Thinking Straight About the Taxation of Electronic Commerce: Tax Principles, Compliance Problems, and Taxable Nexus

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I. Introduction

The Internet Tax Freedom Act (ITFA), which imposed a three-year moratorium on taxes levied by state and local governments on Internet access and prohibited "multiple and discriminatory" state and local taxes on electronic commerce, expires on October 21, 2001.[1] Its extension is the focus of considerable political activity. Some proposals for extension would significantly restrict the taxing power of state and local governments, but others would potentially expand that power.[2] This paper is intended to assist clear thinking about the taxation of electronic commerce.[3]

The current debate over the taxation of electronic commerce in the United States reflects basic defects in the way state and local governments tax sales and corporate income more than the inherent difficulty of taxing most electronic commerce. For the most part, the advent of electronic commerce has highlighted problems that were there all along; it did not create them. Most of these problems — but not all — stem from the lack of uniformity of the taxes imposed by the 50 states (and the District of Columbia) and their numerous political subdivisions. Pointing to that lack of uniformity, the U.S. Supreme Court has said that a state cannot require a remote (out-of-state) vendor to collect its sales tax unless the vendor has a physical presence in the state.[4] Since the states have not solved these problems cooperatively by increasing uniformity, despite having had ample opportunity and incentive to do so, some believe that it would be appropriate for the Congress to mandate a solution. Others warn that this is a step that should not be taken lightly, lest the fiscal sovereignty of the states be unduly compromised. They fear that Congress might legislate solutions to state problems where none is needed or impose inappropriate solutions. Given recent state efforts to find a solution, they counsel a "wait and see" attitude, to allow the states time to simplify their systems.

Section II describes how a state sales tax that is economically neutral and relatively easy to comply with (hereafter the "economically neutral and compliance-friendly system") would be structured and indicates how extant sales taxes deviate from that system and the effects of those deviations. E-commerce, per se, plays a relatively minor role in the discussion, which is equally applicable to sales by other types of remote (out-of-state) vendors. It is perhaps best seen, alternatively, as a catalyst for long-overdue action by state and local governments or as a stalking horse for those who would undermine the taxing power of the states.

Section III summarizes arguments that have been made for and against exempting e-commerce from taxation and suggests that little revenue would be affected by the choice of whether to tax e-commerce. Section IV describes key elements of proposals to accompany extension of the Internet Tax Freedom Act. Section V describes three prior attempts to find a solution to the question of whether and how to tax e-commerce. Section VI compares current reform proposals to those required to achieve the economically neutral and compliance-friendly system. The Appendix discusses application of business activity taxes, which include corporate income taxes and franchise taxes measured by income, to remote commerce. It discusses design issues and describes defects

of the current system. It is substantially less detailed than the discussion of sales and use tax, in part because the latter is where most of the current debate has focused.

II. An Economically Neutral and Compliance-friendly Sales Tax[5]

It is generally agreed that taxes should, to the extent possible, and consistent with other goals, be economically neutral and compliance-friendly.[6]

A. A Neutral Sales Tax

A state sales tax that is economically neutral would tax all consumption occurring in a state equally. A tax on all consumption is economically neutral in ways specified below. Moreover, to the extent private consumption and consumption of public services are correlated, such taxes can be seen as consistent with the benefit principle of taxation, which requires that taxes be related to benefits received from public services. Finally, taxing all consumption is simpler than taxing (or exempting) only selected products; this is explained further below. A state sales tax that satisfied this basic design objective would exhibit these characteristics:

- Taxation of *all* consumption in the state;
- Taxation of *no* sales to business;
- Equal taxation of sales by local and remote (out-of-state) vendors.

Economists emphasize the neutrality of such a system:

- It would not discriminate between types of consumption;
- It would not distort choices of production and distribution;
- It would treat local and remote vendors the same;
- It would not distort the location of economic activity.

The increased efficiency of markets that is generated by e-commerce makes achievement of the conditions for economic neutrality even more important than previously.

B. Administrative Tractability

If the requirement that remote vendors collect tax is not to be onerous, and thus an unconstitutional burden on interstate commerce, another objective must be met: there must be both substantial interstate uniformity and provisions such as de minimis nexus rules and vendor discounts (rebate of taxes intended to cover part of the costs of compliance) that eliminate or substantially reduce compliance burdens on remote vendors making only small amounts of sales into a state.

Interstate uniformity. The lack of uniformity (along with the lack of realistic de minimis rules and vendor discounts) is at the heart of problems in this area. Uniformity in the following areas would simplify compliance:

- A uniform tax base, which implies uniform definitions or treatment of:
  - Taxable and exempt products;
  - Tax-exempt sales to business;
  - Tax-exempt sales to non-profit organizations and governments;
  - Uniform tax-exemption certificates; and
  - Conformity of state and local tax bases.
- Uniform statutes, regulations, and interpretations.

- Simplified administrative procedures ("one-stop" registration, filing, etc. for all states).

States would retain complete control over tax rates, which is the key to fiscal sovereignty and not a source of complexity, at least for state taxes.

Under this system a vendor in San Jose, California (or in Tallahassee, Austin, or anywhere else), being familiar with the tax law of its own state, could easily calculate the tax due on sales to customers in any other state, simply by knowing three things:

- Is it a taxable sale to a consumer or an exempt sale to business (or to a non-profit organization or government)?
- Where is the purchaser located?
- What is the applicable tax rate?

The vendor would not need to contend with interstate differences in such matters as the definitions of taxable and exempt sales, exemption certificates for sales to business, non-profits, and governments, or tax laws; by assumption these would be the same in all states.

The simplicity of taxing all consumption and only that. Little has been said in the current debate about the need to tax all consumption and exempt all sales to business. (What has been said usually focuses on the political difficulty of taxing services and the reduction in the tax base — and the need to increase rates — that would result from exempting sales to business.) Why, then, emphasize these two reforms? Is it only a question of economic neutrality?

Consider the statement above — that "a vendor..., *being familiar with the tax law of its own state*, could easily calculate the tax due on sales to customers in any other state...." The italicized words would be adequate to guarantee simplicity of compliance with the laws of other states only if the tax bases (and the tax laws) of all states are identical. There are, of course, an infinite number of ways to define the identical tax base. But none is as simple as the rule under the economically neutral and compliance-friendly system, which can be summarized in two rules:

- If a product is sold to a household, tax it; and
- If it is sold to a business, a government, or a tax-exempt organization, exempt it.

Certainly this approach is far simpler than basing the tax base of each state on a uniform definition of the potential base (products and types of sales that could be either taxed or exempt) or even on a uniform base that differed from that under the economically neutral and compliance-friendly system.

Nexus and vendor discounts. Remote vendors that make only limited amounts of taxable sales into a state could face a significant burden if required to collect the state's use tax. This could easily be avoided by exempting vendors from the duty to collect tax in states where they do not have a substantial physical presence *and* their taxable sales fall below a de minimis level.[7] (Stated differently, states could assert nexus only if a remote vendor had either a substantial physical presence or non-de minimis taxable sales in the state.) This dual nexus rule for remote vendors could be supplemented by realistic vendor discounts that compensate for the costs of tax collection, which are disproportionately high for those making small amounts of sales.

In applying the physical presence prong of the dual nexus rule the physical presence of a dependent agent in a state could be considered evidence of physical presence of the principal, as now. But, contrary to some state court decisions, so could the presence of corporate affiliates offering essentially the same products as the out-of-state entity. (The presence of affiliates providing

services such as delivery, acceptance of returns, and repairs would presumably be evidence of an agency relationship and thus a physical presence.[8])

Sales of agents and affiliates would presumably be combined for purposes of the sales prong of the dual nexus rule. Thus a corporation or corporate group could not avoid nexus by employing agents or affiliates to make sales.

The physical presence prong of the dual nexus rule just described contains a word not found in the nexus test the Supreme Court has provided — the word "substantial. This higher threshold for the physical presence test would not have the same implications as it would if substituted for the present nexus rule, as it would be supplemented by the sales test. Remote vendors that made a non-de minimis amount of sales in the state would be found to have nexus, even if they had only an insubstantial physical presence in a state.

C. Inevitable Administrative Problems

Several administrative problems exist, even under the economically neutral and compliance-friendly system.

Digitized content. The discussion to this point has focused implicitly on commerce in tangible products. Aside from the difficulty of channeling revenues to local jurisdictions, to be discussed below, there is relatively little difficulty in "sourcing" sales of tangible products (assigning them to jurisdictions of destination), since the vendor generally knows where the products are shipped or delivered.[9]

The situation can be quite different in the case of digitized content, which is directed to an e-mail address. In this case the vendor may not know — and may have no reliable way to learn — where the buyer is located. In some cases the billing address may be used as a proxy for the "ship to" address, but it is subject to manipulation.[10]

It is worth noting that this is the first time this discussion has touched upon an issue that is unique to electronic commerce — that is, one that is not also present in traditional mail-order business.

Local taxes. The discussion to this point has also focused on *state* sales taxes. In fact, local governments also levy sales taxes. This creates the need to determine the local tax rate(s) that should be applied to sales by remote vendors and the locality (or localities) that should receive the revenue from tax on such sales.[11] Provided an exact match of addresses and taxing jurisdictions is not required, it should be possible to overcome this problem in one of several ways, for example, by relying on nine-digit ZIP codes. Alternatively, at the cost of even less precision, remote vendors might be allowed to employ a "blended rate" that reflects the average of all local rates in a given state, relying on the state to divide revenues among local jurisdictions. (This approach would not survive judicial scrutiny under current law, because it would impose an unconstitutional burden on interstate shipments to local jurisdictions with tax rates below the blended rate. The Congress, acting pursuant to the Commerce Clause, could relax this constraint.) Of course, in either event it would be essential that the tax base and the legal and administrative framework for local taxes be identical to those for state taxes.

D. How the Existing System Deviates from the Economically Neutral System

The existing state sales taxes violate all four of the principles of economic neutrality stated above:

- The taxes do not apply to all consumption; most services are exempt, as are a variety of tangible products (with the exemptions varying from state to state).[12]
- The taxes apply to a wide range of sales to business; it has been estimated that, depending on the state, as much as 20-70 percent of taxable sales are not made to consumers.[13]
- There is essentially no uniformity in any aspect of state sales taxes.[14] Moreover, some 2,300 local jurisdictions levy sales taxes, not all of which conform to the provisions of the state tax of the state where they are located. States provide few de minimis rules and vendor discounts generally do not offset compliance costs, especially for small vendors.
- A state cannot compel a vendor to collect its use tax unless the vendor has a physical presence in the taxing state. This results in discrimination in favor of remote vendors and reduces tax revenues of state and local governments.

The existing system creates economic distortions in all the dimensions identified above:

- It favors the consumption of untaxed products; since many of these are services, the exemptions favor the more affluent, who consume disproportionately large amounts of services;
- Because many business inputs are taxed, it distorts choices of production and distribution techniques;
- It discriminates against local vendors;
- It distorts the location of economic activity (favoring remote vendors and producers who are not subject to tax on their inputs). This distortion is aggravated by "entity isolation," the use of legally separate entities to avoid having nexus in a state.[15]

Moreover, for a given tax rate, the de facto inability to tax remote sales to consumers implies that, for a given tax rate, revenues will be lower than if the tax applied to all purchases from remote sellers. Unfair competition from remote vendors and loss of tax base have gained the greatest attention in the recent debate.

III. Implications of Taxing Electronic Commerce

Over the past several years many arguments have been heard for and against taxing electronic commerce. These are reviewed here, followed by a review of the revenue implications of the choice.

A. Arguments against Taxing Electronic Commerce.

Argument for not taxing e-commerce take several forms, some of which are intertwined with arguments for exempting remote sellers from a duty to collect use tax.

One line of reasoning might be characterized as an "infant industry" argument: that e-commerce should experience a period of tax exemption in order to allow it to "get on its feet." Several years ago, when it appeared that e-commerce would swallow the entire economy, the case for a tax subsidy on these grounds was not persuasive.[16] Now that e-commerce has "cratered," despite the existence of that subsidy, the wisdom of the policy is even more suspect.

According to the "digital divide" argument, electronic commerce in general, and Internet access in particular, should be tax exempt, in order to avoid burdening low-income families, for whose children Internet access may represent an important way out of poverty. The general argument for exempting e-commerce is not persuasive, as affluent families spend far more on electronic commerce than do poor ones. The more limited case for exempting all charges for Internet access is no more compelling, since the ostensible objective could be achieved by exempting only basic service. Exempting all Internet access invites Internet service providers to "bundle" content with basic service.

Advocates of exempting electronic commerce have adopted a theory advanced by the mail-order industry — that remote vendors should not be required to collect tax because they do not benefit from services provided by the states where their customers are located. This argument — and counter-arguments that accept the validity of its basic premise — confuse the issue by focusing on services provided to remote vendors, which should be essentially irrelevant. The point is that purchasers pay the sales tax and it is to them that states provide services; the remote vendor would merely collect the tax. There is no reason to believe that a consumer of a given product consumes fewer state services simply because the product is bought from a remote vendor.

Yet another argument against taxing e-commerce involves holding Main Street merchants hostage in order to gain lower taxes. The reasoning is that if e-commerce (or all remote commerce) is not taxed, representatives of Main Street will pressure state and local governments to lower taxes, so that they will not be at so great a competitive disadvantage.

The validity of one argument for not extending the present sales tax system to electronic commerce — or to any form of remote commerce — the complexity of the system, is indisputable.

B. Arguments for Taxing Electronic Commerce

Arguments for taxing electronic commerce are based on equity, economic neutrality, revenue (or lower tax rates), and simplicity of compliance and administration.[17] All are, however, predicated on the assumption that the system is simplified substantially.

There are several strands to the equity argument for taxing e-commerce. Perhaps most important, it is unfair to exempt remote sellers, including those involved in electronic commerce, from the duty to collect a tax that local merchants must collect. Also, it is unfair to exempt e-commerce purchases, which are made disproportionately by the relatively affluent, while taxing purchases from local vendors, made disproportionately by the less affluent.

The neutrality argument for taxing e-commerce is implicit in the descriptions of the economically neutral system and the distortions of the existing system, which would be expanded by exempting electronic commerce. Two aspects of the distortions created by exempting e-commerce deserve special attention. First, many products can be delivered in either a tangible or an intangible (digitized) form. Exempting the latter would tilt choices toward that form of delivery. Second, given the "footloose" nature of many aspects of electronic commerce, exempting sales made by remote vendors would aggravate locational distortions.

Given the complexity of the present system, it may come as a surprise that simplicity of compliance and administration is cited as an advantage of taxing electronic commerce. Exemption of e-commerce in the context of an otherwise radically simplified system would place a premium

on the definition of e-commerce and spur efforts to "shoe-horn" various forms of traditional commerce into the exempt category — and efforts to prevent this — thereby creating complexity.

C. How Much Revenue Is at Stake?

A few years ago state and local officials were issuing dire warnings that their tax base would vanish into cyberspace. Even before the end of the dot.com boom it came to be realized that these fears were vastly overstated.[18]

First, remote sales to business represent a large fraction of e-commerce. Some of these (e.g., sales for resale) are exempt and tax on much of the rest can be collected directly from the buyer, which risks being audited.

Second, some e-commerce transactions would not be taxable in any event, because the products are exempt (e.g., food in many states and services in most).

Third, some e-commerce sales represent a shift from traditional remote transactions that would effectively go untaxed because of the nexus rule of *Quill*.

Finally, some e-commerce sales are by vendors who have nexus and thus collect tax.

Cline and Neubig (1999) found revenue losses in 1998 from the failure to tax electronic commerce to be only on-tenth of one percent of total sales tax revenue. Goolsbee and Zittrain (1999) estimated that revenue losses in 1998 were less than one-quarter of one percent of sales tax revenues and that by 2003 losses would be less than 2 percent of total sales tax revenues. Bruce and Fox (2000) estimated losses in 2003 to be about 1.5 percent of total state and local tax revenues; they did not translate this figure into percent of sales tax revenues. Emphasizing the uncertainty of any such estimates, the General Accounting Office (2000) estimated that revenue losses for 2000 would be less than 2 percent of total sales tax revenues and that in 2003 revenue losses would fall within the range of one to five percent of total sales tax revenues.

IV. Extension of the Internet Tax Freedom Act

To understand the debate over provisions that might accompany extension of the ITFA it is necessary to know a bit about "nexus rules," the judicial and statutory standards that determine whether a state can tax income or require remote vendors to collect sales tax or pay business activity taxes.[19]

A. Nexus for Use Tax Collection

Even before enactment of the ITFA many remote e-commerce sales were already effectively exempt from taxation. In 1967 (in *National Belas Hess*, 386 U.S. 753) and again in 1992 (in *Quill*, 504 U.S. 298) the U.S. Supreme Court ruled that the sales and use taxes imposed by the states are so complicated that requiring remote vendors to collect the tax would impose an unconstitutional burden on interstate commerce. Only if the vendor has a physical presence in the state can it be required to collect tax. Although the buyer is legally liable to remit the tax on purchases from remote vendors who lack nexus, few non-business purchasers actually do so. Thus the tax on sales made to consumers by many remote vendors is, in effect, a voluntary tax that few pay.

Proposals for changes in the nexus rules affecting e-commerce fall into three groups. In the center are proposals simply to extend the ITFA or to make it permanent.[20] These would leave the physical presence nexus rule of *Quill* intact and are opposed by representatives of state and local

governments. While business representatives would like more, they would consider preservation of the status quo a "win."

Industry representatives favor a proposal that would elevate the test of nexus for duty to collect use tax on remote sales from "physical presence" to "substantial physical presence" and provide a list of in-state activities that would not be deemed to constitute nexus.[21] These changes in the nexus standard would significantly restrict the taxing power of state and local governments.

In response to the projected growth of e-commerce — and thus of effectively exempt sales — most of the states are participating in the Streamlined Sales Tax Project (SSTP), which is intended to simplify and modernize sales and use tax collection and administration; the next section describes the SSTP in greater detail. State and local governments favor a proposal that would, in effect, over-ride *Quill* for states that adopt the recommendations of the SSTP.[22] On August 17, 2001 the governors of 42 states sent letters to all members of Congress encouraging extension of the ITFA accompanied by only this provision.[23]

B. Nexus for Business Activity Taxes

The Supreme Court has not applied to BATs the same physical presence test of nexus it applies to sales taxes. But the Congress has limited state assertion of nexus by enacting P.L. 86-272, which prohibits taxation of the income of a seller whose only business activity in the state is solicitation of orders (including solicitation by agents) for sales of tangible personal property to be filled by shipment from outside the state.

P.L. 86-272 provides no protection for a corporation selling intangible property in a state. The Supreme Court of South Carolina has thus ruled (in *Geoffrey*, 437 S.E. 2d 13, *cert. den.* 114 S. Ct. 550, 1993) that the presence of intangibles in the state creates nexus. Since the U.S. Supreme Court refused to grant certiorari in the case, other states have sought to assert "Geoffrey nexus" in similar cases. There is considerable concern in the business community that this legal doctrine could be used to justify income taxes on out-of-state e-commerce firms selling intangibles. To prevent this from happening, one proposal would extend the protection of P.L. 86-272 to sellers of intangible products and apply a newly enacted "substantial physical presence" test of nexus (which would clarify that the presence of intangible assets in state would not constitute nexus) to business activity taxes.[24]

V. Prior Efforts to Find a Solution

Over the past several years several groups have been convened in an to attempt to find a solution to the problems posed by the advent of electronic commerce, especially in the sales tax area; one of these efforts continues.

A. The NTA Project

In 1997 the National Tax Association convened a large group representing business, state and local government, and "others." Virtually all of the business representatives were from the e-commerce/high-tech sectors; other "traditional" business interests were essentially unrepresented. (There seems to be a presumption that it is representatives of the industries that would be affected who should be asked about tax policy in this area. Not surprisingly, they have responded that they would rather not pay income taxes or collect use taxes.)

The NTA Project met periodically for two years. From the outset the Project focused on a possible "compromise" involving greater simplification of the sales and use tax in exchange for an expanded duty to collect tax on remote sales. The Project considered only relatively marginal reforms, such as uniform definitions of potential elements of the tax base (that is, uniform definitions of products that might be taxed or exempt in a given state), the "sourcing" of e-commerce transactions, and "technological fixes" such as processing by credit card companies; it never considered radical reforms such as the economically neutral and compliance-friendly system described earlier, which was deemed to be beyond its frame of reference. Even so, the Project served the useful purpose of identifying issues and increasing mutual understanding among the various parties represented.[25] But, because of strict rules that demanded a substantial qualified majority to make a decision, the Project was eventually unable to reach a consensus on recommendations. One sticking point that deserves notice was concern that government representatives might attempt to parlay business agreement to an expanded duty to collect use taxes into a lower nexus threshold for business activity taxes. (See also the appendix.)

B. The Advisory Commission on Electronic Commerce. The Internet Tax Freedom Act created the Advisory Commission on Electronic Commerce, which was charged with making "a thorough study of Federal, State and local, and international taxation and tariff treatment of transactions using the Internet and Internet access and other comparable intrastate, interstate, or international sales activities." While members of the Advisory Commission ostensibly represented state and local governments, traditional business, and consumers, as well as the e-commerce and high-tech sectors and the federal government, in fact the membership was packed with members who opposed taxation of e-commerce.[26] At the end of the day it was only the combination of the requirement for a two-thirds majority for the adoption of a "finding or recommendation" and the unwillingness of the federal representatives to go along with the opponents of taxation that prevented the Advisory Commission from forwarding to the Congress proposals that, if adopted by Congress, would have drastically reduced the taxing powers of the states. Even so, the Advisory Commission forwarded the following "majority policy proposals":[27]

- A five-year exemption for digitized content downloaded from the Internet and "their non-digitized counterparts." This proposal would effectively exempt music, videos, books and magazines, games, and software from taxation.
- Codification of the *Quill* decision regarding nexus for use tax purposes and provision of safe-harbors that would prevent corporate affiliation, repairs, and returns from being construed as evidence of a physical presence in the state.
- Application of the physical presence test of *Quill*, extended as described above, to nexus for business activities taxes.
- A suggestion that the National Conference of Commissioners on Uniform State Laws (NCCUSL) be asked to draft a uniform sales and use tax act that would include: (a) uniform tax base definitions; (b) uniform vendor discount; (c) uniform and simple sourcing rules; (d) one sales and use tax rate per state and uniform limitations on state rate changes; (e) uniform audit procedures; (f) uniform tax returns/forms; (g) uniform electronic filing and remittance methods; (h) uniform exemption administration rules (including a database of all exempt entities); (i) a methodology for approving software that sellers may rely on to determine state sales tax rates; (j)

a methodology for maintaining revenue neutrality in overall sales and use tax collections within each state.

C. The Simplified Sales Tax Project. Thirty-eight of the 45 sales-tax states are currently involved in the Streamlined Sales Tax Project (SSTP), thirty-two as voting participants and six as non-voting observers. The SSTP, in the words of its Executive Summary:

> is an effort created by state governments, with input from local governments and the private sector, to simplify and modernize sales and use tax collection and administration. The Project's proposals will incorporate uniform definitions within tax bases, simplified audit and administrative procedures, and emerging technologies to substantially reduce the burdens of tax collection. The Streamlined Sales Tax System is focused on improving sales and use tax administration systems for both Main Street and remote sellers for all types of commerce.[28]

On December 22, 2000 state representatives to the SSTP voted unanimously to approve the Uniform Sales and Use Tax Administration Act and the Streamlined Sales and Use Tax Agreement. The Uniform Act would authorize the taxing authority of the state "to enter into the Streamlined Sales and Use Tax Agreement with one or more states to simplify and modernize sales and use tax administration in order to substantially reduce the burden of tax compliance for all sellers and for all types of commerce." The Agreement contains the many details of simplification and uniformity. The National Conference of State Legislatures (NCSL) endorsed the Act and Agreement on January 24, 2001, but only after making modifications that significantly reduce the implied simplification. (Among the items deleted pending further review are uniform definitions of items in the tax base and limitations on tax rate caps, thresholds, and sales tax holidays — all provisions that are important for simplification.)

Although the Project will continue its work throughout 2001, state legislatures began considering the Act and Agreement in January 2001.[29] To date 18 states have approved some form of the legislation and legislation has been introduced in 8 more states.

The key features of the Streamlined Sales Tax System developed by the SSTP include:

- Uniform definitions within tax bases. Legislatures will still choose what is taxable and exempt but will use the common definitions for key items in the tax base.
- Simplified exemption administration for use- and entity-based exemptions.
- Rate simplification. States will be responsible for the administration of all state and local taxes and the distribution of the local taxes to the local governments. State and local governments will use common tax bases and accept responsibility for notice of rate and boundary changes. States will be encouraged to simplify their own state and local tax rates.
- Uniform sourcing rules. The states will have uniform sourcing rules for all property and services.
- Uniform audit procedures. Sellers who participate in one of the certified Streamlined Sales Tax System technology models will either not be audited or will have a limited scope audit, depending on the technology model used.
- Paying for the system. To reduce the financial burdens on sellers, states will assume much of the financial burden of implementing the Streamlined Sales Tax System.

The SSTP falls far short of the uniformity and simplicity of the economically neutral and compliance-friendly system described earlier, especially in two regards: in the specification of the tax base and in the legal framework and administrative procedures. Rather than proposing a uniform tax base, the SSTP proposes uniform definitions of what might be taxed or exempt, leaving to each state the choice of whether or not to tax each identified item. To handle interstate differences in the tax base the Project would rely heavily on "technology" to determine how a given state treats a given product. Similarly, it would trust "technology" to handle interstate differences in statutes, regulations, and interpretations.

The system being developed by the SSTP is a political compromise between simplicity and state sovereignty. It would be substantially simpler than what exists now. But it is far more complex than the economically neutral and compliance-friendly system outlined earlier, largely because of the desire to retain state control over many of the parameters of sales tax policy.

VI. Summary and Analysis of ITFA Options

A. Summary

The *economically efficient sales tax* system described earlier can be summarized in three rules:

- All sales to consumers would be taxed.
- All sales to business would be exempt.
- Sales by local merchants and by remote vendors would be taxed equally.

A *compliance-friendly sales tax* would exhibit substantial simplicity and uniformity. Uniformity would extend to the tax base and to statutes, regulations, and their interpretation, and administrative procedures would be drastically simplified. Remaining compliance cost would be mitigated by de minimis rules and vendor discounts.

Extant sales taxes exhibit none of these characteristics.

- Many sales to consumers are exempt.
- Many sales to business are taxed.
- Many sales by remote vendors are not taxed.
- There is essentially no uniformity.
- The system is extremely complex.
- States make little use of de minimis rules and vendor discounts are inadequate to compensate for compliance costs.

In recent years the states have begun efforts to simplify their sales taxes and make them more nearly uniform. These efforts have not gone as far as the economically efficient and compliance-friendly system. Many sales to consumers would remain exempt and many sales to business would still be taxed. Many elements of non-uniformity would remain. But the system being developed would be simpler than what now exists.

B. Analysis of ITFA Options

As noted earlier, proposals for extension of the ITFA fall into three groups. Some would simply extend the ITFA, leaving remote purchases by consumers effectively exempt. A proposal favored by state and local governments would authorize interstate cooperation to simplify sales and

use taxes and, if such cooperation is forthcoming, replace the physical presence test of nexus (for cooperating states) with one based on the volume of sales a remote vendor makes in a state. By comparison, proposals favored by industry would prohibit state assertion of nexus unless a remote vendor had a "substantial physical presence" in the taxing state and list activities that would not constitute a substantial physical presence.

Combining extension of the ITFA with authorization of an interstate compact to simplify the sales and use tax and eventual elimination of the physical presence test of nexus is most consistent with economic neutrality and simplicity.[30] The "extension only" option, besides condoning the present complexity, would leave much remote commerce untaxed, with obvious implications for equity, efficiency, and revenues. It would maintain pressure on states to simplify their systems, in hopes of gaining approval (from the Supreme Court or the Congress) of an expanded duty to collect use tax. Codification and extension of the physical presence rule of *Quill* to require a "substantial physical presence" would eliminate tax on even more sales; to the extent it achieves simplicity it does so at the cost of economic neutrality, equity, and revenue. Proposals to extend the physical presence test of nexus to BATs would further undermine state revenues, especially where states have adopted the sales only apportionment factor or do not require unitary combination. (On this, see the appendix.)

APPENDIX
Business Activity Taxes

Whereas the debate on sales and use taxes has, from the outset, involved an attempt to gain agreement on a compromise that would combine simplification and an expanded duty to collect use tax, what little debate has occurred on business activity taxes has been limited to the question of nexus. (Business representatives would like to see the physical presence nexus rule of *Quill*, perhaps expended as described earlier, applied to BATs, but fear that states will attempt to stretch nexus for use taxes to assert nexus for BATs.) But this is an extremely narrow view of the problem; nexus must be considered simultaneously with other aspects of BATs if a reasonable result is to be reached.

I. Issues in the Design of State Business Activity Taxes

Unlike the state sales tax, the state corporate income tax and related forms of BATs cannot easily be justified under any accepted principle of taxation. The benefit principle does not provide a fully satisfactory justification, as it is hard to argue that only profitable corporations benefit from public services or that benefits are proportionate to taxable profits. The "squishy" view that states are "entitled" to tax income that has its source within their boundaries fares only a little better. Perhaps the best approach is to be pragmatic, recognizing that the purpose of state corporate income taxes is to tax income that originates in the state.[31] Attempting to implement this "standard" encounters several obstacles and raises a number of issues that must be considered along with nexus rules.[32]

Formula apportionment. Corporate taxpayers do not employ geographical separate accounting, which attempts to measure the income that originates in each state, and requiring them to do so, besides being impractical, would be conceptually suspect and subject to abuse. First, because of the economic interdependence that exists between parts of a corporation operating in various states, it is conceptually impossible to isolate the income originating in each state. Second, corporations could manipulate transfer prices for transactions between parts of the corporation operating in different states to shift net taxable income to low-tax states. To overcome these problems states use formulas to "apportion" the total income of a multistate corporation among the states where it operates. For many years most of the states used a standard formula that assigned equal weights to three apportionment "factors," payroll, property, and sales (at destination). More recently there has been a decided shift toward using only sales to apportion income, so that now "sales only" is the most common formula. It appears that this shift has occurred as part of an attempt to attract economic activity, not because it is thought to produce a better measure of income originating in the state.

Unitary combination. If each member of a corporate group is taxed as a distinct entity manipulation of transfer prices and economic interdependence make isolation of the income of the various entities problematic. To overcome these problems some states "combine" the activities of related corporations deemed to be engaged in a "unitary business" in order to determine the income of corporations doing business within the state. Under unitary combination transactions between members of the unitary group (e.g., sales) are ignored and the total domestic income of the group is apportioned among the states based on the apportionment factors of the entire group.[33] Only a

minority of states employ combination, despite its manifest advantages, and those do so do not all employ the same definition of a unitary business.

B. Defects of the Present System

The present system exhibits the following characteristics.

Inconsistent nexus rules and apportionment formulas. It is readily apparent that the nexus rule of P.L. 86-272 and the trend toward "sales only" apportionment are logically inconsistent; if merely having sales in a state does not create nexus and only sales are used to apportion income, substantial amounts of income may escape taxation. The inconsistency of the two rules can result in substantial loss of revenue, especially when a state does not combine the activities of corporate affiliates engaged in a unitary business; an out-of-state corporation could have significant sales in a state — including one where it has affiliates — without having nexus.[34] Enactment of the physical presence test of *Quill* would exacerbate this problem.

To some degree individual states suffer from a problem they have created and could correct acting alone. That is, a state could minimize the damage to its revenues by requiring unitary combination and avoiding the sales only apportionment formula. (By comparison, the inability to assert nexus for use tax is the result of the collective inability of the states to simplify the system and thus cannot be overcome by any individual state acting alone.) But this would not eliminate the loss of tax base that occurs when a corporation meets the standards of P.L. 86-272 (or that would occur under the physical presence test of nexus). This could be avoided by replacing P.L. 86-272 with a de minimis nexus rule based on the in-state presence of significant amounts of the apportionment factors (as well as the existence of a significant amount of apportionable income).[35]

The lack of uniformity. Such a reform would expose many more corporations to liability for BAT in states where they have no physical presence. This would accentuate compliance problems caused by the lack of uniformity of the such taxes unless the relaxation of nexus rules were accompanied by simplification. A simplified system might exhibit the following forms of uniformity, some of which are analogous to those of the economically neutral and compliance-friendly sales tax system:

- A uniform definition of apportionable income (presumably based on the federal definition of taxable income);
- Application of unitary combination, based on a uniform definition of a unitary business;
- A uniform apportionment formula, based on uniform definitions of apportionment factors;
- Uniform statutes, regulations, and interpretations; and
- Simplified administrative procedures ("one-stop" registration, filing, etc.).

As under the economically neutral and compliance-friendly sales tax system, states would retain complete control over tax rates.

There is currently a lack of uniformity especially in the application of unitary combination and the choice of apportionment formulas. This creates both complexity and the possibilities of over- and under-taxation. Because of reliance on federal concepts, there is somewhat more uniformity of legal and administrative standards than in the sales tax field.

ENDNOTES

*The author wishes to thank James Poterba and Walter Hellerstein for comments on an earlier draft.

1.The ITFA (which also created the Advisory Commission on Electronic Commerce, to be considered in Section V) was enacted on October 21, 1998, as part of the Omnibus Appropriations bill. The Act's pre-emptive effect is more symbolic than real, except in the case of taxes on Internet access, since a) the Act has virtually no effect on sales taxes that do not discriminate against e-commerce and b) decisions of the U.S. Supreme Court (to be considered in Section IV) already effectively prohibit taxation of many e-commerce sales. The symbolism has at least three facets: the emergence of e-commerce as a politically favored sector, the victory of anti-tax forces, and acceptance of federal intrusion into the fiscal decisions of state and local governments.

2.As this is being written in early October, shortly after the terrorists' attack on the World Trade Center, it is unclear whether the Congress will seriously consider the options described here before the expiration of the ITFA; the Act may simply be extended, without provisions that either restrict or expand the taxing powers of the states. Whether the options are considered now or later, the background analysis presented here will be relevant

3.Electronic commerce is "the use of computer networks to facilitate transactions involving the production, distribution, and sale and delivery of goods and services in the marketplace." This definition, from Abrams and Doernberg (1997), is more useful than that in U.S. Treasury Department (1996, ¶3.2.1) the crucial part of which is, "... the exchange of goods or services ... using electronic tools and techniques." The Treasury definition does not clearly differentiate what is commonly known as electronic commerce from such activities as telemarketing and television shopping, which are excluded by the Abrams-Doernberg definition. The paper, does, however, exclude financial services from its purview.

4.Strictly speaking, remote vendors that have nexus in a state are required to collect the *use tax*, which is legally imposed on the in-state purchaser's use of the purchased item, rather than the *sales tax*, which is imposed on in-state sales.

5.I have described this system and its rationale in greater detail in various publications, including McLure (1997), (1998a), (1998b), and (2000a).

6.Some may object that the rules of optimal taxation, rather than economic neutrality, should guide tax policy. Those rules, which call for differential taxation of products, depending on the elasticities of demand and supply for the products, generally ignore the administrative difficulty of implementation, as well as the fact that a vast amount of information is required to put them into practice. See Slemrod (1990). On the other hand not taxing business inputs is generally consistent with the conclusions of Diamond and Mirrlees (1971).

7.States where such vendors are located could be allowed to tax such sales.

8.The California Board of Equalization recently decided that Borders.com could be required to collect use tax, although it has no physical presence in the state, because its parent (Borders) acts as its agent in accepting returns in exchange for cash refunds.

9.Gifts of tangible products constitute an exception to this generalization. But the basic question — whether to assign gifts to the jurisdiction of the donor or that of the recipient — is, in the first instance, more a philosophical issue than an administrative one. Assignment to the jurisdiction of the donor is probably simpler.

10.For a more detailed discussion, see Eads *et al*. (1997).

11.Varian (1999) has suggested that, because of the difficulties of implementing local sales taxes, local governments should abandon the sales tax in favor of the local income tax. McLure (2000b) argues that while Varian might be correct if the nation were starting de novo to create a system of tax assignment, the costs of transition to such a system seem too great to make it a viable alternative.

12.See Due and Mikesell (1994).

13.See Ring (1999).

14.For a more complete description of interstate differences in tax bases, see Due and Mikesell (1994). Cline and Neubig (2000) describe horror stories involving interstate differences.

15.On entity isolation, see McIntyre (1997).

16.Advocates of exempting e-commerce have badly misrepresented the implications of the work of Austan Goolsbee. Goolsbee's conclusion that taxing e-commerce would cause a reduction in the amount of e-commerce is not reason enough to exempt e-commerce; a similar conclusion could be reached for a tax on almost any product or form of commerce. What is required is evidence that there is some form of external benefit (e.g., network externalities) that should be subsidized by exemption. Given current levels of usage of the Internet (or even the levels of a few years ago), it is hard to believe that significant network externalities remain unrealized. Thus, Goolsbee and Zittrain (1999, p. 424), state, "The major network externalities are likely to exhaust or at least diminish once the Internet achieves major scale. Too often, infant industry protection turns into established industry protection. Further, we expect that eventually there will be an important negative network externality ... increasing Internet congestion.... The congestion problem is likely to get worse as the Internet grows and it argues against subsidizing the growth rate through tax policies." similarly, testifying on behalf of the Congressional Budget Office, Thomas Woodward (2001) has said, "Network externalities arising from additional users, however, occur primarily in the early stages of a network's growth. At this point in the Internet's development, there appear to be few external network benefits to be garnered from additional users. ... Effectively exempting remote purchases from sales taxes is an indirect and unevenly

focused means of promoting the Internet's growth that is unlikely to bring significant benefits in terms of additional users or uses." See also Zodrow (2000).

17.Woodward (2001) makes most of these points. The objective of taxing electronic commerce like traditional commerce has been endorsed by the U.S. Treasury Department (1996), the Organisation for Economic Co-operation and Development (2001), and Senator Wyden, one of the original sponsors of the Internet Tax Freedom Act, who has included these words in S. 288:

> As a matter of economic policy and basic fairness, similar sales transactions should be treated equally, without regard to the manner in which sales are transacted, whether in person, through the mails, over the telephone, on the Internet, or by other means.

More than 100 academic tax specialists endorsed the "Appeal for Fair and Equal Taxation of Electronic Commerce," which the author submitted to the Advisory Commission on Electronic Commerce at its meeting in San Francisco. The Appeal, which is reproduced in McLure (2000a) and (2000d), contained the following language:

> Electronic commerce should not permanently be treated differently from other commerce. There is no principled reason for a permanent exemption for electronic commerce. Electronic commerce should be taxed neither more nor less heavily than other commerce.

18.See Cline and Neubig (1999), Goolsbee and Zittrain (1999), Bruce and Fox (2000), and U.S. General Accounting Office (2000).

19.For a much more detailed discussion, see Hellerstein (1997).

20.S. 246, introduced by Senator Smith, would extend the moratorium provided by ITFA for five years, without otherwise modifying it. H.R. 1552, introduced by Congressman Cox, would also extend the moratorium on multiple and discriminatory taxes on electronic commerce for five years, but would make the ban on taxes on Internet access permanent and eliminate the grandfather provision for pre-existing taxes on Internet access. H.R. 1675, also introduced by Congressman Cox, is identical to H.R. 1552, except that it would permanently ban multiple and discriminatory taxes on electronic commerce.

21.S. 664, introduced by Senator Gregg, would do this.

22.S. 288, introduced by Senator Wyden, and S. 512, introduced by Senator Dorgan (and H. R. 1510, introduced by Congressman Istook, which is identical), follow this approach.

23.The governors of California, Colorado, Delaware, Georgia, Massachusetts, New Hampshire, New York, and Virginia did not sign the letter, which is available at http://www.nga.org/nga/legislativeUpdate/1,1169,C_LETTER^D_2466,00.html. The text follows:

> August 8, 2001
>
> TO ALL MEMBERS OF THE UNITED STATES CONGRESS:

> If you care about a level playing field for main street retail businesses and local control of states, local governments, and schools, extend the moratorium on taxing Internet access ONLY with authorization for the states to streamline and simplify the existing sales tax system. To do otherwise perpetuates a fundamental inequity and ignores a growing problem.

24.S. 664, introduced by Senator Gregg, would do this. The presence of a corporate affiliate would not be construed to constitute a substantial physical presence unless the affiliate acts as an agent for the principal.

25.The Final Report of the NTA Project is available at http://ntanet.org/. It does not seem unreasonable to attribute part of the continued state interest in simplifying their systems to greater appreciation that the potential compliance problems cited by business are real.

26.On this, see McLure (1999).

27.The Commission's report is available at http://www.ecommercecommission.org/acec_report.pdf.

28.This description is from the Executive Summary of the SSTP, available at http://208.237.129.206/sline/execsum.pdf.

29.The Uniform Sales and Use Tax Administration Act and the Streamlined Sales and Use Tax Agreement are available at http://208.237.129.206/sline/124amdedactandagrmt.pdf. Issue Papers that explain in more detail the provisions of the proposals are available at http://208.237.129.206/sline/aug01IP.pdf. The status of state action is reported at http://208.237.129.206/sline/statestatus.pdf, and a map showing the status of legislation is available at http://www.nga.org/nga/salestax/1,1169,,00.html. McLure (forthcoming) examines the SSTP proposals.

30.The Dorgan/Istook proposal (S. 512/H.R. 1410) and the Wyden proposal (S. 288), contain minor substantive differences, in addition to seemingly unimportant differences in wording.

31.The U.S. Supreme Court has applied a looser test: tax must be "reasonably related" to the taxpayer's activities in the state.

32.As Dan Bucks, Executive Director of the Multistate Tax Commission, has said, "One cannot study business activity nexus separate from the rest of the structure of corporate tax or franchise taxes. Nexus standards interact with apportionment formulas and with reporting methods -- and by reporting methods, I'm talking generally about combined reporting versus separate-entity corporate reporting. And the overall issue is very complex, and it really involves looking not just at nexus, but looking at an entire structure of the corporate taxes." Public testimony before the NCSL, reported in Sheppard (2001).

33.During the 1980s some states' application of unitary combination on a worldwide basis created considerable international consternation and controversy. That practice has now ended and is not considered here.

34.For further discussion of inconsistencies between these provision, see Mazerov (2001)

35.This argument is developed more fully in McLure (2000c).

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