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A State Cooperative Approach to Collection of Use Taxes in Interstate Commerce

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Advisory Commission on Electronic Commerce**

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In CommerceNet's September 1999 presentation to the Advisory Committee on Electronic Commerce, we emphasized the need for a solution that protects our nationwide market, rather than allowing it to be segmented into a multiplicity of protectionist local markets that offer little of the competition that benefits consumers. In our written submission¹ to the Commission, we stated:

There are a multiplicity of ways that States can collect use taxes on sales made by remote sellers to residents of their states without discriminating against those sellers. The biggest barrier to achieving such a result is the states' belief that Congress will at some point grant them the power to impose taxes and tax collection obligations extraterritorially. Congress should affirmatively disabuse the states of that belief by implementing the solution proposed by Mr. Andal of this Commission.

Commissioner Andal's proposal would prohibit the states from imposing taxes or tax collection obligations extraterritorially. This does NOT mean that the states would be unable to collect their use taxes. It merely means that they would need to find another way to do so.

In that submission we suggested that one of the ways that states might proceed would be to implement a State Cooperative approach, similar to the successful approach now in place via the International Fuel Tax Agreement, which is used to collect fuel use taxes in all the continental states as well as Canada and Mexico. In response to the ACEC's request for suggestions on new tax systems we are now providing additional detail on that suggestion and an analysis of how that system meets the criteria set forth by the Commission.

The State Cooperative Approach

States that impose use taxes on remote e-commerce purchases could aid each other in collecting use taxes. States have the clear right to impose sales tax at the point of sale.² In order to avoid the unconstitutionally discriminatory multiple taxation that would occur if both sales and use taxes were imposed on interstate sales, all states provide for a use tax credit against sales taxes previously imposed on the sale. Currently all states exempt from the sales tax those sales in which the product is shipped outside the state. This allows the destination state to impose the use tax so that the tax is imposed by the state where the customer resides. However, the purpose of this exemption cannot be realized in the current tax environment since there is no way for states to collect that use tax when the seller has no physical presence in the buyer's state. A repeal of the states' exemptions for out-of-state shipments would immediately ensure that taxes are collected on most taxable interstate sales, with the exception of sales from the five states that do not impose sales taxes.

¹ See: <http://www.commerce.net/resources/work/CN-ACECComments-Sept-99.pdf>

² *McLeod v. J. E. Dilworth Co.*, 322 U.S. 327 (1944).

Additional features of a state cooperative approach could include:

- In order to ensure that the repeal of the export exemption does not create a barrier to exports, the states could specify that the sales tax is to be collected at the tax rate of the destination state. The rate to be collected from buyers in other states would be set to the lowest rate in the destination state in order to avoid unadministrable complexity caused by a multitude of different rates and the constitutional problems created by an averaged rate.³
- A merchant would be subject only to the authority of the state in which the merchant was located. Multistate merchants - those with real property or direct employees in multiple states - would file with the state where the office participating in the sale is located.
- Merchants that are now registered in a state where they have no real property or direct employees would de-register in that state.
- If the states so desired they would be free to enter into agreements with other states to remit taxes collected by one state to the state where the buyer resides. This system would be quite similar to the system currently in use for fuel use taxes. A central clearinghouse for making the requisite transfers of funds is already in use for the transfer of use taxes from state to state. That mechanism could be expanded to be used for other taxes or a similar mechanisms could be put in place. The Commission may wish to study the International Fuel Tax Agreement, which was implemented, at the urging of Congress, to solve similar problems in the fuel use tax area. Once the IFTA system was established, Congress required that all states participate.⁴ Alternatively a zero-burden system could be developed as recommended by the NGA's *Streamlined Sales Tax System for the 21st Century*⁵ proposal, with sellers continuing to be accountable only to the states in which they have true physical presence (real property or direct employees).
- As for the five non-taxing states, there are a number of ways of dealing with sellers located in those states – one would be to allow them to register for tax collection purposes in another state and participate in that state's tax administration. The Commission should be wary of the argument that businesses would move to non-tax states to avoid collection obligations. It is unlikely that such a migration would take place since the trade-off for not collecting sales taxes from customers is the company having to pay higher income or property taxes itself, a circumstance that directly affects the company's bottom line. Obviously no-sales-tax states have to fund their governments using other taxes. In any case if such a problem did result, one remedy could be that the federal government might step in with a federal tax against which state sales taxes were credited - thus affecting only no-sales-tax states.

³ See *Associated Industries of Missouri v. Lohman*, 114 S. Ct. 1815 (1994).

⁴ P.L. 103-272, Sec. 1(e), July 5, 1994.

⁵ See: <http://www.nga.org/Internet/Proposal.asp>

- States would exempt from taxation only those sales made into states in which the seller had true physical presence (real property or direct employees) and was registered as a tax collector. This would enable companies that are already collecting in remote states, due to a physical presence in the remote state, to continue to maintain their current tax administration practices if they wished to do so.
- States would also allow merchants to apply for an exemption status if they wished to voluntarily register for tax collection purposes in a remote state. Again, this would enable merchants that wished to do so to continue to maintain their current tax administration practices, or to file in a remote state pursuant to a truly voluntary agreement with that state to do so.

The State Cooperative Approach and the Advisory Commission's Criteria for Evaluation of Alternative Proposals

Simplification

1. How does this proposal fundamentally simplify the existing system of sales tax collection (Some examples may be: common definitions, single rate per state, clarification of nexus standards, and so forth)?

The State Cooperative approach would simplify the system by making each seller location subject only to filing in and auditing by a single state. Nexus standards would be clarified to ensure that true physical presence (real property or direct employees) were required before a state could require a seller to register and file in that state. A single-location seller would only be required to file in one state. Since each state would be responsible for determining the requirements to place on its own sellers, simplification of rates and definitions would simplify the state's responsibility, thus providing a strong incentive for the states to jointly simplify in such areas as common definitions.

2. How does this proposal define, distinguish, and propose to tax information, digital goods, and services provided electronically over the Internet?

Digital goods and services present a problem for destination based taxation in that determination of the destination is difficult if not impossible without invading the privacy of the consumer buyer or adversely affecting confidentiality of the business buyer. The state cooperative approach, since it relies on the repeal of state export exemptions, would tax digital products and services based on the state of origin, unless the destination was known to the seller or voluntarily provided by the buyer when given the opportunity to do so. Of course states would be completely free to redistribute taxes derived from digital goods and services as they see fit amongst themselves.

3. How does this proposal protect against onerous and/or multiple audits?

Single-location sellers would be subject only to audits by the seller's own state. The state would perform the audit on behalf of all states, according to standards jointly set by the

states. Such a system would provide incentive for the states to simplify in order to make the audit process easier for each state to perform on behalf of all the states.

Taxation

4. Does this proposal impose any taxes on Internet access or new taxes on Internet sales?

This system leaves the states free to determine what products and services are taxed. It neither restricts the state's ability to tax specific goods or services nor compels them to do so. It would however provide an incentive for more uniformity amongst the states tax systems since greater uniformity would simplify the state's audit tasks.

5. Does this proposal leave the net tax burden on consumers unchanged? (Does it impose an obligation to pay taxes where such an obligation does not exist today? Does it reduce or increase state and local telecommunication taxes? Does it reduce or increase taxes, licensing fees, or other charges on services designed or used for access to or use of the Internet?)

Since consumers are currently obligated to pay use taxes even when the seller does not collect them, there is no change to the buyer obligation to pay taxes.

6. Does the proposal impose any tax, licensing or reporting requirement, collection obligation or other obligation or fee on parties other than those with a physical presence in a particular state or political subdivision?

This proposal would ensure that sellers are only subject to the jurisdiction in which they have a true physical presence (real property or direct employees), thus ensuring that the seller is represented in the legislative body of the government which has jurisdiction over that seller. The concept that the imposition of taxes or tax collection obligations goes hand-in-hand with having governmental representation for those on whom the obligations are imposed is a fundamental doctrine going back to the founding of the United States of America. This proposal is consistent with that doctrine.

7. What features of the proposal will impact the revenue base of federal, state, and local governments?

To the extent that taxes not now collected would now be collected, state and local governments revenues may increase. Furthermore, within this system, implementation of a zero-burden system such as the NGA proposal would protect local revenues as well.

Burden on Sellers

8. Does this proposal remove the financial, logistical, and administrative compliance burdens of sales and use tax collections from sellers? Does the proposal include any special provisions with respect to small, medium-sized, or start-up businesses?

The burden on the seller of dealing with multiple taxing jurisdictions would be eliminated. Since each state would be responsible for informing its own sellers of the appropriate tax requirements controlling collection of taxes for exported goods, the burden of tracking changes to tax rates and taxable goods in all the states would also be eliminated.

Discrimination

9. Does the proposal treat purchasers of like products or services in as like a manner as possible through the implementation of a policy or system that does not discriminate on the basis of how people buy?

The system would leave the states free to implement the zero-burden system being suggested by the NGA or any other system that maximizes non-discrimination as they see fit.

10. Does the proposal discriminate against out-of-state or remote vendors or among different categories of such vendors?

The system would apply to all sellers, whether the sale was made over-the-counter and shipped to the buyers' residence or other location, made via phone or mail, or made via the Internet. Both "Main Street" and remote sellers would collect taxes on purchases shipped out of state.

International

11. How does this proposal affect U.S. global competitiveness and the ability of U.S. businesses to compete in a global marketplace?

This proposal sets a standard that ensures that sellers are not burdened by having to deal with multiple taxing jurisdictions, thus enabling sellers to compete in nationwide markets without encountering administrative barriers. When scaled to the International level, the proposal would enable global competition without encountering those same barriers on a global level.

12. Can this proposal be scaled to the international level?

This proposal could be scaled to an international level by agreements between the states and the central clearing house to handle the collection of taxes due in foreign countries. The central clearinghouse could make arrangements with central clearinghouses for other countries to collect each other's taxes and remit them appropriately.

13. How does this proposal conform to international tax systems, including those that are based on source rather than destination? Is this proposal harmonized with the tax systems of America's trading partners?

Since this proposal is a source based system, modified to remit taxes through the source location to the destination location, it harmonizes with either source or destination systems. Exact details of the harmonization would need to be worked out between the

relevant jurisdictions. Since the tax system's of America's trading partners are themselves undergoing revision to deal with international remote sales, the question of harmonization cannot be answered at this time. The proposal does however, lend itself to harmonization.

Technology

14. Is the proposal technologically feasible utilizing widely available software to enable tax collection? If so, what are the initial costs and the costs for required updates, and who is to bear those costs?

Under this proposal software could and should be created to handle the tax collection record-keeping and reporting. Whether this is simple accounting and filing software, or the full zero-burden proposal contemplated in the NGA proposal, the costs should be born by the states. If the states cannot impose the costs on the sellers, then the incentive for the states to simplify is much greater.

Privacy

15. Does the proposal protect the privacy of purchasers?

Transactions for which the use destination is not available, or has not been voluntarily specified, would be taxed based on an origin (ie, source) principle by default. How the states handle the allocation of funds so collected is up to whatever arrangement to which they may jointly agree. By treating the taxation of digital goods and services in this manner, privacy need not be violated.

Sovereignty/Local Government Autonomy

16. Does this proposal respect the sovereignty of states and Native Americans?

This proposal respects state sovereignty in that it allows the states to set their tax rates as they see fit. It would allow them to devise a system, such as the NGA's proposed zero-burden system, that could include collection of varying local rates. It also respects state sovereignty in that it ensures that a state has exclusive jurisdiction over it's own merchants rather than allowing other states to impose collection obligations and costs on that state's sellers.

With state sovereignty comes responsibility - the responsibility to implement tax systems that are workable and cost effective. This proposal makes states responsible for their own tax systems rather than the current system in which states attempt to export their tax collection responsibilities onto sellers in other states.

CommerceNet does not have expertise on Native American sovereignty issues with respect to sales and use taxes and therefore we have not considered the impact on Native Americans. CommerceNet urges the states to integrate Native Americans into the system in a way that respects their sovereignty.

17. How does this proposal treat local governments' autonomy and their ability to raise a greater or lesser amount of revenues depending on the needs and desires of their citizens?

This proposal would allow the states to retain local government tax rates if they could devise a system that was simple enough for states to be able to audit for all states (and their local jurisdictions). For example, the NGA's zero-burden proposal could be implemented within this proposed system and could preserve local rates while eliminating the burden of dealing with multiple rates and taxability for both sellers and the auditing states.

Constitutional

18. Is the proposal constitutional?

This proposal is constitutional, as it relies on the principle determined by the U.S. Supreme Court in its 1944 *McLeod v. Dilworth*⁶ decision. In that decision the court concluded that, consistent with "both business and legal notions", the location where the sale takes place is the state of the seller and that furthermore, in order for a state to impose a sales tax on a sale, that sale must take place in that state. Since the state is dealing only with transactions that take place within its borders and the seller dealing only with the state in which it is located, the undue burden issue should not arise.

Conclusion

The "State Cooperative" approach meets the Commission's evaluation criteria and is deserving of serious consideration by the commission. Furthermore, it allows for technological approaches such as the NGA's zero burden approach, while at the same time providing a framework for use tax collection that does not necessarily rely on advanced technological solutions that are not yet developed or deployed. In addition, it respects the sovereignty of the states while at the same time ensuring that businesses are accorded governmental representation in the jurisdiction that imposes obligations on them.

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⁶ *McLeod v. J. E. Dilworth Co.*, 322 U.S. 327 (1944)