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Taxing Internet Transactions

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The Internet Tax Freedom Act (ITFA) was enacted as part of the Omnibus Consolidation and Emergency Supplemental Appropriations Act, P.L. 105-277. The Act imposed a 3-year moratorium on new Internet taxation and established the Advisory Commission on Electronic Commerce (ACEC, the commission) in October of 1998. The final report of the commission, presented in April 2000, is available on the ACEC web page. The Internet tax moratorium prohibits the taxation of Internet access and the multiple or discriminatory taxation of Internet commerce. In the 107th Congress, the moratorium was extended through November 1, 2003 by the Internet Tax Nondiscrimination Act, P.L. 107-75. The moratorium does not preclude states from requiring vendors with substantial nexus in the state from collecting sales and use taxes on products purchased over the Internet. However, the moratorium would preclude state and local governments from levying existing sales and use taxes on Internet access services.

Recent Developments

On January 7, 2003, Senator Wyden and Representative Cox introduced identical legislation, S. 52 and H.R. 49 respectively, that would make the Internet tax moratorium permanent. In addition, S. 52/H.R. 49 would repeal the grandfather clause in the ITFA that allows states that imposed taxes on Internet access taxes at the time of ITFA passage to continue collecting the tax. The states that are collecting Internet access taxes would then lose that revenue source. At a recent Hearing on H.R. 49, the Federation of Tax Administrators (FTA) testified that "...nine states currently impose taxes that are protected - New Hampshire, New Mexico, North Dakota, Ohio, South Dakota, Tennessee, Texas, Washington, and Wisconsin." In the same testimony, FTA argues that "...repealing the preemption would constitute an intergovernmental mandate under the Unfunded Mandate Reform Act."

The House Judiciary Committee approved H.R. 49 on July 16, 2003 after agreeing to an amendment to expand the definition of Internet access to include all modes of accessing the Internet (see H.Rept. 108-234). The Congressional Budget Office estimates that H.R. 49 would impose an intergovernmental mandate on state an local governments that would cost between $80 million and $120 million. Treasury Secretary Snow expressed the Bush Administration's support for the legislation in a recent press release. H.R. 49, as amended, passed the House under suspension of rules on September 17, 2003.

The Senate Commerce Committee held hearings on the proposed extension of the Internet tax moratorium on July 16, 2003 and reported out S. 150 on July 31, 2003. S. 150 would make the moratorium permanent and is similar to S. 52. At the markup of S. 150, Chairman McCain reiterated his pledge to hold hearings on the related streamlined sales tax issue after the August recess. For more on other internet tax legislation in the 108th, see CRS Report RL31929, *Internet Tax Bills in the 108th Congress*, by Nonna Noto.

A coalition of states is currently working to establish a simplified sales and use tax system. The participating states would ask Congress for the permission to compel out of state vendors to collect sales and use taxes if the simplified system were implemented. The 34 states (and the District of Columbia) participating in the simplification project are self identified as the Streamlined Sales Tax Implementing States (SSTIS). On November 12, 2002, the SSTIS approved (31 in favor, 3 absent, and 1 abstention) the model legislation identified as the Streamlined Sales and Use Tax Agreement (the Agreement). The Agreement goes into effect if 10 states representing at least 20% of the population in states that impose a sales tax enact the model legislation and are in compliance with the rules of the Agreement. The National

Governor's Association (NG A) supports the model legislation. At the July 16, 2003 Senate Commerce Committee hearing cited above, chairman McCain said "I believe that we can and should keep the Internet tax moratorium distinct from the simplified sales tax debate." H.R. 3184, the "Streamlined Sales and Use Tax Act," introduced in Congress on September 25, 2003, would grant SSTIS members the authority to compel out-of-state vendors to collect sales and use taxes.

Background

The United States Supreme Court has held that a state has no jurisdiction to require a remote vendor to withhold that State's sales and use taxes unless the vendor has a nexus (loosely defined as physical presence) in the taxing state. The residence of the purchaser is not a sufficient nexus. The Court also has held that Congress, under its power to regulate interstate commerce, could authorize the states to require the collection of these taxes by remote vendors. This issue is important because Internet transactions do not have the sales and use tax added to their price by remote vendors, thus Internet retailers are thought to have a competitive advantage over traditional "brick and mortar" vendors who are required to collect the tax. However, in February 2003, it was reported that some large retailers, such Wal-Mart Stores Inc. and Target Corp., have voluntarily began collecting sales and use taxes on online purchases made by customers in states where the retailer does not have a physical presence. The retailers reached the agreement with 38 states and the District of Columbia.

Most states require that consumers who purchase products from remote vendors to pay use taxes on their purchases. Use taxes are the companion tax to the sales tax and are levied at the same rate as sales taxes. Thus, interstate transactions are taxable though the collection responsibility falls upon the consumer to voluntarily remit the appropriate taxes. In reality, compliance with this requirement is quite low. As a result, states anticipate that as Internet retail sales grow in proportion to total retail sales, sales tax revenue will inevitably decline. Local governments that piggy-back their sales tax on the state sales tax are also confronted with the prospects of a declining retail sales tax base. Though federal revenue is not directly affected, Congress' power to invoke the commerce clause draws the federal government into the debate as the arbiter of any resolution among the states.

The critical question is how to equitably and efficiently address the taxation of Internet transactions. Generally two approaches have been offered. Some suggest that to achieve equity, the sales tax must be removed from all goods. The removal of the sales tax would then tax all goods at the same rate (zero percent), regardless of the mode of transaction. However, the loss in sales tax revenue, which is a major source of revenue at the State level, (45 states impose a general sales and use or gross receipts tax) would most likely lead to an increase or imposition of new taxes to compensate for the lost revenue.

A second approach is for Congress to authorize the states to require vendors to collect the sales and use tax based upon the customer's State and local tax rates. The vendor would then be required to determine the prevailing State and local tax rates of all the taxing jurisdictions in the United States. This approach would also require the vendor to determine and authenticate the State tax exempt status of all customers. In addition to the differential rates, there is also variation in the sales tax base of the 45 states. Proponents of this approach assert that administrative difficulties could be overcome with technology and simplified state and local government sales and use tax systems like the SSTIS compact. The model legislation approved by the SSTIS includes provisions that would require participating states to: (1) establish uniform tax base definitions; (2) impose uniform sales and use tax exemptions; and (3) limit the variation in local tax rates within the state. In a recent news story, a SSTIS delegate characterized the group's objective "...to develop a system that is acceptable to the states and simple enough that the Congress will use it as a basis for mandating the collection of the [sales] tax on remote sales..."

CRS Products

CRS Report RL31929, *Internet Tax Bills in the 108th Congress.*

CRS Report RL31252 *Internet Commerce and State Sales and Use Taxes.*

CRS Report RL31177 *Extending the Internet Tax Moratorium and Related Issues.*

CRS Report RS21537 *State Sales Taxation of Internet Transactions.*

CRS Report RS21596 *EU Tax on Digitally Delivered E-Commerce.*

Additional Reading

Council on State Taxation, "Report Card on Streamlined Sales Tax Implementing States' Agreement," *State Tax Notes*, November 11, 2002, p. 407.

Charles McLure Jr., "SSTP: Out of Great Swamp, But Whither? A Plea to Rationalize the State Sales Tax," *State Tax Notes*, December 31, 2001, p. 1077.

Goolsbee, Austan, and Jonathan Zittrain, "Evaluating the Costs and Benefits of Taxing Internet Commerce." *National Tax Journal,* vol. 52, no. 3 (September 1999): 413-428.

National Tax Association Communications and Electronic Commerce Tax Project Final Report, September, 1999.

U.S. General Accounting Office, *Sales Taxes: Electronic Commerce Growth Presents Challenges; Revenue Losses are Uncertain*, GAO Report OCE-00-165 (Washington: June 2000).