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Reconciling a National Marketplace with State and Local Government Tax Systems: A Path Forward

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Executive Summary

Much discussion has taken place recently, both at Commission meetings and outside them, on the need for state and local governments to collect taxes on transactions in interstate commerce. These issues have been exacerbated by the newly created e-commerce marketplace. However, that is only a small piece of a larger question - whether the U.S. federal government will take active steps to ensure the continued existence of the single national economy envisioned by our founding fathers, in which every business of any size is encouraged to produce by the certainty of free access to every market in the Nation, and every consumer can look to free competition from every producing area in the Nation for protection from economic exploitation, or whether instead the Nation should abandon that concept and allow the states to impose protectionist tax systems that discriminate against interstate commerce.

The Commerce Clause was included in the U.S. Constitution because of the pervasive state-imposed trade barriers that had arisen without it. Even today the States' record, especially in the tax arena, shows that all too often states will discriminate against interstate commerce however they can get away with doing so. Despite repeated direction from the U.S. Supreme Court and recommendations from Congress, the states have proved themselves incapable of restraining their desire for short-term protectionist behavior, even though to do so would ensure the longer term benefits of a free and open national economy. Their misbehavior in the tax area, including imposing clearly unconstitutional taxes against non-resident companies and then attempting to avoid refunding the illegally collected funds, is so egregious as to have been dubbed "tax terrorism" by those who face what seem to be tax authorities acting in defiance of the law.

Given that states have been abusing their power to tax by imposing business activity taxes and indirect use tax collection requirements in a manner which illegally discriminates against out-of-state merchants, any request for an expansion of that power should be met with a resounding **"NO!"** Instead, states should be reigned in, and order in our national market restored, by repairing the defects of state tax systems as they are applied to interstate commerce. In order to repair those systems it will be necessary to:

1. Provide one or more mechanisms by which companies can obtain effective and timely redress when they are subjected to unconstitutionally discriminatory taxes,
2. Provide for federal oversight to ensure that state tax policies do not contradict other federal policies for e-commerce, such as privacy principles or policies of non-discrimination against e-commerce; and
3. Redirect states to a workable solution for the collection of use taxes on transactions in interstate commerce, such as compensation-based or state-cooperative systems, by making it clear that the states will <u>not</u> be allowed to impose tax collection obligations extraterritorially.

These actions would ensure that the U.S. maintains and further promotes a free, open marketplace that benefits both businesses and consumers in all areas of our Nation.

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Reconciling a National Marketplace with State and Local Government Tax Systems: A Path Forward

CommerceNet,[1] an industry consortium dedicated to accelerating the growth of Internet commerce and expanding Internet markets, believes that broad-based electronic commerce is beneficial to both businesses and consumers. We are concerned that state and local taxing authority, when extended extraterritorially, results in a system of tax-based trade barriers to interstate commerce, effectively denying consumers, businesses and the nation as a whole the cost efficiencies that the new digital economy promises.

In 1773, during the effort to secure American independence, the issue of taxation without representation resulted in one of the more famous episodes in American history - the Boston Tea Party. The issue was whether a government had the right to impose taxes without enabling those affected to have a voice in the matter.

In 1789 the Articles of Confederation, which governed the United States from 1777 to 1788, were replaced by the U.S. Constitution - in order to form a stronger federal government that had the power, under the Commerce Clause, to regulate interstate commerce and rid the country of the pervasive, oppressive, and unjustifiable trade barriers that had been enacted by the states against goods from other states.

In 1829, James Madison, one of the signers of the Constitution, stated in correspondence[2] that the need for the Commerce Clause "grew out of the abuses of power by the importing States in taxing . . . , and was intended as a negative and preventative provision against injustice among the States themselves". Indeed the Supreme Court itself has explained that "our system, fostered by the Commerce Clause, is that every farmer and every craftsman shall be encouraged to produce by the certainty that he will have free access to every market in the Nation, that no home embargoes will withhold his exports, and no foreign state will by customs duties or regulations exclude them. Likewise every consumer may look to the free competition from every producing area in the Nation to protect him from exploitation by any. Such was the vision of the Founders; such has been the doctrine of this Court which has given it reality."[3]

Today the Advisory Commission on Electronic Commerce is tasked with determining whether the U.S. States will be allowed to extend their taxing authority extraterritorially to force sellers not located in their jurisdictions to serve as unpaid tax collectors in those jurisdictions where they have no representation.

Any recommendation the Commission makes will inevitably involve the question of whether Congress should embrace their responsibility under the U.S. Constitution to regulate interstate commerce or whether instead they should abandon the national marketplace to the control of the state and local governments.

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[1] Launched in California's Silicon Valley in April 1994, CommerceNet's membership has grown to over 200 leading U.S. organizations, including the leading banks, telecommunications companies, ISPs, online services, and software and services companies, as well as major end-users.

[2] Letter from James Madison to J. C. Cabell, February 12, 1829, quoted in Raoul Berger, "Judicial Manipulation of the Commerce Clause," Texas Law Review, Vol. 74, Issue 4 (March 1996), p. 703.

[3] *H. P. Hood & Sons v. Du Mond* , 336 U.S. 525 (1949), and cited repeatedly in later Supreme Court decisions, most recently in *Camps Newfound/Owatonna, Inc., v. Town Of Harrison, Maine,* 117 S. Ct. 1590 (1997).

To punish the people of Boston for the Boston Tea Party, the British Parliament passed a bill closing the port of Boston. The act was enforced by blockading the harbor. That is the question before us today - should we close the Internet, and indeed our nationwide market, to those who object to paying unfair, unconstitutional taxes imposed by governments in which they have no representation?

What Needs to be Done: Policy Considerations

While there are many policy issues that the Commission will be urged to consider, in this submission CommerceNet will focus on policies necessary to maintain a nationwide marketplace, free of trade barriers between the states, that is accessible to businesses of all sizes and accessible to consumers in every locality. In order to continue to pursue the vision of the founders of the United States of America that has been staunchly protected by the U.S. Supreme Court, it is necessary to consider the following:

1) The need for redress for companies that are subjected to unconstitutionally discriminatory state and local taxation systems.
2) The importance of fixing the current broken state and local use tax[4] collection and business activity tax[5] systems rather than expanding them.
3) The importance of effective and timely federal oversight of state tax systems affecting interstate commerce in order to ensure that state tax policies do not interfere with federal e-commerce policies such as federal privacy principles or policies that e-commerce not be discriminated against.

Finally we will describe a mechanism for moving forward that takes into consideration these important policy issues.

The States Don't Listen to Congress or to the Supreme Court: A Brief Historical Perspective on State Treatment of Interstate Commerce

In 1959, one hundred seventy years after the Commerce Clause was adopted as part of the U.S. Constitution, Congress, recognizing the immense administrative burden that the use tax devised by the states imposes on interstate commerce, created a Commission to study the issue. The Willis Commission issued a 1255 page report, taking 6 years to do so. Several recommendations were made for simplification of the use tax system.[6] For the most part these have been completely ignored by the states – until recently when organizations of state governments at various levels have begun passing completely non-binding resolutions declaring that the system needs simplification.

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[4] A use tax is imposed on sales that take place outside the state but that result in goods or services being used in the state. It is meant to compensate for the fact that the state cannot impose a tax on a transaction that takes place outside its borders.

[5] Business activity taxes include income taxes, franchise taxes, gross receipts taxes, business license taxes, and any other taxes that are imposed on companies based on income or receipts.

[6] For additional background on the Willis Commission Report and the states' lack of response to it, see Kaye Caldwell, CommerceNet Research Note 98-12, *Deja Vu All Over Again: The Willis Commission Recommendations and the NTA's Communications and Electronic Commerce Taxation Project: Will the States Repeat their Major Strategic Error of the Mid-Eighties?* at: http://www.commerce.net/resources/work/dejavu.pdf

Shortly after the 1965 release of the report of the Congressional Commission, commonly known as the Willis Commission Report,[7] the Supreme Court weighed in – ruling that use tax collection requirements, as applied to remote sellers, were unconstitutional under the Court's dormant commerce clause doctrine.[8] This doctrine holds that state laws discriminating against interstate commerce are unconstitutional even in the absence of specific Congressional action invalidating them.

In the late 80's the states decided to ignore the Supreme Court decision and assess use taxes anyway, thus engaging in what some have called "tax terrorism" - assessment of taxes contrary to the law of the land, forcing affected companies to either pay the illegal tax or litigate the issue in the face of the state's clear refusal to follow the Supreme Court's decisions. These illegal assessments were ultimately unsuccessful and led to a second U.S. Supreme Court decision in 1992[9] – stating once again that the states' use tax system – which had not been simplified since the Court's earlier decision – remained unconstitutionally burdensome.

Today the states, raising the specter of electronic commerce decimating their sales tax revenues – are pleading for Congress to overturn the Supreme Court's prohibition of the states' imposition of use tax collection obligations on remote sellers.

The states have created a system that is enormously burdensome, and rather than fix the system are begging that they be allowed to apply it more broadly. At the same time they continue to pass resolutions declaring that the system is bad, something Congress told them a third of a century ago, instead of actually doing anything to fix it. While CommerceNet applauds current state talks and efforts focused on simplifying the use tax collection system, we must remind the Commission that these efforts have been repeated many times and have always failed. Continued talk, especially 33 years of it, is not justification for allowing the current lack of certainty to continue.

While continuing to merely discuss simplification, the states are asking Congress to abandon its responsibility to regulate interstate commerce and to allow the states free reign in the form of an authorization to impose use tax collection obligations extraterritorially. The states are asking for this additional authority even though their record on responsible application of taxes is in some cases abysmal. They have ignored Congress' recommendations in the area of use taxes, and have repeatedly ignored the Supreme Court's decisions in tax areas.[10] Congress should deny the states' requests for more authority – as indeed the Senate has done twice in recent years by voting down legislation to allow states to impose use tax collection obligations on non-resident businesses.

Benefits of a Seamless National Market

The creators of the U.S. Constitution recognized the benefits of a seamless nationwide market, allowing the free flow of goods and services among the states. Europe has also realized the benefits of a unified market – and has been working towards a

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[7] H. R. Reps. Nos. 565 & 952, 89th Congress (1965).

[8] *National Bellas Hess, Inc. v. Department of Revenue of Ill.*, 386 U.S. 753 (1967).

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

[10] For additional details on unconstitutionally discriminatory taxation by the states, see Kaye Caldwell, *States Behaving Badly*, in CommerceNet Public Policy Report, Vol. 1 No. 6, June 1999 at: http://www.commerce.net/resources/work/StatesBehavingBadly.pdf

common market with a single currency through the European Union. A freely accessible market benefits businesses in all the states, particularly small and medium businesses that would not have the resources to deal with a multiplicity of trade barriers in every state. A freely accessible market also benefits consumers by increasing the number of companies they can purchase from, thereby increasing competition. It would be extremely ill-advised to abandon the principles embedded in the Constitution that were intended to ensure the existence of a unified market and to return instead to a system of trade wars among the states.

States claim that remote venders should pay "their fair share" of taxes, a concept adopted by the Supreme Court in *Complete Auto Transit, Inc. v. Brady*,[11] in exchange for access to that state's market. However, *Complete Auto* requires much more of the state than mere access to its market. Among other things, it requires that the tax be fairly related to state-provided services. In the context of interstate commerce, especially e-commerce, what are those services? Will the state of Alabama show up to fight a fire on the premises of a seller in California? Will the police force in Montgomery respond to a burglar alarm in San Francisco? There is no justification for the imposition of taxes extraterritorially. Such taxes, which force out-of-state companies to pay for services provided only to in-state companies, serve as a trade barrier discouraging the entry of out-of-state businesses into the local marketplace and thus preventing the state's consumers from benefiting from the increased competition created in a free market.

The States' Record of Imposing Trade Barriers

Section 2 of the Twenty-first Amendment to the Constitution created an exception to the normal application of the Commerce Clause, permitting the States to regulate commerce in, or the use of, alcoholic beverages. Thus states can freely discriminate against interstate commerce in such goods as wine and beer. And discriminate they do. In fact, nineteen states expressly outlaw the direct purchase of alcoholic beverages by in-state consumers from out-of-state sellers, requiring instead that producers sell through specified wholesalers and distributors. Additionally, twenty more states limit the use and quantity of purchases of alcoholic beverages by in-state consumers directly from out-of-state sellers. Twelve states allow direct purchasing from out-of-state sellers, but only from sellers in those twelve states. Here again we see resolutions[12] being passed decrying the situation, and calling on Congress to support the continued growth and stability of our nation's grape and wine industry, but conspicuously not calling upon the states to remedy the situation by repealing the discriminatory laws.

Another exception to the Commerce Clause is the 1945 McCarran-Ferguson Act, which states that "no act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance, or which imposes a fee or a tax upon such business, unless such Act specifically relates to the business of insurance." Thus the McCarran-Ferguson Act specifically exempts state tax laws affecting the insurance industry from the constraints of the dormant Commerce clause, apparently leaving the states free to impose discriminatory taxes. Once again, the states did indeed discriminate. By 1981, twenty-six states discriminated against out-of-state insurance companies by imposing larger insurance premium taxes than those imposed on in-state insurance companies. In 1984 the U.S. Supreme Court ruled in *Metropolitan*

[11] 430 U.S. 274 (1977).

[12] http://www.ncsl.org/statefed/commerce.htm#wine

Life Insurance Company v. Ward[13] that even though the Commerce Clause did not, as a result of the McCarran-Ferguson Act, protect insurance companies from discriminatory taxation, the Equal Protection Clause of the Constitution did.[14] By 1996, 19 states had been forced to repeal their discriminatory taxes on insurance premiums.

Not all states discriminate. Some states will wisely act to protect their state businesses from discrimination in other states by passing "retaliatory" anti-discrimination laws. Such laws only discriminate against businesses in states that themselves discriminate against out-of-state businesses. Thus they have the effect of discouraging discriminatory laws in other states. California is an example of a state with retaliatory anti-discrimination laws. California's Constitution imposes discriminatory insurance taxes against companies in states that treat California insurance companies less favorably than their own. California is also one of the twelve states with retaliatory alcohol discrimination laws, only prohibiting imports from states that themselves discriminate. Thus California only discriminates against businesses in states where the laws discriminate against California's businesses.

Whether a state considers itself to be primarily a producer state or a market state may impact the state's adoption of discriminatory laws. A state that has few resident exporting companies will not find support for allowing non-discriminatory access to the state's markets since retaliatory anti-discrimination laws of other states do not affect companies that do not export to other states. Unfortunately, discriminatory policies are self-perpetuating. Exporting companies would be foolish to locate in discriminatory states, thereby subjecting themselves to retaliatory discrimination by other states to which they might otherwise export. Such states, unless pushed from outside, may never gain the benefits of a nationwide marketplace for their economies.

The lesson here is that where states are allowed to impose trade barriers, they will do so. Laws that prevent interstate commerce from entering a state act to disadvantage consumers by denying them the benefits of increased competition. Consumers are left at the mercy of protected in-state suppliers. Of course, the in-state businesses that the trade barriers affect favorably are represented in the government creating the barriers since they are located in the state. It is not therefore surprising that such trade barriers arise to protect in-state interests, in spite of retaliatory discrimination laws in other states.

Tax-Based Trade Barriers Are Currently a Plague Upon Our National Economy

While some, indeed many, states will discriminate against interstate commerce when allowed to do so, some states in fact discriminate even when they have been told it is expressly forbidden. Nowhere is this more obvious than in state tax laws. The problem is that the law is so stacked against taxpayers that states and local governments can, and do,

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[13] *Metropolitan Life Insurance Company v. Ward*, 470 U.S. 869 (1985).

[14] Commissioners should infer from this case that even if Congress were to "overturn" *Quill* by authorizing the states to impose use tax collection obligations, continued litigation is likely to result. Out-of-state businesses would look for protection from the imposition of discriminatory tax collection obligations to either the Equal Protection Clause or the Due Process Clause. Unlike the Commerce Clause, Congress cannot "overturn" the protections offered by either of those clauses. Even the ruling in *Quill* regarding the Due Process Clause may not apply to Internet sales.

impose discriminatory taxes until some unfortunate company invests the time and money to litigate the case all the way to the U.S. Supreme Court, sometimes multiple times.

In one of the more egregious cases,[15] Alabama continued to impose discriminatory taxes even though the evidence of the enormous discriminatory effect of the tax was supplied by the state's own revenue department.[16] In fact the state did not even argue before the Supreme Court that the tax was not discriminatory, merely that the Supreme Court should abandon its long-standing dormant Commerce Clause doctrine and should instead allow states to impose discriminatory taxation. In other words, the state knowingly ignored existing Supreme Court rulings and imposed the taxes anyway.[17] Having lost their case before the U.S. Supreme Court, the state is now refusing to provide refunds - an action also prohibited by the Supreme Court.[18]

The problem here is the total lack of timely, effective redress - a situation that affects remote commerce by enabling states to ignore the laws prohibiting discrimination against interstate commerce. The Commission would be well advised to make some recommendations in this area that would provide for redress for companies that have had illegal discriminatory taxes imposed on them.

There are several remedies that Congress could implement to ensure that state and local governments do not impose unconstitutional forms of taxes on e-commerce companies. The most pressing need is to provide some sort of remedy that is actually effective in preventing the collection of unconstitutional taxes. Clearly the states can, and do, abuse the current system, thereby managing to deny refunds of illegally collected taxes for decades. Possible remedies might include:

- Federal legislation providing that in state or local jurisdictions with pay-to-play or bond-to-play rules, the taxpayer has the option of having the case heard in federal, rather than state, courts.
- Federal legislation overturning the U.S. Supreme Court decision denying attorney's fees in tax cases where the tax is found to be unconstitutional. Since those attorney's fees can be awarded against individual state tax officials, this

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[15] *South Central Bell Telephone v. Alabama,* U.S. Supreme Court No. 97-2045, decided March 23, 1999.

[16] For more details on this case, and more examples of states imposing illegally discriminatory taxation, see Kaye Caldwell, *States Behaving Badly*, in CommerceNet Public Policy Report, Vol. 1 No. 6, June 1999 at:
http://www.commerce.net/resources/work/StatesBehavingBadly.pdf
and Kaye Caldwell, *Federalism: Should Congress Take a More Active Role in Restraining the States from Interfering in Interstate Commerce?* in CommerceNet Public Policy Report, Vol. 1 No. 6, June 1999 at:
http://www.commerce.net/resources/work/Federalism.pdf

[17] Additional details on the egregious treatment of the taxpayer in this case can be found in:

- *States Behaving Badly* at:
  http://www.commerce.net/resources/work/StatesBehavingBadly.pdf; and
- The amicus brief filed in the case by the Tax Executives Institute, which compares the taxpayers experiences in Alabama with those of Alice in Wonderland, at: http://www.tei.org/alabamabrief.html

[18] See *Alabama Franchise Tax Reform Moving Forward*, Tax Analysts Document Number: Doc 1999-24655, July 21, 1999.

could provide a major incentive for state tax officials to ensure that their state legislatures refrain from passing unconstitutional taxes.

- Federal legislation to actually ensure the refund of taxes which have been declared unconstitutional. Such legislation might, for example, withhold the tax refunds and administrative costs from federal funds paid to the states and then refund, out of funds withheld, the taxes to the taxpayer that is owed the refund. In the case of local taxes the states could then withhold the amounts from the state funds paid to the local jurisdiction that owes the refund.
- Federal legislation to specify that certain tax schemes are constitutional, thus encouraging states to enact those tax schemes in order to avoid having their tax laws overturned in constitutional challenges.
- Repeal of the Tax Injunction Act which provides in its totality that "the [federal] district courts shall not enjoin, suspend or restrain the assessment, levy or collection of any tax under State law where a plain, speedy and efficient remedy may be had in the courts of such State."[19] It is the Tax Injunction Act that prevents federal courts from ruling on discriminatory taxes until the case has been litigated through the state's entire administrative process as well as the state court system, at which point it may be heard by the U.S. Supreme Court if the Court decides to hear the case. The unfortunate fact is that in some states a plain, speedy and efficient remedy may be, but typically is not, had.

State Systems of Taxation of Interstate Commerce Are Seriously Broken - They Should be Fixed, Not Expanded

As we have seen, in industries where exceptions to the normal application of the Commerce Clause are allowed, states have enacted trade barriers to interstate commerce. If those exceptions are expanded to all interstate commerce through a blanket authorization to impose use tax collection obligations, additional trade barriers are sure to result. Those barriers will negatively affect competition and thereby reduce the benefits that robust competition would otherwise bring to a state's consumers.

Discussions within the National Tax Association's Communications and Electronic Commerce Tax Project[20] indicate that state and local governments intend to impose business activity taxes on non-resident sellers. Such taxes serve as effective trade barriers since many states impose business activity taxes on the same receipts or income when the company is domiciled in their state. Thus unconstitutional double taxation results and is sustained by the current lack of timely, effective redress for such illegal taxation.

In addition to business activity taxes, the states' use tax collection system is seriously broken. Since other commentators will be supplying details of the problems with the use tax system, we will not offer details here. However, we note two facts:

1. As the Commission is aware, the U.S. Supreme Court has ruled that the use tax system is so burdensome that it unconstitutionally discriminates against interstate commerce and cannot be imposed by a state on sellers with no physical presence in that state.

[19] 28 U.S.C. § 1341.

[20] CommerceNet is a voting member of the NTA Communications and Electronic Commerce Tax Project.

2. A unified, simple use tax collection system already exists. Congress requires the states to participate in a simplified system for the collection of fuel use taxes. All the continental states now participate in that system as a result of the passage of a law requiring them to do so.

Both the application of business activity taxes and the use tax collection system are seriously flawed. They should be fixed, not expanded.

In fact, allowing the expansion of flawed tax systems may be quite dangerous for the states in the long run. If Congress did, under its Commerce Clause powers, overturn the *Quill* case, there is no guarantee that the resulting expanded state and local tax systems as applied extraterritorially to interstate commerce would not be ruled unconstitutional on other grounds. As noted previously, the U.S. Supreme Court has ruled discriminatory taxes unconstitutional based on the Equal Protection Clause even when imposed on companies in industries that do not have Commerce Clause protection.[21] Furthermore, the Due Process Clause could also come into play since e-commerce sales may be distinguishable from the facts relied on in the Due Process analysis in *Quill.*[22]

In the long run, it is much safer for the states to rely on tax systems that are not imposed extraterritorially on non-resident companies. That would prevent the devastation to state and local revenues that would result from a Supreme Court decision overturning taxes that the state and local governments had become dependent on. One need only look to the situation in Alabama, where the state may have to repay hundred of millions of dollars in taxes, to see the effects of such a decision.[23]

The Path Forward

Make no mistake – the issue before the Commission is NOT whether or not states can collect their taxes. What is at issue is whether the United States retains a unified nationwide market or whether we allow it to deteriorate into 50 small fragmented markets with a multiplicity of tax-based trade barriers imposed by the states. From pre-Constitution times to modern times, history has shown that when states are given the power to impose their tax systems extraterritorially they do so unfairly, creating tax-based trade barriers.

CommerceNet believes that state and local governments provide important and necessary functions such as maintaining local infrastructures and educational systems that are necessary to the businesses located there. However it is necessary to reconcile the

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[21] *Metropolitan Life Insurance Company v. Ward*, 470 U.S. 869 (1984).

[22] While *National Bellas Hess* had ruled that both the Due Process and Commerce Clause created bars to imposing use tax collection obligations on interstate commerce, the *Quill* case reversed *National Bellas Hess* with respect to the Due Process Clause, while continuing to uphold the Commerce Clause ruling.

[23] In the roughly 10 years since the Alabama case started being litigated, 92% of the franchise tax, which makes up 14% of the general fund, has been illegally collected. If that had to all be refunded in one year it would more than totally wipe out the entire state general fund, which is the funding source for most state services except education. Many taxpayers have been paying under protest for up to 10 years, and most taxpayers have been for the past five years. Alabama state tax authority Bruce P. Ely states that refunds owed could amount to as much as $500-$600 million, which is approximately 75% of the state's yearly general fund expenditures. See *States Behaving Badly* for details.

need for state and local government funding with the maintenance of a robust and accessible nationwide market, free of tax-based trade barriers.

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

Commissioner Andal's proposal would prohibit the states from imposing taxes or tax collection obligations extraterritorially. This does NOT mean that the states would be unable to collect their use taxes. It merely means that they would need to find another way to do so. There are ways in which this could be done – but none of them will be seriously considered until the states are forced to realize that they will not be allowed to require sellers from other jurisdictions to serve as uncompensated[24] tax collectors.

Among the ways that use taxes could be collected are the following:

1) Market-driven[25] (compensation based) approach: One feature of the majority of consumer remote commerce transactions is that they require the use of non-cash payment mechanisms. Those payments mechanisms are highly automated. Furthermore the most common payment system – credit cards – is characterized by control that is concentrated in a very few companies or concentrated in industry organizations. Currently the relevant financial institutions are reluctant to participate in any tax collection scheme due to their fear that burdensome costs will be imposed on them without compensation. This fear is justified. However, if Congress were to prohibit states from imposing collection obligations on them, that fear may be sufficiently alleviated so that a market driven approach would be viable. Financial institutions might then agree to provide tax collection services to the state and local governments under a business model that both ensures them adequate compensation and relieves them of any associated liability other than that for which they have contracted.
2) State Cooperative Approach: States could aid each other in collecting use taxes. States have the clear right to impose sales tax at the point of sale.[26] In order to avoid the unconstitutionally discriminatory multiple taxation that would occur if both sales and use taxes were imposed on interstate sales, all states provide for a use tax credit against sales taxes previously imposed on the sale. Currently all states exempt from the sales tax those sales in which the product is shipped outside the state. The likely purpose of this exception is to allow the destination state to impose the use tax so

[24] Some states do allow for some compensation for use tax collection, however the level of compensation is either very low or is capped. Since the costs associated with collection, in particular the costs of processing credit card payments are both percentage based and uncapped, state compensation today, when it exists at all, is woefully inadequate.

[25] It should be noted that while this option appears attractive now, it is dependent on credit/debit cards remaining the payment mechanism of choice for remote sales. An approach that is not dependent on any specific business sector may be preferable as it is less susceptible to possible erosion over time. Nonetheless this option deserves serious consideration.

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

that the tax is imposed by the state where the customer resides. A repeal of the states' exemptions for out-of-state shipments would immediately ensure that all interstate sales are taxed, with the exception of sales from the five states that do not impose sales taxes. In order to ensure that the repeal of the export exemption does not create a barrier to exports, the states could specify that the sales tax is to be collected at the tax rate of the destination state. The rate to be collected from buyers in other states would be set to the lowest rate in the destination state in order to avoid unadministrable complexity caused by a multitude of different rates and the constitutional problems created by an averaged rate.[27]

If the states so desired they would be free to enter into agreements with other states to remit taxes collected by one state to the state where the buyer resides. This system would be quite similar to the system currently in use for fuel use taxes. The Commission may wish to study the International Fuel Tax Agreement, which was implemented, at the urging of Congress, to solve similar problems in the fuel use tax area. Once established, Congress required that all states participate.[28]

As for the five non-taxing states, there are a number of ways of dealing with sellers located in those states – one would be to allow them to register for tax collection purposes in another state and participate in that state's tax administration. The Commission should be wary of the argument that businesses would move to non-tax states to avoid collection obligations. It is unlikely that such a migration would take place since the trade-off for not collecting sales taxes from customers is the company having to pay higher income or property taxes itself, a circumstance that directly affects the company's bottom line. Obviously no-sales-tax states have to fund their governments using other taxes. In any case if such a problem did result, one remedy could be that the federal government might step in with a federal tax against which state sales taxes were credited - thus affecting only no-sales-tax states.

State and Local Taxation of Interstate Commerce Requires Federal Oversight to Ensure Consistency With Other Federal E-Commerce Policies

A conflict is developing between federally supported privacy principles and calls by tax administrators for buyer identification in e-commerce transactions. Whereas compliance with federally recommended privacy principles requires that a buyer be advised of the consequences of not supplying requested information, states have indicated that providing such information to a buyer may be taken as acting to solicit avoidance of tax obligations, making the seller liable for the taxes. Thus the seller is placed in a position where it can adhere to federal policy or state policy, but not both. In order to ensure that compliance with privacy principles does not run afoul of local tax laws federal oversight will be needed.

Federal oversight may also be needed to ensure that state and local governments do not exempt local merchants from administrative requirements placed on sellers in

[27] See *Associated Industries of Missouri v. Lohman*, 114 S. Ct. 1815 (1994).
[28] P.L. 103-272, Sec. 1(e), July 5, 1994.

interstate commerce. An example of a requirement that threatens to impose more burdens on interstate commerce is the requirement to obtain identifying information from the buyer even when it is not required for delivery. Identification of buyers in local stores is not required, even when those buyers do not reside in the jurisdiction of the seller. Requiring a retail store to obtain the identification of all its walk-in customers, including cash paying customers, would likely give rise to outraged cries regarding invasion of privacy, not to mention administrative burdens. Yet not doing so will constitute discrimination against interstate commerce. The buyer identification issue, if not uniformly adopted for both local and remote commerce, has enormous potential for creating trade barriers against interstate commerce.

Conclusions

States should be redirected to a better path forward: The long recognized need to allow a nationwide marketplace to thrive is exactly why Congress should NOT allow states to impose taxes or tax collection obligations outside of their jurisdiction. However, rather than leaving the question in limbo, Congress should make clear that states cannot extend their taxing authority beyond their borders. **Only clarity from Congress that states cannot impose use tax collection obligations extraterritorially will motivate the states to look for alternate tax collection mechanisms, of which there are several possibilities.** The path forward can and needs to be set by redirecting the states to other solutions instead of the dangerous path that they are now on to impose tax systems extraterritorially on those who have no representation in the government imposing the taxes or tax collection obligations.

Practical redress should be available for unconstitutionally imposed taxes: Congress should ensure that companies that are subject to existing state taxing authority, by having employees or real property in the state, are able to obtain timely and effective redress when subjected to discriminatory taxation by state or local governments. That redress could take several forms, as detailed above.

Additional policy concerns: There are additional policy concerns such as privacy and non-discrimination that may need Congressional oversight.

CommerceNet therefore believes that the Commission should include in its recommendations to Congress:

- A recommendation to adopt the legislation proposed by Commissioner Andal, which would help eliminate tax-based trade barriers in interstate commerce.
- A recommendation to adopt legislation providing for redress for companies exposed to unconstitutionally discriminatory taxes by state and local governments.
- A recommendation for legislation providing on-going oversight of state and local taxation of interstate commerce to ensure that additional policy issues such as privacy and non-discrimination are not ignored, or worse contradicted, by tax laws.

CommerceNet thanks the Commission for this opportunity to present its views on these subjects that are so vital to the development of electronic commerce.

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