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in the 107th Congress*

Internet Taxation

by
JESSICA P. MELUGIN

Contrary to popular belief, the Internet is not a tax-free zone. The Internet Tax Freedom Act (ITFA) of 1998 banned “special and discriminatory taxes” that states might dream up specifically for the Internet. But Internet sales are not specifically exempt from various sales taxes. The 1992 Supreme Court decision in *Quill Corp. v. Heitkamp*, dealing with interstate catalog sales, currently governs questions of sales taxes on the Internet.¹ And it is *Quill*’s constitutional limits on a state’s ability to tax entities outside of its political and geographical borders that supporters of Internet taxes, including the National Governors’ Association, seek to overturn.² If successful, the Internet tax grab would create a *de facto* national-sales-tax cartel. It would violate the time-honored principle of “no taxation without representation” by, in most cases, leaving politicians and tax collectors accountable to no one.³

The nexus test. The 1992 *Quill* decision mandates that states can collect sales taxes only from companies with a substantial physical presence within that state’s geographical borders.⁴ This presence is commonly referred to as “nexus.” ITFA designates a number of Internet-related items as **not** sufficient to qualify as nexus. These items include a retailer’s Internet service provider, digital data on a server, and the use of telecommunications services, among others. But ITFA expires in October of 2001, meaning that Congress will soon have to revisit the issue of Internet taxes.

Tax accountability. NGA and others are lobbying Congress to abandon the principles of ITFA and allow states to collect sales taxes from companies located completely outside of a state’s territory. Not only do states not furnish any services to remote retailers, taxing officials would have no accountability to such extra-territorial taxpayers and thus no incentive to keep tax rates at bay. Congress must prevent states from taxing remote purchases if it wishes to preserve the principle of “no taxation without representation.”

There are currently more than 7,500 different tax jurisdictions in the US, and each has its own set of rules.⁵ The current lack of

uniformity in sales-tax policy from one district to another creates severe practical impediments to asking Internet retailers to calculate every customer's local sales-tax rate. When the ITFA extension passed the House in the 106th Congress, it included a "sense of the Congress" resolution by Rep. Ernest J. Istook (R-Okla.) that urged states to simplify their current sales-tax systems to facilitate and justify remote taxation on the Internet in the future. But even states streamlining their sales-tax rates to facilitate remote taxation won't make the situation right. No matter how user-friendly the sales-tax system might be for retailers and tax collectors, it will still amount to taxation without representation for consumers.

Privacy threatened. NGA suggested a so-called Trusted Third Party (TTP) to calculate, collect, report, and pay the tax instead of the vendor, as is the case for conventional "bricks and mortar" retailers. But unlike traditional retailers, who base the sales-tax rate on their location (a situation which avoids the burden of computing different rates for each of the thousands of tax jurisdictions of which their walk-in customers are residents) these TTPs would have to gather enough information about a customer to calculate and remit the appropriate tax for his home jurisdiction.

Concentrating this amount of personal information has alarming implications for consumer privacy. Presumably, it was with this political liability in mind that NGA recently abandoned the TTP plan, and is now making vague reference to a "technological solution" that would both calculate the correct tax rate and protect the privacy of on-line shoppers. There is no word on what exactly this technology might be, or if it currently exists.

The false logic of a state "revenue crisis." NGA claims as Internet sales grow, tax revenue will become insufficient to fund critical state and local services. Currently, state tax coffers are awash with funds. E-commerce is predicted to reach \$108 billion by 2003, and it is possible that states will take in substantially less from sales taxes.⁶ Contrary to the ideas of NGA, the default answer to tax-revenue concerns is not extending states' taxing and regulatory regimes beyond their geographical borders. A better option would be an origin-based sales-tax model. Purchases would be taxed according to the seller's primary point of business, regardless of the location of the buyer.⁷ This approach promotes tax accountability and tax competition among jurisdictions. NGA's tax cartel would do neither.

First, do no harm. To hear NGA tell it, taxing the Internet is a zero-sum game. The assumption is that every tax-free purchase made over the

Internet would, in the absence of the Internet, be made from a traditional retailer and, thus, would generate tax revenue. This makes little sense in light of how the greater variety and convenience of e-commerce act as incentives for Internet shoppers. A recent study by Austan Goolsbee of the University of Chicago estimates that applying existing sales taxes to Internet commerce could reduce the number of on-line buyers by 24 per cent or more, but that would not necessarily translate into more business for “bricks and mortar” retailers.⁸

Policy recommendation. When these more controversial issues come before Congress, elected officials would be wise to remember that as technology changes the way Americans live, work, and shop, states will need to adjust their modes of operation. Governors need to give careful consideration to how government can properly raise revenue in the new economy. But under no circumstances should Congress give states the opportunity to tax those to whom they are not accountable.

~ JESSICA P. MELUGIN

¹ The Internet Tax Freedom Act, now called the Internet Tax Freedom Law, is available at cox.house.gov/nettax/.

² For more information, visit the National Governors’ Association site at www.nga.org/106Congress/SalesTax.asp.

³ Adam Thierer, “The NGA’s Misguided Plan to Tax the Internet and Create a New National Sales Tax,” The Heritage Foundation, 4 February 2000, p. 9.

⁴ *Quill Corp. v. Heitkamp*, 504 U.S. 298 (1992). Also see *National Bellas Hess, Inc. v. Department of Revenue*, 386 U.S. 753 (1967).

⁵ Julie Foster, “Net Tax In Limbo,” *WorldNetDaily*, 17 December 1999; available at www.wnd.com.

⁶ Aaron Lucas, “A Primer on the Taxation of Electronic Commerce,” Cato Institute, 17 December 1999; available at www.cato.org.

⁷ Terry Ryan and Eric Methke, “The Seller-State Option: Solving the Electronic Commerce Dilemma,” *State Tax Notes*, 5 October 1998.

⁸ Austan Goolsbee, “In a World Without Borders: The Impact of Taxes on Internet Commerce,” National Bureau of Economic Research, revised November 1999, p. 13.