

Subj: Internet Taxes: Perspectives of the E-Fairness Coalition
From: The E-Fairness Coalition, 202-789-2111
To: Internet Caucus Advisory Committee

**The Collection of Sales and Use Taxes on Internet Sales
Legislation Necessary to Level the Playing Field**

The e-Fairness Coalition does not support new taxes on Internet sales. Sales made over the Internet are already subject to sales and use taxes. We support leveling the playing field so all retailers – in-store, online, and catalogue – have the same collection responsibility. Congress should enact legislation allowing states to treat all retail sales equally.

Current Law

Under current law, sales and use taxes are already in place on all remote sales. If the remote retailer has a physical presence (or nexus) in the state of the buyer, the retailer is required to collect and remit the sales tax. However, under the Supreme Court's Quill decision, if the remote retailer does not have a physical presence in the state of the buyer, the retailer cannot be required to collect sales tax. In cases where the retailer does not collect the sales tax, the buyer is required to pay the use tax to their home taxing jurisdiction. The use tax is not widely understood and compliance is very low.

The Quill decision has resulted in a situation where Amazon.com does not collect sales taxes, but Borders.com, which has physical stores in most states, is required to collect sales taxes. This inequitable situation should not be allowed to continue.

Meaning of "Extend the Moratorium"

The Internet Tax Freedom Act of 1998 banned taxes on Internet access and it banned multiple or discriminatory taxes on electronic commerce. **The Internet Tax Freedom Act did not ban the collection of sales and use taxes on sales made over the Internet.** This issue is not widely understood and is regularly mischaracterized in the press.

Merely extending the moratorium will not address the main issue of allowing states to require remote retailers to collect and remit sales taxes. Extending the moratorium will only delay a decision on this issue and allow the current inequitable situation to continue.

Responsible Congressional Legislation is Necessary

The current sales tax rules and definitions of the various states and localities are overly complex and must be simplified. To implement streamlined sales tax systems, we recommend that Congress enact legislation authorizing states to develop and enter into an Interstate Sales and Use Tax Compact. The legislation should provide that states joining the Compact will be required to adopt a simplified sales tax system. States adopting the simplified system would be authorized to require remote sellers above a sales volume threshold to collect use tax on all taxable sales into a state.

Providing a framework for simplification, and allowing states to require collection when the states achieve simplification is a reasonable and necessary step for Congress to take. Merely extending the moratorium is an empty gesture that does not solve the real problem.

<p>The e-Fairness Coalition includes brick-and-mortar and online retailers, retail corporations and associations, publicly- and privately-owned shopping centers, outlet centers and independently owned shops. The coalition advocates fairness for businesses and consumers. It supports a level playing field that ensures consumers are treated fairly regardless of where they choose to shop.</p>

Subj: Internet Taxes: Perspectives of IPI: Center for Technology Freedom
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To: Internet Caucus Advisory Committee

As the sales tax example illustrates, there are a number of different dimensions involved in deciding whether, and if so how, to "tax the Internet." Therefore, before proceeding directly to a discussion of the pros and cons of "taxing the Internet," it is first useful to lay out a framework in which to consider these questions. The first step in defining what is meant by "taxing the Internet" is to categorize the different approaches to Internet taxation that have been suggested and then analyze how current law relates to the resulting categories.

The first useful distinction to draw is between constitutional and unconstitutional methods of "taxing the Internet." The reason it is necessary to belabor the obvious is that some of the most prominent proposals to expand sales tax coverage to all Internet commerce seek to avoid existing constitutional restrictions (e.g., by novel definitions of "nexus") or they involve new approaches to taxing the Internet that are themselves constitutionally suspect (e.g., state laws and interstate agreements designed to collect sales taxes that may run afoul of the Commerce Clause or other constitutional provisions).

It is also useful to sort Internet taxes by the tax base tapped. Some taxes under consideration treat the Internet *per se* as the tax base (e.g., byte taxes or web page excise taxes). Some taxes target activities unique to the Internet as the tax base (e.g., excise taxes on e-mail or Internet access fees). By far the largest category of Internet-related activities that government may seek to tax are activities that may be conducted on the Internet but are not necessarily unique to the Internet. Within this broad category, it is useful to combine income, payroll, real property and business activities into a single category and to treat sales and use taxes as a distinct category.

The framework that results from this typology is shown in Table 1.

- Unconstitutional Internet taxes (black);
- Constitutional taxes already being used to raise revenue from an Internet-related tax base (white);
- New, arguably constitutional taxes the federal government and states might choose to levy on the Internet and Internet-related activities. (gray).

Table 1 provides a ready means to organize the Internet taxation debate as it stands today. Individual entries in the cells of the table consist of taxes that have been actively considered since the emergence of the Internet but one must assume that as this debate advances, advocates of taxing the Internet will devise additional ways to levy cyberspace charges.

A category of new taxes that might be levied constitutionally on the Internet by the federal government and perhaps by the states is shaded yellow in Table 1. Gray shading is chosen to reflect the authors' opinion that these taxes, while probably constitutional in most cases, nevertheless should not be levied on prudential/economic grounds. The white bullet was selected for gray-shaded state taxes in the constitutional column to reflect the authors' opinion that some or all of these taxes may be constitutionally suspect. (See Section II below - constitutionality.)

The gray-shaded area in Table 1 also maps out the categories of taxes currently prohibited by the Internet tax moratorium. The case against these taxes on economic and prudential grounds is straight forward: They are not needed to raise revenue, and they would impose an unacceptable economic burden on the Internet without a compelling non-revenue justification (e.g., tax neutrality) to recommend their adoption.

Table 1

The Internet Taxation Debate				
TAX LEVIED ON	FEDERAL GOVERNMENT TAXES		STATE GOVERNMENT TAXES	
	Constitutional	Unconstitutional	Constitutional	Unconstitutional
Internet <i>Per Se</i>	<ul style="list-style-type: none"> ● Web Site Excise Tax¹ ● Byte Tax¹ ● Bandwidth Tax¹ ● Internet License Fees¹ 		<ul style="list-style-type: none"> ● Web Site Excise Tax^{1,2} ● Byte Tax^{1,2} ● Bandwidth Tax^{1,2} 	<ul style="list-style-type: none"> ● Tax Levied By: i. Unauthorized Interstate Compact; or ii. State Confederacy
Activities Unique to Internet	<ul style="list-style-type: none"> ● Internet Access Fees¹ ● E-mail Excise Tax¹ ● E-commerce Transactions Tax¹ 		<ul style="list-style-type: none"> ● Internet Access Fees^{1,2} ● E-mail Excise Tax^{1,2} ● E-commerce Transactions Tax^{1,2} 	<ul style="list-style-type: none"> ● Tax Levied By: i. Unauthorized Interstate Compact; or ii. State Confederacy
Retail Sales & Use	<ul style="list-style-type: none"> ● Sales, Use and Excise Taxes Collected Directly From Consumer ● Mandated Collection of Sales and Use Taxes by Internet Companies 		<ul style="list-style-type: none"> ● Sales, Use and Excise Taxes on Internet Sales Collected Directly From Consumer ● Mandated Collection of Sales and Use Taxes by Internet Companies w. Nexus 	<ul style="list-style-type: none"> ● Mandated Collection of Sales and Use Taxes by Internet Companies w/o Nexus ● Levied, Collected or Administered by i. Unauthorized Interstate Compact or ii. State Confederacy
Income, Payroll, Real Property & Universal Business Activities	<ul style="list-style-type: none"> ● Corporate Income and Payroll Taxes Levied On Internet Companies ● Income and Payroll Taxes On Wages & Salaries Earned from Internet Companies ● Property Taxes Levied on Internet Companies ● Business and License Fees ● Unemployment and Workers Compensation ● Taxes Collected From Internet Companies 		<ul style="list-style-type: none"> ● Corporate Income and Payroll Taxes Levied On Internet Companies w. Nexus ● Income and Payroll Taxes On Wages & Salaries Earned from Internet Companies w. Nexus ● Property Taxes Levied on Internet Companies w. Nexus ● Business and License Fees Levied On Internet Companies w. Nexus ● Unemployment and Workers Compensation ● Taxes Collected From Internet Companies w. Nexus 	<ul style="list-style-type: none"> ● Corporate Income and Payroll Taxes Levied On Internet Companies w/o Nexus ● Income and Payroll Taxes On Wages & Salaries Earned from Internet Companies w/o Nexus ● Property Taxes Levied on Internet Companies w/o Nexus ● Business and License Fees Levied On Internet Companies w/o Nexus ● Unemployment and Workers Compensation ● Taxes Collected From Internet Companies w/o Nexus

- Constitutional and economically defensible
- May be constitutional but raise serious issues of both law and economic prudence.
- Unconstitutional

1 Tax currently prohibited by the Internet Tax Moratorium.

2 Tax may be constitutionally suspect.

Subj: Internet Sales Taxes: Perspectives of IPI: Center for Technology Freedom
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To: Internet Caucus Advisory Committee

Sales Taxes

The primary focus of attention for Internet tax proponents is an e-commerce sales tax that would require vendors to collect a sales tax when someone purchases something online. Whether some items such as food or prescription drugs would be excluded, as many states currently exclude them under the states' sales taxes, is still up for debate. In addition, it isn't clear whether services such as legal, medical or financial services sold over the Internet would or should be taxed.

Sales tax proponents are currently considering two basic approaches. One approach—a version of which has been proposed by Sen. Ernest Hollings (D-S.C.)—would impose a uniform Internet sales tax nationwide so that all vendors operating within the U.S. would have to collect the tax on all qualified sales.

There are several advantages to this type of approach. Currently, there are some 7,548 taxing jurisdictions within the United States. Knowing which tax level to apply to whom and on which purchases—since states can vary on what items they tax—could be difficult. In addition, there is a growing interest among states, especially in light of so many states having budget surpluses, in exempting for limited periods of time certain items that would normally be taxed—that is, vendors do not collect sales taxes either on certain days or on certain items. For example, the state of Texas recently implemented legislation that bans sales taxes on certain back-to-school items on designated days in August.

A uniform federal sales tax would solve the problem of multiple jurisdictions and the limitations placed on states by the Commerce Clause. Congress would have to set the level of the tax and determine what would and would not be taxed. The sales tax money collected by the businesses could either be sent to Washington, which would redistribute it based on some formula, or could be sent directly to the state or other taxing authority in which the vendor resided.

The downside of this approach is that it would create a huge new opening for the federal government to oversee and regulate taxes at the state level, imposing a real threat to federalism. The states should think very carefully about giving up that much power and control.

The other and more popular approach would require online vendors to collect sales taxes based on the residence of the purchaser, not the vendor.

This approach has the advantage of simply using the existing tax structures within the states and local communities. Congress would not be creating a new tax. However, it would require some type of waiver in the Commerce Clause which currently prohibits requiring such collections, or it would require some type of mutual agreement among the states, similar to the one the NGA is proposing, that did not run afoul of Article I, Section 10 of the Constitution which says "No state shall, without the consent of Congress, enter into any agreement or compact with another State"

One problem is that it would create an administrative nightmare knowing how much to tax whom. Proponents of the tax argue that the software that would calculate the correct tax based upon a purchaser's residence is already available and can be purchased for as little as \$1,000. However, even if software can immediately determine which tax is appropriate for each sale, actually getting the money to the taxing jurisdictions would be difficult. Can you imagine, say, 20 million vendors trying to transfer money to 7,500 different taxing jurisdictions?

Perhaps more importantly is the privacy concern—the sales tax would require some method of collecting the information about the purchaser and what he purchased. If a purchaser buys something in a retail store, there is little need for the vendor to get personal information such as where the customer lives, unless the customer is having the product shipped to his home. And even that is largely non-problematic, since outside entities don't have access to that information. As a result, there is little possibility of someone examining people's purchasing habits—especially by the government—or for that information to be used against the purchaser at some time in the future. Although credit cards leave a trail, that information can be difficult to access without going through the proper channels.

Not so with online purchases subject to a sales tax. Not only will vendors need an address in order to know where to ship the item, they need an address to know which of the 7,500 taxing jurisdictions the customer lives in so they know how much tax to charge. Were vendors able to send the appropriate government bodies a check for the tax as discussed above, that might create an administrative headache, but not a real privacy problem. But high-sales companies could end up writing tax reimbursement checks to all 7,500 jurisdictions. As a result, proponents of this approach are looking for a third party that would receive the tax money from vendors who would in turn distribute it to the taxing jurisdictions. Databases created by such third parties are a real source of privacy concerns—someone, including the government, will know who you are and what you buy.

Of course, if all states decided to tax Internet sales at the same rate, many of the accounting problems would be solved.

One seldom-discussed solution to the problem of the multiple-taxing authorities would be to require online vendors to impose the sales tax appropriate for its place of business, rather than the residence of the purchaser. That is, an online vendor located or incorporated in Texas would charge Texas' sales tax on all sales, regardless of the location of the buyer. And each vendor would turn those taxes over to its respective state. This is, in effect, the way the sales tax works when someone from one state purchases something while in another state. In this case the nexus applies to the seller rather than the buyer, just as when a customer travels to another state and purchases something from a retail outlet (as discussed by Dean Andal below). If Smith purchases something while in another state, the vendor charges Smith the state's sales tax. The vendor doesn't ask or care whether Smith is from another state or not.

This method of taxing Internet sales might also require statutory changes to deal with the Commerce Clause, but at least it simplifies the method of taxation and eliminates the concern that the government would be gathering information on customers and their purchases.

Subj: Internet Use Taxes: Perspectives of IPI: Center for Technology Freedom
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To: Internet Caucus Advisory Committee

Use Taxes

A use tax applies to the location where a purchaser "uses" something he purchased, and is generally considered the flip side of the retail sales tax. If a resident of one state purchases something in another state, that doesn't necessarily mean he can avoid paying a tax on the item purchased. The state of residence can impose a use tax on the item.

Case Study #1:

Texas State Land Commissioner David Dewhurst was recently hit unexpectedly with a tax bill from the Texas comptroller's office. According to a news account, Dewhurst could have to pay up to \$82,500 in taxes for purchasing between \$750,000 and \$1.3 million in furniture, art and other items out of state.

The comptroller's office learned about Dewhurst and 300 other Texans from the U.S. Customs Office. They now have to pay an 8.25 percent excise tax on the value of the purchases. Dewhurst was caught unaware, according to the story, but that is not surprising since almost no one knows about the law. And had the comptroller's office not received notification from the Customs Office, the tax never would have been levied.

Case Study #2:

The state of California recently sent 3,200 residents a tax bill for cigarettes purchased out of state. According to the Orange County Register, thousands of Californians are buying cigarettes online because they can get them cheaper and pay no state tax. However, the out-of-state seller is required by federal law to report the name and address of the buyer to the buyer's state of residence.

Use taxes can be very difficult to implement and monitor. As Dean Andal, vice president of the California State Board of Equalization and a member of the Advisory Commission on Electric Commerce, says:

Unlike the bricks and mortar business that state and local governments so often argue are being discriminated against, the out-of-state retailer is asked to do that which the in-state retailer is not: determine the place of use for each of its customers. For example, the brick and mortar retailer doesn't ask if I'm taking my purchase and going back to my home which is in a different taxing jurisdiction. They don't care. The sales tax treats the place of purchase as the place of consumption. However, if the same transaction occurred online, via the company's web page, different standards would apply. If the store is in my home state, most likely the sales tax would once again apply but the seller would first have to determine the destination of the sale. If the seller was in a different state, the use tax applies and the seller would have to identify the destination of the sale and collect and remit based on the rules and rates for that local jurisdiction assuming the company has nexus (reliance on zip codes is not legally sufficient as many zip codes cross taxing jurisdictions). In the purely digital world, where both the consumption of the agreement and the exchange of the product or service occurs online, location is not just irrelevant; it can be impossible to determine. The use tax is not a surrogate consumption tax as some would suggest. It was a device conceived to protect in-state merchants.

Subj: Internet Access Taxes: Perspectives of IPI: Center for Technology Freedom
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Access Taxes

The Internet Tax Freedom Act prohibits states from imposing new taxes on the Internet, but taxes that were already in effect were permitted to remain. One type of tax that several states had turned to was the "access tax," which taxes access to the Internet by imposing a tax on the fees charged by Internet service providers such as America Online.

For example, according to the National Conference of State Legislatures, by March 1998, 10 states, Washington D.C. and several local governments were taxing Internet access. However, several of those states have since eliminated or suspended the access tax.

Utah Gov. Michael Leavitt has devised a variation of the access tax. As the demand for high-speed Internet access explodes, cable companies are expanding to meet that demand. In 1999, the state's Rights of Way Task Force recommended a one-time, \$500-per-mile charge when cable firms lay cable along the right-of-way strips next to interstate highways. That tax would eventually be passed on to cable users, thus indirectly taxing high-speed Internet access.

While access taxes are fair, in that they tax everyone at the same rate, they have fallen out of favor with many people because they, in effect, impose a tax on information, and the vast majority of people who use the Internet do so for information.

As a result, there seems to be a growing consensus that access taxes, while fair, are not a good policy option for raising revenue.

Subj: Perspectives of Joseph J. Cordes, Senior Fellow at the Progress & Freedom Foundation
From: Joseph J. Cordes,* Professor of Economics, Director of the Ph.D. Program in Public Policy at The George Washington University, and Senior Fellow at the Progress & Freedom Foundation
To: Internet Caucus Advisory Committee

* The views expressed here are his own and do not necessarily reflect those of The Progress & Freedom Foundation, its officers or Board of Directors.

I. INTRODUCTION

Telecommunications has become one of the most dynamic sectors of the economy and will continue to be so for the foreseeable future. Much of this dynamism has been fueled by a combination of technological innovation and competition, spurred by the transition of telecommunications from a regulated monopoly to a more competitive industry.

The taxation of telecommunications services has failed to keep pace with both the technological and the regulatory changes that are rapidly blurring the lines between different telecommunications providers. Traditional telecommunications services not only face the full range of federal, state and local taxes imposed on other businesses, but are also subject to a broad array of taxes and tax-like fees that are levied only on them. Some of these are relics of the telecommunications industry's regulated past, while others are rooted in the budgetary politics of the 1980s and early 1990s. These taxes are not only outdated; they can also be bewildering and, as noted in a recent article in The Washington Post, many phone bills would be a "lot cheaper if there weren't a stack of fees bundled into even the most straightforward local and long-distance charges."

Experts who have examined the issue generally agree that there are sound reasons for replacing much of the current system for taxing telecommunications with a simpler, fairer and more rational approach. This sentiment was most recently evident in widely reported debates of the Advisory Commission on Electronic Commerce. Despite disagreement among several commission members about the merits of taxing Internet commerce, there was general agreement on the desirability of reforming state and local telecommunications taxes and repealing the federal excise tax. And proposals to repeal the tax have been introduced in the U.S. Congress.

Proposals to repeal the federal telephone excise tax predate the deliberations of the Advisory Commission on Electronic Commerce. In the 1980s, the Treasury Department issued a report recommending that the tax, which had its origins as a temporary luxury tax to help finance the Spanish American War, should be allowed to expire as scheduled at the end of 1987.

On balance, there are no strong arguments in favor of the communications excise tax. In addition, there are reasonably strong efficiency and moderate equity arguments against the tax. Further, although reasonably simple in itself, the tax contributes to the complexity of the tax system as a whole. ***For these reasons the tax should be allowed to expire at the end of 1987 as scheduled under current law*** (emphasis added)

Nonetheless, the federal communications excise tax was extended in 1987, mainly because large and persistent budget deficits made it difficult, if not impossible, at the time, to enact tax cuts. Today, however, with sizable actual and projected federal budget surpluses, the fiscal equation has changed, and the time has come to give serious consideration to implementing the original Treasury Department recommendation.

[Editor's note: The remainder of Mr. Cordes' Commentary can be read at http://www.pff.org/POP_7.3.htm. Our apologies to the author for lack of space.]

Subj: Perspectives of Progress & Freedom Foundation
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Introduction and Summary

Driven by technological progress, the telecommunications industry is nearing the end of a 30-year transition from natural monopoly to competitive market. Public policy has recognized this change through substantial deregulation and creation of a legal framework designed to facilitate competition. Tax policy, however, has not kept pace with the changing nature of the telecommunications business. As a result, the telecommunications industry is subjected to a vast array of taxes that have no apparent justification in the modern era and can be explained solely as holdovers from all but forgotten era. Simply put, there are too many taxes on telecommunications services, and they are far too high.

Taxes on telecommunications are, inevitably, taxes on the Internet. Whether through dial-up access or Digital Subscriber Lines (DSL), over cable modems or wireless ones, access to the Internet takes place over the telecommunications network. Thus, high telecommunications taxes slow the spread of Internet access and discourage deployment of the broadband networks needed for the next generation of Internet growth. They raise the costs of electronic commerce for every business, big or small, and raise the price of Internet access for every household, rich or poor. Their impact is probably greatest, however, on poor households, small businesses and rural communities.

The convergence of previously separate telecommunications technologies -- cable, telephone, satellite, wireless -- into a single marketplace adds further urgency to the need for telecommunications tax reform. Each of these different industry sectors is subject to its own tax regime, meaning that the same service can be subject to very different tax treatment depending on the type of firm that offers it, and efforts to eliminate such inconsistencies are hampered by the extreme complexity of the system.

This paper represents a first step in an effort to reassess and to recommend reforms in telecommunications taxes. It describes the current regime and presents very preliminary findings about the impact of current policies in terms of both economic efficiency and fairness. The paper concludes with a brief discussion of potential policy implications.*

[Editor's note: The remainder of Mr. Eisenach's Commentary can be read at <http://www.pff.org/telecomtax.htm>. Our apologies to the author for lack of space.]

* This paper was prepared for presentation to the Advisory Commission on Electronic Commerce, September 14, 1999. It presents preliminary results from an ongoing study of telecommunications taxation underway at The Progress & Freedom Foundation. All results are tentative and subject to further modification. The final study is due out in mid-2000.