May 8, 2000

The Honorable John M McCain
The Honorable Max Cleland
United States Senate
Committee on Commerce, Science, and Transportation
Washington, DC 20510-6125

Dear Chairman McCain and Senator Cleland:

Here are my answers to your questions for the record in response to my testimony before your committee on April 12, 2000, concerning S. 2255, a proposed extension of the Internet Tax Freedom Act.

1. **What is a discriminatory tax?**

   Prof. Walter Hellerstein succinctly defines a discriminatory tax in his article analyzing the provisions of the Internet Tax Freedom Act. Hellerstein writes:

   A discriminatory state tax is ordinarily understood to be an exaction that singles out one class of taxpayers, activities, or property for disadvantageous treatment by comparison with the treatment accorded another class of taxpayers, activities, or property, when the distinction between the two classes is one that the law does not tolerate as an appropriate basis of classification (e.g., the conduct of interstate commerce or the exercise of First Amendment rights).


2. **In an effort to simplify state taxes, would it be sufficient for each state to simply establish a state “remote sales” rate, that is a tax rate, which might be different from the sales tax rate a person would pay during an “in person” sale?**

   If a state were to have one sales tax rate for a purchase made through the Internet, and another for the same transaction entered into in person, the difference would amount to a discriminatory tax, discriminating on the basis of mode of ordering. It is difficult to imagine a valid long-term justification for such discrimination from a policy standpoint, particularly if the remote sales tax rate were higher than the in-person rate.
State sales tax simplification for the purposes of reducing burdens on out-of-state sellers, and thus making a good case to Congress for a liberalization of Quill’s restrictions on applying tax to sellers with no appreciable in-state presence, should focus on administrability (for example, arranging a single point of registration and remittance for merchants for all state sales taxes collected) and scope (for example, harmonizing definitions of “juice” across states; Wisconsin currently taxes any beverage which is not 100% juice, while Pennsylvania allows exemption so long as the beverage contains 24% or more juice). These alone are daunting tasks, especially since states’ respective idiosyncratic exemptions may reflect long-settled local political dynamics. Harmonizing sales tax rates from one state to the next is not necessary so long as the tax is grounded on where the goods or services are consumed rather than sold, and indeed may be undesirable. Such “simplification” across states at the cost of creating intra-state tiers of tax based on mode of ordering or location of seller would be even worse.

There are some states that allow local subdivisions to impose their own additional taxes to state sales tax at a point of sale. As a result, the tax on a given product might amount to 6% in one town and 6.5% in another, even with both towns in the same state. One could imagine a state seeking to create a single, blended tax that averaged across all subdivisions to make calculation easier for remote sellers while retaining the complications for local merchants and consumers. However, the Supreme Court has made it clear that such schemes aren’t allowed without Congressional assent so long as the remote rate ends up higher in comparison to that of any state subdivision. See Associated Industries of Missouri v. Lohman, 511 U.S. 641 (1994). This casts doubt on any attempt to create a remote rate that differs from an in-state rate, even if done for the purposes of simplification.

3. In Georgia, citizens vote by referendum to place sales taxes on products they purchase. Why should Congress limit local citizens’ ability to determine how they want to tax themselves?

There are many reasons to want to leave the determination of state sales tax to the discretion of the respective states, each in turn accountable to its citizens. Under the legal status quo, states are indeed free to set their own consumption tax rates. They can demand of their citizens the remittance of a tax on particular goods and services that they purchase (no matter where purchased), and they can demand that merchants collect that tax on behalf of in-state consumers, so long as the merchants themselves are in-state.

The problem arises in collecting tax through physically remote merchants for transactions involving in-state consumers. In such instances a state’s citizens wish to tax themselves via external parties, and the Supreme Court has held in cases like Quill that those out-of-state parties may be unduly burdened by a

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requirement that they calculate, collect, and remit taxes for distant jurisdictions. The worry inheres not in the fact of state citizens choosing to tax themselves, but rather in a requirement that out-of-state entities participate in the tax scheme. As a result, states are prohibited from requiring physically remote merchants to serve as the instruments of collection of otherwise-legitimate taxes. Congress can relax this requirement if it chooses, so one might suggest that this is a “Congressional limit” even though it has been imposed in the first instance by the Supreme Court.

An ideal solution might see the states working together to present a scheme to Congress for approval that would minimize the tax-collecting burden on out-of-state merchants while still having those merchants collect sales tax. That way, over the long term, the states would not have to choose among (1) allowing the distortion and lost revenues that come from a failure to collect tax on remote sales, (2) seeking to enforce the politically and logistically difficult collection of corresponding use tax from their citizens when no sales tax is paid in a transaction, or (3) giving up the sales tax entirely.

To be sure, a harmonization across states of the scope and definitions of goods and services covered by state sales tax might be an important part of simplification; as my answer to question two suggests, differing interpretations of such matters as what constitutes “juice” could contribute to burdensome confusion among retailers as to whether their goods fall under a given state’s tax regime. Thus simplification could require some measure of compromise: Georgia might be compelled to alter its own definition of, say, “juice” as part of a process to create common definitions among states, thereby lowering tax collection burdens on physically remote vendors and eliminating any reason to remove such vendors from states’ reach.

4. Goods and services ordered over the Internet are delivered to consumers on the roads everyone uses. Roads are subject to wear and tear each time they are used, and the states are receiving no revenue from the delivery causing the damage. However, the state and local leaders are responsible for the upkeep of these roads. Is this an unfunded mandate?

Generally speaking, a Congressional restriction or preemption of state taxing ability may well be an unfunded mandate under the Unfunded Mandates Reform Act of 1995, which erects certain procedural hurdles in the path of Congressional legislation that seeks to impose certain costly duties on states without providing funds to pay for their execution. Indeed, it appears that the drafters of the original Internet Tax Freedom Act’s proscriptions on state taxes contemplated that they could fall under the UMRA. Elements of S. 2255’s extension may, if

resulting in a large enough loss to state coffers, also represent unfunded mandates covered by the Act, as might a Congressional narrowing of the definition of “nexus” such that merchants additional to those covered by Quill were free from state tax collection obligations. However, the current specific restriction on states’ abilities to force physically remote merchants to collect sales tax comes not from the Internet Tax Freedom Act or other affirmative Congressional legislation, but from Supreme Court cases like Quill, grounded in the commerce clause of the Constitution.

As a result, it is difficult to see how Quill’s restrictions are unfunded mandates covered by the UMRA, despite the UMRA’s inclusion of court decisions in the definition of “Federal mandates” generally. The technical definitions of the UMRA aside, however, one might view an inability to effectively collect tax on out-of-state products delivered to in-state addresses as an unfunded mandate in colloquial terms: states are providing certain necessary infrastructure and services while being restricted in their efforts to have those who benefit from them contribute a share. This is why, ultimately, it would be desirable to create a system whereby out-of-state purchases can be treated similarly to in-state purchases. This is true even as, for the next few years while the burgeoning Internet remains an infant industry, the serendipitous restrictions on out-of-state tax collection—a rough proxy for collection of tax on items ordered through the Internet—may be helpful to the economy without great cost to state coffers.

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I hope these answers are helpful. Please don’t hesitate to contact me if you have additional questions or if there is anything I can clarify.

Sincerely,

Jonathan Zittrain

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