Assessing Federal Action on State Efforts to Collect Sales and Use Taxes on Internet Commerce

By Joseph Henchman
Vice President, Legal & State Projects, Tax Foundation

Hearing on Constitutional Limitations on States’ Authority to Collect Sales Taxes in E-Commerce
Before the Committee on the Judiciary,
U.S. House of Representatives

November 30, 2011

Mr. Chairman and members of the Committee:

You have before you a number of bills that seek 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.

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.

As a 501(c)(3) organization, the Tax Foundation takes no position on any pending legislation. However, 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.

We hope that the material we provide will be helpful in the Committee’s consideration of this issue.
Recent Developments in Sales Tax on Remote Sellers

In 2010 and 2011, state legislatures across the United States debated the merits of new measures to collect sales and use tax from online merchants. Pushed by in-state retailers and citing fairness concerns and the desire to send a message to Congress, in many states these efforts were able to overcome the fact that these laws do not result in increased revenue and lead to lengthy litigation due to their dubious constitutionality.

So far, Arkansas and Illinois have enacted new so-called “Amazon” tax affiliate nexus statutes, joining New York, North Carolina, and Rhode Island. Colorado and a few other states considered similar laws that focus on mandatory disclosure of tax obligations to consumers, rather than direct collection as in the other states. Debate continues in many other states.

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 suggest that there are policy options that could achieve both ends.

The Constitution Empowers Congress to Limit States’ Power to Shift Tax Burdens to Non-Residents

The U.S. Constitution exists in large part because states were disrupting the national economy by using trade barriers and discriminatory taxes against each other. Absent some constraints, states have an incentive to shift tax burdens from physically present individuals and businesses to those who are beyond their borders.

Justice Johnson, concurring in Gibbons v. Ogden (1824), wrote that “states’ power over commerce[,] guided by inexperience and jealousy, began to show itself in iniquitous laws and impolitic measures . . ., 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.” Gouverneur Morris argued at the Constitutional Convention that “local concerns ought not to impede the general interest. There is great weight in the argument, that the exporting States will tax the produce of their uncommercial neighbors.”

Congress thus has the power to restrain states from interfering with interstate commerce, particularly with their taxing power. As Justice Story explained, “[T]here is wisdom and policy in restraining the states themselves from the exercise of [taxation] injuriously to the interests of each other. A petty warfare of regulation is thus prevented, which would rouse resentments, and create dissensions, to the ruin of the harmony and amity of the states.” More recently, Professor Daniel Shaviro has noted
that “[p]ercieved tax exportation is a valuable political tool for state legislators, permitting them to claim that they provide government services for free.”

The Commerce Clause prohibits states from imposing a tax on activity out-of-state while leaving identical activity in-state untaxed, a relatively uncontroversial element of the Commerce Clause distinct from the more controversial aspect of the Commerce Clause involving the scope of Congress’s power to regulate private activity. The Import-Export Clause prohibits states from penalizing activity that crosses state lines, particularly imports. The Tonnage Clause prohibits state charges on shipping freight. The Privileges and Immunities Clause of Article IV and the Privileges or Immunities Clause of the Fourteenth Amendment protects the right of citizens to cross state lines in pursuit of an honest living.

State Taxation of Interstate Commerce: From Complete Ban to Complete Auto

So strong was the concern over state misuse of their power, that the rule for a century and a half was that states could not tax interstate commerce at all. See, e.g., Freeman v. Hewitt, 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.”).

This eroded in the 1950s and 1960s as it was recognized that interstate commerce do enjoy benefits in states where they were present, so it is not unfair to have them support those services with taxes. Pushed along by a series of cases treating essentially identical taxes differently based on “magic words” in the statute. For example, an annual license tax imposed on the in-state gross receipts of an out-of-state company was invalidated as discriminating against interstate commerce, but an otherwise identical franchise tax on in-state going concern value, measured by gross receipts, was upheld as valid. Compare Ry. Express Agency v. Virginia, 347 U.S. 359 (1954) (“Railway Express I”) and Ry. Express Agency v. Virginia, 358 U.S. 434 (1959) (“Railway Express II”).

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. See Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977) (holding that states may tax interstate commerce if the tax meets a four part test:

- **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.
Nexus Based on Physical Presence vs. Other Proposals

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. See National Bellas Hess, Inc. v. Dept. of Revenue of Ill., 386 U.S. 753, 759-60 (1967). 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. See Nat’l Geographic Society v. Ca. Bd. Of Equalization, 430 U.S. 551, 559 (1977).

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 were proposed:

- “Out-of-state company is 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 taxpayer’s 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. See Quill Corp. v. North Dakota, 504 U.S. 298 (1992), stating 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.” Justice Byron White dissenting, arguing two points: (1) injustice that some sales escape taxation and (2) arguing that technological change had made discriminatory compliance costs no longer burdensome.

Efforts 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").

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-something states for some time.

This in turn has led to impatience from states and others.

**Efforts to Defy Quill**

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. Remanded to lower court, but Amazon 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.

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. Any out-of-state retailer that is part of “a controlled group of corporations” with at least one member with physical presence in Colorado, all the retailers in the group have nexus with Colorado. However, the “only” obligation with this nexus is notification:
• “[N]otify Colorado purchasers that sales or use tax is due on certain purchases made from the retailer and that the State of Colorado requires the purchaser to file a sales or use tax return.” Penalty of $5 per failure per customer, plus criminal penalties
• “[N]otify] all Colorado purchasers by January 31 of each year showing such information as the Colorado Department of Revenue shall require by rule and the total amount paid by the purchaser for Colorado purchases made from the retailer in the previous calendar year. Such notification shall include, if available, the dates of purchases, the amounts of each purchase, and the category of the purchase, including, if known by the retailer, whether the purchase is exempt or not exempt from taxation.” Must be sent separately from other shipments and be by first-class mail. CC to State. Penalty of $10 per failure per customer, plus criminal penalties.

Amazon.com terminated affiliate programs in Colorado, and the Direct Marketing Association filed lawsuit in federal court. In January 2010, a federal judge stayed the law stayed as probably unconstitutional on First Amendment grounds.

North Carolina followed Colorado by adopting regulation with similar/notification requirements. They demanded out-of-state companies provide them with all customer purchase information dating from 2003, by April 19, 2010. Amazon.com and the ACLU filed lawsuit in federal court, arguing that “[e]ach order of a book, movie, CD or other expressive work potentially reveals an intimate fact about an Amazon customer.” Examples of purchases by North Carolina residents:

• *Bipolar Disorder: A Guide for Parents and Families*
• *He Had It Coming: How to Outsmart Your Husband and Win Your Divorce*
• *Living with Alcoholism: Your Guide to Dealing with Alcohol Abuse and Addiction While Getting the Alcoholism Treatment You Need*
• *What to Do When You Can’t Get Pregnant: The Complete Guide to All the Technologies for Couples Facing Fertility Problems*
• *Outing Yourself: How to Come out as Lesbian or Gay to Your Family, Friends, and Coworkers*
• *Lolita* (1962)
• *Brokeback Mountain* (2005)

A federal judge struck down the North Carolina regulation as violating First Amendment in October 2010.

In 2011, Illinois and Arkansas enacted New York-style laws. 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.
Possible Solutions

Florida “iStart” Proposal

This state legislative proposal would require the State of Florida to create software (“Internet Sales Tax Automated Revenue Tracking”) to enable one-stop sales tax calculation and payment. The state would make it available to retailers selling in Florida and under license to other states. The state would also pay compensation to vendors who collect, and the law prohibits disclosure of purchase information. When revenue from the software exceeds $5 billion per year, the state sales tax is automatically reduced by 1 percentage point.

Origin-Based Taxation

This proposal is premised on the idea that the taxes one pays are a rough approximation for the government services consumed (“benefit principle”). State spending overwhelmingly, if not exclusively, is meant to benefit those who live and work in the jurisdiction. Education, health care, roads, police: the primary beneficiaries are in-state residents.

Thus, individuals and businesses should pay taxes where they work and live; jurisdictions should not tax those who don’t work and live there. In practice for sales tax, Amazon.com would collect Washington sales tax on all transactions. Amazon employees use Washington state services. Resident-purchasers of Amazon products pay other taxes to their states.

This solution is in line with brick-and-mortar practice: tax based on where business is, not where customer is from. It levels playing field (as opposed to the Main Street Fairness Act or “Amazon” taxes, where brick-and-mortar comply only with taxes where they are physically present while online companies must comply with thousands).

While some may criticize origin-based taxation as enabling Internet-based businesses to “escape” taxation by locating in states that do not tax sales, individuals do not all congregate in states with no income tax and corporations do not all congregate in states with no corporate income tax. States compete not only over taxes but over state services, transportation, education, weather, and other factors.

National Online Sales Tax

If states are unwilling to simplify their tax systems to prevent complexities from being imposed on those engaged in national online commerce, another option would be to implement a single default national sales tax to be imposed on online transactions, with the revenue distributed among the states. This could be on its own or distinct from other options and would eliminate much the disparity between goods purchased in brick-and-mortar stores and goods purchased online. Ideally, implementation should be revenue-neutral, with the revenue collected used to reduce other taxes.
Marketplace Fairness Act Proposal

The Marketplace Fairness Act, recently introduced, eliminates the physical presence rule but otherwise quite a few advances towards ensuring that states reduce the burdens associated with collecting their sales taxes. Its provisions:

- States that are currently members of the Streamlined Sales Tax Project (SSTP) are permitted to require collection of sales taxes by out-of-state companies.
- States that are not members of the SSTP pact are permitted to require collection of sales taxes by out-of-state companies if they meet the following minimum requirements:
  - A single state-level agency that administers all sales tax rules, collection, and administration, including for local sales taxes in the state
  - A single audit for all state and local sales taxes in the state
  - A single tax return.
  - One uniform sales tax base in the state used by state and local governments.
  - Require "destination-based" tax collection for online sales (that is, collect taxes based on the delivery location, or if that’s not available, the address associated with the payment instrument, or if that’s not available, the seller’s location).
  - 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, or forgive sellers that don’t adjust tax rates for changes made with less advance notice.
- Remote sellers are exempt from collection obligations if they have less than $500,000 per year in sales in the United States. The limit applies to related firms, preventing subdivision to get under the limit.
- States can collect taxes unless their state supreme court or the U.S. Supreme Court finds them out of compliance with the act.
- Explicitly does not address franchise, income, occupation, or other taxes.

The main sponsor is Sen. Mike Enzi (R-WY), and co-sponsors are Sens. Dick Durbin (D-IL), Lamar Alexander (R-TN), Tim Johnson (D-SD), John Boozman (R-AR), Jack Reed (D-RI), Roy Blunt (R-MO), Sheldon Whitehouse (D-RI), Bob Corker (R-TN), and Mark Pryor (D-AR).

Amazon.com has responded favorably to the bill, although other retailers are concerned that the $500,000 threshold is too low. The National Conference of State Legislatures (NCSL) issued a supportive letter instantaneous with the introduction.
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. If such sales can now expose these businesses to tax compliance and liability risks in states where they merely have customers, they will be less likely to expand their reach into those states.

Unless a single nexus standard is established, the conflicting standards will impede the desire and the ability of businesses to expand, which harms the nation’s economic growth potential.

We here at the Tax Foundation track the numerous rates, bases, exemptions, credits, adjustments, phaseouts, exclusions, and deductions that litter our federal and state 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 to the many taxes in our country, but even we have trouble doing it. It would be extremely difficult for retailers who are in business to sell a good or service, not to conduct tax policy research.

Under either physical presence or economic nexus, brick-and-mortar stores need to worry only about the tax system where they are physically present. The same would be the case for online retailers under a physical presence standard. But under an economic nexus standard, out-of-state and online businesses would have to collect and comply with sales taxes based on where their customers are located. This would burden e-commerce more than brick-and-mortar business, and effectively impose an exit toll on outbound commerce. Effective state simplification must be a part of any national solution.

The Internet has seen an increased amount of commerce, but many state officials seem to view it as a golden goose that can be squeezed without adverse effects on economic growth. It must be understood that the availability of many items in electronic commerce could be hindered if states are permitted to simply extend their sales taxes to online commerce without serious simplification that establishes a level playing field for all types of businesses and reduces costs and burdens to interstate commerce.

Congress can obtain evidence from interested stakeholders and take political and economic factors into consideration when developing new rules of taxation. The Supreme Court, by contrast, must develop broad doctrine in a case-by-case fashion, based on the facts of the particular case before them. (Additionally, the Court seems to have an aversion to tax cases.) This is why congressional action, which can be more comprehensive and accountable than judicial action, and can better address issues of transition, retroactivity, and de minimis exemptions, may now be the best vehicle for preventing burdens to interstate commerce by adopting a uniform physical presence standard. It is up to Congress to exercise its power to protect interstate commerce.
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.

---

**About the Tax Foundation**

The Tax Foundation is a non-partisan, non-profit research institution founded in 1937 to educate taxpayers on tax policy. Based in Washington, D.C., our economic and policy analysis is guided by the principles of sound tax policy: simplicity, neutrality, transparency, and stability. We seek to make information about government finance more understandable, such as with our annual calculation of “Tax Freedom Day,” the day of the year when taxpayers have earned enough to pay for the nation’s tax burden and begin earning for themselves.

**About the Center for Legal Reform at the Tax Foundation**

The Tax Foundation’s Center for Legal Reform educates the legal community and the general public about economics and principled tax policy. Our research efforts focus on the scope of taxing authority, the definition of tax, economic incidence, and taxpayer protections.