

# Multistate Tax Commission



March 6, 2001

The Honorable John McCain  
United States Senate  
Washington, DC 20510

The Honorable Ernest Hollings  
United States Senate  
Washington, DC 20510

Dear Senators McCain and Hollings:

Thank you for your letter of February 26, 2001, in which you request input from the Multistate Tax Commission (MTC) on issues related to the potential extension of the Internet Tax Freedom Act. The Multistate Tax Commission appreciates the opportunity to provide you with its position on issues of state and local taxation of interstate commerce raised in your letter. These views are based on a fundamental commitment to achieving equitable, uniform and non-discriminatory taxation and to securing the benefits of federalism that arise from preserving the proper authority of the states within our nation.

Tax neutrality is essential to achieving equity, uniformity and non-discrimination. Tax policy should not play favorites: similar economic activities should be taxed in similar ways to support the free flow of commerce and equal competition in the national marketplace. States within our nation should be treated in an equal and even-handed manner in support of the economic health, fiscal stability and governmental authority of all. The national economy and the free flow of commerce benefit from the services and laws provided by state and local governments and the efficient tailoring of those services to fit local circumstances. That is the genius of our federal system: by preserving state sovereignty, flexible federalism efficiently supports the national economy.

The MTC provides here a summary response to the points raised in your letter. We will supplement this summary within a few days with a white paper discussing these issues in greater detail.

***Should Congress allow states to require all remote sellers to collect and remit sales taxes on deliveries into that state provided that states and localities dramatically simplify their sales and use tax systems?***

Yes, provided that remote sellers whose sales do not exceed a specified level of *de minimis* national sales (a "sales threshold standard") be exempt from the requirement to collect and remit state sales or use taxes. The recommendations of the Streamlined Sales Tax Project will dramatically simplify sales and use

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taxes to a degree sufficient to require remote sellers above a sales threshold to collect those taxes. Congress should level the playing field between local and remote sellers to advance tax fairness, increase national economic efficiency and growth, and provide for more balanced economic development among states and communities. Congress should form a partnership between the states and the federal government and require remote sellers to collect sales and use taxes once the specified minimum of states have enacted the simplifications recommended by the Streamlined Sales Tax Project. Finally, in light of newly emerging business operations and technologies, Congress should revisit certain provisions in the “multiple and discriminatory” definitions in the Internet Tax Freedom Act if that act is extended. Those provisions, ironically, may increase tax discrimination against local retailers, instead of eliminating that discrimination.

There is no dispute that sales and use taxes are an indispensable element of state and local government finances. No one seriously disputes that such a tax, to be efficient and effective, is best collected at the retailer level—just as federal and state individual income taxes are most efficiently collected through employer withholding.

The inability of the states to require collection of sales and use taxes on remote sales subjects local retailers to unfair competition from remote sellers. Moreover, this substantial inequity violates the standards of tax neutrality and thereby reduces overall economic efficiency and national growth by diverting the allocation of capital away from its most efficient uses. In practical terms, this inequity is a source of additional pressure on the viability of local businesses in communities across the nation—businesses that the marketplace would treat more kindly if only the rules were fair and even-handed.

The inability of the states to require collection of sales and use taxes on remote sales creates a second inequity. It allows remote sellers to benefit from state and local services without helping to collect the taxes that finance those services. The state and local services that benefit remote sellers and, indeed, the national economy are extensive and include: education, university research, state and local infrastructure, public safety, commercial laws, the state court systems, environmental management and energy conservation and development, among others. A sampling of just some of these benefits includes: states and localities provide the roads used by the contract carrier to deliver goods purchased by remote commerce; states provide the courts that enforce the security interest of the remote seller in an installment sale to ensure proper payment; states finance the schools and universities that educate workers for the high technology industry and provide markets for computers and software . . . and the examples go on. Thus, remote sellers should bear the responsibility of participating in the process of financing these services.

The inability of the states to require collection of sales and use taxes on remote sales leads to yet a third inequity. The failure of a large portion of remote sellers to collect sales and use taxes typically allows their customers to escape paying sales and use taxes they owe. In the case of Internet purchases that require ready access to a properly connected computer, these customers tend to have higher incomes than the general population. The ability of higher income individuals to avoid the sales and use tax on purchases from remote sellers puts pressure on state and local governments to keep the rates of sales taxes artificially high to support needed services. This shifts the tax burden to those with the least ability to pay and increases the regressive nature of the sales tax.

In addition, the failure of remote sellers to collect sales and use taxes confuses the public into believing that tax is not due on remote sales. Accordingly, when states attempt—as they increasingly have in recent years—to collect from purchasers the lawfully due use tax, the state is wrongfully accused of imposing a new tax when, in fact, the state is only seeking to collect a tax that has been on the books for decades. By failing to collect the tax, remote sellers first create a collection problem for the states and then make it more difficult for states to solve that problem.

Finally, the current judicial interpretation of nexus for use tax—so-called “physical presence nexus”—actually prevents the free flow of interstate commerce and detracts from balanced economic development by acting as a barrier to capital investment flowing from one state into another. Companies have a disincentive to create jobs and invest in facilities in different states because once they establish facilities in the state they will be subject to a sales and use tax collection requirement. The ability of companies to make substantial sales into a state, but not collect that state’s sales and use taxes, distorts investment decisions. This circumstance tends to “freeze” economic development in states where certain activities originate and prevents the flow of investment into other states in a balanced manner. Thus, the current state of case law, absent congressional action, unwittingly favors some states and regions and prevents investment and prosperity from flowing evenly to all areas of the nation.

Congress can remedy this state of affairs by adopting—consistent with the nature of the modern economy and the principle of tax neutrality—a practical sales threshold standard requiring remote sellers with sufficient sales to collect sales and use taxes. Companies exceeding the sales threshold would no longer refrain from investing in a state out of a fear the investment would trigger a new collection requirement. Instead, the investment would be evaluated entirely on its free market merits. Moving to a sales threshold standard for sales and use tax collection for remote commerce will eliminate a barrier to the free flow of

investment across state boundaries and help generate more balanced economic development across the nation.

In summary, the states' inability to require the collection of sales and use taxes on remote sales constitutes bad tax policy, is inequitable and causes real economic damage. It is unfair to ask local retailers to compete with remote sellers who do not collect tax on identical sales, and that unfair competition creates economic pressures on local businesses and the communities that rely on them. It is unfair for remote sellers to escape collecting the taxes that finance state and local services from which they benefit, and that failure impairs the proper financing of those services. It is unfair that higher income taxpayers can disproportionately avoid sales and use taxes, and that shift in the tax burden makes it harder for lower income families to make ends meet. It is unfair that current standards of sales and use tax nexus tend to freeze economic development in the places of initial investment and prevent prosperity from flowing evenly to all states and regions of the nation. Congress as a matter of equity and sound economic policy should require remote sellers with sales above a certain threshold to collect sales and use taxes in conjunction with state efforts to streamline the administration of those taxes.

States recognize that the current sales and use taxes need to be updated to fit with the modern economy. Forty states—thirty-two voting states and eight observers—have undertaken the Streamlined Sales Tax Project with the active involvement of the multistate business community. The project's work is described in greater detail below. At this point it is sufficient to note that the project has identified the critical areas of change needed to make existing sales and use taxes work efficiently in the modern national economy. Congress should enact a "sales threshold" remote sales collection requirement—subject only to a subsequent congressional veto—when a sufficient number of states have adopted an interstate compact implementing simplification in the areas identified by the Streamlined Sales Tax Project. The federal-state partnership approach will achieve a level playing field in sales and use tax collection based on dramatic simplification of those taxes. Such a role for Congress was clearly envisioned by the framers of our Constitution. If Congress is not prepared to enter into this partnership with the states, it should refrain from specifying the details of simplification and should not preempt the sovereign right of states to have full and fair access to the courts to secure judicial approval of simplifications they may enact.

One final point. The combination of two obscure, ambiguous provisions in the definition of "discriminatory taxes" in the Internet Tax Freedom Act [Section 1104 (A)(iii) and (B)(ii)(II)] may be inadvertently encouraging new inequities among retailers. Some retailers are placing Internet kiosks in local stores,

making sales through those kiosks and allowing customers to return goods to those local stores. A portion of these retailers collect sales and use taxes on their Internet sales. Other retailers employing this practice do not. States find no legal justification for the retailers that fail to collect the sales taxes, despite their physical presence, other than the possibility of an ill-advised reading of the two provisions cited above whose language is manifestly unclear. While states would dispute this unfortunate reading of these provisions, their ambiguity should not be creating new discrimination in the marketplace. They should simply be eliminated if Congress chooses to extend the Internet Tax Freedom Act.

***Should goods purchased from remote sellers be taxed at the same rate as goods purchased through more traditional means (e.g., in-store sales)?***

Yes, it is sound tax policy for the same goods to be taxed at the same rate within any given jurisdiction. Further, the U.S. Constitution requires that goods sold by remote means be taxed at a rate no higher than goods sold locally, and many state constitutions effectively require goods sold by different means to be taxed equally.

Applying the same rate to different modes of selling fulfills the fundamental economic precept that taxes should operate neutrally. Otherwise a tax system in effect chooses winners and losers and displaces the free market determination of efficient and viable economic activity. Once the law selects economic favorites, the interests that benefit from the favored treatment work to preserve their privileged status to the detriment of non-favored players without regard to any underlying need for such protection. Taxing the same good at different rates based on delivery would perpetuate all of the inequities and problems associated with the present circumstance where many remote sales are taxed at a zero rate while local sales of the same goods are taxed at a full rate.

Furthermore, the U.S. Constitution requires that tax rates on products sold in interstate commerce be no higher than on products sold locally. The states accept this fundamental understanding of non-discrimination that supports the national market in our federal union. Traditional local commerce must bear its fair share of taxation as much as interstate commerce, including electronic commerce. The rule is well established that the tax rate imposed on sales by remote sellers not exceed the rate that is imposed on goods sold through the more traditional means. Thus, no further congressional action is needed to ensure equity in tax rates applied to both local and remote sales.

***What simplifications in state and local sales and use tax laws would you consider important to reduce the burden of compliance?***

The recommendations of the Streamlined Sales Tax Project will dramatically simplify the sales and use tax and will reduce compliance burdens for multistate businesses sufficiently to support Congress allowing states to require remote sellers exceeding a specified sales threshold to collect state and local sales taxes. The work of having multistate businesses identify the areas of simplification actually began over six years ago with the industry-led MTC Sales Tax Simplification Committee created by the Multistate Tax Commission. Business representatives on that committee from the American Institute of Certified Public Accountants (AICPA), the Committee on State Taxation (COST), the National Tax Association (NTA), the Tax Executives Institute (TEI) and the Institute for Professionals in Taxation (IPT) completed an inventory of desired areas of simplification in 1997. That process has continued through several other regional and national projects and studies involving multistate businesses, including the National Tax Association Communications and Electronic Commerce Tax Project cited in the Internet Tax Freedom Act. This extensive process of multiple state-industry consultation has reached a sound conclusion in the recommendations of the Streamlined Sales Tax Project. Congress can with confidence endorse—as a complete, comprehensive and sufficient package—the areas of simplification addressed by the project in legislation authorizing states to require collection of sales and use taxes by remote sellers.

Perhaps the most significant area in which simplification is required—and is being addressed effectively by the Streamlined Sales Tax Project—is in reducing the number of sales and use tax returns and reducing the number of tax bases in each state and all of its local entities. Using the benefits of statewide administration, the number of returns a retailer is required to file can be reduced from hundreds nationwide to one per state. Concurrently, the number of tax bases should be reduced so that retailers will be required to keep track of one tax base per period for each state into which it makes sales. These changes radically reduce the compliance burden of multistate retailers. A few dozen returns will suffice for even the largest retailers where hundreds of returns were required before. Smaller retailers will see comparable reductions.

The other areas of simplification being addressed by the Streamlined Project include:

- a centralized, one-stop, multistate registration system for participating sellers;
- uniform definitions for goods or services;
- uniform rules for attributing transactions to particular taxing jurisdictions;

- uniform procedures for handling sales that are exempt from sales and use taxes by virtue of the nature of the purchaser or the use of the purchased item and relief from liability to the states for sellers that rely on such state procedures;
- uniform procedures for certifying software that sellers may elect to determine applicable taxes and relief from liability to the state for sellers that rely on such software;
- simplified, uniform procedures for claiming bad debts;
- a uniform format for tax returns and remittances; consistent electronic filing and remittance methods;
- uniform audit procedures;
- appropriate protections for consumer privacy;
- limitations on the frequency with which local units of government may change their sales and use tax rate and the provision of adequate notice to sellers of the effective dates of such changes;
- standardized procedures requiring each state to provide sellers with the information necessary to assign the appropriate sales and use tax rate to any transaction attributed to the state and relief from liability to the states for sellers relying on such information provided by a state;
- and a study of the cost of collection by retailers before and after simplification.

In total, the elements addressed by the Streamlined Sales Tax Project are the areas of simplification most important to reducing burdens of compliance with sales and use taxes.

***Does simplification necessarily mean that states will have to develop one tax rate per state to apply to a certain taxable good?***

No. All of the simplification benefits of one rate per state can be achieved largely through the approach developed by the Streamlined Sales Tax Project. That approach combines uniform, strategic simplifications in tax policy with technology. Those simplifications include: a) limiting rate changes to quarterly periods, b) providing uniform advance public notice of the changes, and c) relieving enterprises of liability for errors in local rates if they use databases of local rates provided by states. Congress, in the Mobile Telecommunications Sourcing Act, PUB. L. 106-252, 114 STAT. 626 (2000), has already endorsed the use of governmentally supplied tax rate databases. The advantage of the Streamlined Sales Tax Project approach is that it achieves efficiency and simplification for interstate commerce, while allowing states and localities to tailor fiscal policy to fit local needs. It avoids, in particular, the problem of raising

taxes in rural areas to finance services in urban areas that is inherent in requiring “one rate per state.”

The latter portion of the question appears to raise the question whether Congress should require states to eliminate different state tax rates for different goods, such as lower rates on food or electricity than on other items. The states in the Streamlined Sales Tax Project chose wisely to develop a proposal for the phase-out of most of the differential state tax rates that apply to different items of personal property or services. Although current computer technology is sufficiently advanced to be able to assign different rates to different taxable items accurately, having one state rate for most taxable goods certainly is more easily administered. However, the states recognized that a simplified sales tax system could accommodate multiple rates for high value, durable goods such as motor vehicles, aircraft, watercraft, modular homes, manufactured homes and mobile homes—goods that are typically subject to either registration requirements or property taxation. Accordingly, the states did not adopt a phase-out for multiple rates on these enumerated items.

***Should Congress reconsider the definition of Internet access, and if so, how would you propose defining Internet access?***

If Congress extends the moratorium on state and local taxes on Internet access, it should re-evaluate the definition of Internet access within the moratorium to account for the increasing variety and extent of services that are “bundled” with access.

Since Congress wrote the original definition, changes in technology and corporate business structures have made it clear that it is now possible for large enterprises to bundle a broad array of otherwise taxable services with Internet access. The current definition appears to create the potential for discrimination in tax policy that would stifle competition and increase consumer costs, provide financial advantages to large enterprises, and erode state and local tax bases. Services delivered by large enterprises that can assemble the capital, technological, information and entertainment resources to bundle an array of services with Internet access would appear to be granted a tax exemption under the current language of the moratorium. The same services delivered through the Internet by smaller enterprises without the bundling capability or by non-electronic means would remain taxable. There is no economic or tax policy justification for Congress to create this disparity. Expanded bundling by large enterprises can substantially erode the tax bases of state and local governments that tax services.

The definition of Internet access should cover only access to the Internet. Because of the increasing problems in distinguishing between pure access and

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other services, Congress should explore a quantitative approach to defining access, such as was enacted by the State of Texas in the last few years.

The Commission has a neutral position on the question of whether or not Congress should extend a moratorium on state and local taxes of the Internet. We oppose removing, however, the “grandfather protection” in the Internet Tax Freedom Act for state and local governments levying taxes prior to the original moratorium as an unacceptable preemption of existing state and local tax policy.

***Again, this list is not exhaustive. We welcome any and all comments. Our expectation is that the Commerce Committee will conduct a hearing on the Internet tax issue soon after we receive your policy recommendations.***

The questions you raise in the letter of February 26, 2001, reflect a proper focus by the Senate Commerce Committee on sales and use taxes. The U.S. Supreme Court in its *Quill* decision invited Congress to address the issue of use tax collection by remote sellers. We are aware that some interests have sought to burden the sales and use tax issue with unrelated topics, especially the question of the authority of states to levy business activity taxes. Action by Congress to extend the authority of states to require the equitable collection of sales and use taxes will not result in a change in the authority of state and local governments to levy business activity taxes. Claims to the contrary are simply false.

The proposals advocated by some with regard to business activity taxes would dramatically change existing law. Typically the proposals would impose new restrictions on state authority in the form of physical activity standards of nexus for business activity taxes (including corporate income taxes, gross income or gross receipts taxes, and capital stock and franchise taxes). The imposition of these new standards would simply create and multiply within the business activity tax realm many of the problems that have existed in the context of sales and use taxes. Again, tax equity would suffer. Companies earning income from within a state and benefiting from state and local services would be excused from paying their fair share of the cost of those services. These proposals would elevate corporate form over economic substance and allow companies, through sophisticated tax strategies, to shift income unfairly away from where it was earned to tax haven locations. In terms of tax equity, the net result of the proposals would be to allow a select group of corporations to escape their fair share of state and local taxes and to shift that burden to wage-earners, small businesses and traditional manufacturing and natural resource industries—all of which are “captive” within the taxing state.

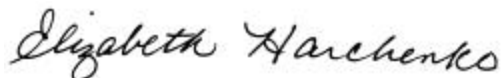
These proposals for new restrictions on state authority to levy business activity taxes would also detract from economic efficiency and balanced economic

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development by, again, discouraging the flow of investment across state boundaries. The physical activity approach to state authority is really an anachronism arising out of 17<sup>th</sup> and 18<sup>th</sup> century mercantilism. Centuries ago, the only way enterprises could earn income from a territory would be to undertake physical activities there. Today, companies can earn substantial income from a state—and in the process benefit from the services of a state—with only minimal activities that might traditionally be labeled “physical.” To achieve tax neutrality—taxing the same income earned in the same state to the same degree—concepts of physical activity as a standard for state taxing authority need to be assigned to the dustbin of history. If companies can earn income from within a state, but escape taxation by keeping their activities within the boundaries of certain physical activities defined in a new federal law, then companies will be discouraged from going beyond those physical activities and making new and more substantial investments in that state. Thus, the proposals for new federal laws restricting state business activity taxes will only interfere with the free flow of commerce and balanced economic growth across the nation.

Thank you again for providing an opportunity for the Multistate Tax Commission to offer information and perspective on this important issue. The MTC would be glad to provide you with any further information or to answer any questions you may have. Please feel free to contact Dan Bucks, MTC Executive Director concerning these issues at 202-624-8699.

Sincerely,



Elizabeth Harchenko  
Director, Oregon Department of Revenue  
Chair, Multistate Tax Commission

cc: The Honorable Ron Wyden, U.S. Senator  
The Honorable Byron Dorgan, U.S. Senator  
The Honorable George Voinovich, U.S. Senator  
The Honorable Mike Enzi, U.S. Senator  
The Honorable John Kerry, U.S. Senator