

“SIMPLIFICATION” IS NOT THE EASY ANSWER

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The United States has long been considered the leader of the free-world and free-market. Over the past decade, the Internet has been a driving force in our prospering economy, despite temporary setbacks. Our country's relative economic strength in technology areas is due, in part, to the political establishment's recognition that the Internet and electronic commerce should be free from legislative and regulatory roadblocks that could impede its evolution.

Congress, in recognizing the Internet's susceptibility to creative tax schemes and the need to protect this new engine of prosperity, adopted the Internet Tax Freedom Act (ITFA) in October of 1998. It imposed a three-year moratorium on multiple, discriminatory and access taxes on the Internet.

The moratorium is set to expire in October, and the debate over its extension is being clouded by a coalition of states that fear an eroded tax base, as more consumers shop online. Some of these states are in the process of enacting model legislation that includes a "simplified and streamlined" sales tax system with the hopes of getting congressional approval to force remote merchants to collect and remit sales taxes on purchases made by their citizens.

In 1992, the Supreme Court ruled in Quill Corp. v. North Dakota that states, without permission from Congress, cannot require out-of-state retailers to collect and remit sales taxes unless the retailer has a substantial physical presence or "nexus" in the state.

This coalition of states, together with traditional brick-and-mortar retailers who oppose the online competition, are lobbying Congress to accept the states' "simplification" plan known as the Streamlined Sales Tax Project. In exchange, the states want permission to reach outside of their taxing jurisdictions, shifting the states' tax collection burden to remote vendors. But the "simplifications" as recommended by the Streamlined Sales Tax Project, which include a minimum of

ten categories addressing, for example, uniform rules, definitions, formats and audit procedures, are anything but simple.

First, the proposed “simplification” scheme contradicts the economic structure that has made our nation a global leader. Contrary to the view of one of our Founding Fathers, Alexander Hamilton, who noted in the Federalist No. 32 that the Constitution did not grant Congress the authority to regulate state tax policies except with regard to exports and imports, it has long been recognized that Congress has the authority, under the Commerce Clause, to regulate state taxation of interstate activities. But the primary evil that the Commerce Clause sought to remedy was attempts by states to export their tax burdens to residents of other states. Because local residents and brick-and-mortar entities benefit from state and local services and infrastructure such as police and fire protection, roads and waste collection, it is appropriate for them, and only them, to bear the tax burdens that finance such services. Based on this premise, out-of state entities should not be forced to take on the states’ responsibility and collect their taxes for them.

If current state tax systems are not adequate for the new economy, or if such systems disadvantage local retailers, states already have it within their power to collect taxes from their citizens for remote online purchases. The failure of the states to collect sales and use taxes from their citizens on such purchases is simply that – the failure of the states. But it should not be the role of Congress to provide a mechanism for states to shift their tax collection burden to out-of-state retailers. Contrarily, Congress’ role should be to ensure the states do not unfairly export this burden, thereby obstructing interstate commerce.

Second, the financial burden on remote businesses to collect and remit states’ sales and use taxes would ultimately result in a de facto tax increase on the consumer. As with any government mandate, especially when dealing with tax schemes, the added costs of doing business is ultimately passed on to consumers by way of increased prices.

There currently are more than 7,500 taxing jurisdictions in this country – all with different, complicated rules and structures. The proposed “simplification” does not go far enough in significantly reducing or simplifying these rules and structures to the point where businesses would not have to endure a considerable financial hardship.

Third, ironically the states’ proposed method of “simplification” could reasonably be considered a violation of state sovereignty. Our country’s historical framework of “no taxation without representation” led to a system of taxation that has traditionally required state legislatures to develop tax policies within their own borders. As a result, states’ tax and regulatory policies employ fiscal incentives such as tax abatements and subsidies in attempting to induce non-resident firms and businesses to locate within their jurisdictions or to keep

resident businesses from moving elsewhere. Congressionally approved collusion between rival states would essentially eliminate such competition, thereby threatening our system of state sovereignty. Such lack of fiscal competition between the states would ultimately have a negative impact on consumers and our nation's businesses. Each state needs to be able to deal with its financial needs as it best sees fit.

Any simplification plan no doubt will come with conditions, such as those suggested in the 106th Congress, that allow only those states signing a compact to collect taxes on Internet commerce. This infringement on state sovereignty does not allow states or localities to give preferences to certain industries or goods or to adapt to their own particular circumstances. Congress should be cautioned against unfettered tampering with state and local fiscal schemes.

Additionally, any "simplification" program or tax collection compact between the states could conceivably require maintenance and oversight by a third party, potentially even the federal government through one of its agencies. The formation of any new bureaucracy overseen by the federal government would further threaten state sovereignty.

Even if one assumes that legislation calling for simplification would be constitutional, this approach has other pitfalls. Through growth of the Internet, expansion of e-commerce results in greater consumer options through interstate and foreign trade. Excessive regulation and taxation that may result from simplification could threaten the United States' superior fiscal position, as it could send more people to overseas vendors, ultimately exacerbating trade imbalances, as consumers in significant numbers learn to exploit currency fluctuations and direct purchase of gray market goods.

Over-regulation of the Internet will be fatal to its continued growth. As evidenced by recent court rulings in France, Germany and Italy banning content from their borders, attempts to regulate the Internet can cause national and international conflict and criticism. Individual attempts by states and countries to place burdensome restrictions on the free flow of trade over the Internet should be avoided in favor of unfettered growth of the many borderless opportunities and advantages that e-commerce provides.

Finally, the implication "simplification" would have on consumer privacy is an open question. Apart from any records that an Internet vendor may keep and use in accordance with the privacy policy that it has adopted, electronic commerce permits an Internet purchaser to maintain a level of anonymity from "big-brother" watching his or her purchasing practices. With few exceptions, the government cannot obtain vendor records without following appropriate search warrant procedures designed to protect the purchaser's fundamental right to privacy. With simplification, however, the audit procedures proffered threaten consumer privacy. The access to personal data that may result through audit

procedures leaves consumers vulnerable to misuses of sensitive information and potentially violates consumers' constitutional rights of privacy and due process. Although some proposals, such as the Internet Tax Moratorium and Equity Act (S. 512), sponsored by Senator Byron Dorgan (D-North Dakota), make passing reference to the need for appropriate protections for consumer privacy, no simplification proposal significantly addresses the issue. Simplification should not be included in any bill unless and until all potential threats to privacy and constitutional rights have been addressed.

One final and significant point is that Congress simply should reaffirm the Supreme Court Quill ruling governing states' collection of sales taxes by adopting a national, uniform nexus standard, as outlined in the New Economy Tax Fairness Act or NET FAIR (S. 664), sponsored by Senator Judd Gregg (R-New Hampshire). NET FAIR establishes a bright-line uniform jurisdictional standard for taxing electronic commerce based on the substantial physical presence or "nexus" test that would secure traditional principles of tax fairness, reinforce rate competition among the states and preserve the states' authority to set their own tax policies on commerce within their jurisdictions.

Congress can, and should, pass legislation that extends the current moratorium on multiple and discriminatory taxation on electronic commerce and make permanent the Internet access moratorium. As language often defines political battles, and in some cases wins them, the term "simplification" is anything but "simple." Congress should not include simplification provisions in the law.

The Center for Individual Freedom is a non-partisan, non-profit organization with the mission to focus attention on individual freedoms and individual rights guaranteed by the U.S. Constitution. As free-market advocates, we oppose over-burdensome state and federal regulations and taxing regimes that will impede the evolution of electronic commerce.