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March 6, 2001

Senator John McCain, Chair
Committee on Commerce, Science, and Transportation
U.S. Senate
241 Russell Senate Office Building
Washington DC 20510

Re.: Internet Tax Freedom Act Revision and Extension

Dear Senator McCain,

Thank you for your letter of February 26, 2001, asking me for comments on the extension and revision of the Internet Tax Freedom Act. I have written a law review article dealing with the matters you raise. It is available on line at <http://www.law.wayne.edu/mcintyre/text/TLR-Electronic.pdf>.

In summary, I have concluded, after extensive study, that the current Court restrictions on State sovereignty that impact Internet sales are undesirable. Like most academics, I favor the proverbial level playing field. I have the following specific responses to the questions raised in your letter:

1. Congress should respect the sovereignty of the States by overturning the Court's ill-considered decision in *Quill* and allow a State to tax cross-border sales when the remote seller has due process nexus with the State.
2. There should not be any discrimination between remote sellers making use of the Internet and local sellers operating out of malls and traditional stores. Of course, a State should not be viewed as engaging in discrimination if it exempts remote sales when the seller does not have due process nexus with the State because the remote sales are sporadic and inconsequential.
3. Simplification of State use taxes is important and is under way in many States. I believe that States should take the responsibility for administration of local taxes so that remote sellers (and local sellers located outside a local jurisdiction) are able to remit taxes due to the State, with the distribution of appropriate amounts to local jurisdictions managed by the State. I also believe that States should eliminate many of their nice distinctions between taxable and nontaxable goods. Indeed, I would prefer that States eliminate all exemptions, with the possible exception of "food." If "food remains an exemption, I would define food broadly to include all goods sold for human consumption other than

medications. I would harmonize the State rules so that a remote seller could rely on Zip Codes in determining local rates. I would require remote sellers that cannot fairly determine the proper rate to be allowed to pay at a blended rate, based on a weighted average of State and local rates. If the remote seller cannot determine the State where the goods are sold, then the seller should be required to pay the use tax at a blended rate into a fund that would be distributed to all States that impose a general sales and use tax. The blended rate would be based on the weighted average of the top 20 use-tax rates imposed by the States.

4. I do not believe in the digital age that one rate for each State is necessary for simplification. One blended rate has advantages, but those advantages compete with policy concerns at the State level for allowing viable local taxes. I do believe, however, as indicated in my response in item 3, that a solution to multiple rates consistent with the accounting systems of remote sellers is highly desirable.

5. I have not considered, in my academic work, the proper definition of Internet access.

In my view, the Commission appointed by Congress as part of the original Internet Tax Freedom Act failed badly. Obviously some members of the Commission did not use their position to promote the public good. Congress deserves some of the blame, however, by failing to require that any proposed resolution of the treatment of remote sellers include an overturning of *Quill*. As a result, some members of the Commission felt free to pursue the interests of their own firms or clients without limit. The leadership of Congress also deserves considerable blame for the appointments made to the Commission. They undermined the potential for consensus by giving almost no representation to main street companies, by appointing a lobbyist for Microsoft as the representative of the public, and by giving too many seats to company executives with an axe to grind. Indeed, the members of the Commission were not experts on cross-border taxation issues.

A notable feature of state governments is that they are able to exercise very limited control over their borders. They cannot, for example, interdict commerce passing into or out of their territory. Because they relinquished control over their borders to form a more perfect union, their ability to levy sales taxes can be threatened by cross-border shopping. Cross-border shopping is a particularly difficult problem for small states that are surrounded by states that do not attempt to levy a sales tax, or that levy it at low rates, or that exempt certain goods and services from the tax. Rhode Island, for example, would have difficulty levying a sales tax on clothing if the malls located just outside its borders were selling clothing free of sales tax. To prevent putting its merchants at a significant commercial disadvantage, Rhode Island might feel compelled to exempt clothing as well.

Shopping over the Internet is cross-border shopping on stilts. Remote sellers using the Internet to communicate with their customers can set up shop almost anywhere, as States generally do not attempt to tax sales to customers located outside the State. In theory, the destination state could impose its sales and use tax on Internet sales. Collecting that tax is nearly impossible, however, without the assistance of the remote seller. The States have so far had little success in obtaining that assistance.

A major issue in the design of nexus rules to govern Internet sales is whether companies will be permitted to avoid those rules by transferring their nexus-creating activities in a State to a related legal entity that is not making remote sales into the State. Professor Charles McLure, of the Hoover Institution at Stanford, rightly claims that permitting "entity isolation" is foolish at best. See Charles E. McLure, Jr., "Electronic Commerce and the Tax Assignment Problem: Preserving State Sovereignty in a Digital World,"¹⁴ *State Tax Notes* 1169 (April 13, 1998). I agree fully with Professor McLure on this point. Entity isolation has become an increasingly important issue under the retail sales tax. One piece of evidence of its importance is the movement of many leading retail store chains in the United States into catalog sales. Traditional department store chains now operating a mail-order business include Abercrombie & Fitch Co., Dillard's, K-Mart, Macy's, Marshall Field's, Saks Fifth Avenue, and Wal-Mart. Any revised version of the Internet Tax Freedom Act, in addition to overturning *Quill*, should make crystal clear that entity isolation is not a viable legal strategy for avoiding tax on remote sales into a State in which related companies are engaged in business.

In my view, the primary duty of the Congress and the States with respect to the Internet Tax Freedom Act extension is to develop a practical strategy for saving state retail sales taxes from the corrosive effects of cross-border shopping, through catalogs and over the Internet. Whatever that strategy, it will need to take account of the reasonable needs of the States and their concerns about the erosion of their sovereignty to tax. It also will need to take account of the political power of the remote sellers, reinforced by voter preferences for purchasing goods free of sales taxes. I will be happy to consult with members of your staff at working toward an appropriate solution to the problems of cross-border sales.

Sincerely yours,

A handwritten signature in cursive script, appearing to read "Mike McLure".

CC: Senators Dorgan, Enzi, Hollings, Kerry, Voinovich, and Wyden