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## The Marketplace Fairness Act Would Create a State Sales Tax Cartel and Hurt Consumers

An Origin-based System Offers an Alternative Forward

By Jessica Melugin\*

The rapid growth of online retailing has been accompanied by increasing calls by state and local officials to allow them to capture more sales tax revenue and by brick-and-mortar retailers to “level the playing field.” The Marketplace Fairness Act (S. 1832) seeks to capture more tax revenue for states on Internet purchases.<sup>1</sup> Traditional retailers, states, and localities have urged Congress to act in the name of “fairness,” but for consumers, this will only mean a tax increase. There certainly are inequities in the way online sales are taxed, but in the case of S. 1832, the cure is worse than the disease. If Congress is to consider Internet sales tax policy as part of broader tax reform efforts, an origin-based approach would address the legitimate need for sales tax reform and avoid the Marketplace Fairness Act’s harmful consequences.<sup>2</sup>

**Quill—Not too Shabby.** The Internet is not a tax-free zone. At the federal level, the Internet Tax Freedom Act of 1998 banned “special and discriminatory taxes” which states might impose, especially for transactions conducted over the Internet. State and local sales tax restrictions are dictated by a 1992 Supreme Court decision, *Quill Corporation v. North Dakota*.<sup>3</sup> In its *Quill* decision, the Court held that a state may not collect sales tax from retailers that have no physical presence, or nexus, within its borders unless Congress uses its Interstate Commerce powers to grant it explicit permission to do so; S. 1832 gives this consent.

Under current law, for example, when a Virginia resident buys a book online from a retailer in Oklahoma, Virginia may not collect sales tax on the purchase unless that Sooner bookseller has a nexus—such as a warehouse, store, or sales representative—in the Commonwealth. Technically, the Virginia resident may owe a use tax on the

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purchase, but these taxes are seldom enforced or collected. When proponents of remote Internet sales taxing argue that they are not calling for “new” taxes, they are referring to these obscure use taxes. For consumers who face increased costs for their online purchases, it is little consolation that those costs are not the result of new taxes, but of existing taxes newly collected.

The current arrangement is not an arbitrary loophole of tax law, but instead a manifestation of the principle of “no taxation without representation.” It is vendors, not customers, who remit the sales tax to governments. And, much to the advantage of consumers, it is vendors, with their trade associations and eyes on the bottom line, who often put more organized pressure on politicians to keep tax rates low.

The principles articulated in *Quill* also promote tax competition between jurisdictions. If state governments were allowed to tax vendors in other states, to whom they are not accountable, that would result in substantially less downward pressure on tax rates. Consumers would wear their states’ tax burden like an albatross even when buying from companies on the other side of the country. When there is no exit for consumers, there is little incentive for politicians to keep tax rates reasonable.

The *Quill* decision also protects the free flow of interstate commerce. It spares sellers the burdensome task of remitting sales taxes to the approximately 7,400 different state and local taxing jurisdictions across the country. The Dallas-Fort Worth Airport has more than a dozen distinct jurisdictions alone.<sup>4</sup> The cost of these calculations would doubtless be passed along to customers and taxpayers.

The Marketplace Fairness Act would do away with all these benefits.

### **The Marketplace Fairness Act—the Good, the Bad, and the Really Bad.**

States and localities can already tax in-state sellers, to whom they are accountable, but S. 1832 seeks Congress’ permission to tax those outside of their jurisdiction, to whom they are not accountable.

Specifically, the proposed legislation codifies into law the Streamlined Sales and Use Tax Agreement (SSUTA).<sup>5</sup> The stated goal of the SSUTA is to “simplify and modernize sales and use tax administration,” and “substantially reduce the burden of tax compliance.”<sup>6</sup> But the agreement also calls for Congress to overturn *Quill* and allow remote taxation, so the *unarticulated* goal of the SSUTA is to form a *de facto* state tax cartel.<sup>7</sup> In practice, that means that member states agree to simplify their sales tax rates and bases, but only in exchange for the lucrative privilege of reaching beyond their borders to tax business in other states. So far, 21 states have joined the SSUTA as full members and tens of others are at various stages of compliance.

The above example of a Virginia resident buying a book online from an Oklahoma retailer would look very different under the SSUTA scheme. Virginia would be able to collect tax from the Oklahoma-based retailer despite the Oklahoma retailer having no physical presence in Virginia. Never mind that the company being taxed has absolutely

no voice in what items Virginia decides to tax or at what rates it does so. And never mind that the company receives no benefit from any services Virginia provides with its tax dollars.

Even more alarming is a scenario where both the seller's state and the vendor's state may collect tax on the same transaction. The SSUTA agreement permits states that join and simplify their tax rates to periodically change their sourcing rules. This opens the door for double taxation. The Internet Tax Freedom Act currently prohibits this, but that protection expires in November 2014.

In any case, consumers will experience remote taxation as a tax hike. It is true that use taxes are already on the books—though, again, seldom collected and remitted—but that tax law technicality will be cold comfort to consumers paying more online for their purchases. Extracting more money from taxpayers to put in state and local tax coffers is, in plain fact, the objective of this legislation. The National Conference of State Legislatures itself has pointed out in a letter to Senators, “[i]n 2012, states will collectively lose an estimated \$23.3 billion in uncollected sales taxes from out-of-state sales.”<sup>8</sup> While that's not enough money to make up for state and local budget shortfalls, it's more than enough for voters to take notice.

Aside from raising tax revenue, proponents of this legislation also argue it will usher in an era of “fairness” in sales taxes between traditional brick-and-mortar retailers and remote sellers.<sup>9</sup> However, tax fairness is only one of many desirable characteristics of sound tax policy. Efficiency, preservation of federalism, privacy, and accountability all must be valued and balanced with an even playing field.

Despite the fairness mantra, S. 1832 sacrifices the goal of fairness with an exemption for smaller online sellers.<sup>10</sup> It would excuse sellers with less than \$500,000 in gross receipts on remote sales in the preceding calendar year from having to calculate, collect, and remit sales taxes on remote transactions. Hence, the inequity between small bricks-and-mortar sellers and small online retailers will continue.

Moreover, the legislation is not particularly fair to the localities that will be forced to align their tax rates and base statewide. The Founders imagined many small policy laboratories in states, wisely acknowledging that governments closer to the people would be more responsive to those they served. Surely this idea also applies to localities within states. The language in the agreement requiring all localities to be homogenous in their sales tax policy flies in the face of this idea. It is, quite simply, an assault on local sovereignty.

Simplification is not all good news for taxpayers, either. A simplified tax base will inevitably involve an across-the-board expansion of what gets taxed. Currently, only about 40 percent of sales that could be taxed are taxed. Certain items enjoy exemptions for a variety of reasons. Foods are frequently viewed as staples. Similarly, a town might exempt the product of its local industry. In the simplification process, each area's exemptions can't be made universal without narrowing the tax base to the vanishing

point. Since that would defeat the whole point of increasing states revenue, states will have to take the opposite tack and harmonize upward. Items subject to tax anywhere will be subject to tax everywhere.

The legislation is not fair to the online retailers that will have to calculate an amount based on approximately 7,400 local and 45 state tax jurisdictions and remit accordingly, while bricks-and-mortar retailers continue to tax at the point of sale. Imagine requiring every clerk behind a counter to ask their customers to prove where they live and wait around while they calculate the applicable tax rate! That would certainly be fair, but it would also be invasive, inefficient, costly, and irritating for all parties involved.

The tax maze is too complex and varied to burden retailers with remote collection and remittance. Tax cartel proponents argue that simplification will ease this burden, but the “simplified” agreement is still 200 pages long and full of loopholes and exceptions.<sup>11</sup>

Supporters of the legislation also argue that software will make all of the tax calculations, thus sparing businesses the burden of doing so. Unfortunately, this technology will have a cost that most likely will be passed along to consumers. It also raises as many concerns as it purports to resolve. The potential for privacy problems when state and local governments gather this amount of personal information is alarming—especially if they store the information.<sup>12</sup> Handing over all that information to a third party to calculate tax obligations creates another opening for potential security breaches. Putting aside the larger question of whether government should be able to track who buys what, where, and when, the practical potential for identity theft, stolen credit card information, and general embarrassment should give legislators pause.

Businesses will not benefit from S. 1832’s brand of fairness—with the exception of a few large online retailers who have already cut rent-seeking incentive deals with states in exchange for collecting and remitting remote taxes. It is not fair to company owners taxed by remote, politically unaccountable authorities who provide them no public services. If someone is going to tax you, shouldn’t you at least be able to vote for, or against, them? For businesses that decided to locate in low sales tax jurisdictions, this amounts to changing the rules mid-play. That is not part of anyone’s idea of fairness.

The proposed legislation is also unfair in that it creates inequities of taxing authority among states, depending on their degree of compliance with the SSUTA.<sup>13</sup> Full membership allows tax collection on remote sellers and some flexibility with sourcing and exemptions, while partial compliance without full SSUTA membership empowers states to collect on remote sales, but denies them the flexibility full member states will enjoy. States that neither join nor comply with SSUTA will not be able to collect on remote sales, but their businesses (even in sales tax-free states) will be subject to other states remote taxation.

Granting states permission to tax remote sellers also undermines federalism. The Founding Fathers understood that, necessarily, one state’s autonomy must end where another’s begins. They sought to preserve the beneficial tension between states when

they are forced to compete for citizens and commerce. For this reason, they granted Congress authority to protect the free flow of interstate commerce. The proposed legislation's request for Congress' blessing of interstate tax collusion flies in the face of this principle of competitive federalism. We have seen what happens when states' rights include protectionism and discrimination against out-of-state entities; it was called the Articles of Confederation, and we all know how that ended. The SSUTA's vagueness in how auditing and court jurisdiction would work will result in further questions of state sovereignty.

**An Origin-Based Alternative.** If Congress intends to tackle Internet sales tax policy as part of broader tax reform efforts, it should consider an origin-based tax regime, where the tax rate is assessed for the vendor's principal place of business instead of the buyer's location. An origin-based approach will address the problems of the current system and avoid the drawbacks of S. 1832 and the SSUTA plan by treating all retailers the same and helping preserve federalism, tax competition, political accountability, and consumer privacy.

Here is how our same online book purchase example would look under an origin-based regime: Regardless of whether the Oklahoma retailer has a store or warehouse in Virginia, the purchase will incur Oklahoma sales tax and perhaps any local taxes on where the bookseller is located. The retailer will remit the sales tax to his tax jurisdiction only.

- ***An origin-based approach would address the “fairness” issue by treat all retailers the same.*** For walk-in stores sales tax is calculated at the point of sale, not by the residency of the customer—who may be crossing state lines or city limits for better deals or tourism. Expanding this origin-based principle to all retailers will ensure that online, catalogue, phone, and yet-to-be-invented sales platforms all will be treated the same as purchases on Main Street.
- ***An origin-based system would help preserve federalism and put downward pressure on taxes.*** It would allow customers to “vote with their wallets” and gravitate towards lower tax-rate jurisdictions when shopping online or by mail. Citizens benefit when states and localities are free to act as policy laboratories, not when they are forced into a one-size-fits-all national scheme like the one S. 1832 would create.
- ***The accounting burden would be minimal.*** Retailers of every sort would only have to calculate and remit the taxes applicable to their primary place of business. Their rate and base stays constant whether they sell an item in the store or mail it across the country. This efficiency benefits the economy at large (with the possible exception of sales tax software companies).
- ***An origin-based regime preserves consumer privacy.*** The tax calculations are based on the seller's location only, so there is no need to collect, store, or share any location information of the buyer. No databases to fill or maintain, no third

parties to calculate rates and no audits to verify accuracy are needed under an origin-based approach.

- ***An origin-based sales tax keeps political authorities accountable to those they tax, namely, businesses in their own jurisdictions.*** This is an especially important consideration for the maintenance of democratic governance. It is simply too easy to tax those who lack a political voice. Therefore, it should be avoided at all costs.

**Conclusion.** The tax-cartel approach in S. 1832 raises the question: Fairness at what cost? Sacrificing the principles of “no taxation without representation,” healthy state and local tax competition, consumer privacy, and economic efficiency is too high a price to pay in order to boost state revenues and appease the special interest group of bricks-and-mortar sellers.

Moreover, it is unnecessary, as there is an alternative approach that brings equity among retailers and preserves the benefits of the current system. If Congress is to act, it should exercise its authority over interstate commerce to produce legislation that fundamentally reforms sales taxes by shifting to an origin-based regime.

## Notes

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<sup>1</sup> Marketplace Fairness Act (S. 1832), 112<sup>th</sup> Congress, 1<sup>st</sup> Session, <http://www.gpo.gov/fdsys/pkg/BILLS-112s1832is/pdf/BILLS-112s1832is.pdf>.

<sup>2</sup> Michael Greve, Testimony Submitted the United States Senate Committee on Finance, August 1, 2001, <http://www.finance.senate.gov/imo/media/doc/080101mgttest.pdf>. See also Veronique de Rugy and Adam Thierer, “The Internet, Sales Taxes, & Tax Competition,” *Mercatus on Policy* No. 98, Mercatus Center October 2011, <http://mercatus.org/publication/internet-sales-taxes-and-tax-competition>.

<sup>3</sup> *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992) No. 91-194, United States Supreme Court, argued January 22, 1992, decided May 26, 1992, [http://scholar.google.com/scholar\\_case?case=3434104472675031870&q=quill+v.+north+dakota&hl=en&as\\_sdt=2,9&as\\_vis=1](http://scholar.google.com/scholar_case?case=3434104472675031870&q=quill+v.+north+dakota&hl=en&as_sdt=2,9&as_vis=1).

<sup>4</sup> Michael Greve, *States Already Can Tax Out-of-State Purchases, But Rarely Enforce Those Laws*, McClatchy Newspapers, June 21, 2012, <http://www.aei.org/article/economics/fiscal-policy/taxes/states-already-can-tax-out-of-state-purchases-but-rarely-enforce-those-laws/>.

<sup>5</sup> Streamlines Sales Tax Governing Board, Inc., *Streamlines Sales Tax Agreement (SSUTA)*, <http://www.streamlinesalestax.org/index.php?page=modules>.

<sup>6</sup> SSUTA, Sec. 102.

<sup>7</sup> SSUTA, Art IV.

<sup>8</sup> National Conference of State Legislatures, Letter to Sens. Richard Durbin, Michael Enzi, Lamar Alexander, and Tim Johnson, November 9, 2011, <http://www.ncsl.org/documents/statefed/LetterofSupportMarketplaceFairnessAct.pdf>.

<sup>9</sup> National Retail Federation, “NRF Lobbies for Sales Tax Fairness,” news release, May 22, 2012, <http://www.progressivegrocer.com/top-stories/headlines/industry-intelligence/id35471/nrf-lobbies-for-sales-tax-fairness/>.

<sup>10</sup> Market Place Fairness Act S. 1832, Section 3 (c), <http://www.gpo.gov/fdsys/pkg/BILLS-112s1832is/pdf/BILLS-112s1832is.pdf>.

<sup>11</sup> SSUTA.

<sup>12</sup> See Daniel Mitchell, *Should You Pay Sales Tax on Amazon?*, *The New York Times*, July 29, 2011, available at <http://www.cato.org/publications/commentary/should-you-pay-sales-tax-amazon>.

<sup>13</sup> SSUTA.