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**U.S. House of Representatives**
**Committee on the Judiciary**

**Hearing on: H.R. 3179 "The Marketplace Equity Act of 2011"**

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**10:00 AM**
**2141 Rayburn House Office Building**

The Competitive Enterprise Institute (CEI) is a non-profit public policy research organization dedicated to advancing individual liberty and free enterprise with an emphasis on regulatory policy. We appreciate the opportunity to comment on the importance of tax equity under our federalist system of government.

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 bricks-and-mortar retailers to "level the playing field." The Marketplace Equity Act (H.R. 3179) seeks to capture more tax revenue for states on Internet purchases.[1] Traditional retailers, states, and localities, urge Congress to act in the name of "fairness," but consumers will perceive this change as a tax increase. Certainly, there are inequities in the way online sales are taxed, but in the case of H.R. 3179, the proposed cure is worse than the disease. If Congress is to consider Internet sales tax policy, an origin-based approach would address the legitimate need for sales tax reform and avoid H.R. 3179's harmful consequences.[2]

## An Overview of *Quill*

The Internet is not a tax-free zone. At the federal level, the Internet Tax Freedom Act of 1998 banned "special and discriminatory taxes" that states might create 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*.[3] In its *Quill* decision, the Court held that a state many not collect sales tax from retailers with no physical presence (nexus) within its borders unless Congress uses its Interstate Commerce powers to grant it explicit permission to do so; H.R. 3179 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 nexus (a warehouse, store, or salesperson) in the Commonwealth. Technically, the Virginia resident may owe a use tax on the purchase, but these taxes are seldom enforced or collected. When proponents of remote Internet sales taxing argue that they're 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 increased costs are not the result of new taxes, but of existing taxes newly starting to be 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, there would be 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.[4] The cost of these calculations would doubtless be passed along to customers and taxpayers.

While H.R. 3179 seeks to address some sales tax inequities, it does away with all these benefits.

**H.R. 3179 – The Good, Bad, and Really Bad**

States and localities can already tax in-state sellers, to whom they are accountable, but H.R. 3179 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).[5] The stated goal of the SSUTA is to, "simplify and modernize sales and use tax administration," and "substantially reduce the burden of tax compliance."[6] But the agreement also calls for Congress to overturn *Quill* and allow remote taxation, so the *un*articulated goal of the SSUTA is to form a de facto state tax cartel.[7] In practice, that means that SSUTA member states agree to simplify their sales tax rates and bases, 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 which H.R. 3179 would codify. 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 doesn't 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 technicality of tax law 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 the plain objective of this legislation. The National Conference of State Legislatures has pointed out in a letter to Senators, "In 2012, states will collectively lose an estimated $23.3 billion in uncollected sales taxes from out-of-state sales."[8] That is not enough money to make up for state and local budget shortfalls, but it is 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.[9] 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, H.R. 3179 sacrifices the goal of fairness with an exemption for smaller online sellers.[10] It would excuse sellers with less than $1 million on remote sales, or less than $100,000 in remote sales in a specific state annually 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 smaller policy laboratories in the 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. 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. As noted, the Dallas-Fort Worth Airport alone has more than a dozen distinct tax jurisdictions.[11] Cartel proponents argue that simplification will ease this burden, but the "simplified" agreement is still 200 pages long and full of loopholes and exceptions.[12]

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 must 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 some were to store the information.[13] Handing over all that information to a third party to calculate tax obligations is another layer of potential security breaches. Putting aside larger question of governments tracking who buys what, where, and when, the practical potential for identity theft, stolen credit card information and general embarrassment should give legislators pause.

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, much of the business community won't benefit from H.R. 3179's brand of fairness. 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 creates inequities of taxing authority among states, depending on their degree of compliance with the SSUTA.[14] 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 challenges to state sovereignty. That is something no one who values federalism should welcome.

**An origin-based alternative**

If Congress intends to tackle Internet sales tax policy as part of broader tax reform, an origin-based tax regime, whereby the tax rate is assessed for the vendor's principal place of business rather than the buyer's location, will address the problems of the current system and avoid the drawbacks of H.R. 3179 and the SSUTA plan. An origin-based approach would treat all retailers the same. It would preserve federalism, tax competition, political accountability, and the privacy of consumers.

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.

This approach would address the "fairness" issue in that an origin-based system would 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 or city limits for better deals or recreation. Expanding this origin-based principle to all retailers will ensure that online, catalog, phone, and yet-to-be-invented sales platforms all will be treated the same as purchases on "Main Street."

An origin-based system preserves federalism and puts downward pressure on taxes by allowing 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 H.R. 3179 would create.

The accounting burden would be minimal, because 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 the privacy of consumers. The tax calculations are based on the seller's location only, so there would be 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.

Perhaps most importantly, an origin-based sales tax keeps political authorities accountable to those they tax, namely, businesses in their own jurisdictions. It is simply too easy to tax those who don't have a political voice. This arrangement should be avoided at all costs.

## Conclusion

The approach in H.R. 3179 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 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 to an origin-based regime.

## Notes

[1] Marketplace Equity Act (H.R. 3179), http://www.gpo.gov/fdsys/pkg/BILLS-112hr3179ih/pdf/BILLS-112hr3179ih.pdf.
[2] See Michael Greve of The American Enterprise Institute's United States Senate Committee on Finance Testimony, August 1, 2001, http://www.finance.senate.gov/imo/media/doc/080101mgtest.pdf. See also Veronique de Rugy and Adam Thierer of The Mercatus Center's, *The Internet, Sales Taxes, & Tax Competition,* October 2011, http://mercatus.org/publication/internet-sales-taxes-and-tax-competition.
[3] *Quill v. North Dakota*, http://scholar.google.com/scholar_case?case=3434104472675031870&q=quill+v.+north+dakota&hl=en&as_sdt=2,9&as_vis=1
[4] See Michael Greve, *States Already Can Tax Out-of-State Purchases, But Rarely Enforce Those Laws*, 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/.
[5] Streamlines Sales Tax Agreement (SSUTA), http://www.streamlinedsalestax.org/index.php?page=modules.
[6] SSUTA, Sec. 102.
[7] SSUTA, Art IV.
[8] Letter from November 9, 2011 from National Conference of State Legislatures, http://www.ncsl.org/documents/statefed/LetterofSupportMarketplaceFairnessAct.pdf.
[9] 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/.
[10] The Market Place Fairness Act S. 1832, Section 3 (c).
[11] Greve.
[12] SSUTA.
[13] See Daniel Mitchell of the Cato Institute, *Should You Pay Sales Tax on Amazon?*, July 29, 2011, op ed published in *The New York Times*, available at http://www.cato.org/publications/commentary/should-you-pay-sales-tax-amazon.
[14] SSUTA.