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Hearing on

H.R. 3179, the Marketplace Equity Act of 2011

Before the Committee on the Judiciary,
U.S. House of Representatives

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The Proper Role of Congress in State Taxation: Ensuring the Interstate Reach of State Taxes Does Not Harm the National Economy

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Mr. Chairman, Mr. Ranking Member, and members of the Committee:

I appreciate the opportunity to testify today on Congress's role in the debate over state sales taxation of online purchases. In the 75 years since our founding in 1937, the Tax Foundation has monitored tax policy trends at the federal and state levels, and our data and research is heavily relied upon by policymakers, the media, and the general public. Our analysis is guided by the idea that taxes should be as simple, neutral, transparent, and stable as possible, and as a 501(c)(3) non-profit, non-partisan organization, we take no position on any pending legislation.

We hope that the material we provide will be helpful in the Committee's consideration of the issue.

Executive Summary

- After the bitter experience of the Articles of Confederation, the Constitution empowered Congress with the responsibility to rein in state tax overreaching when it threatened to do harm to the national economy.
- Consequently, states were not permitted to tax items in interstate commerce at all, from the Founding until approximately the 1950s.
- Since then, as formally adopted by the U.S. Supreme Court in the *Complete Auto* decision (1977), states may tax interstate commerce so long as the tax is non-discriminatory, fairly

apportioned, related to services, and applies only to businesses with substantial presence (nexus).

- In a series of decisions, most recently the *Quill* decision of 1992, the U.S. Supreme Court explained that "substantial nexus" for sales/use tax purposes means physical presence of property or employees. The Court ruled that it exceeds to state powers for them to be able to demand use tax collection from companies that are not physically present in the state.

- States have sought to overrule the *Quill* decision, either legislatively ("Streamlined") or through defiance ("Amazon" tax statutes). The defiance approach in particular has caused significant disruption and uncertainty to the economy.

- Every state with a sales tax also imposes a use tax, levied on taxable items upon which no sales tax has been paid. In other words, use taxes seek to thwart competitive pressure from other states with lower tax rates. Taxpayer compliance with these protectionist use taxes is minimal. (Use tax, with a few exceptions, is imposed on the *consumer* and not the *seller*.)

- Congress has passed a number of statutes limiting the scope of state tax authority on interstate activities ("preemption"), carefully balancing (1) the ability of states to set tax policies in line with their interests and that allow interstate competition for citizens over baskets of taxes and services and (2) limiting state tax power to export tax burdens to non-residents or out-of-state companies, or policies that would excessively harm the free-flow of commerce in the national economy.

- When a resident of a state purchases from a brick-and-mortar retailer, they generally must pay sales tax. When the same resident in the same state purchases the same product from an online retailer, they often do not pay sales tax.

- Many large Internet retailers are expanding the number of states in which they have physical presence, to enable next-day delivery, but that is not the case for many smaller sellers that remain in just one location and use common carriers to deliver purchases.

- There are approximately 9,600 jurisdictions in the United States that collect sales tax, a number that grows by several hundred each year. Subscription tax software is inadequate and can be expensive for occasional sellers, and few states provide adequate tax lookup or consolidated tax filing options. Sales tax can vary by product, by time, and by location in the state. In 7 states, local governments can have a different sales tax base from the state tax base.

- Congress has five basic options on how it may proceed:
  - *Reaffirm the physical presence rule* for sales taxation, and by implication, the disparity of treatment between brick-and-mortar sales and Internet sales.
  - *Reaffirm the physical presence rule* but adopt a new tax approach that mitigates the disparity of treatment between brick-and-mortar sales and Internet sales (such as an origin-based system or a national sales tax on online purchases).
  - *Modify the physical presence rule* in the limited context of state collection of use tax from out-of-state sellers, by those states that have adopted simplified sales tax systems under minimal federal standards, to reduce the harm to interstate commerce. This trade-off would replace the check on state power provided at present by the physical presence rule.
  - *Repeal the physical presence rule* without conditions on the states, granting states unchecked authority to export tax burdens and damage interstate commerce.
  - *Do nothing* and risk the continued growth of unchecked and fragmented state authority to export tax burdens and damage interstate commerce.

The Constitution Empowers Congress to Limit State Tax Power When It Seeks to Shift Tax Burdens to Non-Residents or Do Harm the National Economy

What you have before you is not a new issue. Absent congressional or judicial checks, states have an incentive to shift tax burdens from physically present individuals and businesses, to those who are beyond their borders. Indeed, it was the states' unchecked behavior in this regard that led to the Constitutional Convention in the first place. Under the Articles of Confederation, states with ports taxed commerce bound for interior states, tariff wars proliferated, and the national economy was imperiled. As Justice Johnson described in 1824, these actions were "destructive to the harmony of the states, and fatal to their commercial interests abroad. This was the immediate cause that led to the forming of a convention."[1]

And so the Constitution was adopted, and through that document, the Congress was granted the power to restrain states from enacting laws that harm the national economy by discriminating

[1] *See, e.g.*, *Gibbons v. Ogden*, 22 U.S. (9 Wheat.) 1, 224 (1824) (Johnson, J., concurring).

against interstate commerce.[2] James Madison noted that these powers would check the "clamors of impatient avidity for immediate and immoderate gain" that drive state legislation discriminating against non-residents.[3] Justice Story later praised the "wisdom and policy in restraining the states themselves from the exercise of [taxation] injuriously to the interests of each other. A petty warfare of regulation is thus prevented, which would rouse resentments, and create dissensions, to the ruin of the harmony and amity of the states."[4]

So strong was this concern that the rule for a century and a half was that states could not tax interstate commerce at all.[5] This eroded in the 1950s and 1960s as it was recognized that those engaged in interstate commerce do enjoy benefits in states where they are present, so it is not unfair to have them support those services with taxes. The complete ban on state taxation of interstate commerce was abandoned in 1977, replaced by a recognition that resident businesses engaged in interstate commerce should pay for the fair share of the state services they consume. In *Complete Auto Transit, Inc. v. Brady*, the U.S. Supreme Court held that states may tax interstate commerce if the tax meets a four part test:[6]

- **nexus***, a sufficient connection between the state and the taxpayer;*
- **fair apportionment***, the state cannot tax beyond its fair share of the taxpayer's income;*
- **nondiscrimination***, the state must not burden out-of-state taxpayers while exempting in-state taxpayers;*
- **fairly related***, the tax must be fairly related to services provided to the taxpayer.*

Before and since *Complete Auto*, the courts have routinely exercised this power to restrain state tax infringements on interstate commerce, and these decisions are one of the more non-controversial aspects of constitutional law.[7] Congress has also been active in this area, legislating limits on state tax

[2] *See* U.S. CONST. art. I, § 8, cl. 3 (Interstate Commerce Clause); U.S. CONST. art. I, § 10, cl. 2 (Import-Export Clause); U.S. CONST. art. I, § 10, cl. 3 (Tonnage Clause); U.S. CONST. art. IV, § 2, cl. 1 (Privileges and Immunities Clause); U.S. CONST., amend. XIV, § 1 (Privileges or Immunities Clause).

[3] James Madison, THE FEDERALIST NO. 42 (1788).

[4] 1 STORY CONST § 497.

[5] *See, e.g.*, *Freeman v. Hewit*, 329 U.S. 249, 252-53 (1946) ("A State is … precluded from taking any action which may fairly be deemed to have the effect of impeding the free flow of trade between States"); *Leloup v. Port of Mobile*, 127 U.S. 640, 648 (1888) ("No State has the right to lay a tax on interstate commerce in any form.").

[6] 430 U.S. 274 (1977).

[7] The power of the federal courts to act when Congress is silent is inferred as an implication of the Commerce Clause, a doctrine often referred to as the "dormant" or "negative" Commerce Clause. *See, e.g.*, *Willson v. The Black Bird Creek Marsh Co.*, 27 U.S. 245 (1829). The Commerce Clause prohibits states from imposing a tax on activity out-of-state while leaving identical activity in-state untaxed. *See Boston Stock Exchange v. State Tax Comm'n*, 429 U.S. 318 (1977)

power where states are incapable of achieving a simplified, uniform system that restrain each state from claiming more than its fair share of taxes on interstate commerce. These have included prohibiting state taxes on food stamps, Federal Reserve banks, interstate airline and bus travel, satellite services, and nonresident members of the military and nonresident members of Congress. Congress has also banned discriminatory state taxes on federal employees, interstate electricity transmission, and interstate railroads (see Table 1).

This power—to limit state tax authority—is not a power to use lightly. There are many components of state tax systems that, frankly, are none of Congress's business, even if they are good or bad public policy. Those aspects of state tax systems that are neither motivated by protectionism nor have the effect of raiding revenue from out-of-staters should be left alone as part of our commitment to fifty

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(invalidating a New York tax imposed solely on activity out-of-state while leaving identical activity in-state untaxed); *Westinghouse Elec. Co. v. Tully*, 466 U.S. 388 (1984) (invalidating a New York scheme exempting activity in-state while simultaneously imposed a tax on identical activity out-of-state); *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263 (1984) (invalidating a Hawaii tax imposed on a category of products but exempting activity in-state); *Am. Trucking Ass'n v. Scheiner*, 483 U.S. 266 (1987) (invalidating a Pennsylvania scheme imposing fees on all trucks while reducing other taxes for trucks in-state only); *New Energy Co. v. Limbach*, 486 U.S. 269 (1988) (invalidating an Ohio tax credit to all ethanol producers but disallowed for non-Ohio producers); *West Lynn Creamery, Inc. v. Healy*, 512 U.S. 186 (1994) (invalidating a Massachusetts general tax on dairy producers where the revenue was then distributed to domestic dairy producers); *Camps/Newfound/Owatanna, Inc. v. Town of Harrison*, 520 U.S. 564 (1997) (invalidating Maine's denial of the general charitable deduction to organizations that primarily serve non-Maine residents). *But see Dep't. of Revenue of Ky. v. Davis*, 553 U.S. 328 (2008) (upholding Kentucky's exclusion from tax of interest earned from its state bonds, but not other states bonds, on the grounds that Kentucky is acting as a market participant no different from any other bond issuer).

The Import-Export Clause prohibits states from penalizing activity that crosses state lines, particularly imports. *See, e.g.*, *Michelin Corp. v. Wages*, 423 U.S. 276, 295 (1976) (stating that the Import-Export Clause prohibits import taxes that "create special protective tariffs or particular preferences for certain domestic goods…."). Justice Clarence Thomas, a critic of dormant commerce clause jurisprudence, nonetheless argues that taxes that discriminate against nonresidents should be invalidated by the courts under the Import-Export Clause. *See Camps/Newfound/Owatanna*, 520 U.S. at 610 (Thomas, J., dissenting) ("That the expansion effected by today's decision finds some support in the morass of our negative Commerce Clause case law only serves to highlight the need to abandon that failed jurisprudence and to consider restoring the original Import-Export Clause check on discriminatory state taxation to what appears to be its proper role.").

The Tonnage Clause prohibits charges on shipping freight.

The Privileges and Immunities Clause of Article IV and the Privileges or Immunities Clause of the Fourteenth Amendment protects the right of citizens to cross state lines in pursuit of an honest living. *See, e.g.*, *United Bldg. & Constr. Trades v. Mayor*, 465 U.S. 208, 219 (1984) (identifying "pursuit of a common calling" as a privilege of citizenship protected by the Constitution); *Saenz v. Roe*, 526 U.S. 489 (1999) (invalidating a law that did not restrict state travel *per se* but discouraged the crossing of state lines with a punitive and discriminatory law); *id.* at 511 (Rehnquist, J., dissenting) ("The right to travel clearly embraces the right to go from one place to another, and prohibits States from impeding the free passage of citizens); Erwin Chemerinsky, CONSTITUTIONAL LAW 450 (2d ed. 2002) ("The vast majority of cases under the [Article IV] privileges and immunities clause involve states discriminating against out-of-staters with regard to their ability to earn a livelihood.").

simultaneous laboratories for policy experiments, to paraphrase Justice Brandeis.[8] If bad state policy can be corrected by the political pressure of voting resident taxpayers or by the economic pressure of the out-migration of people and dollars, it ought to be left to the states to handle.

Table 1: Examples of Congressional Preemption of State Tax Authority

4 U.S.C. § 111	Preempting discriminatory state taxation of federal employees
4 U.S.C. § 113	Preempting state taxation of nonresident members of Congress
4 U.S.C. § 114	Preempting discriminatory state taxation of nonresident pensions
7 U.S.C. § 2013	Preempting state taxation of food stamps
12 U.S.C. § 531	Preempting state taxation of Federal Reserve banks, other than real estate taxes
15 U.S.C. § 381 *et seq.*	Preempting state and local income taxes on a business if the business's in-state activity is limited to soliciting sales of tangible personal property, with orders accepted outside the state and goods shipped into the state. (Often referred to as Public L. 86-272.)
15 U.S.C. § 391	Preempting discriminatory state taxes on electricity generation or transmission
31 U.S.C. § 3124	Preempting state taxation of federal debt obligations
43 U.S.C. § 1333 (2)(A)	Preempting state taxation of the outer continental shelf
45 U.S.C. § 101	Preempting state income taxation of nonresident water carrier employees
45 U.S.C. § 501	Preempting state income taxation of nonresident employees of interstate railroads and motor carriers, and Amtrak ticket sales
45 U.S.C. § 801 *et seq.*	Preempting discriminatory state taxation of interstate railroads
47 U.S.C. § 151	Preempting state taxation of Internet access, aside from grandfathered taxes
47 U.S.C. § 152	Preempting local but not state taxation of satellite telecommunications services
49 U.S.C. § 101	Preempting state taxation of interstate bus and motor carrier transportation tickets
49 U.S.C. § 1513 *et seq.*	Preempting state taxation of interstate air carriers and air transportation tickets
49 U.S.C. § 40101	Preempting state income taxation of nonresident airline employees
49 U.S.C. § 40116(b)	Preempting state taxation of air passengers
49 U.S.C. § 40116(c)	Preempting state taxation of flights unless they take off or land in the state
50 U.S.C. § 574	Preempting state taxation of nonresident members of the military stationed temporarily in the state

Source: Tax Foundation compilation.

However, there are situations where it is vital that Congress use this power, where the alternative is the problem we experienced as a young country under the Articles of Confederation. While everyone is for simple taxes and fair taxes, in practice states look for any advantage or opportunity to shift tax burdens from voting residents to non-voting non-residents, to benefit in-state businesses and

[8] *See New State Ice Co. v. Liebmann*, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting) ("It is one of the happy incidents of the federal system that a single courageous State may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country.").

individuals by adopting tax policies that discriminate against out-of-state businesses and individuals. For all the discussion about how nonresident companies benefit from state services, the real issue usually is shifting tax burdens away from voting residents to someone else. As Professor Daniel Shaviro has put it, "Perceived tax exportation is a valuable political tool for state legislators, permitting them to claim that they provide government services for free."[9] Without court intervention or congressional action (or the threat of congressional action), efforts to get states to solve interstate tax issues have historically failed, because as soon as a state thinks they can get a bigger share of the pie by breaking the agreement, they do so, and the whole thing unravels.

As one example, the threat of congressional action by the Willis Commission in 1959 led to the adoption of uniform state corporate income tax apportionment rules. This standardization, however, only lasted twenty years before Iowa deviated from it to gain an advantage for itself. Many other states have followed, and today, only 11 states still adhere to the uniform rule. The trend continues to move away from uniformity, not towards it, despite the existence of voluntary organizations like the Multistate Tax Commission (MTC) and the Federation of Tax Administrators (FTA) that exist to advance uniformity in such rules.

Nexus Based on Physical Presence

We at the Tax Foundation have monitored the increasing use of tax policy by states to do precisely what I have described: shift tax burdens from out-of-state businesses and individuals to benefit in-state businesses and individuals, through discriminatory tax policy. These generally involve disputes over "nexus" standards: the proper scope of state tax power over non-resident individuals and businesses.

Generally, the historical standard is that states may tax those physically present in the jurisdiction, and may not tax those not physically present. This is premised on a view known as the "benefit principle": that the taxes you pay should roughly approximate the services you consume. State spending overwhelmingly, if not completely, is meant to benefit the people who live and work in the jurisdiction. Education, health care, roads, police protection, broadband access, etc.: the primary beneficiaries are state residents. The "benefit principle" thus means that residents should be paying taxes where they work and live, and jurisdictions should not tax those who don't work and live there.

[9] Daniel Shaviro, "An Economic and Political Look at Federalism in Taxation," 90 Mich. L. Rev. 895, 957 (1992).

A physical presence standard for state taxation is in line with this fundamental view of taxation.

Developments have arisen in the three major state tax areas (corporate income tax, individual income tax and sales tax), as well as with some other state taxes (such as telecommunications taxes, taxes on digital goods, car rental taxes, and so forth). Bills have been introduced in the Congress that seek to reaffirm the physical presence rule in these areas (such as BATSA with corporate income tax, Mobile Workforce with individual income tax).

Recent Developments in State Sales Tax: Overview

There are a number of proposals to reverse a series of U.S. Supreme Court decisions (most recently the *Quill* decision of 1992) that prohibit states from imposing sales tax collection obligations on businesses with no property or employee in the state. This "physical presence" standard is meant to prevent states from shifting tax burdens to non-residents away from residents who are the primary beneficiary of state services, while also protecting the free flow of interstate commerce from the compliance costs of non-uniform and numerous (9,600+) sales tax jurisdictions in the United States (see Figure 1, Figure 2, Table 2, and Table 3).

The steadily increasing growth of Internet-based commerce has however led to frustration with this standard, primarily due to disparate sales tax treatment of similar goods within states that has no economic basis. This can be addressed while also ensuring that some standard exists to restrain states from engaging in destructive behavior, such as tax exporting to non-voters or imposing heavy compliance costs on interstate businesses, that the Congress is empowered to prevent. Further, because economic integration is greater now than it has ever been before, the economic costs of nexus uncertainty are also greater today and can ripple through the economy much more quickly.

These actions are only the latest chapter in a long saga over the proper tax treatment of sales made over the Internet, and an even longer saga over the proper scope of state taxing authority. At its core is a dispute over which is more important: limiting state power to tax nonresidents and thus harm the national economy, or ensuring that some transactions do not escape tax because they are conducted online. Discussions following a recent compromise in California, driven by the desire of large Internet retailers to expand their physical presence to enable next-day delivery, suggest that there are policy options that could achieve both ends.

Figure 1: New State/Local Sales Tax Jurisdictions Created Each Year

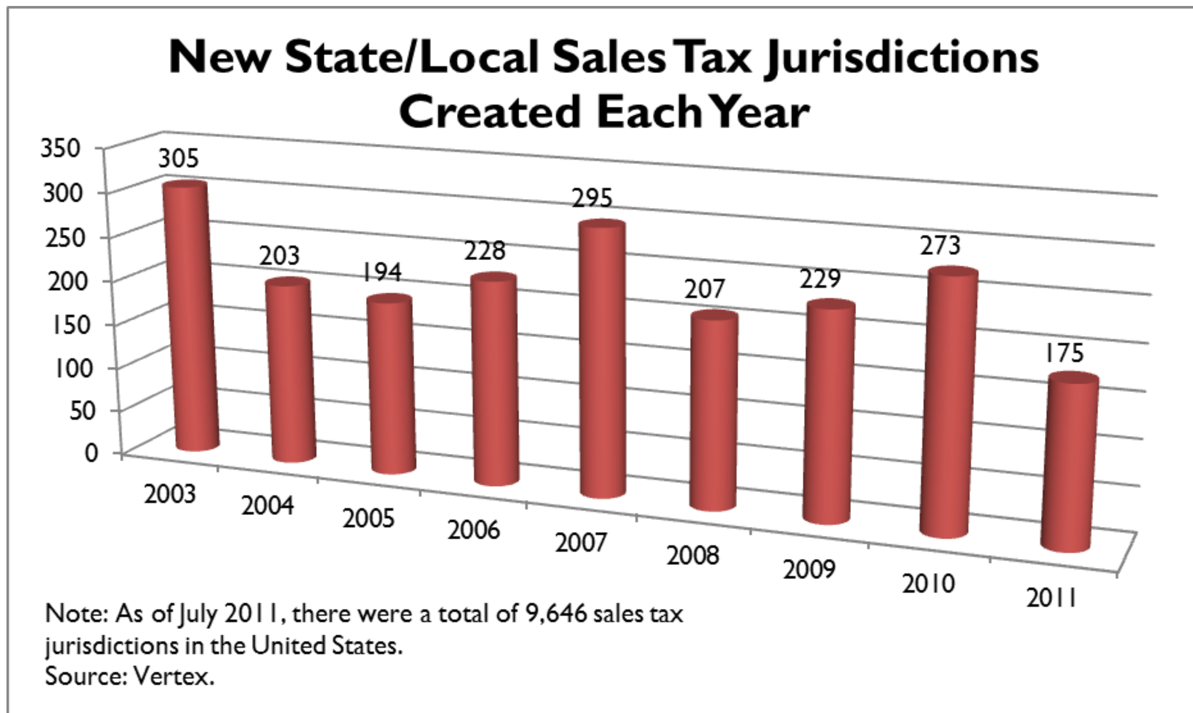

Figure 2: Sales Tax Jurisdictions with Changes Each Year

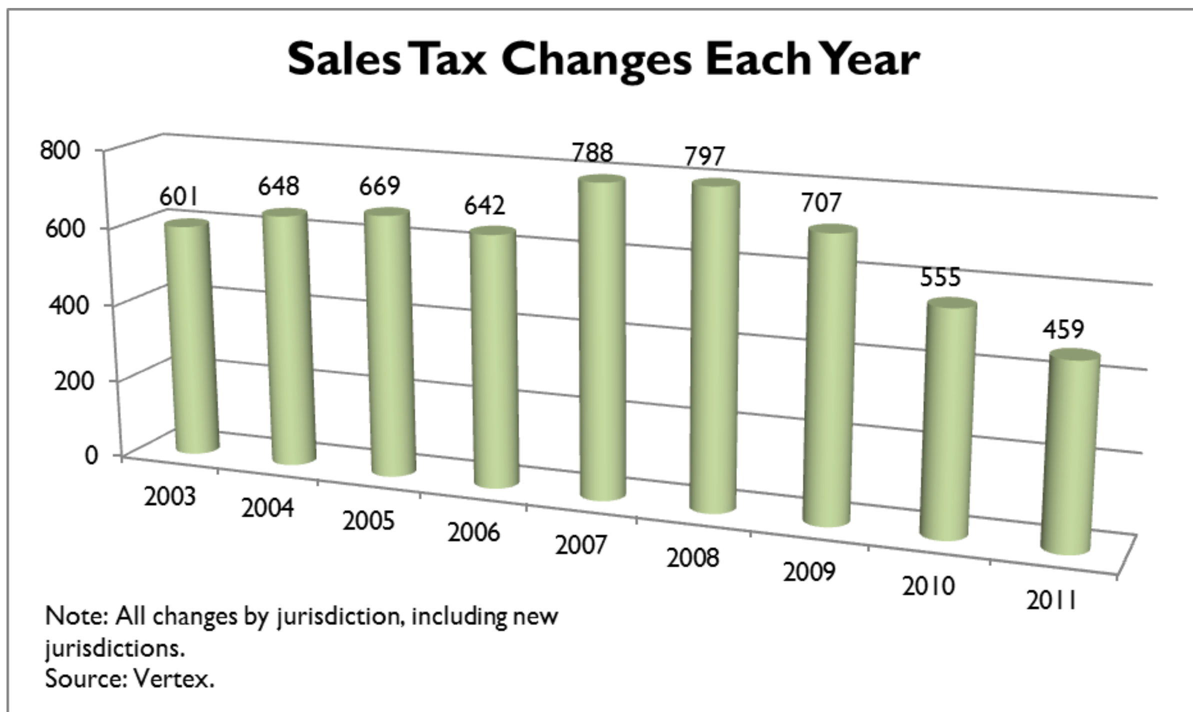

Table 2: Example of Sales Tax Complexity: Taxation of a Bottled Frappuccino® Beverage Under Current and Proposed State Legislation

State	Tax on Bottled Frappuccino®?
Enacted	
Arkansas	No
Tennessee	Yes
Virginia	No
West Virginia	Yes
Proposed	
Arizona	No
California	No
Connecticut	Unclear
Hawaii	Yes
Illinois	Yes
Mississippi	Yes
Montana	Yes
New Mexico	Yes
Oregon	No
Rhode Island	No
Tennessee	Yes
Texas	Yes
Utah	Yes
Vermont	Yes

Source: Scott Drenkard, *Overreaching on Obesity: Governments Consider New Taxes on Soda and Candy*, Tax Foundation Special Report No. 196 (Oct. 2011)

Table 3: Other Examples of Contributors to Sales Tax Complexity

States With Local Option Sales Taxes: **37**
States That Permit Local Government to Define A Separate Sales Tax Base: **7**
States With Sales Tax Holidays: **17**

The *Quill* Decision: Not a Loophole, But a Check on State Power to Export Tax Burdens and Do Harm Interstate Commerce

What is nexus for a remote seller? In 1967, the U.S. Supreme Court held that a business does not have nexus with a state if the business has no retail outlets, solicitors, or property in the state, and communicates with customers only by mail or common carrier as part of a general interstate business.[10] Otherwise, the Court concluded, states could "entangle National's 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." This decision was reaffirmed after the *Complete Auto* test was announced in 1977.[11]

During the 1980s, some academics and many states criticized *National Bellas Hess* as archaic, formalistic, and outmoded. Officials were encouraged to ignore the decision, and some state courts disregarded it, even as the number of sales taxes rose from 2,300 to 6,000. Different murky definitions of economic nexus have been proposed:

- Engaged in exploiting the local market on a regular, systematic, large-scale basis.
- Presence of intangible property or affiliates
- Number of customers in state, value of assets or deposits in the state, and receipts attributable to sources in the state
- Analysis of frequency, quantity, and systematic nature of taxpayer's economic contacts with the state
- Derivation of economic benefits from state's residents

Defying the Court rulings, North Dakota enacted a law requiring the out-of-state Quill Corp. to collect sales tax on its sales to 3,000 in-state customers. Any state that advertised three times in the state was liable. In the case, the U.S. Supreme Court reaffirmed *National Bellas Hess* and *Complete Auto*.[12] There they stated that the physical presence rule "firmly establishes the boundaries of legitimate state authority to impose a duty to collect sales and use taxes and reduces litigation concerning those taxes." Justice Byron White dissented, arguing two points that continue to be made today: (1) injustice that some sales escape taxation and (2) arguing that technological change had made discriminatory compliance costs no longer burdensome.

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[10] *See National Bellas Hess, Inc. v. Dept. of Revenue of Ill.*, 386 U.S. 753, 759-60 (1967).
[11] *See Nat'l Geographic Society v. Ca. Bd. Of Equalization*, 430 U.S. 551, 559 (1977).
[12] *See Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

The Streamlined Sales Tax Project Has Watered Down Membership Standards in an Unsuccessful Effort to Entice More State Members in Its Effort to Change *Quill*

Today, there are over 9,600 state and local sales tax jurisdictions in the United States. There are different rates on different items, they change frequently, and are not even aligned to 9-digit zip codes. States are reluctant to cooperate on even basic rules and definitions.

The Streamlined Sales Tax Project (SSTP) was launched in 2000 with the mission of getting states to adopt changes to their sales taxes to make them simple and uniform. SSTP then hopes to convince Congress or the courts to overrule *Quill* and allow use tax collection obligations on out-of-state companies ("Main Street Fairness Act").

However, the SSTP has abandoned simplification efforts and any attempt to reduce the number of sales tax jurisdictions, instead focusing on uniformity efforts. In many cases, the Project has enabled state sales tax complexity by permitting separate tax rates for certain goods. States generally are reluctant to yield parochial advantages, even with the possibility of online sales tax revenue in return, undermining their argument to Congress as part of the Main Street Fairness Act that they have succeeded in their mission. Large states have generally avoided the SSTP, and membership has been stuck at ~20 states for some time. This in turn has led to impatience from states and others.

Some States Have Sought to Defy *Quill* through Unconstitutional Legislation

In 2008, New York adopted an "Amazon" tax, nicknamed after the Internet retailer as the most visible target. The law held that a person or business with no physical presence in the state nevertheless has nexus if it (1) enters into agreement with in-state resident involving commissions for referring potential customers; and (2) has gross receipts from sales by out-of-state company from referrals within the state are more than $10,000 in a 12-month period.

Amazon.com & Overstock.com responded by terminating affiliate programs in New York, and Amazon.com filed a lawsuit in state court. The law was upheld by a trial judge (New York's trial courts are called the "New York Supreme Court," causing confusion about who upheld the Amazon tax as constitutional); the judge concluded that Amazon.com's in-state affiliates are necessary and significant to establishing and maintaining out-of-state company's market in the state. But because they make up only 1.5% of sales, that was the basis for the appeal. The New York Supreme Court, Appellate Division ruled in late 2010 that law is not facially unconstitutional but may be

unconstitutional for Amazon. The case was remanded to the lower court, but Amazon is appealing to state's highest court, the New York Court of Appeals. The case is ongoing.

In 2009, Rhode Island and North Carolina adopted identical New York-style laws. Neither has seen any revenue and Rhode Island has actually seen revenue loss due to reduced income tax collections from terminated in-state affiliates. Laws were also passed in California and Hawaii but vetoed. (See Table 4 for a status of all state efforts to defy *Quill* legislatively.)

Table 4: Status of State Efforts to Defy *Quill* Legislatively

Arkansas	Enacted mid-2011.
California	Enacted mid-2011 but effective date postponed after agreement reached with state.
Colorado	Enacted 2010. Ruled unconstitutional.
Connecticut	Enacted mid-2011.
Illinois	Enacted 2011. Ruled unconstitutional.
New York	Enacted 2008. In litigation.
North Carolina	Enacted 2009. Ruled unconstitutional.
Rhode Island	Enacted 2009. Officials report that the law has reduced state tax collections. May be repealed.

Source: Tax Foundation compilation. Does not include states where legislation was proposed but not adopted.

In 2010, Colorado considered the same law but faced opposition from in-state affiliates. Instead it adopted a law (H.B. 10-1193) designed to push Amazon into collecting use taxes without explicitly requiring it. Any out-of-state retailer that is part of "a controlled group of corporations" with at least one member with physical presence in Colorado, all the retailers in the group have nexus with Colorado. However, the "only" obligation with this nexus is notification:

- "[N]otify Colorado purchasers that sales or use tax is due on certain purchases made from the retailer and that the State of Colorado requires the purchaser to file a sales or use tax return." Penalty of $5 per failure per customer, plus criminal penalties.
- "[Notify] all Colorado purchasers by January 31 of each year showing such information as the Colorado Department of Revenue shall require by rule and the total amount paid by the purchaser for Colorado purchases made from the retailer in the previous calendar year. Such notification shall include, if available, the dates of purchases, the amounts of each purchase, and the category of the purchase, including, if known by the retailer, whether the purchase is exempt or not exempt from taxation." Must be sent separately from shipments and be by first-class mail. CC to State. Penalty of $10 per failure per customer, plus criminal penalties.

Amazon.com terminated affiliate programs in Colorado. In January 2010, a federal judge stayed the law stayed as probably unconstitutional on First Amendment grounds, and the law was thrown out completely in April 2012.[13]

North Carolina followed Colorado by adopting regulation with similar/notification requirements. They demanded out-of-state companies provide them with all customer purchase information dating from 2003, by April 19, 2010. Amazon.com and the ACLU filed lawsuit in federal court, arguing that "[e]ach order of a book, movie, CD or other expressive work potentially reveals an intimate fact about an Amazon customer" (see Table 5).

Table 5: Examples of Purchases Required to Be Disclosed to State Officials under the North Carolina Law

Bipolar Disorder: A Guide for Parents and Families
He Had It Coming: How to Outsmart Your Husband and Win Your Divorce
Living with Alcoholism: Your Guide to Dealing with Alcohol Abuse and Addiction While Getting the Alcoholism Treatment You Need
What to Do When You Can't Get Pregnant: The Complete Guide to All the Technologies for Couples Facing Fertility Problems
Outing Yourself: How to Come out as Lesbian or Gay to Your Family, Friends, and Coworkers
Lolita (1962)
Brokeback Mountain (2005)
Fahrenheit 9/11 (2004)

Source: ACLU brief in the North Carolina case.

A federal judge struck down the North Carolina regulation as violating First Amendment in October 2010. In 2011, Illinois and Arkansas enacted New York-style laws (the Illinois law was subsequently ruled unconstitutional). California enacted one but after a possible repeal referendum was proposed, the state and Amazon.com reached an agreement whereby Amazon.com will develop a physical presence in the state (*i.e.*, build warehouses).

While for the most part unsuccessful, these state efforts have highlighted the desire to modify the *Quill* holding in some way. This pressure is likely to continue.

[13] *See* Mark Robyn, "Colorado Amazon Regulations Ruled Unconstitutional," (Apr. 4, 2012), http://www.taxfoundation.org/blog/show/28111.html

Possible Solutions

Substantial progress has been made in recent months toward possible solutions that could (1) simplify sales tax systems and avoid discriminatory compliance costs, (2) eliminate non-neutral tax rates on similar products sold by online and brick-and-mortar businesses, (3) limit taxation in a state to those residents who enjoy the benefits of state services, (4) prevent multiple taxation of interstate commerce, and (5) prevent unconstitutional and fragmented state attempts to impose such tax burdens in a destructive manner.

Congress has five basic options on how it may proceed:

- *Reaffirm the physical presence rule* for sales taxation, and by implication, the disparity of treatment between brick-and-mortar sales and Internet sales.
- *Reaffirm the physical presence rule* but adopt a new tax approach that mitigates the disparity of treatment between brick-and-mortar sales and Internet sales (such as an origin-based system or a national sales tax on online purchases).
- *Modify the physical presence rule* in the limited context of state collection of use tax from out-of-state sellers, by those states that have adopted simplified sales tax systems under minimal federal standards, to reduce the harm to interstate commerce. This trade-off would replace the check on state power provided at present by the physical presence rule.
- *Repeal the physical presence rule* without conditions on the states, granting states unchecked authority to export tax burdens and damage interstate commerce.
- *Do nothing* and risk the continued growth of unchecked and fragmented state authority to export tax burdens and damage interstate commerce.

I'll focus the remainder of my analysis on the third option, which would allow the states to collect use tax from remote sellers on condition that they simplify their sales tax systems in accordance with minimum federal specifications. If the Committee is interested in further discussion of the other alternatives, we will be happy to do so.

The Marketplace Equity Act (H.R. 3179) and Marketplace Fairness Act (S. 1832) are two recent proposals that would eliminate the physical presence rule but otherwise make advances towards ensuring that states reduce the burdens associated with collecting their sales taxes. Example provisions include requirements that states have a single state-level agency that administer all sales

tax rules, offer one tax return and audit for the entire state, require one uniform tax base for the entire state, provide software that identifies the applicable tax rate for a sale, including local rates and hold sellers harmless for any software errors or mistakes by the state, provide 30 days' notice of any local sales tax rate change, and exempt sellers with a *de minimis* level of collections. (See Table 6 for a comparison.)

Effective simplification is a necessity for any federal proposal.

Table 6: Provisions of Current Pending Federal Legislation

Before Collecting Remote Use Tax, State Must...	Marketplace Equity Act	Marketplace Fairness Act	Main Street Fairness Act
Designate one state entity to collect, process, and audit returns for all tax jurisdictions in the state.	✓	✓	✓
Establish unified audit of remote sellers for all taxing jurisdictions in the state.	✗	✓	✗
Establish a single tax return for all taxing jurisdictions in the state.	✓	✓	✓
Provide or certify tax collection and remittance software. (**Note**: Not necessarily free software)	✓	✓	✓
Hold remote sellers harmless for errors in state-provided software.	✓	✓	✓
Adopt standardized definitions of commonly taxed goods.	✗	✗	✓
Offer immunity to remote sellers who misapply sales tax holidays.	✗	✗	✗
Compensate vendors.	✗	✗	✓
Offer a single statewide blended rate as an option.	✓	✗	✗
Require local jurisdictions to use the state's sales tax base.	✓	✓	✓
Require local jurisdictions to align geographically with 5-digit zip codes	✗	✗	✗
Legislation explicitly preempts other state efforts to force use tax collection by tax out-of-state sellers.	✗	✗	✗
"Small seller exception"	$1m in U.S., $100k in state	$500k in U.S.	To be set
Legislation establishes federal court jurisdiction for enforcing simplification standards.	✗	✗	✓

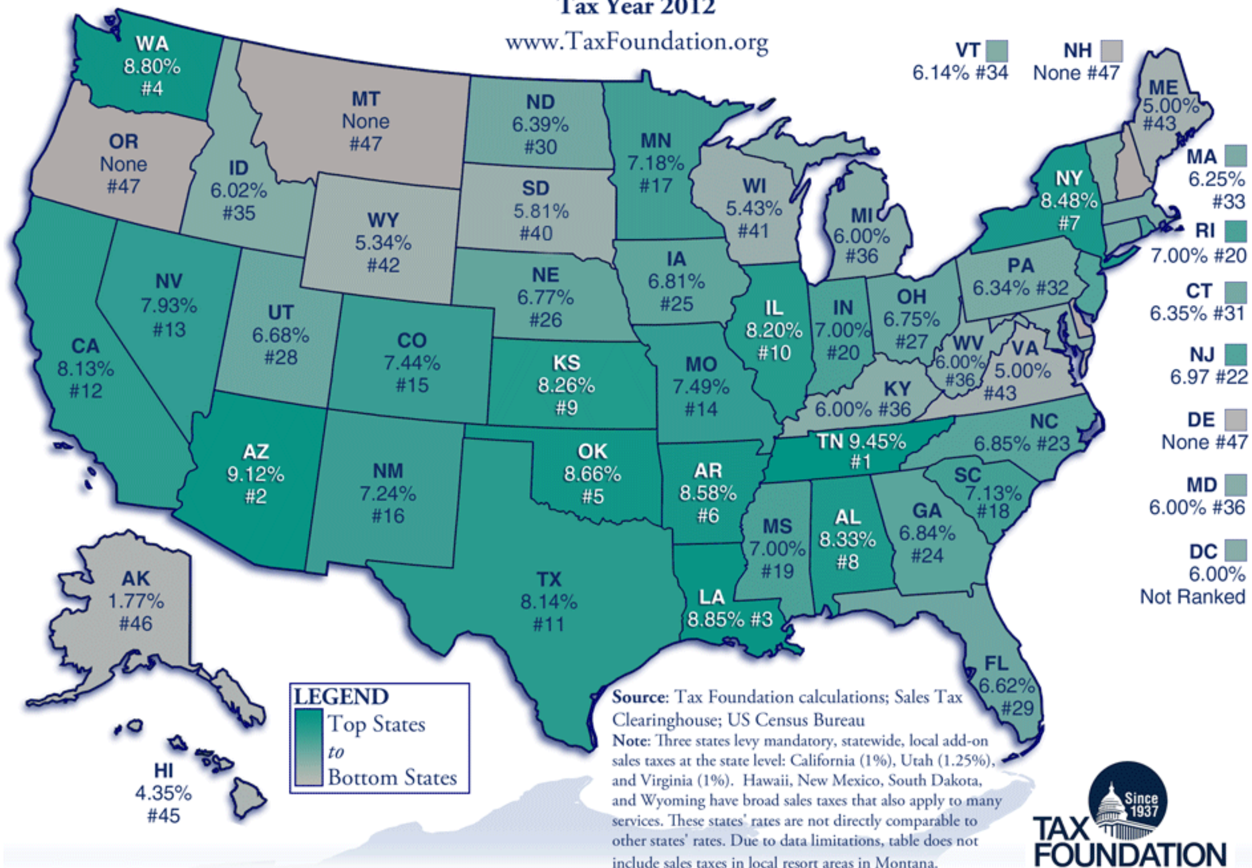
Source: Tax Foundation review of legislation. Main Street Fairness Act review includes only provisions incorporated in federal law, not those merely adopted by its Governing Board.

All these simplifications are desirable, and together would provide a sufficient check on state tax overreaching while leaving ample space for states to structure their tax systems and rates in line with their own preferences. The only infringement on state sovereignty is an infringement on state power to burden interstate commerce with problematic tax policy.

Congress has passed a number of statutes limiting the scope of state tax authority on interstate activities, carefully balancing (1) the ability of states to set tax policies in line with their interests and that allow interstate competition for citizens over baskets of taxes and services and (2) limiting state tax power to export tax burdens to non-residents or out-of-state companies, or policies that would excessively harm the free-flow of commerce in the national economy. A package specifying a floor of all the simplifications listed in Table 6 would be welcome and would greatly reduce constraints on economic growth.

Sales Tax: Combined State and Average Local Rates

Tax Year 2012



Note: Some states levy gross receipts taxes in addition to sales taxes. See Table 20 for information on gross receipts taxes.
(a) City, county and municipal rates vary. These rates are weighted by population to compute an average local tax rate. (b) Three states collect a separate, uniform "local" add-on sales tax: California (1%), Utah (1.25%), Virginia (1%). We include these in their state sales tax. (c) The sales taxes in Hawaii, New Mexico and South Dakota have broad bases that include many services, so their rates are not strictly comparable to other states. (d) Due to data limitations, table does not include sales taxes in local resort areas in Montana. (e) Some counties in New Jersey are not subject to the statewide sales tax rate and collect a local rate of 3.5%. Their average local score is represented as a negative.
Source: Tax Foundation; Sales Tax Clearinghouse.

State and Local Sales Tax Rates
As of January 1, 2012

State	State Tax Rate	Rank	Avg. Local Tax Rate (a)	Combined Rate	Rank
Ala.	4.00%	38	4.33%	8.33%	8
Alaska	None	46	1.77%	1.77%	46
Ariz.	6.60%	9	2.52%	9.12%	2
Ark.	6.00%	16	2.58%	8.58%	6
Calif. (b)	7.25%	1	0.86%	8.11%	12
Colo.	2.90%	45	4.54%	7.44%	15
Conn.	6.35%	11	None	6.35%	31
Del.	None	46	None	0.00%	47
Fla.	6.00%	16	0.62%	6.62%	29
Ga.	4.00%	38	2.84%	6.84%	24
Hawaii (c)	4.00%	38	0.35%	4.35%	45
Idaho	6.00%	16	0.02%	6.02%	35
Ill.	6.25%	13	1.95%	8.20%	10
Ind.	7.00%	2	None	7.00%	20
Iowa	6.00%	16	0.81%	6.81%	25
Kans.	6.30%	12	1.96%	8.26%	9
Ky.	6.00%	16	None	6.00%	36
La.	4.00%	38	4.85%	8.85%	3
Maine	5.00%	31	None	5.00%	43
Md.	6.00%	16	None	6.00%	36
Mass.	6.25%	13	None	6.25%	33
Mich.	6.00%	16	None	6.00%	36
Minn.	6.875%	7	0.30%	7.18%	17
Miss.	7.00%	2	0.004%	7.00%	19
Mo.	4.225%	37	3.26%	7.49%	14
Mont. (d)	None	46	None	0.00%	47
Nebr.	5.50%	28	1.27%	6.77%	26
Nev.	6.85%	8	1.08%	7.93%	13
N.H.	None	46	None	0.00%	47
N.J. (e)	7.00%	2	-0.03%	6.97%	22
N.M. (c)	5.125%	30	2.12%	7.24%	16
N.Y.	4.00%	38	4.48%	8.48%	7
N.C.	4.75%	35	2.10%	6.85%	23
N.D.	5.00%	31	1.39%	6.39%	30
Ohio	5.50%	28	1.25%	6.75%	27
Okla.	4.50%	36	4.16%	8.66%	5
Ore.	None	46	None	0.00%	47
Pa.	6.00%	16	0.34%	6.34%	32
R.I.	7.00%	2	None	7.00%	20
S.C.	6.00%	16	1.13%	7.13%	18
S.D.	4.00%	38	1.39%	5.39%	41
Tenn.	7.00%	2	2.45%	9.45%	1
Tex.	6.25%	13	1.89%	8.14%	11
Utah (b)	5.95%	27	0.73%	6.68%	28
Vt.	6.00%	16	0.14%	6.14%	34
Va. (b)	5.00%	31	None	5.00%	43
Wash.	6.50%	10	2.30%	8.80%	4
W.Va.	6.00%	16	None	6.00%	36
Wis.	5.00%	31	0.43%	5.43%	40
Wyo.	4.00%	38	1.34%	5.34%	42
D.C.	6.00%	(16)	-	6.00%	(36)

Conclusion

Businesses throughout our nation's history have plied their trade across state lines. Today, with new technologies, even the smallest businesses can sell their products and services in all fifty states through the Internet and through the mail. Business travel is easier than ever before. If such sales, travel, or activity can now expose these businesses to tax compliance and liability risks in states where they merely have customers, they will be less likely to expand their reach into those states. Interstate commerce is not a golden goose that can be squeezed without adverse effects on economic growth. Unless a single uniform nexus standard is established, the conflicting standards will impede the desire and the ability of businesses to expand, which harms the nation's economic growth potential.

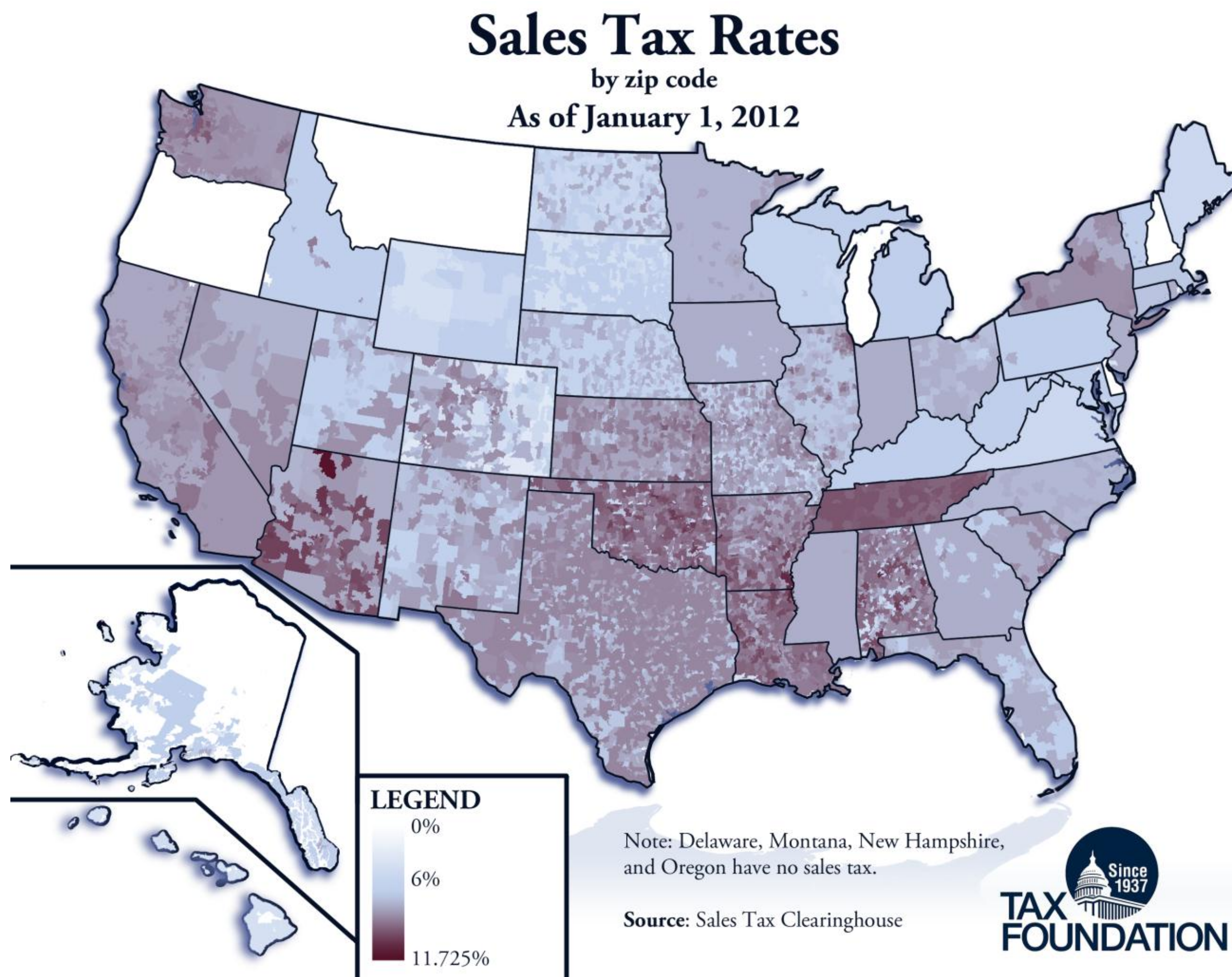
We at the Tax Foundation track the numerous rates, bases, exemptions, credits, adjustments, phaseouts, exclusions, and deductions that litter our federal and state tax codes. Frequent and ambiguous alterations of tax codes and the confusion they cause are a key source of the growing tax compliance burden. We have several staffers as well as computer-based and publication subscriptions dedicated to being up to date and accurate on the frequent changes to the many taxes in our country, but even we have trouble doing it. It would be extremely difficult for individuals and businesses who are in business to sell a good or service, not to conduct tax policy research.

Congress can obtain evidence from interested stakeholders and take political and economic factors into consideration when developing new rules of taxation. The Supreme Court, by contrast, must develop broad doctrine in a case-by-case fashion, based on the facts of the particular case before them. (Additionally, the Court seems to have an aversion to tax cases in general and these type of tax cases in particular.) This is why congressional action, which can be more comprehensive and accountable than judicial action, and can better address issues of transition, retroactivity, and *de minimis* exemptions, may now be the best vehicle for preventing burdens to interstate commerce. It is up to Congress to exercise its power to protect interstate commerce.

We now live in a world of iPods, telecommuting, and Amazon.com. It is a testament to the Framers that their warnings about states' incentives to hinder the national economy remain true today.

Some may argue that faster roads and powerful computers mean that states should now be able to tax everything everywhere. While some constitutional principles surely must be revisited to be applied to new circumstances, the idea that parochial state interests should not be permitted to

burden interstate commerce remains a timeless principle regardless of how sophisticated technology may become.



About the Tax Foundation

The Tax Foundation is a non-partisan, non-profit research institution founded in 1937 to educate taxpayers on tax policy. Based in Washington, D.C., our economic and policy analysis is guided by the principles of sound tax policy: simplicity, neutrality, transparency, and stability.

About the Center for Legal Reform at the Tax Foundation

The Tax Foundation's Center for Legal Reform educates the legal community and the general public about economics and principled tax policy. Our research efforts focus on the scope of taxing authority, the definition of tax, economic incidence, and taxpayer protections.