Written Submission of

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Hearing on

Marketplace Fairness:
Leveling the Playing Field for Small Businesses

Before the Committee on Commerce, Science, and Transportation
U.S. Senate

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TAX FOUNDATION Since 1937

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The Proper Role of Congress in State Taxation: Ensuring the Interstate Reach of State Taxes Does Not Harm the National Economy

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Mr. Chairman, Mr. Ranking Member, and members of the Committee:

I appreciate the opportunity to submit this statement on Congress's role in the debate over state sales taxation of online purchases. In the 75 years since our founding in 1937, the Tax Foundation has monitored tax policy trends at the federal and state levels, and our data and research is heavily relied upon by policymakers, the media, and the general public. Our analysis is guided by the idea that taxes should be as simple, neutral, transparent, and stable as possible, and as a 501(c)(3) non-profit, non-partisan organization, we take no position on any pending legislation.

We hope that the material we provide will be helpful in the Committee's consideration of the issue.

Executive Summary

- After the bitter experience of the Articles of Confederation, the Constitution empowered Congress with the responsibility to rein in state tax overreaching when it threatened to do harm to the national economy.
- Consequently, states were not permitted to tax items in interstate commerce at all, from the Founding until approximately the 1950s.
- Since then, as formally adopted by the U.S. Supreme Court in the *Complete Auto* decision (1977), states may tax interstate commerce so long as the tax is non-discriminatory, fairly apportioned, related to services, and applies only to businesses with substantial presence (nexus).
- In a series of decisions, most recently the *Quill* decision of 1992, the U.S. Supreme Court explained that "substantial nexus" for sales/use tax purposes means physical presence of property or employees. The Court ruled that it exceeds to state powers for them to be able to demand use tax collection from companies that are not physically present in the state.

- States have sought to overrule the *Quill* decision, either legislatively ("Streamlined") or through defiance ("Amazon" tax statutes). The defiance approach in particular has caused significant disruption and uncertainty to the economy.
- Every state with a sales tax also imposes a use tax, levied on taxable items upon which no sales tax has been paid. In other words, use taxes seek to thwart competitive pressure from other states with lower tax rates. Taxpayer compliance with these protectionist use taxes is minimal. (Use tax, with a few exceptions, is imposed on the *consumer* and not the *seller*.)
- Congress has passed a number of statutes limiting the scope of state tax authority on interstate activities ("preemption"), carefully balancing (1) the ability of states to set tax policies in line with their interests and that allow interstate competition for citizens over baskets of taxes and services and (2) limiting state tax power to export tax burdens to non-residents or out-of-state companies, or policies that would excessively harm the free-flow of commerce in the national economy.
- When a resident of a state purchases from a brick-and-mortar retailer, they generally must pay sales tax. When the same resident in the same state purchases the same product from an online retailer, they often do not pay sales tax.
- Many large Internet retailers are expanding the number of states in which they have physical presence, to enable next-day delivery, but that is not the case for many smaller sellers that remain in just one location and use common carriers to deliver purchases.
- There are approximately 9,600 jurisdictions in the United States that collect sales tax, a number that grows by several hundred each year. Subscription tax software is inadequate and can be expensive for occasional sellers, and few states provide adequate tax lookup or consolidated tax filing options. Sales tax can vary by product, by time, and by location in the state. In 7 states, local governments can have a different sales tax base from the state tax base.
- Congress has five basic options on how it may proceed:
    - *Reaffirm the physical presence rule* for sales taxation, and by implication, the disparity of treatment between brick-and-mortar sales and Internet sales.
    - *Reaffirm the physical presence rule* but adopt a new tax approach that mitigates the disparity of treatment between brick-and-mortar sales and Internet sales (such as an origin-based system or a national sales tax on online purchases).
    - *Modify the physical presence rule* in the limited context of state collection of use tax from out-of-state sellers, by those states that have adopted simplified sales tax systems under minimal federal standards, to reduce the harm to interstate commerce. This trade-off would replace the check on state power provided at present by the physical presence rule.
    - *Repeal the physical presence rule* without conditions on the states, granting states unchecked authority to export tax burdens and damage interstate commerce.
    - *Do nothing* and risk the continued growth of unchecked and fragmented state authority to export tax burdens and damage interstate commerce.

The Constitution Empowers Congress to Limit State Tax Power When It Seeks to Shift Tax Burdens to Non-Residents or Do Harm the National Economy

What you have before you is not a new issue. Absent congressional or judicial checks, states have an incentive to shift tax burdens from physically present individuals and businesses, to those who are beyond their borders. Indeed, it was the states' unchecked behavior in this regard that led to the Constitutional Convention in the first place. Under the Articles of Confederation, states with ports taxed commerce bound for interior states, tariff wars proliferated, and the national economy was imperiled. As Justice Johnson described in 1824, these actions were "destructive to the harmony of the states, and fatal to their commercial interests abroad. This was the immediate cause that led to the forming of a convention."[1]

And so the Constitution was adopted, and through that document, the Congress was granted the power to restrain states from enacting laws that harm the national economy by discriminating against interstate commerce.[2] James Madison noted that these powers would check the "clamors of impatient avidity for immediate and immoderate gain" that drive state legislation discriminating against non-residents.[3] Justice Story later praised the "wisdom and policy in restraining the states themselves from the exercise of [taxation] injuriously to the interests of each other."[4]

So strong was this concern that the rule for a century and a half was that states could not tax interstate commerce at all.[5] This eroded in the 1950s and 1960s as it was recognized that those engaged in interstate commerce do enjoy benefits in states where they are present, so it is not unfair to have them support those services with taxes. The complete ban on state taxation of interstate commerce was abandoned in 1977, replaced by a recognition that resident businesses engaged in interstate commerce should pay for the fair share of the state services they consume. In *Complete Auto Transit, Inc. v. Brady*, the U.S. Supreme Court held that states may tax interstate commerce if the tax meets a four part test:[6]

- **nexus**, *a sufficient connection between the state and the taxpayer;*
- **fair apportionment**, *the state cannot tax beyond its fair share of the taxpayer's income;*
- **nondiscrimination**, *the state must not burden out-of-state taxpayers while exempting in-state taxpayers;*
- **fairly related**, *the tax must be fairly related to services provided to the taxpayer.*

Before and since *Complete Auto*, the courts have routinely exercised this power to restrain state tax

[1] *See, e.g.*, *Gibbons v. Ogden*, 22 U.S. (9 Wheat.) 1, 224 (1824) (Johnson, J., concurring).
[2] *See* U.S. CONST. art. I, § 8, cl. 3 (Interstate Commerce Clause); U.S. CONST. art. I, § 10, cl. 2 (Import-Export Clause); U.S. CONST. art. I, § 10, cl. 3 (Tonnage Clause); U.S. CONST. art. IV, § 2, cl. 1 (Privileges and Immunities Clause); U.S. CONST., amend. XIV, § 1 (Privileges or Immunities Clause).
[3] James Madison, THE FEDERALIST NO. 42 (1788).
[4] 1 STORY CONST § 497.
[5] *See, e.g.*, *Freeman v. Hewit*, 329 U.S. 249, 252-53 (1946) ("A State is ... precluded from taking any action which may fairly be deemed to have the effect of impeding the free flow of trade between States"); *Leloup v. Port of Mobile*, 127 U.S. 640, 648 (1888) ("No State has the right to lay a tax on interstate commerce in any form.").
[6] 430 U.S. 274 (1977).

infringements on interstate commerce, and these decisions are one of the more non-controversial aspects of constitutional law. Congress has also been active in this area, legislating limits on state tax power where states are incapable of achieving a simplified, uniform system that restrain each state from claiming more than its fair share of taxes on interstate commerce. These have included prohibiting state taxes on food stamps, Federal Reserve banks, interstate airline and bus travel, satellite services, and nonresident members of the military and nonresident members of Congress. Congress has also banned discriminatory state taxes on federal employees, interstate electricity transmission, and interstate railroads.

Nexus Based on Physical Presence

Generally, the historical standard is that states may tax those physically present in the jurisdiction, and may not tax those not physically present. This is premised on a view known as the "benefit principle": that the taxes you pay should roughly approximate the services you consume. State spending overwhelmingly, if not completely, is meant to benefit the people who live and work in the jurisdiction. Education, health care, roads, police protection, broadband access, etc.: the primary beneficiaries are state residents. The "benefit principle" thus means that residents should be paying taxes where they work and live, and jurisdictions should not tax those who don't work and live there.

A physical presence standard for state taxation is in line with this fundamental view of taxation. Developments have arisen in the three major state tax areas (corporate income tax, individual income tax and sales tax), as well as with some other state taxes (such as telecommunications taxes, taxes on digital goods, car rental taxes, and so forth). Bills have been introduced in the Congress that seek to reaffirm the physical presence rule in these areas (such as BATSA with corporate income tax, Mobile Workforce with individual income tax).

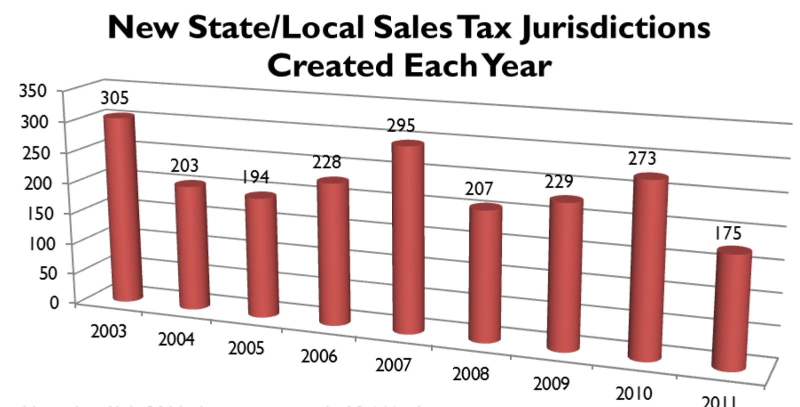
Recent Developments in State Sales Tax: Overview

There are a number of proposals to reverse a series of U.S. Supreme Court decisions (most recently the *Quill* decision of 1992) that prohibit states from imposing sales tax collection obligations on businesses with no property or employee in the state. This "physical presence" standard is meant to prevent states from shifting tax burdens to non-residents away from residents who are the primary beneficiary of state services, while also protecting the free flow of interstate commerce from the compliance costs of non-uniform and numerous (9,600+) sales tax jurisdictions in the United States (see Figure 1, Figure 2, and Table 2).

The steadily increasing growth of Internet-based commerce has however led to frustration with this standard, primarily due to disparate sales tax treatment of similar goods within states that has no economic basis. This can be addressed while also ensuring that some standard exists to restrain states from engaging in destructive behavior, such as tax exporting to non-voters or imposing heavy compliance costs on interstate businesses, that the Congress is empowered to prevent. Further, because economic integration is greater now than it has ever been before, the economic costs of nexus uncertainty are also greater today and can ripple through the economy much more quickly.
These actions are only the latest chapter in a long saga over the proper tax treatment of sales made

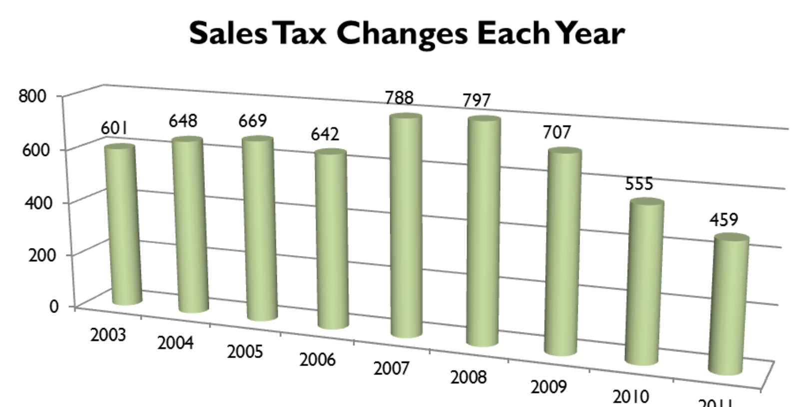
over the Internet, and an even longer saga over the proper scope of state taxing authority. At its core is a dispute over which is more important: limiting state power to tax nonresidents and thus harm the national economy, or ensuring that some transactions do not escape tax because they are conducted online. Discussions following a recent compromise in California, driven by the desire of large Internet retailers to expand their physical presence to enable next-day delivery, suggest that there are policy options that could achieve both ends.

Figure 1: New State/Local Sales Tax Jurisdictions Created Each Year



Note: As of July 2011, there were a total of 9,646 sales tax jurisdictions in the United States.
Source: Vertex.

Figure 2: Sales Tax Jurisdictions with Changes Each Year



Note: All changes by jurisdiction, including new jurisdictions.
Source: Vertex.

Table 2: Other Examples of Contributors to Sales Tax Complexity

States With Local Option Sales Taxes: **37**
States That Permit Local Government to Define A Separate Sales Tax Base: **7**
States With Sales Tax Holidays: **17**

The *Quill* Decision: Not a Loophole, But a Check on State Power to Export Tax Burdens and Do Harm Interstate Commerce

What is nexus for a remote seller? In 1967, the U.S. Supreme Court held that a business does not have nexus with a state if the business has no retail outlets, solicitors, or property in the state, and communicates with customers only by mail or common carrier as part of a general interstate business.[7] Otherwise, the Court concluded, states could "entangle National's interstate business in a virtual welter of complicated obligations to local jurisdictions with no legitimate claim to impose a fair share of the cost of the local government." This decision was reaffirmed after the *Complete Auto* test was announced in 1977.[8]

During the 1980s, some academics and many states criticized *National Bellas Hess* as archaic, formalistic, and outmoded. Officials were encouraged to ignore the decision, and some state courts disregarded it, even as the number of sales taxes rose from 2,300 to 6,000. Different murky definitions of economic nexus have been proposed:

- Engaged in exploiting the local market on a regular, systematic, large-scale basis.
- Presence of intangible property or affiliates
- Number of customers in state, value of assets or deposits in the state, and receipts attributable to sources in the state
- Analysis of frequency, quantity, and systematic nature of economic contacts with the state
- Derivation of economic benefits from state's residents

Defying the Court rulings, North Dakota enacted a law requiring the out-of-state Quill Corp. to collect sales tax on its sales to 3,000 in-state customers. Any state that advertised three times in the state was liable. In the case, the U.S. Supreme Court reaffirmed *National Bellas Hess* and *Complete Auto*.[9] There they stated that the physical presence rule "firmly establishes the boundaries of legitimate state authority to impose a duty to collect sales and use taxes and reduces litigation concerning those taxes."

The Streamlined Sales Tax Project Has Watered Down Membership Standards in an Unsuccessful Effort to Entice More State Members in Its Effort to Change *Quill*

Today, there are over 9,600 state and local sales tax jurisdictions in the United States. There are different rates on different items, they change frequently, and are not even aligned to 9-digit zip codes. States are reluctant to cooperate on even basic rules and definitions.

The Streamlined Sales Tax Project (SSTP) was launched in 2000 with the mission of getting states to adopt changes to their sales taxes to make them simple and uniform. SSTP then hopes to convince Congress or the courts to overrule *Quill* and allow use tax collection obligations on out-of-state companies ("Main Street Fairness Act").

[7] *See National Bellas Hess, Inc. v. Dept. of Revenue of Ill.*, 386 U.S. 753, 759-60 (1967).

[8] *See Nat'l Geographic Society v. Ca. Bd. Of Equalization*, 430 U.S. 551, 559 (1977).

[9] *See Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

However, the SSTP has abandoned simplification efforts and any attempt to reduce the number of sales tax jurisdictions, instead focusing on uniformity efforts. In many cases, the Project has enabled state sales tax complexity by permitting separate tax rates for certain goods. States generally are reluctant to yield parochial advantages, even with the possibility of online sales tax revenue in return, undermining their argument to Congress as part of the Main Street Fairness Act that they have succeeded in their mission. Large states have generally avoided the SSTP, and membership has been stuck at ~20 states for some time. This in turn has led to impatience from states and others.

Some States Have Sought to Defy *Quill* through Unconstitutional Legislation

In 2008, New York adopted an "Amazon" tax, nicknamed after the Internet retailer as the most visible target. The law held that a person or business with no physical presence in the state nevertheless has nexus if it (1) enters into agreement with in-state resident involving commissions for referring potential customers; and (2) has gross receipts from sales by out-of-state company from referrals within the state are more than $10,000 in a 12-month period.

Amazon.com & Overstock.com responded by terminating affiliate programs in New York, and Amazon.com filed a lawsuit in state court. The law was upheld by a trial judge (New York's trial courts are called the "New York Supreme Court," causing confusion about who upheld the Amazon tax as constitutional); the judge concluded that Amazon.com's in-state affiliates are necessary and significant to establishing and maintaining out-of-state company's market in the state. But because they make up only 1.5% of sales, that was the basis for the appeal. The New York Supreme Court, Appellate Division ruled in late 2010 that law is not facially unconstitutional but may be unconstitutional for Amazon. The case was remanded to the lower court, but Amazon is appealing to state's highest court, the New York Court of Appeals. The case is ongoing.

In 2009, Rhode Island and North Carolina adopted identical New York-style laws. Neither has seen any revenue and Rhode Island has actually seen revenue loss due to reduced income tax collections from terminated in-state affiliates. Laws were also passed in California and Hawaii but vetoed. (See Table 3 for a status of all state efforts to defy *Quill* legislatively.)

Table 3: Status of State Efforts to Defy *Quill* Legislatively

Arkansas	Enacted mid-2011.
California	Enacted mid-2011 but effective date postponed after agreement reached with state.
Colorado	Enacted 2010. Ruled unconstitutional.
Connecticut	Enacted mid-2011.
Illinois	Enacted 2011. Ruled unconstitutional.
New York	Enacted 2008. In litigation.
North Carolina	Enacted 2009. Ruled unconstitutional.
Rhode Island	Enacted 2009. Officials report that the law has reduced state tax collections. May be repealed.

Source: Tax Foundation compilation. Does not include states where legislation was proposed but not adopted.

In 2010, Colorado considered the same law but faced opposition from in-state affiliates. Instead it adopted a law (H.B. 10-1193) designed to push Amazon into collecting use taxes without explicitly requiring it. In January 2010, a federal judge stayed the law stayed as probably unconstitutional on First Amendment grounds, and the law was thrown out completely in April 2012.[10] A similar law in North Carolina was also struck down as violating the First Amendment in October 2010.

In 2011, Illinois and Arkansas enacted New York-style laws (the Illinois law was subsequently ruled unconstitutional). California enacted one but after a possible repeal referendum was proposed, the state and Amazon.com reached an agreement whereby Amazon.com will develop a physical presence in the state (*i.e.*, build warehouses).

While for the most part unsuccessful, these state efforts have highlighted the desire to modify the *Quill* holding in some way. This pressure is likely to continue.

Possible Solutions

Substantial progress has been made in recent months toward possible solutions that could (1) simplify sales tax systems and avoid discriminatory compliance costs, (2) eliminate non-neutral tax rates on similar products sold by online and brick-and-mortar businesses, (3) limit taxation in a state to those residents who enjoy the benefits of state services, (4) prevent multiple taxation of interstate commerce, and (5) prevent unconstitutional and fragmented state attempts to impose such tax burdens in a destructive manner.

Congress has five basic options on how it may proceed:

- *Reaffirm the physical presence rule* for sales taxation, and by implication, the disparity of treatment between brick-and-mortar sales and Internet sales.
- *Reaffirm the physical presence rule* but adopt a new tax approach that mitigates the disparity of treatment between brick-and-mortar sales and Internet sales (such as an origin-based system or a national sales tax on online purchases).
- *Modify the physical presence rule* in the limited context of state collection of use tax from out-of-state sellers, by those states that have adopted simplified sales tax systems under minimal federal standards, to reduce the harm to interstate commerce. This trade-off would replace the check on state power provided at present by the physical presence rule.
- *Repeal the physical presence rule* without conditions on the states, granting states unchecked authority to export tax burdens and damage interstate commerce.
- *Do nothing* and risk the continued growth of unchecked and fragmented state authority to export tax burdens and damage interstate commerce.

The third option is the basis for several pending pieces of legislation; this would allow the states to collect use tax from remote sellers on condition that they simplify their sales tax systems in

[10] *See* Mark Robyn, "Colorado Amazon Regulations Ruled Unconstitutional," (Apr. 4, 2012), http://www.taxfoundation.org/blog/show/28111.html

accordance with minimum federal specifications. The Marketplace Equity Act (H.R. 3179) and Marketplace Fairness Act (S. 1832) are two recent proposals that would eliminate the physical presence rule but otherwise make advances towards ensuring that states reduce the burdens associated with collecting their sales taxes. Example provisions include requirements that states have a single state-level agency that administer all sales tax rules, offer one tax return and audit for the entire state, require one uniform tax base for the entire state, provide software that identifies the applicable tax rate for a sale, including local rates and hold sellers harmless for any software errors or mistakes by the state, provide 30 days' notice of any local sales tax rate change, and exempt sellers with a *de minimis* level of collections. (See Table 4 for a comparison.) Effective simplification is a necessity for any federal proposal.

Table 4: Provisions of Current Pending Federal Legislation

Before Collecting Remote Use Tax, State Must…	Marketplace Equity Act	Marketplace Fairness Act	Main Street Fairness Act
Designate one state entity to collect, process, and audit returns for all tax jurisdictions in the state.	✓	✓	✓
Establish unified audit of remote sellers for all taxing jurisdictions in the state.	✗	✓	✗
Establish a single tax return for all taxing jurisdictions in the state.	✓	✓	✓
Provide or certify tax collection and remittance software. (**Note**: Not necessarily free software)	✓	✓	✓
Hold remote sellers harmless for errors in state-provided software.	✓	✓	✓
Adopt standardized definitions of commonly taxed goods.	✗	✗	✓
Offer immunity to remote sellers who misapply sales tax holidays.	✗	✗	✗
Compensate vendors.	✗	✗	✓
Offer a single statewide blended rate as an option.	✓	✗	✗
Require local jurisdictions to use the state's sales tax base.	✓	✓	✓
Require local jurisdictions to align geographically with 5-digit zip codes	✗	✗	✗
Legislation explicitly preempts other state efforts to force use tax collection by tax out-of-state sellers.	✗	✗	✗
"Small seller exception"	$1m in U.S., $100k in state	$500k in U.S.	To be set
Legislation establishes federal court jurisdiction for enforcing simplification standards.	✗	✗	✓

Source: Tax Foundation review of legislation. Main Street Fairness Act review includes only provisions incorporated in federal law, not those merely adopted by its Governing Board.

All these simplifications are desirable, and together would provide a sufficient check on state tax overreaching while leaving ample space for states to structure their tax systems and rates in line with their own preferences. The only infringement on state sovereignty is an infringement on state power to burden interstate commerce with problematic tax policy.

Congress has passed a number of statutes limiting the scope of state tax authority on interstate activities, carefully balancing (1) the ability of states to set tax policies in line with their interests and that allow interstate competition for citizens over baskets of taxes and services and (2) limiting state tax power to export tax burdens to non-residents or out-of-state companies, or policies that would excessively harm the free-flow of commerce in the national economy. A package specifying a floor of all the simplifications listed in Table 5 would be welcome and would greatly reduce constraints on economic growth.

Conclusion

Businesses throughout our nation's history have plied their trade across state lines. Today, with new technologies, even the smallest businesses can sell their products and services in all fifty states through the Internet and through the mail. We at the Tax Foundation track the numerous rates, bases, and exemptions that litter our state sales tax codes. Frequent and ambiguous alterations of tax codes and the confusion they cause are a key source of the growing tax compliance burden. We have several staffers as well as computer-based and publication subscriptions dedicated to being up to date and accurate on the frequent changes, but even we have trouble doing it. It would be extremely difficult for those in business to do business, not conduct tax policy research.

We now live in a world of iPods, telecommuting, and Amazon.com. It is a testament to the Framers that their warnings about states' incentives to hinder the national economy remain true today. Some may argue that faster roads and powerful computers mean that states should now be able to tax everything everywhere. While some constitutional principles surely must be revisited to be applied to new circumstances, the idea that parochial state interests should not be permitted to burden interstate commerce remains a timeless principle regardless of how sophisticated technology may become.