Protecting Internet Commerce from Undue Tax Burdens

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The Internet is facing two threats from lawmakers in Washington that could hamper its ongoing development and raise taxes on Americans already struggling under a hefty tax burden.

The first threat is proposed legislation that would allow states to require out-of-state retailers to collect sales taxes on online purchases even if the retailer has no physical presence in the buyer's home state. The potential of expanding the sales tax to these sales is often referred to as an "Internet sales tax," since the bulk of such out-of-state sales are made online.

The second threat comes in the form of Congress allowing states to tax mere *access* to the Internet, a tax on which it placed a moratorium in 1998.

In the case of both threats, it would be best for Congress to continue its long-standing policies to avoid placing unnecessary burdens on the Internet, as well as protect American taxpayers from higher taxes.

Background

Currently, states can only collect sales taxes on purchases their residents make online if the retailer has a physical presence in the state. A store, workforce, factory, storage facility, building, or employees in a state usually establish a physical presence.

The physical-presence standard was established by the 1992 Supreme Court decision in *Quill v. North Dakota*.[74] It applies to all remote sales, which include online sales as well as mail order and catalog sales.

The standard has come under pressure because state legislatures, and state tax collectors, are increasingly frustrated by not being able to collect sales taxes on some online sales that they believe they should be able to tax. They see online sales as eroding their sales-tax base.

Adding to the pressure to overturn the standard are "brick-and-mortar" retailers. These traditional sellers see the current situation as unfair because, they argue, it hurts their ability to compete. They must collect the sales tax on all their sales. If a customer buys an identical product online from a retailer with no physical presence in the customer's state of residence, the customer does not have to pay the applicable sales tax, lowering the price he pays by the amount of the sales tax.

Online sellers that have substantial physical presence also want to see online sales taxed. Because they are physically present in many states, they are already collecting taxes on many of their sales. Similar to brick-and-mortar sellers, they want to put the added burden of collecting sales tax on their smaller competitors.

These groups have put strong pressure on Congress to change the physical-presence standard, something the Supreme Court gave it power to do in its *Quill* decision. They have found significant sympathy for their position in Congress because, theoretically, a consumer should pay the same tax on an item regardless of whether he purchases it at a store or online. But meeting that theoretical standard has proven problematic in the legislative solutions that have been proposed.

Recent Bills in Congress

In 2014, the Senate passed the Marketplace Fairness Act (MFA) to address online sales taxes. The MFA would have allowed states to enforce their sales tax on out-of-state online retailers if those states had more than $1 million in sales. This posed two major problems. First, it would have violated the principle of federalism by allowing states to enforce their sales tax laws outside their borders. Second, it would have imposed an enormous burden on smaller online sellers. There are close to 10,000 sales tax jurisdictions in the U.S. because localities, in addition to states, levy the tax. Online retailers would have been responsible for knowing the rate, base, and other rules and regulations for each of those jurisdictions so they could have collected the appropriate amount of tax from their customers and return those collections to the right locale. Because of these flaws, and others, the House did not take up the MFA.[75]

In early 2015, Chairman of the House Judiciary Committee Bob Goodlatte (R–VA) released a different plan known as "home rule and revenue return."[76] Under this plan, retailers would collect sales tax on sales to out-of-state customers based on the sales tax law in the business's home state, if their state joins an inter-state agreement. This would reduce the burden that the MFA would have placed on online retailers, since they would not be responsible

for knowing the sales tax laws of nearly 10,000 jurisdictions. However, the plan would force online businesses in the four states that do not have a sales tax (Delaware, Montana, New Hampshire, and Oregon) to collect a minimum sales tax, or to report the name and address of the buyer to their home state tax authority. In effect, it would create a federal sales tax that online businesses in these states would have to collect. This, despite the fact that these no-sales-tax states have expressly chosen not to place the burden of collecting a sales tax on their businesses. Such a federal obligation represents a dangerous extension of the reach of state tax collectors.[77]

Proposals Have Not Been Able to Thread the Needle

A top-down policy from Washington that raises taxes on customers and burdens retailers could curtail the growth of the Internet as an engine of economic growth and set a dangerous precedent that expands the taxing power of states. The failure of recent proposals to find an adequate solution is strong evidence that the best approach to solving this perceived problem is to maintain the policy that has been in place for 23 years—the physical-presence standard. It has held up remarkably well for a standard that was set before the Internet became an ever-present part of daily life.

This standard has withstood the test of time in large part because the biggest online retailers have a growing physical presence around the country. As such, sales taxes already apply to a significant portion of online purchases. According to one recent survey, half of all consumers said they paid sales taxes on their most recent online purchase.[78] Using 2008 data, one study found that 17 of the 20 largest online sellers—ranging from Office Depot to Apple—had retail stores or other facilities nationwide, and collected taxes in all or almost all 46 states that impose sales taxes.[79] These data do not include recent steps by Amazon and other online sellers to expand their physical operations to meet ever-shorter shipping timelines demanded by their customers. This trend, if continued, could solve the dilemma on its own.[80]

Taxing Internet Access

The moratorium on state and local government taxation of Internet access and other Internet services, such as e-mail and instant messaging, or a direct tax on “bits,” has been in place for 17 years now, but has been set to expire periodically. The last time the moratorium was scheduled to expire was in December 2014, when Congress extended it until the end of 2015. The ever-present threat of its expiration is disrupting to consumers and the economy. It is time for Congress to make the moratorium permanent.[81]

If states were allowed to levy these taxes, they could greatly reduce access to Internet services by raising the price for consumers. According to a study by economist George Ford of the Phoenix Center, even a relatively low average tax of 2.5 percent could reduce broadband subscribership by five million to 15 million people, compared to what it would otherwise be. If state taxes average 5 percent, the loss could total between a whopping 10 million and 30 million subscribers.[82]

Entrepreneurs and businesses that rely on the Internet also need the certainty that permanency provides. The prospect of higher taxation makes businesses less willing to invest, and makes it harder for would-be entrepreneurs to go into business.

The drag on the economy of this uncertainty is not trivial. Of the 25 firms investing the most in the U.S. economy, 11 are in Internet-related businesses—including the two largest, AT&T and Verizon, who invested nearly $35 billion in 2013.[83]

There are concerns among some that a permanent ban on state taxes would violate the principle of federalism. However, the Internet is undoubtedly part of interstate commerce, and it is therefore well within Congress’s power to apply a ban on taxing it.

Congress will soon have the opportunity to ban taxes on Internet access and activities permanently. It should do so.

Endnotes

74. 504 U.S. 29 (1992).
75. In March 2015, the measure was re-introduced in the Senate as S. 698.
76. Christopher Cox, "Statement of Christopher Cox on behalf of NetChoice," testimony before the Committee on the Judiciary, U.S. House of Representatives, March 12, 2014, http://judiciary.house.gov/_cache/files/a034c54e-46a6-4570-9e86-f41160dee495/cox-testimony.pdf (accessed January 20, 2015).
77. James Gattuso and Curtis Dubay, "New GOP Plan Would Force Online Sales to Be Taxed at Rate of Seller's State," The Daily Signal, January 16, 2015, http://dailysignal.com/2015/01/16/new-gop-plan-force-online-sales-taxed-rate-sellers-state/.
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80. For further information, see James L. Gattuso, "Taxing Online Sales: Should the Taxman's Grasp Exceed His Reach?" Heritage Foundation *Backgrounder* No. 2817, June 19, 2013, http://www.heritage.org/research/reports/2013/06/taxing-online-sales-should-the-taxmans-grasp-exceed-his-reach.
81. James L. Gattuso, "Read My Bits: No New Taxes (Permanently)," Heritage Foundation *Issue Brief* No. 4242, June 30, 2014, http://www.heritage.org/research/reports/2014/06/read-my-bits-no-new-taxes-permanently.
82. George S. Ford, "Should the Internet Tax Moratorium Be Made Permanent?" Phoenix Center *Policy Perspective* No. 14-03, June 2, 2014, http://www.phoenix-center.org/perspectives/Perspective14-03Final.pdf (accessed January 20, 2015).
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