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## Internet Sales Tax: Headaches Ahead for Small Business?

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# THE INTERNET SALES TAX: HEADACHES AHEAD FOR SMALL BUSINESS?

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## HEARING

BEFORE THE  
SUBCOMMITTEE ON REGULATORY REFORM AND  
OVERSIGHT

OF THE  
COMMITTEE ON SMALL BUSINESS  
HOUSE OF REPRESENTATIVES

ONE HUNDRED NINTH CONGRESS

SECOND SESSION

WASHINGTON, DC, FEBRUARY 8, 2006

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## **THE INTERNET SALES TAX: HEADACHES AHEAD FOR SMALL BUSINESS?**

**WEDNESDAY, FEBRUARY 8, 2006**

HOUSE OF REPRESENTATIVES  
SUBCOMMITTEE ON REGULATORY REFORM AND  
OVERSIGHT  
COMMITTEE ON SMALL BUSINESS  
*Washington, DC*

The Subcommittee met, pursuant to call, at 10:00 a.m., in Room 2360 Rayburn House Office Building, Hon. W. Todd Akin [Chairman of the Subcommittee] presiding.

Members present: Representatives Akin, Sodrel, Kelly, Bordallo, and Christensen.

Mr. AKIN. The committee will come to order. I am Congressman Todd Akin. We will proceed as I make an opening statement. There will also be a couple of other opening statements, one by the Ranking Member Ms. Bordallo. She is due here any minute. And also from Congresswoman Kelly, also very interested in this topic. After that what I would like to do is to proceed through all of our witnesses.

I think it is better for us who are in Congress, the different staffers that are here as well, I think we get a better picture by just running through all of your testimony. Then you can submit written statements if you would like. What I would like to do is in order of time, keep you to somewhere in the five minutes range? I just want to hit the highlights of what you want to say in five minutes.

When we get done going through all the witnesses we will come back with specific questions. Different members here will ask you questions based on comments that you made but maybe comments that someone else made and want to just cross check with you. Typically I have a pretty good record of being able to get things done in an hour.

Today this may be a hot enough topic that we may want to run a little bit more than that but I would think maybe at the most an hour and a half we should be able to wrap things up. You will see these little lights. There is a little light in front of you. When it gets red that means your five minutes is up. I don't usually throw these things but still we want to keep things moving.

Good morning and welcome to today's hearing entitled "The Internet Sales Tax: Headaches Ahead for Small Business?" I want to especially thank those witnesses who have traveled to partici-

pate in today's hearing, particularly all the way from Washington State.

The Internet has emerged as an extremely important channel of commerce in our nation. For this reason, we must be vigilant in keeping this medium as unencumbered from regulations and taxes as possible. I am skeptical of anything that constitutes a new tax or imposes new onerous regulations on our nation's businesses, especially those selling over the Internet.

We are here to investigate recent federal and state efforts to shift responsibility to collect state sales and use taxes to out-of-state Internet vendors. A state currently can not impose that burden unless a business has a constitutionally significant presence or "substantial nexus" within the state. Because e-commerce has become a vital channel for businesses of all sizes, many states are concerned with the loss of potential tax revenue.

Consequently, these states have banded together to form the Streamline Sales and Use Tax Agreement, which is an effort to harmonize sales and use tax laws and simplify tax collection for vendors. Member states of this agreement argue that by creating a more uniform system of laws in this nation and easing burdens on vendors, they in turn should be given the authority by Congress to collect sales and use taxes from out-of-state Internet vendors.

Currently, two nearly identical bills have been introduced in the Senate that would provide such authority to states. Both measures include an exception from remote sales and use tax collection for small businesses. However, the bills differ in how this should be accomplished. Thus far, no companion legislation has been introduced in the House.

Today our panelists will address the many issues surrounding implementation of the Streamline Sales and Use Tax Agreement. Particular emphasis will be placed on the scope of the current federal legislation and the many new compliance burdens that could be placed on our nation's businesses if this legislation is enacted.

I look forward to the testimony from our witnesses today. I now yield for an opening statement from the gentlelady from Guam. If she is not here, we will proceed to a second opening statement. I want to explain if it wasn't previously clear that this is the Small Business Committee and one of the things that we are jealous to do is to guard small businesses from unnecessary red tape and regulations because we are big believers that small businesses are the engine of the future growth of our country. Certainly that is the angle that we are looking at this issue from is the Small Business Committee. That is why we are having the hearing in the first place.

Now I would recognize the gentlelady from New York State, Ms. Kelly.

[Chairman Akin's opening statement may be found in the appendix.]

Ms. KELLY. Thank you very much, Mr. Chairman. I represent New York's Hudson River Valley where small businesses simply can't bear additional burdens, especially as they relate to taxes. The existing moratorium that affects state and local taxation of Internet transactions should be handled in a way that certainly does not have a negative impact on these small businesses.

We cannot forget that we are dealing with small businesses that have limited resources in terms of employment and finances which also means limited capabilities. When the Government puts unnecessary and unreasonable strains on such, those small businesses will be forced to close. There is no doubt that having to collect and remit taxes for states other than the state where the small business resides would be an extreme burden. It is not just collecting and remitting.

Specifically, these taxes involve tracking closely where the items are purchased as well as the tax code of that state to be certain that the proper tax is collected. Further, the paperwork would prove to be a nightmare for these small businesses and it would be expensive. It is a burden that many small businesses simply cannot meet. Companies would be forced to limit sales outside the state they are in.

No business should be held to such limitations simply because the tax requirements are insurmountable. I am hopeful that through discussions such as this today and in the future that we can develop a solution that does not hurt the people who are involved. Most importantly we must work to eliminate existing tax burdens on our small businesses and not create new ones.

I thank all of our panel here today. I look forward to your testimony and I appreciate the sensitivity that you have to this issue. Thank you for being here.

Mr. AKIN. Thank you, Congresswoman. Appreciate your perspective and your care and interest in small business as well.

Also now from our ranking member, Ms. Bordallo, opening statement, please.

Ms. BORDALLO. Thank you very much, Mr. Chairman. Greetings to all of the witnesses here. I apologize for being a few minutes late.

I want to thank you, Mr. Chairman, for holding this hearing to review the application of a sales tax to Internet commerce and the affect that this would have on the vitality of American small businesses. I look forward to hearing the testimony today.

I represent Guam, way out there in the Pacific. Internet based commerce is particularly important to my constituents. The advent of the Internet and the massive growth of the e-commerce sector have certainly opened up a wealth of opportunity for business owners and consumers on Guam and across the country.

On site such as Amazon.com, eBay and countless others have allowed sellers and buyers and it has made it easier for the purchasing of goods and services at the competitive price. Internet based commerce has had a notable positive impact on the U.S. economy that has resulted in tens of thousands of new highly-skilled and high-paying jobs. Expectations are that the Internet commerce industry will continue to grow in the coming years.

For example, retail e-commerce sales projected to top \$80 billion for fiscal year 2005 which is up from \$69.2 billion in on-line retail sales generated in fiscal year 2004. Many small businesses will contribute to and benefit from this growth. The Internet allows them to expand their markets at marginal additional cost allowing them to compete more fairly with their larger counterparts.

However, the uncertainty of the sales tax treatment of goods sold over the Internet is a major obstacle for many small businesses entering into Internet based commerce. In particular, the collection and remittance of taxes on Internet commerce is a complex and costly problem from small businesses to solve.

Currently, on-line buyers are taxed according to where the item they purchased will be delivered as opposed to where the vendor is located. The opposite is the case with traditional over-the-counter sales in traditional businesses. A buyer, for instance, from Guam who makes a purchase from a store in Virginia will pay Virginia sales tax.

Because the tax law varies from state to state and among U.S. territories, small businesses, many of which only have a few employees, face difficulty in comply with the complexity of these various tax codes and a barrage of federal regulations that they need to follow.

Although the Internet may be able to quickly connect you to every community across the U.S. knowing the particulars for the roughly 7,500 distinct tax jurisdictions in the United States, is quite a daunting task even for the most talented of entrepreneurs. The application of a sales tax to Internet commerce would appear to be a potential to curb the further growth of this unique sector of the American economy.

Today's hearing, gentlemen, will provide us with an opportunity to hear more about this issue in an effort to better understand the potential impact of tax collections on small on-line retailers. I am particularly interested in hearing more on how these changes will impact the future development of our nation's 23 million small businesses many of which have already tried their hand at Internet sales. Thank you very much, Mr. Chairman.

[Ranking Member Bordallo's opening statement may be found in the appendix.]

Mr. AKIN. Thank you for that opening statement. With that we are going to just proceed pretty much down the line here with our witnesses. Our first is a distinguished professor of law at the University of Georgia, Walter Hellerstein. Did I get that right?

Mr. HELLERSTEIN. That's good enough.

Mr. AKIN. Pretty close? And I note you are a graduate of Harvard and the University of Chicago Law School. Look, we've only got five minutes but we are going to try to be good students and go back to class here and try and pick your brain for five minutes of highlights. Thank you. Proceed, please.

#### **STATEMENT OF MR. HELLERSTEIN, UNIVERSITY OF GEORGIA**

Mr. HELLERSTEIN. Thank you very much, Mr. Chairman. I really appreciate your invitation and the opportunity to address this Subcommittee. I want to just try to do two things in my oral testimony. One, briefly —

Mr. AKIN. Is your mic on or is it aimed at you in anyway?

Mr. HELLERSTEIN. First of all, I want to thank you very much for inviting me. I want to focus just on two points in the oral testimony. One, to try to give you a broad overview of what the law is, the law of Internet sales taxation. Second, to try to focus on what



policy choices you have should you decide to change the law in any way that you deem appropriate.

First of all, what is the law? Every state that started to have a sales tax had this problem. The problem was if someone went to a jurisdiction that didn't have a sales tax, they would lose revenue. Their business would lose revenue. So they couldn't impose a sales tax. Washington can't impose a sales tax on a sale that takes place in Oregon which doesn't have a sales tax. What do they do? They impose something called a use tax. What is a use tax? A use tax is the same thing as the sales tax but it is within the state's jurisdiction because it is imposed on the use of property in the state.

I will give you an example. I come from Georgia. Say I go to Oregon to buy a car. Do I pay a sales tax? No. Why not? Oregon doesn't impose a sales tax. I bring my car back to Georgia. What happens? I go to register my car and I pay a use tax equal to the sales tax that I would have paid had I bought the car in Georgia.

Okay. Now, I buy a book from Amazon.com. Do I pay sales tax? No. Why not? The sale takes place in Washington or wherever their fulfillment facility is. I bring the book back to Georgia. Very simple. I go to the book registry. Right? There is no book registry. As long as we have a first amendment there probably won't be a book registry. I owe the use tax but I'm not going to be the first person in the history of Georgia voluntarily to remit a use tax. Now you see the problem.

The tax is due, I'm not going to voluntarily remit it, and there is no jurisdiction over Amazon to require Amazon to collect the tax in the same way that a Wal-Mart or a local vendor would collect the tax. Why not? For the very reasons that you have already alluded to. There are so many different state tax laws and so many different states and counties that the U.S. Supreme Court said, "It is so complicated we're not going to require the out-of-state vendor to collect the tax unless there is a physical presence."

There you have it very briefly. There is power to tax the stuff that I am bringing into Georgia wherever I buy it. There is no power to require the out-of-state vendor to collect it and, therefore, these taxes that are legally due don't get collected.

Now, what do you do about this? If you like the law the way it is, you leave it. You do nothing but maybe you don't and here it seems to me there is a question of what you might think about in terms of your choices. First of all, I think one policy choice not before you is whether or not something that I buy over the Internet is taxable. It is taxable.

Every state, the 45 of the 50 states that have sales taxes say, "We want to tax stuff that you buy in other states that don't have sales taxes." I don't think that should be on your plate. What is on your plate is whether or not it's right to require a small mom and pop business to collect. I think you might want to look at these questions in deciding whether the law is appropriate as it is or should be fixed.

What are the costs of collecting sales and use tax under this new regime? What are the additional revenues collected under the proposed regime? What is the relationship between nationwide gross sales and these costs? What is the relationship between costs in a particular state and cost of collection and revenues? What is the re-

relationship between having a separate legal entity and cost collection?

I think in the end you have to decide on the basis of facts that I don't have personally but you will hear from other witnesses what is the appropriate line to draw? Right now we have a physical presence test. Does that make sense? Does it make sense if we are concerned about small business, for example? A small business sends one sales person into a state and they have physical presence.

They have to collect a huge multi-million dollar retailer that maybe has sophisticated software and a staff of tax people. Maybe it is appropriate for them to collect. I don't know but I think one thing you have to ask is what test makes sense, if any? Maybe you want to say nobody who sells over the Internet should ever have to collect a tax because that makes sense. All I'm telling you, or urging you to focus on, is the policy issues associated with the collection of taxes and the revenues of the states that derive from it. With that I see the yellow light is on. I will end my testimony.

[Mr. Hellerstein's testimony may be found in the appendix.]

Mr. AKIN. You have redeemed about 30 seconds of your time. That is admirable and a great way to start a hearing. Thank you very much for coming in and we'll get back with some questions.

Our next witness is Brian—is it Bieron?

Mr. BIERON. Bieron.

Mr. AKIN. Bieron. And you are the Senior Director of Federal Government Relations with eBay?

Mr. BIERON. Yes, sir.

Mr. AKIN. And hailing from Washington, D.C. right here. Is that right, Brian?

Mr. BIERON. Well, before I started in Buffalo, New York. I'm originally from Buffalo, not from here.

Mr. AKIN. Thank you, Brian. Please proceed.

#### **STATEMENT OF MR. BIERON, EBAY, INC.**

Mr. BIERON. Mr. Chairman, thank you, and thank you to the members of the Subcommittee. I would like to thank the Committee for giving eBay this opportunity. We agree that this is a critically important issue to small business entrepreneurs who increasingly use the Internet to compete in the 21st century economy.

One of the most important developments on the eBay market place is that hundreds of thousands of small businesses from across America have discovered that eBay is a vibrant place to do business. Currently over 700,000 of our nation's small business people are using eBay as a valuable marketing channel. We believe that nearly a half million of these began their business off of eBay, in many cases in brick and mortar stores.

They are using the Internet as a new way to compete and grow. Increasingly main street and the Internet are not competing with each other so much as main street small businesses are using the Internet to compete and survive against global retail companies. That creates small business jobs in communities all across the nation. The stated goal of the Streamline Sales Tax Project is to increase state revenues.

empt small business from taxes or whether or not we should not provide the taxes owed to local jurisdictions. It really is a matter of resolving both of these two competing interests through the use of technology.

[Mr. Rawlings' testimony may be found in the appendix.]

Mr. AKIN. Thank you for completing your testimony. It is interesting. All of you have had fascinating questions, potential questions anyway, that are quite interesting. Obviously from a political point of view there are a whole series of different questions involved here.

Some of them are fairly complicated in the sense that they are touching so many different jurisdictions. Then there is the overall question about taxes themselves. As the Chairman I guess I have the opportunity to start with some questions. Maybe I'll start, Walter, with you. I'll just say what will happen if Congress does nothing and the states try to relitigate the Quill decision?

Mr. HELLERSTEIN. That is a very good question. I think a question frankly that no one really knows the answer to. What it will depend on is whether or not the court, which in the past has said things are so complex for the remote or out-of-state vendor that we can't require them to collect without imposing a burden on commerce and, therefore, they can't be required to collect.

The question is have things gotten simple enough that that burden doesn't exist anymore? Honestly, Mr. Chairman, I don't think we know the answer to that question. If you ask me, I suppose right now would I take on a contingency a case that was going to relitigate Quill no I wouldn't.

If Streamlined were enacted, obviously in the absence of congressional blessing, and every state or 35 out of the 45 states joined, and there was additional evidence of administrative simplification, maybe my answer to that would change. I think it is a very good question and the key to the answer is to what extent have the states actually simplified to remove the underlying premise of Quill which is that life is too complicated.

Mr. AKIN. Then just a follow-up question. Should Congress enact legislation that enable the collection of taxes on remote sales?

Mr. HELLERSTEIN. If Congress can satisfy itself that it has provided sufficient standards to simplify the life of the small business person. I think presumably with some reasonable threshold. I think it is important to have a threshold, a reasonable threshold that makes sense, whether it is based on 100 pounds of flesh in the state or \$200 million of sales in the state, I don't know.

I think you need to have evidence on that issue but I would very much encourage you to do that because I think that way you have a fair collection of revenues without putting a burden on small business. And you satisfied yourself that the simplification is sufficient but I think those are the questions you need to look at very carefully. What is sufficient simplification and what is the appropriate standard for exempting small business.

Mr. AKIN. I guess part of what I was asking and maybe to venture into a little bit of a policy question, is it possible that this non-tax part of commerce is something that actually is very positive and will drive the economy. Maybe by exempting it in a sense we

are just allowing something to go on which is good for the economy overall. I guess I was getting a little bit at that.

Mr. HELLERSTEIN. Again, my answer is that that is an important policy point but I guess I would say assuming that is correct, it is important to have a rational standard for exemption. I am not sure that 100 pounds of flesh is a rational standard.

Mr. AKIN. My co-Chair here.

Ms. BORDALLO. Thank you very much, Mr. Chair. I have just one question, I guess, for each one of them but I will go back to you, Mr. Chairman. The first is for Dr. Hellerstein. Is that correct?

Mr. HELLERSTEIN. Some people call me Dr. I think doctors give injections. Walter is just fine.

Ms. BORDALLO. Walter is fine. All right. It is understandable that local communities wish to collect taxes from the sale of goods over the Internet just as they tax the sale of goods over the counter. Local communities stand to generate a significant amount of revenue by doing so. However, in your opinion would a tax on Internet sales prevent small firms from doing business on the Internet?

Mr. HELLERSTEIN. I think, Representative, the answer to that question is really what you have already talked about and what other witnesses have spoken about which is the extent to which that burden would impose cost on the small business. I think that at some point if the marginal cost of collecting tax is greater than the marginal revenue of the sale, they will no longer do that. That is a factual question. I don't know the answer to it but I think I know how I would go about inquiring.

Ms. BORDALLO. Thank you. Then I have one for Brian Bieron. Is that correct?

Mr. BIERON. Yes, ma'am.

Ms. BORDALLO. If sellers on eBay were required to collect sales taxes in as many as 7,500 taxing jurisdictions, would you expect to see some of eBay's sellers close their businesses?

Mr. BIERON. Well, we have been told by many of them that they think that it would be a significant burden. As Mr. Hellerstein said, it would raise their cost. It would make it far more complicated to do business. In many cases we think it would dissuade them from starting down the path. In a lot of ways eBay is a market place that is very friendly to small business so small businesses come and start doing some business over our market place.

As I said, we have about 500,000 of the small businesses that are using the market place now. They didn't start there. They weren't born on eBay but they were small businesses who came to it to get at a global market really. We think that it would create a new complicated burden where let's say you have a storefront somewhere and you are competing with the Wal-Mart's of the world. You think that the Internet is a new place to start to get some marginal sales. If part of that first hurdle was to have to take on this whole burden, we think that would stop a number of the small businesses from trying that avenue.

Ms. BORDALLO. Thank you. I have a couple more questions, Mr. Chairman.

Mr. AKIN. Go for one more.

Ms. BORDALLO. All right. Okay. This is for Ernest Perry. If your business were to be charged with collecting sales taxes from cus-

tomers from out of state, what impact would this have on your bottom line and what kinds of human and technical resources would you need to fulfill this particular requirement?

Also, it seems to me that if you are required to collect sales taxes on Internet sales to out-of-state customers, this could be an expensive proposition for you that might require you to raise prices on items in your storefront. Is this possible?

Mr. PERRY. You are exactly right and I am glad you asked that question. I was just sitting here thinking listening to these comments that I am paying taxes now in the state of North Carolina and I was just thinking about how much paperwork that it takes that I have to keep for like five years. It would be the equivalent of this table just to keep the North Carolina sales tax. Can you imagine if I had to keep tax records for 50 different states, although it would be maybe simplified.

Then I have got to worry about maybe being audited by any or all of those 50 states at any given time of the year. It would be a nightmare and I just don't think that it would be—I think it would discourage a lot of Internet sellers, especially the small mom and pop that are working out of their garage or out of their bedrooms even to just throw their hands up and not even try. It would be impossible.

I mean, there is no way they can keep up with the paperwork they would have to keep up with. Also the worry about the audits that they may have to worry about. I am sure the technology companies can do it but we have to pay these guys to do this and we don't know if it is going to work or not. We will still be the ones that would saddle the burden for all of that.

Ms. BORDALLO. Thank you.

Mr. AKIN. I just think I will continue along the same line of questioning just to make things fair here.

Rory, you have got the company that has got all this stuff programmed. You must be a very patient fellow to have programmed all of these different jurisdictional laws into a computer, or else you have hired some very patient people. I wanted to give you a chance to respond to the other comments.

Mr. RAWLINGS. Sure. I appreciate that opportunity. When it really comes down to the burden on small business, small businesses are currently burdened. Small businesses currently pay sales tax. Small businesses currently spend a lot of money paying sales tax. Sales tax compliance is very difficult. It is very complicated. It is very confusing.

Even with a single taxing jurisdiction you have got to deal with product exemptions. You have got to deal with entity based exemptions. You have got to deal with filling out the forms. Many of these small business owners don't know how to fill out these forms. They are making guesses.

The real solution, or I believe the real solution, is solved in technology with the convergence of Internet technologies, security technologies, and geo-spacial technologies we can accurately determine what those taxes are. We can take those tax transactions and the history of those tax transactions and store it in a secure database behind multiple firewalls. We can use the power of the Internet, the same Internet that we are talking about.

Mr. AKIN. If I could jump in, are you saying that you would then as a service provide all the record keeping that was necessary for a small business?

Mr. RAWLINGS. Absolutely. That is what we do today and that is what we have been doing for the past three years.

Mr. AKIN. Go ahead and proceed.

Mr. RAWLINGS. So we maintain those tax transactions. We automatically generate those tax returns through a web browser interface. Here again the power of the Internet. The small business owner opens up their web browser, logs on through a secure log on, and views their tax return, prints out all of their historical transactions. All that information is available for an audit. Under Streamline it even gets simpler.

I do believe there are opportunities under Streamline to make the taxes even simpler. Really from a technology standpoint it doesn't make a difference. All of those rules are coded into the software. The software will be, and is in the process of being certified by the states. The security and the reliability is being certified by the states.

We have gone through months of audits and months of review and months of working with the states submitting multiple test decks and verifying that we can generate it in an electronic return and verify that we can, in fact, collect the taxes, that we can, in fact, remit those taxes to the states. We have gone through many, many hours of review.

From my perspective, it is not a matter of increasing the burden on small business. It is a matter of providing a service that is affordable. Now, whether that is paid for by the state or paid for by the small business, frankly we have got 2,200 users from the beginning of 2005 so our business is growing 200 percent quarter over quarter.

We have got a very big need to fill with or without sales tax, with or without a change in policy. Our belief and our experience is that small businesses are burdened today with the collecting and complying with sales tax in their local jurisdiction. Here, again, we have 2,200 users. We are growing at 200 percent quarter over quarter rate.

We charge a lot of our customers \$29 a month for a complete compliance solution. Does it make sense to exempt small businesses? That really is a policy question. Avalara does not want to get involved in policy but I believe it is a timing issue. You know, it is a matter of adoption. We may want to as a nation exempt small businesses to begin with and then start dropping the exemption over time. Whatever makes sense for the country but I can tell you this. I can tell you that there are technology solutions available, that there are very easy almost zero burden tax compliance solutions available. In my mind it doesn't make sense to use that as an excuse to exempt—

Mr. AKIN. I hear what you are saying. If there is a mistake made, who is liable? Let us say that something isn't calculated the right way and the small business guy says, "Hey, wait a minute. You did something wrong." Is it your company or is it the small business guy that has to pick up the tab legally if something isn't done right?

Mr. RAWLINGS. Under Streamline I am liable. For anyone who uses my system I am liable. If I make a mistake, I have to pay the difference.

Mr. AKIN. And not the small business guy? Okay. Thank you.

Next question, Ms. Bordallo.

Ms. BORDALLO. Thank you, Mr. Chairman. I have just one other question and I think it is along the same lines of your question. I don't want a dollar figure but how much would a comprehensive software package cost to small business? Do you feel it would be reasonable? Is it affordable? Do you have different types of packages for them to engage in such as just the basics or full service? Also in line, you said your firm has conducted audits. Have they always been successful?

Mr. RAWLINGS. First of all, the types of services that we do provide. We have various levels of service. We have a basic plan. We have a full product tax ability, what we call AvaTax Pro. Then we have a full breadth of services so we have a full service offering which is nearly zero burden as far as the business is concerned. The costs do start at \$29.95 cents a month.

Ms. BORDALLO. That is the basic package?

Mr. RAWLINGS. Yes.

Ms. BORDALLO. Your audits.

Mr. RAWLINGS. Oh, the audits. Here again, we have 2,200 users and none of those users have ever had an issue with the tax audit. We have had numerous clients that have gone through multi-year audits with California and virtually every state in the country. Not once have we had anyone of those clients come back and say, "Hey, you guys really screwed up and we are having trouble."

Ms. BORDALLO. Having trouble, yeah. All right. Thank you, Mr. Chairman. That concludes my questions.

Mr. AKIN. Thank you.

This is a general question. Usually now sales tax is collected at the original of where a sale is made is my understanding. What we will be talking about here would be a destination type of sales tax. Does that make things more complicated or how do you see that influencing things? Walter, if you want to start.

Mr. HELLERSTEIN. Mr. Chairman, I really don't think it is appropriate to say that the sales tax is tax at origin. The sales tax is a destination tax. It is a consumption tax. In fact, for example, if a Georgia vendor sells to an out-of-state purchaser, there is no tax. When we buy over the counter, origin and destination happen to be the same. In the end a consumption tax, which a sales tax generally is, is normally imposed at the destination. That is exactly why Georgia will impose a use tax on me when I go to Oregon to buy a car.

In fact, if a Washington dealer could ship a car out of Washington, the title not passing, they wouldn't impose a tax. Nobody wants to impose a tax on exports. So really we have a destination based sales tax in this country except when we have destination and origin that in the particular transaction are at the same point.

Mr. AKIN. So you are saying in a way that is a false distinction. You are saying everything is destination. Is that what you are saying?

Mr. HELLERSTEIN. What I am saying is that, in general, sales tax is a destination based tax and states generally tax things coming into the state and exempt things going outside the state. When I go to South Carolina and I buy something over the counter, to be sure I am going to pay a South Carolina sales tax.

In principle when I get back to Georgia I would owe a use tax and get a credit against the South Carolina sales tax but that is just a matter of cross-border shopping. No one tries to trace an over the counter transaction back to my destination. But I think it is fair to say that we have a destination-based sales tax in the U.S.

Mr. AKIN. A couple of others. Brian and then Paul.

Mr. BIERON. Just to mention that a couple of states who are in the effort to make their state taxes compliant with the SSTP concept have actually headed down the path that you are talking about which is switching from a source based internal state sales tax process because, of course, until Congress changes the law it would not apply to out-of-state sales.

But in a state, and I will use the example of Kansas, where they have different sales tax rates at the county level, and it is a state that has a huge number of counties, they have actually over the last couple of years headed down the path of trying to become internally compliant and changing their internal sales tax regime from a source based to a destination based. I know that at eBay we have had complaints from some sellers—

Mr. AKIN. I don't quite understand how that would work in Kansas.

Mr. BIERON. I will give you an example. I am not an expert on Kansas geography so I am afraid I might run into problems but I think Topeka and Lawrence, for example, are both inside Kansas. We have some eBay sellers who have been concerned that if they sell over eBay from Lawrence to Topeka that their sales tax requirements will have changed because currently let us say they have a store front. If somebody comes from Topeka and buys it in Lawrence, they charge the source tax rate whatever is the Lawrence tax rate. But if they mail the product, if they deliver the product into Topeka because they sell over eBay or over another Internet or—

Mr. AKIN. Are they worried that they have got to pay the—

Mr. BIERON. They would. Kansas was proposing to change the law inside Kansas and with hundreds and hundreds of different jurisdictions in Kansas that was really going to be a little test case of what this whole switch from source based to destination based would be like. I can tell you that those Kansas sellers have been extremely dismayed by this change. I know that there were a couple of years where Kansas deferred, essentially delayed the implementation of this because of the uproar from small businesses. It really makes it much more complicated. Of course, it can only happen right now inside a state.

Mr. AKIN. That means in Kansas the small business guy now has to know about all the jurisdictions within his own state. Not within the nation but within his own state.

Mr. BIERON. Right.

Mr. AKIN. Even that is a major headache for him.



Mr. BIERON. My understanding is that many of those small businesses their attitude has been essentially they are going to charge their local rate because it is just too complicated.

Mr. AKIN. It is just too complicated. And Kansas government is just going to have to put up or shut up.

Mr. BIERON. To be honest I don't think that the Kansas state government thinks that there is a huge revenue windfall from getting that compliance inside the state. But that is an example of what you are talking about and you can multiply it. I know that there are technology companies at the table who would describe on one hand how extraordinarily complicated this would be to go from just the complexity of one state or one county like Mr. Perry's store just in one place in North Carolina to the whole country.

Obviously I think we can all recognize that would be extraordinarily complicated. If a technology company were offering solutions, the fact is in the real world there is some relationship between how complicated something is, how much you have to have the service, and how much it ends up costing. If you require this mandate on everybody and it wasn't just, for example, inside Kansas but the whole country that there would be a cost and it would be a cost that small businesses operating on fairly narrow margins would really feel.

Mr. AKIN. Thank you.

Paul, I'll let you have a crack at that.

Mr. MISENER. Thanks, Mr. Chairman. I think I was going to say some of the same things that Brian was but it also helps to calibrate this whole thing. If we step back a second and look at what the Streamline Sales and Use Tax Agreement is all about, Missouri is not part of it. They are not in it and not part of it.

Mr. AKIN. Now you are getting personal.

Mr. MISENER. It doesn't apply to the territories outside at all. The states that are not party to it, the major ones, California, Texas, Illinois, all have the same source issue that Brian was describing. They currently have a longstanding rule of you buy something, if you live in Laredo and you buy it from Dallas, the retailer in Dallas makes the collection and sends it to the Dallas government.

To flip flop that, to become compliant with the Sales and Use Tax Agreement would be a huge internal upheaval in states like California, Texas, Illinois. New York is not part of it either. I mean, the major population centers of the country have not been in and that is a key reason why.

We have said at Amazon that we are going to collect for small businesses. We have a platform business and we are going to do it. We are a technology company. We are fairly sophisticated with computers. There are others that are as well. To small sellers I say that if Amazon can do it, your platform service provider also can do it almost certainly. If not, certainly you are welcome to come to Amazon.

Mr. Perry's business is perhaps the perfect example or the perfect kind of business to run through eBay. He is selling high value items that are very small and light. As a result, the opportunities for sales tax arbitrage are very great because the price differential between what is paid on-line and what is paid on main street is

very great, but the shipping costs are very low. You don't see many very successful eBay sellers that are selling, say, fertilizer which is just the opposite.

What we have just suggested is that at some level you just want to not have quirky sales tax exceptions that drive businesses unnecessarily into different directions. I really meant the point about the ballpoint pen. A lot of small business persons are required to drive to their place of employment. We don't expect them to make automobiles.

We don't expect them to make ballpoint pens to sign their legal documents but we still require them to sign in ink. This is a case where we don't expect small businesses to be pouring over tax tables in 7,600 jurisdictions and all that. There will be service providers. Amazon has said it has stepped up and said that, "We will do this." Eventually I would imagine others will as well.

Mr. AKIN. We have another member that is joining us. Would you like to jump into the discussion?

Mr. SODREL. No, I am just playing catch-up right now. Thank you. I may have some questions later.

Mr. AKIN. Okay. Let me just toss a different question out entirely. One of the things that is at least being theoretically, and maybe even more than theoretically looked at is tax simplification. There are two competing schemes out there right now.

One of them is the flat tax which has its own political problems and that is that every time you want to cut out an exemption somebody is going to offer an amendment so you end up with not a flat tax. That is one question. You take the basic income tax and you get rid of a whole lot of exemptions and the theory is you can file it on a card.

The competing alternative out there is the national sales tax. I guess my question is if we were thinking about it, and obviously that would require probably an appeal of the constitutional amendment that created the income tax so that is a big hurdle, too, politically. Let us say we were to get to the point where we are really looking at a national sales tax. How does that impact our discussion?

Mr. PERRY. I will speak to that briefly. In one of the papers this morning there is a little article about eBay complains about the European tax system. The Internet in Europe right now is really not growing anywhere like here in the states because of the complexity of the tax situation over there.

Basically some of the tax rates over there are from 15 to 25 percent, I understand, and it scares me to death to think that as a retailer I have got to charge if we go this national sales tax somewhere between 15 to 20 percent sales tax. It is going to drive a lot of business back to the underground into the flea markets. It will be devastating to our economy in my opinion. The flat tax is okay. I think that would be fine.

Mr. AKIN. Let me make a distinction, I didn't do this, between what is called a value added tax which is what the Europeans do. It is a great thing for politicians because you can crank it a fraction of a percent and just gain tremendous taxes. The trouble is it just kills the economies and that is why a lot of the European economies are really flat.

We are not talking about a value added tax. It would be over most of our dead bodies to do something like that. We are talking about a straight sales tax which is very different. The value added is every time something changes like if you are starting with a paper clip, you start with an ingot or whatever it is, and the Coke Company and whoever, the Ingot Company. The guy who has got the rolling mirror there is a tax there. Then there is a guy that rolls it and a guy that bends it. You have all these layers of taxes where we are talking about just simply a simple sales tax as opposed to value added.

Mr. PERRY. I am certainly not a tax expert but it just seems to me like if the burden is passed on as a national sales tax to retailers, we become the IRS in essence and I am not sure our customers are going to be real excited about looking on us in the same light they do now.

Mr. AKIN. Any other thoughts?

Mr. HELLERSTEIN. Yeah, just a few general observations. I am going to agree with Mr. Perry. I think at one level clearly we could not have a sales tax that substituted for the national income tax at the rates that we would need to generate the same amount of revenue and have it take the same form that we have.

Let me just give a clarification of the value added tax. The truth of the matter is that in the end a value added tax and a retail sales tax do precisely the same thing. The value added tax is simply collected at many points, that is on the intermediary. If I am General Motors and I buy steel, I pay a value added tax on that. When I sell the car and I collect a value added tax on my output, I get a credit against the tax that I paid. In the end the only person that pays a value added tax is the ultimate consumer.

Now, the truth is that if you are going to have something with rates from 15 to 25 percent as we have on a VAT, then you have to have it collected at each level because, as Mr. Perry correctly points out of the incentives to go to the black market. We have this in Europe, too with carousel fraud.

There is a lot of fraud because the rates are so high but at least there are a lot of collection points. I think that if we were to switch to a consumption tax which is way beyond the scope of what you people are focusing on, it is a huge question. I think we would almost have to go to a VAT from a mechanical and administrative standpoint. If we are going to have a national consumption tax it would almost have to be a VAT because you couldn't raise the revenues and rely on that final transaction, that 25 percent, as being the only place where we collected tax.

Mr. AKIN. That is interesting. It is maybe a little bit afield but, on the other hand, as people think about one thing, it does sort of affect our overall question about sales tax and how that is collected.

Brian, did you want to make a comment?

Mr. BIERON. No, just to say that certainly eBay doesn't generally take positions on broad tax reform, although we believe that if lower taxes incurred stronger economic growth, then that is good for everybody involved with the eBay market place.

I would say, though, that as a retail company at the end of day eBay is a retail market place and having the entire tax burden on

the retail business we think would hurt all the—again, eBay's success is tied entirely to the success of the sellers who actually do the business over eBay and we think those retailers—if all of the federal tax burden were put on the retail sector, that was the collection point, that would reduce consumption and hurt those sellers.

Mr. AKIN. Right. I am not going to do the counter argument for the national sales tax. It is an interesting discussion and it is sort of a little philosophical change whether you are taxing consumption or whether you are taxing income. I mean, there is a difference there in what you are trying to accomplish but I hear what you are saying.

Are there any other questions?

Ms. BORDALLO. I have none.

Mr. AKIN. Thank you all very much for attending today and helping us out with some of these difficult and vexatious items here. I appreciate your expertise. With that the hearing is concluded.

[Whereupon, at 11:11 a.m. the Subcommittee adjourned.]

**Testimony of Walter Hellerstein**

**Before the**

**Subcommittee on Regulatory Reform and Oversight**

**Of the**

**Committee on Small Business  
United States House of Representatives**

**Hearing on**

**“The Internet Sales Tax: Headaches Ahead for Small Business?”**

***Framing the Debate Over the Need for Federal Legislation  
Addressing State Taxation of Internet Sales: A Primer on Existing Law  
and the Policy Choices Facing Congress***

**February 8, 2006**

I am Walter Hellerstein, the Francis Shackelford Professor of Taxation at the University of Georgia School of Law. I have devoted most of my professional life to the study and practice of state taxation and, in particular, to state taxation of interstate commerce and the federal constitutional restraints on such taxation.

I am honored by the Chairman's invitation to testify today. I welcome the opportunity to share with the Subcommittee my views on the existing legal framework governing state taxation of sales made over the Internet and the policy issues that Congress faces with regard to such taxation. I do not appear here on behalf of any client, public or private, and the views I am expressing here today reflect my independent professional judgment.

My testimony is divided into three parts. Part I describes the legal framework that currently governs state taxation of Internet sales, including the underlying state tax regimes and the federal constitutional and statutory restraints on those regimes. Part II considers Congress's power to prescribe the rules that it believes are appropriate for state taxation of Internet sales. Part III delineates the policy choices that Congress faces in determining whether it should modify the existing rules governing state taxation of Internet sales.

## **I. CURRENT LEGAL FRAMEWORK GOVERNING STATE TAXATION OF INTERNET SALES**

In describing the current legal framework governing state taxation of Internet sales, I would like to focus on three sets of questions:

- (1) What is the basic structure of the states' sales tax laws and how do these laws apply to sales over the Internet?
- (2) What are the existing federal constitutional restraints on the states' power to impose sales taxes and how do those restraints limit the states' ability to apply their laws to sales over the Internet?
- (3) What are the existing federal statutory restraints on the states' power to impose sales taxes and how do those restraints limit the states' ability to apply their laws to sales over the Internet?

### **A. The Structure of State Sales Tax Laws**

Probably the most significant structural feature of existing state sales tax laws insofar as they apply to Internet sales is that state sales taxes generally apply only to sales of tangible personal property and not to most sales of digital products, services, or intangible property. While a few states tax a wide range of services and digital products (including information and data processing services and access to data bases), and many states tax some services and digital products (such as telecommunications services and digital downloads), most state sales taxes are limited to sales of tangible personal property.

Accordingly, if one divides the universe of Internet sales into two broad categories – transactions involving sales of tangible personal property and transactions involving sales of services and digital products, it is only the first category of transactions that generally falls within the scope of the states’ sales taxes. Thus, if one buys a book from Amazon.com by clicking on its Web site or a computer from Dell by clicking on its Web site, it is clear that most states will seek to tax that purchase, just as if one walked into a store to buy a book or a computer. On the other hand, if one accesses an information data base over the Internet, or purchases plane tickets over the Internet, or trades stocks over the Internet, or enrolls in distance learning courses over the Internet, or enjoys so-called adult entertainment over the Internet, most of those transactions would not be subject to tax in the overwhelming majority of states.

This is not to suggest that tomorrow the states could not change their sales tax laws to include such transactions in the tax base. Nor do I mean to imply that there will not be pressures on states to expand their sales tax bases to include digital transactions, in light of the enormous shift towards, and increase in, commerce in digital form. It is only to make the simple point that right now the states generally seek to tax only a small portion of the universe that we regard as Internet sales. Accordingly, insofar as this Subcommittee is concerned with the “headaches ahead for small business” caused by the “Internet sales tax,” this is – for the moment at least – a contemporary version of the familiar problem of state taxation of mail-order and other remote sales of tangible personal property.

#### **B. Federal Constitutional Limitations on State Taxation of Internet Sales**

Insofar as the states do seek to impose taxes on Internet sales (i.e., sales consummated over the Internet, but usually involving tangible personal property), the next question is what are the existing federal constitutional restraints on their ability to do so? To appreciate fully my somewhat extended answer to this question, we must start with an understanding of the constitutional structure governing the power of states to tax interstate sales. To do this we must begin with an explanation of a use tax.

When states first enacted sales taxes during the Depression, they faced the problem that they would lose revenue, and their merchants would lose business, if their residents shopped in neighboring states without sales taxes (or with sales taxes with lower rates). Under the judicially articulated restraints imposed on the states under the Constitution’s Commerce and Due Process Clauses,<sup>1</sup> it has always been clear that one state may not impose a sales tax on a sale that occurs in another state. To address this problem, states enacted use taxes.

A use tax is imposed on the use, storage, or consumption of tangible personal property and selected services in the state. It is functionally equivalent to a sales tax. It is imposed with respect to the same transactions and at the same rates as the sales tax that would have been imposed on the transaction had it occurred within the state’s taxing jurisdiction. However, because the use, storage, or consumption of property or services

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<sup>1</sup> U.S. Const. art. I, § 8, cl. 3; U.S. Const. amend. XIV, § 1.

within the state are subjects within the state's taxing power, there is no constitutional objection to the imposition of such a tax<sup>2</sup> – as there would be with regard to a tax on an out-of-state sale.

In principle, then, an in-state consumer stands to gain nothing by making an out-of-state or interstate purchase free of sales tax, because he will ultimately be saddled with an identical use tax when he uses, stores, or consumes the property or services in his home state. If, for example, a Washington resident were to go to Oregon to purchase a car, she would pay no sales tax in Oregon, which does not tax sales, but she would pay use tax in Washington, when she went to register her car, equal to the sales tax that she would have paid had she bought the car in Washington. Every one of the 45 states and the District of Columbia that has sales taxes also imposes complementary use taxes.

In theory, the basic sales/use tax regime that I have just described applies to sales over the Internet in the same manner that it applies to transactions involving automobiles. Thus, if I buy a book from Amazon.com, and it is shipped to me in Athens, Georgia, there is no question that I will owe a Georgia use tax equal to the sales tax that I would have paid had I bought the book in a bookstore in Athens.

There is, however, one significant difference between the purchase from Amazon.com and the purchase of the automobile I described above. With respect to the purchase of the automobile, the state has a practical means of requiring the purchaser to pay the use tax – namely, collecting it upon registration of the vehicle. But states do not require that consumers register books they purchase (and presumably will not be able to do so long as we have a First Amendment). Consequently, unless the consumer voluntarily remits the use tax on the purchase from the out-of-state vendor, which consumers rarely do notwithstanding their legal obligation to do so, the state has no practical means for collecting the use tax unless it can require the out-of-state vendor to collect the use tax in the same way that it relies on the in-state vendor to collect the sales tax.

It is at this point of the legal analysis that we confront the principal constitutional constraint the states face in connection with sales and use taxation of Internet sales – and, I may add, in connection with sales and use taxation of all remote commerce including mail-order sales – namely, that unless the out-of-state vendor has a substantial connection or “nexus” with the state, the states lack the constitutional power to require the vendor to collect the use tax that the consumer owes with respect to the purchased item.

In *National Bellas Hess, Inc. v. Department of Revenue*,<sup>3</sup> decided in 1967, the U.S. Supreme Court held that the Commerce and Due Process Clauses prohibited a state from imposing a use tax collection obligation on a mail-order seller with no physical presence in the state. Twenty-five years later in 1992, the Court in *Quill Corp. v. North Dakota*<sup>4</sup>

<sup>2</sup> See *Henneford v. Silas Mason Co.*, 300 U.S. 577 (1937) (sustaining constitutionality of state use tax scheme).

<sup>3</sup> 386 U.S. 753 (1967).

<sup>4</sup> 504 U.S. 298 (1992).



reaffirmed the essential holding of *Bellas Hess* – namely, that states may not require a mail-order seller without physical presence in the state to collect the use tax due on goods sold to in-state purchasers, although it rested its decision entirely on the Commerce Clause.<sup>5</sup> Central to the Court’s Commerce Clause holding in *Bellas Hess* and *Quill* – and to the issue before this Subcommittee and Congress – was the perceived burden that the duty of collection of taxes on remote sales imposed on interstate commerce in light of the complexity of the nationwide pattern of state and local sales taxes:

North Dakota’s use tax illustrates well how a state tax might unduly burden interstate commerce. On its face, North Dakota law imposes a collection duty on every vendor who advertises in the State three times in a single year. Thus, absent the *Bellas Hess* rule, a publisher who included a subscription card in three issues of its magazine, a vendor whose radio advertisements were heard in North Dakota on three occasions, and a corporation whose telephone sales force made three calls into the State, all would be subject to the collection duty. What is more significant, similar obligations might be imposed by the Nation’s 6,000- plus taxing jurisdictions. See *National Bellas Hess* ... (noting that the “many variations in rates of tax, in allowable exemptions, and in administrative and record-keeping requirements could entangle [a mail-order house] in a virtual welter of complicated obligations”).<sup>6</sup>

To conclude this discussion of the federal constitutional restraints on state sales and use taxation of Internet sales, it is clear under existing law that states possess the constitutional power to impose a tax on the in-state use, storage, or consumption of tangible personal property sold over the Internet. It is equally clear, however, that states lack the constitutional power to require a non-physically present, out-of-state vendor to collect use taxes that a state may seek to impose on the in-state use of such property. As a consequence, any use taxes that a state may impose on property acquired through Internet purchases from non-physically present vendors are likely to go uncollected, just as use taxes that are legally due on many interstate mail-order or telephone sales currently go uncollected.

### **C. Federal Statutory Limitations on State Taxation of Internet Sales**

In addition to the federal constitutional limitations on state taxation of Internet sales – or, more accurately, on state use tax collection obligations imposed on remote Internet vendors – Congress imposed additional limitations on state taxation of Internet-related transactions in the Internet Tax Freedom Act (ITFA). Although these limitations are narrow in scope and do not significantly alter the constitutional landscape described above, a brief

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<sup>5</sup> The significance of the precise constitutional basis for the physical-presence requirement, which may seem like a technical debating point, is that Congress is clearly free to change the rules that the Court articulates under the Commerce Clause, whereas there is serious question whether Congress can change rules the Court articulates under the Due Process Clause. I will return to the implications of this distinction in Part II of my testimony.

<sup>6</sup> *Quill*, 504 U.S. at 313 n.6.

description of these provisions is nevertheless appropriate to complete the picture of federal restraints on state taxation of Internet sales.

In 1998, Congress enacted the Internet Tax Freedom Act (ITFA).<sup>7</sup> The Act imposed a three-year moratorium (subsequently extended through 2007<sup>8</sup>) on three types of taxes: (1) taxes on Internet access; (2) discriminatory taxes on electronic commerce; and (3) multiple taxes on electronic commerce.

### 1. Taxes on Internet Access

The prohibition against taxes on Internet access forbids states from taxing charges for “a service that enables users to access content, information, electronic mail or other services over the Internet.”<sup>9</sup> ITFA plainly forbids states from taxing the monthly fee that America Online and other Internet access providers charge to their customers for connecting to the Internet. The original prohibition contained a flat exclusion of telecommunications services from the definition of Internet access. The 2004 extension of the moratorium added language making it clear that all forms of Internet access were covered by the moratorium, including high speed wireline (DSL) and wireless service (i.e., telecommunications services “purchased, used, or sold by a provider of Internet access to provide Internet access”<sup>10</sup>).

The original act grandfathered preexisting state taxes on Internet access by excluding from ITFA’s scope any tax that “was generally imposed and actually enforced prior to October 1, 1998.”<sup>11</sup> Although that provision has been extended through 2007, a more limited grandfathering provision for states that were taxing the telecommunications services that were covered by the moratorium for the first time (i.e., telecommunications services purchased, used, or sold to provide Internet access) were grandfathered only through November 1, 2005. The 2004 extension of ITFA also makes it clear that the prohibition does not apply to any tax for a voice or similar service using Internet Protocol (voice over Internet Protocol or VOIP), except to the extent the services are incidental to the Internet access such as voice-capable email or instant messaging.

<sup>7</sup> Pub. L. No. 105-277, §§ 1101-04, 112 Stat. 2681-719 to 2681-726 (1998). For a general discussion of ITFA, see Walter Hellerstein, “Internet Tax Freedom Act Limits States’ Power to Tax Internet Access and Electronic Commerce,” 90 *Journal of Taxation* 5 (January 1999).

<sup>8</sup>In November 2001, Congress retroactively extended ITFA for two years through October 2003. “Internet Tax Nondiscrimination Act,” H.R. 1522, 107th Cong., 1st Sess. (2001). In late 2004, Congress again retroactively extended the act, with some modifications, this time through November 2007. Pub. L. No. 108-435, 118 Stat. 2615 (2004).

<sup>9</sup> ITFA § 1104(5).

<sup>10</sup> Pub. L. No. 108-435, § 2(c) 118 Stat. 2615, 2616 (2004).

<sup>11</sup> ITFA § 1101(a)(1).

## 2. Discriminatory Taxes

The Act's prohibition against discriminatory taxes on electronic commerce would have had little impact had it been confined to that concept as it is generally understood, since there are no taxes of which I am aware that single out transactions in electronic commerce for invidious treatment. However, because Congress defined "discriminatory taxes" to include certain taxes in which a remote seller has only minimal nexus with the state, ITFA may have limited impact with respect to use tax collection obligations. Specifically, Congress classified as "discriminatory" any tax (other than a grandfathered tax on Internet access), if the "sole ability to access a site on a remote seller's out-of-State computer server is considered a factor in determining a remote seller's tax collection obligation."<sup>12</sup> In substance, this provision forbids states from imposing taxes on Internet sales by "remote" (i.e., non-physically present) sellers, if the state relied on the purchaser's "sole ability" to access the seller's out-of-state computer server as a factor in determining whether the remote seller has nexus with the state and, consequently, an obligation to collect a tax on the transaction.<sup>13</sup> ITFA also prevents the states from claiming that they have nexus with a remote seller for purposes of requiring the remote seller to collect a use tax on its Internet sales into the state by characterizing an Internet access provider (e.g., America Online) as the remote seller's agent "solely as a result of (I) the display of a remote seller's information or content on the out-of-State computer server" of the Internet access provider or "(II) the processing of orders through the out-of-State computer server" of the Internet access provider.<sup>14</sup>

<sup>12</sup> ITFA § 1104(2)(B).

<sup>13</sup> This provision contains a fundamental ambiguity: whether the critical phrase "a remote seller's *out-of-State* computer server" – which a state is barred from considering in determining the out-of-state seller's nexus with the state – should be read from the vantage point of the taxing state or from the vantage point of the seller. If read from the perspective of the taxing state, which is the more natural reading, the provision is redundant with existing constitutional jurisprudence and is thus virtually meaningless. It would prevent a state from asserting nexus over an out-of-state Internet seller if the state relied solely on the seller's computer server *in some other state* as a factor in considering whether the taxpayer had nexus in the taxing state. But existing constitutional law would preclude an assertion of jurisdiction in these circumstances. Hence, thus construed, the provision adds nothing to existing constitutional protections. If the phrase "a remote seller's *out-of-State* computer server" is read from the standpoint of the seller, so that a state would be forbidden from imposing a use tax collection obligation on a remote Internet seller based exclusively on the presence of the seller's server in the taxing state, then the provision would have some theoretical significance, but not much practical impact. Most states have indicated that they would not assert jurisdiction over an out-of-state seller based solely on the presence of the out-of-state seller's server in the state.

<sup>14</sup> ITFA § 1104(2)(B)(ii). This provision contains an ambiguity similar to that contained in the provision described above, see *supra* note 13, whether the "*out-of-State* computer server" – which a state is barred from considering in determining whether the Internet access provider is the agent of the remote seller – should be read from the vantage point of the taxing state or from the vantage point of the seller. For reasons set forth above, the provision would have meaning only if read from the standpoint of the seller. Thus read, it prevents a state from asserting nexus over an out-of-state Internet seller if the state relied solely on the Internet access provider's computer server in the taxing state as a factor in considering whether the Internet access provider was the remote seller's nexus-creating agent in the taxing state. Construed from this perspective, the provision essentially forbids the states from invoking an "attributional nexus" theory based

### 3. Multiple Taxes on Electronic Commerce

ITFA's prohibition of multiple taxation of electronic commerce is not a model of clarity. A multiple tax is defined as

any tax that is imposed by one State . . . on the same or essentially the same electronic commerce that is also subject to another tax imposed by another State . . . (whether or not at the same or rate or on the same basis), without a credit (for example, a resale exemption certificate) for taxes paid in other jurisdictions.<sup>15</sup>

Congress excluded from this definition of a "multiple tax" sales or use taxes imposed concurrently by a state and its political subdivisions on the same electronic commerce and "a tax on persons engaged in electronic commerce which may also have been subject to a sales or use tax thereon."<sup>16</sup> Although one can discern Congress' objective in enacting this provision – to prevent the same electronic commerce from being subject to tax by more than one state – the language that Congress chose to accomplish that goal was opaque at best. While a prohibition against one state taxing "the same electronic commerce" that is subject to tax in another state might leave some room for debate, the prevention of states from taxing "*essentially* the same electronic commerce" seems almost to invite controversy. To date, however, none appears to have arisen, perhaps because states generally provide a credit against their use taxes for sales taxes paid to other states and the "savings clause" for taxes imposed on persons engaged in electronic commerce removes most other taxes from the scope of the prohibition.

## II. CONGRESS'S POWER TO ADOPT RULES IT DEEMS APPROPRIATE FOR STATE TAXATION OF INTERNET SALES

Part II of my testimony considers Congress's power to prescribe the rules that govern state taxation of Internet sales. There should be no serious debate over Congress's broad authority to adopt or consent to virtually any rule that it believes is appropriate in this domain.

First, it is critical to understand that the judicially developed restraints on state taxing power that the Court has articulated under the Commerce Clause are simply irrelevant in determining the scope of congressional authority to exercise its affirmative "Power . . . [t]o regulate commerce among the several States . . ."<sup>17</sup> Those judicially developed restraints on state taxing power, which the Court has delineated under the so-

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solely on the remote seller's use of the Internet access provider's in-state server.

<sup>15</sup> ITFA § 1104(6)(A).

<sup>16</sup> ITFA § 1104(6)(B).

<sup>17</sup> U.S. Const. art. I, § 8, cl. 3.

called “dormant” or “negative” Commerce Clause, are controlling only when Congress itself has not exercised the constitutional authority that it enjoys under the Commerce Clause. When Congress exercises its own power under the Commerce Clause, it may consent to state legislation affecting interstate commerce that would be unconstitutional under the “dormant” Commerce Clause in the absence of such consent, and it may preempt state legislation that would be constitutional under the dormant Commerce Clause in the absence of such preemption.

As the U.S. Supreme Court has declared, the “plenary scope” of the congressional commerce power

enables Congress not only to promote but also to prohibit interstate commerce, as it has done frequently and for a great variety of reasons. That power does not run down a one-way street or one of narrowly fixed dimensions. *Congress may keep the way open, confine it broadly or closely, or close it entirely*, subject only to the restrictions placed upon its authority by other constitutional provisions and the requirement that it shall not invade the domains of actions reserved exclusively for the states.<sup>18</sup>

Second, in light of Congress’s broad power to legislate under the Commerce Clause, we can now appreciate the significance of the Court’s having rested its holding in *Quill* entirely on the Commerce Clause. Because the Court based the physical-presence requirement for mandatory collection of use taxes exclusively on the Commerce Clause, Congress clearly retains ample power to modify that rule (as well as any other rule the Court has articulated under the Commerce Clause) in forging a legislative solution to the problems raised by state taxation of Internet sales. Indeed, the Court could not have been more explicit about this point in *Quill*. Thus, in justifying its refusal to renounce the “bright-line” physical-presence test of *Bellas Hess*, the Court declared:

This aspect of our decision is made easier by the fact that the underlying issue is not only one that Congress may be better qualified to resolve, but also one that Congress has the ultimate power to resolve. No matter how we evaluate the burdens that use taxes impose on interstate commerce, Congress remains free to disagree with our conclusions. Indeed, in recent years Congress has considered legislation that would “overrule” the *Bellas Hess* rule. Its decision not to take action in this direction may, of course, have been dictated by respect for our holding in *Bellas Hess* that the Due Process Clause prohibits States from imposing such taxes, but today we have put that problem to rest. Accordingly, *Congress is now free to decide whether, when, and to what extent the States may burden interstate mail-order concerns with a duty to collect use taxes.*<sup>19</sup>

<sup>18</sup> *Prudential Insurance Co. v. Benjamin*, 328 U.S. 408, 434 (1946) (emphasis supplied).

<sup>19</sup> *Quill*, 504 U.S. at 318 (footnotes and citations omitted, emphasis supplied). In a similar vein, but in a slightly different context, the Court has declared that “[i]t is clear that the legislative power granted by the Commerce Clause of the Constitution to Congress would amply justify the enactment of legislation requiring all States to adhere to uniform rules for the division of income.” *Moorman Manufacturing Co. v. Bair*, 437 U.S. 267, 280 (1978).

Finally, let me briefly address the limitations on Congress's power to enact legislation expanding, restricting, or otherwise prescribing rules governing state taxation of Internet sales. It is true that some of the Court's more recent decisions construing Congress's affirmative power under the Commerce Clause have taken a narrower view of that power than the Court articulated during the New Deal era,<sup>20</sup> when it sustained the broad exercise of congressional power to regulate even local activities that may affect interstate commerce.<sup>21</sup> But these decisions do not seriously inhibit the extensive power that Congress plainly possesses to deal with the problems raised by state taxation of Internet sales for the reasons stated by the Court itself.<sup>22</sup>

### III. POLICY CHOICES FACING CONGRESS

Legislation has been introduced into Congress authorizing the states, under specified conditions, to require collection of sales and use taxes with respect to sales by remote sellers, notwithstanding their lack of physical presence in the state (otherwise constitutionally required under the *Quill* decision), if the states conform to the provisions of the Streamlined Sales and Use Tax Agreement (SSUTA).<sup>23</sup> The fundamental purpose of SSUTA is "to simplify and modernize sales and use tax administration in the member states in order to substantially reduce the burden of tax compliance."<sup>24</sup> The proposed congressional legislation declares that it is the "sense of Congress" that SSUTA – to the extent that it meets congressionally prescribed simplification requirements (which generally track those embodied in SSUTA) –

provides sufficient simplification and uniformity to warrant Federal authorization to Member States that are parties to the Agreement to require remote sellers, subject to the conditions provided in this Act, to collect and remit the sales and use taxes of such Member States and of local taxing jurisdictions of such Member States.<sup>25</sup>

<sup>20</sup> See *United States v. Morrison*, 529 U.S. 598 (2000) (Congress lacks the power under the Commerce Clause to provide a civil remedy for victims of gender-motivated violence because gender-motivated crimes do not substantially affect interstate commerce); *United States v. Lopez*, 514 U.S. 549 (1995) (Congress lacks the power under the Commerce Clause to prohibit possession of firearms in school zones because possession of a gun in a local school zone does not affect interstate commerce).

<sup>21</sup> See, e.g., *Wickard v. Filburn*, 317 U.S. 111 (1942) (sustaining Congress's power to regulate under the Commerce Clause the amount of wheat a farmer grew for his own consumption).

<sup>22</sup> See generally Walter Hellerstein, "Federal Constitutional Limitations on Congressional Power to Legislate Regarding State Taxation of Electronic Commerce," 53 *National Tax Journal* 1307 (2000).

<sup>23</sup> For a detailed description and analysis of SSUTA, see Walter Hellerstein & John A. Swain, *Streamlined Sales and Use Tax* (Warren Gorham & Lamont, Rev. ed. 2005).

<sup>24</sup> SSUTA § 102.

<sup>25</sup> "Streamlined Sales Tax Act Simplification Act," S. 2153, 109th Cong., 1st Sess. § 3 (Dec. 20, 2005); "Sales Tax Fairness and Simplification Act," S. 2152, 109th Cong., 1st Sess. § 3 (Dec. 20, 2005).

The proposed legislation declares that “[t]he Congress consents to the ... Streamlined Sales and Use Tax Agreement.”<sup>26</sup> This explicit consent, coupled with the “sense of Congress” language quoted above reflecting Congress’s intent in granting such consent, removes any Commerce Clause barrier to any member state’s requirement that remote vendors collect sales or use taxes on sales to in-state consumers. If the states satisfy SSUTA’s requirements, Congress would authorize mandatory collection by remote sellers, but with additional conditions and limitations beyond those required by SSUTA. These include, among other things, a “small business exception” (which is defined differently in the two legislative proposals),<sup>27</sup> reasonable seller compensation (including compensation that covers all tax-processing costs of remote sellers), and federal court review of controversies arising under SSUTA.

The fundamental policy questions the proposed legislation raises for Congress may be simply stated (which is *not* the same thing as saying that the question is simple):

Does the legislation provide sufficient simplification and related protections (e.g., vendor compensation) to justify modification of the constitutional rule that a physically remote vendor has no obligation to collect use taxes on taxable items sold to purchasers within a state?

If so, what are the appropriate standards for requiring remote vendors to collect use taxes on items sold to purchasers within a state?

My testimony does not purport to answer these questions<sup>28</sup> or, indeed, even to provide this Subcommittee with the essential facts it will need to answer these questions. Rather the balance of my testimony is designed to assist the Subcommittee in identifying the key criteria upon which it should focus in seeking to answer these questions. In other words, the balance of my testimony is designed to assist the Subcommittee in its effort to determine under what conditions, if any, it would be desirable as a matter of policy to relax or modify the law as it now stands governing use tax collection by out-of-state

<sup>26</sup> “Streamlined Sales Tax Act Simplification Act,” S. 2153, 109th Cong., 1st Sess. § 2 (Dec. 20, 2005); “Sales Tax Fairness and Simplification Act,” S. 2152, 109<sup>th</sup> Cong., 1<sup>st</sup> Sess. § 2 (Dec. 20, 2005).

<sup>27</sup> The “Streamlined Sales Tax Act Simplification Act,” S. 2153, 109th Cong., 1st Sess. § 4(d) (Dec. 20, 2005), leaves the definition of a “small business” to be determined by the Small Business Administration, subject to congressional review. The “Sales Tax Fairness and Simplification Act,” S. 2152, 109<sup>th</sup> Cong., 1<sup>st</sup> Sess. § 4(d) (Dec. 20, 2005), defines a small business as a “seller and its affiliates” that “collectively had gross remote taxable sales nationwide” of less than \$5 million in the year preceding the date of the sale or a “seller and its affiliates” that met the \$5 million threshold but where “the seller had less than \$100,000 in gross taxable sales nationwide.” Except for the differing “small business” exceptions, the two legislative proposals are identical.

<sup>28</sup> My views, however, along with those of Charles E. McLure, Jr., on the merits of an earlier (but substantially similar version) of this legislation are contained in Charles E. McLure, Jr. & Walter Hellerstein, “Congressional Intervention in State Taxation: A Normative Analysis of Three Proposals,” *State Tax Notes*, March 1, 2004, p. 721 (also in *Tax Notes*, March 15, 2004, p. 1350).

vendors, and, if such relaxation or modification is appropriate, what criteria should govern the determination whether a remote vendor has a duty to collect use taxes.

**A. Key Policy Choice *Not* Facing Congress: Whether Internet Sales of Tangible Personal Property Consummated Over the Internet Should Be Taxed**

Let me begin with a one policy choice that, in my judgment at least, plainly is *not* facing Congress or this Subcommittee, namely, whether tangible personal property purchased over the Internet should be taxed. In my view, that is a policy choice that is appropriately made by the individual states, and, as indicated in Part I of my testimony, 45 of the 50 states (and the District of Columbia) have already made that choice. The only question before Congress is whether the states in seeking to collect the taxes that indisputably are owed on property used within their borders can require out-of-state vendors to collect the tax, just as states require in-state vendors to collect the tax.

**B. Criteria Bearing on Determination Whether and, If So, How to Modify Existing Law Governing Vendor Collection of Use Tax on Remote Sales**

As noted above, the fundamental policy questions facing Congress (and this Subcommittee) are (1) whether the proposed legislation provides sufficient simplification and related protections (e.g., vendor compensation) to justify modification of the constitutional rule that a physically remote vendor has no obligation to collect use taxes on taxable items sold to purchasers within a state; and if so, (2) what are the appropriate standards for requiring remote vendors to collect use taxes on items sold to purchasers within a state? Although there are no easy answers to these questions, I would urge the Subcommittee to focus on the following criteria in attempting to arrive at answers:

- Costs of collecting sales and use taxes under the proposed regime
- Additional revenues collected under proposed regime
- Relationship between nationwide gross sales and nationwide costs of collection
- Relationship between gross sales nationwide and costs of collection in a particular state
- Relationship between physical presence in a state and costs of collection in a state
- Relationship between costs of collection and separate legal identity of an entity that controls, is controlled by, or is under common control of a seller

I am aware that each of these criteria requires a factual determination for which there may be no hard data, at least for the moment. Nevertheless, it seems to me that one cannot make an informed judgment about the wisdom of changing the existing rules without having some practical sense of the costs and benefits of doing so. I doubt anyone would favor changing a rule that imposed \$1 of increased compliance costs for every penny of revenue raised from taxes that everyone agrees are legally due (i.e., a use tax on in-state consumption). By the same token, I doubt anyone would resist changing a rule that permitted collection of \$1 of revenue for every penny of increased compliance costs,



at least if those who bore the increased costs were reimbursed for them.

It may well be, of course, that even the existing rules make no sense from a policy perspective. For example, it may well be that a rule dependant entirely on physical presence could ensnare a small Mom and Pop operation in the use tax collection regime of a state into which it happens to send a single salesperson, whereas a multimillion dollar retailer with sophisticated tax collection and remittance personnel and software, but with no physical presence in the state, would have no use tax collection duty. Whether this makes sense depends on the facts that will no doubt be presented to this Subcommittee. My point is simply that without such facts it is virtually impossible to make an informed judgment about whether the existing rules are appropriate and, if not, how they should be changed to reflect economic reality and fairness to remote vendors and states alike.

### C. Sourcing Issues

Before completing my testimony, I would like briefly to address one particular area of concern, the so-called “sourcing” provisions of SSUTA. SSUTA identifies the provision of “[u]niform sourcing rules for all taxable transactions”<sup>29</sup> as one of the essential features of the streamlined system designed to “simplify and modernize sales and use tax administration.”<sup>30</sup> In implementing this requirement, SSUTA adopts a set of “general” sourcing rules for most transactions.<sup>31</sup> These rules broadly embrace the destination principle, and they apply in a hierarchical sequence depending on the circumstances surrounding the particular transaction (e.g., where the product is received) and the availability of information regarding the destination or the constructive destination of the sale (e.g., the purchaser’s address). These general provisions apply in principle “regardless of the characterization of a product as tangible personal property, a digital good, or a service.”<sup>32</sup>

SSUTA provides a hierarchical or prioritized series of five general sourcing rules for the sale of all products except those specifically sourced under other provisions or excluded from SSUTA’s scope altogether.

1. When a purchaser receives a product in an over-the-counter transaction at the seller’s business location, the sale is sourced to that business location.
2. When (1) does not apply, the sale is sourced to the location where the

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<sup>29</sup> SSUTA § 102(F).

<sup>30</sup> SSUTA § 102.

<sup>31</sup> SSUTA §§ 310(A), 311.

<sup>32</sup> SSUTA § 309(A).

- purchaser receives the product – typically, the purchaser’s “ship to” or delivery address – if the seller knows the location.
3. When (1) and (2) do not apply, the sale is sourced to the purchaser’s address if it is available from the seller’s business records.
  4. When (1), (2), and (3) do not apply, the sale is sourced to the purchaser’s address obtained during the consummation of the sale (including the address of the purchaser’s payment instrument).
  5. When none of the foregoing rules applies, the source of the sale is its origin (i.e., the point from which property was shipped, from which digital products were transmitted, or from which services were provided).<sup>33</sup>

These rules are designed to implement the underlying principle that a sale should be sourced on a destination basis.<sup>34</sup> In so doing, they take into account the information about the destination that a seller could reasonably be expected to possess at the time of the sale. In the case of an over-the-counter sale or a sale with a geographically determinate “ship to” or delivery address, the sourcing rules follow the physical flow of the product. When physical product flows cannot be determined, the sourcing rules rely on the purchaser’s address when the seller is in a position to know that address. Finally, recognizing that there may well be situations in which one cannot reasonably determine the destination of a sale on the basis of available information regarding physical flows or the seller’s address, SSUTA adopts an origin-based sourcing principle as a default rule.

Although there is an acute need for uniform sourcing rules if sales and use taxes are to be simplified, and the SSUTA sourcing provisions address that need, they do create a problem for certain intrastate “cross-border” transactions. In other words, the sourcing issue arises not only in the interstate context but also in the intrastate context in determining the appropriate local rate to apply when transactions, though occurring wholly within a state, have a connection with more than one locality. For example, if a pizza is prepared at a pizza parlor in one county but delivered to a customer in another, a uniform destination sourcing rule that applied on a state-wide basis would require the local pizza parlor to collect tax at the rate in force in the county of delivery. Needless to say, the imposition of a destination sourcing rule on a wide variety of local businesses that are accustomed to collecting taxes at the rate of their local county could create additional administrative costs for such businesses. Moreover, the shift from an origin-based tax to a destination-based tax could also have revenue implications for the counties concerned.

My purpose here is only to describe the issue for the benefit of the Subcommittee and not to address the difficult political issues that are raised by attempting to reconcile

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<sup>33</sup> SSUTA § 310(A).

<sup>34</sup> See generally Streamlined Sales Tax Project, Sourcing Issue Paper 6 (Jan. 2002), available at [www.streamlinedsalestax.org](http://www.streamlinedsalestax.org).

the demands of a streamlined interstate sales tax and the concerns of local taxpayers and their political subdivisions.

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Once again, I thank the Chairman for inviting me to testify before this Subcommittee, and I will be happy to respond to any questions or to provide any other assistance that the Chairman or other Members of the Subcommittee may find helpful.