible consumer protection and labor laws.

A State that offers an attractive environment along all of those dimensions, or most of them, will be able to exact a sales tax. A State that heavily regulates its industries will not be able to compensate for that just by saying we are not going to have any sales tax, period.

You will have more competition, but the scenario that everybody will sort themselves into five or six no-tax States, thus forcing the sales tax everywhere to zero, is not going to happen.

Senator LINCOLN. No, it is not. I do not think the Supreme Court is going to let that happen either, at least indicative from that case.

Now, the brick-and-mortar issue, which is obviously a very important one. Clearly, some businesses who are choosing to operate both as brick-and-mortar sellers and Internet sellers—Mr. Julian, you are in that category, I believe—will have a nexus with most, if not all, taxing jurisdictions, if that be the case as we move forward.

Why is it fair for a company that has an ancillary nexus with a jurisdiction to remit sales tax to a State, but a company which performs the same operation would not?

Mr. JULIAN. Senator, we believe the issue is the complexities of the current sales tax system. Federated is a big company. We have stores in 34 States through different subsidiaries. We do not have any one subsidiary that is in all 34.

But, as a company, we collect over $1 billion a year in sales tax for those 34 States and it costs us tens of millions of dollars out of our pocket every year to comply with those sales tax laws. That is why we are strongly advocating substantial simplification of the sales tax system.

Take definitions. There are 13 States right now that exempt clothing from sales tax on a temporary or a permanent basis. In six of those States, a handkerchief is defined as clothing, therefore, not taxable. In another six, that same handkerchief is defined as not clothing, therefore, taxable. In one of them, it leaves it to the retailer's best guess. It should not be that difficult to define clothing.

So, we are strongly advocating substantial simplification and, if the States substantially simplify in a manner set forth by Congress, then we do not oppose collection by remote sellers.

Senator LINCOLN. But in terms of simplification, your opinion is that it is going to take us a lot longer to come up with that simplification.

Mr. JULIAN. The streamlined sales tax project has been operating for about a year-and-a-half, maybe a little bit less than that. It opened up its meetings to the public beginning in June of 2000. So for 13 months, its meetings have been open to the public.

I have attended each and every one of those meetings, as has a representative from Wal-Mart and other retailers. It is interesting. When Mr. Bullington and I testify, oftentimes we are viewed as being at opposite ends of the spectrum.

But it is interesting, when we go to the SSTP meetings, the Wal-Mart representative and myself are generally in lock-step in terms of the types of simplification that we are advocating.

When the SSTP project started, they had 60 or 70 years' worth of sales tax complication to try to simplify. It is a very difficult task. They have made some progress, but there is still a long way to go.

I am hopeful that they can get their simplification act together very soon. One thing that happened that I think really derailed the process, was when the NCSL, in January, basically gutted a lot of the work that the SSTP did.

In the NCSL's model legislation, they removed all of the common definitions. The NCSL proposal does not even advocate one sales tax base per State. The 7,600 jurisdictions, by the way, is a number that grows on the average or 200 or 300 per year.

In the State of Colorado, for example, if widgets are exempt from sales tax, they are saying, well, the City of Denver should still be able to say, that is fine for the State, but they are still taxable in the City of Denver, or the City of Aspen, or any other city.

If you are going to export those burdens to remote sellers, particularly small businesses, it is not going to work. It is going to put a lot of small businesses out of business and it is going to be very burdensome.

Senator LINCOLN. Well, in terms of the context of the Dorgan bill, does it not require the uniform definitions?

Mr. JULIAN. The Dorgan bill requires uniform definitions. Our problems with the Dorgan bill primarily are the lack of one sales tax rate per State, we think that is very important, and also the difference between the positive trigger and the negative trigger.

That is, under Senator Dorgan's bill, it says Congress grants the States authority for the compact and Congress would then have 120 days within which to, in effect, withdraw that authority. I think, politically, that would never happen, versus Senator Wyden's bill, which we strongly support.

Senator Wyden's bill calls for one rate per State. Senator Wyden's bill also calls for Congress to evaluate the States' simplification efforts.

Again, if you need evidence as to why there needs to be Congressional oversight, just look at this legislative process. The multicolored exhibit that was attached to my testimony is from the streamlined sales tax project's web site.

This shows the different stages of the State legislation. If you look at the bills that have been passed right now, two States have passed the SSTP agreement, which is the piece of the SSTP project that really has the meat of the simplification. Wyoming and Minnesota are the only States that have passed that.

Five States have passed the SSTP act, which just means they are going to continue to go forward. Six States have passed the NCSL legislation, which, in our view, is very watered down. Three States have concocted their own hybrid legislation. So on a topic in which the goal is tax uniformity, this smacks of chaos.

Senator LINCOLN. So what you are advocating is more uniformity in the tax. But you do agree that there is some uniform definition in the Dorgan bill?

Mr. JULIAN. Certainly, there are some uniform definitions right now, but we just think it needs to be more if you are going to export it, particularly to small businesses.

Senator LINCOLN. Mr. Bullington, I am interested in the computer software that you all have developed to collect sales and use tax in many jurisdictions. Can you expand on any of that?

Mr. BULLINGTON. We use software in connection with our Samsclub.com to collect for all the 6,5000 jurisdictions. It incorporates aspects of TaxWare software, a particular vendor. Our California-based operation, wal-mart.com, uses software, too, for the four States that it collects for.

So we are well down the road on understanding how you use the software and what its limitations are. There are limitations and refinements to be made yet, but it makes a good, valid effort at collecting for all those jurisdictions.

Senator LINCOLN. This is software that you all have developed yourself, is that correct?

Mr. BULLINGTON. The TaxWare modules give you the rates and tie into your system. You have to do integration from there to make it work well with your web site.

Senator LINCOLN. But obviously, unless we begin the process of developing it and working with it, it is not going to happen down the road, probably. Yes?

Mr. RAUSCHENBERGER. I hate to be anxious, but I would like to respond to Mr. Julian on just a couple of points. I serve on the task force that he accuses of gutting and watering down the hard work of SSTP.

But let me say four things fairly quickly. First of all, Mr. Julian neglects to point out to members of Congress that there is a collection allowance in many of the States. In fact, in the State of Illinois we allow his stores in our State to retain 1.75 percent of the sales tax they collect.

I would argue, Illinois is already a zero-burden State. He should ask his local retail association whether they believe that they gain enough in the collection allowance to pay for Illinois' system.

The second thing, as he talks about the complications of sales tax he is forgetting to remind members of Congress that the people who lobby for sales tax holidays, and for exemptions for clothing, and for 4th of July special legislation are the retailers of the States.

I think maybe he needs to work harder with his own trade group and we need to talk about what real simplification is. I just think we need to be a little bit clear and fair.

When we talk about how much time it is going to take for States, operating under separate constitutions, in a year when we are doing redistricting and reapportionment, States went to the table and have enacted the second set of model acts to move us along a process that is a process of conversion. There will be no bright light. This is not about the NASA space rocket going to the moon, it is about moving States together to a common system with a common set of definitions, which is achievable.

The last thing I just need to point out as a State legislator, because members of Congress need to hear it officially, is to ask me, who has worked 3 years on this process, to go back to my State and tell my legislative leaders, busy with other things, worried about education, concerned about the economy, that all we have to do, Mr. Senate President and Mr. Speaker of the House in Illinois, is do this politically risky thing, simplify our sales tax, incur a lot of frustration by different people who have done well with this tax system over the last 70 years. We simplify this and, as soon as we are done, we hope 20 other States do it. If those 20 other States do it, then we go back to Congress and hope we can talk them into approving.

Now, if people want to talk about reasonable third party scoring to make sure that States measure up, I think that is a fair thing, you know, the Congressional Budget Office, the department, if there are parameters set.

But for people up here to argue that one rate per State is the only way to proceed when, technologically, we know that is not true, for people to say that you have to have a proactive Congressional trigger which politically kills it in the State, is just not being fair about the whole thing.

To talk about the burden of a system that his member stores have lobbied to create, there are advantages all through this system that were lobbied for by stores that are now members of Federated.

So, it is not like legislators thought up how to make this process complicated. We had a lot of help in the States. We are going to need a lot of help to move back to make it a better system.

It is no more complicated, however, than the Federal Tax Code. You Congressional members know how complex that is, whether it is the realtors or other people in that system.

So I just think people should be careful in Washington characterizing the States as somehow backward or stupid. We do a pretty good job. We have the balanced budgets in here. We are not the ones with the complex systems or long-term liabilities that the Federal Government has.

We just need to be fair and reasonable about what you can expect State legislatures, under their State constitutions, under their constraints to do, and in what reasonable amount of time.

Senator LINCOLN. I do not think anyone here, whether in Congress or you as witnesses, would argue that this is not a complicated issue. It is definitely a complicated issue, even for those who have made great strides in moving the ball down the field. I think we can all agree on that.

But I think we also, at least in my opinion, have come to a point where we do need to continue to move the ball down the field, and there are certain measures that we hope we will be able to move.

Mr. RAUSCHENBERGER. A Congressional appropriation to help us pay for the process, which clearly would show Congress' intent, would make it clear how you guys felt about the process and would be welcomed by all of us. It is much harder than people realize to focus and motivate 7,000 State legislators who may be fairly comfortable with the system as it exists today.

Senator LINCOLN. Well, far too often people out in our States think the sky is the limit. As my grandfather used to say when he would take me to the Dairy Queen when I was little, he said, the sky is the limit, but you can only spend a nickel. [Laughter.] That is sometimes our problem here in Washington.

Did any of you other gentlemen have comments that you would like to make?

Mr. BULLINGTON. Senator Lincoln?

Senator LINCOLN. Yes.

Mr. BULLINGTON. If I could, I would like to speak to the chaos that Frank referred to in the streamlined sales tax process. Also, the aspect of asking—Steven, I forgot what you said—7,000 legislators, or what, to come up with this system. I think this is key to where we are.

It is that nudging that is needed as far as a sense of direction where the States need to get to at this point to find the finish line. The Dorgan bill does not say, tomorrow there is going to be a broadened collection authority.

It expects the States to go create the system that is necessary, that will take a period of time, that will take continued dialogue and effort by the States, but it gives the broad criteria that has to be met. There may be some policy things that some nudging would be helpful on, like a single rate is not absolutely necessary.

But we think the remaining things as far as guidance in a bill like Dorgan, or maybe it is somewhere a bit from there, there is a lot of common ground to be reached between the Wyden bill and the Dorgan bill. We think it is really close at this point. We certainly encourage this committee and the Congress to continue to nudge that process forward.

Senator LINCOLN. Yes, Mr. Woodward?

Mr. WOODWARD. Yes. I would like to address a couple of things that Dr. Greve said, because I think they may leave the wrong impression with respect to some of the economic effects of the current problem of collection.

It is really not a matter of whether all firms eventually move to five States with zero taxes. It is really not a matter of whether there are other considerations that they take into account when they decide where to locate.

Economic efficiency, productivity, and growth are all things that occur on the margin. Large shifts do not have to occur for the economy to incur costs. An origin-based system along the lines of what Dr. Greve is talking about is a system that moves the sales tax more in the direction of one in which tax, rather than real resource costs, motivates the allocation of resources.

You do not have to have every firm move into a State where it can avoid nexus, you only have to have a few where the transportation costs are higher, but is offset by the tax saving.

You do not have to have every consumer buying through the Internet, you only need some who do so and incur a greater cost in terms of real resource use in order to save taxes.

The inherent inefficiency of taxes comes from the fact that people engage in behaviors to try to avoid them. When they engage in those behaviors, they incur real costs. An origin-based system still has a problem with economic efficiency.

It is a clean system in a lot of ways. It may be a desirable system. But the one thing it does not fix is the neutrality problem, the economic efficiency problem, which is the concern that many people have when you have a system that adds to the opportunities for tax avoidance.

Senator LINCOLN. Dr. Greve, did you want to respond?

Dr. GREVE. Thank you, Senator. Just very briefly. It is true that an origin-based system is not locationally neutral, but that is also true of the existing system. When I spoke of neutrality, what I meant was neutrality among different kinds of sales techniques or channels.

In that regard, an origin-based system is more neutral than the current system unless a local jurisdiction—that is to say, a State—decides for some reason or another to tax different sales differently.

Senator LINCOLN. Well, thanks to all of you gentlemen. We appreciate it. This is not a topic that we will be able to solve, probably, quickly or very easily. We will continue to call upon your expertise in coming up with a resolution as quickly as we can. Thank you.

The committee is adjourned.

[Whereupon, at 11:50 a.m., the hearing was concluded.]+

APPENDIX

Additional Material Submitted for the Record

Prepared Statement of David Bullington

Mr. Chairman, Senator Grassley and members of the Committee, my name is David Bullington. I am the Vice President of Taxes for Wal-Mart Stores, Inc. Wal-Mart is a founding member of the e-Fairness Coalition, which includes brick-and-mortar and online retailers, realtors, retail and real estate associations, publicly- and privately-owned shopping centers, and several major high-tech-related companies. Wal-Mart is also a member of the International Mass Retail Association, a trade association representing the mass retail industry. Each of these organizations and entities is committed to the establishment of a level playing field for retailing, in which sales of goods are taxed in the same manner regardless of the medium of sale. We all agree that it is simply unfair that brick and mortar retailers are required to collect sales taxes while remote, online competitors are exempt.

Wal-Mart has participated in the Internet economy for some time now and, like a lot of companies, has modified its approach to on-line selling as it went. A year and a half ago, we adjusted our corporate structure so that our Wal-Mart.com online site would reside in a separate subsidiary corporation. One of the reasons for taking this step was so the site would not have to collect sales taxes for the vast majority of states and, accordingly, would be more price competitive with other online sellers. This posturing so as not to have to collect sales tax has become prevalent among other major retailers as they strive to compete head-on with their pure-play competitors. For example, you see this in the collection policies of the online arms of Borders, Barnes & Noble, K-Mart, Target and Gateway Computer. The planning gymnastics being encouraged by today's environment run counter to sound, consistently applied tax policy. At Wal-Mart, we believe the time has come to put in place the mechanism whereby a level playing field can be created between companies so that all large companies participate in across-the-board collection of existing state and local sales taxes.

I should mention our samsclub.com which collects sales tax on all taxable sales to our Sam's Club members. The Sam's Club online business is structured to more closely integrate the club member with his or her local Sam's Club. For shipments to home and business addresses, sales tax collection occurs at the local rates for the jurisdictions into which delivery is made. I mention samsclub.com because on a very tight developmental budget it put in place the underlying infrastructure and software necessary to collect taxes for all of the 6,500 jurisdictional possibilities, a feat that has so often been referred to as an impossibility.

Now back to Wal-Mart.com, it is currently beginning the process of moving its online business to one that is fully integrated with the operations of the Wal-Mart physical stores. As Walmart.com adds interactive kiosks in our stores or undertakes other activities within a state, it will start collecting sales taxes within each such state. We envision that by some time in early 2002, Walmart.com will be collecting for almost every state. Nevertheless, nothing today prohibits us at a later date from setting up a new online subsidiary business devoted to delivering certain products strictly in interstate commerce without sales tax collection. Competitive formats and price sensitive product lines may demand such a result. The states are committed to solving the collection issue, but can only go so far. Mr. Chairman, Congress can provide that needed sense of direction as to what has to be achieved. With this Committee's leadership, the sales tax loophole on remote commerce can be eliminated. The existing loophole discriminates against an important part of our customer base, the lower-income family. That family pays the sales tax day-in and day-out but likely has neither Internet access nor the banking and credit card relationships necessary to order online. Wal-Mart and most other retailers are only seeking equitable tax treatment—where a product is taxed the same regardless of how it is ordered or delivered.

As a final matter, I would like to respond to an argument that some opponents of this approach have made in recent months. The argument is that resolution of the sales tax issue is too controversial and complicated for Congress to address at this time, and that the only feasible course, therefore, is for Congress to extend the current Internet Tax Freedom Act moratorium now and resolve the sales tax issue at a later time. In response, it can fairly be said that most of the interests currently participating in the debate on this matter have developed a consensus on the major points involved in that debate. First, there is agreement among most of those who have testified before Congress—including a number of major e-tailers—that there should in fact be a level playing field. There is also agreement that substantial sales tax simplification should precede congressional action to create the level playing field. And there is agreement on the very large majority of the elements of simplification that have been considered as possible components of an acceptable sales tax system. The very few elements that remain in dispute we believe can be addressed quickly and without great difficulty by Congress prior to the expiration of the moratorium.

Moreover, if the Committee should disagree with that assessment—which we strongly hope it will not—we have a related recommendation. In that event, the moratorium should be extended for only so long as it takes for the Congress to resolve whatever issues it cannot resolve before October 21st. While we do not believe the moratorium should be allowed to expire, the only simple extensions that should be considered are those that are measured in months, not years. Any longer extension would send precisely the wrong message to states that are now addressing simplification—that is, a message that Congress is less than committed to addressing the issues identified by the Supreme Court's decision in *Quill*, to providing adequate guidance to the states regarding simplification, and to establishing a level playing field on an expeditious schedule. It is a message that we hope this Committee would be reluctant to send.

Mr. Chairman, Wal-Mart appreciates your invitation to provide its views on this matter and would welcome the opportunity to elaborate further on these comments.

Responses to Questions From Senator Graham

Question 1: If Congress chooses to ignore the sales tax problem when extending the moratorium, will more businesses follow this "tax shelter" method and if so, is this an economically beneficial policy for the Federal government to follow?

Answer: Several nationwide brick-and-mortar retailers operate their Internet retail businesses as separate subsidiaries in order to avoid having to collect sales or use taxes (except where the subsidiary has a physical presence). Other nationwide retailers have not chosen to go this route, based in part on the expectation that Congress will act soon to rectify the existing sales tax collection loophole, and are collecting and remitting taxes everywhere they have stores.

Economic Inefficiency

As the Congressional Budget Office (CBO) testified before the Senate Finance Committee on August 1, "most taxes generate economic inefficiency because they interfere with the choices that producers and consumers would otherwise make. The more unevenly a tax is applied, the more producers and consumers waste resources in their efforts to avoid it." At least some consumers make shopping decisions based on tax avoidance (shopping on the Internet or through a catalogue, rather than in a physical store). If Congress were to decide to let the "tax shelter" of remote sales continue, economic inefficiency would be exacerbated.

Economic (Revenue) Loss for States

States, not the Federal government, impose and collect sales (or use) taxes on sales of tangible personal property. Thus, allowing this "tax shelter" to continue would be economically detrimental to the states, as the CBO and others testified, even though it would not necessarily result in lost revenue to the Federal government. To the extent that the states might look to the Federal government to take on more responsibilities—if states are unable, due to sales tax revenue loss, to fund traditional state operations it could prove to be an unfavorable economic policy for the Federal government.

Help or Hinder Growth of e-Commerce

There is little evidence that allowing states to require remote sellers to collect sales and use taxes would have a detrimental effect on the growth of Internet businesses (assuming the states simplify their systems so that the burden of collecting is minimal). Even so, Congress should not be in the business of picking winners and losers among businesses competing with each other to make retail sales. Just as pure Internet retailers should not be subject to "discriminatory" taxes, nor should they be given preferential tax treatment.

Question 2: Are you confident that [the samsclub.com] software provides accurate information about thesales taxes samsclub.com is required to collect and can serve as a model for other remote venders?

Answer: Yes, we believe the software to be extremely accurate. The rate and zipcode module is supplied by TaxWare and is a currently available third party software package. The Streamlined Sales Tax Project will, when implemented, make similar software readily available for use by retailers of all sizes at no or minimal cost.

Question 3: If simplifications to state sales tax systems as outlined in S. 512 were adopted, how much simpler would your program become?

Answer: The ability to integrate the tax software with other retail systems is made easier because product codes can be developed to tie to the common definitions that would exist for the different categories of products that certain states treat differently. Further, the ability to maintain the integrity of the system for the differences between states as to what is taxed is greatly simplified. Our sales tax personnel make these determinations today by way of considerable manual intervention in assigning the tax characteristics associated with each item we sell online at samslub.com.

Question 4: Do you believe you are at a competitive disadvantage with remote sellers that don't collect sales taxes?

Answer: Yes, we have observed consumer behavior favoring online ordering when the tax is not collected. In particular, we have observed such behavior in the higher dollar consumer electronics categories, including computers, as well as DVD music and movie categories.

RESPONSES TO QUESTIONS FROM SENATOR BREAUX

Question 1: Are you aware of any cases where a court has used a different standard (*i.e.*, a standard different from the *Quill* standard of physical presence) allowing BAT taxes to be imposed on remote businesses that do not have a physical presence in the state? Can you describe any such rulings for me?

Answer: Geoffrey Inc. v. South Carolina Tax Commission, 437 S.E.2d 13 (S.C. 1993), *cert. denied* 510 U.S. 992 (1993). The issue in *Geoffrey* was whether South Carolina could tax income from royalties paid to Geoffrey, a Delaware corporation with no physical presence in South Carolina, by Toys R Us stores located in South Carolina. Geoffrey is a Toys R Us affiliate that acquired various trademarks and trade names, including Toys R Us, and then licensed their use to Toys R Us in return for the royalties provided. Delaware does not tax royalty income.

The court concluded that the tax met the two Due Process Clause requirements outlined in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992). Geoffrey consented to the use of its licensed intangibles in South Carolina, which along with the presence of its intangibles in the state created the necessary "minimum connection." The second prong of the Due Process test—whether the challenged tax is rationally related to the benefits conferred upon the business being taxed—was also satisfied. The court determined that South Carolina maintains a business climate that allowed Geoffrey to license its intangibles to businesses in the state. The court said that because the South Carolina statute sought only to tax income attributable to the intangibles used in the state, the tax was rationally related to the benefit to Geoffrey of being able to take advantage of the state's business climate.

The court also determined that the tax satisfied the *Quill* Commerce Clause test. It restated the four-prong *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977) test the U.S. Supreme Court used in *Quill* but did not test each prong, as not all were raised by Geoffrey. Importantly, the court brushed aside Geoffrey's assertion that it has no physical presence in the state as being a misplaced reliance on *National Bellas Hess v. Department of Revenue of Illinois*, 386 U.S. 753 (1967). The court interpreted the *Quill* ruling to mean that the physical presence requirement only applies to sales and use taxes and said that the *Quill* decision did not extend the physical presence requirement to other types of taxes. Claiming that it is well settled law that the presence of intangible property is sufficient to establish nexus for income to be taxed, the court held that licensing intangibles for use in South Carolina and earning income from those licenses creates "substantial nexus." The court held that Geoffrey was subject to South Carolina's income tax and the state's corporate license fee.

SYL Inc. v. Comptroller of the Treasury, No. C–96–0154–01, 1999 Md. Tax LEXIS 3 (Md.Tax Apr. 26, 1999). In this case, the Maryland Tax Court found taxation of a Delaware holding company's income to be unconstitutional.

The facts in *SYL* are much like those in *Geoffrey*. SYL is a Delaware corporation that owns the trademarks and trade names of Syms (a retailer), which it licenses to Syms for a fee in various states, including Maryland. Syms is the parent company of SYL. The Maryland Comptroller of the Treasury assessed taxes on the income earned by SYL on licenses to Syms in Maryland.

In its ruling, the Maryland Tax Court, like the South Carolina Supreme Court, reviewed the *Quill* decision. While the Maryland court refused to read *Quill* as stating that physical presence is necessary only for sales and use tax nexus, the court further noted, "Absent apparent explicit direction, we hesitate to expand the *Quill* physical presence requirement to taxes, other than sales and use." 1999 Md. Tax LEXIS 3 at *13 (quoting *MCIIT v. Comptroller*, No. C–96–0028–01 (Md. Tax 1999). It then reasoned that, notwithstanding that posture of the court, "substantial nexus" with the taxing jurisdiction was still required by the Commerce Clause, and, that accordingly SYL's "lack of in-state activity precludes the imposition of tax." *Id*. at *14. The court explained, "[SYL] is not doing business in Maryland. Its income producing activity all occurs outside of Maryland. [SYL] has no offices, employees, agents or property in Maryland. Its only Maryland contact is an affiliation with an entity in Maryland. This affiliation is hardly enough to satisfy substantial nexus." *Id*.

The Maryland Tax Court decision specifically addressed the discrepancy between its decision in *SYL* and the South Carolina Supreme Court's *Geoffrey* decision. According to the court, *Geoffrey* concerned South Carolina law, and therefore was not a precedent Maryland courts were required to follow. Also, the court said that it simply disagreed with the holding in *Geoffrey*.

Borden Chemicals and Plastics. L.P. v. Zehnder, 726 N.E.2d 73 (111. App. Ct. 2000). In this case, an out-of-state taxpayer owned a substantial interest in a limited partnership that conducted business in Illinois. The taxpayer claimed that the income derived from the Illinois activity was not subject to Illinois income tax because the taxpayer's limited partnership interest was a "passive investment" and the taxpayer had no physical presence in the state. The court found that physical presence is not a requirement for imposition of an income tax, and that the out-of-state parent was subject to the tax because it derived income from the benefits and protections that the state offered the partnership.

Specifically with respect to *Quill*, the court stated: "[T]he physical presence requirement of *Quill* is inapplicable to the instant case. Other jurisdictions have also declined to extend Quill to cases not involving sales and use taxes. . . . We conclude that the requirement of a physical presence does not apply to the present case and, even if it did, plaintiff has a physical presence in the form of an Operating Partnership. . . . The *Quill* court merely carved out anarrow exception in the area of use tax calculation duties." 726 N.E.2d at 81.

Couchot v. State Lottery Comm'n, 659 N.E.2d 1225 (Ohio 1996). This case relied on *Geoffrey* to find that Ohio could tax an out-of-state individual on his Ohio lottery winnings. The case explicitly stated that the Quill physical presence requirement does not apply to taxes relating to income derived from the state.

The court observed: "The Supreme Court in *Quill* reaffirmed the physical-presence requirement as to sales and use taxes. The court pointed out that 'concerning other types of taxes we have not adopted a similar bright-line, physical-presence requirement.' There is no indication in *Quill* that the Supreme Court will extend the physical presence requirement to cases involving taxation measured by income derived from the state. Thus, the physical presence requirement of *Quill* is not applicable to the case *sub judice*." 659 N.E.2d at 1230 (citations omitted).

As the above discussion indicates, there are a number of cases in which courts have specifically concluded that the physical presence test of *Quill* does not apply outside the sales and use tax area. There is also authority, however, for the contrary view—in particular, the case of *J.C. Penney National Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999). In that case, Tennessee sought to apply its net income tax to a corporation domiciled in Delaware that managed a substantial number of in-state credit card accounts and derived substantial fee income from Tennessee residents. The court applied *Quill*'s physical presence requirement to the facts at hand and concluded that the requisite physical presence was lacking. The court stated: "The only real issue is whether there is any reason to distinguish the present case from *Bellas Hess* and *Quill*. The Commissioner argues that those cases are distinguishable because they involved use taxes, whereas the present case involves franchise and excise taxes. We must reject the Commissioner's argument. While it is true that the *Bellas Hess* and *Quill* decisions focused on use taxes, we find no basis for concluding that the analysis should be different in the present case." 19 S.W.3d at 839. *See also America Online, Inc. v. Johnson*, No. 97–3786–III, (Tenn. Ch. Mar. 13, 2001), *reprinted in*, 2001 State Tax Today 6143 (Mar. 29, 2001).

Question 2: Should the Congress adopt language that states clearly that for BAT purposes courts shall use the physical presence standard developed in *Quill*? This should leave both sides in the same position—the status quo. Why is this not reasonable?.

Answer: If what is proposed, as the reference to the status quo suggests, is that Congress would provide that the application of *Quill*'s physical presence requirement to business activity taxes would be governed by current and future case law determinations, we would not object to the proposal, provided it were drafted to avoid the endorsement of any particular view of the law. If, on the other hand, what is proposed is that Congress would specifically legislate that the physical presence nexus test developed in *Quill* would apply to business activity taxes in the same way that it now applies to sales and use taxes, we would have serious objections. As will be discussed, our objections are based on the view that any such proposal, if included in legislation now before the Committee to extend the Internet Tax Freedom Act moratorium and address the sales and use tax collection issue, would make that legislation significantly more controversial and complicated and would thereby diminish its chances for enactment.

The BAT cases discussed above, and particularly the conflicting positions taken in those cases, lead to two principal conclusions. The first is that the question of whether *Quill*'s physical presence requirement currently applies for BAT purposes is a matter of considerable controversy. Accordingly, any legislation that would expressly impose that requirement with respect to business activity taxes would also be viewed as highly controversial. Many of those who support the holding and reasoning of *J.C. Penney* no doubt would welcome such legislation. Those who oppose the physical presence nexus requirement, however—in particular, many state and local taxing authorities—would almost certainly regard such legislation as objectionable and as a major departure from the status quo. Thus, whatever one's view of the merits of the legislation, it is fair to conclude that such legislation would precipitate substantial controversy and debate.

The second conclusion that emerges from the cases is that the issue of BAT nexus is an extremely complex one. The cases consider a substantial number of factors in determining whether nexus exists in particular fact situations. If Congress legislates in this area, it will need to involve itself in assessing these various factors in order to select the best available nexus test. Comparisons between alternative tests would also be needed. Thus, it would not be reasonable, for example, to adopt a physical presence test for BAT purposes without first determining that the test is preferable to others in balancing the competing objectives of free-flowing interstate commerce and adequately financed state and local governments. Moreover, the cases discussed above merely scratch the surface of the relevant case law that should be examined before decisions are made to either codify or supplant existing law. In short, the establishment of any nexus test through legislation would be a difficult and complicated undertaking.

We urge the Committee not to burden the moratorium and sales tax legislation it is now considering with this added layer of controversy and complexity.

Question 3: How do you recommend Congress address the BAT issue?

Answer: The answer to this question is closely related to the previous answer. In light of the difficulties that would be associated with any effort to legislate with respect to BAT nexus, we believe that any such effort should proceed as a separate legislative matter. It may be appropriate to include in the pending moratorium extension and sales tax collection proposalslanguage to ensure that no party to the BAT nexus dispute will be prejudiced by the enactment of those proposals. Beyond the inclusion of such "BAT-neutral" language, however, the current proposals ought not to relate in any way to business activity taxes.

Some may argue that the controversy and complexity regarding BAT nexus is no greater than that associated with sales and use tax collection legislation. We strongly disagree. With respect to the question of controversy, Wal-Mart believes, as discussed in the testimony I submitted to the Committee on August 1, 2001, that a consensus has developed on the major issues associated with proposed sales and use tax collection legislation. As noted in the testimony, there is basic agreement on (i) the need for a level playing field, (ii) the need for appropriate state and local sales tax simplification as a precondition to the establishment of a level playing field, and (iii) the appropriateness of a large majority of the requirements that have been proposed as elements of an acceptable simplified system. By contrast, there is no hint of a consensus among the parties to the BAT nexus dispute. As for the question of complexity, the sales and use tax proposals notably do not involve the complicated task of selecting an appropriate nexus test. Rather, they are based on the proposition that nexus should be considered irrelevant to sales and use tax collection responsibilities.

For these reasons, our strong view is that BAT issues should be excluded from the Internet/state and local tax package the Committee is now considering. We are persuaded that the addition of such subject matter to that package will threaten expeditious consideration of proposals that are otherwise ripe for enactment.

Prepared Statement of Jeffrey A. Friedman

I. INTRODUCTION

Chairman Max Baucus (D–MT), Ranking Member Charles Grassley (R–IA), and distinguished members of the Senate Finance Committee, thank you for inviting me to speak at today's hearing on Internet taxation. The views I will express today are my own, and do not necessarily represent the views of KPMG LLP or its clients.

In my remarks today I am going to discuss some of the international tax developments in Europe and the OECD that could affect U.S.-based businesses conducting business over the Internet.

International issues are relevant to our domestic discussions for at least three reasons. First, there are similar tax policy discussions taking place overseas, and as a result it is helpful to consider and perhaps benefit from those ongoing discussions. Second, as USbased multinational companies are often subject to both foreign consumption taxes and US sales and use taxes, many business representatives would like to see governments make similar tax policy decisions in the hope of simplifying today's taxes. Finally, some of the difficult issues that have prevented an international compromise on tax reform are also relevant to the domestic sales and use tax debate.

By way of background, discussions concerning how to adapt consumption taxes to electronic commerce are taking place at the Organization for Economic Cooperation and Development (OECD) and the European Commission (EC). These discussions are focused on how to apply value added taxes (VAT) and similar taxes to sales of digitized goods and services, such as music, software, and information services.

There are several parallels between what is happening overseas and the domestic debate. For instance, the OECD and the EU are grappling with issues such as:

- Which jurisdiction will have the right to impose consumption taxes and what will be the resulting tax rate?
- What are the appropriate enforcement mechanisms if a remote vendor refuses to collect consumption taxes?
- How can consumption taxes be made simple enough to maximize the changes to compliance?

II. EUROPEAN VAT IMPOSED ON DIGITIZED GOODS AND SERVICES

In June 2000, the EC released a proposal for a directive to modify the rules for applying VAT to digitized goods and services.[1] The objective of the EC was to create a level playing field between EU and non-EU vendors selling products and services delivered electronically (e.g., digitally delivered software, music, information services). It is important to note that the EC has broad authority over value added taxes imposed by its fifteen member nations.

Currently, non-EU vendors do not have to charge VAT on sales of digitized goods and services to European customers. The EC's proposal would change this treatment so that all sellers would have to charge VAT on sales to EU customers.

Specifically, the proposed directive would require non-EU vendors to register for VAT in a single EU member state, and to collect VAT on all sales within the EU based on the VAT rate in the chosen state of registration. VAT would be remitted only to the state of registration and there would be no obligation on the part of the state of registration to share revenue with other EU member states. Thus, non-EU sellers would be able to select which European country receives tax revenue for all of its European sales.

In the fall of 2000, EU member states began expressing concern with the proposed directive. VAT rates vary substantially in the EU, ranging from 15–25%. EU member states with high VAT rates were concerned that because non-EU vendors would be able to select one country in which to register for all European sales they would

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[1] Proposal for a Council Directive Amending Directive 77/388/EEC as regards the value added tax arrangements applicable to certain services supplied by electronic means, COM(2000) 349, *http://europa.eu.int/comm/taxation—customs/proposals/taxation/tax—prop.htm*, June 7, 2000.

be tempted to register in the member state with the lowest applicable tax rate, i.e., Luxembourg.

Several EU member states suggested changes to this part of the directive. France suggested that registration for VAT be required in every member state in which sales were made. The EC reportedly opposed that effort because it would result in too heavy a compliance burden on non-EU vendors and, as a result, non-EU vendors would not comply with the directive.[2] The EC's concern is similar to the concern of certain lawmakers here in the United States that a prerequisite to efforts to expand sales and use tax collection should be the adoption of a simplified collection system that does not impose unreasonable burdens on remote vendors.

A revised proposed directive was prepared by EC staff in March of this year. The revised proposed directive would continue to permit non-EU vendors to register in only one member state and to pay VAT only to that member state (the "member state of identification"). However, unlike the original proposed directive, non-EU vendors would be required to charge VAT based on the tax rate in the customer's jurisdiction.

The revised proposed directive must be unanimously approved by the EU member states in order to go into effect. The revised proposal has received the endorsement of all but one EU member state the United Kingdom. The new EU president has said that the Commission will press ahead on trying to obtain EU-wide agreement on the proposal.[3]

A. Technical Issues Raised by Proposed Directive

Some U.S. businesses have expressed concern that the revised proposed directive could create new competitive distortions and place U.S. business at a disadvantage vis-a-vis EU vendors.

For instance, under current law, an EU vendor located in one member state (e.g., Luxembourg) selling digital goods and services to an individual consumer located in a *different* EU member state (e.g., France) is permitted to charge VAT based on where the seller is located as opposed to where the customer is located (assuming the vendor's sales do not exceed certain thresholds). By contrast, under the revised proposed directive, a non-EU vendor would be required to charge and remit VAT based on where its customers are located. Therefore, an EU vendor located in an EU member state with a low VAT rate could enjoy a competitive advantage over non-EU vendors.

The revised proposed directive also would presumably require non-EU sellers to verify where the customer is located at the time each sale takes place. Many business representatives have said that they often do not know or cannot verify where their customers are located at the time of a sale. Therefore, this part of the proposed directive is of great concern to non-EU vendors that would be required to collect VAT.

The revised proposed directive also does not provide a de minimis sale threshold for collection. Under current law, when goods are sold by U.S. companies to European consumers and shipped by common carrier, individual shipments under a certain threshold—generally around $25—may be exempt from VAT in certain circumstances. The revised proposal directive does not provide a similar exemption for digitized goods and therefore treats them more harshly than traditional sales.

Finally, the revised proposed directive would be applicable even to very small vendors. The original proposed directive would have exempted companies that had less than 100,000 euros in sales in Europe, but the revised proposed directive includes no such threshold.

B. U.S. Treasury Response

In July of last year, the prior Administration publicly criticized the EC's original proposed directive.[4] While acknowledging that the proposed directive seeks to address what is perceived to be an uneven playing field between EU and non-EU vendors of digitally-delivered goods, the Administration raised several of the issues discussed earlier.

Additionally, Treasury expressed the view that the issue of imposing VAT on digital goods and services should be handled within the OECD and that OECD member countries or groups of countries should not act unilaterally. The United States, the

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[2] Joe Kirwin, *French Compromise VAT Plan on Digital Products Meets EC Rebuff*, Daily Tax Report, 192 DTR G–1, October 3, 2000.

[3] *Belgium to Press for EU E-Commerce Tax This Year*, National Journal's Technology Daily, July 17, 2001.

[4] See Remarks of Deputy Treasury Secretary Stuart E. Eizenstat before the Coalition of Service Industries and Tax Council, *http://www.treas.gov/press/releases/00arch.htm#*, July 26, 2000.

EC, the EU member states and other interested stakeholders (including the private sector) have been working within the OECD on the very complex substantive and administrative issues associated with e-commerce taxation.

C. OECD and Consumption Taxes

The OECD—through a subsidiary body of the Committee on Fiscal Affairs called Working Party No. 9—has also been examining some of the technical issues that are raised by requiring VAT to be collected on sales of digital goods and services. In general, the OECD process is comprehensive and solicits the views of member countries, non-member countries and business representatives. As a result, the OECD process is broadly supported but is not as far along as the EC process. In addition, unlike the EC, the OECD's role in developing solutions is advisory and not binding on the thirty member countries of the organization. Ultimately, each OECD member country is free to make its own decisions on VAT collection.

Working Party No. 9 issued a report in February in which it reiterated its support for requiring VAT collection on sales of digital goods and services, but it also remarked on some of the technical problems raised by implementing such a system.[5] In particular, the report discussed the issue of collection mechanisms. It recommended:

- a reverse charge or "self-assessment" mechanism for business-to-business transactions, and
- a simplified registration and remittance system for business-to-consumer transactions.

In the case of business-to-consumer transactions, the recommended system would oblige non-resident businesses to register for value-added taxes and to charge, collect and remit such taxes based on the VAT rate in the jurisdiction where the consumer has his usual place of residence.

The report goes on to state that current technology does not permit the vendor to verify accurately the purchaser's stated place of residence. It further states that the available options for collecting consumption taxes on business to consumer transactions present serious difficulties, either because they impose significant burdens on non-resident sellers, or because they are costly for revenue authorities to administer.

In sum, although the report sets forth certain preliminary conclusions with respect to collection, it appears that the Working Party has a great deal more work to do in developing administrable recommendations that can be implemented by OECD member countries.

III. TARIFFS

Turning for just a moment to tariffs, recent developments have been limited. As part of the Internet Tax Freedom Act enacted in 1998, Congress expressed its view that the United States should seek to assure that electronic commerce is free from tariffs.[6] Member governments of the World Trade Organization adopted a temporary moratorium on customs duties on electronic transmissions in May 1998.[7] WTO members may consider an extension of this moratorium at their ministerial conference later this year.

IV. DIRECT TAX ISSUES

A. The OECD

I would like to touch briefly on some of the developments with respect to income taxes. The OECD has been the primary forum for discussions on how to adapt our current system of income tax treaties to electronic commerce. Tax professionals from both member governments and the business community have been working with the OECD on these difficult issues and have been doing very good work.

In December 2000, the OECD's Committee on Fiscal Affairs adopted amendments to the commentary of the OECD Model Tax Convention which clarify what types

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[5] Working Party No. 9 on Consumption Taxes, *Consumption Tax Aspects of Electronic Commerce, http://www.oecd.org/daf/fa/e—com/public—release.htm#Consumption—tax—issues*, February 2001.

[6] Pub. L. 105–277, Sec. 1203.

[7] *Declaration on Global Electronic Commerce*, Geneva WTO Ministerial Conference, adopted May 20, 1998, *http://www.wto.org/english/thewto—e/minist—e/min98—e/ecom—e.htm*, (". . . we also declare that Members will continue their current practice of not imposing customs duties on electronic transmissions.").

of contacts with a jurisdiction constitute a permanent establishment.[8] The amendments provide that an Internet web site alone will not generally constitute a permanent establishment. The amendments further provide that an Internet Service Provider (ISP) will not, except in very unusual circumstances, constitute an agent of another enterprise so as to create a permanent establishment.

The OECD Model Tax Convention commentary also discusses whether an enterprise that has a server at its disposal has a permanent establishment. In order for a server or other computer equipment owned or leased by a business to constitute a permanent establishment, it must be in a fixed location, the business must be wholly or partly carried on in the jurisdiction where the server or equipment is located, and the activities carried out through the server or equipment must be core functions.

The work of the OECD and their associated technical advisory groups is continuing. To date, their work has been based on the premise that existing tax principles should be adapted to electronic commerce. Whether they will re-examine foundational income tax principles (such as the taxation of business profits based on the existence of a permanent establishment) remains to be determined. Meanwhile, however, countries that are not members of the OECD have signaled that they may follow their own separate path in determining how to tax electronic commerce.

B. Non-OECD Countries

According to press reports, tax authorities in India are proposing to amend the income tax regime so they can tax the activities of foreign companies that lack a physical presence in India.[9] In general, the tax authorities there have expressed concern that existing concepts of permanent establishment are too narrow and allow companies that sell their products and services through e-commerce to avoid taxes even though they conduct substantial business in the country.

If India follows through with its proposal, it could have significant consequences for the tax treatment of transactions between U.S. businesses and Indian customers, and, conceivably, could have adverse consequences on US-Indian trade. It could also set a precedent that could be followed by other developing nations.

In addition to abandoning settled concepts such as permanent establishment, non-OECD countries may attempt to re-characterize payments that should be treated as business profits as royalty payments. In general, payments that represent business profits are often not subject to withholding taxes, but payments that represent royalties are often subject to withholding taxes. In 1999, India's Authority for Advance Ruling issued a ruling in a case involving a credit card and travelers' check processing business in which it found that payments by the company's Indian subsidiary for the use of the U.S. parent's computer systems located in the United States and in Hong Kong constituted royalty income, rather than business profits.[10] Such a position has dramatic tax consequences as it leads to taxation of a business that only has "electronic" contacts with India. The U.S. Treasury will need to continue to monitor how its existing treaty network is being applied to electronic commerce.

V. CONCLUSION

In conclusion, international tax developments demonstrate that many nations are grappling with how to adapt their taxation systems to electronic commerce and that there are many competing concerns. Policymakers here and abroad are correctly seeking input from various stakeholders including government representatives, the business community, and tax practitioners. Their work will continue, and answers to some of the most difficult tax policy issues do not appear imminent. Thank you for the opportunity to address these issues today.

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[8] OECD Committee on Fiscal Affairs, *Clarification on the Application of the Permanent Establishment Definition in E-Commerce: Changes to the Commentary on the Model Tax Convention on Article 5, http://www.oecd.org/daf/fa/e—com/ec—1—PE—Eng.pdf*, December 22, 2000.

[9] Parveen Nagree, *Indian Tax Authorities Propose e-Commerce Income Tax Amendments*, Worldwide Tax Daily, 2001 WTD 142–6, July 24, 2001; Aziz Nishtar, *India Mulls Taxation of Foreign Companies' E-Commerce Income*, Worldwide Tax Daily, 2001 WTD 141–1, July 23, 2001.

[10] Shreya Pandit and Shefali Goradia, *Indian AAR Issues Landmark Ruling on e-Commerce Taxation under U.S.-India Tax Treaty*, Worldwide Tax Daily, 1999 WTD 128–5, July 6, 1999.

Prepared Statement of Dr. Michael S. Greve

1. INTRODUCTION

Mr. Chairman, members of the Committee: thank you very much for giving me the opportunity to testify on the vexing question of interstate sales taxation.

The thrust of my testimony is that the Congress can and should harmonize the contending principles of Federalism, economic efficiency, and tax equity. At first sight, that may seem impossible. The Governors' insistence on the states' rights seems to run headlong into remote sellers' strenuous objections to being regulated by states with which they have no tangible connection. The e-commerce camp's insistence on that position, in turn, conflicts with the principle of tax equity, championed vigorously by mainstreet retailers. And so on. Federalism, equity, and efficiency can be reconciled, however, by providing that interstate sales through whatever channel (direct, catalogue, or Internet) are subject to sales taxation at their point of *origin*, meaning the seller's home state—not, as is currently the case, on the basis of their *destination*, meaning the customer's home state. As a practical matter, that solution requires Federal legislation.

I harbor no illusions about the political viability of adopting an origin-based approach, at least in the current round of legislation. While the proposal has been floated in the tax literature,[1] in the publications of some think tanks (such as the Competitive Enterprise Institute, the Heritage Foundation, the Cato Institute, and—in an international context—the Progressive Policy Institute),[2] and in some versions and applications before the Advisory Commission on Electronic Commerce,[3] it has received little, if any, public and legislative debate and consideration, and time is running out. Alternative proposals under consideration, however, seem unattractive, unworkable, or both. Moreover, the choice between origin and destination as the basic regulatory principle has broad applications in other arenas—consumer privacy, for example, and especially the international trade matters under this Committee's jurisdiction. In those arenas, the choice of the wrong jurisdictional principle—destination—would entail terrible consequences. In that light, I respectfully urge the Committee, and the Congress, to refrain from hasty e-tax legislation that might set a bad precedent and preclude a shift to origin-based taxation at a more opportune time.

2. PRINCIPLES

In light of the intense controversy over e-commerce taxation, it may be helpful to begin with the principles that are (or at least should be) common ground.

Efficiency. State and local governments, the business community, customers, and tax economists all agree that sales taxes should be easy and cheap to administer. All agree, moreover, that the existing sales and use tax regime is absurdly cumbersome and expensive. Compliance costs are very high, especially for smaller and medium-sized firms.[4] Even with the best intentions (and the best tax software), companies find it inordinately difficult to determine their tax remittance obligations in thousands of jurisdictions with different, and constantly changing, tax rates, definitions, and reporting requirements.

Equity. Happily, "[v]irtually all concerned parties agree that state taxes on electronic commerce should be economically neutral."[5] Less happily, not everyone agrees on the meaning of "neutrality" and its cousins, such as "equity" or "fairness." Tax experts argue that taxes should not divert economic resources from one use to an alternative use—in this instance, from conventional sales to e-commerce sales. Nat-

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[1] *See, e.g.*, Andrew Wagner & Wade Anderson, *Origin-Based Taxation of Internet Commerce*, STATE TAX NOTES (July 19, 1999), 187; Terry Ryan & Eric Miethke, *The Seller-State Option: Solving the Electronic Commerce Dilemma*, STATE TAX NOTES (Oct. 5, 1998), 881.

[2] See, e.g., Jessica Melugin, *Internet Sales Taxation: Beyond the Moratorium* (Competitive Enterprise Institute Policy Brief, Mar. 28, 2000); Adam D. Thierer, *E-Commerce: A Taxing Issue* (Mar. 23, 2000) (http://www.heritage.org/views/2000/ed032300.html); Aaron Lukas, *Tax Bytes: A Primer on the Taxation of Electronic Commerce* (Cato Institute, Dec. 17, 1999), 37–38; Shane Ham & Robert D. Atkinson, *A Third Way Framework for Global E-Commerce* (Progressive Policy Institute, March 2001).

[3] *See* Andrew Wagner & Wade Anderson, *Proposal of an Origin Based Tax Solution for the Possible Taxation of Digitized Products Sold Over the Internet* (Nov. 8, 1999) (http://www.ecommercecommission.org/proposal.htm)

[4] Robert J. Cline & Thomas S. Neubig, *Masters of Complexity and Bearers of Great Burden: The Sales Tax System and Compliance Costs for Multistate Retailers* (Ernst & Young, Sept. 1999) (estimating compliance costs from 14 percent of taxes collected for large retailers to 87 percent for small retailers).

[5] Walter Hellerstein, *State Taxation of Economic Commerce: Preliminary Thoughts on Model Uniform Legislation*, STATE TAX NOTES (Apr. 28, 1997), 1315.

urally, "mainstreet" merchants and state and local government lobbies have made much of this argument—arguably, too much, since no conceivable state and local sales tax regime can be entirely neutral.[6] Nonetheless, the argument that our sales tax regime should not artificially favor some sales channels over others possesses considerable force. The rejoinder that the existing sales and use tax regime is in fact neutral *with respect to all forms of "remote" commerce* does not fully meet legitimate concerns over tax neutrality and equity.

Federalism. Governors and state organizations argue with great conviction that Congress should not interfere with the states' traditional authority and autonomy over their traditional sources of revenue. For reasons explained below, I am inclined to think that the states have in the e-commerce debate pushed that principle beyond its breaking point. The principle is eminently reasonable, however, in this crucial respect: over the entire course of American history, the states and the national government have remained very respectful of each other's revenue sources and taxing authority.[7]

Early in the e-commerce debate, proposals surfaced to nationalize sales taxes and to distribute the proceeds to the states. Those proposals, mercifully, appear to have died a well-deserved death. Any form of joint state-Federal taxation would eventually transform the states from autonomous actors into supplicants and administrators of Federal largesse. That result cannot be in anyone's interest.

3. COMPROMISE?

Current compromise efforts—reflected, for example, in various bills before the Senate Commerce Committee[8]—essentially attempt to reconcile the clashing interests and principles by granting state and local governments expanded tax authority over "remote" commerce in exchange for a credible commitment to "simplify" and "harmonize" sales and use taxes. The search for a compromise along these lines is in my judgment a fool's errand. Simplification has proven elusive for decades, and not for lack of trying.[9] It will continue to prove elusive. For the sake of brevity, I mention only two of the many reasons:

- "Simplification" must, at a bare minimum, mean a single tax rate per state. Even under that regime, sellers would be stuck with 46 different sales tax regimes, but—less is more, in this case—46 state taxing jurisdictions beat 7,500 local jurisdictions any day of the week. A single-rate regime, however, would effectively wipe out the tax autonomy of local jurisdictions. That should not happen, and it is not going to happen. For this reason alone, "simplification" is a chimera.
- From a tax efficiency standpoint, what really needs simplification is not the tax *rate* but the tax *base*.[10] Questions as to whether Air Jordans constitute taxable sportswear or tax-exempt footwear are legendary, as are questions as to whether potato chips and French fries do or do not constitute food. (The National Governors Association has, without a sense of irony, issued a press release on the complexities of taxing a marshmallow.) For all the easy ridicule, however, most of the seemingly absurd complexities have plausible reasons. Variations in the tax base reflect political efforts to favor domestic over foreign industries; attempts to mitigate the regressive effects of sales taxes; differences in local customs and habits; varying social judgments concerning individual consumption patterns that ought to be discouraged or encouraged; and many other considerations. Even if all the variations and exemptions were wholly irrational and illegitimate, which they are not, the forces that produced them are not going to go away. Even if it were possible to harmonize the sales tax base once (an extremely doubtful proposition), variations would soon re-appear.

Simplification and efficiency, we are being reassured by state officials, are nonetheless achievable through centralized, computerized sales tax data collection and

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[6] The only locationally neutral (and in that sense efficient) sales tax is a uniform national sales tax. However, even a uniform national sales tax on products, *but not services*, will at the margin induce an inefficient substitution of services for products. Thus, the only truly neutral tax is a tax on both products and services or else, a national prohibition on any sales tax. I take it that state and local governments do not advocate either of these options.

[7] The segregation of revenue sources is a bit of a miracle, considering that Washington and the states (and for that matter local governments) have not been remotely so conscientious in separating funding and administrative responsibilities.

[8] *See, e.g.*, S–288 (Sen. Wyden); S–512 (Sen. Dorgan).

[9] *See, e.g.*, Kendall L. Houghton & Walter Hellerstein, *State Taxation of Electronic Commerce: Perspectives on Proposals for Change and Their Constitutionality*, 2000 B.Y.U.L. REV. 9, 29–30 (describing unsuccessful simplification efforts).

[10] *See* DANIEL SHAVIRO, FEDERALISM IN TAXATION: THE CASE FOR GREATER UNIFORMITY (American Enterprise Institute, 1993).

administration under the auspices of a "Streamlined Sales Tax Project" (SSTP), sponsored by the Multistate Tax Commission and the Federation of Tax Administrators. Comparable experiments to centralize the calculation of *local* taxes in a few states, however, provide little reason to believe that the proposed project is technically feasible, and a representative of Taxware, the producer of perhaps the most sophisticated tax compliance software on the market, has testified that existing technology simply cannot cope with the maze of definitions, exemptions, and reporting and remittance requirements.[11] Moreover, the SSTP proposal raises grave privacy concerns. Considering the pronounced public unease over personal data collection and use, a governmentally sponsored and administered data collection system on interstate sales is not an appealing idea.

In addition to these pragmatic considerations, an important point of principle is at stake. We do not really have a problem with *sales* taxes. Rather, we have a problem with *use* taxes, which are owed by customers to their various home states (and subordinate jurisdictions) on purchases from "remote" out-of-state sellers. For practical and political reasons, governments find it inconvenient to collect use taxes—except on big-ticket, easily traced items, such as boats and cars—from individual, in-state citizens. Thus, the common practice is to impose the tax collection and remittance obligations on out-of-state sellers.

States are of course free to levy use taxes on their own citizens. The question is whether they may impose the obligations to calculate, collect, and remit those taxes *on out-of-state sellers*. Under existing Supreme Court precedent, the states are forbidden from doing so unless the seller has a "nexus," such as a store, in the taxing jurisdiction.[12] That is why state and local governments are asking the Congress, under its authority to regulate interstate commerce, to lift that restriction and to extend the states' regulatory and tax authority to "remote" sellers.

Even the existing sales and use tax regime, however, poses a serious threat to our most elementary political principles. Its extension to remote sales, *no matter how "simplified" and "harmonized,"* would greatly exacerbate that threat.

First, the imposition of tax collection, reporting, and remittance obligations on out-of-state parties severs (as the economists say) the *political* incidence of taxation from its *economic* incidence. That is a variation on a theme our ancestors called "taxation without representation."

Second, the genius of American Federalism, as Justice John Paul Stevens has put it, is that citizens choose their state, not the other way around.[13] That principle applies not only to permanent physical relocations but also to work, tourism, and other activities—including shopping. Under the existing tax regime and especially under its proposed extension to remote sales, however, a citizen's home state tax law tags after him like a junkyard dog. Such a system negates the citizen choice that is Federalism's principal attraction.

It also, and third (and relatedly), constitutes an insult to state sovereignty. States' rights, like individual rights, must end where another's rights begin. Federalism means that states may regulate and regiment their own citizens—but not the citizens of other states. The imposition of use tax obligations by each state on foreign entities amounts to mutual regulatory aggression on other states' corporate citizens. That is not Federalism but very nearly its opposite.

In sum, the sales-tax-expansion-with-simplification agenda will not work. Even if it could be made to work, it would be a bad idea. In that light, the alternative of an origin-based sales tax system merits consideration.

4. ORIGIN-BASED TAXATION

The effect of the existing sales-and-use tax regime, as noted, is to tax interstate sales transactions on the basis of their *destination*—that is, the customer's residence. All the seemingly intractable problems of the internet sales tax debate—in particular, the differential treatment of "mainstreet" and "remote" sales, the extravagant compliance and administrative costs—stem from the choice of destination as the regulatory principle, not from the existence of a decentralized sales tax system *per se*.

Under an *origin*-based system, in contrast, interstate sales of all descriptions, through all channels, would be based on the seller's instead of the buyer's domicile

[11] Jon W. Abolins (Chief Tax Counsel and Vice President, TAXWARE International, Inc.), Testimony to the House Judiciary Subcommittee on Commercial and Administrative Law, July 18, 2001.

[12] Quill v. North Dakota, 504 U.S. 298 (1992).

[13] Saenz v. Roe, 526 U.S. 489, 501–11 (1999).

state—that is, the company's principal place of business, as defined (for other purposes) by the Uniform Commercial Code.[14]

That one swift move from destination to origin would solve equity and efficiency problems. Amazon.com's sales would be taxed in the same fashion, at the same rate, by the same entity, as would the sales of the local book store—that is, by the state of Washington. No discriminatory tax treatment would occur unless a particular state or local jurisdiction decided, for the sorts of industrial policy reasons that often induce jurisdictions to favor some industries over others, to extend tax advantages (or disadvantages) to some sales channel or other. Administrative and compliance costs would plummet. Regardless of how and where a company's products are sold, each company will be subject to reporting and remittance obligations for interstate sales only in its domicile state (and perhaps its local jurisdiction), and nowhere else.

At the same time, an origin-based system is fully consistent with sound Federalism principles. Each state would be free to tax and regulate its own businesses and citizens as it sees fit. Each state's regulatory autonomy and authority, however, would stop at the border—which is precisely where they ought to stop.

The origin principle is a perfectly natural choice. We already follow it, in real life, with respect to local sales, even if the parties are from different states. If I, as a Virginia resident, buy a Lacrosse stick for my son on a business trip to North Carolina, I will be charged the North Carolina sales tax. The company that sells me the stick cares not one whit whence I came, where I reside, or where the stick is going to be used. If my son purchases the next stick from the same company, which has no store in Virginia, over the Internet or by phone or mail order, he (or more likely I) will not pay North Carolina's tax. We will instead owe the Virginia use tax—technically speaking, since neither of us has ever paid or been asked to pay that tax. Under the existing and under the proposed, "simplified" system, it matters whether the stick came to me, or I came to the stick. An origin-based system would harmonize the tax treatment.

We also follow the origin principle, even in interstate transactions, with respect to (of all items) flowers [15] and, since last year, mobile telephone calls. One reason why the origin principle has proven so readily acceptable in those areas is an expected reciprocity of advantage. A few areas (such a college towns) may experience a net export of flowers, thus reaping a benefit from origin taxation; a few other areas (such as those with lots of retirement communities) may experience sizeable net imports. By and large, though, states are content to ignore the question (Where have all the flowers gone?) because the flows will average out. So, for that matter, will telephone calls.[16]

The expectation that such average reciprocity would *not* prevail is a central reason for the existing, destination-based sales and use tax system. In the 1930s, when that system came into being, "consumer" states feared that "producer" states would reap all the advantages from an origin-based system, thus leaving stranded the states that were most in need of revenues.[17] That concern, however, while understandable in an industrializing country with enormous economic heterogeneity among the various states, seems increasingly incongruous in a far more homogeneous, service-oriented and information-based economy.

It is true that a shift from destination-based taxation to origin-based taxation would tend to benefit the net exporters of taxable retail products and hurt net importers. That objection, however, gains its plausibility chiefly from an unstated baseline comparison with a destination regime under which all interstate sales will in fact be taxed. That assumption is manifestly unrealistic. (As noted, use taxes are rarely collected under the existing system, and even the proposed SSTP tax cartel would exempt many purchases.) And while producer states might gain from a shift to origin-based taxation, that advantage is easily swamped by tax advantages that the "losing" consumer states may possess.[18]

[14] Local, in-state sales would be taxed, as they are now, at the locally applicable rate.

[15] Ryan & Miethke, *The Seller State Option* at 883 n. 11.

[16] *Cf.* Goldberg v. Sweet, 488 U.S. 252 (1989) (sustaining state excise tax on interstate telecommunications on, *inter alia*, reciprocity grounds).

[17] Ryan & Miethke, *The Seller State Option* at 888.

[18] I have attached a table of commodity flows among the states for the most recent year (1997) for which that data is available. For any number of reasons, the table provides no insight at all as to whether any given state would gain or lose from any given sales tax regime. (***E.g.***, the big exporters tend to be producers of agricultural and food stuffs, which are rarely subject to sales taxes.) For what it is worth, though, note that most of the big import states have access to revenue sources that are unavailable to other states. Florida and Utah have the luxury of taxing tourists, whereas "producer" states like Iowa and Nebraska do not. An arguable origin-tax "loser" such as Montana can charge severance taxes for raw materials; a "winner" like New

Continued

5. OBJECTIONS

The elegant, origin-based sales tax solution is vulnerable to two objections. The first of these is based on considerations of efficiency. The second, politically more potent objection arises from concerns over possibly excessive tax competition.

Efficiency. An origin-based system implies jurisdictional variations with respect to both the tax base and the tax rate. Those variations will at the margins shape and, relative to a completely neutral system, "distort" both purchasing decisions and firm location. That objection, however, applies also to the existing system and, for that matter, to the SSTP.[19]

Competition. Under an origin-based sales tax system, every jurisdiction will attempt to match the largest number of sellers and purchasers. All else being equal, one might think, the sales tax rate will be zero in every jurisdiction.[20]

The trouble with this "race-to-the-bottom" argument is that all else is not in fact equal. Sales taxes are merely one stick in a bundle of services and obligations that are being offered by each jurisdiction. Thus, a jurisdiction that provides an educated labor force, an excellent infrastructure, a favorable regulatory environment, a sensible and efficient judicial system, or "quality of life" attractions will be able to exact a sales tax. An unattractive jurisdiction that drives up the cost of doing business, meanwhile, will be unable to compensate those self-inflicted disadvantages by becoming a "sales tax haven."

It is true, of course, that an origin-based tax system would, relative to the existing sales tax regime, exert downward pressure on sales taxes and, quite probably, change the mix of the tax burden in many and perhaps most jurisdictions. The magnitude of that effect cannot be forecast with any confidence; its direction, however, is certain.

The question, though, is not whether we do or not want sales tax competition. We have that competition in any event: the evidence is visible up and down I–95, from Delaware's blaring "Tax Freedom" billboards to the busloads of New York shoppers at Potomac Mills, VA. The benefits of tax competition, however, are very unevenly distributed. They are more available to the residents of Philadelphia than to those in Salt Lake City; more available to prosperous citizens with cars than to less wealthy and mobile citizens.

I call that phenomenon choice and competition. State and local officials call it tax "evasion" or "flight" and the jurisdictions that offer it, tax "havens." Under any name, though, sales tax choice or "evasion" will continue no matter what the United States Congress, or any individual state, may do. The only *legislative* choice is to contain choice and competition within its current, artificial and inequitable boundaries or else, to expand and democratize it. Origin-based taxation implies a choice for expanded competition.

6. ORIGIN VERSUS DESTINATION: IMPLICATIONS

The choice between origin and destination as a regulatory principle reaches far beyond the e-commerce tax question—substantively, and geographically. As to substance, consider the intensely contested question of internet privacy and consumer protection.[21] Let the service provider's home state govern transactions with customers, and market participants will, sooner rather than later, sort themselves into

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Hampshire cannot. Each state has competitive and comparative advantages—some deserved, others not. It is a grave mistake to look at one dimension in isolation—or to think that national policy could or should equalize the conditions among the states.

[19] By technical economic criteria of locational efficiency, any form of tax competition is *ipso facto* inefficient. The question of whether the gains from competition exceed its efficiency costs is the subject of a voluminous literature. One's confidence in the centralized, supposedly efficiency-enhancing approach will stand in direct proportion to one's confidence in the ability of centralized political institutions to generate tax regimes that conform to the optimality criteria on a blackboard at the University of Chicago or MIT. Since my own confidence on that score is nil, I opt for real competition over theoretical efficiency.

[20] That result might in fact obtain if retailers were entirely free to designate their home state, or to designate their place of incorporation as their home state. The principal-place-of-business rule, in contrast, disciplines the sellers' choices.

[21] For the sake of brevity, I limit the discussion to a single example. Many other examples come readily to mind, and some of these overlap substantially with the e-tax debate. The contemplated extension of state e-tax authority, for instance, has generated controversy as to whether that extension is to apply only of sales and use taxes or also to the allocation of interstate business income and its taxation. For yet another example, economists who otherwise oppose origin taxation for tangible products have tentatively endorsed it for the taxation of digitized products in e-commerce, a closely related problem. See, e.g., Houghton & Hellerstein, *State Taxation of Electronic Commerce* at 54 and sources cited *ibid*.

jurisdictions that match their privacy preferences.[22] Let the customers' state govern the transactions, and providers must tailor their product to each jurisdiction's specifications or, if tailoring proves impossible or excessively expensive, comply with the most restrictive jurisdiction, which will by definition reflect nobody else's preference. Since either result is intolerable to business, customers, and most states, the destination principle will prompt centralized intervention. In the end, then, states do not really have a choice between regulatory autonomy with or without competition. They only have a choice between autonomy under the competitive conditions of origin-based regulation—or else, neither competition nor autonomy.

Domestically, we can always trump the ill effects of decentralized, destination-based regulation by means of (yet another) preemptive Federal law. While such centralized interventions are not always wise or well-designed, protecting the national common market from regulatory obstacles is, in the end, a constitutional mandate, entrusted to the United States Congress. On an international scale, in contrast, efforts to trump parochial, destination-based regulation through "harmonization" entails the creation of anti-competitive, unaccountable bureaucracies.[23]

Democratic and Republican administrations alike have, by and large, wisely defended international competition against "harmonization." We have likewise resisted the notion that French judges or Brussels bureaucrats have any business regulating the content and practices of American-based websites solely because those sites are accessible from European destinations.

We can in some sense afford to suppress regulatory and tax competition here at home and yet champion it in the international arena—simply by throwing our considerable weight around. We do so, however, at the peril of international resentment and recriminations. It is much better to practice at home the competition that we preach abroad—both because we should set an example for a more competitive world economy, and because our domestic practices are not easily contained. Origin-based e-commerce taxation, for a pristine example, is easily scaled internationally: let us tax our companies' international sales here at home, let foreign countries do the same to their companies, and let that be the end of the matter. Destination-based taxation on an international scale, in contrast, means that we have no cause for complaint when German tax inspectors insist on auditing Apple Computer's books, the better to verify the company's compliance with tax obligations incurred on sales from Aachen to Aschaffenburg. It means, in the end, some sort of international SSTP. I take it that we would not consent to such a scheme. The best way to resist it is to resist it here at home.

7. CONCLUSION

At the present stage of the legislative process, it would be best to refrain from legislation that would affirmatively foreclose future consideration of an origin-based sales tax regime. A congressional endorsement of the SSTP would, unfortunately, likely entail that result. For that reason, I believe that the proposal should be rejected.

Alternative courses of action would keep the origin-based option open. An extension of the existing moratorium is one such option; a codification of "nexus" standards may be another option, depending on the standards chosen.[24] Finally, doing nothing at all may well be an acceptable course of action. Inaction would mean a missed opportunity to reform a sales tax system that is uniformly, and rightly, viewed as an extravagant absurdity. It would, however, preserve the option of reforming that system at a more opportune time, after more systematic consideration.

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[22] See Bruce H. Kobayashi & Larry E. Ribstein, "A Recipe for Cookies: State Regulation of Consumer Marketing Information" (American Enterprise Institute, May 2001) (available at http://www.federalismproject.org.)

[23] For a very thoughtful discussion of international jurisdiction and the unworkability of the destination principle in that context *see* Ham & Atkinson, *A Third Way Framework for Global E-Commerce*.

[24] A codified "nexus" standard can in principle generate any jurisdictional regime, from an extension to remote sales (under an extremely loose nexus test) to a *de facto* origin system (under a standard requiring a very tight nexus, such as the actual operation of an in-state store).

State-to-State Commodity Flows 1997

	Exports	Imports	Balance	1997 GSP	Trade Balance as % of GSP
AL	64,982	57,039	7,943	104,213	7.62%
AK	903	5,357	-4,454	26,575	-16.76%
AZ	44,900	58,846	-13,946	122,273	-11.41%
AR	46,338	46,034	304	59,141	0.51%
CA	308,458	287,936	20,522	1,045,254	1.96%
CO	42,687	48,507	-5,820	129,575	-4.49%
CT	61,060	39,050	22,010	134,968	16.31%
DE	12,567	15,201	-2,634	31,263	-8.43%
DC	1,446	6,997	-5,551	50,546	-10.98%
FL	75,659	163,396	-87,737	389,473	-22.53%
GA	138,296	156,647	-18,351	235,733	-7.78%
HI	405	5,541	-5,136	38,537	-13.33%
ID	14,438	12,544	1,894	29,388	6.44%
IL	222,735	206,883	15,852	400,327	3.96%
IN	150,127	115,669	34,458	162,953	21.15%
IA	70,145	51,482	18,663	81,695	22.84%
KS	52,604	43,117	9,487	72,998	13.00%
KY	87,114	82,215	4,899	101,535	4.82%
LA	61,518	68,008	-6,490	123,549	-5.25%
ME	15,618	14,956	662	30,409	2.18%
MD	49,944	74,526	-24,582	154,646	-15.90%
MA	88,384	87,031	1,353	223,571	0.61%
MI	171,160	181,735	-10,575	279,503	-3.78%
MN	91,051	71,430	19,621	152,334	12.88%
MS	40,590	36,834	3,756	58,743	6.39%
MO	105,061	103,447	1,614	155,811	1.04%
MT	5,438	10,609	-5,171	18,907	-27.35%
NE	39,503	26,657	12,846	49,275	26.07%
NV	12,082	30,810	-18,728	59,248	-31.61%
NH	25,049	15,900	9,149	37,470	24.42%
NJ	180,944	144,366	36,578	299,986	12.19%
NM	8,567	17,950	-9,383	47,829	-19.62%
NY	165,876	221,767	-55,891	663,377	-8.43%
NC	151,207	115,366	35,841	221,629	16.17%
ND	7,793	10,106	-2,313	15,910	-14.54%
OH	245,124	186,813	58,311	326,451	17.86%
OK	35,752	45,781	-10,029	79,423	-12.63%
OR	56,144	48,171	7,973	97,510	8.18%
PA	192,679	180,315	12,364	347,306	3.56%
RI	11,310	10,900	410	29,409	1.39%
SC	70,929	78,133	-7,204	95,447	-7.55%
SD	11,864	8,824	3,040	19,767	15.38%
TN	107,773	108,374	-601	151,738	-0.40%
TX	222,999	262,282	-39,283	608,622	-6.45%
UT	22,212	32,834	-10,622	55,070	-19.29%
VT	10,365	8,617	1,748	15,510	11.27%
VA	80,800	97,094	-16,294	212,105	-7.68%
WA	60,159	80,898	-20,739	175,242	-11.83%
WV	26,036	23,142	2,894	38,281	7.56%
WI	122,258	85,304	36,954	148,194	24.94%
WY	5,560	5,172	388	16,244	2.39%
			0	8,224,963	

Source: Department of Transportation, The Commodity Flow Survey, shipments by domestic U.S. establishments in manufacturing, wholesale, mining and selected other industries
http://www.bts.gov/ntdata/cfs/cfs97od.html

PREPARED STATEMENT OF FRANK G. JULIAN

INTRODUCTION

Good morning. My name is Frank Julian. I am Operating Vice President and Tax Counsel for Federated Department Stores, Inc. in Cincinnati, Ohio. Federated is one of the nation's leading department store retailers. We operate more than 450 department stores in 34 states, plus Puerto Rico and Guam, under the names of Bloomingdale's, Macy's, Burdines, Goldsmith's, Lazarus, Liberty House, Rich's, and The Bon Marche. Federated also has a significant direct mail catalog and electronic commerce business with its Fingerhut, Bloomingdale's By Mail, bloomingdales.com, Macy's By Mail and Macys.com subsidiaries.

Although Bloomingdale's By Mail, bloomingdales.com, Macy's By Mail and Macys.com are each separate subsidiaries, they collect sales tax on sales into any state where Bloomingdale's and Macy's, respectively, have department stores.

I am here today on behalf of The Direct Marketing Association ("DMA"). The DMA is the leading and largest trade association for businesses interested in interactive and database marketing, with almost 5,000 members from the United States and 53 other nations. I chair the DMA's Use Tax Steering Committee. The DMA is a member of the Internet Tax Fairness Coalition ("ITFC").

SUMMARY OF POSITION

The DMA firmly believes that the moratorium against new and discriminatory taxes on the Internet should be extended, and the moratorium against taxes on Internet access should be made permanent.

While there is widespread support for extending these moratoria, many have urged Congress to make collection of sales tax by remote sellers a *sine qua non* to extending the moratoria. We do not believe that these two issues are so intertwined that the moratoria cannot be extended without addressing the sales tax issue. However, to the extent Congress is inclined to address the sales tax collection issue, we believe it is imperative for Congress to require the states to substantially simplify their sales tax systems, and then to evaluate the states' simplification efforts, before granting the states the authority to require remote sellers to collect their sales tax.

The myriad of confusing and inconsistent state and local sales tax systems in existence today places tremendous burdens interstate commerce and the economy. The DMA supports the following objectives for reducing the tax burdens imposed on interstate commerce that thwart the development of a borderless marketplace:

- Establish simple and uniform sales and use tax rules that reduce compliance burdens for all taxpayers, and provide a reasonable collection allowance to compensate all sellers for the burdens they must incur in collecting the tax.
- Enact nexus standards for business activity taxes that eliminate uncertainty and the potential for double taxation.
- Promote availability of the Internet to all by prohibiting taxes on access fees.
- Prevent multiple and discriminatory taxation by extending the application of established nexus rules to remote commerce.

The DMA supports neutral tax treatment of electronic commerce; it does not support the creation of a "tax-free" zone for electronic commerce. However, the DMA believes that Congress should not pass any legislation that would give states "prior approval" to a simplification compact before the details of the simplification are known and evaluated by Congress.

DISCUSSION

The burdens that the current sales tax systems place on interstate commerce have been well documented. The Supreme Court recognized these intolerable burdens on interstate commerce in its 1967 decision in *National Bellas Hess v. Department of Revenue*, and again in 1992 in *Quill Corp. v. North Dakota*. In *National Bellas Hess*, the Court found that the "many variations in rates of tax, in allowable exemptions, and in administrative and record keeping requirements could entangle interstate business in a virtual welter of complicated obligations to local jurisdictions with no legitimate claim to impose 'a fair share of the cost of the local government.'"

The hearings conducted by the Advisory Commission on Electronic Commerce ("ACEC") raised an awareness, in an unprecedented manner, of the level of complexity and burdens imposed by the current sales tax systems. By the time the ACEC completed its work, there was near universal agreement that the disparate state sales tax systems in place today must be substantially simplified and unified—as they apply to **all** sellers—if they are to survive.

Federated collects and remits more than $1 billion per year in sales tax for the state and local governments where we do business. We incur substantial costs in collecting and remitting these taxes, and in administering the many audits that follow.

While this is a steep burden for us, it is not one that will put us out of business. The same may not be said, however, for some smaller companies or those less financially stable. In those cases, such a burden could put them out of business.

Substantial simplification of the sales tax systems will make it much easier for the states to administer and enforce the tax, and will make it much easier for sellers to comply with tax collection requirements.

GUIDELINES FOR SIMPLIFICATION AND UNIFORMITY

DMA believes that simplification and uniformity must be at a level that eliminates undue and discriminatory burdens on interstate commerce. The ITFC has developed draft Federal legislation that it believes would encourage the states to simplify and unify their sales and use tax systems so as to eliminate undue burdens on interstate commerce. The DMA is fully supportive of the ITFC's draft legislation. Some of the specific items in that draft that we believe are crucial to achieving such a goal include:

1. A centralized, one-stop, multi-state registration system for sellers.
2. Uniform definitions for goods or services that could be included in the tax base.
3. Uniform and simple rules for attributing transactions to particular taxing jurisdictions.
4. Uniform rules for the designation and identification of purchasers and transactions exempt from sales and use taxes, including a database of all exempt entities and a rule ensuring that reliance on such a database shall immunize sellers from liability for both under-collection and over-collection of tax.
5. Uniform procedures for the certification of software upon which sellers may rely to determine applicable sales and use tax rates and taxability, and immunity from liability for under-collection and over-collection of tax for sellers who rely on such software.
6. Uniform bad debt rules.
7. Uniform tax returns, remittance forms, and filing and remittance dates.
8. Uniform electronic filing and remittance methods.
9. State administration of all sales and use taxes in such state.
10. Uniform audit procedures, including a provision giving a seller the option to be subject to no more than a single audit per year using those procedures; provided that if the seller does not comply with the procedures to elect a single audit, any state can conduct an audit using those procedures. If elected, however, the single audit binds other states.
11. Reasonable compensation for tax collection by all sellers.
12. Exemption from use tax collection requirements for remote sellers falling below a specified de minimis threshold of less than $5,000,000 in prior-year gross annual sales, or less than $100,000 in any state during that prior-year. This exemption would not, however, operate to exempt a seller with less than $5,000,000 in prior-year gross annual sales for any obligation to collect and remit sales or use taxes imposed by the state in which that seller is located.
13. Appropriate protections for consumer privacy.
14. A single, uniform statewide sales and use tax rate and base on all transactions on which a sales or use tax is imposed.
15. For those states that impose a sales or use tax on digital products, an origin state default rule, for transactions where the location of the customer is not disclosed during the transaction, that permits the seller to rely upon information given by the customer during the transaction.
16. Appropriate bright-line nexus standards for business activity tax nexus purposes that limit business activity tax nexus to sellers that lease or own substantial tangible personal property, or have a number of employees or actual agents, in the taxing jurisdiction for more than 30 days during the taxable year.
17. Uniform dates, not to exceed two (2) in any calendar year, on which changes to sales and use tax rates may become effective, and a requirement that a state give at least 120 days' notice before any change in its sales or use tax rate becomes effective.
18. Allows the Untied States Court of Federal Claims to resolve conflicts that arise with regard to interpretation of similar sales and use tax provisions of the different states.
19. Such other features that will achieve a simplified and uniform sales and use tax system.

Of these 19 principles of simplification, however, two that are among the most important to the business community are the two that state and local governments have opposed most vigorously: One sales and use tax rate and base per state, and nexus standards for business activity taxes. A third very important principle, uniform definitions for goods and services, also seems to be a very difficult pill for state and local governments to swallow.

Two bills have been introduced in the Senate which would establish certain simplification parameters. S. 288, introduced by Sen. Ron Wyden and Sen. Patrick Leahy, and S. 512, introduced by Sen. Byron Dorgan. We are pleased that S. 288 contains virtually all of the simplification parameters contained in the ITFC's draft legislation. DMA fully supports S. 288. The level of simplification called for in S.

512, on the other hand, is inadequate and would result in intolerable burdens being placed on remote sellers.

ONE RATE AND ONE BASE PER STATE

There are more than 7,600 different sales tax jurisdictions in the United States today, each with its own tax rate, and many with their own tax base and rules and regulations. I should also note that in 1967, when the Supreme Court ruled in *National Bellas Hess* that it was an unconstitutional burden on interstate commerce to require sales tax collection in states where the seller did not have a physical presence, there were "only" 2,300 jurisdictions to deal with. This proliferation of taxing jurisdictions is symbolic of the ever-increasing complexity of the existing sales and use tax systems.

In the State of Texas alone there are 1,109 separate city tax rates and 119 county tax rates. In addition, there are 67 "special" tax jurisdictions, ranging from crime control districts to library districts; 27 of these special jurisdictions have geographical boundaries that do not correspond to any city or county boundary. When combined with the state rate, this results in 1,296 different taxing jurisdictions in the State of Texas.[1]

Is it fair to require a direct marketer with presence only in Montana to know which combination of these 1,296 rates applies to every item of merchandise it sends to a customer in Texas, and then to collect and remit the proper amount of tax to the Texas authorities, when that same direct marketer is not required to collect any sales tax on behalf of its home state of Montana[2]? Add to this the fact that there is a zero margin of error for the seller: If the seller under-collects the tax from its customer, the seller must pay the tax out of its pocket and is subject to interest and penalties by the taxing authorities. If the seller over-collects the tax, it is subject to class action law suits from its customers, as well as consumer fraud actions from state attorneys general. This puts the seller in an untenable position.

The states will argue that this problem can be fixed by using software that calculates the applicable sales tax rate by ZIP Code. We submit that this is not an acceptable solution. There are hundreds of five digit ZIP Codes across the country in which there are multiple taxing jurisdictions; moreover, there are scores of nine digit ZIP Codes in which there is more than one taxing jurisdiction. Thus, even if software existed that could provide an accurate nine digit ZIP Code for every order placed with a remote seller, the seller still might not be able to accurately collect the proper amount of sales tax.

It should also be noted that none of the proposed "software solutions" will alleviate the problems faced by sellers whose customers pay by check.

The states have suggested alternatives that would use the Census Bureau's "FIPS" Code, or would create a unique 10-character coding scheme for each separate taxing jurisdiction.[3] None of this very sophisticated technology exists today. However, under the best of circumstances, forcing remote sellers to collect tax for 7,600 different taxing jurisdictions will saddle interstate commerce with substantial burdens. The DMA believes that Congress should do everything in its power to eliminate undue burdens on this vital segment of America's economy.

In 1999, the National Tax Association ("NTA") conducted a Communications and Electronic Commerce Tax Project, the precursor to the ACEC, which included all the major state and local government organizations and electronic commerce industry trade associations. **The only tax reform measure to receive unanimous agreement from the Project's participants was "There should be one rate per state which would apply to all commerce involving goods or services that are taxable in that state."**

S. 512 recommends that there be one statewide "average" tax rate per state for remote commerce only, and that in-state businesses continue to collect all of the local jurisdictions' taxes. The NTA Project participants considered, and rejected, this proposal. The DMA agrees that such a proposal is ill-advised for the following reasons:

The DMA strongly advocates "channel neutrality" in the treatment of commerce. To achieve channel neutrality, and to avoid favoring one business medium over another, the sales tax rate applicable to a particular item must be the same regardless

[1] Although Texas was used for illustration purposes here, there are several states in which the burdens imposed by the local taxing jurisdictions are significantly greater than in Texas.

[2] Montana is one of five states in the country that does not have a sales tax. The others are Alaska, Delaware, New Hampshire and Oregon.

[3] For example, a remote seller sending merchandise to a customer who lives in the Dripping Springs Community Library District in Texas would need to know that the customer lives in Tax Jurisdiction Number 48DLI21424.

of whether the purchase was made from an Internet vendor or from an in-state brick and mortar store.

The ITFC also strongly believes that there should only be one tax base per state. Allowing local jurisdictions within a state to separately determine the taxability of items sold in, or shipped to, their jurisdictions adds immeasurable confusion and complexity. If the State of Colorado exempts widgets from sales tax, the City of Denver should not be allowed to impose a sales or use tax on that same widget.

Congress has a duty under the Commerce Clause to facilitate the flow of commerce among the states. Incorporated in this duty is Congress' responsibility to limit the imposition of barriers to the free flow of commerce. Insisting that there be no more than one tax rate and one tax base per state, for **all** types of commerce, before requiring remote sellers to collect sales tax in states where they lack a physical presence is wholly consistent with Congress' duty under the Commerce Clause.

BUSINESS ACTIVITY TAX NEXUS

The ability of a jurisdiction to impose a tax should be governed by one fundamental principle: A government has the right to impose economic and administrative burdens only on taxpayers that receive meaningful benefits or protections from that government.

In the context of business activity taxes[4], this guiding principle means that businesses that are not physically present in a jurisdiction, and are therefore not receiving significant tangible benefits or protections from the jurisdiction, should not be required to pay a business activity tax to that jurisdiction.

In its Commerce Clause jurisprudence, the Supreme Court has ruled that a business must have "substantial nexus" in a state before a state can constitutionally subject that business to its taxing power. For purposes of requiring a business to collect a state's sales and use tax, the Supreme Court has ruled that substantial nexus requires "physical presence" in the state.

Although the Supreme Court has not had occasion to address the requisite level of nexus for a state to impose a business activity tax, several state courts have addressed the issue. Many of these state courts have affirmed that the nexus standard for business activity taxes can be no less than the "physical presence" standard for collection of sales and use taxes. For example, one state court has held that the retention of credit cards by an out-of-state credit card issuer was insufficient to give the issuer physical presence for state income tax purposes. Unfortunately, courts in some states have reached the opposite conclusion.

Litigation and uncertainty in this area continue to proliferate. If remote sellers are required to begin collecting and remitting sales tax in every state, then those states will have a road map by which to aggressively pursue these same sellers for business activity taxes. Many small and medium-sized sellers lack the resources to challenge spurious claims for state income taxes.

If Congress is going to exercise its authority under the Commerce Clause to require remote sellers to collect sales tax in states where they have no physical presence, then Congress should, at the same time, protect those sellers from being subjected to business activity taxes in those same states. The manner in which to provide this protection to business, and to put and end to the litigation and uncertainty, is for Congress to enact a bright line nexus standard that requires physical presence in a state before a company can be subjected to a state's business activity tax. Sen. Judd Gregg and Sen. Herb Kohl have introduced a bill, S. 664, that appropriately addresses this issue.

ALL SELLERS SHOULD RECEIVE A REASONABLE COLLECTION ALLOWANCE

We believe that all sellers should receive a reasonable collection allowance to compensate them for the costs they incur in collecting sales tax.

Obviously, the more simplification measures that are enacted, the more the collection costs incurred by sellers will be reduced, thus reducing the amount of collection allowance that will be required.

Studies have shown that the average cost to collect sales tax exceeds 3% of the amount of tax collected. Of the 45 states with a sales tax, however, only seven provide for an uncapped collection allowance of greater than 1%. For a company like Federated, this amounts to tens of millions of dollars a year in expenses we incur to serve as a tax collector for the states. This number will clearly grow if we are

[4] "Business activity tax" refers to tax imposed directly on businesses and not generally passed directly on to consumers. These include corporate income taxes, franchise taxes, single business taxes, capital stock taxes, net worth taxes, gross receipts taxes, use taxes and business and occupational taxes.

forced to collect tax on behalf of every state in the country. For smaller businesses, and for those with tight budgets, the unreimbursed cost of collecting sales tax is yet one more large straw on the camel's back. In today's economic times, it could be the fatal straw for many companies.

Several members of the business community and representatives from certain state and local government organizations are in the preliminary stages of jointly commissioning a new, independent study to determine the cost of collecting sales tax. Such a study should prove very helpful to Congress in determining the amount of collection allowance to which sellers are entitled.

We are pleased that both S. 288 and S. 512 recognize the need for such a collection allowance.

CONGRESS MUST PROVIDE THE FRAMEWORK FOR SIMPLIFICATION

The Commerce Clause vests in Congress the authority to regulate interstate commerce, and to guard against interference with interstate commerce. This is a serious responsibility that Congress should not abdicate to the states.

For this reason, DMA believes it is incumbent upon Congress to (1) establish the parameters of simplification and uniformity that must be enacted before states are given the right to require remote sellers to collect their tax, and (2) review and evaluate the measures which the states enact—**before** granting them extended tax collection authority—to ensure that the states actually have met the Congressionally mandated standards. The failure of S. 512 to call for affirmative Congressional review of the states' simplification efforts prior to approving the compact amounts to giving the foxes the keys to the hen house.

The states have begun efforts to simplify their sales tax systems. Beginning in March, 2000, an ever-growing number of state tax administrators has been working on the Streamlined Sales Tax Project ("SSTP")[5]. The SSTP was formed to develop measures to design, test and implement a sales and use tax system that radically simplifies sales and use taxes.

The ultimate goal of the Project is to develop a simplified sales tax system under which remote sellers without a presence in a state will voluntarily agree to collect sales tax on their sales into that state. In December, 2000, the SSTP released a model act and model agreement that it encouraged its member states to adopt.

The various state tax administrators who have been involved in the Project have worked tirelessly to accomplish their goal. They have included in their work product some of the important tax simplification standards that we believe are essential. Moreover, the SSTP proposals include elements of tax simplification that will be beneficial to brick and mortar sellers in collecting the tax in the states where they do business. However, many of the tax simplification provisions the SSTP has proposed are not even designed to become effective until 2006.

Before Congress authorizes the states to require remote sellers to collect tax in states where they lack a physical presence, the sales and use tax laws must be **substantially** simplified and made more uniform. The sales tax system developed by the SSTP, however, falls into the category of "simplification light." While it alleviates some burdens on all sellers, it would nonetheless result in undue burdens on interstate commerce if all sellers were required to collect in every state under this system.

Some of the particular shortfalls of the SSTP proposal include: (1) failure to require only one tax rate per state[6], (2) failure to call for business activity tax nexus standards, and (3) failure to provide simple definitions for items like "clothing." Moreover, many of the simplification provisions in the SSTP model do not even become effective until 2006.

In January, 2001, the National Conference of State Legislatures ("NCSL") met to discuss the legislation proposed by the SSTP. The NCSL was unhappy with several provisions in the SSTP's final proposals, so it made several significant modifications and created its own version of a model act and agreement. In particular, the NCSL version does not call for one tax base per state, and eliminated virtually **all** of the common definitions included in the SSTP model.

If the SSTP's proposal represented a first step toward the kind of simplification the business community believes could lead to a reduction in compliance burdens, the NCSL's proposal represents a step backwards.

[5] On behalf of the DMA, I have attended every SSTP meeting that has been open to the public. The DMA plans to continue working with the SSTP, throughout the duration of its existence, to try to find ways to simplify the existing sales tax systems.

[6] The SSTP calls for one tax base per state beginning in 2006.

The stated purpose for the NCSL's actions was to be able to have model legislation that would be likely to pass in many state legislatures this year. In our view, the goal should not be to propose legislation that will pass just for the sake of passing. The goal must be to achieve simplification and uniformity that will substantially reduce, not merely maintain, the current undue burdens on interstate commerce.

The result is that there are now competing versions of sales tax simplification in the states. According to the SSTP's web site, as of July 13, 2001, seven[7] states have passed some form of the SSTP's model legislation, six states have passed the NCSL version, and three states passed some hybrid version of legislation. (A printout of this portion of the SSTP's web site is attached as Exhibit A.)

For a topic in which the goal is tax uniformity, this smacks of chaos. The DMA believes that Congress should establish clear criteria that will enable states to direct their efforts toward a uniform simplification plan that works for all sellers.

CONGRESS SHOULD EXTEND THE MORATORIUM AND BAN TAXES ON INTERNET ACCESS

The moratorium contained in the Internet Tax Freedom Act on multiple and discriminatory taxes on electronic commerce should be extended, and taxes on Internet access should be permanently banned.

The purposes of the moratorium were to (1) ensure that the rules that apply to other forms of remote commerce also applied to electronic commerce, and (2) allow time for the ACEC to study ways to simplify the current complex state sales and use tax systems. The Internet Tax Freedom Act has never prevented the states from collecting sales and use tax otherwise due on goods and services purchased over the Internet.

Allowing the moratorium to expire would send a signal to the states that it is now permissible for them to treat electronic commerce differently from transactions using other channels. Extending the moratorium on discriminatory taxes thus is essential to ensuring neutral tax treatment for electronic commerce going forward. To the extent that state and local government groups oppose the moratorium suggests that they are poised to assert that the nexus rules that apply to mail order transactions do not apply to Internet transactions. If this is not the position of the state and local governments, then they have nothing to fear from an extension of the moratorium.

The DMA also supports a permanent ban on sales tax on Internet access charges. A majority of the ACEC recommended a similar ban.

The Internet has been a tremendous growth engine for our economy. Access to this very important medium should not be burdened with taxes. Moreover, imposition of sales taxes on Internet access will have a deterrent effect on the ability of lower income families to use the Internet. Elimination of these taxes will help to close the so-called digital divide.

THE SKY IS NOT FALLING

During the past three years, many of my fellow retailers, as well as representatives from the shopping center industry, state and local government and others, predicted that there would be an explosive growth of electronic commerce, and that it would be detrimental to their interests. Remarkably, they argued to the ACEC and to Congress that if electronic commerce were not saddled with complex tax collection burdens, it could spell the end of traditional brick and mortar retail as we know it today.

Although I have a lot of respect and admiration for my fellow retailers, this is one instance where they were wrong: The sky is not falling on brick and mortar retailers. Many of the once feared "dot-com's" have become "dot-bombs." The demise of E-Toys is just one example of many recent failures in the electronic commerce world. Our weakening economy is having a profound negative impact on the fledgling electronic commerce sector.

Allowing state and local governments to unleash economic anarchy in the current environment could have long term, devastating effects on the economy, business and employment. We believe it is critical for Congress to protect this vital segment of our economy from potentially fatal tax burdens by extending the moratorium against discriminatory taxes, and by demanding that the states significantly simplify their sales tax systems before being allowed to require remote sellers to collect their tax.

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[7] Of these seven, only two, Minnesota and Wyoming, adopted the SSTP Agreement, which is the piece that contains actual tax simplification. The remaining five only passed the SSTP Act, which merely manifests an intent to move forward on the project at some point in the future.

THE ALLEGED KIOSK "LOOPHOLE"

Several members of Congress have been told that sales tax collection can be avoided if an Internet affiliate of a brick and mortar store places a kiosk in the store, at which customers can place orders for merchandise. This is simply not true.

Under existing law, a seller that has physical presence or "nexus" in a state, through property, employees, or agents, is required to collect sales tax on all of its sales made into that state. The presence of a remote seller's kiosk in a state, whether located in a store with a similar name or elsewhere, would constitute nexus in the state for the remote seller, thus legally obligating that remote seller to collect applicable tax on all its sales to customers in that state. The fact that the kiosk is located in a retail store is also likely to cause that store to be the agent of the remote seller, thus providing an additional basis for nexus.

To the extent there are remote sellers trying to take advantage of this perceived "loophole," the remedy is for the state revenue authorities to enforce existing law. It does not require an overturning of the Supreme Court's decision in *Quill*, or any act of Congress or the state legislatures.

COMPARISONS TO THE FEDERAL AIRLINE TICKET TAX

Some people have compared collecting sales and use tax on remote sales to collecting the Federal airline ticket tax. There is no legitimate basis for such a comparison. The Federal airline ticket tax is a single tax rate on a single commodity collected for one jurisdiction: the Federal government. Requiring remote sellers to collect sales tax under the current environment would involve collecting 7,600 tax rates on behalf of 7,600 different jurisdiction on millions of different products and services.

CONCLUSION

Congress should act now to extend the moratorium on new and discriminatory taxes on the Internet and to permanently ban taxes on Internet access charges. Granting the states the power to require remote sellers to collect sales tax should not be a condition precedent to extending these moratoria.

However, if Congress is going to address the sales tax issue, it must be cognizant of its duties under the Commerce Clause of the Constitution. Any grant of authority to the states to require remote sellers to collect their sales and use tax must insure that it does not interfere with, or place undue or discriminatory burdens on, interstate commerce.

To achieve this result, Congress must establish the parameters under which the state sales and use tax systems should be substantially simplified and made more uniform. Congress must then evaluate the states' efforts to be sure that the requisite level of simplification and uniformity has been attained. Only then should Congress grant the states the broad tax collection powers they now seek.

I sincerely appreciate the opportunity to testify before you today, and I will be happy to answer any questions.

STATUS OF STATE EFFORTS ON STREAMLINED SALES TAX PROJECT
(as of 07/13/01)

Indicates SSTP Version of Legislation; Indicates NCSL Version of Legislation; Indicates Modified Act; Indicates Legislative Enactment; Indicates No Sales Tax State

STATE	LEG. ADJ.? (Y/N)	LEGISLATION, DATE OF INTRODUCTION, AND SPONSOR	LEGISLATIVE STATUS	REVENUE DEPARTMENT CONTACT	OTHER INFORMATION
Alabama	N (5/14)	HB 472 and SB 321 (SSTP Act only) introduced on 02/19/01 by Rep. Lindsey and Sen. Sanders.	Both bills have been referred to the tax-writing committees. No hearings have been scheduled as legislature is currently in Special Session.		
Alaska	N (5/8)				
Arizona	N (4/17)				
Arkansas	Y	HB 2170 (SSTP Act only) introduced on 02/27/01 by Rep. Hunt and Sen. Hill	HB2170 signed into law by Gov. Huckabee on 04/04/01.	Mary Cameron 501-682-7030	
California	N (9/14)				
Colorado	N (5/9)				
Connecticut	N (6/6)				
Delaware		NO SALES TAX			
Florida	N (5/4)	SB1638 and HB 1329 introduced week of 03/13/01.	HB 21 (incorporating provisions from SB 1638 and HB 1329) signed into law by Gov. Bush on 06/13/01.		
Georgia	Y				
Hawaii	N (5/1)				
Idaho	Y				
Illinois	N (5/25)	SB164—(NCSL Act and Agreement) introduced by Sen. Rauschenberger	SB 164 approved by Senate on 04/03/01; approved by the House on 05/09; awaits action by Gov. Ryan.		
Indiana	N (4/29)	SB 269 (NCSL Act only) introduced on 01/10/01 by Sen. Borst	SB 269 signed into law by Gov. O'Bannon on 05/02/01.	Jim Turner 317-232-1862	
Iowa	Y	SF409 (NCSL Act only) introduced 03/08/01 by Sen. McLaren	Legislature adjourned absent consideration of SF409.	Carl Castelda 515-281-5990	Rev. Dept. officials have held a number of meetings with stakeholder groups, i.e., state retail federation, taxpayers association, local government groups; task force formed by Iowa Taxpayers Assn. to study proposal.

STATE	LEG. ADJ.? (Y/N)	LEGISLATION, DATE OF INTRODUCTION, AND SPONSOR	LEGISLATIVE STATUS	REVENUE DEPARTMENT CONTACT	OTHER INFORMATION
Kansas	Y (5/08)	SB 252 (Modified Act only) introduced upon recommendation of the Revenue Department and SSTP Oversight Committee.	SB 252 approved on February 14, 2001 by the full Senate; sent to the House Tax Committee for consideration; session adjourned 05/08 with no further action.	Richard Cram	
Kentucky	Y	HR 367 (SSTP Act) introduced on 02/20/01 by Rep. Moberly.	HB 367 signed into law by Gov. Patton on 03/13/01.	Charlotte Quarles 502-564-6843	
Louisiana	N (6/18)	HB 994 (SSTP Act) introduced on 03/26/01 by Rep. Hammett	HB 994 signed by Gov. Foster on 05/29/01.	Raymond Tangney 225-925-6047	
Maine	N (6/20)				
Maryland	Y	HB 1390 (NCSL Act only) introduced on 02/23/01.	HB 1390 approved by House on 03/18; approved by Senate on 04/04; signed by Gov. Glendening on 05/18/01.		
Massachusetts	N (Full Year)	H1523 (SSTP Act only) introduced on 01/03/01 by Rep. Travis	Referred to the Committee on Taxation; no hearings scheduled		
Michigan	N (Full Year)	SB433 (Modified Act only) introduced on 04/26/01 by Sen. Emmons.	SB433 approved by Senate on 05/17/01.	Nancy Taylor 517-241-2734	Rev. Dept. officials feel legislators still need more education on issue; stakeholder meetings have been held with state retailers.
Minnesota	N (5/21)	S1325 by Sen. Rest H1416 by Rep. Abrahms introduced on 03/08/01 (SSTP Act and Agreement)	Legislation approved as a part of H.F. 1 on 06/28/01; signed by Gov. Ventura on 06/30/01.	Jenny Engh 651-226-9640	Gov. Ventura held press conference on date of introduction stressing the importance of simplification; Rev. Dept. will be using media and industry focus groups to publicize efforts; have prepared talking points that will be made available to other states.
Mississippi	Y				
Missouri	Y (5/30)	HB 803 (NCSL Act) introduced on 02/15/01 by Reps. Bray and Kennedy	Substitute bill (SB 460) approved by House on 05/14.		
Montana		NO SALES TAX			
Nebraska	N (6/1)	LB172 (SSTP Act only) introduced on 01/19/01 by the Revenue Committee.	Signed by Gov. Johanns on 05/31/01.	Mary Jane Egr 402-471-5604	LB172 made two changes to the Act—gives the Governor authority to enter into Agreement and requires ratification of Agreement by the Legislature before state can participate.
Nevada	N (6/4)	AB455 (modified Act only) introduced on 03/19/01 by Asbmn. Goldwater, Cegavske & Arberry and Sens. McGinness, Coffin and Schneider.	Gov. Guinn signed AB 455 into law on 06/05/01.	Woody Thorne 775-687-5774	The agreement will fall under the jurisdiction of the State's referendum law. Any changes to definitions, exemptions, etc. will require approval of the voters before taking effect. Thus, a major voter education effort will be required.

STATE	LEG. ADJ.? (Y/N)	LEGISLATION, DATE OF INTRODUCTION, AND SPONSOR	LEGISLATIVE STATUS	REVENUE DEPARTMENT CONTACT	OTHER INFORMATION
New Hampshire		NO SALES TAX			
New Jersey	N (Full Year)				
New Mexico	Y				
New York	N (Full Year)				
North Carolina	N (7/1)	SB 144 (SSTP Act and Agreement) introduced on 02/14/01 by Sen. Kerr.	SB 144 approved by Senate on 05/31/01; legislation now pending before House Finance Committee.	Sabra Faires 919-715-0237	Rev. Dept. holding meetings with stakeholder groups to provide education and gain support.
North Dakota	N (4/15)	SB 2455 (NCSL Act) introduced on 02/08/01 by Sen. Cook and Sen. Nething	SB 2455 signed by Gov. Hoeven on 04/23/01.	Gary Anderson 701-328-3471 Myles Vosberg 701-328-3011	
Ohio	N (Full Year)	SB143 (NCSL Act) introduced by Sen. Blessing on 06/28/01		Bill Marshall 614-466-4810	
Oklahoma	N (5/25)	SB 703 (NCSL Act) introduced by Sen. Monson	SB 589 signed by Gov. Keating on 05/24/01.		
Oregon		NO SALES TAX			
Pennsylvania	N (Full Year)	HB 900 (NCSL Act) introduced on 03/14/01 by Rep. Steil.	HB 900 referred to Intergovernmental Affairs Committee.	Tom Armstrong 717-697-1959 or Tom Kimmett 717-787-1382	
Rhode Island	N (6/30)	HB 6494 introduced on 06/06/01.	HB 6494 signed by Gov. Almond on 07/10/01.	Bob Geruso 401-222-3050	
South Carolina	N (6/7)		Legislation is being drafted and discussed, but introduction date not determined	Meredith Cleland	
South Dakota	Y	SB 166 (SSTP Study Proposal) passed 03/01/01	Governor signed SB 166 on 03/05/01; Legislature forms Task Force to study impact on municipalities; report due in Dec. 2001.	Scott Peterson 605-773-3311	
Tennessee	N (5/31)	HB 1459 (NCSL Act) introduced on 02/14/01 by Rep. Kisber; SB 1722 (NCSL Act) introduced on 02/14/01 by Sen. Cooper.	HB 1459 signed by Gov. Sundquist on 05/30/01.	Jack Kopald 615-741-5884	
Texas	N (5/28)	HB 1845 (NCSL Act) introduced on 02/21/01 by Rep. Oliveira; SB 1184 introduced by Sen. Van de Putte on 04/15.	HB 1845 signed by Gov. Perry on 06/15/01.		Rev. Dept. officials holding ongoing meetings with stakeholder groups to gain support.
Utah	Y	SB 74 (modified Act) introduced by Sen. Hillyard.	SB 74 signed into law by Gov. Leavitt on 03/15/01.	Bruce Johnson 801-297-3901	
Vermont	Y (6/01)	H457 (SSTP Act only) introduced by Rep. Keenan on 03/01/01.	Legislation referred to Ways and Means Committee.	George Phillips 802-828-2532	
Virginia	Y				

STATE	LEG. ADJ.? (Y/N)	LEGISLATION, DATE OF INTRODUCTION, AND SPONSOR	LEGISLATIVE STATUS	REVENUE DEPARTMENT CONTACT	OTHER INFORMATION
Washington	N (4/22)				
West Virginia	N (4/14)	SCR 17 introduced to create an interim study committee to examine feasibility of Act.	05/07/01 Joint Committee on Gov. and Finance approved assigning SCR 17 to interim study committee.		
Wisconsin	N (Full Year)	AB317 and SB 152 introduced by Joint Committee on Information Policy. AB 317 introduced on 04/12/01; SB 152 introduced on 04/18/01.	Sb-152 and AB-317 approved by Joint Information Policy and Technology Committee on 05/09; sent to Senate and Assembly for consideration.	Diane Hardt 608-266-6796	Rev. Dept. continuing meetings with stakeholders; Rev. Dept. has put together talking points and information for insertion in business community newsletters—effort well received.
Wyoming	Y	HB259 (SSTP Act and Agreement) introduced on 01/23/01 by Rep. Hines and Sen. Peck	HR 259 signed into law by Gov. Geringer on 03/01/01; Act will have immediate effective date; conforming amendments in Agreement have an effective date of July 1, 2002.	Johnnie Burton/Dan Noble 307-777-5287	

RESPONSES TO QUESTIONS FROM SENATOR BREAUX

Question: Am I aware of any cases where a court has used a different standard allowing BAT taxes to be imposed on remote businesses who do not have a physical presence in the state?

Answer: In *Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E.2d 13 (S.C. Sp. Ct. 1993), the court held that an out-of-state company that granted its parent company a license to use trademarks and trade names was subject to South Carolina income tax on its royalty income, notwithstanding that the company did not have any physical presence in South Carolina. The court concluded that the situs of intangible property in the state alone was sufficient to create nexus for business activity tax purposes.

We believe the holding in the *Geoffrey* case is constitutionally flawed. When faced with similar issues, numerous courts in other states have refused to apply, and/or have been critical of, the *Geoffrey* holding and have instead ruled that a taxpayer must have a **physical presence** in the state before it can be subjected to business activity taxes. (*See, e.g., J.C. Penney Nat'l Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999), *appeal den*. (Tenn. 2000), *cert. den.* 531 U.S. 927, 212 S.Ct. 305 (2000), *Rylander v. Bandag Licensing Corp*., 18 S.@.3d 296 (Tex. App. 2000), *9.4 Percent Manufactured Housing Service v. Dept. of Revenue*, Docket No. Corp. Inc. 95–162 (Ala. Admin. Law Div. Dec. 11, 1995), and *MeritCare Hospital v. Comm. of Revenue*, No. C2–94–12818 (D.C. Minn. Sept. 22, 1995).)

While these rulings upheld a physical presence standard, all of these cases illustrate the aggressive stance being taken by state revenue departments to undermine a physical presence standard. This litigation should not have been necessary, and was very costly to the companies involved. Fortunately, these companies had the resources needed to vindicate their rights.

Question: How do you recommend Congress address this issue?

Answer: Congress should enact legislation that codifies the existing *Quill* standard and clarifies that before a state can subject a business to its business activity taxes, that business must have a substantial physical presence in the state. A state should not be permitted to impose its business activity taxes on companies that do not have a substantial physical presence in that state.

Such legislation should contain a bright line standard that would be applied to determine if a business has substantial physical presence in a state. I note that "bright line standards" are contained in S. 664 and H.R. 2526.

Absent Congressional action, many state revenue departments will continue their pattern of aggressively trying to impose novel theories of nexus on out-of-state companies. Litigation and uncertainty will abound. In the current environment, many smaller companies cannot afford the significant legal fees that are required to defend against these spurious tax assessments, and have no choice but to forgo their constitutional rights and succumb to the whim of the tax collectors.

Question: Why is [the language upon which we were asked to comment] not reasonable?

Answer: We were very encouraged by Senator Breaux's comments at the hearing, as well as in posing these questions, that there should be a physical presence standard applied for business activity taxes. The proposed language, however, does not achieve this result. It is ambiguous at best, and will lead to continued uncertainly and litigation in this area.

The proposed language appears aimed at taking a neutral position with regard to business activity tax nexus. The proposed language would do nothing to prevent the current attempts by many states and local jurisdictions to expand their taxing power beyond current constitutional limitations.

Subsection (c) of the proposed language is very troubling. It provides that "Nothing in this Act shall be construed as . . . affecting the authority of States to impose business activity taxes against a person that lacks physical presence in the State." This language has an implicit assumption that there currently exists authority for a state to impose business activity taxes against a person that does not have physical presence in the state. No such authority exists under current law.

Congress must make it clear that substantial physical presence is a prerequisite to imposition of business activity taxes.

If states are given the authority to require remote sellers to collect their sales tax, the sales tax returns that the remote sellers will be required to file will give the states a road map by which they can attempt to impose business activity taxes on these remote sellers. This is not mere speculation. There have been several instances in recent years where states attempted to impose business activity taxes on remote sellers that volunteered to collect sales tax for a state in which they do not have a physical presence. These states claim that the amount of sales reported on the sales tax returns constitutes gross income attributable to their states. They then send letters to these out-of-state businesses demanding that they file business activity tax returns.

We are very concerned that this practice will become commonplace if all remote sellers are required to collect and remit sales tax for every state. We are also concerned that these claims by multiple jurisdictions increase the likelihood that businesses will be subjected to double taxation.

The government of India is considering changing its income tax laws to impose tax on e-commerce income earned by foreign companies that do not have a physical presence in India. This would be a departure from OECD guidelines, and would have significant consequences for American businesses that sell products on a web site that can be accessed in India. If India begins to impose its income tax on foreign businesses without a physical presence in India, what will stop other countries from doing the same?

I have to believe that the United States government will try to discourage India (and other countries) from adopting such a change in its tax laws. It seems, however, that our ability to stop other countries from imposing their business activity taxes on foreign businesses that lack a physical presence in that country will be severely diminished if Congress does not act now to prevent state governments from imposing their business activity taxes on companies that do not have a substantial physical presence in the state.

I hope that these answers are helpful to Senator Breaux and the other members of the Finance Committee. If you have additional questions or if I can be of any further assistance to the Committee, please contact me.

PREPARED STATEMENT OF STEVEN RAUCHENBERGER

Chairman Baucus, Ranking Member Grassley and members of the Finance Committee, I appreciate the invitation to testify before you today on behalf of the National Conference of State Legislatures. The National Conference of State Legislatures is a bi-partisan organization representing every state legislator from all fifty states and our nation's commonwealths, territories, possessions and the District of Columbia.

I am pleased to have the opportunity to speak to you about state and local taxation of electronic commerce, particularly, the ability of state and local governments to collect the sales and use tax presently owed on transactions which occur on the Internet through remote sellers. Let me make clear, state legislators are not advocating any new taxes on electronic commerce. We desire, however, to create a streamlined sales and use tax collection system to more efficiently collect the transactional taxes legally imposed by our states.

Electronic Commerce and the States

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

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

It is important to note for the record that no state has enacted any Internet specific taxes. In some states where a tax on Internet access was grandfathered by the Internet Tax Freedom Act of 1998, state legislatures have worked to repeal those taxes. For example, the state legislatures in Connecticut and Iowa have voted to do so.

With that said, we need to make clear that state legislatures are equally concerned about the impact that sales tax free electronic commerce transactions will have on state revenues and the unfair competitive burden it will have on small main street businesses, the life blood of many of our small towns and communities. We ask you to consider the words of one of the leading proponents of sales tax reform, Senator Richard Finan, President of the Ohio Senate, in a speech he made to state legislators from across the country, "I am sure many of you each year are asked to help sponsor a little league team or take an ad in a high school yearbook somewhere in your district. Your Main Street retailer does that everyday, every year." Senator Finan continued, "Will AOL-Time Warner, Amazon.com, Microsoft, or Cisco sponsor your son's or daughter's little league team or support your local Boy and Girl Scout troops? I think you know the answer."

Furthermore, the general sales and use tax is our primary consumption tax. This tax provides about one-third of state revenue—over $150 billion in 1998—with most of the funds used to finance K–12 education. Of every dollar spent on education in this country, 93 cents come from state and local revenues, and only 7 cents comes from the Federal government.

Sales Tax Popularity

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

Voters all over the country have approved local sales taxes to pay for sports stadiums, added police protection, land acquisition for open space, and transportation improvements. The taxpayers of the state of Michigan overwhelmingly voted to use the sales tax as opposed to property tax as the major source of revenue for education and then the next year, they voted to increase the sales tax.

As you know, the sales tax is imposed on the customer, not the seller. Sellers collect the tax on behalf of state and local governments and pass this money along to them. Some have argued that requiring remote sellers to collect the state and local sales tax amounts to taxation without representation. This is a specious argument because it is the consumer that pays the sales and use tax to his or her state, not the seller. Many states pay merchants for this service, typically allowing them to keep between 1 and 3 percent of what they collect to offset the administrative cost.

Sales Tax and Electronic Commerce

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

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

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

According to the Center for Business and Economic Research at the University of Tennessee, in 2003 alone states will lose $ 11 billion in sales tax revenue due to the emergence and growth of electronic commerce. This amount will continue to grow each year. The following is a list of the revenue losses for those states which have a member serving on this Committee:

State	2003 (Electronic Commerce Alone) (Millions of dollars)
Arizona	$183
Arkansas	$101
Florida	$754
Illinois	$454
Iowa	$88
Louisiana	$244
Maine	$42
Massachusetts	$163
Mississippi	$111
New Jersey	$274
New Mexico	$103
North Dakota	$21
Oklahoma	$160
South Dakota	$31
Tennessee	$293
Utah	$85
Vermont	$17
West Virginia	$56

As state legislators, we recognize that we have been part of this problem. We have created a confusing, administratively burdensome tax system with very little regard for the compliance burden placed on multi-state businesses. In 1999, NCSL passed a resolution, written by NCSL's Task Force on State and Local Taxation of Telecommunications and Electronic Commerce, that acknowledged that states need to simplify their sales and use taxes and telecommunications taxes for the 21st Century. We recognize that we have been a key part of the problem—and we also are the solution.

In our resolution, we formulated a set of seven principles that we used to develop a proposal for simplifying and streamlining state and local sales and use tax collection systems. The overriding theme of those seven principles is competitive neutrality. State legislators from across the country unanimously approved this resolution that declared, "state and local tax systems should treat transactions involving goods and services, including telecommunications and electronic commerce, in a competitively neutral manner." The resolution further stipulated, "that a simplified sales and use tax system that treats all transactions in a competitively neutral manner will strengthen and preserve the sales and use tax as vital state and local revenue sources and preserve state fiscal sovereignty."

Streamlined Sales Tax Project

In January of 2000, the NCSL Task Force drafted model legislation directing state revenue departments to join in multistate discussions to develop a simpler, uniform and fairer system of sales and use taxation, that removes the burden imposed on retailers, preserves state sovereignty and enhances the ability of U.S. firms to compete in the global economy. In only the second time in NCSL history, the NCSL Executive Committee approved the model legislation and sent it to the states for consideration in the 2000 legislative sessions. While drafting the model legislation, the Task Force members had felt that between five and ten states joining the multistate discussions would demonstrate a significant commitment on behalf of the states to simplify the admittedly complex sales and use tax systems from state to state. By the end of 2000, 32 states had joined what is now called the Streamlined Sales Tax Project (SSTP) through either legislative or executive action.

The Streamlined Sales Tax Project has met almost monthly since February of 2000 working on recommendations to implement the key features of the Streamlined Sales Tax System. These key features are SIMPLIFICATION of sales and use tax laws and administration; the USE OF TECHNOLOGY for calculating, collecting, reporting and or paying the tax; and STATE ASSUMPTION of the COSTS of the system for remote sellers. Until Congress grants the states the authority to require collection of sales taxes on remote sales, the system will be voluntary to sellers.

The simplifications of a streamlined sales tax system are:

- Uniform state and local sales tax base;
- Uniform sourcing rule;
- Uniform procedures for exempt transactions;
- Uniform definitions;
- Uniform deduction for bad debts;
- Central, one-stop registration system;
- Limits on the frequency when rate changes may be made;
- Required advanced notice of changes;
- Remittance of tax to state level only, states to remit to the local governments.

Taken as a package, state and local groups believe that such a system will eliminate the undue burden on remote sellers who collect sales and use taxes, while at the same time providing positive reforms for all sellers.

We are pleased to report that these are the same simplifications that are embodied in S. 512, *The Internet Tax Moratorium and Equity Act*, sponsored by Senator Dorgan along with Senators Bennett, Breaux, Chafee, Cleland, Daschle, Durbin, Enzi, Graham, Hutchinson, Hutchison, Johnson, Lincoln, Nelson (Nebraska), Rockefeller, Thomas and Voinovich.

Simplification Process Moving Forward

In January of this year the Streamlined Sales Tax Project issued its recommendations in the form of a model act and an interstate agreement. The NCSL Task Force modified the SSTP act and agreement to provide an alternate measure for legislatures to consider that would allow for greater participation for elected policymakers in the next round of negotiations of the final terms of simplification requirements in the interstate agreement.

Some have portrayed the action by NCSL as a split with the SSTP. However, the changes made to the SSTP model act and agreement were only made to complement the decision making process as the simplification requirements are agreed upon. Let me make perfectly clear, states that acted on either version of the model act will come back to the same table to finalize the ground breaking work that has been done so far.

In a letter to state leaders, signed by the Executive Directors of the National Conference of State Legislatures, the National Governors' Association, the Federation of Tax Administrators and the Multistate Tax Commission, the national organizations made clear the following points:

- **"There is only one state and local sales and use tax simplification effort underway among the states, and there should continue to be only a single simplification effort.** That simplification effort should accommodate the participation of the largest number of states possible. The work of the SSTP and NCSL are complementary and differ only in the degree of simplification considered achievable in the short term."
- "Each state that passes legislation this year or next committing to development and implementation of a streamlined sales tax system should recognize all other states passing such legislation as equal partners in the continued development of the streamlined system, regardless of whether the measure enacted is based on the SSTP or NCSL version or is some hybrid of the two. The important point is that each state passing such legislation evidences the state's commitment to simplification and uniformity in administration of the sales tax."
- "Those states passing simplification legislation should be considered the 'governing states' for the simplification effort and have authority to finalize an interstate sales and use tax agreement. The governing states should use a one vote per state rule in their deliberations. The composition of the delegation from each state should be determined by the state."

As of July 26, 2001 sixteen states **(Arkansas, Florida, Indiana, Kentucky, Louisiana, Maryland, Minnesota, Nebraska, Nevada, North Dakota, Oklahoma, Rhode Island, Tennessee, Texas, Utah and Wyoming)** have enacted one version of the model act establishing intent to simplify based on the above mentioned principles of the Streamlined Sales Tax System and securing a vote as a "governing state" to finalize the last terms of the agreement. The legislation also has passed both Houses of the legislature in **Illinois and North Carolina** and awaits the signature of their governors. Action is still pending this year in **Michigan, Ohio, Pennsylvania, Massachusetts and Wisconsin.**

The NCSL, NGA, MTC and FTA will convene the representatives of the "governing states" for their inaugural meeting in late September or early October.

Overcoming seventy-five years of modifications to 46 different sales tax systems will not be an easy task, however, the progress that the states have made collectively over the past two years should make clear my colleagues' level of commitment to simplifying the sales and use tax system.

INTERNET TAX MORATORIUM

The current moratorium on Internet access taxes as established in the Internet Tax Freedom Act of 1998, will expire on October 21, 2001.

Today, we know Internet access generally refers to the $22.95 (+/-) consumers pay for their monthly access to the "net" through America Online, Mindspring, Microsoft and so on. However, as we witness the convergence of technologies and industry giants, what will Internet access mean in three years, or five years and so on? For example, telephony technology is quickly improving to allow consumers to actually make telephone calls and speak over the Internet. Thus, consumers may soon be able to make long distance or local calls through a function of their Internet service provider at no additional cost, other than the fee paid for Internet access. You can already download free service from such sites as "dialpad.com," or "Net2phone.com." Current state revenues will decline, as states will be unable to tax these long distance or even local telephone calls. This also would put telephone companies at a competitive disadvantage to Internet service providers.

As the industry mergers continue, consumers may soon be receiving their telephone, cable television and Internet service from the same vendor. The vendor will be able to bundle all these services for one price under the banner of Internet access, likewise for Internet service providers that merge with content providers of music or movies. Under the present definition of Internet access as contained in the Internet Tax Freedom Act of 1998, a permanent moratorium would force states and localities to find new revenue sources to make up for the loss from not being able to tax telephone, cable services and/or downloaded movies, music, books, magazines and so on. Therefore, any extension of the moratorium using the current definition of Internet access must be short term, no more than three to four years with the grandfather clause maintained.

The grandfather clause in the original Internet Tax Freedom Act of 1998 allowed those states presently collecting a tax on Internet access the ability to continue to do so. Presently, the states of Hawaii, New Hampshire, New Mexico, North Dakota, Ohio, South Dakota, Tennessee, Texas, Washington and Wisconsin would face a reduction in current revenues if the grandfather clause is repealed. Total loss in 2000 to the listed states would have been over $ 75 million. This loss combined with future revenue decreases from the prohibition on Internet access would lead the Congressional Budget Office to score a lengthy or permanent extension of the moratorium as an unfunded Federal mandate on state and local governments under the provisions of the Unfunded Mandates Relief Act of 1995.

S. 512 The Internet Tax Moratorium and Equity Act

The National Conference of State Legislatures acknowledges that states need congressional approval for the authority to require remote sellers to collect our states' sales and use taxes, though at the same time, we have serious concerns about congressional interference with state tax policy. **Therefore, we support S. 512, the Internet Tax Moratorium and Equity Act, as introduced by Senators Dorgan, Enzi, and 16 of your colleagues.** I am pleased to testify before this Committee, as five of you are sponsors of this legislation; Senators Graham, Lincoln, Breaux, Rockefeller, and Daschle.

NCSL supports Federal legislation that ensures that any sales and use tax simplification process would be developed and implemented on the state and local level and grant to those states the authority to require out of state sellers to collect and remit sales and use taxes. Preservation of state sovereignty is a cornerstone of our Federal system; S. 512 as introduced promises an important opportunity to secure our fiscal sovereignty.

With that said, however, I want to make clear that NCSL will oppose any Federal mandates that would bring to a halt the simplification process already moving forward in the states. *NCSL will oppose any congressional legislation or amendment that requires one sales tax rate per state for remote commerce, requires states to address non-sales tax telecommunications taxes at the same time that states are simplifying sales tax systems and/or restricts state nexus standards for business activity taxes.*

It is our understanding that there are ongoing discussions to try to reach a consensus on a bill that would appear to grant states collection authority but only after the states met a new list of proposed Federal mandates. Such new Federal mandates as one rate per state, restrictions on state business activity taxes and telecommunications taxes would reduce state revenues substantially more than any offset from uncollected sales and use taxes, thus dooming state simplification efforts.

I would briefly like to discuss the impact of a Federal mandate for one rate per state.

One sales and use tax rate per state.

A single rate—even if it only applies to remote sales—is unattainable in a dozen or more states and raises a host of problems.

- *First, it preserves a dual system for nexus and non-nexus merchants that will prevent states from simplifying the sales and use tax system for "clicks and mortar" retailers*. Sellers with physical stores and remote operations will face two sets of tax rates, frustrating efforts at simplification for all types of retailers. We believe that a competitive marketplace should decide business decisions and not tax policy. The Streamlined System being developed by the states would create a single system for all retailers. Businesses and technology companies tell us that the rate issue is the easiest one to overcome with technology. It is not necessary to mandate a single rate in a simplified system.
- *Second, the dual system will lead to continued litigation over nexus because different rates will be charged based upon the seller's nexus status*. The Streamlined Sales Tax System being developed by the states would make nexus irrelevant and treat all sellers the same.
- *Third, we anticipate that some state legislatures could not support a blended rate that would increase tax rates for some taxpayers*. The alternative choosing the lowest rate in the state—could cause powerful cities to oppose such a system. Businesses located in areas with high tax rates that now "self-report" use taxes would have incentives to buy from remote vendors.
- *Finally, a Federal mandate of one sales tax rate per state would prohibit states from participating where "bond covenants" exist*. As I mentioned earlier, a number of state and local governments have issued bonds for the construction of sports stadiums and arenas, land preservation and highway improvements, and have earmarked sales tax revenues to settle the bonds. Thus the sales tax revenues may be under a bond covenant to pay off a bond, and no action by a state legislature to alter the rate structure would be allowed under those covenants.

For the Committee's information, I would like to list some of the recent activity where bonds were issued for stadiums payable by receipts from the sales tax:

Ballpark at Arlington (MLB), Dallas/Fort Worth, **Texas**, $153 Million in bonds; BankOne Ballpark (MLB), Phoenix, **Arizona**, $270 Million in bonds; Raymond James Stadium (NFL), Tampa, **Florida**, $190 Million in bonds; Paul Brown Stadium (NFL), Cincinnati, **Ohio**, $452 Million in bonds; Great American Ballpark (MLB), Cincinnati, **Ohio**, $224 Million in bonds; Coors Field (MLB), Denver, **Colorado**, $161 Million in bonds; Invesco Field at Mile High (NFL), Denver, **Colorado**, $270 Million in bonds; Excel Energy Center (NHL), Minneapolis, **Minnesota**, $130 Million in bonds; Safeco Field (MLB), Seattle, **Washington**, $393 Million in bonds; New Seahawks stadium (NFL), Seattle, **Washington**, $323 Million in bonds; New Lambeau Field (NFL), Green Bay, **Wisconsin**, $169 Million in bonds; Miller Park, (MLB), Milwaukee, **Wisconsin**, $232 Million in bonds;

The National Conference of State Legislatures encourages you and your colleagues to do no harm this year to your state and local governments' efforts to streamline our sales and use tax collection systems. We would urge you to let the states proceed with the next phase of the Streamlined Sales Tax Project as envisioned in S. 512.

Thank you for this opportunity to discuss the state legislative viewpoint on state and local taxation of electronic commerce and telecommunications.

PREPARED STATEMENT OF FRANK SHAFROTH

Good morning, Mr. Chairman. I appreciate the opportunity to present testimony to the committee this morning with regard to issues relating to taxation and the Internet. The nation's Governors want to ensure the country will be competitive in a global economy in which the dominant source of social wealth is knowledge and information. Governors understand that the traditional state local structure of property, sales, and income taxes does not reflect the elimination of borders in this new borderless economy or the knowledge forces driving the national economy. The Governors recognize there must be structural changes for a new state-local tax structure that matches this information age. That will require the cooperation and insight of our national leaders in the private sector, academia, and public sector. They look forward to your leadership and support in making this a joint effort.

Governors understand that these changes must address:

- What should be taxed in the future as production and consumption become disconnected from the geography;
- How to create a fair, neutral tax system, one that does not discriminate for or against new technologies that improve productivity and enhance opportunity;
- How to address a growing, long-term structural gap between the investment needs of state and local governments—especially in education and health care by states—and current state revenues; and
- How to preserve state and local autonomy at a time when the networked economy pushes society toward uniform standards and common protocols.

Two years ago, the Governors, at their annual meeting in St. Louis, discussed whether to initiate work on a new state-local revenue system to replace the sales tax, or whether to develop a twenty-first century sales tax that can achieve fairness for all forms of sales: Main Street, mail order, and Internet. The Governors recognized that the current system simply does not function efficiently or fairly in a global economy. The Governors determined that a streamlined sales tax with simplified compliance requirements would ensure that states are prepared to support the global electronic marketplace of the next century.

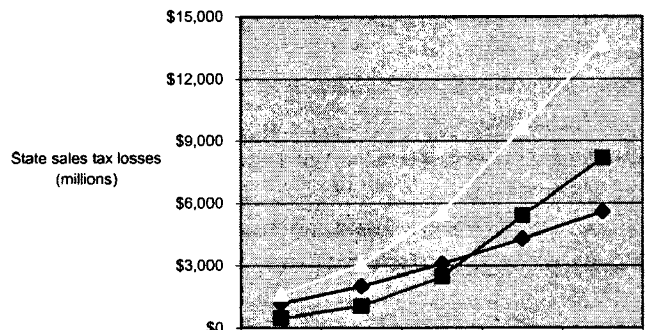
At the Federal level, the Governors strongly support the proposal by Senators Dorgan, Voinovich, Graham, Enzi, and others, S. 512, to provide states with the authority to require remote sellers to collect state and local sales taxes combined with an extension of the Internet Tax Freedom Act. Such changes could provide a far more efficient economy and significantly reduce the burden on sellers. Florida and Texas are the 2 most recent of the 16 states that have enacted streamlined sales tax laws this year. The Governors believe that the 32 participating states in the Streamlined Sales Tax Project have a unique opportunity to work together with Congress to enact a twenty-first century sales tax that will ensure states are prepared to support the global electronic marketplace. With estimates that one-third of the $8 trillion national economy could be conducted electronically over the course of the decade, we believe that all parties should compete—as they do under the Federal Internet tax system—on a level playing field, just as Representative Cox, Robert Comfort of Amazon.com, and Governor Engler recommended in testimony before the House Judiciary Committee.

Background

Currently, Internet-based merchants are not required to collect sales and use taxes, which places them at a significant advantage over traditional retailers. This inequity could have a profound negative impact on not only retailers but local communities because it risks states' ability to collect the revenue needed for education, police, and other essential services, and could lead to increases in state property or income taxes.

Nearly 40 percent of all state revenues come from the sales tax; it is the single most critical source of funding for public education in the United States. But, unless Congress moves to restore a level playing field, current industry and academic studies project States will lose between $10–20 billion in sales tax revenues by 2003.

Figure 1: eCommerce Sales Tax Loss Will Grow to $13 Billion By 2004



	2000	2001	2002	2003	2004
Business-to-consumer (B2C)	$1,169	$2,022	$3,079	$4,274	$5,580
Business-to-business (B2B)	$468	$1,042	$2,465	$5,389	$8,156
TOTAL (millions)	$1,637	$3,064	$5,544	$9,663	$13,736

Figure 1, Source: Forrester Research, November, 2000.

Many believe—incorrectly—that the Internet Tax Freedom Act (ITFA) passed by Congress in 1998 made the Internet tax-free. It did not. Businesses and consumers are charged taxes on Internet purchases from companies that have nexus in their state, and they are supposed to pay use taxes on the rest of their online purchases. The ITFA merely prevents states from adopting new Internet-specific taxes. But absent Federal action, states may not require remote sellers to collect the taxes owed on transactions.

What's the Problem

When the nation was founded and before there was a Federal government, land in that agrarian society was the dominant source of wealth. Both state and local governments relied upon the property tax for public revenue. As the industrial economy matured, the sales tax was created in the 1930s to partly capture the growing appetite of mass production and consumption. The sales tax fit nicely to a consumption system within easy geographic access. It led to the evolution of today's 7,500 state and local governments with authority to levy sales taxes. Not surprisingly, these sales tax systems have evolved over the last 60 years in response to their own unique political pressures. This combination functioned well in the industrial era when both production and consumption functions were predominately local ones. Today, the production of goods, services, and intellectual property can occur anywhere in the world. Knowledge workers are mobile, because their jobs are portable.

Similarly, consumption has been detached from the traditional Federal, state, and local concepts of borders. In the last 30 years, the purchase of services has risen from about 45 percent of personal expenditures to nearly 60 percent, a relative increase of one-third in generally non-taxable expenditures. The sales and use taxes have become a relic of the depression era, applying almost only to the sale of tangible personal property. This antiquated system faces the following problems:

- **The elimination of borders**. U.S. Supreme Court rulings prevent states from requiring sellers that do not have a physical presence in the state from collecting existing and legally owed taxes on sales made into a state. With the advent of electronic commerce and the drastically increased ability to engage in remote marketing, the amount of uncollected revenue increases each year. Congress has steadfastly refused to grant states the authority to require remote sellers to collect these taxes, even though the Court has said it is squarely within their prerogative to do so.
- **Inequity and non-neutrality**. The status quo means that remote sellers are not required to collect the state and local sales/use taxes except where they have a physical presence. The Mom and Pop retailer on Main Street or in the mall is required to charge, collect, and remit sales taxes to their respective governments. National retailers, which have a physical presence in most states, must collect these taxes in their many stores, and through other ways (catalog, telephone, or Internet). Wal-Mart, Inc. files 10,000 different forms with various taxing jurisdictions across the country each year. E-tailers are exploiting this peculiar tax advantage in an industry with notoriously tight margins.
- **Preservation of state and local autonomy**. The Internet Tax Freedom Act applies only to state and local—not Federal—taxes on the Internet. It marks an extraordinary intrusion by Congress into one of the most fundamental aspects of Federalism: the responsibility and accountability of elected officials to the citizens who elected them. Some in Congress now may feel that micromanaging the state tax system has become part of its policy terrain.
- **The current system can no longer bridge a growing gap**. While the short-term fiscal outlook for states is bleak, the long-term outlook is far more serious. A population surge for the school-age population and the aging of the nation will create enormous pressures on the largest drivers of state budgets—education and Medicaid. The states raised $192 billion from the sales tax in 1998. But, absent changes, Federal policies will exacerbate these structural, driving forces of these spending changes. At the same time, the current tax and revenue structure of states and local governments is becoming increasingly obsolete. It is inadequate to meet these surging budget demands. Again, Federal actions threaten to exacerbate this problem rather than provide the states opportunities to restructure and reform their revenue laws and systems to meet a fundamentally altered economic time and the structural forces that will drive unique demands on state budgets over the next decade.
- **Meeting the nation's competitive needs**. The dominant driving force in the world economy today is knowledge and information. It is a networked economy with enormous pressure for common standards, definitions, and rules. These pressures will require both substantial investment by states in public education, especially post-secondary education, to ensure that young Americans are equipped to lead. It will require states to achieve tax reform that achieves horizontal equity across industries.
- **The erosion of this most important source of revenue will accelerate**. Congressman Cox has wisely acknowledged that exempting domestic and international airline tickets purchased over the Internet from the Federal taxes would lead to accelerated transfer from over-the-counter to over-the-Internet purchases—with consequent repercussions for the Airport and Airway Trust Fund and the Federal budget. Similarly, the growth and penetration of broadband and all public and private data demonstrate the increased erosion of state sales taxes. Not long ago, Bill Gates predicted that within five years from 25 percent to 30 percent of all U.S. homes will be connected to broadband services of some sort. That such changes have implications for the viability of the state sales tax should be apparent to everyone who understands the growth and potential of electronic commerce. Business analysts with IBM estimate that as much as one-third of the $8 trillion national economy could be conducted electronically within the coming decade. The Internet is not a temporary phenomenon. In short, given the nature of continuing economic trends and the accelerated movement to remote selling, the state and local retail sales and use tax will fail to keep pace with economic activity unless some substantial changes are made in the near term. Absent that, only rate increases are likely to enable the tax to play an increasing role in the state-local finance system

The Federal Role—The Internet Tax Freedom Act

Electronic commerce has been an important component of the national economy since Marconi invented the telegraph and Alexander Graham Bell invented the telephone. Every credit card use involves the electronic transfer of data; the electronic transfer of accounts between banks is another form. No one has ever suggested that there was something so unique about these forms of electronic commerce that the Federal government should prohibit the states from imposing taxes on transactions using these forms of electronic commerce.

Nevertheless, Congress enacted the Internet Tax Freedom Act (ITFA) in 1998. This legislation established a three-year moratorium on the state and local taxation of Internet access and "multiple or discriminatory taxes on electronic commerce." The ITFA provided "grandfather" protection for the states that were already applying these taxes on Internet access at the time of enactment. There were four aspects of this legislation that are troubling from the states' perspective:

- The first is that it preempted the states in determining whether Internet access should be subject to state taxation. The sales tax has been a mainstay of the state-local revenue structure for 65 years. For most of that period, Congress had the good sense to not mess with this revenue source. From a Federalist perspective, the states should be making the decision about taxing Internet access.
- The second is that it has contributed to the myth that Internet transactions are tax-free. This, of course, is not true. Any seller with a presence in a state must collect the sales or use tax on transactions—in traditional stores, via mail-order, or from its website. Staples has a physical presence in 48 states, and it must collect the sales tax on purchases made by the residents of each of those states. Its affiliate, Staples.com, uses software to compute location-specific sales taxes. Only remote vendors that lack a physical presence in a state enjoy the advantages of not collecting the sales tax when residents of that state make remote purchases.
- Third is the troubling aspect of the vagueness of the definition of Internet access. With all the recent news about proposed purchases and mergers between cable and telecommunications firms, these developments raise the potential for the new firms to become dominant providers of Internet access. Would this be Internet access, cable, or telecommunications service? Would the service provide long distance phone calls, movies on demand, cable TV, movies on demand, and broadband Internet access? Governors believe that Internet content and services should not be exempted from state and local taxes. Governors believe it important for the committee to carefully evaluate the definition of access and maintain the current grandfather for the ten states that have continued their taxes. As we all know, the industry is moving to both bundle services such as television programs, games, books, music, and motion pictures into one fee, as well as to adapt rapidly changing technology.
- The fourth, and most troubling, aspect of the ITFA is what appears to be exacerbating an increasing tendency of Congress to ignore its own house and intrude upon the responsibilities of states. There are multiple bills pending in the House and Senate today to interfere with existing state and local authority, regulations, and current revenues on Internet transactions. There are no comparable bills to limit Federal taxes or authority.

Despite a widespread perception that states are fiscally healthy, the speed with which states have been spending down their accumulated surpluses has been stunning. This has been especially sobering because of the number of states that have been forced to tap their reserves in the absence of a recession—especially at a time when the national economy is still growing. Indeed, there is growing evidence that an exuberant national economy covered up structural cracks in state economies in recent years—cracks that are now surfacing. So while the Federal government has experienced revenue growth that has far exceeded state revenue growth in each of the last six years, states have, at the same time, been forced to confront structural problems on both the spending and revenue sides. This disparity has been aggravated by a Federal misperception and a growing tendency to interfere with the ability of states to restructure their own programs and economies.

Technology convergence and globalization have important implications for the role of states. States are, and always have served as, critical laboratories for the nation. But a common response to this emerging global economy from much of government at the Federal level and industry has been to respond with a one-size-fits-all Federal fix instead of rethinking how governments can restructure themselves to be flexible, innovative, and responsive in meeting changing needs and expectations of citizens and businesses. This response can create Federal authority to set the rules and undercut state and local resources—threatening to erode the flexibility and innovative nature of the states, as well as accountability. Those efforts compromise innovation and reduce responsibility and accountability. They introduce shocks to the system.

Shocks to the system affect state and local economies. They affect the delivery of Federal and state programs and services. They affect not just state and local economies, but, inevitably, the national economy and the nation's competitive capacity. Health care in America today is so interwoven between Federal and state responsibilities that a shock administered by the Federal government to states, intentionally or not, will have immediate and lasting repercussions for the Federal government. Similarly, inability to comprehend the structural costs of education to the states over the next decade will have serious impacts in our knowledge-based economy on the U.S. role in the global economy.

What are the States Doing?

The Governors are committed to work differently and that states must work hard to achieve tax reform by striving for equity across industries and reforming state tax systems. Most Governors understand this second task will require more effort and more cooperation among the leaders of Congress and the private sector than the incremental reform initiatives of the past. Key steps states are taking include:

- A year ago, President Clinton signed the Mobile Telecommunications Sourcing Act into law. The effort culminated nearly three years of negotiations between states, local governments, and industry. The new law preserves state and local rates, but it sets common definitions, and, importantly for the wireless telecommunications industry, it sets common rules for state and local taxation in an era where more and more Americans make wireless calls while passing through multiple jurisdictions. The new law slightly reduced revenues in some states and increased it in others. It marked a radically new way for states to do business. The bill passed Congress without a dissent.
- Now the Governors, state legislators, and other state organizations have worked hard on a compromise effort to break the stalemate on taxing retail electronic commerce. At the 2001 NGA Winter Meeting, policy EC–12, Streamlining State Sales Tax Systems, was reaffirmed. The policy calls for joint industry/government development of a simplified sales tax system, including streamlined administration and audit requirements, and uniform definitions of the goods and services that may be taxed. States retain the authority to determine what is taxed and at what rate. The policy establishes incentives for states to streamline and simplify their sales tax systems by calling on the Federal government to restore fairness in the sales tax by requiring remote sellers to collect sales taxes for states that simplify their taxes. A minimum level of sales would be established; companies that made sales in the past year above that de minimus level would be required to collect and remit the sales tax to qualified states.
- Last January, the participating states in the Streamlined Sales Tax Project (SSTP) voted unanimously to adopt the multistate streamlined sales and use tax agreement that set the parameters for states to participate in a joint effort to simplify and modernize sales and use tax administration to substantially reduce the burden of tax compliance. Governors are now working with state legislators to set a meeting for the participating states to reach consensus on the requirements for states to join, or be ejected, from a multistate system, a system that provides for uniformity in state and local tax bases, a central electronic registration system, simplification of state and local sales tax rates, and terms for certified service providers. The new system will include a number of uniform definitions, including for food and clothing, and set forth states' policy for the protection of privacy. Since January, 16 Governors have signed streamlined enabling legislation into law.
- The project launched a pilot in four states in November to test the capabilities of tax collection software under current law. The pilot will provide valuable information about how software programs could be adjusted to conform to a new tax-collection system. The participating states are North Carolina, Kansas, Michigan, and Wisconsin.

A Partnership for Tax Equity and Sovereignty for States in the Digital Age

Governors recognize, Mr. Chairman, that the transformation of the patchwork state and local sales tax system to streamline it for the new economy cannot be accomplished by states alone. The Federal government must be a partner in encouraging and providing incentives for this unprecedented undertaking—one that will be far easier to block than enable. For that reason, the Governors strongly support the proposal by Senators Dorgan, Voinovich, Graham, Enzi, and others, S. 512, to provide states with the authority to require remote sellers to collect state and local sales taxes combined with an extension of the Internet Tax Freedom Act. Such changes could provide a far more efficient economy and significantly reduce the burden on sellers. The Governors believe that the 32 participating states in the Streamlined Sales Tax Project have a unique opportunity to work together with you in Congress to enact a twenty-first century sales tax that will ensure states are prepared to support the global electronic marketplace. With estimates that one-third of the $8 trillion national economy could be conducted electronically over the course of the decade, we believe that all parties should compete—as they do under the Federal Internet tax system—on a level playing field.

The Governors know that states cannot succeed in this effort on their own, but rather want to work in a partnership with the private sector and the Federal government to ensure the flexibility for states to structure a 21st century revenue system that could be the underpinning of this new, knowledge-based economy.

Thank you.

The Streamlined Sales Tax Project's Agenda

States want to radically simplify and streamline the sales tax to create significant efficiencies into the new economy and provide a level playing field.

SSTP	Challenge	Timetable
• Initiated at the NGA Annual Meeting in 1999, the project was established in March 2000 • Made up of 30 participating states and 9 observer states	There are more than 7,500 tax jurisdictions in the United States. The Supreme Court has ruled that it is an undue burden for remote sellers to collect taxes, maintain records, and remit taxes to multiple jurisdictions.	• December 2000: participating states voted unanimously to adopt the project model state legislation and agreement • 2001: complete pilot project • 2001: complete recommendations • States begin to enact

How

1. Craft model legislation to be adopted by each state that would modernize sales tax systems by simplifying state and local sales and use tax codes and tax administration processes uniformly across the United States.
2. **Reduce the collection burden placed on remote sellers enough to convince Congress to mandate that remote sellers collect and remit use taxes to states.**

Critical Issues to be addressed

Audit	Tax rates
Exemption administration	Technology models
Privacy policy	Uniform definitions
Rounding rules	Uniform rules for bad debts
Vendor compensation	

PREPARED STATEMENT OF G. THOMAS WOODWARD

Mr. Chairman, Senator Grassley, and Members of the Committee, I am pleased to be here today to talk about collecting sales and use taxes on remote purchases such as those made over the Internet. My remarks are limited to that issue; they do not address other taxes on Internet use.

I will make three central points in my statement.

- States and localities cannot easily collect sales taxes on out-of-jurisdiction purchases by their residents. The growth of those purchases and the difficulty of enforcing compliance combine to erode their sales tax bases. Current estimates suggest that such erosion could be large enough to compel many states to choose between reducing spending or seeking new revenues through higher tax rates or new taxes.
- As long as consumers in a state that imposes a sales tax can escape that tax by buying from an out-of-state vendor, tax considerations rather than economic costs will in part drive decisions about consumption and production, generating economic inefficiency by misallocating resources and causing some output to be lost.
- Requiring out-of-state vendors to collect and remit sales taxes could impose significant compliance costs on them because states and localities levy those taxes at different rates and include different goods and services in their tax bases. Compliance costs might be significantly reduced by using computer technology and developing new institutional arrangements for more streamlined tax collection, or by partially "harmonizing" state sales tax regimes among those states that impose such taxes.

THE EROSION OF THE SALES TAX BASE

Forty-five states and the District of Columbia impose sales taxes on purchases made within their borders, and those taxes account for about 33 percent of their total tax revenue. Among states with sales taxes, 33 of them also allow localities to impose such taxes; those receipts make up about 12 percent of total local tax revenue. All of those taxing jurisdictions impose an equivalent "use" tax on their residents' purchases of items out of state. Such purchases, called remote sales, include items that have been ordered over the Internet, by telephone, or by mail. It is the collecting of taxes on remote sales that is at issue.

States collect sales and use taxes in different ways. For in-state purchases, taxing jurisdictions require retailers to collect and remit sales taxes, an arrangement that reduces the state's administrative costs for collection from what they would be if the taxes had to be collected directly from consumers. That kind of collection mechanism is not in place for the identical use tax imposed on remote sales: states must largely collect that tax from individual purchasers. While states find it relatively easy to ensure that their residents comply with the sales tax—because it is collected and remitted by retailers—they find it much more difficult to make individuals remit use taxes on out-of-state purchases. For the most part, the use taxes that states and localities collect come from business-to-business purchases that are subject to tax, since those purchases are easier to monitor and audit.

Most taxing jurisdictions want a mechanism for collecting use taxes that parallels the one they have for collecting sales taxes. (For the remainder of my statement, I will use the term "sales taxes" generically to mean both sales and use taxes.) Under such an arrangement, a firm selling to an out-of-state customer would assess and collect the tax and remit it to the customer's home state. However, states are currently limited in their power to impose such a requirement on out-of-state establishments. Only if the firm has a physical presence in the taxing jurisdiction—a situation known as nexus—does that jurisdiction have the legal authority to require sellers to collect and remit the tax.

The Supreme Court has held that when nexus is absent, states' efforts to collect taxes on remote sales run afoul of the Constitution by placing an undue burden on interstate commerce. The Court found that requiring vendors to collect and remit sales taxes on out-of-state purchases would subject firms to an intolerable obligation: that of calculating taxes—for thousands of taxing jurisdictions—that differ in their rates, in the categories included in their tax bases, and in the definitions of goods within those categories. Added to the direct costs of complying with remote collection would be the indirect costs associated with being subject to audit by the administrative tax authorities of all those jurisdictions. The costs of that compliance would probably be much greater than those borne by an in-state retailer that must comply with only a single set of tax laws. Nonetheless, the Court concluded that if the Congress so wished, it could give states the authority to require vendors to collect and remit sales taxes on remote purchases.

Until recently, concerns about collecting such taxes centered on catalog and telephone sales. Now, the growth of electronic commerce (e-commerce) has shifted that focus and heightened those concerns. Indeed, remote sales of all kinds have shown strong growth: the Bureau of the Census estimates that remote retail sales in total (including catalog, telephone, and e-commerce) rose from $35 billion in 1992 to $92 billion in 1999. Of the latter amount, e-commerce is estimated to account for $15 billion, or 17 percent of the total.

Much of e-commerce is not retail in nature—most of it is business-to-business transactions that are exempt from sales tax. As a result, the amount of on-line purchases subject to sales taxes is much smaller than the amount of total sales over the Internet. Data on e-commerce, however, are incomplete. For example, the Federal government has been publishing statistics on such sales only since 1998. As of 1999, the annual value of e-commerce totaled $660 billion, with more than 90 percent of that amount attributable to nonretail transactions. Private-sector forecasters expect e-commerce sales to rise to about $2 trillion by 2003.

Because of the paucity of good data and the fact that many remote sales would not be subject to sales taxes anyway, estimating how much revenue states lose by being unable to collect sales taxes is difficult. The General Accounting Office has projected that the revenue loss in 2003 will be between $2.5 billion and $20.4 billion. The midpoint of that range, $11.5 billion, is about 4 percent of the total revenue that states expect to receive from sales taxes. That estimate is not too different from other projections made by forecasters in the private sector.

Although imprecise, such estimates of the erosion of the sales tax base are large enough to generate debate within the states about what should be done to deal with their lost revenue. Of course, options that are more fundamental than remote collection—and that are beyond the scope of this testimony—are open to them, including reducing spending, raising sales tax rates on transactions that remain in the base, raising other existing taxes, or imposing new taxes. Generally, states have indicated that they want the Congress to grant them the authority to require remote sellers to collect sales taxes, and some observers of state tax policy suggest that in exchange for that right, states could change their tax systems to reduce remote sellers' compliance costs.

ECONOMIC EFFICIENCY AND REMOTE COLLECTION OF TAXES

Most taxes generate economic inefficiency because they interfere with the choices that producers and consumers would otherwise make. The more unevenly a tax is applied, the more producers and consumers waste resources in their efforts to avoid it. Effectively exempting remote purchases from sales taxation is one source of such 4 unevenness. Consumers are willing to purchase a good remotely even if the total cost of production and delivery exceeds the comparable in-state cost because the money they save in taxes compensates for the money they pay in shipping costs. Similarly, producers are willing to construct facilities in locations where production and shipping costs are high to avoid nexus and the need to charge their customers sales taxes. And as more sales escape taxation over time, states and localities may seek to maintain the same level of receipts by increasing tax rates, which exacerbates the tax's inherent inefficiency.

Effectively exempting goods from taxation because they are purchased out of the taxing jurisdiction thus results in more resources being used to produce and deliver goods than would otherwise be the case. The economic logic of requiring remote collection by vendors is essentially the same as that underlying most proposals for tax reform: a broader tax base combined with a lower tax rate tends to result in less economic inefficiency.

In certain circumstances, a subsidy in the form of special tax treatment for a sector of the economy may not lead to more inefficiency. That may be the case when the sector is characterized by positive "externalities." Externalities are benefits that accrue to people other than the ones who make the economic decision to purchase or produce a good. The benefit that is sometimes cited for the Internet is "network externalities"—in which a person joining the network not only benefits him- or herself but, by adding to the total number of participants in the network, provides benefits to other Internet users who may interact with the new user. Network externalities arising from additional users, however, occur primarily in the early stages of a network's growth. At this point in the Internet's development, there appear to be few external network benefits to be garnered from additional users. Moreover, subsidies that help more people gain access to the Internet already exist. Effectively exempting remote purchases from sales taxes is an indirect and unevenly focused means of promoting the Internet's growth that is unlikely to bring significant benefits in terms of additional users or uses.

REDUCING COMPLIANCE COSTS

The compliance costs that retailers would face in collecting and remitting taxes on their remote sales could be reduced. The process by which merchants calculate and remit taxes could be streamlined by using computer technologies and by creating institutional structures that would centralize and simplify the process of directing collections to appropriate jurisdictions. The taxes themselves could be simplified through "harmonization," in which states with sales taxes adopt common definitions for categories of goods in their sales tax bases or adopt more-similar bases for their sales taxes.

Computer technology might reduce the costs that remote sellers incur in assessing sales taxes on purchasers from a variety of jurisdictions. For example, sellers could use shipping destinations to help identify the state or locality for which the tax must be collected and then directly access a database to determine whether the good being sold is taxed in that jurisdiction. The computer system would automatically calculate the appropriate rate and the division—if any—of the total tax between overlapping jurisdictions. Supplementing the software for computing taxes could be institutional arrangements that would provide a central entity to administer the system and remit the collected taxes, and legal protocols that would simplify the process of computing and remitting them. Those protocols might include automated tax compliance systems, simplified vendor registration, and so-called safe-harbor mechanisms designed to limit the potential for multiple audits.

Harmonization holds some promise of decreasing the compliance costs of remote collection because so much of that burden stems from the multiplicity of different sales tax regimes. The categories of purchases subject to taxation vary among jurisdictions since many kinds of products are exempt. In addition, the definitions of exempt categories—such as food, medicine, and clothing—vary from one jurisdiction to the next. Harmonization could range from agreed-upon definitions of categories of purchases, to more similar bases, to uniform rates among states that impose sales taxes. It could also limit how often rates and bases might be changed and provide uniform procedures by which purchasers might obtain tax exemptions.

A number of states that levy sales taxes have already begun to explore ways to lessen the costs of remote collection through an endeavor known as the Streamlined Sales Tax Project. Their efforts could result in a voluntary agreement to simplify the cost of collecting and remitting taxes through changes in the collection process and the tax structures themselves. Simplification or harmonization, or both, could also be a condition of conferring on states the right to require remote collection.

OTHER ISSUES

There are three additional issues relevant to the debate about remote sales tax collection that economic analysis can illuminate but not fully address. First, both proponents and opponents of remote collection argue that effectively exempting remote purchases from sales taxes raises issues of fairness. Second, opponents argue that states' inability to force their residents to comply with such taxes works as a desirable brake on the size of the public sector and that requiring remote collection would eliminate that restraint. Third, both sides raise concerns about state and local fiscal autonomy.

Fairness

One aspect of the issue of fairness relates to consumers. By effectively exempting remote sales from taxation, a jurisdiction's tax system violates the standard expectation that taxpayers in similar situations will be treated in the same way. A violation of that kind occurs when two people with equivalent purchases of goods can pay different taxes because one person buys remotely without paying the sales tax. In addition, because access to the Internet—as well as the use of credit cards and other instruments necessary to buy something on-line—tends to rise with income, effectively exempting e-purchases from taxation causes the states' sales tax systems to be more regressive than they would be without such an exemption.

The other issues related to fairness involve businesses. Proponents of collecting taxes on remote sales argue that in-state vendors are at a competitive disadvantage relative to out-of-state firms that do not collect the tax. That contention is really about whether the price of a good being sold reflects the cost of the resources used in producing it—which is essentially the argument about efficiency that I discussed earlier. Opponents of remote collection maintain that businesses that receive no benefits or services from a state or locality by virtue of being located elsewhere should not have to pay taxes to support those benefits and services. Sales taxes, however, are taxes on consumers that are collected by firms. Ending the effective exemption for remote sales would help ensure that they were borne by consumers in a jurisdiction and not by businesses or others involved in producing a good.

Constraining the Size of the Public Sector

Some opponents of remote collection regard the public sector as too large or as subject to an inherent bias toward a larger-than-optimal size. From their point of view, the difficulties that states face in collecting taxes on remote sales act as a brake on the growth of government. For example, a jurisdiction might find it difficult to raise sales tax rates or enact other taxes to compensate for the revenue lost on remote sales. Remote collection of sales taxes might mean collecting more taxes. Thus, lower collection costs might tip the balance toward more taxes and bigger government. If jurisdictions decided to reduce compliance costs by harmonizing their state sales taxes, interstate tax competition another potential brake on the public sector's size might also decline.

State and Local Fiscal Autonomy

The remaining issue looming over the debate about remote collection of sales taxes is that of state and local fiscal autonomy. Granting states the authority to require vendors to carry out those collections in exchange for harmonizing the various sales tax regimes would constrain the states' options for tailoring their sales taxes to their citizens' preferences. As a result, harmonization in some forms could reduce differences in sales taxes among jurisdictions. At the same time, formally exempting purchases over the Internet from sales taxes or weakening the nexus standard—proposals that have been advanced by some opponents of remote collection—would also undermine state and local fiscal autonomy by imposing new limitations on states' and localities' ability to collect taxes on some sales.

RESPONSES TO QUESTIONS FROM SENATOR BREAUX

Question: Another serious disagreement between the two sides in this debate is the issue of defining nexus for Business Activity Tax (BAT) purposes. The Supreme Court has never ruled on the issue of what nexus standard should be applied for BAT purposes, but lower courts have adopted the *Quill* standard of physical presence.

Are you aware of any cases where a court has used a different standard allowing BAT taxes to be imposed on remote businesses who do not have a physical presence in the state? Can you please describe any such ruling for me?

Answer: Decisions by state courts conflict regarding whether the physical presence standard for substantial nexus are enunciated in *Quill* is applicable to taxes other than sales and use taxes. Some state courts have invalidated business activity taxes imposed on firms on the basis of the lack of physical presence in the taxing state. [See *J.C. Penney*, 19 S.W.3d 831 (Tenn. 1999), *cert. denied*, 531 U.S. 927 (2000) (franchise tax) and *Marx. v. Truck Renting and Leasing Association, Inc.*, 520 So. 2d 1333 (Miss. 1987) (income tax).] Other courts have upheld such taxes after concluding that the Supreme Court did not extend *Quill*'s physical presence test to taxes other than sales and use taxes. [See *Truck Renting and Leasing Association, Inc. v. Commissioner of Revenue*, 746 N.E.2d 143 (Mass. 2001) (corporate minimum excise tax); *Couchot v. State Lottery Commission*, 659 N.E.2d 1225 (Ohio 1995), *cert. denied*, 519 U.S. 810 (1996) (income tax); and *General Motors Corporation, v. City of Seattle*, 25 P.3d 1022 (Wash. 2001) (business and occupation tax).] Even in these latter cases, however, the courts focused on the tangible property or level of activity of the remote taxpayer in the taxing state.

In one case—*Geoffrey, Inc. v. South Carolina*, 437 S.E.2d 13 (S.C. 1993), *cert. denied*, 510 U.S. 992 (1993)—the court rejected the physical presence standard for nexus and upheld the imposition of income tax on a remote business with no physical presence in the taxing state. Geoffrey, Inc., a Delaware corporation with no employees, offices, or tangible property in the state of South Carolina, appealed the state's imposition of income tax on royalty payments made to it by Toys-R-Us as a licensee of trademarks and trade names owned by Geoffrey. The Supreme Court of South Carolina upheld the tax, stating that "the taxpayer need not have a tangible, physical presence in a state for income to be taxable . . . the presence of intangible property alone is sufficient to establish nexus." The court found Geoffrey's "reliance on the physical presence requirement . . . misplaced," stating (in a footnote) that the Supreme Court affirmed the vitality of physical presence for sales and use taxes but "noted that the physical presence requirement had not been extended to other types of taxes." [For a contrary decision see *Syl, Inc. v. Comptroller, 1999 Md. Tax LEXIS 3*, M.T.C. No. C–96–0154–01 (1999), in which the Maryland Tax Court reversed an income tax assessment on income derived from trademark licensing fees, explicitly rejecting the *Geoffrey* analysis.]

Question: How do you recommend Congress address this issue?

I have always said that addressing this sale and use tax issue is a separate issue because sales and use taxes are really paid by the resident of a state. They are not paid by the business—they just collect the taxes. It is the residents who must pay for the services that their state provides them by paying sales taxes. I have not supported changing the standard for BAT purposes.

I have some language there that I'd like all of the panelists to comment upon, because again I think this is a reasonable solution to this issue. It states clearly that for BAT purposes, courts shall use the physical presence standard developed in *Quill*. This should leave both sides in the same position—the status quo. Why is this not reasonable?

Answer: The Congress should distinguish between the standard used for sales and use taxes on the one hand and the standard used for business activity taxes on the other. If the objective is to leave both the states and businesses in the same legal position that they currently occupy with regard to business activity taxes, then the Congress could alter only the Commerce Clause nexus standard with respect to sales and use taxes or otherwise confer collection authority only for sales and use taxes.

At the same time, it could, as you suggest, legislate the *Quill* standard for determining "substantial nexus" for business activity taxes. While that standardization would largely preserve the status quo, it would change the standard for courts such as those discussed above that have not applied the *Quill* approach to business activity taxes.

COMMUNICATIONS

STATEMENT OF THE AMERICAN BANKERS ASSOCIATION

The American Bankers Association (ABA) is pleased to have an opportunity to submit this statement for the record on "Cybershopping and Sales Tax: Finding the Right Mix."

The American Bankers Association brings together all categories of banking institutions to best represent the interests of this rapidly changing industry. Its membership—which includes community, regional and money center banks and holding companies, as well as savings associations, trust companies and savings banks—makes ABA the largest banking trade association in the country.

BACKGROUND

The Internet Tax Freedom Act (ITFA)[1] imposed a three year moratorium on "multiple or discriminatory taxes on electronic commerce". The moratorium is scheduled to expire on October 21, 2001. Legislation to extend the moratorium, but under certain circumstances, allow states to tax Internet transactions, has been introduced by Senators Ron Wyden (D–OR) (S. 288, the "Internet Tax Nondiscrimination Act) and Byron Dorgan (D–ND) (S. 512, the "Internet Tax Moratorium and Equity Act").

Briefly, the U.S. Constitution requires that a state have sufficient contacts or "nexus" with a corporation in order for the state to assert its tax jurisdiction over the corporation. It is generally believed that the corporation must be "physically present" in a state to be subject to that state's tax. If the physical presence requirement is eliminated, state and local tax commissioners could be expected to tax out-of-state lending companies, subjecting them to multiple taxes in various jurisdictions.

The Wyden bill (S. 288) would extend the Internet tax moratorium through December 31, 2006 and provide that authorized nexus with respect to compulsory use tax compliance should *not* affect other state taxes, such as business activity tax or income tax. S. 288 requires that the taxing state's law contain certain "necessary elements", one of which is "a clear business activity nexus standard that limits nexus to sellers that have continuous and systematic contacts with the state."[2]

The bill would protect sellers that lack nexus, or other tax obligation to a state, from compulsory use tax compliance until authorized by Congressional Resolution.

By contrast, the Dorgan bill, S. 512, would extend the moratorium through December 31, 2005 and would authorize states that "adequately simplify their tax systems" to compel use tax compliance. It provides that states "should take the lead. . .and should work with localities to develop a streamlined sales and use tax system"

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[1] The Omnibus Consolidated and Emergency Supplemental Appropriations Act of 1999, Pub. L. No. 105–277, Title XI, 112 Stat. 2681 (1998).

[2] The state law must also provide: (1) one-stop, multi-state registration, (2)uniform definitions for goods and services included in the tax base, (3) uniform and simple rules for attributing transactions to particular taxing jurisdictions, (4) uniform rules with respect to sales and use tax exemption, (5) uniform procedures to certify use tax software, (6) uniform bad-debt rules, (7) uniform tax returns and forms, (8) uniform electronic filing methods, (9) State administration of all State and local sales taxes and a single rate and filing for all states, (10) uniform audit procedures for out-of-State sellers and an option to limit compliant sellers to one audit per year, (11) reasonable compensation to sellers for collection of taxes, (12) use tax exemption for sellers whose gross annual sales are less than $5,000,000, (13) consumer privacy, (14) a single uniform Statewide sale and use tax rate, (15) "an origin State default rule" with respect to goods or services delivered via the Internet when the customer's location is not disclosed, and must permit the seller to rely on customer-provided information.

that addresses concerns that the Wyden bill sets out as "essential elements".[3] S. 512 would help states develop a tax system and authorize states that adopt such system to impose collection responsibilities "not withstanding any other provision of law." Thus, S. 512 would effectively repeal the longstanding nexus principle set out in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).[4]

CONGRESS SHOULD CODIFY THE *quill* bright-line physical presence test for business activity taxes

Congress is currently considering extension of the moratorium on internet taxes and whether, and under what conditions, the states should be authorized to collect sales and use taxes on interstate sales of goods and services arranged over the Internet. The ABA strongly supports further extension of the internet tax moratorium. However, we are concerned about internet tax simplification legislation that would relax existing restrictions for sales/use tax collection by allowing states to impose collection responsibility on remote sellers under certain circumstances.

If Congress remains silent or adopts "neutrality language" as to state imposition of direct taxes on out-of-state corporations, it will have effectively eroded *Quill* with respect to business activity taxes (BAT). Rather, Congress should codify the *Quill* bright-line physical presence test for BAT by prohibiting state imposition of BAT on an out-of-state corporation that lacks substantial physical presence. In this connection, the legislation could set forth clear examples of the types of activities not meeting the threshold for imposition of BAT. Alternatively, Congress may express clearly that the legislation preserves the status quo for BAT by retaining the *Quill* physical presence standard for BAT purposes. A "neutral" or "no inference" position by Congress will leave much room for controversy and confusion, and will inevitably lead to protracted litigation.

By way of example, the *Quill* bright-line test has recently been applied to prevent imposition of business activity tax by the Tennessee Court of Appeals in *J.C. Penny National Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999) *cert. denied*, 121 S. Ct. 305 (2000) and by the Tennessee Chancery Court in *America Online, Inc. v. Johnson*, (Docket no. 92–3786–III, 3/13/2001).

In *J.C. Penny*, Tennessee's Commissioner of Revenue attempted to impose franchise and excise taxes on and out-of-state bank that had no office, no employees, and no tangible property (other than credit cards) in the state. J.C. Penny had economic presence through its in-state credit cardholders. The Court of Appeals held that although J.C. Penny had sufficient minimum contacts to satisfy the due process nexus requirements, it lacked the physical presence required by the Commerce Clause. The Court rejected the Commissioner's argument that *Quill*'s physical presence standard does not extend to business activity taxes. The court found no reason why the application of the Commerce Clause analysis should be different for sales/use tax and business activity tax.

In the *America Online* case, the Commissioner sought to extend the meaning of "physical presence" to include economic presence. The court rejected this argument, holding that *Quill* requires "literal physical presence" before business activity taxes can be imposed. Literal physical presence means that the company must have offices, employees, or a place of business. AOL did not have such presence even though it had economic presence (in-state customers). The court also rejected the assertion of nexus based on AOL's computer-Internet services that originated and terminated in the state; its software copyright and license used in Tennessee; and providing in-state telephone access numbers to the Tennessee customers. The court explained that *Quill* established a "clear rule" that physical presence is required in order to satisfy the first prong of the *Complete Auto Transit* "substantial nexus" provision. It further explained that the u.S. Supreme Court expressly rejected the economic presence standard in determining "substantial nexus". The *AOL* court concluded that this "substantial nexus" standard applies for sales/use tax as well as business activity taxes.

[3] Under S. 512, the reasonable compensation element would be determined by a comprehensive study to be conducted by State and local governments along with the business community.

[4] *Quill* prohibits compulsory use tax compliance in the absence of physical presence of the seller within the state. In that case, the U.S. Supreme Court said that a vendor whose only contacts with the taxing state were by mail or common carrier lacked the "substantial nexus" required by the Commerce Clause. The Court bifurcated the Due Process and Commerce Clause physical presence nexus standard suggested by *National Bellas Hess, Inc. v. Dept. of Revenue*, 386 U.S. 753 (1967), overruled the Due Process standard but upheld the Commerce Clause standard. However, since Congress has broad power to regulate under the Commerce Clause, it may overrule by legislation *Quill*'s requirement of physical presence.

In *AOL*, the Tennessee Commissioner relied, in part, on *National Geographic Society v. California Bd. of Equalization*, 430 U.S. 551 (1977), a use tax collection case, contending that the requisite presence can be shown for BAT either by the in-state presence of the taxpayer's property or the conduct of economic activities. The Tennessee Chancery Court rejected this argument on grounds that the U.S. Supreme Court in *National Geographic* found that physical presence (two offices) and the activities of the offices were sufficient to support the tax. The U.S. Supreme Court did not dilute the substantial nexus standard to mere economic presence. It is instructive that *National Geographic* supports a greater nexus standard for imposing BAT against a corporation than that which would be required for merely imposing a collection responsibility. Thus, Congress by taking a "neutral" position on BAT would have weakened the nexus standard for BAT contrary to *National Geographic*.

STATES WILL INTERPRET CONGRESS' SILENCE OR A NEUTRAL POSITION AS AUTHORITY TO IMPOSE BAT ON CORPORATIONS NOT PHYSICALLY PRESENT IN THE STATE

The U.S. Supreme Court, in *Complete Auto Transit, Quill*, and *National Bellas Hess*, made it clear that taxation of a corporation that is not physically present in a state violates the Commerce Clause of the United States Constitution. Despite the Court's strong support for a physical presence standard, state tax administrators continue to argue that physical presence is not a prerequisite to the imposition of BAT. A number of state tax administrators have taken the position that general interstate business activities involving intangibles and economic presence constitute sufficient nexus to impose BAT. The Supreme Court decisions requiring physical presence recognize that plenary power over interstate commerce rests with Congress.[5] If in exercising its power under the Commerce Clause, Congress fails to expressly support the physical presence standard for BAT, state tax administrators will continue to establish lower commerce clause standards by imposing taxes on out-of-state corporations that are engaged in general interstate commerce.

A prime example of the states' efforts to establish lower commerce clause standards for BAT is the case of *Geoffrey, Inc. v. South Carolina Tax Commission*, 313 S.C. 15, 437 S.E.2d 13 (South Carolina 1993). The Geoffrey corporation received royalties from licensing the use of Toys "R" Us trademarks throughout the United States. Geoffrey did not have physical presence in South Carolina. It had no employees, no offices, and no tangible property in the state. Geoffrey had economic presence in South Carolina, to wit, the use of trademarks from which it received royalties measured by South Carolina sales. Based on this economic presence, the South Carolina Supreme Court ruled that Geoffrey had sufficient nexus for the state to impose BAT. The court reasoned that even though Geoffrey did not have physical presence, the company's purposeful direction of its activities into South Carolina coupled with its ownership of intangible rights located in the state were sufficient to meet the due process nexus standard. Moreover, the South Carolina Supreme Court limited *Quill*'s physical presence requirement as being applicable only to sales/use tax cases. The court concluded that Geoffrey's economic presence constituted substantial nexus under the Commerce Clause.

Following the *Geoffrey* decision, a number of state tax administrators have taken the position that intangibles and economic presence within a state constitute sufficient nexus to impose business activity taxes.[6] The Federation of Tax Administrators[7] advised member-states that:

> "The case could become a basis for other state courts to hold companies subject to income and franchise taxes on the basis of economic presence. Companies

[5] Congress has previously exercised its Commerce Clause power to prevent state taxation of interstate commerce from burdening the national economy when it enacted Public Law 86–272. This law prohibits states from imposing income tax on out-of-state businesses that solicit orders for sale of tangible personal property in a state where the orders are sent outside the state for approval and the orders are filled by shipment of property from outside of the state. P.L. 86–272 does not apply to sales of intangible property or services. Congress should expand this law so that its applies to solicitation of orders for sale of all types of property or services.

[6] Arkansas, Florida Indiana, Iowa, Kentucky, Massachusetts, Minnesota, New Jersey, New Mexico, North Carolina, South Carolina, Tennessee, Texas, West Virginia, Wisconsin.

[7] The Federation of Tax Administrators (FTA) is an organization that represents the interests of state tax administrators before Federal policymakers. It provides services to state tax authorities and administrators, including research and information exchange, training, intergovernmental and interstate coordination. The organization's membership consists of tax collection agencies of the 50 states, the District of Columbia, and New York City.

particularly at risk would be those who provide services, such as financial institutions, and brokers."[8]

Geoffrey's weakening of *Quill*'s bright-line physical presence standard signifies the states' intention to expand their taxing authority in areas of interstate commerce if that authority is left unchecked by Congress. Such unchecked authority will burden and obstruct the development of interstate business over the Internet and in other areas of electronic commerce.

S. 512 includes language that some have referred to as remaining "neutral" on the BAT issue. The language states that no provision of the legislation shall be considered in determining the application of any other taxes, including franchise taxes. However, this language is not neutral. Rather, it erodes the *Quill* protection because such a position indicates that Congress is indifferent as to whether or not an out-of-state corporation, without physical presence, should be subject to BAT.

States have inherent power to tax. However, taxpayers need protection from the unconstitutional exercise of the states' taxing power. Such protection was provided by the U.S. Supreme Court in *Quill* when it prohibited states from taxing out-of-state corporations that do not have "substantial nexus" (physical presence). This prohibition has been applied against imposition of sales/use tax as well as BAT. The *Quill* prohibition can only be removed or altered by Congress. Silence or neutral language in the case of BAT would indicate that Congress did not endorse or necessarily agree with the prohibition. It would also send the message that *Quill* only applies in sales/use tax cases, and that the sales/use tax impediment had been fixed through simplification.

If Congress adopts a "neutral" position on BAT, as S. 512 would provide, the physical presence standard would be seriously jeopardized. Services businesses like financial institutions, which have no physical presence in a state, could become subject to BAT. The *Quill* bright-line physical presence Commerce Clause standard should apply for sales/use tax as well as for BAT. Congress' removal of the bright-line test for sales/use tax in simplification legislation and the expression of a "neutral" position on nexus for BAT, as contained in S. 512, would provide states with the momentum for further erosion of the physical presence standard for BAT. States will contend that Congress has overruled *Quill* or limited its application to sales/use tax, and that economic presence by virtue of customers, intangibles, or business relationships within a state is sufficient for BAT.

Simplification in the sales/use tax arena focuses on the practicality of the administrative function of collecting tax on a remote seller, while relaxing the standard for imposition of BAT will result in a tax increase and potential double taxation. Congress should preserve the judicial safeguards that have developed since *Quill* regarding BAT.

CONCLUSION

The ABA appreciates having this opportunity to present our views on internet taxation. We look forward to working with you in the future on these most important matters.

STATEMENT OF THE CENTER FOR INDIVIDUAL FREEDOM

The United States has long been considered the leader of the free-world and free-market. Over the past decade, the Internet has been a driving force in our prospering economy, despite temporary setbacks. Our country's relative economic strength in technology areas is due, in part, to the political establishment's recognition that the Internet and electronic commerce should be free from legislative and regulatory roadblocks that could impede its evolution.

Congress, in recognizing the Internet's susceptibility to creative tax schemes and the need to protect this new engine of prosperity, adopted the Internet Tax Freedom Act (ITFA) in October of 1998. It imposed a three-year moratorium on multiple, discriminatory and access taxes on the Internet.

The moratorium is set to expire in October, and the debate over its extension is being clouded by a coalition of states that fear an eroded tax base, as more consumers shop online. Some of these states are in the process of enacting model legislation that includes a "simplified and streamlined" sales tax system with the hopes of getting congressional approval to force remote merchants to collect and remit sales taxes on purchases made by their citizens.

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[8] "South Carolina High Court Applies Quill Decision," Federation of Tax Administrators, Tax Amin. News (1993).

In 1992, the Supreme Court ruled in *Quill Corp. v. North Dakota* that states, without permission from Congress, cannot require out-of-state retailers to collect and remit sales taxes unless the retailer has a substantial physical presence or "nexus" in the state.

This coalition of states, together with traditional brick-and-mortar retailers who oppose the online competition, are lobbying Congress to accept the states' "simplification" plan known as the Streamlined Sales Tax Project. In exchange, the states want permission to reach outside of their taxing jurisdictions, shifting the states' tax collection burden to remote vendors. But the "simplifications" as recommended by the Streamlined Sales Tax Project, which include a minimum of ten categories addressing, for example, uniform rules, definitions, formats and audit procedures, are anything but simple.

First, the proposed "simplification" scheme contradicts the economic structure that has made our nation a global leader. Contrary to the view of one of our Founding Fathers, Alexander Hamilton, who noted in the Federalist No. 32 that the Constitution did not grant Congress the authority to regulate state tax policies except with regard to exports and imports, it has long been recognized that Congress has the authority, under the Commerce Clause, to regulate state taxation of interstate activities. But the primary evil that the Commerce Clause sought to remedy was attempts by states to export their tax burdens to residents of other states. Because local residents and brick-and-mortar entities benefit from state and local services and infrastructure such as police and fire protection, roads and waste collection, it is appropriate for them, and only them, to bear the tax burdens that finance such services. Based on this premise, out-of state entities should not be forced to take on the states' responsibility and collect their taxes for them.

If current state tax systems are not adequate for the new economy, or if such systems disadvantage local retailers, states already have it within their power to collect taxes from their citizens for remote online purchases. The failure of the states to collect sales and use taxes from their citizens on such purchases is simply that—the failure of the states. But it should not be the role of Congress to provide a mechanism for states to shift their tax collection burden to out-of-state retailers. Contrarily, Congress' role should be to ensure the states do not unfairly export this burden, thereby obstructing interstate commerce.

Second, the financial burden on remote businesses to collect and remit states' sales and use taxes would ultimately result in a de facto tax increase on the consumer. As with any government mandate, especially when dealing with tax schemes, the added costs of doing business is ultimately passed on to consumers by way of increased prices.

There currently are more than 7,500 taxing jurisdictions in this country—all with different, complicated rules and structures. The proposed "simplification" does not go far enough in significantly reducing or simplifying these rules and structures to the point where businesses would not have to endure a considerable financial hardship.

Third, ironically the states' proposed method of "simplification" could reasonably be considered a violation of state sovereignty. Our country's historical framework of "no taxation without representation" led to a system of taxation that has traditionally required state legislatures to develop tax policies within their own borders. As a result, states' tax and regulatory policies employ fiscal incentives such as tax abatements and subsidies in attempting to induce non-resident firms and businesses to locate within their jurisdictions or to keep resident businesses from moving elsewhere. Congressionally approved collusion between rival states would essentially eliminate such competition, thereby threatening our system of state sovereignty. Such lack of fiscal competition between the states would ultimately have a negative impact on consumers and our nation's businesses. Each state needs to be able to deal with its financial needs as it best sees fit.

Any simplification plan no doubt will come with conditions, such as those suggested in the 106th Congress, that allow only those states signing a compact to collect taxes on Internet commerce. This infringement on state sovereignty does not allow states or localities to give preferences to certain industries or goods or to adapt to their own particular circumstances. Congress should be cautioned against unfettered tampering with state and local fiscal schemes.

Additionally, any "simplification" program or tax collection compact between the states could conceivably require maintenance and oversight by a third party, potentially even the Federal government through one of its agencies. The formation of any new bureaucracy overseen by the Federal government would further threaten state sovereignty.

Even if one assumes that legislation calling for simplification would be constitutional, this approach has other pitfalls. Through growth of the Internet, expansion of e-commerce results in greater consumer options through interstate and foreign trade. Excessive regulation and taxation that may result from simplification could threaten the United States' superior fiscal position, as it could send more people to overseas vendors, ultimately exacerbating trade imbalances, as consumers in significant numbers learn to exploit currency fluctuations and direct purchase of gray market goods.

Over-regulation of the Internet will be fatal to its continued growth. As evidenced by recent court rulings in France, Germany and Italy banning content from their borders, attempts to regulate the Internet can cause national and international conflict and criticism. Individual attempts by states and countries to place burdensome restrictions on the free flow of trade over the Internet should be avoided in favor of unfettered growth of the many borderless opportunities and advantages that e-commerce provides.

Finally, the implication "simplification" would have on consumer privacy is an open question. Apart from any records that an Internet vendor may keep and use in accordance with the privacy policy that it has adopted, electronic commerce permits an Internet purchaser to maintain a level of anonymity from "big-brother" watching his or her purchasing practices. With few exceptions, the government cannot obtain vendor records without following appropriate search warrant procedures designed to protect the purchaser's fundamental right to privacy. With simplification, however, the audit procedures proffered threaten consumer privacy. The access to personal data that may result through audit procedures leaves consumers vulnerable to misuses of sensitive information and potentially violates consumers' constitutional rights of privacy and due process. Although some proposals, such as the Internet Tax Moratorium and Equity Act (S. 512), sponsored by Senator Byron Dorgan (D-North Dakota), make passing reference to the need for appropriate protections for consumer privacy, no simplification proposal significantly addresses the issue. Simplification should not be included in any bill unless and until all potential threats to privacy and constitutional rights have been addressed.

One final and significant point is that Congress simply should reaffirm the Supreme Court *Quill* ruling governing states' collection of sales taxes by adopting a national, uniform nexus standard, as outlined in the New Economy Tax Fairness Act or NET FAIR (S. 664), sponsored by Senator Judd Gregg (R-New Hampshire). NET FAIR establishes a bright-line uniform jurisdictional standard for taxing electronic commerce based on the substantial physical presence or "nexus" test that would secure traditional principles of tax fairness, reinforce rate competition among the states and preserve the states' authority to set their own tax policies on commerce *within their jurisdictions*.

Congress can, and should, pass legislation that extends the current moratorium on multiple and discriminatory taxation on electronic commerce and make permanent the Internet access moratorium. As language often defines political battles, and in some cases wins them, the term "simplification" is anything but "simple." Congress should not include simplification provisions in the law.

The Center for Individual Freedom is a non-partisan, non-profit organization with the mission to focus attention on individual freedoms and individual rights guaranteed by the U.S. Constitution. As free-market advocates, we oppose over-burdensome state and Federal regulations and taxing regimes that will impede the evolution of electronic commerce.

STATEMENT OF THE E-FAIRNESS COALITION

INTRODUCTION

Thank you for providing us this opportunity to discuss the issues surrounding Internet taxation and specifically whether Congress should extend the Internet Tax Freedom Act, and if so, what changes may be needed. We commend your efforts to include diverse views in the Senate's consideration of these important issues.

The e-Fairness Coalition includes brick-and-mortar and online retailers, realtors, retail and real estate associations, as well as publicly and privately owned shopping centers. The e-Fairness Coalition also includes the American Newspaper Association and high tech related companies such as Gateway and Vertical Net. Through these companies and associations our Coalition represents 1 in 4 American workers on this issue.

The e-Fairness Coalition advocates a level playing field for sales and use tax collection for all retailers. However, we also support the continued growth of the Internet and firmly oppose any form of discriminatory taxes and taxes on Internet access. But, we also believe the government should not provide preferential sales tax treatment based solely upon the distribution system used to sell goods. Equitable collection of the sales tax needs to be addressed concurrently with an extension of a moratorium on discriminatory taxes and taxes on Internet access.

Requiring brick and mortar retailers to collect sales taxes while exempting their online competitors is fundamentally unfair, and presents a glaring national problem that requires Congressional action. We urge Congress to use its Commerce Clause authority, to which the Supreme Court emphatically deferred in its 1992 *Quill* decision, to assist states by enacting Federal legislation to ensure a level playing field.

By way of background, in 1992, the Supreme Court ruled in *Quill v. North Dakota* (504 U.S. 298) that the Due Process Clause of the United States Constitution did not bar enforcement of the State's use tax if the vendor purposefully directed its activity toward the State, even if the vendor had no physical presence in the State. At the same time, however, the Court reaffirmed the Commerce Clause rule of *National Bellas Hess* that an out-of-state vendor must have a physical presence in the State in order to be required to collect use taxes on sales into the State. In the decision, the Court reasoned, "the underlying issue is not only one that Congress may be better qualified to resolve, but also one that Congress has the ultimate power to resolve." *To date, the Quill decision's invitation for Congressional action has been unanswered*.

Under *Quill*, the Court indicated that any further refinements of the Commerce Clause rule of physical presence must emanate from Congress in light of its authority to "regulate Commerce with foreign Nations, and among the several States." Justice Stevens addressed this in his opinion in *Quill*:

> "No matter how we evaluate the burdens that use taxes impose on interstate commerce, Congress remains free to disagree with our conclusions. See *Prudential Insurance Co. v. Benjamin*, 328 U.S. 408 (1946). Indeed, in recent years Congress has considered legislation that would "overrule" the *Bellas Hess* rule. Its decision not to take action in this direction may, of course, have been dictated by respect for our holding in *Bellas Hess* that the Due Process Clause prohibits States from imposing such taxes, but today we have put that problem to rest. Accordingly, Congress is now free to decide whether, when, and to what extent the States may burden interstate mail-order concerns with a duty to collect use taxes."

We must have a level playing field for three reasons: (1) the current sales tax system is broken—it simply does not work in the "clicks and bricks" environment; (2) equity or "fairness;" and (3) states rights—that is the rights of states to set their own tax policy.

CLOSING THE LOOPHOLE: THE CURRENT CONSUMPTION TAX SYSTEM IS BROKEN

The most urgent issue facing the Senate is the viability of the current consumption tax system. No longer are we looking at catalog sellers who owned a small percentage of the marketplace. We are discussing the ability of States to maintain their revenues and to provide a level of services needed within the current system. The General Accounting Office (GAO) estimated in June 2000 that state and local revenue losses from remote sales would be as much as $20 billion by 2003.

The current sales tax system does not work in today's competitive business environment. Due to market realities, brick-and-mortar retailers are forced to respond to their online tax-free competitors, by setting up their online stores as separate subsidiaries. They then avoid physical nexus rules and corresponding sales tax collection responsibilities, and only collect sales taxes in states where they have a warehouse or a headquarters. For example, K-Mart's online store, bluelight.com, only collects sales taxes in California and Ohio; Barnes and Noble.com only collects in New Jersey, Nevada, New York, Tennessee and Virginia; Wal-Mart.com only collects in Arkansas, California, Ohio and Utah. As long as this system is in place, more and more retailers will do the same. I have attached here two items, which discuss this very subject. The first, an E-Commerce Tax Alert article from March 2000, describes how to set up such a system, and the second is drawn from the *www.thewebstoreguide.com*. That piece outlines for consumers how to avoid paying sales tax and also refers to the growing practice of setting up separate Internet entities "just to avoid having to charge customers sales tax."

A number of retailers are currently installing kiosks with Internet terminals in their physical stores. A customer can today enter the store, sample or try on the merchandise, have the sales person order the merchandise over the Internet, and have it delivered the next day to the consumer and avoid charging and collecting the sales tax. While the law is still unclear on this issue, it is possible that a consumer may purchase goods on the Internet off of a personal computer and then choose to return those items to a physical store. Those retailers may well argue that this would not establish nexus as the Internet business has contracted with the physical store to accept returns. States then have to rely on the consumer voluntarily paying the use tax owed, devise a system to track the sale or delivery, or forego the sales tax. This is the major risk that Internet retailing presents for state and local revenues.

However, we would like to note that most of the country's largest retailers, who—in order to compete in the Internet economy—are forming these subsidiaries under the current law, would rather not be forced to do so. In fact, many are members of the e-Fairness Coalition and strongly advocate a level playing field. They recognize that the current consumption tax system is inadequate and that the responsible path begins with steps to a more equitable collection structure. The nation's largest on-line retailers, such as Wal-Mart, are also the nation's largest physical retailers—and they are willing for forsake short-term advantages for a collection system that is fair for all.

Since even in-store sales can now be set-up to avoid sales tax collection, the question is no longer whether pure internet sellers should collect sales taxes; the question is where will states go to make up for the loss of revenue due to the explosion of the dot.com subsidiary. Will it be increased personal or commercial property taxes—or will states cut funds for education, police, and roads?

FAIRNESS IN THE CONSUMPTION TAX SYSTEM

The issue of equity—or "fairness" is not a question of whether there should be a consumption tax on goods and services, but rather, if a state chooses to have a consumption tax, should it be implemented equally. Simply put, there is no logical argument that supports taxing the same retail transaction differently depending on the delivery system. The market place should determine sales decisions, not discriminatory tax policies.

It is bad policy and bad economics to have a tax policy that favors one group of businesses over another when both groups are selling the same products to the same consumers into the same localities. Tax policy should not distort the free enterprise system by picking winners and losers in the marketplace. Consumers should make their buying decisions based on price, availability, service and convenience. They should not be influenced by discriminatory tax policy.

STATES RIGHTS

The States, and not the Federal government, should have the right to impose, or not impose, consumption taxes as they see fit. The reality is that education and other essential services are funded largely by the States, especially through sales taxes. Passing an extension of the moratorium without taking steps toward a comprehensive solution would send a clear signal to the states that Congress is willing to ignore a major, national inequity in order to provide some businesses with preferential tax treatment. This would halt the substantial progress the states have made in simplifying and unifying their sales tax systems, and may force states to consider raising property or income taxes to make up for the revenues lost to remote sales that are made with no sales tax collection.

We firmly believe that Congress should allow states to require all remote sellers to collect and remit sales taxes on deliveries in that state provided that states and localities dramatically simplify their sales and use tax systems. Simply put, remote retailers—that is Internet and catalog retailers—should be subject to the same sales tax collection responsibilities as traditional or Main Street retailers, if the states are successful in simplifying their sales tax systems. Once the states simplify, thereby lifting administrative burdens off of retailers, there is no reason to provide remote sellers with an exemption from collecting sales taxes.

The e-Fairness Coalition believes that states should have the right to either opt in—or not opt in—to a compact that would require simplification and decide for themselves whether or not to require collection. If a Governor of a state believes that remote sellers should be exempt from having to collect use taxes—they will maintain their right to not collect taxes. However, if another state chooses to require collection and meets simplification criteria set out by the Congress, similarly, that state should be given the mandate to require collection. Pure and simple, this is an issue of Federalism and of states' rights.

SUPPORT FOR THE "INTERNET TAX MORATORIUM AND EQUITY ACT"

That is why the e-Fairness Coalition supports a comprehensive solution to this issue. We support the "Internet Tax Moratorium and Equity Act," which is co-sponsored by Senators Dorgan, Enzi, Daschle, Breaux, Chafee, Durbin, Hutchison, Graham, Lincoln, Rockefeller, Thomas, and Voinovich. This legislation will (1) promote the continued growth of the Internet and (2) will allow states to ultimately require that remote sellers collect and transmit sales and use taxes just as traditional retailers do today.

The "Internet Tax Moratorium and Equity Act" promotes the growth of Internet related entities through such provisions as an exemption from use tax collection requirements for remote sellers falling below a de minimus threshold of $5 million in gross annual sales; reasonable compensation for tax collection by sellers; and uniform audit procedures.

OPPOSITION TO S. 288

In addition to suggestions that the current moratorium should merely be extended without resolving the larger issue, the e-Fairness Coalition also opposes the language found in S. 288—a bill pending before the Senate Commerce Committee. We take issue with a number of aspects of this bill. Simply put the Wyden-Leahy bill would impose unreasonable burdens on the states during the simplification process without ultimately providing them with the mandate to require that remote sellers collect.

Our opposition to S. 288 is based on a number of specific factors. First, in regard to uniformity requirements, Section 4(b)(1)(B) of the Wyden bill requires uniformity among all states "in which a seller is located or does business." In other words, under the Wyden bill, no state could require a seller to collect use taxes if any single state in which that seller "is located or does business" had a dissimilar "tax, procedure, standard, or system." Thus, for any state to institute a comprehensive collection system, uniformity would be required in all 50 states.

Second, unlike the Internet Tax Moratorium and Equity Act, S. 288 requires as any "simplified sales and use tax system for remote sales" a single statewide rate for all sales subject to use tax. While the Coalition may ultimately agree to support legislation (such as S. 2775 introduced in the 106th Congress) that includes one use tax rate per state, we do not believe that one rate is integral to simplification.

Third, the e-Fairness Coalition believes Federal legislation must include language that would state that it is the "Sense of the Congress" that any simplified system that is determined by the Congressional Budget Office to meet the statutory criteria should be approved by the Congress. There is no such assurance in the Wyden bill. This means that under the Wyden bill, states would have less incentive to enact controversial simplification measures. Proponents of simplification may have difficulty getting such measures passed by state legislatures when critics would complain that simplification and conformity with Federal guidelines might well go entirely unrewarded.

Fourth, the Wyden bill would expressly preclude the overruling of Quill corp. v. North Dakota. Section 5(a) reserves to the Congress the exclusive authority to change existing nexus law for the collection of sales and use taxes. This provision would be effective even if Congress did not grant any collection authority over remote sales. It would therefore freeze current nexus law with no chance of redress in the Supreme Court, even if the states simplified their sales and use tax systems to the point that the Court might otherwise find that they did not burden interstate commerce.

Finally, we oppose S. 288 because the Wyden bill includes a provision regarding business activity taxes an issue that is not addressed in the current Dorgan, Enzi et al bill. The e-Fairness Coalition does not believe that restrictions on the application of business activity taxes should be imposed as a precondition to a grant of broader collection authority for sales and use taxes. These two issues are unrelated and should not be linked together. S. 288 would require as part of any "simplified sales and use tax system for remote sales" a restriction that is not related to sales and use taxes: a nexus standard for corporate income taxes and similar levies that is significantly narrower than the existing standard. The Wyden bill would exempt businesses from any business activity taxes in states where they do not own or lease property or have employees or agents more than 30 days a year. If this provision were applicable, it would almost certainly force many states to choose between continuing to lose use tax revenues and giving up a portion of the business activity taxes that they are currently collecting. It would be extremely unfortunate to create a situation where states that are willing to simplify their sales and use taxes are discouraged from doing so because of the possible curtailment of their ability to collect corporate income and franchise taxes.

Thank you for the opportunity to provide input on these important policy questions. We look forward to continuing to work with you to provide an equitable and streamlined sales tax collection system.

E-Commerce Tax Alert Vol 1 Issue 1 (March 2000)

Separate incorporation for e-commerce boosts tax planning strategies

As more established companies move on to the Internet, competitiveness with smaller dot-com operations creates questions over how to avoid sales and use tax nexus and keep the playing field level. While most large companies have nexus nationwide, small web-based upstarts often carefully choose where they locate with avoiding nexus in mind.

How can your company meet this challenge? Some experts advocate having an affiliate conduct your e-commerce operations. It sounds radical, but it represents solid tax-planning advice for some companies selling goods on the web. Internet tax headaches and the accompanying competitive disadvantages may be avoided by setting up a nexus-breaking subsidiary to shield transactions from sales tax collection duties in all but a few instances.

Perhaps the next memo you write should be addressed to those in charge of your company's electronic sales operation. Before they start selling, explore the possibility of creating a new subsidiary or affiliate to handle Internet sales and separate those sales from the nexus-creating activity your company already conducts.

Learn by example

Traditional businesses can learn from upstart cyberspace operations, which offer the convenience of shopping online and not collecting sales tax, suggests Jeremiah Lynch, a partner with Ernst & Young LLP in New York. Just as mail-order sellers avoid collecting sales or use taxes in most states, companies that rely on the Internet instead of a sales staff establish nexus only in states where they have offices, staff or property.

While brick and mortar businesses race to set up electronic commerce operations, many don't realize that a traditional structure establishes nexus for online transactions as well. Lynch says they miss an opportunity to reduce the number of states in which they must collect tax.

Just as companies once limited nexus through mail-order affiliates (Saks Holdings Inc., for example, set up Folio to handle its mail-order sales), they can establish affiliates to handle electronic sales. Lynch says the tactic limits nexus-creating activities to traditional transactions and offers customers a lower overall price—a necessity in a world where smaller competitors are selling the same goods with no sales taxes applied.

Amazon.com founder Jeff Bezos has said many times that he chose Washington state because it would not account for a large number of sales, thus allowing the bookseller to avoid nexus in major markets nationwide. When Amazon built an East Coast distribution center, it chose Delaware because that state has no sales tax.

Though Amazon's competitor, barnesandnoble.com, was not created solely with tax considerations in mind, the online bookstore has nexus only in New Jersey, New York and Virginia, where it has a distribution center, its headquarters and its online site, respectively, explains Ben Boyd, vice president of communications for the online bookseller.

A competitive issue

Traditional companies must consider such factors because upstart competitors that sell exclusively on the Internet offer the same products without charging tax. Though consumers who purchase goods free of sales tax are supposed to remit use tax, most never do, and states rarely press the issue unless it involves business-to-business transactions.

If sales tax is a competitive issue for booksellers, imagine the implications of purchasing large-ticket items tax-free. When an online customer faces the choice of purchasing a $2,000 computer from a vendor who charges sales tax or one who doesn't, the decision is obvious, Lynch says.

Internet sales continue to climb, and whenever sales tax is a competitive issue, traditional retailers should at least consider setting up a separate affiliate for online transactions. "Too many businesses are not taking advantage of this," Lynch says. "There would be no reason not to form a separate company for electronic commerce."

Ever wondered why only some online stores charge sales tax?
Never pay tax again! Simply follow these principles below to save!

1 If an Internet Store has a physical presence in the state that you are buying from, you will be charged that state's local sales tax.

2 If you buy from an internet store that isn't based in the state you are buying from, you will not be charged sales tax - great huh?

3 Even bricks and mortar stores count as a physical presence. Therefore it is much more likely that online sellers like Borders and Barnes&Noble will charge you sales tax because they have retail stores in most states

4 As a result of number 3, some companies are now even setting up separate internet divisions of there company, just to avoid having to charge customers sales tax. Good news for internet shoppers then!

Examples of taxing:

1 If you live in New York and buy from Bigwords.com, they do not have a physical presence in that state, so you won't be charged any sales tax.

2 If you live in New Jersey and buy from CDNOW, they have a physical presence in that state so they will charge you New Jersey's sales tax - currently 3 percent.

TheWebStoreGuide Sales Tax Advice

Take a look at the table below to see whether you will be charged sales tax, as this can save you extra dollars. This is especially true when the product you want to purchase costs the same price in more than one online store - pick the store that won't charge you sales tax. Or buy from 800.com, they are based in *Oregon which has no sales tax*! *Tough luck if you live in California* - its the worst state to live in for being taxed in - many online stores have a physical presence there! Basically, if you buy from a store that has a presence in the same state as you, you will always pay the local sales tax

List of Stores and Where They Charge Sales Tax

Online Store (Click to Read Review)	**States tax charged in**	**Comments**
Amazon	WA	-
Barnes&Noble.com	TN, NJ, NY, VA	Separate online business
Bigstar.com	MN, NY, CA, NV	-
Borders.com	MI, TN	-
Buy.com	CA, TN, MA, IN	Many distribution centers
CDNOW	CA, PA, FL, NY, NJ	Many distribution centers
CD Universe	CT	-
Drugstore.com	WA	-
E-Toys	CA	-
Outpost.com	CT, OH	-
Petopia.com	CA, MN, OH, IL, NY, NJ, TN	Many distribution centers
VarsityBooks		
800.com	OR	Oregon has no sales tax!

Members of the e-Fairness Coalition include:

Alabama Retail Association
American Booksellers Association
American Jewelers Association
Ames Department Stores
Atlantic Independent Booksellers Association
CBL & Associates Properties, Inc.
Circuit City Stores, Inc.
Electronic Commerce Association
First Washington Realty Trust, Inc.
Florida Retail Federation
Gateway Companies, Inc.
General Growth Properties, Inc.
Georgia Retail Association
Great Lakes Booksellers Association
Home Depot
Illinois Retail Merchants Association
International Council of Shopping Centers (ICSC)
International Mass Retail Association (IMRA)
Kentucky Retail Association
Kimco Realty Corporation
K-Mart Corporation
Lowe's Corporation, Inc.
The Macerich Company
Michigan Retailers Association
Mid-South Booksellers Association
Missouri Retailers Association
Mountains & Plains Booksellers Association
National Association of College Stores
National Association of Convenience Stores
National Association of Industrial and Office Properties (NAIOP)
National Association of Real Estate Investment Trusts (NAREIT)
National Association of Realtors (NAR)
National Community Pharmacists Association
National Retail Federation
New England Booksellers Association
Newspaper Association of America
North American Retail Dealers Association
Northern California Independent Booksellers
Pacific Northwest Booksellers Association
Performance Warehouse Association
RadioShack Corporation
Regency Realty Corporation
Retailers Association of Massachusetts (RAM)
ShopKo
Simon Property Group
Southeast Booksellers Association
Southern California Booksellers Association
South Carolina Merchants Association (SCMA)
Target, Inc.
Taubman Centers, Inc.
The Gap, Inc.
The Macerich Company
The Musicland Group, Inc.
The Real Estate Roundtable
The Rouse Company
Variety Wholesalers
VerticalNet, Inc.
Virginia Retail Merchants Association
Wal-Mart
Weingarten Realty Investors
Westfield America, Inc.
(As of July 30, 2001)

STATEMENT OF DR. LAWRENCE HUNTER AND GEORGE PIELER, J.D.

We congratulate the Committee on Finance for holding these hearings. The issue of possible state-level taxation of sales made over the Internet is one of the most critical controversies the nation faces in the field of taxation. It raises important questions for the critical interface between the states, the Federal Commerce Clause, and the New Economy. Equally important is the assertion by this Committee of jurisdiction over the issue of Internet sales. With its plenary authority over revenue matters, and its long history of involvement with issues of intergovernmental relations in our Federal system, the Committee on Finance will be a decisive force in shaping any congressional response to the issue of Internet sales.

With that preface, and with the understanding that the Committee is not reviewing specific legislation on this occasion, we want to make clear our belief that the best avenue for Congress to pursue is to extend the current moratorium on Internet taxation, which includes, *inter alia*, a bar against "multiple and discriminatory" Internet taxation. Legislation such as S. 777, by Senators Allen and Burns, does precisely that, heading off any threat that states will jump into the field of Internet taxation in new, exciting, and economically destructive ways. Maintaining a strict ban on innovative Internet taxes, such as access fees, while acknowledging Supreme Court jurisprudence setting prudential limits on the power of states to collect sales-type taxes outside their geographic borders, strikes the right balance among economic, constitutional, and Federal-state considerations.

For this reason also, we urge the Committee to reject any legislative attempts to build momentum for an interstate tax agreement, understanding, or compact that would broaden the states' power to tax sales (whether over the Internet or not) beyond their borders. However meritorious the claims of states to a "fair share" of revenue in an increasingly complex retail system driven by the explosion of telecommunications technologies, there is no justification for rewriting the Constitution or creating a *de facto* national sales tax regime to help rid states (and in some cases businesses) of the burden of adjusting their tax policies to an increasingly integrated national and global economy. For this reason alone, efforts such as the Streamlined Sales Tax do not represent acceptable public policy choices for the 21st century economy.

This may strike the Committee as too harsh. After all, what could be wrong with simplifying and revising state and local sales and use taxes, adopting more uniform rules and compliance procedures from state to state, and making compliance much simpler for a wide array of businesses that operate in many different jurisdictions?

A lot, actually. Ever since the National Governors Association began promoting the notion of an 'integrated' sales tax system to be adopted by a consortium of states, concerns about protecting both consumer privacy and constitutional principles have proved a formidable obstacle. The NGA's own "trusted third party" scheme (proposing the use of private-sector agents to collect centralized data on consumer purchases) exposed the impossibility of protecting consumer privacy from massive new government intrusions under such a regime. The Streamlined Sales Tax approach is an attempt to move in the same direction, but in a series of steps, presumably so that taxpayers and consumers won't figure out what's happening until it is too late.

This just won't do. States can't enhance their powers over taxing interstate commerce without trampling on consumer privacy, raising the overall tax burden, and violating important constitutional principles. And many states who don't want to join a sales tax consortium might be pressured into doing so by businesses interested in having a uniform compliance regime. Even if a sales-tax consortium remained limited to a voluntary association of states, that association would of necessity have to make collective decisions about taxation, and could only do so by creating a coordinating body of some sort: a *de facto* third tier of government between the states and the national government, with no constitutional standing whatsoever.

If states are concerned about a "level playing field" between bricks-and-mortar retailers, mail order companies, and Internet sellers, all they need to do is reduce sales taxes across the board. The fact is that local retailers increasingly do e-tailing as well, at least for promotional purposes, and more and more large retailers (i.e. WalMart) are seeking e-commerce partners to diversify their marketing and sales efforts. The Internet is just another way of doing business, at least where retailing is concerned, and the collapsing barriers between e-commerce and traditional retailing will solve most "problems" of sales tax collection as time goes by, because a larger and larger volume of e-tail transactions will be done by companies with constitutional nexus in the state seeking to levy sales tax.

The growth of the New Economy and its generation of unprecedented budget surpluses for all levels of government should prove, once and for all, that increasing taxes or broadening the reach of tax collectors is not the way to build economic strength, or even to generate revenues for the legitimate purposes of government. As the Institute for Policy Innovation reminds us, state and local sales tax collections grew from $132 billion in 1995 to nearly $166 billion in 1999: all at a time when the growth of Internet sales supposedly was “hollowing out” the sales tax base. It just isn’t true.

One decisive change since the Internet sales tax debate began is the collapse of the high-tech sector in terms of venture capital, job creation, and even share of commercial transactions. Estimates of Internet sales growth from just a year ago have proved wildly optimistic. The last thing our economy needs now is new burdens on the New Economy, which still holds the keys to our economic future but is struggling through an inevitable period of transition. This Committee’s watchword must be, no new taxes; no new multistate taxing cartels; and no new Federal, state, and local collusion in favor of new taxes.

Dr. Hunter is Chief Economist at Empower America and in the early 1980’s staffed the Subcommittee on Intergovernmental Affairs of the Committee on Finance. Mr. Pieler is Washington Representative for the National Tax Limitation Committee and served as Tax Counsel to the Committee on Finance from 1981 to 1985.

Statement of the Industry Council for Tangible Assets

The Industry Council for Tangible Assets (ICTA) appreciates this opportunity to submit our comments to the Committee. We are the national trade association for the precious metals and rare coin industry. The organization speaks for more than 5,000 businesses nationwide, 84% of which are small (1–5 employees) “mom and pop” shops. Even our largest dealers would be considered small businesses by national standards.

For reasons unique to our industry, we oppose taxing interstate e-commerce in precious metals and rare coins. In addition, we support the views of many commentators that the evolving e-commerce market should continue to be left unhampered to develop. Should some form of taxation be imposed, despite the sound arguments of these commentators, precious metals and rare coins should be exempted due to their unique nature and as low-profit investment items.

INDUSTRY BACKGROUND

- When compared to consumer goods (the usual target of sales and use taxes), precious metals and rare coins have fairly large gross sales prices, with unusually low profit margins. For example, a common “small” investment transaction of just 10 ounces of gold currently has a gross sales value of about $3,000. The **gross** profit margin on these commodity/investment products is usually less than 2%. Consumer products, of course, have much higher profitability—often from 50% to over 100%.
- Precious metals and rare coins are currently exempt from sales taxes in 26 states, and 5 more states have pending exemption legislation. These states have rightly recognized that it is not appropriate to tax precious metals and rare coins as though they were consumer goods; precious metals and rare coins are exempt from sales/use tax for the same reasons that commodity transactions on exchanges and stocks and bonds are exempt. Precious metals and rare coins are usually purchased as investments to balance portfolios and provide long-term investment stability. Many of these products are accepted as tax-advantaged investments in IRA’s and other pension and profit-sharing plans. Industry Council for Tangible Assets
- Historically, low gross profit margins have made national collection of out-of-state sales/use tax prohibitively expensive for even larger precious metals and rare coin dealers. Pre-Internet, dealers managed their out-of-state tax liabilities by observing the bright line rulings of Quill v. North Dakota (1991) and National Bellas Hess, Inc. v. Department of Revenue of Illinois (1967).
- Unlike consumer goods, rare coins are unique. They cannot be ordered in the same way as fungible (interchangeable) consumer merchandise. In fact, for the most part, these products are only available on a secondary market because they are no longer being manufactured. Often investors and dealers must search nationwide for a particular item. Dealers and investors regularly contact one another to buy and sell via advertisements in national publications.
- Rare coins are not consumed (used) at all in the same sense as intended for sales and use taxes. Most rare coins will be bought and resold every few years, which would result in more taxes being paid on a single rare coin over time

than the actual value of the coin. Such multiple taxation would clearly be an unintended result.

- The Internet is starting to augment other means of nationally searching and networking for precious metals and rare coins but, like the telephone/mail order business, Internet commerce is hampered by ever-increasing shipping costs that, of course, are not applicable to brick and mortar merchants. In fact, shipping costs are often higher than the local sales taxes would have been. In 2001 alone, the US Postal Service has implemented two *significant* increases in its Priority Mail rates, which is the most popular method for delivering merchandise.
- Our small businesses are experimenting with Internet commerce. Over time, the Internet should help foster a truly national market in precious metals and rare coins but near term, like many other merchants, our dealers who use the Internet mostly report that they are struggling for profitability.
- We are aware that a number of states are working cooperatively on a sales tax simplification plan. In our view, it is not likely that any state simplification plan will be as "simple" as state regulators would believe and would ultimately place a complex burden on merchants, including our industry's small businesses.

INDUSTRY CONCERNS

- We would hope that the existing exemptions would be honored in any Internet taxing plan. Otherwise, if interstate/Internet commerce is taxed, we could see two sets of rules—one for within the state and one for interstate transactions via the Internet. Industry Council for Tangible Assets
- We understand that a *de minimis* exemption might be under consideration. However, the high dollar value of precious metals and rare coin sales will quickly propel sales figures of even mom and pop shops past any "normal" *de minimis* that might be established for consumer products.
- Applying sales/use taxes to interstate e-commerce in precious metals and rare coins would discriminate against residents of rural and smaller population states that do not have access to brick and mortar facilities.
- Low gross profit margins make national collection of out-of-state sales/use taxes prohibitively expensive for even larger dealers. Certainly the additional burden placed on small dealers inhibits their ability to compete in our national market.

On a more general note, we believe that expanding taxation to any interstate commerce will be especially harmful to senior citizens living on fixed incomes, especially the infirm. This includes those who can no longer shop at brick and mortar stores and, therefore, must rely on mail and phone orders for many of their needs. They are already forced to pay more for the items they purchase due to shipping and handling charges, and they can no longer shop for discounts. We feel that making changes in the application of sales taxes is punitive, if not discriminatory, for older Americans.

Our small businesses wish to compete in Internet commerce, and we support the comments submitted by others concerning premature burdens on e-commerce. We urge the Committee to allow Internet commerce to operate unimpeded so it can reach its potential of a viable marketplace and, thereby, become a major provider of tax revenue that results from successful, profitable trade.

Specifically, for the precious metals and rare coin industry, imposition of Internet/interstate sales taxes will have a major disruptive impact on the marketplace for these low profit margin investment items and our small businesses that deal in these products.

STATEMENT OF THE INTERNATIONAL COUNCIL OF SHOPPING CENTERS

ICSC is the global trade association of the shopping center industry. Its 39,000 members in the United States, Canada and more than 75 other countries around the world include shopping center owners, developers, managers, investors, lenders, retailers and other professionals. The shopping center industry contributes significantly to the U.S. economy. In 2000, shopping centers in the U.S. accounted for $1.14 trillion in retail sales, collected $46.6 billion in state sales taxes and employed 10.7 million people. ICSC is a founding member of the e-Fairness Coalition, a diverse group of brick-and-mortar and on-line retailers and trade associations that support a level playing field with regard to sales and use tax collection.

Today, your Committee is holding a hearing on (1) whether (and how long) to extend the moratorium on Internet access taxes and on new, multiple and discriminatory taxes on electronic commerce, and (2) whether (and under what conditions) states should be authorized to require the collection of remote sales taxes. ICSC would like to present its views on this very important issue and the need to enact legislation that would allow states that simplify their sales tax systems to require remote merchants to collect sales and use taxes on their behalf.

Simply stated, we believe that all goods, regardless if they are purchased over the Internet, via catalog or in traditional retail stores, should be subject to the same state and local tax collection requirements. One form of commerce should not receive preferential tax treatment over another. Unfortunately, existing tax law is structured to favor electronic commerce over sales made in local retail stores.

Contrary to what some may say, it is not the current moratorium on Internet taxes that precludes states from requiring out-of-state retailers to collect sales and use taxes. Instead, it is a 1992 Supreme Court case, *Quill v. North Dakota*, that held that remote merchants are not required to collect sales and use taxes for states in which they do not have a physical presence or "nexus." The moratorium—which expires in October—applies only to taxes on access charges and to new, multiple and discriminatory taxes on electronic commerce.

ICSC does *not* support the enactment or implementation of Internet access taxes or new, multiple or discriminatory taxes on electronic commerce. Instead, we believe that *existing* sales and use taxes should be collected uniformly on all types of retail sales. The taxes which states should be able to require remote sellers to collect are not new taxes. Instead, they are existing use taxes which buyers are currently obligated to remit to their state and local governments. However, as a practical matter, most individuals are either unaware of their tax obligations, or simply do not bother to comply.

We support electronic commerce and believe it should be fostered. In fact, many traditional brick-and-mortar retailers have incorporated e-commerce into their businesses in order to obtain new customers and better serve existing ones. However, as a matter of fairness and sound tax policy, Internet-based retailers should not receive a competitive tax advantage over traditional brick-and-mortar merchants simply because electronic commerce is a new and growing form of transacting business.

The inequitable situation that traditional retailers find themselves in is very clear to most Americans. In fact, ICSC commissioned Wirthlin Worldwide last year to survey Americans on this issue and found that two-thirds of them believe it is unfair to require brick-and-mortar retailers to collect state and local sales tax without requiring Internet-based retailers to do the same.

The reality is, as more and more Americans go online to purchase goods, the competitive tax advantage that Internet-based retailers currently enjoy will negatively affect many local brick-and-mortar retailers, shopping centers and their communities in the near future. Not only will traditional retailers sell fewer goods, but their employees will suffer from reduced working hours, wages or layoffs.

In addition, many state and local governments are beginning to experience slower growth in sales tax revenues—revenues that provide essential public services such as education, police and fire protection, and road repairs. Governments that rely heavily on sales tax revenues to fund key programs, are beginning to, or will soon, face severe budget shortfalls. When Wirthlin Worldwide surveyed Americans about this scenario, they found that a majority (55%) believes that reduced sales tax revenues would cause state and local governments to either raise other taxes, such as property or income taxes, or cut state and local programs.

Furthermore, if governments decide to increase sales tax rates to make up for lost revenues, lower-income individuals would wind up paying an even higher share of their income on sales taxes since they are less likely to own computers and purchase products on-line. The survey found that Americans overwhelmingly agree (62%) that this situation would be unfair.

Our critics assert that electronic commerce is a new and growing industry and, therefore, should not be saddled with "old world" sales tax collection requirements. They say we should not kill the goose that lays the golden egg. Our response is that, while electronic commerce is a growing and important part of our economy, subjecting it to the same sales tax collection requirements that traditional merchants have been subject to for decades would not harm its growth or vitality. Electronic commerce will continue to flourish, regardless of whether or not sales and use taxes are collected by on-line retailers.

These critics also claim that forcing Internet retailers to collect sales and use taxes for the thousands of state and local taxing jurisdictions across the country would be too burdensome on electronic commerce and cannot be done. We agree that all businesses, especially small businesses, should not be overburdened by sales tax collection requirements and that state and local governments should continue to work to simplify their sales tax systems. However, software is currently available that can assist Internet retailers in computing, collecting, filing and remitting sales and use taxes on their out-of-state sales. Furthermore, ICSC supports efforts being made by the Streamlined Sales Tax Project (SSTP), the National Conference of State Legislatures (NCSL) and participating state governments to simplify and streamline our nation's state and local sales and use tax systems.

Another argument often made by our critics is that states and localities are flush with cash and do not need to tax electronic commerce. While many state and local governments are currently enjoying budget surpluses, a growing number of states and municipalities are beginning to feel the effect of our slowing economy. Some states, such as Kentucky and Tennessee, are currently experiencing budget difficulties and will soon have to cut back on government services or raise taxes.

It is important to reiterate that the shopping center industry does *not* oppose the actual substance of the current moratorium or bills that would extend it. *However, we strongly believe that any extension of the moratorium must also level the playing field with regard to sales and use tax collection*.

ICSC strongly supports the *Internet Tax Moratorium and Equity Act* (S. 512) introduced by Senators Byron Dorgan, Michael Enzi and others. In addition to extending the moratorium for several years, S. 512 would allow those states that simplify their sales tax systems to require remote sellers to collect sales and use taxes on their behalf.

In closing, we would like to point out that the U.S. Supreme Court has clearly recognized Congress' authority to enact legislation that would allow state and local governments to require out-of-state retailers to collect sales and use taxes. Therefore, ICSC urges Congress to enact S. 512, or a reasonable compromise, that would level the playing field among Internet-based and traditional retailers.

Thank you for this opportunity to express our views on this very important matter.

STATEMENT OF THE NATIONAL RETAIL FEDERATION

[SUBMITTED BY SCOTT CAHILL]

The National Retail Federation (NRF) appreciates the opportunity to provide comments regarding a possible extension of the Internet Tax Freedom Act (ITFA), and more importantly, how state sales taxes should apply to remote commerce.

By way of background, the National Retail Federation is the world's largest retail trade association with membership that comprises all retail formats and channels of distribution including department, specialty, discount, catalog, Internet and independent stores. NRF members represent an industry that encompasses more than 1.4 million U.S. retail establishments, employs more than 22 million people—about 1 in 5 American workers—and registered 2000 sales of $3.1 trillion. In its role as the retail industry's umbrella group, NRF also represents 32 national and 50 state retail associations.

ELIMINATE THE SALES TAX LOOPHOLE NOW

Retailers oppose any new taxes on the Internet, including any new "access" or "bit' taxes. Legislation to prohibit states from imposing these new taxes on the Internet itself is not objectionable as a substantive matter. What is objectionable is that proposals to extend this moratorium do not eliminate the existing inequity in state sales tax law that unfairly exempts some remote sellers from collecting a states' sales tax. Refusing to address this "sales tax loophole" in the same context as other Internet tax issues ensures that an "unlevel tax playing field" will continue to exist for retailers and low-income consumers.

If the ITFA is extended this year without eliminating the sales and use tax inequity, resolution of this inequity, as a practical matter, will be deferred for many years—perhaps forever. This will lead to a continued erosion of state sales tax revenue, continued discriminatory tax treatment that disadvantages storefront retailers, and intensification of the digital divide. Projected shifts of commerce to the Internet, already evidenced today, will only exacerbate this dilemma and enhance this discrepancy over time.

EXISTING SALES TAX LAW IS UNFAIR

Under current law, retailers are required to collect sales taxes from a customer and immediately remit this tax to the state. However, based on two Supreme Court rulings, some out-of-state retailers (those without a physical presence in the purchaser's state) are not required to collect and remit a state's sales and use tax. Since many Internet sites and remote sellers aren't located in a purchaser's state, they are not required to collect these taxes. Allowing some out-of-state sellers freedom from having to collect sales taxes while requiring their in-state counterparts to do so creates an "unlevel playing field" among retailers. **Current sales and use tax law creates an "unlevel playing field" among retailers.**

In an industry where a 1–2 percent profit margin is standard, a 6–8 percent tax differential (the average state's sales and use tax rate) is a significant price advantage. Consumers should pick winners and losers based on factors which they decide are important such as selection, service, and convenience. Tax policy should not provide one retailer a pricing advantage over another. **The government should not be in the business of picking winner and losers.**

On average, sales and use taxes account for approximately 40 percent of a state's total tax revenue (more than $150 billion in 1998). With on-line sales continuing to increase, state and local governments could lose as much as $20 billion in uncollected sales taxes. Sales tax revenue is used to fund basic state and local governmental services including police and fire protection, school funding, etc. **State and local government services will suffer as their revenue base decreases.**

According to a Commerce Department study, wealthy individuals are 20 times more likely to have Internet access. Unfortunately, single parents, Hispanics and Blacks lag behind in computer ownership. With an average Internet household income of $70,000, an "unlevel playing field" would benefit those with higher levels of income and shift the tax burden to lower income individuals who can only buy locally (and thus pay sales tax at the sales counter). **An "unlevel playing field" disproportionately hurts the poor.**

THE THREAT STILL EXISTS

According to the Commerce Department, U.S. e-commerce sales for the first quarter of 2001 were up 33.5 percent from the first quarter of 2000. Despite a slowdown in retail sales in 2000 and 2001, e-commerce sales increased almost 70 percent over 4th quarter 1999 to 2000 (the holiday shopping season). Ninety-six million Americans have browsed a website, 68 million have made on-line purchases. Thirty-six million Americans shopped on-line in December of last year, spending an average of $304.

Despite varying figures, remote sales account for between 3.5 and 6.0 percent of total retail sales. Close to $50 billion in consumer purchases were made on-line in 2000, while more than $110 billion were spent on catalog purchases. Books, music, and videos purchased from remote sellers account for more than 10 percent of all retail sales.

Though some high-profile Internet retailers have failed in recent months, remote sales (Internet and catalog) continue to increase. Many of these fledgling companies never adopted a sound retail business strategy, and suffered from that mistake. Retailing is a very competitive business. On average, 15,000–18,000 retailers go out of business every year. The retail industry in general has fallen on hard times, not just Internet retail companies. For example, after more than 125 years in business, Montgomery Wards went out of business in 2001, closing 252 stores and laying off more than 35,000 employees in one day.

No sector of the economy or an industry should be provided with preferential treatment. Retailers only seek equitable tax treatment, regardless of where or how they sell their goods.

THE SOLUTION—A FEDERAL LEGISLATIVE ROADMAP

Federal legislation must encourage States to simplify their sales and use tax systems in order to minimize the collection burden for all sellers. It is essential that any Federal legislation provide States the authority to collect from all remote sellers once this simplification and unification is achieved. More important, this legislation must also provide for tax simplification and expanded state authority to collect in an expedited and detailed manner to ensure that the existing inequity is eliminated.

NRF and interested parties have worked closely with Members of the House and Senate to find an acceptable solution to this problem. Negotiations have included representatives from state and local governments, the high-tech community, and the retail industry. **S. 512, introduced by Senator Byron Dorgan (ND), and H.R. 1410, introduced by Rep. Ernest Istook (OK), both provide the level of sales tax simplification and uniformity needed by both in-state and out-of-state retailers**. Furthermore, these proposals would allow interested states to opt-in to this new system, and ultimately expand their collection authority to remote sellers.

EQUITABLE TAX COLLECTION OBLIGATIONS FOR ALL RETAILERS

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 single or multi-channels in which a retailer does business, should be treated equally with respect to collection obligations 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. Tax policy should be channel neutral.

In order to achieve parity, goods purchased from remote sellers should be taxed at the same rate as goods purchased through traditional stores. Congressional action is necessary to allow businesses to operate in an equitable environment that ensures fair competition, protects all consumers, sustains our communities, and addresses simplification of state sales and use tax systems.

SALES TAX UNIFORMITY AND SIMPLIFICATION

NRF believes it is important to set forth principles that should guide the effort to create a fair, workable, and simplified sales and use tax system. NRF recognizes that general principles do not always provide answers to specific problems, in part because there is sometimes tension between the implications of such principles. In building a simplified tax system, there will be occasion when one or another of the guiding principles will take precedent over another, at least for a time. Nevertheless, NRF believes that it is important to articulate guiding principles if for no other reason than to have a standard against which to measure the soundness of any proposed simplified sales and use tax regime.

To that end, NRF endorses the following guiding principles, which have been endorsed by the United States government and most other developed nations under the auspices of the Organization for Economic Cooperation and Development (OECD):

> *Neutrality*—taxation should seek to be neutral and equitable between forms of e-commerce and between conventional and electronic commerce, so avoiding double taxation or unintentional non-taxation.
>
> *Efficiency*—compliance costs to business and administration costs to governments should be minimized as far as practical.
>
> *Certainty and simplicity*—tax rules should be clear and simple so that both taxpayers and tax collectors understand them.
>
> *Effectiveness and fairness*—taxation systems should be designed to minimize the possibility of evasion or avoidance.
>
> *Flexibility*—taxation systems should be flexible and dynamic to ensure that they keep pace with technological and commercial developments.[1]

NRF is committed to creating a fair, workable, and simplified sales and use tax system for the twenty-first century. NRF believes the creation of such a system is critical to the future of a vibrant retail sector in which vigorous competition occurs without regard to artificial tax advantages or barriers. Uniform definitions, a centralized system of registration and tax administration, a limited number of state tax rates, uniform sourcing rules, and vendor compensation are important components addressed in a paper which details NRF's view of the essential elements of a viable sales and use tax system in depth. This detailed list of retail industry prerequisites for sales and use tax simplification is attached in the industry white paper entitled, *The Level Playing Field and Beyond, A Framework for a Fair, Workable, and Sustainable Sales and Use Tax System (March 2001).*

The Single-Tax-Rate-Per-State Issue

Some in the business community have argued that a single sales tax rate per state is necessary for simplification to remove any future collection and compliance burden from retailers. **NRF, representing a significant majority of the U.S. retail industry, the very people that will use this new simplified sales tax system, does not believe a single-rate per state is mandatory**. Rather, NRF believes that simplification can still be achieved with a limited number of rates per state, assuming the states and locals can agree to adopt uniform definitions for goods and services, limit the frequency of rate changes, and that software is made available to vendors that is capable of synthesizing this information quickly and accurately. It is worth repeating that retailers believe that uniform definitions (uniform base) is the most critical element of any simplification process.

[1] Organization for Economic Cooperation and Development, Taxation Principles and Electronic Commerce (1998).

New Business Activity Tax (BAT) Standards

There are concerns by some in the business community that if Federal legislation either directly, or indirectly, overturns *Quill's* physical presence precedent, a businesses' exposure to income tax or other BAT taxes could be increased. To address this concern, most legislative proposals (S. 512 and H.R. 1410) detailing simplification criteria, as well as state and local simplification projects, include provisions stating that any sales and use tax collection obligation will not be a factor in determining whether a seller has nexus with a state for any other tax purpose.

Others in the business community, however, see an extension of the ITFA and a possible resolution to the sales tax inequity as an opportunity to provide new bright-line BAT nexus standards in other areas. *While the retail industry recognizes some of their concerns, retail does not believe additional BAT provisions should be incorporated into this debate at this time*. Reaching a consensus on any new BAT standards at this time will be difficult, and will shift focus away from the primary goal of sales tax simplification and uniformity of state sales tax structures.

Offsetting and Measuring Compliance Burdens Under a New Tax System

Due to the complexity of existing sales and use tax systems, the state and local governments that impose these taxes require an outside third party (i.e. 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. Retailers expend significant time and resources collecting and remitting the taxes to the appropriate taxing authority and documenting their compliance. The costs of collecting these consumption-based taxes does not fall on the states or locals, but rather on retailers who are required by law to act as the taxing jurisdiction's collection agent.

Retailers do not oppose acting as a states' collection agent, however, it is only fair that states provide these mandated vendors with some sort of compensation for the compliance costs associated with collecting and remitting sales taxes. *One simple solution to determine what, if any, compliance burden actually exists on vendors would be to undertake a joint state/vendor study to determine the actual costs of collection and remittance of sales and use taxes under the old versus a new sales tax system.*

Not only would this study measure compliance burdens under existing state sales tax systems, but it could also quantify the level of simplification achieved when compared to the sales tax simplification provisions which are ultimately adopted. The results of this study would provide legitimate data for the states and vendors as to the actual costs of compliance, and consequently, what compensation should be provided to vendors as the state sales tax simplification process moves forward. The study would be continually updated.

The National Retail Federation, and the U.S. retail industry, looks forward to working with the Senate Finance Committee to address these issues and to find a resolution that eliminates the existing state sales tax inequity.

THE LEVEL-PLAYING FIELD AND BEYOND: THE NATIONAL RETAIL FEDERATION'S POSITION PAPER ON THE FRAMEWORK FOR A FAIR, WORKABLE, AND SIMPLIFIED SALES AND USE TAX SYSTEM

INTRODUCTION

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, catalog, 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 is strongly committed to efforts to create a fair, workable, and simplified sales and use tax system for the twenty-first century and beyond. NRF believes the creation of such a system is critical to the future of a vibrant retail sector in which vigorous competition occurs without regard to artificial tax advantages or barriers as well as the continued fiscal health of our nation's state and local governments. With these goals in mind, NRF has set forth below its view of the essential elements of a viable sales and use tax system for the future.

I. GUIDING PRINCIPLES

NRF believes it is important at the outset to set forth the principles that should guide the effort to create a fair, workable, and simplified sales tax and use tax system. NRF recognizes that general principles do not always provide answers to specific problems, in part because there is sometimes tension between the implications of such principles. This can happen because the specific steps necessary to implement the general principles can sometimes conflict with each other. For example the goal of economic neutrality (treating all similar forms of commerce similarly) may conflict with the goal of administrative simplicity if one form of commerce is not amenable to the same rules appropriate for another form of commerce. NRF nevertheless believes that it is important to articulate the guiding principles if for no other reason than to have a standard against which to measure the soundness of any proposed sales and use tax regime.

NRF endorses the following guiding principles, which have been endorsed by the United States Government and most other developed nations under the auspices of the Organization for Economic Cooperation and Development (OECD):

- Neutrality—taxation should seek to be neutral and equitable between forms of e-commerce and between conventional and electronic commerce, so avoiding double taxation or unintentional nontaxation.
- Efficiency—compliance costs to business and administration costs to governments should be minimized as far as practical.
- Certainty and simplicity—tax rules should be clear and simple so that both taxpayers and tax collectors understand them.
- Effectiveness and fairness—taxation systems should be designed to minimize the possibility of evasion or avoidance.
- Flexibility—taxation systems should be flexible and dynamic to ensure that they keep pace with technological and commercial developments.[1]

II. THE ESSENTIAL ELEMENTS OF A FAIR, WORKABLE, AND SIMPLIFIED SALES AND USE TAX SYSTEM

A. Uniform Tax Base Definitions

A fair, workable, and simplified sales and use tax system must have a uniform set of tax base definitions across state lines. A uniform set of tax base definitions does not mean identical tax bases. States would retain the authority, within the limits of the uniform set of definitions of goods and services, to determine which goods and services they wish to tax. However, the definitions themselves must be identical and comprehensive, i.e., there can be no variation from state to state in the identification of particular goods and services, and classification of goods and services must leave no good or service unidentified.[2]

Other elements of the uniform set of tax base definitions must assure that there are no local variations from the state approach (i.e., if a good or service is taxable or exempt at the state level it must likewise be taxable or exempt at the local level); that changes in the base (taxable or nontaxable) be made only annually, effective January 1 of the succeeding year, and communicated at least six months prior to the effective date; that "bundled" transactions (involving more than one identifiable category of goods and/or services for a single price) be either fully taxable or fully exempt based on whether more or less than 50% of the charge is for the taxable items; that the taxability of the goods or service not depend on the price of the item, the age of the buyer, or whether the item upon which services are performed is new or used; that taxes, finance charges, and shipping and handling charges be treated uniformly (e.g., always excluded, always included, or excluded if separately stated); that coupons be treated uniformly (e.g., vendor coupons reduce price, manufacturer's coupons do not); that taxes be refunded on returns without limitation and that a clear rule for trade-ins (taxable on net or gross) be stated. The foregoing list is intended to be illustrative rather than exhaustive and may be subject to modification as the process of refining the tax base progresses.[3]

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[1] Organization for Economic Cooperation and Development, Taxation Principles and Electronic Commerce (1998).

[2] This does not mean that the list of identifiable goods and services must be long. Indeed, NRF strongly believes that the number of identifiable categories of goods and services should be kept as short as possible. To account for goods and services that do not clearly fall within one of the identifiable categories, there would be a catchall or default category, and a state would have to determine whether goods or services falling into the residual category were taxable or nontaxable.

[3] It has been suggested that no menu of taxable and exempt goods and services, unless it just contains a handful of items, can address the problem of those who make catalog purchases and wish to pay by check, so that there will be no interaction with any tax administration software, that ordinarily would facilitate the tax determination and collection process. While this is jut one of many details that will have to be ironed out in developing a final proposal for a fair, workable, and simplified sales and use tax system, such transactions could be addressed through a general default principle (e.g., fully exempt, or fully taxable at the purchaser's state rate) or by making tax remittance information readily available at a toll-free number and, in any event, by holding vendors harmless from any tax liabilities in underpayment circumstances.

B. Uniform Exemption Rules

Closely related to—and equally important as—a uniform set of tax base definitions to the creation of a fair, workable, and simplified sales and use tax system is the adoption of uniform exemption rules and procedures. In other words, wholly apart from the initial determination of whether the good or service sold is taxable or exempt, see Section A above, there must be a uniform methodology for determining whether a particular purchase is exempt because of the status of the purchaser (e.g., a church) or the purchase (e.g., a sale for resale). The uniform exemption certificate or certificates must be available in electronic as well as tangible form and there must be standard procedures under which a seller, by complying with such procedures, will be protected from any liability arising out of the transaction.

In this connection, NRF believes that the Streamlined Sales Tax Project appears to have properly identified the salient features of a redesigned exemption administration process. Specifically, the Project is currently developing a process under which (1) a buyer will claim exemption by completion of a standard set of information (on paper or electronically) indicating the identity of the purchaser and the reason for the exemption and (2) a seller will not be held liable or responsible for verifying the validity of the claimed exemption or the "good faith" of the purchaser. The obligation will be on the state to police any potential exemption abuse through the information provided when the exemption is claimed. A procedure as that outlined above will be essential if the Streamlined Sales Tax is to receive NRF endorsement.

C. Uniform and Centralized Administration

An indispensable feature of a fair, workable, and simplified sales and use tax system is the replacement of the existing system of multiple and inconsistent administrative requirements with a uniform and, to a certain extent, centralized administrative structure. Specifically, this system must include a centralized, one-stop multistate registration system for vendors; uniform tax returns and remittance forms (electronic as well as paper); uniform audit procedures; and state administration of all state and local taxes.

D. Limited Number of State Rates

One of the most nettlesome sources of complexity and uncertainty in the existing system of state and local sales and use taxes is the multiplicity of tax rates in the more than 7600 state and local jurisdictions across the country that impose sales and use taxes. It is often difficult for a multi-state vendor to determine the appropriate rate for the appropriate jurisdiction when the tax equation is further complicated by multiple, sometime conflicting, definitions for goods and services. Indeed, it was this very problem that led the U.S. Supreme Court in *Bellas Hess* and *Quill* to hold that requiring remote sellers to collect use taxes would impose a significant and impermissible burden on interstate commerce.

In order to create a fair, workable tax system in which all sellers can be required to collect sales taxes, any compliance burden must be minimized by limiting the number of state sales tax rates per state. NRF recognizes the legitimate needs of local governments for tax revenues and believes that some flexibility on the number of rates within a state must be made to ensure local needs are met. This "limited number" of rates is, however, a problem that is most appropriately left for the states and localities to resolve on an individual basis in light of their particular circumstances. While one-rate-per-state may be the preferred solution to existing tax simplification problems, NRF believes that simplification can still be achieved with a limited number of rates per state, assuming the states and locals can agree to adopt uniform definitions for goods and services, limit the frequency of rate changes, and that software is made available to vendors that is capable of synthesizing this information quickly and accurately.

E. Uniform Sourcing Rules

A fair, workable, and simplified sales and use tax system must have uniform (and simple) rules for attributing transactions to particular jurisdictions. NRF believes that the governing rule for sourcing transactions in this new system, which is designed to be a tax on consumption, is and should continue to be the destination principle. NRF also believes, consistent with its view that there should only be one rate per state, see Section D above, that goods and services should be sourced only to the state level. With respect to sales of tangible personal property, the "ship to" address, where known or readily available, should be used to determine the destination state. With respect to sales of digital products or services, there should be a hierarchy of rules depending on the nature of the transaction and the information readily available to the vendor. Where the seller, at the time and in the ordinary course of the transaction, has knowledge of the actual state of destination or use, the sale would be sourced to that state. Where the actual state of destination or use is not known or readily available, the buyer's billing address, where readily available, would be employed as a proxy for the actual state of destination. Where neither actual state of destination nor the buyer's billing address is known, or readily available, a default rule would apply which would subject the transaction to a single tax rate that is the same for all sellers in all states.

NRF recognizes that the foregoing sourcing principles provide no more than the framework within which more precise corollaries of these principles must be spelled out. Among other issues that must be addressed are the treatment of the sale of digital products or services for use in multiple destinations and the treatment of gifts. With regard to the former, which largely involves business-to-business transactions, NRF strongly believes that the increased use of the direct-pay mechanism, which must be an integral part of a redesigned sales and use tax system, will provide considerable assistance in resolving this issue. Under a direct-pay procedure, in which registered businesses self-assess sales and use tax, business purchasers of digital products or services would assign a portion the tax to the state or states in which it used the digital products or services. With respect to gifts, they should be treated as any other transaction and taxed based on destination.

F. Uniform Collection Obligations: The Level Playing Field

A fair, workable, and simplified sales and use tax system requires that all vendors, except those making de minimis sales into a state, collect sales and use tax on all sales into the state regardless of their physical presence in a state. There is no sound tax policy reason for exempting goods or services from sales tax in a state merely because they have been purchased from a remote vendor. Indeed, as a matter of law such goods or services currently are fully subject to use tax. The only reason such goods or services have enjoyed a de facto exemption is because the U.S. Supreme Court has held that the existing system of sales and use taxation is so complex that it would be a burden on interstate commerce to require the remote seller to comply with varying and often inconsistent rules of thousands of state and local taxing jurisdiction, and states not have successfully induced consumers to remit use taxes voluntarily. With the adoption of the uniform rules and procedures outlined above, those burdens will be eliminated, and states can reasonably require remote vendors to collect tax on sales into their state imposed on a uniform base and at a single rate. Any other rule would create an artificial and unfair tax advantage for those selling from remote locations to the detriment of local retailers and their customers.

G. De Minimis Rule for Small Vendors

Recognizing that small enterprises may have difficulty in complying with even a radically simplified sales and use tax regime, there should be a principle that relieves small vendors from the obligation to collect sales or use taxes on sale into multiple jurisdictions. NRF believes that vendors with less than $2–$5 million in gross annual sales should be relieved of any requirement to collect use taxes into jurisdictions in which they have no physical presence. The $2–$5 million cap should apply to total sales of all entities in a Federal Consolidated Group.

H. Vendor Allowances

A fair, workable, and simplified sales and use tax system must provide for reasonable compensation for all vendors, designed to compensate vendors for their actual costs. To determine those costs, NRF recommends undertaking a joint state/vendor study to determine the actual costs of collection and remittance of sales and use taxes. The study would review costs under the current sales and use tax structure, and what compliance costs would be under a new "simplified" sales and use tax system ultimately adopted by the States. Upon completion, the study would provide data to determine for the States and vendors what compliance costs are, and consequently, what compensation should be provided to vendors.

I. Uniform Procedures for Certifying Software

A fair, workable, and simplified sales and use tax system must provide uniform procedures for certification of software that sellers may rely upon to determine their state sales and use tax obligations and, if they rely upon such software, be held harmless from any additional liability.

J. Interstate Sales Tax Uniformity Commission

A fair, workable, and simplified sales and use tax system must provide for the creation of an Interstate Sales Tax Uniformity Commission to assure that the fair, workable, and simplified system that we create today will continue to be a fair, workable, and simplified system tomorrow. No matter how prescient the designers of a reformed sales and use tax system may be, controversies will inevitably arise in construing those provisions and there will no doubt be need for further refinement of the system in light of experience. For these reasons, NRF believes that it is absolutely essential to create a centralized administrative body empowered to address these questions in an authoritative manner. States must be fully answerable to this body and must therefore waive their Eleventh Amendment immunity if they wish to participate in the redesigned sales and use tax regime that will permit them to require remote vendors to collect sales and use taxes. The body should have representatives from the states and from the business community, including a fair and equitable representation of main street retailers.

K. No Effect on Nexus

No use tax collection obligation imposed on remote sellers in conjunction with the creation of the fair, workable, and simplified sales and use tax system described in this position paper shall be considered in determining whether a seller has nexus with a state for any other tax purpose. Specifically, except as provided above, nothing in this position paper should be read to permit a state:

(1) to license or regulate any business;

(2) to require any business to transact intrastate business; or

(3) to subject any business to any other nexus-based state taxes not specifically or exclusively related the sale of goods or services.

III. CONCLUSION

NRF is strongly committed to helping craft a fair, workable, and simplified sales and use tax system for the twenty-first century and beyond. NRF believes the creation of such a system is critical to the future of a vibrant retail sector in which vigorous competition occurs without regard to artificial tax advantages or barriers as well as the continued fiscal health of our nation's state and local governments. NRF believes the creation of a simplified system should be guided by the principles of: Neutrality, Efficiency, Certainty, Effectiveness, Fairness and Flexibility. The eleven essential elements outlined in Sections A through K above are not a conclusive list, but NRF views each of these elements as critical components of a viable sales and use tax system for the future.

STATEMENT OF ROBERT P. STRAUSS *

1. INTRODUCTION

This prepared testimony builds on earlier testimony before the Oversight Subcommittee of the House Committee on Ways and Means on May 16, 2000.[1]

It has not been fashionable in recent years to view Federal, state, and local taxes as intertwined. However, growing world economic interdependencies due to the spread of market economies and technological change obviously imply greater financial interdependencies for our governments.[2] It is my judgment that the states can not resolve such issues themselves; the very slow progress of the Streamlined Sales Tax Project warrants this conclusion.

Federal legislation is necessary for the states to have a sensible *structure* of revenue instruments which will allow them to decide the rate of consumption tax necessary to finance the level of public services they agree on. As an alumnus of the US Treasury and Staff of the Joint Committee on Internal Revenue Taxation. I have some preference that such Federal legislation be the responsibility of the tax writing committees of Congress. You and your staffs have the expertise to deal with the complexities of design and fiscal implications of such design. It is quite puzzling to me that the tax committees of Congress repeatedly have allowed the clear usurpa-

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[1] See Robert P. Strauss, "Federal Tax Mechanisms to Enable State Taxation of Final Consumption," *Tax Notes*, 87, 12 (June 19, 2000), 1657–64.

[2] The original 1913 Federal personal income tax recognized such interdependencies by requiring all taxpayers to deduct state and local taxes in arriving at Federal taxable income. At that time, Federal ability to pay was thought to occur *after* taxpayers took care of their state and local tax responsibilities.

tion of their legislative prerogatives in this area by several of the non-tax writing committees of Congress.

There is a need in my view for a steadying Federal hand in both the areas of electronic commerce and its taxation. In the case of especially retail electronic commerce. it will not flourish until there are in place, counterpart to existing paper institutions, electronic institutions that establish trust, customer-merchant and merchant-customer protections.[3] It is difficult to envision Americans parting with large fractions of their incomes across the net for goods and services unless they are certain they are as protected as when they engage in face to face commerce. Since much of the appeal for electronic commerce is its increased speed across jurisdictional boundaries, only the Federal government can effectively devise systems of standards that will make the appeal a reality. Related to the establishment of various standards for authentication, electronic record-keeping, and electronic notary services, is the supervision of such trusted third parties. For example, as the IRS and tax committees of Congress should have learned, simply enabling but not closely supervising private agencies to transmit tax returns does not always work as planned.

Below in Section 2, I address alternative ways the tax committees of Congress can, through Federal legislation, enable the states to deal constructively with their various consumption taxes, and in Section 3 suggest, as a precursor to any Federal legislation dealing with state taxation of sales over the Internet, that you strengthen the Jenkins Act. Recall that the Jenkins Act, passed by the tax committees of the Congress, has since 1949 obligated remote sellers of cigarettes to inform monthly destination state tax authorities the name and address of the person to whom shipment was made, the brand of cigarettes and the quantity purchased.

2. THE PROBLEMS OF STATE SALES AND USE TAXES AND POSSIBLE FEDERAL ROLES

2.1 PROBLEMS OF STATE SALES AND USE TAXES

Over time, state personal and corporate income taxes have become increasingly similar to their Federal counterparts. Because there is no Federal retail sales tax, there has been no comparable Federal template for the states to choose to gravitate to. As you know, state sales and use taxes are extremely important to state budgets, and in some states, the same is true for local sales and use taxes. Among the states, the structure of state sales and use taxes vary considerably. Whether the seller or customer is liable for the tax, the precise nature of whether a good or service is taxable, the rate, and a myriad of other administrative provisions vary. As a result, it is very difficult for a customer or vendor new to a state, let alone a local area, to be confident about what their duty to collect and remit is.[4]

Also, the fact that current sales and use taxes are substantially imposed on business input purchases is troubling from both economic and political perspectives. Such hidden taxes encourage purely tax motivated changes in business form (vertical integration), location of activity (through drop shipments and warehousing), and hide from voters true tax burdens.[5]

Table 1 displays the design decisions each state makes with regard to its sales tax.[6] The Constitution and Supreme Court decisions require that consumption taxes in classes A and C, and E and G be the same. From an economic perspective, state sales and use taxes would likely be much better were activities in classes E–G in Table 1 not taxed. Similarly, state sales and use taxes would be much better (and easier to administer) if the exemptions in the final consumption tax base, B and D, were as small as possible. The stricture “broad base, low rate” is as applicable to household or final consumption taxes as it is to income taxes.

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[3] Arguably, the disappointing growth of retail electronic commerce (B2C) can be explained by the absence of legal safeguards to consumers for seller fraud. See Karen Clay and Robert P. Strauss, “Trust, Risk and Electronic Commerce: 19th Century Lessons for the 21st Century, *Proceedings* of the 93rd Annual Conference of the National Tax Association, Santa Fe, New Mexico, November 9, 2000 (in press).

[4] See, Due, John and John L. Mikesell (1994). *Sales Taxation: State and Local Structure and Administration*. Second Edition. (Washington, D.C.: Urban Institute Press, 1994).

[5] The lack of political transparency of sales and use taxes is likely viewed positively by state and local elected officials.

[6] In Arizona, there is local control over the definition of what is taxable and exempt.

Table 1: Classification of State Consumption Tax Design Problem

Geography of Activity	Final Consumption		Intermediate Production	
	Taxable	Exempt	Taxable	Exempt
Sales	A	B	E	F
Use	C	D	G	H

How much are business inputs taxed by current state sales and use taxes? Table 2 displays recent estimates by state of the extent to which households (Column 3) and non-households or essentially business (Column 4) pay sales and use taxes. On average about 40% of sales and use taxes are paid by business; the range is from 11% (West Virginia to 72% (Hawaii)).[7] (We shall return to Table 2 when I discuss what a reformed state sales and use tax system might entail.) Current state and local sales and use taxes are thus far from transparent, and, in my view, nothing citizens in each state should be particularly proud of as a way to finance their public services.[8]

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[7] The non-household share, Column [3] in Table 2, can be thought of as the ratio of (E+G) to (A+C+E+G) in Table 1.

[8] Much testimony in the Committee's August 1, 2001 hearing was devoted to supporting *origin* based taxation rather than the current sate and local (and international) standard of *destination* based taxation. Dividing geographic principles is easily a recipe for tax planning that would result in the claim that all sales originated in sales tax free states such as Oregon, and create ambiguity and confusion over which kinds of transactions would be subject to origin vs. destination sourcing rules. Perhaps the most obvious argument in favor of destination as a sourcing rule involves the simple admission that the purpose of taxation is to pay for public services which residents enjoy. Given the obvious incidence of final consumption based taxes (on final consumers of the goods and services), placing taxation where the public services are enjoyed makes the most sense and avoids the most confusion and tax planning opportunities.

Table 2: State Sales and Use Tax Rates, Household's Share, and Estimated Final Consumption Sales and Use Tax Rates

State	January, 2000 State Sales & Use Tax Rates	Household Fraction Of Sales & Use Taxes	Non-Household Fraction of Sales & Use Taxes	1998 Sales Taxes as % of State Personal Income	1998 Sales Taxes as % of State Personal Outlays	Final Consumption State Sales and Use Tax Rate	Final Consumption State Rate as % of Current State Rate
	[1]	[2]	[3]	[4]	[5]	[6]	[7]
Alabama	4.0%	73.0%	27.0%	1.8%	2.2%	3.1%	76.3%
Arizona	5.0%	50.0%	50.0%	2.4%	3.0%	6.0%	119.4%
Arkansas	4.6%	60.0%	40.0%	2.9%	3.7%	6.1%	132.7%
California	6.0%	53.0%	47.0%	2.4%	3.0%	5.6%	93.5%
Colorado	3.0%	60.0%	40.0%	1.3%	1.7%	2.8%	93.8%
Connecticut	6.0%	58.0%	42.0%	2.5%	3.1%	5.3%	89.0%
Florida	6.0%	50.0%	50.0%	3.3%	4.2%	8.4%	140.2%
Georgia	4.0%	64.0%	36.0%	2.1%	2.6%	4.1%	101.8%
Hawaii	4.0%	28.0%	72.0%	4.1%	5.1%	18.2%	455.4%
Idaho	5.0%	62.0%	38.0%	2.5%	3.2%	5.1%	102.4%
Illinois	6.3%	68.0%	32.0%	1.7%	2.1%	3.1%	48.9%
Indiana	5.0%	54.0%	46.0%	2.2%	2.8%	5.2%	103.1%
Iowa	5.0%	59.0%	41.0%	2.2%	2.8%	4.7%	94.8%
Kansas	4.9%	67.0%	33.0%	2.5%	3.1%	4.6%	94.4%
Kentucky	6.0%	54.0%	46.0%	2.8%	3.5%	6.5%	107.7%
Louisiana	4.0%	51.0%	49.0%	2.4%	3.0%	6.0%	149.4%
Maine (4)	5.5%	57.0%	43.0%	2.9%	3.7%	6.4%	116.5%
Maryland	5.0%	60.0%	40.0%	1.7%	2.2%	3.6%	72.6%
Massachusetts	5.0%	62.0%	38.0%	1.5%	1.8%	3.0%	59.3%
Michigan	6.0%	58.0%	42.0%	3.0%	3.8%	6.5%	108.9%
Minnesota	6.5%	56.0%	44.0%	2.8%	3.6%	6.4%	97.9%
Mississippi	7.0%	66.0%	34.0%	3.9%	4.9%	7.4%	106.0%
Missouri	4.2%	64.0%	36.0%	2.0%	2.5%	3.9%	92.2%
Nebraska	5.0%	60.0%	40.0%	2.2%	2.8%	4.7%	93.2%
Nevada	6.5%	44.0%	56.0%	3.7%	4.7%	10.6%	163.4%
New Jersey	6.0%	62.0%	38.0%	1.7%	2.2%	3.5%	58.6%
New Mexico	5.0%	50.0%	50.0%	4.5%	5.6%	11.3%	225.2%
New York	4.0%	66.0%	34.0%	1.4%	1.7%	2.6%	65.8%
North Carolina	4.0%	62.0%	38.0%	1.8%	2.3%	3.7%	91.4%
North Dakota	5.0%	60.0%	40.0%	2.6%	3.3%	5.5%	110.8%
Ohio	5.0%	66.0%	34.0%	2.0%	2.5%	3.7%	74.8%
Oklahoma	4.5%	66.0%	34.0%	2.7%	3.4%	5.2%	114.9%
Pennsylvania	6.0%	64.0%	36.0%	2.0%	2.5%	3.9%	64.3%
Rhode Island	7.0%	59.0%	41.0%	2.0%	2.5%	4.2%	60.4%
South Carolina	5.0%	61.0%	39.0%	2.7%	3.4%	5.5%	109.8%
South Dakota	4.0%	61.0%	39.0%	2.7%	3.4%	5.5%	137.8%
Tennessee	6.0%	63.0%	37.0%	3.1%	4.0%	6.3%	104.6%
Texas	6.3%	53.0%	47.0%	3.0%	3.8%	7.2%	115.2%
Utah	4.8%	63.0%	37.0%	2.9%	3.6%	5.8%	121.2%

State	January, 2000 State Sales & Use Tax Rates	Household Fraction Of Sales & Use Taxes	Non-Household Fraction of Sales & Use Taxes	1998 Sales Taxes as % of State Personal Income	1998 Sales Taxes as % of State Personal Outlays	Final Consumption State Sales and Use Tax Rate	Final Consumption State Rate as % of Current State Rate
	[1]	[2]	[3]	[4]	[5]	[6]	[7]
Vermont	5.0%	56.0%	44.0%	2.2%	2.7%	4.8%	96.7%
Virginia	3.5%	70.0%	30.0%	1.4%	1.8%	2.6%	74.0%
Washington	6.5%	49.0%	51.0%	3.1%	3.9%	8.0%	123.4%
West Virginia	6.0%	89.0%	11.0%	2.8%	3.6%	4.0%	66.7%
Wisconsin	5.0%	62.0%	38.0%	2.3%	2.9%	4.7%	94.3%
Wyoming (3)	4.0%	54.0%	46.0%	3.0%	3.8%	7.0%	174.9%
Mean	5.2%	59.4%	40.6%	2.5%	3.1%	5.6%	111.1%
Std Dev	1.0%	8.8%	8.8%	0.7%	0.9%	2.7%	61.4%
Min	3.0%	28.0%	11.0%	1.3%	1.7%	2.6%	48.9%
Max	7.0%	89.0%	72.0%	4.5%	5.6%	18.2%	455.4%

Notes: Column [1] from Federation of Tax Administrators Webpage www.taxadmin.org; 2000; Column [2] and [3] from Raymond Ring, Jr. "Consumers' Share and Producers' Share of the General Sales Tax," *National Tax Journal*, LII, 1 (March, 1999), Table 1, p. 81;Column [4] John L. Mikesell, "Retail Sales Taxes, 1995-98: An Era Ends," *State Tax Notes*, Table 4, pp. 592-3. Column [5]= Column [4] / .794, the ratio of 1998 BEA Consumer Outlays/BEA Personal Income; Column [6]=Column [5] / Column [2]; Column [7]=Column [6] / Column [1]

The other emerging problem of state sales and use taxes is the likely erosion of states sales and use tax bases as retail electronic commerce grows. As you know, under *Bella Hess* and *Quill*, the states are not able to obligate remote sellers without a physical presence to collect and remit use taxes, although their residents remain legally obligated to pay them. Traditional merchants find themselves increasingly at a disadvantage as remote electronic vendors join remote mail and phone catalog vendors in arbitraging on price differentials that reflect use taxes not being collected. Business equity issues are thus becoming more pronounced. Both problems become exacerbated when the economy slows and state and local tax receipts decelerate.

Vendor collection and remittance at the time of sale makes far more sense and eliminates customer record keeping. How might the Federal government assist the states in obtaining better compliance with its use taxes?

2.1 ALTERNATIVE NEW FEDERAL ROLES

State Piggybacking onto New Federal Retail Sales Tax

Periodically, there has been discussion about the desirability of moving to a Federal consumption tax—either a value added tax or retail sales tax. In conjunction with such a redesign of Federal revenues, it has been suggested that the states could piggyback onto Federal administration. Time and space limitations do not permit an extensive discussion of whether or not it is a good idea to now consider a Federal retail sales tax as a mechanism for either fundamental Federal tax reform or as a way to help the states. However, let me state my conclusion, having looked at the issue closely several years ago,[9] that the economic argument favoring Federal consumption tax as a cure to lackluster economic performance is not as persuasive today as it was a decade ago. Even if the Federal government were to enact its own national retail sales tax, it is unclear whether or not the states would be drawn to such a template, especially if they did not retain control of their own rate of tax.

Federal Revenue Sharing to States of New Federal Retail Sales Tax

Were the Federal government to enact a national retail sales tax and then share back some or all of the revenues to the states, the states would still likely want to maintain their own sales and use taxes, although they might reduce reliance on their own. Issues of sovereignty would undoubtedly arise while the method or formula for Federal revenue sharing would likely be a difficult issue for Congress to resolve. Moreover, this approach might not readily deal with the above mentioned use tax problems should the states retain their own sales and use taxes, nor would it deal with cascading or complexity issues either.

Federal Assistance/Insistence but not Federal Collection of State Use Taxes

If state piggybacking onto a new Federal sales tax is not in the offing and revenue sharing is also not a plausible solution to state use tax issues, then what? What follows involves a solution based on the following tax policy pieces:

[9] Robert P. Strauss, "Administrative and Revenue Implications of Federal Consumption Taxes for the State and Local Sector," *State Tax Notes*, 15, 5 (February 1, 1999), 327–338.

a) agreement to dramatically simplify state sales and use taxes though state absorption of local sales and use taxes and the keeping whole of local governments which give up their local sales and uses taxes,

and

b) Federal assistance/insistence to ensure that remote vendors collect and remit use taxes.

To these I would add the elimination of sales and use taxes currently imposed on business inputs. However, the ideas which follow can be put together without this. What is essential is one definition across all states imposing a consumption tax of what constitutes taxable consumption so that intra and inter-state vendors can readily determine if the purchase is taxable or not.

2.2 A GRAND POLITICAL TRADE

In good measure the growing complexities which traditional multi-state vendors were experiencing with local sales taxes as well as growing concerns states were having about use tax collections from catalog and Internet vendors precipitated industry-government discussions at the NTA Project and then ACEC. The basic idea still being discussed is to:

> legislatively overturn *Bella Hess* and *Quill* through an expanded duty on remote sellers to collect and remit use taxes to the jurisdiction of destination or use currently without such obligation
>
> in return for
>
> a vastly simplified sub-Federal sales and use tax system that would eliminate intra-state diversity in sales and use taxation, and standardize administration across the states[10].

Under this grand trade, states would agree to move to one tax rate per state that was revenue neutral, and business would join with state and local governments to find suitable legislative vehicles to make it a reality. Some of the participants in the NTA Project also hoped that sales and use tax simplification would also lead to reform, e.g. agreement on a uniform *final* consumption tax base.

Much of the impetus for extending the moratorium for a long period of time (say 5 years) is to give the states sufficient time to work out among themselves just what a simplified system might be. However, I am doubtful that such a voluntary or cooperative approach can work, and suggest that with some Federal assistance or insistence, the states can readily adopt a model statute, with many simplifications, that will make the above grand political trade a reality. Below, I sketch out the essential pieces to this.

2.3 SIMPLIFYING AND REFORMING STATE SALES AND USE TAXES

There are two ingredients to devising a new system of state sales and use taxes: 1) creating a definition of final taxable consumption for all states with sales and use taxes that is workable, and 2) finding a credible mechanism to enforce the expanded duty to collect on remote vendors (e.g., catalog and Internet).

2.3.1 DEFINING FINAL TAXABLE CONSUMPTION

There are several reasons to favor the states moving to the same definition of household consumption. First, it makes administration much more simple, especially for remote vendors, since one need not keep track of the extraordinary fine distinctions among goods and services which the states have made over the years for public policy and other reasons. Second, a broader base means that the rate of tax can be lower, and thus have a smaller impact on consumption choices made by households. Third, by just taxing final consumption, the states will inform their citizens about what the tax costs of government are.

Historically there have been a variety of approaches to define what is taxable under state sales and use taxes, and how to exempt certain items, either in terms of the nature of the customer, or in terms of the nature of the good or service. A rather simple way to move a household final consumption sales and use tax base is to reverse the way sales and use tax laws are typically drafted, and to introduce a new construct for sales and use tax purposes, the "taxable person."

Under the taxable person approach, sales and use taxation is an *exception* to a general *prohibition* on the taxation of anything. The exception is for *anything* purchased for or purchased by a "taxable person" for "non-business use". What is a "taxable person"? A "taxable person" is any natural person (and thus *not* a corpora-

[10] Periodically the states have said they would engage in revenue sharing intra-state to keep those local governments now dependent on local sales and use taxes whole.

tion or other recognized legal form of a business or government). "Purchase" would cover any consumer purchase or rental. This concept is quite broad; for example, consumer services would be automatically covered under this definition since they are paid for by a natural person who is not a business.[11] The first phase, "purchased for" is necessary for sole proprietorships, and for closely held businesses, and more generally to avoiding passthroughs from businesses to persons as a way to circumvent the sales and use tax.

How might such a system work in the world of web commerce? Unless a purchaser had a registration certificate, *any* purchase, main street or remote, would be taxable at a single state rate. Provision of the business registration number by the agent for the company making the purchase would preferably be in a uniform format (a single national registration form with a single structure to the registration number) and provided in a secure (encrypted) form to the seller. Just as a seller has to confirm the authenticity of a credit card number and any other identifying information prior to agreeing to the sale, the seller would confirm the business registration certificate number at a regional or central clearinghouse that would maintain this information in a secure fashion. To ascertain whether or not the purchase is a pass-through for personal use the purchaser would have to be queried about this, and the proper response noted and recorded. The final issue involves the destination of delivery or use, and the application of the correct state sales and use tax rate. Again, the purchaser would need to be queried as to this and the seller would have to record it.[12]

Table 2 contains some preliminary estimates about what the range of sales and use tax *rates* might be if the tax base were final consumption rather than the current amalgam of both some household and some business purchases. Moving to broad-based final consumption from a hybrid base entails first a base narrowing in order to tax just households, and then a base broadening to include all items of consumer outlay. Column [6] of Table 2 displays by state a rough estimate of what the equal yield tax rate would have to be if the base were household outlays. The mean final consumption state sales and use tax rate is 5.6% compared to the current mean sales and use tax rate of 5.2%. Alabama could cut its current 4% state rate to 3.1% if it levied it on all final household consumption. Similarly, California could lower its rate from 6% to 5.6%, and so forth. For states that have heavy tourism, such as Florida, Hawaii, and Nevada, the estimated final consumption tax rates undoubtedly overestimate the extent of change that would have to occur. Of course, if the model sales and use tax statute were to exempt necessities such as food, clothing, and medicine, then equal yield rates would have to be higher. I view these first estimates as generally encouraging.

2.3.2 FOUR FEDERAL APPROACHES TO ASSISTING/INSISTING ON AN EXPANDED DUTY TO COLLECT AND REMIT USE TAXES

After the issuance of the NTA *Final Report* in September, 1999, the National Governors Association and National Conference of State Legislators began developing a proposal which they believed would enable the states through bilateral, cooperative agreements to obligate businesses which originated inter-state sales to remit to the destination state as a consequence of the cooperative agreement being in place. The states evidently view this approach to eliminating the need to come before the Congress to ask for Federal legislation. Elsewhere[13] I have characterized this as "each state permitting the other to fiscally hunt in the dark." I am not alone in such pessimism, and I have heard that some governors wonder if their bilateral approach can be timely, practical and effective.

Certainly, there is no impediment to the Congress legislating to assist the states under its taxing or commerce powers. The general solution to what is usually called the tax harmonization problem I develop below involves Federal participation to ensure compliance of remote vendors to collect and remit, but one that stops a bit short of actual Federal piggybacking.

One set of Federal solutions lies in constructing a tentative (Federal) tax which may be offset by a credit for other "qualified" (state) taxes that the seller collects

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[11] Third party payments (e.g. health insurance) are a gray area but would seem to be an example of a business pass through to an individual which would thus be taxable to the third party (regardless if it was tax exempt or not). Anything purchased for personal use would be covered by the non-business use.

[12] Evidently the new Russian Federation's Regional Sales Tax appears to be structured in a similar manner. See John L Mikesell, "Structure of the Russian Federation's New Regional Sales Tax," *Tax Notes International*, 18 (March 15, 1999).

[13] Robert P. Strauss, "Further Thoughts on State and Local Taxation of Telecommunications and Electronic Commerce," *State Tax Notes*, 17, 17 (October 25, 1999), 1113–1124.

and remits directly to the states. Failure to collect and remit means loss of the credit, and the payment of the tentative tax to the Federal government rather than in effect zeroing it out with the payment of the state tax. Since there is a tentative Federal tax, there will necessarily be a Federal review of books and records (Federal audit), and oversight of the remittances so they go to the proper state.

Another set of Federal solutions entails a free-standing Federal penalty tax should non-compliance to collect and remit occur.

2.3.2.1 HOLLINGS S1433

In July, 1999 Senator Hollings introduced S1433 whose purpose was to impose a Federal tax on internet or catalog sales at a rate of 5%, but which could be offset by a credit for collection and remittance of state and local sales and use taxes at rates of up to 5%. The bill created the construct of sales by a "local merchant" to which the tentative tax and credit would *not* apply. The net Federal proceeds of such an approach would go into a trust fund whose proceeds would be used by the Secretary of the Treasury to make grants, based on a population and poverty allocation formula, to each state and the District of Columbia to supplement salaries of primary and secondary public school teachers.

The Hollings mechanism puts extreme pressure on the states to adopt use tax rates at 5%. This arguably will have a chilling effect on state sovereignty that might be far worse than pure piggybacking because most piggyback models permit state discretion in tax rate, but use a purely Federal collection mechanism.

2.3.2.2 EXPAND FUTA ELIGIBILITY REQUIREMENTS TO INCLUDE EXPANDED DUTY TO COLLECT

A second variant of this type of harmonization, and one that is more workable in my view, is to utilize an existing well harmonized Federal-state tax instrument. The historical harmonization of Federal and state unemployment taxes can be a vehicle for assuring that the new duty to collect and remit use taxes is in fact honored. The idea would be to amend eligibility for the FUTA tax credit to require positive agreement by an employer to participate in the collection and remittance of the newly enabled use taxes. Remote sellers of any consequence have employees, and are thus necessarily involved in existing Federal and state unemployment compensation programs. As a result, they are already subject to audit and regulation by both IRS and the US Department of Labor and their state counterparts.

Under this scheme, qualification to take the historical credit for state unemployment taxes against the tentative Federal unemployment tax would simply entail a new responsibility, namely demonstrably agreeing to collect and remit use taxes enabled under the grand political trade. One would amend current FUTA requirements to include reporting about all sales and the use tax remittances to aid in administration and audit. Under this approach, the states retain control over their use tax rates, get remittances directly from remote sellers, and IRS would perform some audit and oversight functions, but not deal with each transaction. This approach would also allow remittances mechanisms to evolve as technology develops, and as the market place provides software solutions to remote sellers. It is reasonable to expect that some form of vendor discount be made available to amortize the costs of such software investments.

Whether or not the unemployment system can or should handle this new responsibility remains an open question. Also, given that current state use tax rates are in the 3–7% range, it is possible that remote vendors might simply forego taking advantage of the Federal credit since 3 to 7% of their gross sales would dwarf any Federal offset of state employment taxes.

2.3.2.3 CONDITIONAL 10% FEDERAL SALES TAX

Another, related way to encourage remote vendors to collect and remit use taxes would be to obligate any Federal taxpayer, engaged in remote sales, to pay to the IRS an excise equal to 10% of its sales, *unless* it agreed to collect and remit use taxes to each destination state which had in place a reformed sales tax base contained in Federal law (e.g. per Section 4.1 above) at the state's use tax rate. If a state did not have in place the reformed or "qualified sales and use tax", the state would not benefit from Federal insistence on the remittance of the use tax. This would enable all non-sales tax states to remain sales tax free. As long as taxpayers collected and remitted, IRS would never see or touch any of the use tax monies. With suitable administrative mechanisms in place, states would continue to enjoy fiscal autonomy by virtue of having control (with suitable notification) of their sales and use tax rates.

Compliance with this obligation to collect and remit would entitle the taxpayer to an exemption from the 10% Federal sales tax. Presumably all taxpayers would understand they would do much better by collecting and remitting the use tax than standing in non-compliance and be subject to the 10% Federal tax.

2.3.2.4 10% FEDERAL PENALTY APPROACH

A variant on the conditional 10% Federal sales tax would be to structure the relationship between the taxpayer and a Federal agency as a penalty for non-compliance, given that the destination state had in place a "qualified state sales and use tax." Now, the penalty would be measured by a high percentage (e.g. 10%) applied to the taxpayer's sales. Arguably the penalty approach could be acted upon by a committee other than a tax committee of the Congress, although there would be a question of which Federal agency to turn over any possible proceeds, as well as a question of which Federal agency, if not Treasury/IRS, would be responsible for determining that any state indeed had in place a "qualified" sales and use tax.

An advantage of these approaches is that they could be devised to leave both *Quill* and *Bella Hess* undisturbed, and thus not raise *any* nexus issues in *other* areas of state taxation (e.g. business gross receipts, income or franchise taxes). Remote vendors would be collecting and remitting simply to forestall an adverse, Federally imposed financial consequence. By the same token, any state which felt strongly that its current sales and use tax base, imposed partly on households and partly on business, rather than on final consumption, was more meritorious than a "qualified state sales and use tax" could continue to enjoy its sovereignty over base and tax rate. In this circumstance, remote vendors would not be obligated under threat of Federal penalty to collect and remit use taxes. Of course, such states would continue to find use tax remittances lagging, and, as electronic retail commerce grows, this could have increasingly serious financial consequences to them.

Congress might find legislating under this second approach somewhat easier, because you would not be requiring *per se* that each state with a sales and use tax to necessarily adopt the "qualified state sales and use tax." Greater state sovereignty would be, of course, at the expense of simplification, ease of administration and compliance, and elimination of tax cascading.

3.0 STRENGTHENING CURRENT FEDERAL LAW TO SOLVE THE PROBLEMS OF STATE AND LOCAL SALES USE TAXES: AN EXPERIMENT TO MODERNIZE REPORTING REQUIREMENTS UNDER THE JENKINS ACT

Under Title 15 Chapter 10A of the US Code, enacted by the tax committees of the Congress in 1949 and typically referred to as the Jenkins Act, remote sellers of cigarettes have been obligated to provide destination state tobacco tax administrators with monthly memoranda of retail cigarette sales into each state. The memoranda must contain ". . . the name and address of the person to whom the [retail] shipment was made, the brand, and the quantity thereof." Were state *sales* tax administrators provided comparable information from remote sellers, their use taxes would undoubtedly be better collected from residents.

The Jenkins Act reflects a long-standing Federal policy of intergovernmental tax administration. As Congress considers how to extend the Moratorium, there is merit in my judgment in modernizing the Jenkins Act as an experiment to ascertain if Federally mandated information reporting is a sensible template for improving state use tax administration. Not only is the consumption item (cigarettes) already well defined, there are relatively few sellers in the market. Further the vendors are already subject to Federal supervision through application of the Federal tobacco tax.

Modernization of the Jenkins Act would entail enhanced and more standardized reporting, and utilization of new technology. For example, Congress could enhance the required memoranda to include the dollar value and prices of various cigarettes in the shipment. Also, Congress could require that the Federal government promulgate a standardized *format* for the memoranda reporting requirement,[14] and positively affirm that electronic transmission of such memoranda from remote vendor to state tobacco administrator fulfils the reporting requirement. Much could be learned about the practicalities of Federally required information reporting requirements as a more general solution to the problem of improved use tax collections.

Finally, Congress could strengthen the Jenkins Act by statutorily providing a supervisory role for the Treasury and/or IRS. Such supervision might include Federal penalties for vendor non-compliance in conjunction with these modernized Federal reporting requirements.

[14] Reporting could be required to be on a Treasury Department promulgated form.

4.0 CONCLUDING COMMENTS

The purpose of this paper been to explain several different ways the tax committees of the Congress might assist the states in moving to a simplified system of sales and use taxes, and in so doing ensure that remote vendors, currently without a duty to collect and remit use taxes, would do so in the future. The ideas I have presented contemplate a more integrated vision of tax policy in our Federal system that has been fashionable in recent years. But it may also anticipate that, because our daily lives are increasingly affected by events far away, our fiscal institutions need to adapt as well. Federal leadership requires Congressional action. State cooperation to accomplish inter-state harmonization of state sales and use taxes, but without Federal legislation, seems well intentioned, but not likely to be fruitful.

Should the Finance Committee take a more limited view of what it thinks it can accomplish in relation to renewal of the Moratorium, there is substantial merit, in my view, to accompany renewal with an experiment in modernized Federal-state tax administration. Modernizing the Jenkins Act, which currently requires interstate vendors of cigarette products to provide destination states information about its customers, to include the dollar value of the shipment, on standardized if not electronically transmitted forms, and requiring active oversight of this process by the US Treasury might provide very useful lessons in how the Federal government can be involved in tax aspects of the New Economy.

STATEMENT OF TAXWARE INTERNATIONAL, INC.

[SUBMITTED BY JON W. ABOLINS]

I. EXECUTIVE SUMMARY

Sales tax technology has been in existence for over twenty years, and is applied successfully by thousands of merchants in every industry. TAXWARE's current activities include the modification of our existing, widely used tax technology to accommodate the sales tax simplification efforts of the Streamlined Sales Tax Project and the National Conference of State Legislatures.

The implementation of existing tax software applying existing rules cannot singlehandedly achieve the level of simplification sought by the private or public sectors. The lack of timely tax information from government sources, the continued need to obtain valid paper exemption certificates from customers and the need to fill out hundreds of local tax returns each month represent tremendous operating costs for any merchant doing business in many states. To insure the success of sales tax simplification, four major issues must be addressed:

1. There must be unified administration of state and local taxes.
2. State taxing authorities must work together to create uniform definitions for specially taxed products and services.
3. State taxing authorities should simplify exemption procedures eliminating current exemption certificate requirements.
4. State taxing authorities must adopt uniform rules for reporting and remitting sales tax liabilities.

Many simplification proposals include a requirement that each state enact only one rate, eliminating local authority to enact the tax rate and base best suited to residents of that community. Proponents of this position argue that today's tax technology is incapable of accommodating local tax rates. Tax technology accommodates multiple tax rates with ease; any limitation in this area should be attributed to the lack of information available from taxing authorities. TAXWARE has spent several years and millions of dollars working with taxing authorities to ensure that their suggested simplifications include provisions under which merchants would be held harmless for failure to apply changes to tax laws due to insufficient notice.

The Streamlined Sales Tax Project and National Conference of State Legislatures have proposed simplifications that render sales tax schemes manageable and economically feasible. These simplifications include requirements for the timely, proactive notification of tax law changes, with corresponding safe harbors. Both organizations propose to compensate tax technology providers for the creation and maintenance of sales tax systems directly; the implementation of tax technology can be performed at no cost to merchants. The de minimis standards proposed in most sales tax simplification legislation will obviate the need for "mom & pop" merchants to use tax technology, even though thousands of small merchants making remote sales apply tax technology today.

II. WRITTEN STATEMENT TO THE SENATE FINANCE COMMITTEE REGARDING THE AUGUST 1, 2001 INTERNET TAXATION HEARING: CYBERSHOPPING AND SALES TAX: FINDING THE RIGHT MIX

Sales tax technology has been in existence for over twenty years, and is applied successfully by thousands of merchants in every industry. This technology determines the taxing location in multistate transactions through use of the mailing addresses of the merchant and its customer. Exemption databases are searched in transactions involving specially treated products, services, entities or uses. The applicable state and local tax rates are applied, the transaction is recorded, and tax liability information is inserted to the correct space on the applicable tax return.

TAXWARE International has been advising taxing authorities on the use of sales tax technology since 1998. We have met with several state and local governmental agencies and associations over the past three years, in an ongoing effort to demonstrate the capabilities of tax technology. Our efforts contributed to the technology models proposed by the Streamlined Sales Tax Project and the National Conference of State Legislatures, and we are currently participating in a feasibility study of these technology models. Our activities include the modification of our existing, widely used tax technology to accommodate sales tax simplification efforts, while concurrently ensuring the protection of consumer privacy. We are convinced that our participation in this pilot system will prove that proposed technology models are indeed feasible.

The implementation of existing tax software applying existing rules will not achieve the level of simplification sought by the private or public sectors. The lack of uniform standards for tax technology forces every business to develop a customized sales tax compliance system, even if third party tax calculation software is applied. The lack of timely tax information from government sources, the continued need to obtain valid paper exemption certificates from customers and the need to fill out hundreds of local tax returns each month represent tremendous operating costs for any merchant doing business in many states. To insure the success of sales tax simplification, four major issues must be addressed:

- First, there must be unified administration of state and local taxes. Merchants and tax technology providers should be able to obtain all necessary information from a state taxing authority. This will eliminate the need to seek out ordinances and other tax information from local taxing authorities, a sometimes impossible task. State taxing authorities must be required to provide notification of law or rule changes within sufficient time for implementation into a computer system, and those reliant upon such information should be held harmless if that information is not provided
- Second, state taxing authorities must work together to create uniform definitions for specially taxed products and services. The harmonization of existing tax bases through implementation of common definitions is a viable alternative to restricting those tax bases
- Third, state taxing authorities should simplify exemption procedures eliminating current exemption certificate requirements. Today, merchants must obtain and maintain paper exemption certificates as evidence of tax-free transactions with churches, charities, and other exempt purchasers. Failure to comply with this rule can result in significant liability to the merchant. Sales tax simplification efforts must include the elimination of the requirement to obtain exemption certificates. Purchasers claiming they are exempt from sales tax should be the party required to prove that the product or service purchased was actually used for an exempt purpose; merchants should be held harmless for granting an exemption as long as they retain sufficient information to identify the purchaser and the product or service purchased
- Fourth, state taxing authorities must adopt uniform rules for reporting and remitting sales tax liabilities. Tax returns should only be filed with state taxing authorities. A nationwide standard for the format of a tax return is essential to simplification efforts

After these four issues are resolved, merchants will be able to set up tax technology quickly, and customers of merchants using tax technology will notice no difference in their shopping experiences. It is important to note that the model simplification statutes approved by the National Conference of State Legislatures and the Streamlined Sales Tax Project include provisions that satisfy these four issues, and the technology components of both versions of model legislation have already been enacted in sixteen states.

Many simplification proposals include a requirement that each state enact only one rate, eliminating local authority to enact the tax rate and base best suited to residents of that community. Proponents of this position argue that today's tax technology is incapable of accommodating local tax rates. Tax technology accommodates multiple tax rates with ease; any limitation in this area should be attributed to the lack of information available from taxing authorities. TAXWARE has spent several years and millions of dollars working with taxing authorities to ensure that their suggested simplifications include provisions under which merchants would be held harmless for failure to apply changes to tax laws due to insufficient notice. Following the example set by the Mobile Telecommunications Sourcing Act, state taxing authorities are proposing to provide databases of all mailing addresses within their taxing jurisdictions, and will hold merchants applying these databases to assign tax rates harmless from liability for inaccuracies. If these databases are made available, the assignment of many tax rates to a mailing address could be performed cost-effectively.

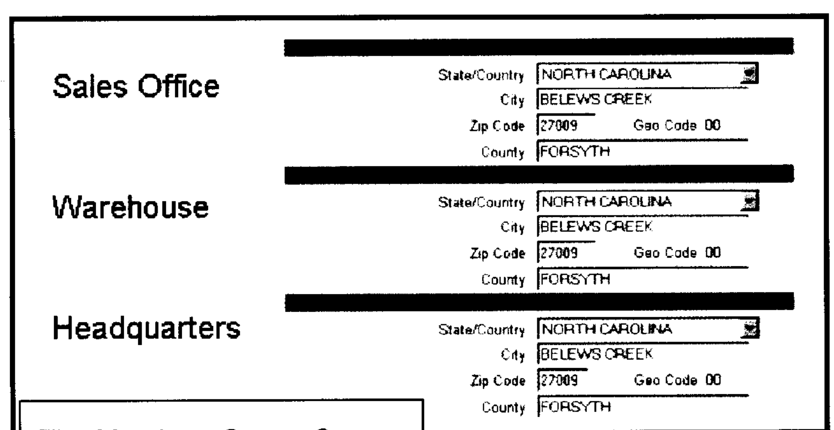
Some merchants have argued that tax technology cannot fully address the myriad complexities of current sales tax schemes. Although it is an incontrovertible fact that sales tax complexity increases the costs and resources merchants and tax technology providers must allocate to create and apply sales tax compliance systems, the Streamlined Sales Tax Project and National Conference of State Legislatures have proposed simplifications that render sales tax schemes manageable and economically feasible. Further, both organizations propose to compensate tax technology providers for the creation and maintenance of sales tax systems directly; the implementation of tax technology can be performed at no cost to merchants. These groups' proposed simplification provisions, coupled with the elimination of tax technology implementation costs to merchants, can achieve sufficient sales tax simplification.

Whenever tax technology is addressed in the context of sales tax simplification, questions regarding the implementation of tax technology into the operations of a "mom & pop merchant" are always raised. Although the de minimis standards proposed in most sales tax simplification legislation will likely obviate the need for such merchants to use tax technology, it should be noted that thousands of small merchants making remote sales apply tax technology today. Sales tax calculations are a standard component of the software that Internet retailers have applied for years.

TAXWARE appreciates the opportunity to present its views on this important issue of public policy. We welcome future opportunities to discuss and demonstrate sales and use tax technology in greater detail.

III. SALES AND USE TAX TECHNOLOGY IN ACTION

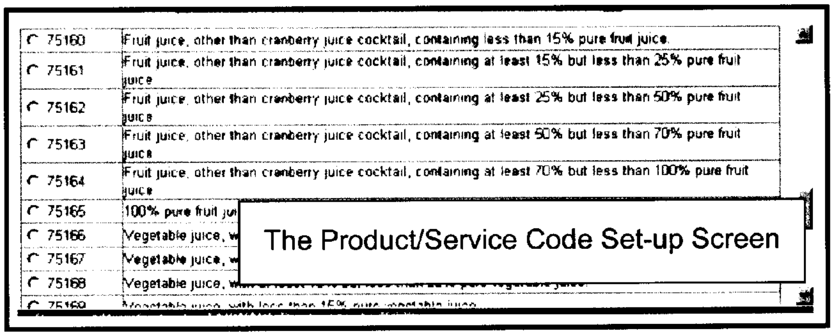
Sales and use tax calculation software has been on the market for over twenty years, and has been applied successfully by thousands of merchants across the United States. Although some features of the technology will be unnecessary after tax simplification, the fundamental structures and processes of the system will remain the same.



The Merchant Set-up Screen

Merchant Tax Data Files allow vendors to implement their use tax collection obligation by turning off taxing jurisdictions in which they have no physical presence. Merchants also input their business locations into the system, and associate their product- or service-lines with exempt product and service codes. Merchant Exemption Files allow vendors to implement exemptions based upon receipt of a direct pay or exemption certificate.

During the tax calculation process, the vendor and customer mailing addresses are compared to determine the taxing location, and the type of tax (i.e., sales or use). Exemptions are sought in the Tax Rate File, the Product Taxability File and Merchant Exemption Files; tax calculation systems have the ability to implement both product-based exemptions, and entity- and use-based exemptions.



After transactions are calculated, the results are sent to billing applications and e-Commerce billing solutions for entry onto the transaction document (i.e., invoice), and are concurrently stored in an Audit File. Automated tax return software places summary data from the audit file onto the appropriate space on the applicable tax return.

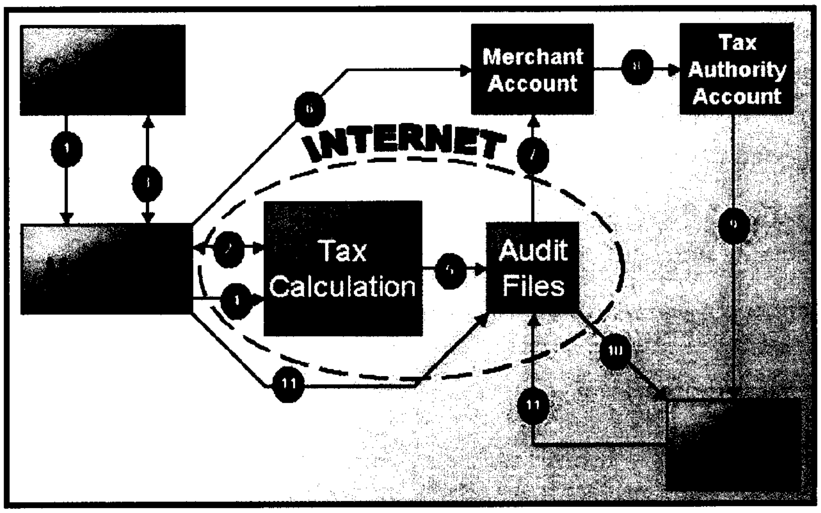
IV. THE STREAMLINED SALES TAX PROJECT AND NATIONAL CONFERENCE OF STATE LEGISLATURES' PROPOSED TECHNOLOGY MODELS

Sixteen states have to date enacted legislation that will lead to the certification of the sales and use tax calculation software merchants use to determine tax liabilities. The legislation is based upon model legislation authored by either the Streamlined Sales Tax Project or the National Conference of State Legislatures. Both versions of the model legislation include the creation of three certified technology models.

Model 1—The Certified Service Provider

The Streamlined Sales Tax Project and National Conference of State Legislatures "Model 1" technology is defined as a system through which a "[s]eller selects a Certified Service Provider (CSP) as an agent to perform all the seller's sales or use tax functions, other than the seller's obligation to remit tax on its own purchases." The CSP will use technology to calculate, report and remit the tax liabilities for all transactions of all merchants using its service. Merchants licensing CSP services will be relieved of liability for any incorrect tax calculations unless merchant fraud is found. The CSP will be liable to taxing authorities for any incorrect tax calculations produced by the software. Taxing authorities will compensate CSPs for the performance of CSP services; the technology to be applied by merchants, including the integration of merchants' existing systems to CSP systems, will be offered to merchants at no charge.

Tax liabilities on the transactions of merchants using a CSP will be ascertained, reported and remitted in an eleven-step, automated process:



1. A customer selects products or services, and places a sales order with the merchant. The customer or order entry clerk enters all required information.

2. The tax calculation software determines the applicable tax liability and sends the calculation results to the merchant's system for presentment to the customer or placement on an invoice.

3. The customer or order entry clerk finalizes the transaction after tax liability is displayed.

4. The final tax liability is calculated. This could happen weeks after the placement of the sales order, as many merchants accept sales orders for products on that are on back order.

5. The tax information related to the transaction is stored in Audit Files.

6. The tax paid by the customer to the merchant is deposited into the merchant's account using existing practices.

7.The Audit Files are used to determine how much is tax due from the merchant to all applicable taxing authorities.

8.The information learned in step 7 is used to transfer funds from the merchant's account to all applicable taxing authority accounts. The transfer is performed using standard ACH Credit or Debit, or EFT Credit or Debit protocols.

9.The taxing authority receives a statement from their bank reflecting all deposits into the taxing authority account.

10. The CSP transmits a periodic tax return for each merchant using the service.

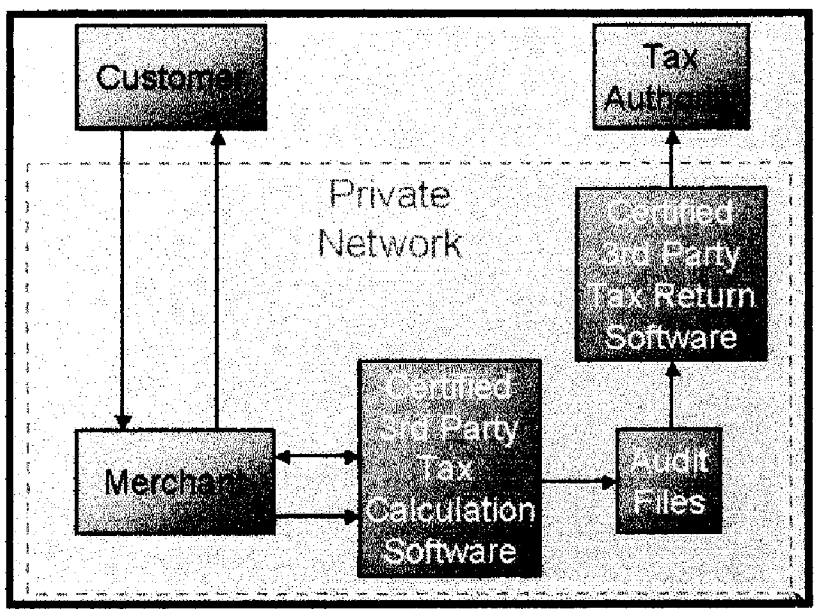
11. The taxing authority or merchant can use an Internet browser to review information in the Audit Files. Information can be downloaded or printed.

The Model 1 technology will be used in practice for the first time in mid-2001. Four states, Kansas, Michigan, North Carolina and Wisconsin, were enabled by their state governments to participate in a Streamlined Sales Tax Pilot System. The state of North Carolina issued a Request for Proposals for the creation of Model 1 technology in June, 2000, and awarded two contracts to TAXWARE International in August, 2000. To date, three merchants have agreed to process their sales and use tax liabilities through a CSP, and many more are reviewing the prospect of doing so. Pilot System revenues, costs and operations will be studied to determine whether the technology models proposed by the Streamlined Sales Tax Project and the National Conference of State Legislatures are technically and economically feasible.

Model 2—Certified Automated Software

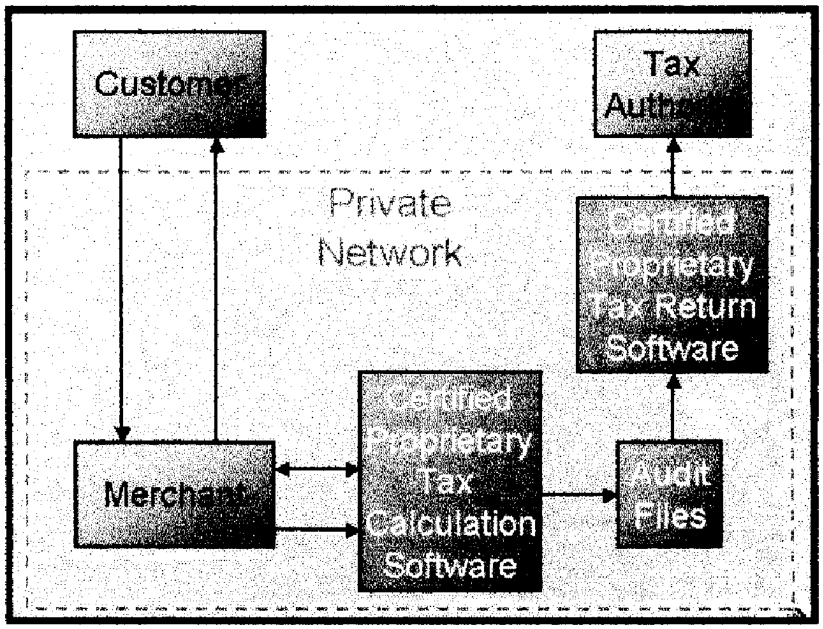
Many merchants do not favor Model 1 technology, as it could potentially slow transactions. Other merchants do not want their transactions processed outside of their internal computer security systems. The Streamlined Sales Tax Project and National Conference of State Legislatures created a separate technology model to avoid these issues. "Model 2" technology is defined as a system through which a "[s]eller selects a Certified Automated System (CAS) to use which calculates the amount of tax due on a transaction."

The CAS is a certified software application that is installed inside of a merchant's private computer network. The certification of transaction tax software was recommended by the Advisory Commission on Electronic Commerce, and is a component of most versions of proposed Federal legislation on sales tax simplification. Merchants using a CAS will be relieved of liability for transactions incorrectly calculated by the software, but they will remain liable for reporting and remitting transaction tax obligations to the applicable taxing authorities. Merchants will license CAS directly from the third party creators of the software; the states are currently contemplating how to compensate merchants for CAS license fees.



Model 3—The Certified Proprietary System

The Streamlined Sales Tax Project's "Model 3" technology is defined as a system through which a "[s]eller utilizes its own proprietary automated sales tax system that has been certified as a CAS." This technology model was created to allow those merchants that have created their own tax calculation systems to enjoy some elements of certification. The level of certification will vary according to the features of the merchants' proprietary systems.



V. RECENT HISTORY OF U.S. TRANSACTION TAX SIMPLIFICATION EFFORTS

The first significant group to address transaction tax simplification was the National Tax Association Communications and Electronic Commerce Tax Project. Formed in 1997, the NTA Project was an industry-state tax initiative with a goal to "develop a broadly available public report that identifies and explores the issues involved in applying state and local taxes and fees to electronic commerce." Although the NTA Project ended without agreement between the public and private sectors, it produced a report that is widely regarded as the first comprehensive document detailing the issues surrounding transaction tax simplification.

In December, 1998, three states joined forces to form the Northwest Regional Sales Tax Pilot Project. Representatives from the states of Idaho, Utah and Washington challenged industry to develop products or services that would assist in the simplification of administration of their sales and use taxes. Ensuing meetings were held with the Multistate Tax Commission, the Federation of Tax Administrators, the National Governors' Association, the National Conference of State Legislatures, the U.S. League of Cities, the U.S. Conference of Mayors, the National Association of Counties and other state and local governmental bodies. The final outcome of this series of meetings was the Zero Burden proposal rejected by the Advisory Commission on Electronic Commerce in mid-2000.

Recognizing that the Advisory Commission on Electronic Commerce would not recommend that the U.S. Congress enact the Zero Burden proposal, the Multistate Tax Commission and the Federation of Tax Administrators joined forces in early 2000 to create the Streamlined Sales Tax Project, a group that would author proposed transaction tax simplification legislation. Representatives from thirty-eight states met on a monthly bases, and in December 2000, handed off proposed legislation to the National Conference of State Legislatures' Task Force on Taxation and Electronic Commerce for review. The NCSL Task Force held a public hearing on this legislation in Washington D.C. on December 12, 2000. On January 27, 2001, the NCSL Task Force voted to substantially amend the legislation, and the NCSL Executive Committee issued a Resolution that endorsed the amended legislation the next day. On March 2, 2001, the State of Wyoming was the first state to enact streamlined sales tax legislation; Kentucky, Utah, Arkansas, North Dakota, Indiana, Maryland, Oklahoma, Louisiana, Tennessee, Nebraska, Nevada, Florida, Texas, Minnesota and Rhode Island followed. As of July 13, 2001, thirteen other states had initiated legislative efforts to enact some or all of the proposed legislation (Alabama, Illinois, Iowa, Kansas, Massachusetts, Michigan, Missouri, North Carolina, Ohio, Pennsylvania, Vermont, West Virginia and Wisconsin).

VI. CURRICULUM VITAE—JON W. ABOLINS

Jon W. Abolins is Chief Tax Counsel and Vice President of TAXWARE International's Tax and Government Affairs Department, where he is responsible for all tax decisions in all company programs. In this key function, Mr. Abolins applies his knowledge of tax law to products that address all transaction-based taxes. He is also responsible for sustaining TAXWARE's relationships with taxing authorities and legislative bodies around the globe, frequently advising legislators and regulators seeking to simplify tax laws and rules through technology. Mr. Abolins is a graduate of the University of Southern California and the Boston University School of Law. He is licensed to practice law in Massachusetts. A frequent speaker on transaction tax automation issues, Mr. Abolins has spoken at events sponsored by the Institute for Professionals in Taxation, the Conference Board, CommerceNet, the American Taxation Association, the World Research Group, the Equipment Leasing Association, and Harvard Law School's International Tax Program. Mr. Abolins frequently speaks at sales and use tax or eCommerce tax automation policy meetings to such entities as the Congress of the United States, the Streamlined Sales Tax Project, the National Governors' Association, the U.S. Conference of Mayors, the National Conference of State Legislatures, the Multistate Tax Commission, the Northwest Regional Sales Tax Pilot Project, and the Louisiana Association of Tax Administrators.

STATEMENT OF THE UNITED STATES TELECOM ASSOCIATION

The Unite4d States Telecom Association (USTA) appreciates the opportunity to submit a statement for the record of the Senate Finance Committee's August 1, 2001, hearing on the Internet Tax Freedom Act.

USTA is the largest trade association representing the U.S. telecom industry, serving more than 1,200 telecom companies worldwide that provide local exchange, long distance, wireless, internet and cable services. USTA's members have played an integral role in the expansion of the Internet in this country, and are currently at the forefront of the expansion of the next generation of Internet: broadband and wireless services.

USTA supports a clarification and an extension of the Internet Tax Freedom Act (ITFA) tax moratorium, and amendments to ITFA to reflect the developing technology of the Internet. Necessary amendments to ITFA will help ensure that the purpose of ITFA—to prevent taxation from stifling the growth of the Internet—will be maintained in the face of the changing technology landscape. USTA also believes strongly that any provisions in the ITFA extension legislation relating to streamlined sales and use tax systems should apply to telecommunication taxes as well. The following discusses these points and presents proposals in turn.

I. NECESSARY AMENDMENTS TO ITFA TO REFLECT DEVELOPING TECHNOLOGIES

Technological Developments Have Resulted in the Convergence of Industries Historically Subject to Different Regulatory Classifications:

Companies that may be classified as telecommunications, cable, mobile radio, satellite companies or Internet service providers are all likely to provide voice, data, video and Internet access services individually or as part of a bundle of such services and possibly others) to consumers. As a result of historic differences in the regulatory classification of businesses that sell voice, data, video and Internet access services, such companies are taxed differently merely because of such classifications.

Equivalent Services That Provide Access to the Internet Should Be Taxed the Same Regardless of Who Provides Such Services:

ITFA provides an exemption from all State and local taxation for Internet access, including access to proprietary content, information, and other services offered as part of a package of services to users. Because of concerns primarily related to universal service, however, ITFA specifically excludes "telecommunications services" from the scope of the Internet access exemption. Whether a service is a "telecommunications service" is determined for purposes of ITFA based on Federal regulatory definitions and the Federal excise tax on telecommunications services (which is universally viewed as an antiquated tax that was targeted for repeal by the 106th Congress). Accordingly, under ITFA, providers of the same type of Internet service might be treated differently depending on whether they are classified as a telecommunications provider, or whether the service provided is a "telecommunications service."

A moratorium on state and local taxation that applies to all types of Internet access except for access that is provided by telecommunications carriers could create a permanent advantage for companies that can avoid such classification. This inequity could be especially burdensome to telecom companies, which already face a nationwide average effective tax rate applicable to sales of telecommunications services (17.74%) that is far in excess of the rate applicable to sales of goods by general business (6.0%).[1]

Where Services are Bundled, the Moratorium Should Apply to the Portion of Service Charges Attributable to Internet Access Charges

Increasingly, American consumers are paying for access to the Internet as part of a bundled package of services, that may also include telephone, video, and/or other services. This development has raised the question of how the "Internet access" portion of bundled charges—which is protected from taxation by the ITFA moratorium—should be determined.

Solution:

USTA supports amending the definitions of "Internet access" and "telecommunications services" in ITFA to ensure equitable treatment of all providers of comparable services. This proposal would protect the "telecommunications services" definition and the principles of universal service.

These definitions should also be amended to ensure equal treatment for wireless access to the Internet, which was not generally available when ITFA was enacted in 1998, by clarifying that "Internet access" services provided by wireless telecommunications providers—i.e. wireless web access—also qualify under ITFA's moratorium.

In addition, recognizing technological advances since the original enactment of ITFA, ITFA's moratorium should be expanded to include broadband services. Doing so will both encourage the deployment of this new and important Internet technology and also "level the tax playing field" for diverse providers as these broadband services converge. This amendment would ensure that broadband Internet services (service that is capable of a rate greater than 384 kps for wireline, fixed wireless and satellite and 128 kps for mobile wireless) are not subjected to state and local taxation. This expansion should also apply to comparable advanced wireless data transmission services.

Finally, USTA supports an amendment to ITFA to stipulate that the moratorium will not apply to Internet access that is aggregated by a seller with taxable services, unless the seller separately accounts for the Internet access charges, or, in lieu of using separate accounting for such charges, elects to apply a "Internet access standard charge amount." Such standard charge amount would be determined annually by the Secretary of Commerce for different levels of Internet service, and would provide a safe harbor for sellers for whom separate accounting of Internet access charges would be especially burdensome.

II. THE PROVISIONS OF THE INTERNET TAX FREEDOM ACT RELATING TO THE STREAMLINED SALES AND USE TAXES SYSTEM SHOULD APPLY TO TELECOMMUNICATION TAXES AS WELL.

Simplification of transaction tax statutes, such as sales and use tax statutes, should include the "rationalization" of transaction tax statutes applicable to the telecommunications companies that comprise the Internet backbone and that sell services subject to multiple levels of taxation.

The administrative filing requirements documented in the 2000 COST Update reflect an increase in telecommunications tax filing requirements from 1999 (63,879 returns now required to be filed across the nation) as compared to sellers of goods (8,951 returns nationwide). This tremendous filing burden on telecom companies imposes significant costs that ultimately increase the cost of telecommunications services. A streamlining of these taxes could thus result in significant savings for all users of such services in this country. This will benefit all involved, most importantly consumers, who shoulder a portion of the filing costs associated with the current multiplicity of taxes.

[1] The Committee On State Taxation 50-State Study and Report on Telecommunications Taxation 2000 Update (2000 COST Update), http://www.statetax.org.

Solution:

USTA supports applying provisions relating to a streamlined sales and use tax system to the "rationalization" of telecommunications taxes. Although this idea encompasses the need for state and local governments to simplify their tax system, reduce compliance costs and level the tax burden of similar services provided by all providers, it does not by definition require an overall reduction of the tax burden.

* * *

We at USTA look forward to working with the Senate Finance Committee as the Committee considers an extension, and improvements, to the Internet Tax Freedom Act.