INTERNET TAX ISSUES

HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

OF THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDRED SIXTH CONGRESS

SECOND SESSION

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INTERNET TAX ISSUES

TUESDAY, MAY 16, 2000

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON OVERSIGHT,
Washington, DC.

The Subcommittee met, pursuant to call, at 2:26 p.m., in room 1100, Longworth House Office Building, Hon. Amo Houghton (Chairman of the Subcommittee) presiding.

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON OVERSIGHT

FOR IMMEDIATE RELEASE CONTACT: (202) 225–7601

May 2, 2000

No. OV–18

Houghton Announces Hearing on Internet Tax Issues

Congressman Amo Houghton (R–NY), Chairman, Subcommittee on Oversight of the Committee on Ways and Means, today announced that the Subcommittee will hold a hearing on Internet tax issues within the Committee's jurisdiction. The hearing will take place on Tuesday, May 16 , 2000, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 2:00 p.m.

Oral testimony at this hearing will be from invited witnesses only. Invited witnesses include representatives from the telecommunications, software, retail, and Internet access industries as well as representatives from State and local government and consumer groups. However, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee and for inclusion in the printed record of the hearing.

BACKGROUND:

In October 1998, Congress passed the Internet Tax Freedom Act (ITFA), Title XI of the Omnibus Appropriations Act of 1998 P.L. 105–277). The ITFA imposed a three-year moratorium on new, multiple, and discriminatory taxes on Internet access and electronic commerce and established the Advisory Commission on Electronic Commerce to examine issues related to Internet taxation.

The Advisory Commission was given 18 months, until April 2000, to study local, State, Federal, and international taxation of commerce conducted over the Internet, Internet access, and other related activities. The Commission was made up of three representatives from the Federal Government (the offices of the Secretary of Commerce, the Secretary of the Treasury, and the United States Trade Representative), eight representatives of State and local governments, and eight representatives from affected businesses. Congress required a two-thirds majority in order for the Commission to make formal recommendations.

On April 3, 2000, the Chair of the Advisory Commission, the Honorable James S. Gilmore, III, Governor of the Commonwealth of Virginia, transmitted the Commission's final report. A majority, though not the super-majority required to make formal recommendations, supported a number of measures including the repeal of the three percent Federal excise tax on telecommunications services, an extension of the current moratorium on multiple and discriminatory taxes on electronic commerce for an additional five years through 2006, and a moratorium on any international tariffs on electronic transmissions over the Internet.

In announcing the hearing, Chairman Houghton stated: "There is no question that the decisions involving taxation of the Internet and electronic commerce are bound to shape the dimensions of the new economic era. We need to make sure that all Americans have the chance to participate in the Information Age. We ought to take a few prudent steps to continue the expansion of electronic commerce and at the same time avoid crippling the infrastructure that has created so many opportunities."

FOCUS OF THE HEARING:

The focus of the hearing will be to consider matters in the report transmitted to Congress by the Advisory Commission on Electronic Commerce within the Committee's jurisdiction, and related topics, such as, the consequences of taxation of electronic commerce, telecommunications services, Internet access and measures to bridge the digital divide.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Any person or organization wishing to submit a written statement for the printed record of the hearing should submit six (6) single-spaced copies of their statement, along with an IBM compatible 3.5-inch diskette in WordPerfect or MS Word format, with their name, address, and hearing date noted on a label, by the *close of business*, Tuesday, May 30, 2000, to A.L. Singleton, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements wish to have their statements distributed to the press and interested public at the hearing, they may deliver 200 additional copies for this purpose to the Subcommittee on Oversight office, room 1136 Longworth House Office Building, by close of business the day before the hearing.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be submitted on an IBM compatible 3.5-inch diskette in WordPerfect or MS Word format, typed in single space and may not exceed a total of 10 pages including attachments. Witnesses are advised that the Committee will rely on electronic submissions for printing the official hearing record.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. A witness appearing at a public hearing, or submitting a statement for the record of a public hearing, or submitting written comments in response to a published request for comments by the Committee, must include on his statement or submission a list of all clients, persons, or organizations on whose behalf the witness appears.

4. A supplemental sheet must accompany each statement listing the name, company, address, telephone and fax numbers where the witness or the designated representative may be reached. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press, and the public during the course of a public hearing may be submitted in other forms.

Note: All Committee advisories and news releases are available on the World Wide Web at "http://waysandmeans.house.gov".

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202–225–1721 or 202–226–3411 TTD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

Chairman HOUGHTON. Thank you very much for coming to our hearing. I apologize for being late, we had a little mixup on the votes and I think we will be all right for at least another hour.

I would like to say something before I make my opening statement. I hope that all the witnesses within earshot will remember to keep your statements to five minutes or less because we have a lot of people, a lot of issues, a short period of time and if you do that, it would be not only effective for you but also very helpful for us. Thanks very much.

We are here today to discuss issues that get a lot of attention but are not particularly well understood—taxes relating to the Internet commerce. To many, the question is simply whether one supports or opposes taxes on Internet sales. The sales and use tax issues are not that simple. Also, there are many other issues that affect Internet commerce that do not receive the same attention but are every bit as important.

Several of our witnesses today will testify as to whether Congress should impose taxes on Internet sales and if so, how to develop simple and fair ways to collect those taxes. Resolving this issue will take quite a bit of cooperation among State and local governments, consumers, businesses and also members of Congress. We will have to think out of the box and explore ideas that have been dismissed in the past or that have not even been developed if we hope to resolve the issue.

Others will testify on issues such as repealing the 3 percent excise tax on phone services extending, a moratorium on taxes on Internet access, and also international tariffs on electronic commerce and bridging the digital divide. These are issues that affect everyone in this room. They represent challenges that can be addressed and resolved relatively quickly.

When we discuss taxes on Internet commerce, let us not overlook these important issues which will have a longlasting effect on the public. Let us move quickly and decisively to fix them this summer if it is conceivably possible.

I look forward to a lively but constructive debate today and I am pleased to yield to our Ranking Democrat, Mr. Coyne.

Mr. COYNE. Thank you, Mr. Chairman.

Issues surrounding the taxation of Internet transactions continues to be debated throughout the country and here in the Congress. Without question, the Internet and e-commerce have changed all of our lives and this Nation's economy in very positive ways.

There are many competing views on Internet taxation which merit our understanding and discussion. I commend Subcommittee Chairman Houghton for scheduling today's hearing. The hearing witnesses who will appear before the subcommittee were selected with politics aside and to provide a balanced discussion of Internet tax issues.

I want to personally welcome one of our first panelists, Robert Strauss, who is joining us from Carnegie-Mellon University in Pittsburgh, Pennsylvania. Because the Congress is in the midst of approving a series of Internet bills urged by the high tech industry,

it is important and timely that we step back and take a close look at the underlying Internet tax issues in controversy today.

Testimony from our State tax administrators, brick and mortar businesses, Internet retailers and dot.coms and high technology providers will be most valuable to the oversight review today.

Thank you very much.

Chairman HOUGHTON. Thank you very much, Mr. Coyne.

Does anyone else have an opening statement? Mr. Portman?

Mr. PORTMAN. No, sir.

Chairman HOUGHTON. Mr. Weller?

Mr. WELLER. I have a brief statement.

I want to commend you on holding what I feel is an extremely important hearing today particularly as we focus on some of the issues now presented to us by the new economy.

There are some interesting statistics out there. Over 100 million Americans use the Internet. In fact, it just took five years for 50 million Americans to use the Internet and it took 38 years for radio to reach that same market. Clearly more and more Americans are going on line to access today's new economy.

Also, I think it is important to point out that the average high tech wage is 77 percent higher than the average wage in other parts of our economy and that the Federal Reserve Board indicates that one-third of all new jobs are created by technology.

That clearly means there is a tremendous amount of opportunity out there. Today we are going to focus on one of those issues we look at to find ways to keep the new economy tax-free, trade-barrier free and regulation-free. That is the tax treatment of Internet access and e-commerce.

If you look at statistics, some talk about something called the digital divide and as we look at who today has access to the Internet, we notice in families with incomes of higher than $75,000, they are 20 times more likely than those with lesser incomes to have Internet access at home.

If you survey those who do not have Internet access, particularly low and moderate income families, they cite the cost of Internet access as the chief barrier for their families to go on line.

When I talk to educators back home, whether school board members or teachers, administrators or parents active in education, they point out they have noticed in the classroom that there is a difference when young children compete against each other in the classroom between those who have a computer at home and those who do not. I think we would all like to have every child to have the opportunity to participate in digital opportunity.

Clearly, as we look at some of the issues today, I hope we focus on ways of reducing the cost of Internet access. I am proud that last week with the five-year extension of the Internet tax moratorium there is language in there which prohibits new taxes on Internet access from being imposed by local and State government. Today we passed legislation which would deny the FCC the ability to impose a tax or fee on Internet access, so that is progress.

Tomorrow the Ways and Means Committee—I want to salute my friend, Mr. Portman, for his leadership on this—is going to vote to repeal the 3 percent excise tax on telephone use. It has been there a century. It was established to finance the Spanish-American War.

That war has been over a long time. It is one of those temporary taxes that never went away.

The reason it is so important is 96 percent of Americans who access the Internet use their telephone service, so if you impose a 3 percent tax on telephone use, you are increasing taxes on use of the Internet. Let us remember aggressive excise tax hurts the poor the most.

Last, I want to call attention to a proposal that Representative Lewis and I are offering. We call it the "Data Act," legislation which also helps make access to the Internet more affordable for working families. We are fortunate that many private sector companies have stepped forward to offer computers and Internet access as an employee benefit as one way of eliminating the so-called digital divide. I want to salute Ford Motor Company, American Airlines, Delta Airlines and Intel which now are offering 600,000 working families the opportunity to have a computer at home. Whether you are the janitor or the guy working in the shop or on the assembly line, you will have universal access to the Internet via this employee benefit, meaning their children will have a computer and Internet access at home and be able to do their school work.

The Net is a good thing, it is good policy and many, many other Fortune 100 companies are looking at doing the same thing. However, their tax lawyers are telling them that if they move forward in providing and Internet access benefit for their employees, they are creating a taxable benefit, meaning the employees will be taxed.

That is why the Data Act is so important as we clarify the tax code to ensure that the Treasury or the IRS cannot tax that computer and Internet access benefit and that it should be treated the same as an employer contribution to a pension or an employer contribution of health care benefits.

This is an important hearing. I commend you for conducting this hearing. I hope we focus on finding ways to reduce the cost of access to the Internet and I look forward to the testimony from the witnesses.

Chairman HOUGHTON. Thank you, Mr. Weller.

We are going to call our first panel: William Harden, Assistant Professor of Accounting, Bryan School of Business and Economics, University of North Carolina at Greensboro; Erick Gustafson, Director, Technology and Communications Policy, Citizens for a Sound Economy; and Robert P. Strauss, Professor of Economics and Public Policy, H. John Heinz, III School of Public Policy and Management, Carnegie-Mellon University.

Thank you very much and Mr. Harden, I appreciate you passing along your view point on the tax notes. Will you proceed?

STATEMENT OF J. WILLIAM HARDEN, ASSISTANT PROFESSOR OF ACCOUNTING, BRYAN SCHOOL OF BUSINESS AND ECONOMICS, UNIVERSITY OF NORTH CAROLINA AT GREENSBORO

Mr. HARDEN. Thank you for allowing me the opportunity to speak with you.

As you know, the sales tax has been a substantial method of revenue generation for the States. As the transportation ability of consumers and mail order distribution methods of retailers increased, however, States were forced to implement a use tax. The issue of requiring the mail order retailer without a physical presence in a State to collect the tax has not met with success.

Electronic commerce is interesting and it possesses characteristics of both mail order and traditional retail sales. The consumer does not physically move into contact with the retailer but at the same time, the electronic store allows more interaction than a mail order catalog.

The implications of imposing this type of tax can be examined in terms of two extremes. Referring to the case of the tax on an expanding market, Exhibit 1, picture a product in which there is a given quantity demanded at various prices and a given quantity supplied.

Next, assume demand for the product is increased. Assume the demand is created by the new presence of electronic commerce, this will shift the point at which the market demand and market supply meet to a higher level of consumption. When a tax is added to this scenario, however, the price of the product is increased by the amount of the tax. At this higher price, the consumer will want less of the product.

It cannot be known in advance whether the consumer or producer will bear the incidence of the tax. What is known is that the level of production and consumption will be lower than they would have been in the absence of the tax.

In very simple terms, this is the argument for not taxing electronic commerce. The imposition of a tax will slow the growth of electronic commerce.

Next, refer to the case of the effects of a tax on an equilibrium market, Figure 2. Visualize a good that is available to consumers in two markets. Assume consumers have sorted themselves between the markets based on their personal preferences so that an equal price appears in both markets.

Picture a tax added to one of the markets only. This causes the price of the good in that market to increase. As this occurs, consumers will move to the other market which now has a lower price. As consumers relocate their purchases to the new market, the price in that market will increase.

Producers will now shift their products to this untaxed market where they can obtain a higher price. Eventually a new equilibrium state will occur but consumption levels will have increased in the untaxed market and decreased in the tax market.

Again, in very simple terms, this is the argument for taxing electronic commerce. Failing to tax such commerce will cause a shift in consumption from traditional retailers who are required to collect the tax to electronic retailers and the States will suffer the erosion of their tax base.

This situation provides a unique dilemma to the U.S. policymakers because the amount of electronic commerce is expected to be so large and could potentially dominate traditional retail for some products. Retailers are split over the issue because those that are electronic only and do not possess a physical presence in a

State will not likely be required to collect the tax. At the same time, retailers who possess a physical presence in the State will be required to collect the tax.

This presents an extraordinary result in that the intent of interstate commerce protection is to prevent an out of State party from being harmed by protectionist activity. In this case, however, the in-State party may be at a disadvantage since it may be required to charge a larger amount than the normal selling price (gross of the sales tax) for the product in order to obtain the same profit.

In contrast, it is also possible that the amount of the sales tax will be effectively offset by additional shipping charges or other costs facing the electronic retailer.

If the growth in electronic commerce comes from new economic growth rather than simply being a transfer from traditional sales, a tax on sales can be expected to slow this growth. If this tax combined with other costs is large enough to make the electronic retailer no longer price competitive with traditional retailers, electronic retailers will fail to survive.

The States, on the other hand, have a reasonable fear that their tax bases will be eroded substantially if electronic sales are not taxed and the increase in these sales is at the expense of traditional retail sales.

While the use tax is an adequate remedy in the case of goods requiring a license, it is not currently thought to be an effectively enforceable tax. In addition, there is a policy concern that exempting electronic sales from sales tax will make the sales tax even more regressive.

As to the issue of unfair competition between different types of retailers, this is a question that will eventually be settled by factual evidence. At the present time, we can be certain of two things. First, imposing a tax on an expanding market will cause a decrease in the amount demanded if consumers are price sensitive.

Second, if the same good is taxed differently in two markets where all other costs and revenues facing retailers are the same, the one operating with the lower tax will have an advantage if consumers can move between the markets.

Likewise, the issue of whether the States will lose tax revenue is not yet settled. If the States cannot effectively impose the sales tax, they will certainly lose growth in their sales tax base relative to the growth they would have experienced had they been able to tax it.

However, whether their tax bases will shrink relative to their current size or how much more slowly their bases will grow due to electronic commerce is not known. This question will also be decided based on consumer preferences and the ability of consumers to move between the traditional retail and electronic markets.

My testimony here, along with the Tax Notes article I have written with Professor Biggart, is not intended to recommend what action the subcommittee should take regarding the taxation of Internet sales. Instead, the hope is you will have a better picture of the issues and motivations both for and against such taxation.

I would be pleased to respond to your questions.

[The prepared statement follows:]

Statement of J. William Harden, Assistant Professor of Accounting, Bryan School of Business and Economics, University of North Carolina at Greensboro

Mr. Chairman and Distinguished Members of this Subcommittee:

Thank you for allowing me the opportunity to speak with you regarding the subject of the individual states applying sales (or use) tax to the sale of tangible goods over the internet. This is a complex issue as you are doubtless aware, and unfortunately it is highly unlikely that a simple solution exists that will be satisfactory to all parties to this issue. Following is a background discussion of how we arrived at the sales tax dilemma we now face and a discussion of the implications of allowing such taxation as well as the alternative of disallowing such taxation.

BACKGROUND

As you are aware, the sales tax has been a substantial method of revenue generation for the states, and this is particularly true of states that do not impose an income tax. At the time of inception of the sales tax over half a century ago, the states' ability to employ such a tax was on solid ground. Since the majority of sales were made through physical retail distribution, it was reasonable to expect retailers to keep abreast of the sales tax rate as well as which types of goods were subject to the tax. As the transportation ability of consumers and mail-order distribution methods of retailers increased, however, states were forced to implement a use tax. Basically the use tax requires the consumer to pay the equivalent of the sales tax if a purchase is made that is not subject to sales tax.

Of course, the product with which such a use tax strategy has been successful is the automobile. Because an automobile must be licensed, a state has a very simple task in requiring the payment of this tax should a consumer go to a different state to make the purchase. With unlicensed tangible goods purchased through mail-order channels, this enforcement mechanism is not present. Compliance with the tax is based on consumers paying the use tax to the state or by requiring the seller to make collection for the state. The issue of requiring the mail-order retailer, without a physical presence (nexus) in a state, to collect the tax has not met with success. Retailers that possess both a physical retail location in a state and provide mail-order sales in state are required to collect the tax on those mail-order sales.

The current issue of electronic commerce is interesting in that it possesses characteristics of both mail-order and traditional retail sales. The consumer does not physically move into contact with the retailer, but at the same time, the electronic store allows more interaction than a mail-order catalog. It is arguable whether by entering the electronic store the consumer has entered into a retailer's "space." Alternatively, it could be asked whether the electronic retailer has relocated itself into a state by allowing access of its electronic store by the consumers in that state or by having its electronic store reside on a server located in that state.

ANALYSIS OF IMPOSING TAX

The implications of imposing this type of tax will be examined in terms of two extremes. This method is chosen because these two extremes often represent the expressed viewpoints of those parties interested in this debate. Of course this analysis is a simplification which looks at the issue from the product demand side. Reality lies somewhere between the two alternatives and involves more complexity.

Referring to the case of the effect on an expanding market (Exhibit 1), picture a product for which there is a given quantity demanded at various prices and a given quantity supplied at various prices. Next assume that to this market demand for the product is increased. For purposes of this present debate, assume the demand is created by the new presence of electronic commerce. This will shift the point at which the market demand and market supply meet to a higher level of consumption. When a tax is added to this scenario, however, the price of the product is increased by the amount of the tax. At this higher price the consumers will want less of the product. Also, it cannot be known in advance whether the consumer or the producer will bear the incidence of the tax. What is known is that the level of production and consumption will be lower than they would have been in the absence of the tax. In very simple terms, this is the argument for not taxing electronic commerce. The imposition of the tax will slow the growth of electronic commerce. At the extreme, it can be fatal to the market by causing electronic businesses to be noncompetitive.

Next refer to the case of the effects of a tax on an equilibrium market (Exhibit 2). Visualize a good that is available to consumers in two markets. Assume there are no market problems, and consumers have sorted themselves between the markets based on their personal preferences so that an equal price appears in both mar-

kets. Now picture a tax added to one of the markets only. This causes the price of the good in that market to increase. As this occurs, consumers will move to the other market which now has a lower price (because it is not taxed), or will choose not to consume the product. As consumers relocate their purchases to the new market, the price in that market will also begin to increase, as an indirect result of the tax. Producers will now shift their products to this untaxed market where they can obtain a higher price. Eventually a new equilibrium state will occur, but consumption levels will have increased in the untaxed market and decreased in the taxed market. Again in very simple terms, this is the argument for taxing electronic commerce. Failing to tax such commerce will cause a shift in consumption from traditional retailers, who are required to collect the tax, to electronic retailers and the states will suffer erosion of their tax base. At the extreme, electronic businesses could attract so much of the market that traditional retailers of some products will not be able to keep their doors open and the states would collect no sales tax on those products.

IMPLICATIONS

This situation provides a unique dilemma to you as policymakers because the amount of electronic commerce is expected to be so large and could potentially dominate traditional retail for some products. You will doubtless hear from many points of view regarding this issue. Retailers are split over the issue because those that are electronic only, and do not possess a physical presence in the state, will not likely be required to collect the tax. At the same time retailers who possess a physical presence in the state will be required to collect the tax.

This presents an extraordinary result in that the intent of interstate commerce protection is to prevent an out-of-state party from being harmed by protectionist activity. In this case, however, the in-state party may be at a disadvantage since it may be required to charge a larger amount, the normal selling price gross of the sales tax, for the product in order to obtain the same profit. You will note that this may be, but is not necessarily, the result. The cost structures for the competing firms may be such that the amount of the tax does not have an impact. In contrast, it is also possible that the amount of the sales tax will be effectively offset by additional shipping or other costs facing the electronic retailer.

If the growth in electronic commerce comes from new economic growth, rather than simply being a transfer from traditional sales, a tax on sales can be expected to slow this growth. If the tax, combined with other costs, is large enough to make the electronic retailer no longer price competitive with traditional retailers, the electronic retailer will fail to survive. Therefore, both types of retailers have competing concerns over the issue.

The states, on the other hand, have a reasonable fear that their tax bases will be eroded substantially if electronic sales are not taxed and the increase in these sales is at the expense of traditional retail sales. While the use tax is an adequate remedy in the case of goods requiring a license, it is not currently thought to be an effectively enforceable tax, due to difficulties in auditing consumers' purchases subject to the tax. In addition, there is a policy concern that exempting electronic sales from sales tax will make the sales tax, which is already considered regressive relative to income, even more regressive. Given that access to the Internet has a real cost to the consumer, those consumers that do not possess such access will be forced into making purchases subject to the tax, while those with access can purchase electronically and avoid the tax.

CONCLUDING REMARKS

In the absence of activity on the part of Congress, the issue may not be immediately settled. Those retailers without physical presence will still have the judicial remedies available to mail-order retailers until the courts alter their position regarding nexus or establish a distinction between the electronic retailer and the mail-order retailer. Likewise, a continuation of the moratorium will not eliminate the ability of a state to impose the use tax, equivalent in amount to the sales tax, on its own residents. The issue again becomes one of enforcement by the states.

As to the issue of unfair competition between different types of retailers, this is a question that will eventually be settled by factual evidence. At the present time we can be certain of two things. First, imposing a tax on an expanding market will cause a decrease in the amount demanded if consumers are price sensitive (the price is elastic). Second, if the same good is taxed differently in two markets where all the other costs and revenues facing retailers are the same, the one operating with the lower tax will have an advantage if consumers can move between markets (traditional retail versus electronic).

Likewise, the issue of whether the states will "lose" tax revenue is not yet settled by factual evidence. If the states cannot effectively impose the sales tax they will certainly lose growth in their sales tax base relative to the growth they would have experienced had they been able to tax it. However, whether their tax bases will shrink relative to their current size, or how much more slowly their bases will grow due to electronic commerce is not known. This question will also be decided based on consumer preferences and the ability of consumers to move between the traditional retail and electronic markets.

My testimony here, along with the Tax Notes [1] article I have written with Professor Biggart, is not intended to recommend what action the Subcommittee should take regarding the taxation of Internet sales. Instead, the hope is that you will have a better picture of the issues and motivations both for and against such taxation. I would be pleased to respond to your questions.

[1] "Tax Internet Sales? The Issue Is Not So Black and White." Tax Notes. Volume 87, Number 5, May 1, 2000, 705–710.

Exhibit 1
The Effect of Imposing a Tax on an Expanding Market

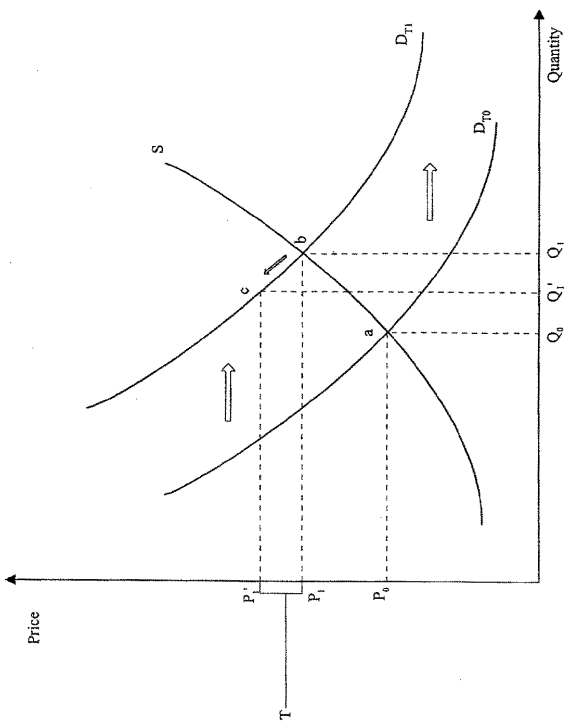
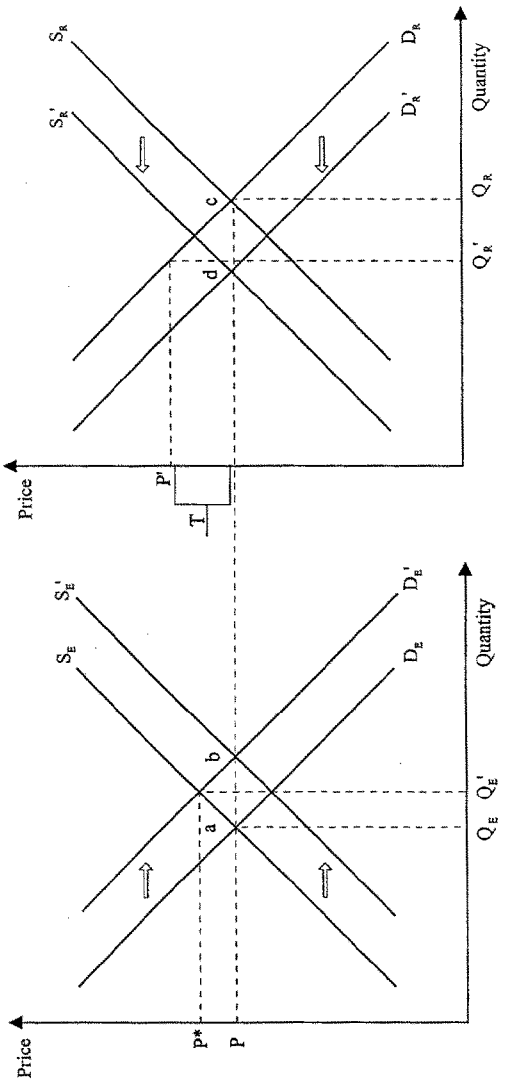


Exhibit 2
The Effects Imposing a Differential Tax on an Equilibrium Markets



Chairman HOUGHTON. Thank you.
Mr. Gustafson?

STATEMENT OF ERICK GUSTAFSON, DIRECTOR, TECHNOLOGY AND COMMUNICATIONS POLICY, CITIZENS FOR A SOUND ECONOMY

Mr. GUSTAFSON. Thank you for the opportunity to share my views on the work of the Advisory Commission on Electronic Commerce, Internet communications taxes and the effect they have on the digital divide. I present these views on behalf of members of Citizens for A Sound Economy Foundation, a consumer education organization that promotes market-based solutions to public policy problems.

The topic of today's hearing has long been an interest for us. Our activists were a force pressing for the passage of the Internet Tax Freedom Act and CSC Foundation staff and members have attended or participated in every meeting of the Advisory Commission over the past year.

We were both pleased by the substance of the Commission's full report and frustrated by those commissioners whose abstention from several key votes limited the report's formal recommendations. We believe that Governor Gilmore and his colleagues have provided Congress with a valuable prescription for addressing a number of issues confronting consumers in our Nation's growing technology sector. In part, the House has already acted on the substance of the Commission's report by passing the Internet Nondiscrimination Act.

When we at CSC Foundation examined the topic at hand, we began with two tenets essential to our mission. First, governments already collect too much money and individuals are taxed far too much. Second, excessive taxation and regulation of communications services is the greatest impediment to access to technology and further compounds the digital divide.

Consider the following facts. Every State in America began the year with a budget surplus, the collective total of which exceeded $35 billion. State tax revenues have doubled in the last 10 years alone. Last year, State and sales taxes increased by 11 percent. State government spending in 1999 was up 8 percent.

At a time like this, the tax debate should be focused on cutting tax rates for consumers and small businesses, not adding new taxes to the Internet. Following the Commission's advice would be a solid step in that direction. In fact, adopting just three of the suggestions in the Commission's report will save American consumers billions of dollars.

First, repeal the 3 percent Federal excise tax on telecommunications services. We all know it has been around for 102 years and it is time it be repealed. The fact it still shows up on our monthly phone bills is another example of how difficult it is to remove a tax once instituted, no matter how onerous it may be.

Next, extend the current moratorium on multiple and discriminatory taxation of electronic commerce for a minimum of five years.

When the Internet Tax Freedom Act was passed, the Internet itself was in its infancy and e-commerce was virtually nonexistent. Today the specter of the taxes, right of way taxes and other onerous tax schemes are little more than a pigment of the overactive imagination.

Also make permanent the current moratorium on Internet access taxes. Taxes raise the cost of going on-line and keep many Americans off-line every year.

Each of these recommendations is a step in the right direction but undoubtedly someone will tell you America cannot move forward. You may hear that States and cities will lose too much revenue, that small mom and pop retailers are unable to take on a global market or that no retailer can compete against an Internet tax advantage.

These arguments are unable to withstand a basic factual analysis. In the fourth quarter of 1999, the most recent holiday season, total retail sales exceeded $526 billion. Of that total, on-line resales constituted just $5.3 billion or .64 percent. To claim that States and cities will not be able to fund schools or law enforcement because of revenue lost to Internet sales is pure demagoguery.

Small business have embraced the Internet in droves despite facing unfamiliar technologies and unproven ways of reaching customers. A newly released survey shows that small businesses out spent consumers by more than $5 billion last year as they made travel reservations and purchased office and computer equipment in record numbers.

Those small businesses that do venture on-line find it far from being a threat. The Internet actually adds to their profitability. The Internet economy accounts for nearly one-third of our Nation's economic growth. It is estimated that if taxes were applied to on-line sales, the growth in that new technology sector would be slowed by 24 percent. Intervention in the high tech market place creates fear and uncertainty among investors and threatens to destroy our economy and weaken the tax base.

At the start of the 21st Century, we have both the opportunity and the ability to give consumers the full benefits of high technology without harming main street or state governments. The Advisory Commission on Electronic Commerce has pointed us in that direction. I urge Congress to heed their advice and send a strong message that the Internet will remain free from heavy government taxation.

Thank you.

[The prepared statement follows:]

Statement of Erick Gustafson, Director, Technology and Communications Policy, Citizens for a Sound Economy

Mr. Chairman, and members of the Committee, thank you for the opportunity to share my views on the work of the Advisory Commission on Electronic Commerce (ACEC), Internet and communications taxes, and the effect they have on the digital divide. My name is Erick Gustafson, and I present these views on behalf of the members of Citizens for a Sound Economy Foundation (CSE Foundation), a consumer education organization that promotes free market solutions to public policy

problems. At CSE Foundation, I am the director for technology and communications policy.[1]

More than a quarter-million strong, CSE Foundation's members are in every congressional district of America. Our members distinguish themselves as policy activists. They constantly remind us that decisions made in Washington, D.C., are felt in places far away from here; and that is where CSE Foundation is found. We at CSE Foundation believe that individual liberty and the freedom to compete expands consumer choice and provides individuals with the greatest control over what they own and earn.

The topic of today's hearing has long been an interest for CSE Foundation. Our activists were a force pressing for passage of the Internet Tax Freedom Act and CSE Foundation staff and members have either attended or participated in every meeting of the Advisory Commission over the past year. We were both pleased by the substance of the Commission's full report and frustrated by those Commissioners whose abstention from several key votes limited the report's formal recommendations.[2] Despite differing with the Commission on a few key points, we believe that Governor Gilmore and his colleagues have provided Congress with a valuable prescription for addressing a number of issues confronting consumers and our nation's growing technology sector.

In part, Congress has already acted on the substance of the Commission's report by passing The Internet Nondiscrimination Act (H.R. 3709). This legislation would extend the current moratorium for five years and terminate a communications service tax currently being charged to some consumers for Internet access.

When we at CSE Foundation examine the topic of Internet, communications taxes, and the digital divide, we begin with two tenets that are central to our mission:

• Governments already collect far too much money, and individuals are taxed far too much; and

• Excessive government taxation and regulation of communication services is the greatest impediment to access of technology and further compounds the digital divide.

Consider the following facts: Every state in America began the year with a budget surplus, the collective total of which exceeded $35 billion. State tax revenues have doubled in the last 10 years. Last year alone, state taxes increased by 11 percent. State government spending in 1999 was up 8 percent. [3]

At a time like this, the tax debate should be focused on cutting tax rates for consumers and small businesses, not adding new taxes on the Internet. Rather than exploring new ways to tax the engine of our economic growth, government should be looking for ways to end outdated taxes and open the doors of the Internet to everyone. Following the Commission's advice would be a solid step in that direction. In fact, adopting just three of the suggestions in the Commission's report will save American consumers billions of dollars.

Repeal the 3-percent federal excise tax on telecommunications services. The 3-percent federal excise tax on telecommunications services was introduced to fund the Spanish-American War. This tax costs Americans nearly $6 billion each year simply for the "luxury" of keeping a phone in the house.[4] The fact that this tax is still on our monthly phone bills 102 years after the Spanish-American War ended demonstrates just how difficult it is to remove a tax. Regrettably, this is just one of the many taxes and outdated regulations that make it more expensive for Americans to go online. We won the Spanish-American War more than 100 years ago; yet, the wartime levy still exists—it is time we win the war against taxes that expand the so-called digital divide.

Extend the current moratorium on multiple and discriminatory taxation of electronic commerce for a minimum of five years. When the Internet Tax Freedom Act was passed, the Internet itself was in its infancy and e-commerce was virtually nonexistent. Today the specter of bit taxes on emails, right-of-way taxes on the transfer of information, and other onerous tax schemes are little more than a figment of overactive imaginations. Had any of these plans been allowed to take hold or had the Internet been treated differently from other types of remote sales it is extremely unlikely that we would have the economy we know today. The Senate should, without delay, follow the lead of the House and act to extend the current moratorium

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[1] CSE Foundation does not receive any funds from the U.S. Government.

[2] More than seven members of the Advisory Commission on Electronic Commerce abstained on 10 key votes during the Dallas Meeting on March 20–21, 2000.

[3] Background for these tax statistics available upon request.

4 Mark Zuckerman, "From 'Remember the Maine' to 'No New Taxes': A History of the Telecommunications Excise Tax" Citizens for a Sound Economy Foundation, July 29, 1999.

so that discriminatory taxes do not threaten electronic commerce. To preserve our rapidly expanding economy we must continue to allow consumers, small businesses, and students to browse, shop, and learn online without facing unique and harmful taxes.

Make permanent the current moratorium on Internet access taxes. Taxes at the on-ramp to the Information super highway raise the cost of going online and keep too many Americans offline every year. Consumers pay between 20 percent and 30 percent in taxes on communications services—tax rates similar to those on "sin" taxes.[5] By imposing regressive rates of taxation while simultaneously proclaiming the need to rapidly expand technology to all regions and income levels, government officials only ensure that taxes will hit hardest those who can least afford it. Policymakers must understand, as they look for ways to bridge the digital divide, the best way to give consumers the full benefits of high technology is by removing the high taxes and obsolete government regulations that are barriers to competition and innovation.

CSE Foundation has long asserted, and a study by the Stanford Institute for the Quantitative Study of Society (SIQSS) has found, that eliminating taxes and regulations is the best approach the government can take to bridge the digital divide. The Stanford study found that demographics only account for 20 percent of the digital divide. Unfortunately, government efforts at bridging the digital divide have traditionally been designed to target specific demographic groups. This study indicates that these types of programs will not solve the problem. If government truly wants to get more people online the best solution is to lower the cost of going online. There are numerous free Internet Service Providers (ISPs), but Internet access fees and highly taxed phone lines are barriers to these ISPs. By eliminating discriminatory taxes on communications, the government could lower the cost of going online and take a huge leap forward in eliminating the digital divide. Now is the time for Congress to act and ensure that taxes will not keep Americans offline.

Each recommendation is a step in the right direction, but undoubtedly someone will tell you that America cannot move forward. You may hear that states and cities will lose too much revenue, that small Mom-and-Pop retailers are unable to take on a global electronic market, or that no retailer can compete against an Internet tax advantage. Know that those who tell you such things either seek to increase tax revenue or to protect existing business models from competition.

In the fourth quarter of 1999, the most recent holiday season, total retail sales exceeded $526 billion. Of that total, online retail sales constituted just $5.3 billion or 0.64 percent.[6] To claim that states and cities will not be able to fund schools or law enforcement because of revenue lost to Internet sales is an outright lie. The fact is, in spite of all the media attention lavished on e-commerce, an overwhelming number of retail sales still take place at bricks and mortar retailers. Moreover, Internet sales are subject to sales taxes in many instances—the same as catalogue sales have been for decades.

Researchers at the University of Chicago and Harvard University recently calculated the impact of Internet transactions on sales tax revenue. They found that online transactions reduce state and local revenues by only $430 million annually—less than one-quarter of 1 percent of total sales tax revenues. Industry watchers expect online sales to grow by 70 percent per year over the next few years, but even then, the revenue lost will represent less than 2 percent of sales tax revenue in 2003.[7]

Small businesses have embraced the Internet in droves despite facing unfamiliar technologies and unproven ways of reaching customers. A newly released survey shows that small businesses outspent consumers by more than $5 billion last year as they made travel reservations and purchased office and computer equipment in record numbers.[8] Those small businesses that do venture online find that, far from being a threat, the Internet actually adds to their profitability.

The Internet economy accounts for nearly one-third of our nation's economic growth. It is estimated that if taxes were applied to online sales, growth in the technology sector would be slowed by 24 percent. Intervention in the high-tech marketplace creates fear and uncertainty among investors and threatens to destroy our

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[5] Jeffery Eisenach, "The High Cost of Taxing Telecom," study prepared for presentation to the Advisory Commission on Electronic Commerce, September 14, 1999.

[6] "Retail E-Commerce Sales for the Fourth Quarter 1999 Reach $5.3 Billion, Census Bureau Reports," U.S. Department of Commerce News, March 2, 2000.

[7] Austan Goolsbee and Jonathan Zittrain, "Evaluating the Costs and Benefits of Taxing Internet Commerce" (Manuscript, May 20, 1999).

[8] Access Markets International Partners Survey, released May 15, 2000.

economy. The government must be stopped from taxing to death the goose that laid the golden egg.

At the start of the 21st century we have the opportunity and the ability to give consumers the full benefits of high technology without harming Main Street or state governments. The Advisory Commission on Electronic Commerce has pointed us in that direction, I urge Congress to heed their advice and send a strong message that the Internet will remain free from the heavy hand of government taxation.

Chairman HOUGHTON. Thank you.

Mr. Strauss?

STATEMENT OF ROBERT P. STRAUSS, PROFESSOR OF ECONOMICS AND PUBLIC POLICY, H. JOHN HEINZ III, SCHOOL OF MANAGEMENT AND PUBLIC POLICY, CARNEGIE-MELLON UNIVERSITY, PITTSBURGH, PENNSYLVANIA

Mr. Strauss. Thank you for the invitation.

I have a ten-page statement that I would like included in the record. I have a one-page summary that I would like to go through.

I think my remarks are perhaps more germane for an odd numbered year but perhaps by the end of my testimony, you will see merit in having the Treasury and Joint Tax Committee jointly look into ways the Federal Government can aid the States to collect use tax and have some hearings on the report.

There are four premises to my remarks. First, the Internet needs a Federal steadying hand to promote web commerce. Also the States need to be able to collect use taxes from residents who don't pay them, but who are legally responsible to do so under current State use tax law.

Second, State sales and use taxes are nothing to be proud of for citizens in any State. Taxes may be the cost of civilization but the way we tax ourselves in the States under consumption taxes is hardly worth bragging about.

The table behind this one-page outline indicates that business on average pays 40 percent of consumption taxes in the States, which causes both inefficiencies and hides the true cost of government. I think both of those are unfortunate and to be avoided.

Third, there is an obvious need to simplify State sales and use taxes, especially at the local level and move to one tax rate per State, and to do so in return for an expanded duty to collect and remit use by remote vendors.

Business and government have been close to agreeing on this, but negotiations outside of the Congress have basically stopped, they are asking, at least on the business side, for more time.

Fourth, final consumption should be the base of any sales tax. The States could readily lower their rates in many instances if they broadened the base to total consumption and eliminated business taxes on inputs.

I have some numbers on this base broading matter. New York's sales and use tax rate could go from 4 to 2.6 percent if it was just on final household consumption; Pennsylvania could drop from 6 to 3.9 percent; California 6 to 5.6 percent and so forth.

When you look at income taxation, the Internal Revenue Code has provided a template that the States have moved towards in the case of personal and corporate income taxes, but there is no such

template in the consumption tax area. If there were a Federal sales tax, there might be something the States could agree on and that would simplify their systems.

I don't think, given my reading of the economy and the kinds of debates that have occurred in this committee literally over the last ten years, that a national sales tax for States to piggy back on, or to move towards, in terms of a template, is a realistic option.

What I would like to suggest to you next are four different ways this committees with jurisdiction, Ways and Means and Finance, could use its powers to enable the States to collect use taxes broadly and simplify consumption taxes dramatically.

Last year, Senator Hollings introduced a 5 percent sales tax as a mechanism to encourage States to move towards that and if they did the tax would credit out. The difficulty with this kind of approach is that it mandates what the rate should be for the States. I think State sovereignty issues would overwhelm that sort of approach.

Earlier last year, I suggested modifying the tax credit eligibility for FUTA to require vendors to collect and remit use taxes into States they sell into as one sort of Federal approach that would have the Internal Revenue Code encourage vendors to collect and remit.

A second approach would be to create the construct of a "qualified sales and use tax base" in the Internal Revenue Code and impose a ten percent excise on vendor sales into a destination State unless the vendor collected and remitted that State's use tax to the destination State, and, in so doing, would not be subject to the 10 percent Federal excise tax.

Another variant of this, which could be done by the Commerce and Judiciary Committees, would be to make that mechanism I just described a penalty rather than a tax *per se*.

These three approaches don't require the IRS to actually touch the use tax money. They do create templates against which the States would gravitate and would also leave the States free to choose the rate of tax, and make our consumption taxes far more transparent than they are today.

This is probably not something that you want to jump on today, but come next year or the year after when main street becomes more persuasive, I suggest it is something you might want to take a look at.

Thank you very much.

[The prepared statement follows:]

Statement of Robert P. Strauss, Professor of Economics and Public Policy, H. John Heinz III, School of Management and Public Policy, Carnegie-Mellon University, Pittsburgh Pennsylvania

1. INTRODUCTION

Chairman Houghton, Congressman Coyne, and members of the Ways and Means Subcommittee on Oversight, I want to thank you for the opportunity to testify this afternoon on certain state tax issues which arise from commerce occurring over the Internet. It has not been fashionable in recent years to view federal, state, and local taxes as intertwined. However, growing world economic interdependencies due to the spread of market economies and technological change obviously imply greater

financial interdependencies for our governments.[1] It is my judgment today that the states can not resolve such issues themselves. Federal legislation is necessary for the states to have a sensible structure of revenue instruments which will allow them to decide the rate of consumption tax necessary to finance the level of public services they agree on. As an alumnus of the US Treasury and Staff of the Joint Committee on Internal Revenue Taxation, I have some preference that such federal legislation as I describe below be the responsibility of the tax writing committees of Congress. You and your staffs have the expertise to deal with the complexities of design and fiscal implications of such design.

There is a need in my view for a steadying federal hand in both the areas of electronic commerce and its taxation. In the case of especially retail electronic commerce, it will not flourish until there are in place, counterpart to existing paper institutions, electronic institutions that establish trust, customer-merchant and merchant-customer protections. It is difficult to envision Americans parting with large fractions of their incomes across the net for goods and services unless they are certain they are as protected as when they engage in face to face commerce. Since much of the appeal for electronic commerce is its increased speed across jurisdictional boundaries, only the federal government can effectively devise systems of standards that will make the appeal a reality. Related to the establishment of various standards for authentication, electronic record-keeping, and electronic notary services, is the supervision of such trusted third parties. For example, as the IRS and tax committees of Congress are learning, simply enabling but not closely supervising private agencies to transmit important electronic documents does not always work as planned.

In my remarks to you this afternoon, I shall address alternative ways the tax committees of Congress can, through federal legislation, enable the states to deal constructively with their various consumption taxes. My focus will be on the use tax problems that arise from inter-state retail sales on the Internet, and alternative ways federal legislation can solve them.

2. The Problems of State Sales and Use Taxes and Possible Federal Roles

2.1 Problems of State Sales and Use Taxes

Over time, state personal and corporate income taxes have become increasingly similar to their federal counterparts. Because there is no federal retail sales tax, there has been no comparable federal template for the states to choose to gravitate to. As you know, state sales and use taxes are extremely important to state budgets, and in some states, the same is true for local sales and use taxes. Among the states, the structure of state sales and use taxes vary considerably. Whether the seller or customer is liable for the tax, the precise nature of whether a good or service is taxable, the rate, and a myriad of other administrative provisions vary. As a result, it is very difficult for a customer or vendor new to a state, let alone a local area, to be confident about what their duty to collect and remit is.[2]

Also, the fact that current sales and use taxes are substantially imposed on business input purchases is troubling from both economic and political perspectives. Such hidden taxes encourage purely tax motivated changes in business form (vertical integration), and hide from voters true tax burdens.

Table 1 displays the design decisions each state makes with regard to its sales tax. The Constitution and Supreme Court decisions require that consumption taxes in classes A and C, and E and G be the same. From an economic perspective, state sales and use taxes would be much better were activities in classes E-G in Table 1 not taxed. Similarly, state sales and use taxes would be much better (and easier to administer) if the exemptions in the final consumption tax base, B and D, were as small as possible. The stricture "broad base, low rate" is as applicable to household or final consumption taxes as it is to income taxes.

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[1] The original 1913 federal personal income tax recognized such interdependencies by requiring all taxpayers to deduct state and local taxes in arriving at federal taxable income. At that time, federal ability to pay was thought to occur after taxpayers took care of their state and local tax responsibilities.

[2] See, Due, John and John L. Mikesell (1994). *Sales Taxation: State and Local Structure and Administration.* Second Edition. (Washington, D.C.: Urban Institute Press, 1994).

Table 1: Classification of State Consumption Tax Design Problem

Geography of Activity	Final Consumption		Intermediate Production	
	Taxable	Exempt	Taxable	Exempt
Sales	A	B	E	F
Use	C	D	G	H

How much are business inputs taxed by current state sales and use taxes? Table 2 displays recent estimates by state of the extent to which households (Column 3) and non-households or essentially business (Column 4) pay sales and use taxes. On average about 40% of sales and use taxes are paid by business; the range is from 11% (West Virginia to 72% (Hawaii).[3] (We shall return to Table 2 when I discuss what a reformed state sales and use tax system might entail.) Current state and local sales and use taxes are thus far from transparent, and, in my view, nothing citizens in each state should be particularly proud of as a way to finance their public services.

Table 2: State Sales and Use Tax Rates, Household's Share, and Estimated Final Consumption Sales and Use Tax Rates

State	January, 2000 State Sales & Use Tax Rates	House-hold Fraction Of Sales & Use Taxes	Non-House-hold Fraction of Sales & Use Taxes	1998 Sales Taxes as % of State Personal Income	1998 Sales Taxes as % of State Personal Outlays	Final Con-sumption State Sales and Use Tax Rate	Final Con-sumption State Rate as % of Cur-rent State Rate
	[1]	[2]	[3]	[4]	[5]	[6]	[7]
Alabama	4.0%	73.0%	27.0%	1.8%	2.2%	3.1%	76.3%
Arizona	5.0%	50.0%	50.0%	2.4%	3.0%	6.0%	119.4%
Arkansas	4.6%	60.0%	40.0%	2.9%	3.7%	6.1%	132.7%
California	6.0%	53.0%	47.0%	2.4%	3.0%	5.6%	93.5%
Colorado	3.0%	60.0%	40.0%	1.3%	1.7%	2.8%	93.8%
Connecticut	6.0%	58.0%	42.0%	2.5%	3.1%	5.3%	89.0%
Florida	6.0%	50.0%	50.0%	3.3%	4.2%	8.4%	140.2%
Georgia	4.0%	64.0%	36.0%	2.1%	2.6%	4.1%	101.8%
Hawaii	4.0%	28.0%	72.0%	4.1%	5.1%	18.2%	455.4%
Idaho	5.0%	62.0%	38.0%	2.5%	3.2%	5.1%	102.4%
Illinois	6.3%	68.0%	32.0%	1.7%	2.1%	3.1%	48.9%
Indiana	5.0%	54.0%	46.0%	2.2%	2.8%	5.2%	103.1%
Iowa	5.0%	59.0%	41.0%	2.2%	2.8%	4.7%	94.8%
Kansas	4.9%	67.0%	33.0%	2.5%	3.1%	4.6%	94.4%
Kentucky	6.0%	54.0%	46.0%	2.8%	3.5%	6.5%	107.7%
Louisiana	4.0%	51.0%	49.0%	2.4%	3.0%	6.0%	149.4%
Maine (4)	5.5%	57.0%	43.0%	2.9%	3.7%	6.4%	116.5%
Maryland	5.0%	60.0%	40.0%	1.7%	2.2%	3.6%	72.6%
Massachusetts	5.0%	62.0%	38.0%	1.5%	1.8%	3.0%	59.3%
Michigan	6.0%	58.0%	42.0%	3.0%	3.8%	6.5%	108.9%
Minnesota	6.5%	56.0%	44.0%	2.8%	3.6%	6.4%	97.9%
Mississippi	7.0%	66.0%	34.0%	3.9%	4.9%	7.4%	106.0%
Missouri	4.2%	64.0%	36.0%	2.0%	2.5%	3.9%	92.2%
Nebraska	5.0%	60.0%	40.0%	2.2%	2.8%	4.7%	93.2%
Nevada	6.5%	44.0%	56.0%	3.7%	4.7%	10.6%	163.4%
New Jersey	6.0%	62.0%	38.0%	1.7%	2.2%	3.5%	58.6%
New Mexico	5.0%	50.0%	50.0%	4.5%	5.6%	11.3%	225.2%
New York	4.0%	66.0%	34.0%	1.4%	1.7%	2.6%	65.8%
North Carolina	4.0%	62.0%	38.0%	1.8%	2.3%	3.7%	91.4%
North Dakota	5.0%	60.0%	40.0%	2.6%	3.3%	5.5%	110.8%
Ohio	5.0%	66.0%	34.0%	2.0%	2.5%	3.7%	74.8%
Oklahoma	4.5%	66.0%	34.0%	2.7%	3.4%	5.2%	114.9%
Pennsylvania	6.0%	64.0%	36.0%	2.0%	2.5%	3.9%	64.3%
Rhode Island	7.0%	59.0%	41.0%	2.0%	2.5%	4.2%	60.4%

[3] The non-household share, Column [3] in Table 2, can be thought of as the ratio of (E + G) to (A + C + E + G) in Table 1.

Table 2: State Sales and Use Tax Rates, Household's Share, and Estimated Final Consumption Sales and Use Tax Rates—Continued

State	January, 2000 State Sales & Use Tax Rates	Household Fraction Of Sales & Use Taxes	Non-Household Fraction of Sales & Use Taxes	1998 Sales Taxes as % of State Personal Income	1998 Sales Taxes as % of State Personal Outlays	Final Consumption State Sales and Use Tax Rate	Final Consumption State Rate as % of Current State Rate
	[1]	[2]	[3]	[4]	[5]	[6]	[7]
South Carolina	5.0%	61.0%	39.0%	2.7%	3.4%	5.5%	109.8%
South Dakota	4.0%	61.0%	39.0%	2.7%	3.4%	5.5%	137.8%
Tennessee	6.0%	63.0%	37.0%	3.1%	4.0%	6.3%	104.6%
Texas	6.3%	53.0%	47.0%	3.0%	3.8%	7.2%	115.2%
Utah	4.8%	63.0%	37.0%	2.9%	3.6%	5.8%	121.2%
Vermont	5.0%	56.0%	44.0%	2.2%	2.7%	4.8%	96.7%
Virginia	3.5%	70.0%	30.0%	1.4%	1.8%	2.6%	74.0%
Washington	6.5%	49.0%	51.0%	3.1%	3.9%	8.0%	123.4%
West Virginia	6.0%	89.0%	11.0%	2.8%	3.6%	4.0%	66.7%
Wisconsin	5.0%	62.0%	38.0%	2.3%	2.9%	4.7%	94.3%
Wyoming (3)	4.0%	54.0%	46.0%	3.0%	3.8%	7.0%	174.9%
Mean	5.2%	59.4%	40.6%	2.5%	3.1%	5.6%	111.1%
Std Dev	1.0%	8.8%	8.8%	0.7%	0.9%	2.7%	61.4%
Min	3.0%	28.0%	11.0%	1.3%	1.7%	2.6%	48.9%
Max	7.0%	89.0%	72.0%	4.5%	5.6%	18.2%	455.4%

Notes: Column [1] from Federation of Tax Administrators Webpage www.taxadmin.org;
Column [2] and [3] from Raymond Ring, Jr. "Consumers' Share and Producers' Share of the General Sales Tax," National Tax Journal, LII, 1 (March, 1999), Table 1, p. 81.
Column [4] John L. Mikesell, "Retail Sales Taxes, 1995–98: An Era Ends," State Tax Notes, Table 4, pp. 592–3.
Column [5]= Column [4]/.794, the ratio of 1998 BEA Consumer Outlays/BEA Personal Income
Column [6]=Column [5]/Column [2]
Column [7]=Column [6]/Column [1]

The other emerging problem of state sales and use taxes, and the immediate reason for this hearing, is the likely erosion of states sales and use tax bases as retail electronic commerce grows. As you know, under Bella Hess and Quill, the states are not able to obligate remote sellers without a physical presence to collect and remit use taxes, although their residents remain legally obligated to pay them. Traditional merchants find themselves increasingly at a disadvantage as remote electronic vendors join remote mail and phone catalog vendors in arbitraging on price differentials that reflect use taxes not being collected. Business equity issues are thus becoming more pronounced. Michigan's experiment last month, which puts a use tax line on its personal income tax return,[4] is carefully being watched by other states. However, vendor collection and remittance at the time of sale makes far more sense and eliminates customer record keeping. How might the federal government assist the states in obtaining better compliance with its use taxes?

2.1 Alternative Federal Roles

State Piggybacking onto New Federal Retail Sales Tax

Periodically, there has been discussion about the desirability of moving to a federal consumption tax—either a value added tax or retail sales tax. In conjunction with such a redesign of federal revenues, it has been suggested that the states could piggyback onto federal administration. Time and space limitations do not permit an extensive discussion of whether or not it is a good idea to now consider a federal retail sales tax as a mechanism for either fundamental federal tax reform or as a way to help the states. However, let me state my conclusion, having looked at the issue closely several years ago,[5] that the economic argument favoring federal consumption tax as a cure to lackluster economic performance is not as persuasive today as it was a decade ago. Even if the federal government were to enact its own

[4] Line 30 of Michigan's personal income tax return, MI–1040, asks the taxpayer to report use tax due from a worksheet.
[5] Robert P. Strauss, "Administrative and Revenue Implications of Federal Consumption Taxes for the State and Local Sector," State Tax Notes, 15, 5 (February 1, 1999), 327–338.

national retail sales tax, it is unclear whether or not the states would be drawn to such a template, especially if they did not retain control of their own rate of tax.

Federal Revenue Sharing to States of New Federal Retail Sales Tax

Were the federal government to enact a national retail sales tax and then share back some or all of the revenues to the states, the states would still likely want to maintain their own sales and use taxes, although they might reduce reliance on their own. Issues of sovereignty would undoubtedly arise while the method or formula for federal revenue sharing would likely be a difficult issue for Congress to resolve. Moreover, this approach might not readily deal with the above mentioned use tax problems should the states retain their own sales and use taxes, nor would it deal with cascading or complexity issues either.

Federal Assistance/Insistence but not Federal Collection of State Use Taxes

If state piggybacking onto a new federal sales tax is not in the offing and revenue sharing is also not a plausible solution to state use tax issues, then what? What follows involves a solution based on the following tax policy pieces:

a) agreement to dramatically simplify state sales and use taxes though state absorption of local sales and use taxes and the keeping whole of local governments which give up their local sales and use taxes,

and

b) federal assistance/insistence to ensure that remote vendors collect and remit use taxes.

To these I would add the elimination of sales and use taxes currently imposed on business inputs. However, the ideas which follow can be put together without this. What is essential is one definition across all states imposing a consumption tax of what constitutes taxable consumption so that intra and inter-state vendors can readily determine if the purchase is taxable or not.

3. The Grand Political Trade

In good measure the growing complexities which traditional multi-state vendors were experiencing with local sales taxes as well as growing concerns states were having about use tax collections from catalog and Internet vendors precipitated industry-government discussions at the NTA Project and then ACEC. The basic idea still being discussed is to:

legislatively overturn Bella Hess and Quill through an expanded duty on remote sellers to collect and remit use taxes to the jurisdiction of destination or use currently without such obligation

in return for

a vastly simplified sub-federal sales and use tax system that would eliminate intra-state diversity in sales and use taxation, and standardize administration across the states[6] .

Under this grand trade, states would agree to move to one tax rate per state that was revenue neutral, and business would join with state and local government to find suitable legislative vehicles to make it a reality. Some of the participants in the NTA Project also hoped that sales and use tax simplification would also lead to reform, e.g. agreement on a uniform final consumption tax base.

Much of the impetus for extending the moratorium for a long period of time(say 5 years) is to give the states sufficient time to work out among themselves just what a simplified system might be. However, I am doubtful that such a voluntary or cooperative approach can work, and suggest that with some federal assistance or insistence, the states can readily adopt a model statute, with many simplifications, that will make the above grand political trade a reality. Below, I sketch out the essential pieces to this.

4. Simplifying and Reforming State Sales and Use Taxes

There are two ingredients to devising a new system of state sales and use taxes:

- Creating a definition of final taxable consumption for all states with sales and use taxes that is workable, and
- Finding a credible mechanism to enforce the expanded duty to collect on remote vendors (e.g., catalog and Internet)

4.1 Defining Final Taxable Consumption

There are several reasons to favor the states moving to the same definition of household consumption. First, it makes administration much more simple, espe-

[6] Periodically the states have said they would engage in revenue sharing intra-state to keep those local governments now dependent on local sales and use taxes whole.

cially for remote vendors, since one need not keep track of the extraordinary fine distinctions among goods and services which the states have made over the years for public policy and other reasons. Second, a broader base means that the rate of tax can be lower, and thus have a smaller impact on consumption choices made by households. Third, by just taxing final consumption, the states will inform their citizens about what the tax costs of government are.

Historically there have been a variety of approaches to define what is taxable under state sales and use taxes, and how to exempt certain items, either in terms of the nature of the customer, or in terms of the nature of the good or service. A rather simple way to move a household final consumption sales and use tax base is to reverse the way sales and use tax laws are typically drafted, and to introduce a new construct for sales and use tax purposes, the "taxable person."

Under the taxable person approach, sales and use taxation is an exception to a general prohibition on the taxation of anything. The exception is for anything purchased for or purchased by a "taxable person" for "non-business use." What is a "taxable person"? A "taxable person" is any natural person (and thus not a corporation or other recognized legal form of a business or government). "Purchase" would cover any consumer purchase or rental. This concept is quite broad; for example, consumer services would be automatically covered under this definition since they are paid for by a natural person who is not a business.[7] The first phrase, "purchased for" is necessary for sole proprietorships, and for closely held businesses, and more generally to avoiding passthroughs from businesses to persons as a way to circumvent the sales and use tax.

How might such a system work in the world of web commerce? Unless a purchaser had a registration certificate, any purchase, main street or remote, would be taxable at a single state rate. Provision of the business registration number by the agent for the company making the purchase would preferably be in a uniform format (a single national registration form with a single structure to the registration number) and provided in a secure (encrypted) form to the seller. Just as a seller has to confirm the authenticity of a credit card number and any other identifying information prior to agreeing to the sale, the seller would confirm the business registration certificate number at a regional or central clearinghouse that would maintain this information in a secure fashion. To ascertain whether or not the purchase is a pass-through for personal use, the purchaser would have to be queried about this, and the proper response noted and recorded. The final issue involves the destination of delivery or use, and the application of the correct state sales and use tax rate. Again, the purchaser would need to be queried as to this and the seller would have to record it.[8]

Table 2 contains some preliminary estimates about what the range of sales and use tax rates might be if the tax base were final consumption rather than the current amalgam of both some household and some business purchases. Moving to broad-based final consumption from a hybrid base entails first a base narrowing in order to tax just households, and then a base broadening to include all items of consumer outlay. Column [6] of Table 2 displays by state a rough estimate of what the equal yield tax rate would have to be if the base were household outlays. The mean final consumption state sales and use tax rate is 5.6% compared to the current mean sales and use tax rate of 5.2%. Alabama could cut its current 4% state rate to 3.1% if it levied it on all final household consumption. Similarly, California could lower its rate from 6% to 5.6%, and so forth. For states that have heavy tourism, such as Florida, Hawaii, and Nevada, the estimated final consumption tax rates undoubtedly overestimate the extent of change that would have to occur. Of course, if the model sales and use tax statute were to exempt necessities such as food, clothing, and medicine, then equal yield rates would have to be higher. I view these first estimates as generally encouraging.

4.2 Four Federal Approaches to Assisting/Insisting on An Expanded Duty to Collect and Remit Use Taxes

After the issuance of the NTA Final Report in September, 1999, the National Governors Association and National Conference of State Legislators began developing a proposal which they believed would enable the states through bilateral, coopera-

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[7] Third party payments (e.g. health insurance) are a gray area but would seem to be an example of a business pass through to an individual which would thus be taxable to the third party (regardless if it was tax exempt or not). Anything purchased for personal use would be covered by the non-business use.

[8] Evidently the new Russian Federation's Regional Sales Tax appears to be structured in a similar manner. See John L Mikesell, "Structure of the Russian Federation's New Regional Sales Tax," *Tax Notes International,* 18 (March 15,1999).

tive agreements to obligate businesses which originated inter-state sales to remit to the destination state as a consequence of the cooperative agreement being in place. The states evidently view this approach to eliminating the need to come before the Congress to ask for federal legislation. Elsewhere[9] I have characterized this as "each state permitting the other to fiscally hunt in the dark." I am not alone in such pessimism, and I have heard that some governors are now wondering if their bilateral approach can be timely, practical and effective.

Certainly, there is no impediment to the Congress legislating to assist the states under its taxing or commerce powers. The general solution to what is usually called the tax harmonization problem I develop below involves federal participation to ensure compliance of remote vendors to collect and remit, but one that stops a bit short of actual federal piggybacking.

One set of federal solutions lies in constructing a tentative (federal) tax which may be offset by a credit for other "qualified" (state) taxes that the seller collects and remits directly to the states. Failure to collect and remit means loss of the credit, and the payment of the tentative tax to the federal government rather than in effect zeroing it out with the payment of the state tax. Since there is a tentative federal tax, there will necessarily be a federal review of books and records (federal audit), and oversight of the remittances so they go to the proper state.

Another set of federal solutions entails a free-standing federal penalty tax should non-compliance to collect and remit occur.

4.2.1 Hollings S1433

In July,1999 Senator Hollings introduced S1433 whose purpose was to impose a federal tax on internet or catalog sales at a rate of 5%, but which could be offset by a credit for collection and remittance of state and local sales and use taxes at rates of up to 5%. The bill created the construct of sales by a "local merchant" to which the tentative tax and credit would not apply. The net federal proceeds of such an approach would go into a trust fund whose proceeds would be used by the Secretary of the Treasury to make grants, based on a population and poverty allocation formula, to each state and the District of Columbia to supplement salaries of primary and secondary public school teachers.

The Hollings mechanism puts extreme pressure on the states to adopt use tax rates at 5%. This arguably will have a chilling effect on state sovereignty that might be far worse than pure piggybacking because most piggyback models permit state discretion in tax rate, but use a purely federal collection mechanism.

4.2.2 Expand FUTA Eligibility Requirements to Include Expanded Duty to Collect

A second variant of this type of harmonization, and one that is more workable in my view, is to utilize an existing well harmonized federal-state tax instrument. What I have in mind here is to utilize the historical harmonization of federal and state unemployment taxes as a vehicle for assuring that the new duty to collect and remit use taxes is in fact honored. The idea would be to amend eligibility for the FUTA tax credit to require positive agreement by an employer to participate in the collection and remittance of the newly enabled use taxes. Remote sellers of any consequence have employees, and are thus necessarily involved in existing federal and state unemployment compensation programs. As a result, they are already subject to audit and regulation by both IRS and the US Department of Labor and their state counterparts.

Under this scheme, qualification to take the historical credit for state unemployment taxes against the tentative federal unemployment tax would simply entail a new responsibility, namely demonstrably agreeing to collect and remit use taxes enabled under the grand political trade. One would amend current FUTA requirements to include reporting about all sales and the use tax remittances to aid in administration and audit. Under this approach, the states retain control over their use tax rates, get remittances directly from remote sellers, and IRS would perform some audit and oversight functions, but not deal with each transaction. This approach would also allow remittance mechanisms to evolve as technology develops, and as the market place provides software solutions to remote sellers. It is reasonable to expect that some form of vendor discount be made available to amortize the costs of such software investments.

Whether or not the unemployment system can or should handle this new responsibility remains an open question. Also, given that current state use tax rates are in the 3–7% range, it is possible that remote vendors might simply forego taking

[9] Robert P. Strauss, "Further Thoughts on State and Local Taxation of Telecommunications and Electronic Commerce," State Tax Notes, 17, 17 (October 25, 1999), 1113–1124.

advantage of the federal credit since 3 to 7% of their gross sales would dwarf any federal offset of state employment taxes.

4.2.3 Conditional 10 % Federal Sales Tax

Another, related way to encourage remote vendors to collect and remit use taxes would be to obligate any federal taxpayer, engaged in remote sales, to pay to the IRS an excise equal to 10% of its sales, unless it agreed to collect and remit use taxes to each destination state which had in place a reformed sales tax base contained in federal law (e.g. per Section 4.1 above) at the state's use tax rate. If a state did not have in place the reformed or "qualified sales and use tax ", the state would not benefit from federal insistence on the remittance of the use tax. This would enable all non-sales tax states to remain sales tax free. As long as taxpayers collected and remitted, IRS would never see or touch any of the use tax monies. With suitable administrative mechanisms in place, states would continue to enjoy fiscal autonomy by virtue of having control (with suitable notification) of their sales and use tax rates.

Compliance with this obligation to collect and remit would entitle the taxpayer to an exemption from the 10% federal sales tax. Presumably all taxpayers would understand they would do much better by collecting and remitting the use tax than standing in non-compliance and be subject to the 10% federal tax.

4.2.4 10 % Federal Penalty Approach

A variant on the conditional 10% federal sales tax would be to structure the relationship between the taxpayer and a federal agency as a penalty for non-compliance, given that the destination state had in place a "qualified state sales and use tax." Now, the penalty would be measured by a high percentage (e.g. 10%) applied to the taxpayer's sales. Arguably the penalty approach could be acted upon by a committee other than a tax committee of the Congress, although there would be a question of which federal agency to turn over any possible proceeds, as well as a question of which federal agency, if not Treasury/IRS, would be responsible for determining that any state indeed had in place a "qualified" sales and use tax.

An advantage of these approaches is that they could be devised to leave both Quill and Bella Hess undisturbed, and thus not raise any nexus issues in other areas of state taxation (e.g. business income or franchise taxes). Remote vendors would be collecting and remitting simply to forestall an adverse, federally imposed financial consequence. By the same token, any state which felt strongly that its current sales and use tax base, imposed partly on households and partly on business, rather than on final consumption, was more meritorious than a "qualified state sales and use tax" could continue to enjoy its sovereignty over base and tax rate. In this circumstance, remote vendors would not be obligated under threat of federal penalty to collect and remit use taxes. Of course, such states would continue to find use tax remittances lagging, and, as electronic retail commerce grows, this could have increasingly serious financial consequences to them.

Congress might find legislating under this second approach somewhat easier, because you would not be requiring per se that each state with a sales and use tax to necessarily adopt the "qualified state sales and use tax." Greater state sovereignty would be, of course, at the expense of simplification, ease of administration and compliance, and elimination of tax cascading.

5. Concluding Comments

The objective of my remarks has been to explain several different ways the tax committees of the Congress might assist the states in moving to a simplified system of sales and use taxes, and in so doing ensure that remote vendors, currently without a duty to collect and remit use taxes, would do so in the future. The ideas I have presented contemplate a more integrated vision of tax policy in our federal system than has been fashionable in recent years. But it may also anticipate that, because our daily lives are increasingly affected by events far away, our fiscal institutions need to adapt as well. Federal leadership requires Congressional action. State cooperation to accomplish inter-state tax harmonization of state sales and use taxes, but without federal legislation, seems well intentioned, but not likely to be fruitful.

The range of federal interventions I have suggested, various kinds of federal taxes to be imposed unless states have more uniform sales and use taxes, and vendors collect and remit use taxes to the destination state, requires further exploration to flesh out administrative details and their fiscal implications. I urge, if some sort of further moratorium is to become federal law, that you obligate in such extension legislation that the U.S. Treasury and Joint Committee on Taxation undertake a very serious examination of the sort of alternatives and related details that I have

sketched out this afternoon. Such a joint executive-legislative study[10] should be completed by a date certain. Afterwards, I think there should be a significant set of public hearings to discuss the findings also by date certain.

I would be happy to respond to any questions you may have about this testimony or issues related to it.

Chairman HOUGHTON. I am going to turn over the microphone to Mr. Coyne for questions.

Mr. COYNE. Thank you.

Mr. Strauss, I wonder if you could let us know what are the major points and general principles we ought to be considering here in Congress in evaluating the overall taxation of e-commerce?

Mr. Strauss. I talked to my daughter this morning back in Pittsburgh and she said, "Daddy, what are you doing in Washington?" I said, "I am going to talk to the Congress about taxing things that you buy on the Internet." She said, "Oh, what will the money be used for?" I said, "To fix the Pennsylvania Turnpike and fix up our schools." She said, "Oh, you mean like when I go into the store and pay the same tax?" I said "yes." She said, "Well, that is cool." So she "gets it."

My point to you this afternoon is I hope ultimately that the Congress "gets it" and helps the States collect its use tax. Treating same economic events in the same way is an important principle. In an interdependent world, the Federal Government helping the states deal with cross jurisdictional events in a reasonable fashion, I think, is another important principle.

Third, I support low rate and broad base; I suggest to you the kinds of ideas I just described will encourage the States to clean up their consumption taxes, something that I would suggest they cannot do themselves or agree among themselves to do.

Those are the principles I would suggest you consider.

Mr. COYNE. Would you be able to give us your views on the Commission's final report and their informal findings?

Mr. STRAUSS. There are a few things I agree with in the Commission's report, there are lots of things I disagree with. That would require more than 3.20 minutes. I just don't think the Commission's approach serves the public's interest in the 21st Century which is to basically give the States the revenue instruments they need in a very interdependent world. It does not reflect the kind of overall view which the Congress can come up with.

There is a lot of stuff in there that has some merit but there is frankly not enough detail to really give you advice.

I come back to my notion of having the Treasury and the Joint Tax Committee look at the issues of use taxation and report back to the Congress. Frankly, I think on those two professional staffs you can get some very detailed insight, some good constitutional

[10] Lists of various administrative details that would need to be addressed to simplify state sales and use taxes can be found in both the NTA *Final Report* and the ACEC Report to Congress. The NTA *Final Report* contains extensive discussion of most of the problems and options to simplify state sales and use taxes. Hopefully such a federal review would deal more extensively than either *Report* with the problems the states would face in keeping their local governments whole once local sales and use taxes were phased out. It is imaginable, for example, that new federal statistics on the intra-state patterns of local retail sales would have to be collected to enable the states to share back state revenues on an acceptable basis to local governments.

advice and deal with the issues the way this committee over the decades has dealt with them, in a very concrete, broad fashion.

Mr. COYNE. I wonder if you could touch on the distribution implications of exempting Internet-based commerce from the sales tax?

Mr. STRAUSS. There are a couple of reactions. First of all, if you look by income class at who is using the Net, and data is a little bit old, it is upper income families. So if you say they buy through the Net and don't have to pay the use tax, don't write down on the State income tax form if the State bothers to ask, what the use tax should be, they are the ones getting the free ride and the cost of public services are borne by everyone else. Most sales and use taxes in most States are regressive anyway, so it exacerbates it.

The thing I dislike most about leaving use purchases across the Net tax free is that it makes liars out of us all the time. It is the same problem with catalog sales. We all know what we are supposed to pay; I think the vendors have the computer power and the mechanisms to readily do it. It is just a question of making sure that we are honest in an easy and practical fashion. I think there are a lot of different ways that can be accomplished.

Mr. COYNE. Thank you.

Chairman HOUGHTON. Mr. Weller?

Mr. WELLER. I would like to focus my questioning to Mr. Gustafson. You noted in your testimony a point similar to what I stated in my opening statement, that is while we find that the higher the income in the household, the more likely they are on-line. Frankly, I have also seen statistics that show the educational level, whether high school or college or graduate school also increases the likelihood of being on-line, having a computer and Internet access at home.

You also made the point that if government truly wants to get more people on-line, the best solution is to lower the cost of going on-line. You indicated right now consumers on average pay between 20 to 30 percent in taxes on communications services?

Mr. GUSTAFSON. Yes, that is correct.

Mr. WELLER. Is there any other part of our economy where that tax burden is higher?

Mr. GUSTAFSON. Perhaps sin, things like alcohol or tobacco, those sorts of things, things that are traditionally discouraged, we tax higher. That one of the problems with the sales tax structure, that you are able to single out certain items through the tax structure and encourage or discourage their use or consumption.

Mr. WELLER. So essentially, you are saying unless you smoke or drink alcohol, you are paying the highest level of taxation if you want to communicate?

Mr. GUSTAFSON. Pretty close, gasoline or something along those lines, but yes, for something that is encouraged within society, talking to one another and communicating, we tax it at a disproportionate rate compared to other things we try to encourage.

Mr. WELLER. The House has taken the lead in finding ways to reduce Internet access cost. We passed legislation last week that would prohibit State and local government from imposing new Internet access taxes or fees or charges. Today, we passed legislation out of the House which passed unanimously I believe which would prohibit the unelected bureaucracy at the FCC from impos-

ing a new Internet access charge, so we blocked them off at the pass.

Tomorrow, this committee is going to vote on legislation to eliminate the 3 percent excise tax which I call 3 percent Internet access tax.

Are there any other measures or ideas out there that we could also consider as ways to reduce the cost of accessing the Internet?

Mr. GUSTAFSON. I think more than obviously taking those steps and looking at all the tax structures, encouraging States to lower their tax burdens and also not raising taxes like the e-rate tax which is another tax on long distance service, the Gore tax as it is often referred to, is something else out there that needs to be reexamined.

At one point you are encouraging the substantization of the service because you want people to consume it, in this case Internet access, and on the other hand, you are taxing the number one way people go on line actually to consume that service. It seems a little paradoxical. Obviously it is the kind of thing that Congress should avoid.

Aside from that while it is important to lower the cost of accessing the Internet, it is not necessarily important to get out there and actively subsidize its consumption. As I think you noted also, this particular type of technology is spreading more rapidly than any other sort of consumer technology in the history of mankind. It is something the market has already taken care of. I wouldn't necessarily get out there and encourage government spending to the people on-line.

Mr. WELLER. I think I have seen statistics that 7 new Americans go on-line every second with increased access to the Internet.

I also would note with legislation we are going voting on tomorrow regarding the Federal excise tax if you consider the taxation on telephone service, which 96 percent of Americans use to access the Internet, I think I have seen figures where the taxation has gone up 62 percent in the last few years nationwide, local, State as well as Federal because of increased use of the telephone.

I am concerned about the employee benefit of computers and Internet access that is now being provided by some employers—American Airlines, Delta, Ford Motor Company, Intel. In talking with some of the workers who would like to take advantage of that benefit, they have learned it might be a taxable benefit and have expressed concern that they don't want to pay higher taxes if they give the opportunity to have a computer and Internet access at home.

From the point of view of your organization, do you have any views on that?

Mr. GUSTAFSON. Obviously increasing the amount of taxes people pay is not something Citizens for A Sound Economy would support, so if you start examining the benefits of what an individual receives in terms of extending their tax base, I am not sure that is wise. We may as well start looking at the company picnic or the company Christmas party and treating those as taxable benefits as well.

If they do decide to tax the benefit of a computer the company gives the individual, then they ought to at least accurately account

for the cost of the computer and today, if you sign up for an Internet service provision plan can fall as low as $150 or less. Sometimes they are free computers, so it is not something we would actively encourage and oppose.

Mr. WELLER. Thank you. I see I have run out of time.

Chairman HOUGHTON. Mr. McDermott?

Mr. MCDERMOTT. I want to commend the Chairman for having this hearing. I asked for it because I come from a State where we don't have income tax and all we have is sales tax. Having been a Ways and Means Chairman and having had to wrestle with where the money comes from, I look at the Internet as being a hole in the bottom of the bucket.

I would ask unanimous consent to enter into the record a statement by Gary Tober, an Adjunct Professor of Law at the University of Washington. He is not here today in part because he is working on three IPOs in Seattle.

[The information follows:]

Statement by Gary P. Tober, Adjunct Professor of Law, University of Washington School of Law

Thank you Chairman Houghton and Mr. Coyne, for the opportunity to present this statement to the Committee on Ways and Means Subcommittee on Oversight on Internet Tax Issues. Thank you Mr. McDermott, for inviting me to submit this statement on the taxation of Electronic Commerce.

Business activity on the Internet is rapidly increasing and has become an important part of the national economy. Consummation via the Internet of commercial and consumer transactions has become commonplace. Business activities are being developed or modified for the Internet. Some Internet businesses are proving to be successful; some are not. Manufacturers, mercantile businesses, and service providers are expanding their activities to include the Internet as part of how they conduct business. These are exciting times for entrepreneurs.

One of the recurring challenges associated with the debate over Internet taxation is the lack of a consensus on a definition of electronic commerce. If electronic commerce is defined narrowly, the tax issues are camouflaged. If electronic commerce is given an all-encompassing definition, the task of addressing its taxation becomes impossible. A major part of the challenge, as well as the excitement, of electronic commerce is the constant enhancement and evolution in its capabilities that is taking place. The speed at which the Internet is expanding (not only its connections and content, but also its capabilities) and thereby becoming a larger part of each business day makes it difficult and maybe impractical to apply existing tax rules or develop appropriate tax rules.

Many aspects of electronic commerce are dealt with by the existing tax code. Congress should not overlook this fact. The Internal Revenue Code provides an adequate basis for dealing with the federal tax ramifications of the solicitation and sale of tangible personal property through the Internet. The tax issues presented by these consumer transactions or business-to-business transactions are the same ones presented and dealt with by Congress when technological advancements occurred in the past, such as the television, cellular telephones, and pagers, to name a few.

However, the Internet allows business activity to be conducted in novel ways. Electronic commerce is difficult to tax under current tax principles primarily because it is at once everywhere and nowhere. Transactions completed via the Internet can reflect multiple aspects and a blending of attributes of various types of commercial transactions outside the Internet, none of which is dominant. When a single Internet transaction is a combination of providing services, selling goods, and licensing property rights, the current tax rules do not provide adequate guidance as to the correct tax result. The current tax consequences of commercial transactions conducted over the Internet and how they should be treated by the tax code warrants the attention of Congress.

Electronic commerce is characterized by few barriers to entry by a new business. It takes only a small capital investment for an entrepreneur to start an Internet business. The ease and efficiency by which information can be disseminated on the Internet is remarkable. The potential market for a business is not limited by geographic or time constraints. Further, the consumer has been empowered with a tool

to quickly compare price and quality, possibly negotiate better terms or price, and all at the consumer's convenience.

My statement will touch on three areas of taxation of electronic commerce: state and local taxation; federal taxation; and international taxation. Each of these tax areas have challenges presented by the emergence of electronic commerce.

STATE AND LOCAL TAXATION

Each state and local taxing authority can put forth a legitimate basis for taxing business activity on the Internet. The primary issue that must be worked out is how to allow these taxing authorities to assert their taxing jurisdiction (or grant them the taxing authority), and to do so in such a way that commerce will flow unimpeded over the Internet.

Jurisdiction of state and local governments to tax is separate and distinct from that of the federal government. State and local governments derive their authority to levy taxes from state constitutions. States impose a variety of taxes such as income, franchise, capital stock, gross receipts, ad valorem, and sales and use taxes.

With the substantive shift in commerce made possible by the Internet, states have had to apply statutes to transactions that were not envisioned at the time the statutes were written and have had to use as precedent court decisions that were made at a time when such media did not exist. The current state and local tax systems were developed at a time when most transactions involving tangible goods were based primarily on the manufacturing and selling of goods and on concepts of physical assets, geographic locations, and over-the-counter transactions. However, electronic commerce is based on a technologically advanced, service-oriented economy and on technology where there is no locality or physical presence.

A preliminary question that must be answered is: What attributes of an electronic commerce transaction should be considered a proper subject for taxation by the state and local governments? The types of potentially taxable electronic commerce include Internet access charges, sales of goods or services, digitized products, consulting services, searches of databases, gambling, stock trading and banking. Certain taxes are imposed on the business and certain taxes, such as the sales and use tax, are typically imposed on the buyer.

The next question to be answered is: Which state, if any, can or should impose a tax? The U.S. Constitution provides for a system of checks and balances between the federal and state governments. The Due Process Clause, Commerce Clause, Supremacy Clause, and other provisions of the U.S. Constitution place limitations on state and local governments' power to levy taxes. The Commerce Clause focuses on limiting the effects of state regulations imposed on the national economy. The test that has become the standard for Commerce Clause analysis of state taxation of interstate commerce is Complete Auto Transit v. Brady. In that case, the U.S. Supreme Court held that a state tax must be "applied to an activity with a substantial nexus with the taxing State."

State and local tax rules need to be re-examined. Congress passed the Internet Tax Freedom Act in 1998. This Act imposed a three-year moratorium on taxation of Internet access, multiple taxation and discriminatory taxation of electronic commerce. At this time, Congress is proposing to extend the moratorium until October 21, 2006. However, Congress should not postpone providing guidance by legislation to deal with the borderless market presented by the Internet. It is necessary to try to achieve a balance between encouraging the development of electronic commerce and the need for fairness in taxation, while at the same time taking into consideration the needs of the state and local governments. Some states rely heavily on sales taxes. No other state relies so heavily on sales taxes as does the State of Washington. The reliance on general sales taxes in Washington State is over twice the national average. Consequently, Washington State could be heavily impacted by the moratorium and a delay in developing appropriate rules for the imposition of sales tax on electronic commerce.

The primary issue in the state and local tax area is whether the substantial nexus standard—a physical presence in the taxing jurisdiction—is a viable approach for electronic commerce. There has been confusion in the courts of how much physical presence is substantial enough to meet the "substantial nexus" requirement, i.e., may it be manifested by the presence in the taxing State of the vendor's property or the conduct of economic activities in the taxing state performed by the vendor or its agent? Should there be a distinction between substantial nexus and substantial physical presence? The physical presence requirement loses viability when the Internet is used to supply services or intangible products to consumers.

Secondarily, what is the appropriate basis of determining substantial nexus for the different types of state and local taxes? Some legal scholars have argued that

the physical presence requirement only applies to sales and use taxes and not to all other state and local taxes. There are no uniform rules for determining nexus for all the different state and local taxes.

Many of the state and local tax issues raised by electronic commerce also depend upon the characterization of items of income or transactions giving rise to income under definitions and concepts born in the age of bricks and mortar. In some cases these laws do not readily adapt themselves to the world of electronic commerce. A transaction on the Internet (such as a sale of software downloaded over the Internet), may be characterized as a sale of a tangible good; a sale of an intangible good, i.e., a royalty fee; or a service. Depending upon the characterization, there may be imposed one or all of the following taxes: a sales and use tax, a gross receipts tax or a service tax. It is difficult to determine with a high level of certainty under the existing rules the type of income derived from certain commercial transactions.

Sales taxes are generally imposed on retail sales of tangible personal property and certain enumerated services purchased within the state. Generally, the purchaser pays the tax and the seller is responsible for collecting and remitting the tax. Businesses have argued that the cost of collecting sales taxes and filing tax returns for electronic commerce transactions would be overly burdensome. However, the collection and remittance of the taxes would be no more burdensome to electronic commerce businesses than to mail-order catalog businesses. It can hardly be said that the growth of Internet sales would cease or be severely halted because vendors would have to collect sales taxes. Mail-order sales were not reduced because certain mail-order companies were required to collect such taxes. The greatest advantage of Internet sales to the consumer is the ease and convenience of purchasing goods and services while never leaving home.

Businesses want complete uniformity between state and local taxes. The current laws and court rulings are inadequate to reduce the risk of multiple taxation of a commercial transaction completed via the Internet. Although Congress has not provided guidance in the past, I encourage it to do so now.

FEDERAL TAXATION

The only federal statute, regulation, ruling or case expressly dealing with tax aspects of electronic commerce is the Internet Tax Freedom Act which imposed a three-year moratorium (I note that the Internet Nondiscrimination Act of 2000 would extend the moratorium until October 21, 2006) on taxation of Internet access and electronic commerce. The issues of federal taxation relating to electronic commerce are primarily related to residence, character of income, deductibility of expenses, source of income, and tax reporting and collection.

The United States imposes tax on the worldwide income of its citizens and residents. Residence of corporations is determined by the place of incorporation. The Internet gives a business the ability to sell to and provide product or services to certain markets on a worldwide basis, but also creates the possibility of companies establishing themselves in low-tax jurisdictions, thereby limiting the amount of income reportable to the United States. In addition, the application of existing transfer pricing rules to related corporate groups, the arm's length standard, may be difficult where a company's operations are carried out electronically and results in the loss of identifiable comparable third party transactions.

The Internal Revenue Code has traditionally focused on mercantile transactions, such as the sale of property, compensation for services rendered, and the receipt of royalties or rents for use of property or property rights. The Internet has made such characterization difficult where "digital goods" can be downloaded for future use, to browse or use directly on-line. The issue of proper characterization of Internet transactions has important ramifications, not only for electronic commerce, but also existing mercantile activities.

The Internal Revenue Code subjects income from United States sources to taxation regardless of whether derived by a United States citizen, tax resident of the United States or foreign person. The proper application of the source of income and expense rules, as currently provided by the Internal Revenue Code, to digitized goods or Internet services results in legitimate disagreements between business and tax administrators. Technological advancements for the Internet will only make determining the appropriate tax treatment more difficult.

Businesses transacting with consumers may have no practical incentive to self-assess a tax which may apply to a transaction. Will the cost and burdens of filing tax returns for electronic commerce transactions be commensurate with the usefulness of the information provided the Internal Revenue Service? Is the imposition of a withholding tax a fair and efficient method of insuring collection of the tax due? As Congress considers the tax issues presented by the Internet, the development of

a fair and efficient tax reporting and collection system will be of paramount importance.

INTERNATIONAL TAXATION

International income tax rules need to be re-examined and possibly re-formulated to deal with the borderless market presented by the Internet. The primary issue in this area is whether the international standard for nexus, permanent establishment, is a viable approach for determining nexus to tax electronic commerce. In broad terms, a "permanent establishment" is a fixed place of business through which the business of the enterprise is wholly or partly carried out. Limited business activities are granted a nexus exemption and do not constitute a permanent establishment, such as activities of a preparatory or auxiliary nature. However, certain circumstances will result in a non-resident being deemed to have a permanent establishment, such as a dependent agent. The permanent establishment concept loses viability when the Internet is used to supply services or intangible goods to consumers.

Secondarily, what is the appropriate basis of determining source-based taxation? The Internal Revenue Code provides detailed rules for determining whether income derived from various transactions (sale of goods, provision of services, royalty derived from the licensing of property rights, etc.) is derived from U.S. sources and therefore subject to U.S. tax. Since a transaction on the Internet may carry attributes of a number of different commercial transactions, it is difficult, if not impossible, to apply the existing source rules to make a correct determination.

Thirdly, how is income from electronic commerce to be characterized? Just as in the case of applying the source rules to transactions consummated via the Internet, it is difficult to determine under the existing rules with a high level of certainty the type of income derived from certain commercial transactions.

In addition, what is the proper basis for attributing and allocating income and expenses from electronic commerce? Since U.S. companies are taxed on a worldwide basis, domestic businesses must rely on the credit of foreign taxes or an exemption from taxation provided by a tax treaty to reduce double or multiple taxation when more than one country asserts the authority to tax a commercial transaction. In the absence of a tax treaty, the United States subjects foreign persons to U.S. tax on income effectively connected with the conduct of a trade or business conducted within the United States. These rules may prove to be inadequate to reduce the risk of multiple taxation of a commercial transaction completed via the Internet.

And finally in the area of taxation of income, what role will international tax treaties play in resolving potential conflicts with not just are treaty partners but also countries with which the United States does not have tax treaties? Should international tax treaties be the mechanism for resolving the tax issues presented by electronic commerce of nexus, source, characterization, and attribution and allocation of income and expenses?

Not to be overlooked is the fact that business activity via the Internet will present tax issues relating to customs and duties, the imposition and collection of indirect taxes, e.g., value-added taxes, goods and services tax, sales tax, etc. If a country is not willing to give up these taxes, what documentation, hard copy, or electronic equivalent will businesses need to generate to satisfy the particular requirements of that country?

CONCLUSION

In conclusion, the Internet presents some unique challenges to a taxing authority. I submit for your consideration that a sound tax policy for electronic commerce should provide for predictable and equitable taxes for businesses; should not result in multiple taxation of the same income; should not create a distortion in how the business use of the Internet will be conducted by exclusively internet businesses or non-exclusively internet businesses; should allow a taxing authority to inexpensively verify the financial results of a transaction; and should not cause a distortion in the development of electronic commerce, whether conducted as the primary or secondary focus of a business.

I want to thank Ms. Ada Ko, attorney-at-law, of the law firm of Lane Powell Spears Lubersky LLP in Seattle, Washington, for assisting me in the research and preparation of this statement.

Mr. MCDERMOTT. You have 3,900 jurisdictions in this country that levy sales taxes and you have 50 States. That is a fairly simple computer program, 3950 options. For people who can land on the moon, it doesn't seem to me to be a technical problem to give to each retailer a piece of software they could use that would pick out what ZIP code I live in and tell me what my sales tax is.

I live in 98119 which is one of the ZIP codes in Seattle. You ought to be able to pull that up and put the tax on what they send out to me. I cannot see any technical problem with doing that. If you have an idea, I would love to hear it.

Mr. STRAUSS. The State of Washington in its wisdom may not define bagels the same way we do in Pennsylvania or it may not define clothing in the same fashion. The real problem that remote vendors face selling into a State and not being sure about things is the definition of what is taxable and not the rate. That is why in my testimony I talked about the wisdom of going to a concept of final consumption that would be uniform across the States.

That takes some of the fun out of the game at the State level of providing exemptions and the like, which those of you in State legislatures may remember fondly, but it certainly would simplify things if what was taxable was uniformly defined.

It is very hard for the Congress to do that directly. You may be able to do it indirectly.

Mr. MCDERMOTT. The State legislature had a long debate over whether candy was food or not. Food is not taxed, candy is, so I understand the point. How do you deal with that common definition then?

Mr. STRAUSS. In my detailed testimony, I provide a very simple definition of what a taxable person is and what their consumption is. It is something that would take about half a paragraph of code language that would subject all services to taxation that we utilize for final consumption and would free up business inputs.

Mr. MCDERMOTT. Would it tax food?

Mr. STRAUSS. Sure. If you want to exempt food, you raise the rate; I have in my testimony hold harmless tax rates by State, sort of rough estimates.

Mr. MCDERMOTT. Is there any way you can make the playing field level for local businesses and not tax the Internet? We went through this whole battle. Every couple of years, there would be a surge of sales. IREA was a big sales operation in our area and we would think how can we get access to what they sell out of State. We went around and around trying to figure out how to do that. We never figured out how to make it fair for somebody who bought with a catalog fair with going down to the store and buying it.

Mr. STRAUSS. Your residents in Washington are liable, they just forget to pay it somehow. There is not a good mechanism. If you had a common definition across the country and one the States could live with, one that was adjudicated here once, put in the Code and left sacrosanct, I think you could go a very long way. That is not for today I hasten to add but I think it is an imaginable think. In the 21st Century, a little more uniformity, a little more clarity might be a desirable set of goals to work toward.

Mr. MCDERMOTT. So you are suggesting a sort of uniform code like we have a Uniform Commercial Code that has been adopted by a number of States?

Mr. STRAUSS. Yes.

Mr. MCDERMOTT. You would have the same thing, a Uniform Tax Code by the States?

Mr. STRAUSS. I would put it into the Internal Revenue Code as a qualified sales and use tax base and any State who adopted it, would then have a way for IRS to make sure remote vendors would collect and remit. Otherwise they would be subject to either Federal penalty or Federal excise tax themselves which wouldn't be very healthy. I am very mindful of the power of this committee, sir.

Mr. MCDERMOTT. So you would basically give the IRS the enforcement power?

Mr. STRAUSS. It might not ever have to be used but it would start there, yes. Look at FUTA as a mechanism that has worked over the decades, the Federal unemployment tax. This is a play on that idea. I hate to look at what is going on behind me but that is okay, I have tenure.

Chairman HOUGHTON. Mr. Portman?

Mr. PORTMAN. Mr. Strauss, I am glad you are mindful of the power of this committee. Sometimes the Judiciary Committee and the Commerce Committee don't understand our great power.

Mr. STRAUSS. I would be happy sometime to explain to you how you can expand your power. When I served this committee, I was very mindful.

Mr. PORTMAN. We will have to have a hearing on jurisdiction after this one.

I appreciate you holding this hearing, Mr. Chairman, in part for us to have the opportunity as Ways and Means members to take a look at some of these issues and see where our jurisdiction does fall, and also to look at the Advisory Commission on Electronic Commerce, and one of the recommendations of the Commission which was to end the tax on talking, the three percent excise tax we are going to get into in the next panel.

I will not spend a lot of time on it now but just say that seems to me to be in the category of the extension of the moratorium on access fees and the ramp up to the Internet as Mr. Gustafson talked about which is to say Congress should pass that overwhelmingly and I think will once the committee marks it up this week and takes it to the floor next week.

I have a couple of questions for you, Mr. Harden. Your article in Tax Notes was excellent, very balanced and I appreciate your being here today and giving us both sides of the story.

I think Lyndon Johnson said, "Bring me a one-armed economist on the one hand," and my only question to you would be where do you come down in terms of recommendations to this Congress as to where we should go from here? You seem to be saying that simplification would be very important State by State to create that level playing field between e-commerce and the brick and mortar companies but I don't see any specific recommendations. Maybe you are still trying to figure out where you come out.

You have heard some interesting testimony from Mr. Gustafson who says we ought to repeal the sales tax altogether. E-commerce

is like .64 percent of all commerce and we don't want to chill this important driver of our economic prosperity.

Mr. Strauss talked about some realistic ways to come up with some uniform, simpler system. How do you come out on it?

Mr. HARDEN. It is interesting you asked that question. When Dr. Biggert and I sat down to write the article, each of us thought it would be an easy answer as to which viewpoint was more correct and we disagreed on which was the more likely scenario.

Mr. PORTMAN. Where did you come out?

Mr. HARDEN. As far as the argument that you should eliminate all taxes was the better argument or the argument that you should put the traditional retailers and electronic retailers on the same footing. We still disagree on that issue.

At this point I am not sure we have enough information to make a long term decision on the issue. The easiest solution is to move away from the sales tax. Unfortunately, as was pointed out, the income tax is not palatable to many jurisdictions which would be one way of avoiding this issue.

Barring that, moving toward a more consistent method of taxing between the States may help but I am not very optimistic about that because we have had the system in place since 1934 or 1935 when Mississippi enacted the first sales tax and they have remained inconsistent since that time, so I am not sure barring Federal action, anything can be done about that.

My personal bias is to not favor any type of regulation that can be avoided but in this case, the one thing we mention in our article is possibly taxing or allowing taxation at a very low or nominal rate, possibly the lowest sales tax existing among the 50 States and move from there. At this point, I am not sure we have enough data because we don't know how much electronic commerce will be hurt by imposing a tax. Likewise we don't know how much traditional retailers will be hurt.

Dr. Biggart and I dealt with a clothing retailer and this particular retailer is one that operates in three areas, mail order, electronic commerce and traditional retail and they actually have set up the three divisions as three separate corporations. They are telling us their same store sales are up 20 percent this year.

This manager's opinion was that electronic commerce is not hurting at all. Our comeback was where would you have been in the absence of electronic commerce. At this point, we just don't think we have enough information to make that recommendation rationally.

Mr. PORTMAN. It sounds like you are a normal human being and you have two hands on the one hand and you are a normal economist, but maybe what you are saying is a moratorium might be appropriate to let things sift out a little over a period of at least a couple of years. It sounds as though you believe there is still more data to come in to be able to decide how to deal with this?

Mr. HARDEN. Yes, that actually would be my recommendation.

Mr. PORTMAN. It is an even numbered year as Mr. Strauss noted earlier, so that is helpful, to put something off in an even-numbered year as controversial as this.

I want to pose one more question and I will just throw it out and is looking at a VAT tax as compared to a sales tax, Mr. Strauss, what might that mean?

Mr. STRAUSS. At the State level, sir?

Mr. PORTMAN. You talked about the template earlier and the fact that the Federal income tax provides a template and the Federal sales tax could provide another template.

Mr. STRAUSS. I looked very carefully at that about four years ago and came away very worried about what the transition would be if there was a national VAT and States were to gravitate to it.

One of the arguments in favor of a VAT historically has been that we haven't been growing enough but we now are doing just fine. In fact, we are growing too fast. I don't know what the Fed did but they didn't lower rates, so that is kind of one concern.

Another concern is it wouldn't be more simple than the income tax. There is not a VAT we could administer to bring in the kind of money we are talking about nationally that wouldn't wind up complicated; you would find yourself making somewhat different kinds of decisions in this committee but very difficult ones.

The history of the VAT in Europe is not attractive. I think we ought to stay where we are at the Federal level with income taxation.

Chairman HOUGHTON. Mr. Hulshof?

Mr. HULSHOF. Mr. Strauss, do you believe that traditional merchants at are at a competitive disadvantage due to remote mail and phone catalog vendors?

Mr. STRAUSS. Yes.

Mr. HULSHOF. I think the Bella-Hess decision, if I am not mistaken, was in 1967?

Mr. STRAUSS. Somewhere around there.

Mr. HULSHOF. Isn't it true that State and local governments and retailers have said even from the old days when Bella-Hess was first decided that there were going to be sales tax shortfalls?

Mr. STRAUSS. They didn't grow as fast as they would have. It all depends on one's state of mind. Certainly use tax collections, if we look at it in those terms, have been not as significant as they would otherwise be.

The other point is we have a far more independent country than we used to have so this issue we are talking about, use tax across boundaries, the Supreme Court cases and all that, it is growing. I can't give you the percentages but it is growing.

Mr. HULSHOF. I know in your longer statement, which I have had a chance to peruse, and your questions from Mr. Portman, you are talking about a larger picture template but certainly would you agree or disagree that mail and phone catalog vendors and purchases over the Internet should be treated consistently or do you see a reason we should treat Internet sales differently than catalogs?

Mr. STRAUSS. No, not differently all the same. It is very simple equity.

Mr. HULSHOF. Mr. Harden, you seemed to key in on that question. Did you have any comment before I move on to Mr. Gustafson?

Mr. HARDEN. Yes, sir. This relates to your question and to Representative McDermott's question.

There may be a slight problem with regard to the case law. In the Bella-Hess decision, the mail order retailer that doesn't have a physical presence in the State is exempted under two clauses, the due process and the commerce clauses.

In 1992, there was another decision called Quill which basically took away that due process argument because it said when you intentionally send mail order material into the State, you are on notice yourself that you are to solicit business there and therefore you should not be able to use the due process as an argument against it. The commerce protection was still there and it would be up to Congress to make a decision.

With electronic commerce, you may fall back under due process being applicable as a defense even if you allow the States to collect the tax, they may have a judicial remedy simply because they don't intentionally go after a particular customer; it is open to anyone who can access the Web.

Mr. HULSHOF. Mr. Gustafson, in the panel coming behind you as you expect will be some of those traditional retailers and there have been arguments made by main street that they are at a competitive disadvantage because they have to collect sales taxes while e-retailers do not. What argument do you provide to that objection?

Mr. Gustafson. I would suggest that both have competitive advantages and competitive disadvantages, both classes of retailers, traditional brick and mortar and also the e-tailer class. Brick and mortar have the added advantage of being right around the corner when you need something. Going on-line takes three days or overnight at a minimum. Each represents a means of providing consumers with a considerable good.

They have been saying those sorts of things a long time now and we have not seen a slack in the builders of commercial retail sites. They are opening new malls at record paces. Tax revenues to States have not slacken at all, so it does not seem that e-tail will really draw much from the traditional brick and mortar. If anything, it may well add to the nature of brick and mortar sales.

Mr. HULSHOF. Personally I am a kick the tires, flip through the book in the book store shopper and I am not sure if I am in the majority or the minority any longer. I guess it sort of brings up the age old question that many small communities in the 9th District of Missouri or across the midwest and that is when you have the super center that builds on the outskirts of town and drawing away from the riverfront, downtown businesses or when the new mall opens across the State line 20 miles away and draws businesses away from that mom and pop store.

Mr. GUSTAFSON. You have described how retail evolves over time and the Internet is another means by which consumers and businesses can interact. It represents another time in our history that retail will be required to evolve. They are going to have to look and say how do you interact with this new medium. The genie is out of the bottle and they are going to have to learn to deal with it one way or another.

There are certain implications for tax policy, of course, but to suggest it is going to drive brick and mortar out of business totally

is not true. Shopping is too much of a social aspect of American life for that to happen.

Mr. HULSHOF. Thank you.

Chairman HOUGHTON. Ms. Dunn?

Ms. DUNN. Mr. Strauss, I wanted to ask a question about another of the recommendations of the Commission. This was to expand the definitions of the TANF grant, what is eligible for expenditures by TANF dollars.

I know we are all trying to expose children to the Internet and to a greater education. My only concern is if we decide to expand the definitions of what is eligible, it seems it may be spent for things that don't really provide for phasing children into better circumstances. I am wondering what you think about that recommendation.

Mr. STRAUSS. I have a 17-year-old son who has access in his bedroom and he locks the door. He wants a bigger disk drive all the time. [Laughter.]

I favor everyone having access to the Internet. I think it ought to be in libraries for people who can't afford it. If not available in their homes, I think it ought to be publicly provided and publicly supervised.

When you ask the States to spend monies you used for training for this additional purpose, you face the question of who is going to supervise what they, the kids, really do, I have some concerns there.

Second, if you are going to ask that my tax dollars be used to be spent for computer hardware, I would like to get something in return from the hardware vendors participating at the other end. I want them to collect and remit. That is my preference. I don't think you will go that way.

I can see some merit in trying to use existing Federal expenditures to broaden access but I think it ought to be in the context of public institutions at the local level where there is public supervision and the Federal agency, HHS, would take a look and make sure it is not going into something very, very different.

I am mindful that even though you think you are running a surplus and you think the States are running a surplus, there is less surplus there than you think. I would just make that additional comment.

Ms. DUNN. Mr. Gustafson, in your written testimony you alluded to a Stanford study and it concluded that telecommunications taxation is a major contributor to the digital divide. Can you talk to us about how telecom taxation limits access to the Internet? Could you touch on different demographic groups?

Mr. GUSTAFSON. The Stanford Study concluded that affordability was the number one issue for going on-line, whether or not and individual would buy the hardware, subscribe to the service and all these things was one of I have a dollar, where do I spend it.

Taxes that increase the bottom line make that decision bias in favor of something that is less costly. It is more about a mans of bringing information into your life than it is purely Internet access. So if the cost of that information is lower via the television, through cable or over the phone, if you are getting news from a

friend or buying a newspaper, that is the basis by which an individual makes their decision.

From our standpoint, at a time when Congress is talking about setting up programs to subsidize the spread of the Internet, the first thing they need to look at is are we taxing this, how are we treating the medium we are looking to subsidize. If you are taxing it with one hand and subsidizing it with another, that seems not to make a great deal of sense to those of us on this side of the podium.

Chairman HOUGHTON. Mr. McInnis?

Mr. MCINNIS. Mr. Gustafson, has anyone with your think tank done any research when catalog sales first came out as to the remarks by retailers and government entities as to the taxation of catalogs when they first came on the retail scene back in the 1930s or 1940s?

Mr. GUSTAFSON. I have not personally done that research. There is anecdotal evidence all over the place about how Sears & Roebuck was going to drive smaller genuine mom and pop retailers out of business by virtue of their size and scope but we are writing a history of some of the telecommunications technology policies and that is due out later this fall. No doubt, that topic will be in there.

Mr. MCINNIS. I think that research would be helpful because my guess would be you will find a lot of panic, the sky is falling in type of statements.

I think it would be very helpful to compare the thought pattern back then as to now. I think there will be a lot of parallels.

Mr. Strauss, I was interested by your remark that your statement was made because you have tenure. What would be the change in your statement if you didn't have tenure?

Mr. STRAUSS. At a high tech university?

Mr. MCINNIS. No, the statement you just made earlier.

Mr. STRAUSS. My pattern has always been to speak my mind for better or for worse. I have explained myself.

Mr. MCINNIS. I think it would be good to do away with tenure.

The number the gentleman from Washington used, I have heard it all the time, that there are 3,200 taxing entities? What is that number?

Mr. STRAUSS. Local jurisdictions, primarily counties that have their own sales and use tax and in your State they are quite prevalent.

Mr. MCINNIS. Where did that 3,200 originate? I have heard it talked about a lot.

Mr. STRAUSS. The Census Bureau measures it for one. Every five years they enumerate the kinds of governments we have in the country and what their taxing authority is. There are also some private companies like Vertex outside of Philadelphia which keep track of this.

Mr. MCINNIS. Who said that number?

Mr. STRAUSS. I have heard larger number, more like 7,000. I could look it up and write you a letter if you like.

Mr. MCINNIS. That would be helpful. I am trying to figure out a source because when I look at the complexity of the current taxing system, based on a lot of what you said earlier which I think is correct, the bagel is not the same and in our State we have

sewer districts and we have the Bronco stadiums in a different district. It is not as simple as a ZIP code with the implication you just zip it out and you have it figure out.

I would appreciate it if you would contact me with some reliable source that I can look at and try to figure out.

Chairman HOUGHTON. I have one question I would like to ask Mr. Gustafson. You mentioned on the last page of your testimony the study by the University of Chicago and Harvard indicated there were minimum amounts of impact on sales tax revenues, one was 2 percent by 2003?

I don't know whether those figures are right or not. We don't know what is happening five minutes from now but assume they are, aren't you really starting a trend? Isn't it sort of a way of life, sort of a mindset when you start doing this? I don't quite understand what your point was there.

Mr. GUSTAFSON. My point in including it in my testimony was merely to illustrate the opportunity costs of not having Internet taxes for States was minimal currently and even under projections far into the future, three years into the future now, that it would still not be a significant loss of revenue so to speak for States.

In terms of creating an expectation, do you mean for people going on-line and buying goods on-line?

Chairman HOUGHTON. The expectation is there will be no tax forever and therefore it makes it difficult. If you have inequities which are not really highlighted in the Harvard or Chicago study, doesn't it make it difficult to reverse yourself a little later on once the pattern has been established?

Mr. GUSTAFSON. There are lots of stated purposes of tax policy, one of them being neutrality so economic activity is treated equally across the range of different taxing authorities and such, regardless of how the good is consumed, it is neutrally treated.

The problem is less one of figuring out the correct technological solution and how to collect the tax, whether it is a ZIP code or something else, and more of an issue of whether or not the Constitution would permit it. We have heard about due process and the Interstate Commerce Clause. I think our objections to on-line sales taxes fall into those categories more than the fact that it is really not a great degree of loss revenue for States.

We look at this and say, this is an issue, not a new issue to Congress, States or commerce in general. It has to due with where the State's power begins and ends and whether or not a certain type of transaction can be taxed by an extra territorial authority.

We look at it and say this is a remote sale and unlike catalog, unlike anything along those lines and should not be treated as a brick and mortar sale.

Chairman HOUGHTON. Thank you very much. I appreciate your testimony.

The second panel is Les Ledger, owner of Ledger Furniture in Copperas Cove, Texas on behalf of the National Retail Foundation; Ronald R. Honaker, Owner, salons4u and the Glow Shop, and he will be joined by his wife, Margaret. I am told they drove more than 15 hours to get here from St. Louis. We are delighted to have you here.

Thirdly there will be Jeanne Lewis, President of Staples.com from Framingham, Massachusetts; Harley Duncan, Executive Director, Federation of Tax Administrators; Mark Nebergall, President, Software Finance and Tax Executives Council; and John R. LoGalbo, Vice President, Public Policy, PSINet from Ashburn, Virginia.

Mr. Ledger?

STATEMENT OF LES LEDGER, OWNER, LEDGER FURNITURE, COPPERAS COVE, TEXAS, ON BEHALF OF NATIONAL RETAIL FEDERATION

Mr. LEDGER. Thank you and good afternoon.

I appreciate you letting me come to testify before the subcommittee. My name is Les Ledger. I am the owner and operator of Ledger Furniture in downtown Copperas Cove. I am a small, main street furniture store. My store was started by my father in 1950.

Today, we have 14 employees. I just called home and checked with my wife and they all showed up today. I am darned pleased. That has been a bit of a problem.

Chairman HOUGHTON. Do they do better when you are not there or when you are there?

Mr. LEDGER. I left mom at home. She is going to make sure they do very well.

We have annual sales, and I want to say it loud so my competitors will know it, of $1.8 million. We hope and pray we continue.

I am testifying on behalf of the National Retail Federation which has 1.4 million members or establishments and employs 22 million employees. I am here to discuss a tax matter which unfortunately has not been addressed by Congress over the ACEC. This involves a loophole in the existing sales and use tax laws that allows many of my out-of-state competitors to avoid collecting a State sales tax and use tax.

The ACEC not only ignored this issue, it lacked the super majority mandated by Congress for approval of its recommendations and I might point out it did not include a main street retailer on the commission as dictated in statutory language. So that makes me doubly proud that you have allowed me to speak.

Under current law, 45 States impose sales tax and sales taxes on tangible goods. These States impose these taxes and require retailers like me to collect them and remit them. In the State of Texas I have exactly 20 days to get it to Austin.

Some out of state retailers are exempted or are not required to collect and remit a State sales and use tax. Exempting these Internet and catalog sellers from collecting sales tax while I must creates an uneven tax playing field among retailers. Congress must address this issue in the same context as the other Internet tax issues to ensure that the level playing field exists.

If a State wants to impose sales tax, I only want my competitors to collect the taxes just like I do. I want a level playing field. Tax policy should not determine who wins and who loses. In my industry margin that margin of profit is one, two, three percent. I can't absorb a six to eight percent tax differential.

Consumers should pick their winners and losers based on selection, service, convenience and not tax. State and local governments

will suffer. It is estimated by some projections that the Internet sales will be $300 billion by 2002. State and local governments could lose as much as $20 billion in uncollected sales tax.

This tax also disproportionately hurts the poor. Mr. Weller pointed out that over 100 million are using the Internet and with the average Internet income user being about $70,000 the current system would allow the wealthy to escape the tax and let the people who do not have Internet access pay taxes locally.

Folks, my conclusions are not borne out by conjecture but by personal experience in dealing with a business that is not required to collect sales tax and that operates less than seven miles from my front door.

Our Store is located near Ft. Hood, Texas. Army Air Force Exchange operates a 17,000 square foot furniture store at its PX. We know the number of people who leave our store and buy from a facility that is not required to collect State taxes.

The reason they leave is because my prices will always be 8.25 percent higher but I am required by the wonderful State of Texas to collect its sales tax from my customers. I don't have to wait to see what the effect will be of tax free purchasing on my business. I already know how it feels, I see the dollars leave.

If my sales suffer as a result of the current sales tax disparity, I will be forced to cut back my work force. In addition, the revenues I collect and pay to the State and Federal Government would decrease as I go down. I have collected $149,000 in sales tax in the last year. I have paid $31,000 in Social Security and FICA taxes. That is my portion. And I have paid $15,000 in personal property taxes.

Congress has the responsibility to my business, my employees and my community to eliminate this existing tax inequity. A level playing field is all I want. As a retailer, my bottom line and the survival of my store is affected by numerous factors and Federal regulations. While I have learned to live with these setbacks, I cannot—and should not—be expected to live with an 8 percent tax pricing disadvantage compared to my Internet and remote commerce counterparts.

Congress can act to address this disparity. It can give States the authority to collect sales and use taxes from out-of-State sellers once the States have adequately simplified their sales tax structures.

I appreciate you all letting me come, and I'm ready for any questions.

[The prepared statement follows:]

Statement of Les Ledger, Owner, Ledger Furniture, Copperas Cove, Texas, on behalf of National Retail Federation

Good afternoon, Mr. Chairman. My name is Les Ledger. I am the owner/operator of Ledger Furniture in Copperas Cove, Texas, a small main street furniture store first opened by my parents in 1950. Today, we have 14 employees (if everyone shows up) with an annual sales volume of around $1.8 million.

I am testifying today on behalf of the National Retail Federation (NRF), the world's largest retail trade association, representing 1.4 million retail establishments that employ more than 22 million Americans. In addition, I am a past president of the Texas Retailers Association and the International Home Furnishings Association.

The growth of consumer shopping on the Internet is expanding at a rapid rate. In 1999, 40 million Americans shopped online, up from 17 million in 1998. The total of goods and services traded on the Internet is expected to reach $300 billion by 2002. The Internet provides retailers the opportunity to reach millions of people in markets never before imagined and provides consumers instant access to goods, products and services from around the world. As this new medium evolves, so too should government policy to ensure that no one is left behind, and that everyone competes on a level playing field.

In 1998, Congress enacted a moratorium on any "new" Internet taxes until October 21, 2001, while creating a special advisory commission, the Advisory Commission on Electronic Commerce (ACEC), to address a host of Internet and remote commerce tax issues in the interim. Unfortunately, most of this debate has ignored a broader inequity that currently exists in the state sales and use tax systems that disadvantages mainstreet retailers and low-income consumers.

Both the ACEC, as well legislation passed by the House of Representatives last week, failed to address the broader state sales and use tax inequity that exists today. Not only did the ACEC findings lack the supermajority consensus mandated by Congress for approval of its recommendations, it did not include a "mainstreet" retail representative, as was dictated in the original statutory language.

Like many others, retailers oppose new taxes on the Internet, including "bit" and/or "access" taxes, and even the existing telephone "excise" tax. However, the retail industry feels that Congress must also address the broader more complicated state sales and use tax inequity as well.

Existing sales and use tax law creates an "unlevel playing field" among retailers. Presently, 45 states and the District of Columbia impose sales and use taxes on purchases of tangible goods. Under current law, retailers are required by the states to collect these taxes from a customer and immediately remit this sales tax to the state. However, based on two Supreme Court rulings, some out-of-state retailers (those without a physical presence in the purchaser's state) are not required to collect and remit a state's sales and use tax. In this case, the consumer still has the legal responsibility to pay a "use" tax directly to his or her own state. Since many Internet sites and remote sellers aren't located in a purchaser's state, they do not have to collect these taxes. Exempting some out-of-state sellers from having to collect sales and use taxes creates an "unlevel playing field" among retailers.

Refusing to address the existing state sales and use tax inequity in the same context as other Internet tax issues ensures that an unlevel tax playing field will continue to exist. If the current inequity is not addressed soon, resolution of this issue could be deferred for years, with the result being continued erosion of the state tax base and continued discriminatory tax treatment that disadvantages store-front retailers and low-income consumers.

Retailers only want a "level playing field" -where a product is taxed (or not taxed) the same regardless of how it is ordered or delivered. All retailers, regardless of the channel or channels in which they do business, should have the same collection responsibilities -no matter if the transaction is made in a traditional store, through a traditional store's own website, by a strictly e-commerce retailer or through any other type of remote seller.

Government tax policy shouldn't determine the winners and losers. In the retail industry, where a 1–2% net profit margin is standard, a 6–8% tax differential (the average state sales and use tax rate) is a significant pricing advantage. Why would someone buy something in a store when they could pop onto the Internet and buy it for 8% less? Consumers should pick winners and losers based on factors which they decide are important such as selection, service, convenience, etc. Tax policy shouldn't provide one retailer a pricing advantage over another.

A "level playing" field does not mean a new tax-consumers are already required to pay "use" taxes. Under current law, if sales tax is not paid on an out-of-state purchase at the time of sale, the purchaser is required by state law to pay a comparable "use" tax to his or her state, usually when they file their state income tax return. Historically, states have not enforced collection of "use" taxes, but they do exist.

States and local government services will suffer as their revenue base decreases. On average, sales and use taxes account for approximately 40% of a state's total tax revenue (more than $150 billion in 1998). With projections of on-line sales estimated to exceed $300 billion by 2002, state and local governments could lose as much as $20 billion in uncollected sales taxes. Sales tax revenue is used to fund basic state and local governmental services including police and fire protection, school funding, etc.

An "unlevel playing field" disproportionately hurts the poor. In 1998, 55 million people had access to the Internet. According to a recent Commerce Department study, wealthy individuals are 20 times more likely to have Internet access. With

an average Internet household income of $70,000, an "unlevel tax playing field" would benefit those with higher levels of income and shift the tax burden to lower income individuals who can only buy locally (and thus pay sales tax at the sales counter).

My conclusions are drawn from personal experience in dealing with a business that is not required to collect sales taxes and that currently operates only 7 miles from my store. Our store is located next to Fort Hood, Texas. The Army/Air Force Exchange operates a 17,000 square foot furniture store at its PX. We can see the number of people who leave our store and buy from a facility that is not required to collect sales tax. The reason they leave is because my price will always be 8.25 % higher, because I am required by the state of Texas to collect and remit its sales tax. I don't have to wait to see the effect that tax-free purchasing has on my business. I already know how it feels to compete with an entity that has a government imposed tax subsidy.

As consumers purchases shift to the Internet where some sales are exempted from sales and use tax obligations, the impact on my business and my community will be significant. Last year alone, I collected $149,000 in sales taxes that funded schools and police and fire protection efforts in my community. In addition, I paid $31,000 in payroll and social security taxes and $51,000 in local property taxes. If my sales suffer as a result of this tax inequity, I will be forced to lay off employees and the revenues I collect and pay to the state and federal governments will diminish significantly.

Almost 51% of Texas' revenues come from sales tax collections. Should this revenue stream decrease significantly, Texas will have to seek other sources of revenue. Although Texas doesn't currently have a state income tax, it may be forced to move in that direction if tax-free sales continue on the Internet. In an interesting twist, federal revenues would actually decrease under this scenario if Texans began deducting their newly-imposed state income taxes from their Federal income taxes.

Congress has a responsibility to my business, my employees, and my community to eliminate this existing tax inequity. A level tax playing field is fair and it is practical. As a retailer, my bottom line and, therefore, the survival of my store, is affected by numerous factors beyond my control including the economy, the weather, and numerous federal and local government regulations. While I've learned to live with many of these, I cannot and should not be expected to compete at an 8% tax pricing disadvantage compared to my Internet and remote commerce counterparts.

Congress can act to address this disparity. It can level the sales tax playing field by giving States the authority to collect sales and use taxes from out-of-state sellers once the States have adequately simplified their sales tax structures.

Chairman HOUGHTON. Thank you very much, Mr. Ledger.

I think we should turn to Mr. Honaker.

STATEMENT OF RONALD R. AND MARGARET HONAKER, OWNERS, SALONS 4 U, AND GLOW SHOP, ST. LOUIS, MISSOURI

Mrs. HONAKER. Mr. Chairman and members of the committee, my name is Margaret Honaker. I am President of salons4u.com. We currently own or maintain 51 web sites, while I am still a full-time cosmetologist. Ron and I would like to provide some thoughts about the implications of adding more taxes to the Internet, starting with a little background.

Currently, my daughter, Heather, would like to own her own beauty salon, but it appears that the mall management companies do not favor the Mom & Pop shops. Their first question seems to be, "How many salons do you have in your chain?" Now, these mall management companies in our area are managing most of the commercial strip centers and applying the same policies to the Mom & Pop shops, driving any start-up businesses to the Internet. So we went to the Internet.

To increase my business as a stylist, I found that a single page competing with the other 500 million web pages out there would

not work, so we built our own community-service web search engine for the beauty industry. We provided free pages to every one of the 250,000 salons nationwide, free pages to the 1,200 beauty-related suppliers, and free listings for all beauty professionals, thus creating a one-stop place to find beauty-related information for both the public and the beauty professionals. How could this site be taxed more? Therefore, I have asked Ron to assess the effects of any additional taxation on our web sites.

Mr. HONAKER. We are in one of the most exciting times in history because of the Internet. Things are advancing so quickly, but change seems to be an opportunity to some and just downright scary to others.

Margaret has become a powerful listener to the many clients that she has, and they all tell her they don't want another tax. Well, then, who would want more taxes? How about the small towns in America with eroding tax bases? Yes, they are very scared, and rightfully so, but it appears all they want to do is just do the easy thing, and that is just put more taxes on rather than use the Internet to work for them.

We keep hearing in the media about "no taxes on the Internet." The Internet already has at least two major sets of taxes, the front-end and back-end taxes. The front-end are the ones being paid on the profits made by the businesses using the Internet. The back-end taxes are the ones being paid by the Internet service providers. They are the ones that connect your computers to the Internet system. These ISPs pay taxes on their communication lines and their profit, passing on the cost directly to the Internet users.

I guess the thought is, how can we be taxed in the middle?

Creating an Internet tax based on web site pages, no matter how small, would close the books on salons4u. Even $1 per page would mean over $250,000 in taxes for salons4u.

Where salons4u receives its revenue to support the maintenance costs is from salons, suppliers, and beauty professionals that choose to place additional information or custom information on their pages. Since these businesses are in absolutely every location of the country, a one-time service-based tax may seem easy, but the overhead costs of sending checks to each of their cities, counties, and States would be an accounting roadblock.

To learn about commerce on the Internet—we call it e-commerce—and for fun, we started theglowshop.com, a site where we items for resale, such as hats and glowsticks, electric shirts, lights, glow-in-the-dark vinyl, etc. We found out how Americans love gadgets and how innovative they can be with our products. In the short time that theglowshop.com has been on line, less than 1 percent of our sales are from Missouri residents, on which we collect and pay sales tax to the State of Missouri. Fortunately, we only have to pay one tax to the State, and they redistribute the taxes to the county we live in. If we had to pay monthly, quarterly, semiannually, and/or yearly to the thousands of cities, counties, and States, it would be devastating. Just think, the stamps and writing of checks would be overbearing.

Sales tax in this case would not only turn the lights out for theglowshop.com, but would simply kill every small reselling business on the web.

We believe that taxes are designed to raise revenue or for controlling such things as moving money to charities or slowing down sins. So if a State places taxes on servers, we will be confused why they are taxing the servers for the revenue or for control. I will tell you that people are loyal to lower prices and will move the servers out of the State to a tax-free zone. Small businesses have the advantage to change and quickly win all the prizes that come with hard work, but almost always have the disadvantage of not having the quantity of research funding that is available to larger businesses. Additional taxes will slow down the rate of new inventions by individual people.

We are a very small business, and we thank you for considering the catastrophes that can happen to a very small business with any additional taxes. The people applaud Congress for providing the great economic environment for the new jobs in America that we have recently enjoyed. But for humor, let it be know that very few want a new job to exist in America called "Internet Tax Preparers."

[The prepared statement follows:]

Statement of Ronald R. and Margaret Honaker, Owners, Salons 4 U and Glow Shop, St. Louis, Missouri

We currently own or maintain 51 web sites, while I am still a full time cosmetologist. Ron and I would like to provide some thoughts about the implications of adding more taxes to the Internet starting with a little background.

Currently, my daughter, Heather, would like to own her own beauty salon, but it appears that the malls management companies do not favor the Mom & Pop shops. Their first question seems to be "how many salons do you have in your chain?" Now, these mall management companies in our area are managing most of the commercial strip centers and applying the same policies to the Mom & Pop shops, driving any start-up businesses to the Internet. So, we went to the Internet.

To increase my business as a stylist, I found that a single page competing with the other 500 million web pages out there would not work. So we built our own community service, web search engine for the beauty industry. We provided FREE pages to every one of the 250,000 salons nation-wide, FREE Pages to the 1,200 beauty-related suppliers, and FREE listings for all beauty professionals. Thus, creating a one-stop place to find beauty-related information for both the public and the beauty professionals. How could this site be taxed more? Therefore, I have asked Ron to assess the effects of any additional taxation on our web sites.

We are in one of the most exciting times in history with the Internet. Things are advancing so quickly, but change can be seen as opportunity to some and down right scary to others.

Margaret has become a very powerful listener to the many clients she has and they tell her they do not want another tax. Well then, who would want more taxes? I don't think politicians would more taxes in an election year. Big business, a most likely YES. Or, how about the small towns in America with an eroding tax base? YES, they are very scared, and rightfully so. But appears they want to do the easy thing, just put on more TAXES rather than to use the Internet to work for them.

The Internet already has at least two major sets of taxes. The front-end taxes and back end taxes. The front-end taxes are being paid on the profits made by the businesses using the Internet. The back end taxes are the ones that are the Internet Service Provides (ISP), and they are the ones that connect your computers to the Internet system. These ISPs pay taxes both on their communication lines and their profit, passing on the cost directly to the Internet users. I guess the thought is how can we be taxed the middle?

Products on the Internet can be of two types, Real and Virtual. Real Products are those items which we have been traditionally been buying everyday and that you can touch, feel and ship by trucks. Virtual products for sale are newer. They are the digital stuff, such as music, movies, information and services. Can you image that we can tax things that do not really exist?

Creating an Internet tax based on pages, no matter how small, would close the books on salons4u.com. Even just one dollar per page would mean over $250,000 in taxes for salons4u.com.

Where salons4u receives its revenue to support the maintenance costs is by the salons, suppliers, and beauty professionals that choose to place additional or custom information to their page. (Service and Virtual Products) Since they are in absolutely every location in this country, a one-time service base tax seems easy, but the overhead costs of sending out checks to each of their cities, counties, and states would be an accounting roadblock.

To learn about commerce on the Internet (e-commerce) and FUN, we started theglowshop.com. A site that we have items relating to light, such as hats, glow sticks, electro-shirts, lights, glow in the dark vinyl, etc. We have found out how Americans love gadgets. By the way, less than one percent of our sales are from Missouri residents, which we collect and pay sales tax to Missouri. Fortunately, we only have to one tax to pay to the state and they redistribute the correct taxes to the county that we live in. If we had to pay monthly, quarterly, semi-annually and/or yearly to thousands of cities, counties and states. Just the stamps and writing checks would over bearing.

Our forefathers were wise in their judgement about interstate taxes.

We believe that taxes can be used to raise revenue or for controlling such things as moving money to charities or slowing down sins. So if a state places taxes on servers, we will be confused why they are taxing servers for (revenue or control). I will tell you that people are loyal to lower costs and will move the servers out of that state to a tax free zone.

Small businesses have the advantage to change quickly and win all the prizes that come with hard work, but almost always have the disadvantage of not having research funding available to larger businesses. Additional taxes will slow the rate of new inventions by individual people.

And, let's not forget about the not-for-profits and 501s. Like Gateway to a cure that raises research dollars for a cure for spinal cord injuries. We are very very close to finding the cure! Additional indirect taxes affect their bottom line contributions.

Lets have a little fun here with a worst case for Internet sales taxes. Say a person in an airplane has a mobile Internet device, or even some new aircraft have Internet connections on board. A person flying aboard an aircraft over state 1 (tax1) orders a small gift for a person in another state. The communication link from the aircraft links to a communication tower in state 2 (tax 2) and connects to the Internet to server in state 3 (tax 3) for theglowshop in state 4 (tax 4), theglowshop has that item dropped shipped from another company in state 5 (tax 5) with its servers in state 6 (tax 6). The person in state receiving the gift in state 7 has to pay a use tax, which is a camouflage sales tax. Who knows which and where the connecting hubs are located.

We, a very small business employ you to consider the catastrophes that can easily happen to small businesses with any additional taxes.

While the people applaud Congress for providing the great economical environment for new jobs in America we have recently enjoyed, let be known only a very few will want a new job to exist: "Internet Tax Preparers".

Thank you for inviting us, so we could be part of America's government process.

Chairman HOUGHTON. Thank you very much.

Would you like to say something, Mrs. Honaker?

Mrs. HONAKER. Just thank you for having us.

Chairman HOUGHTON. Well, we thank you both for being here.

Now, Jeanne Lewis, President of Staples.com.

STATEMENT OF JEANNE LEWIS, PRESIDENT, STAPLES.COM, FRAMINGHAM, MASSACHUSETTS

Ms. LEWIS. Mr. Chairman and members of the committee, my name is Jeanne Lewis. I am the President of Staples.com, and I am honored to be here today to testify on behalf of Staples, the office supply superstore, and our e-commerce business, Staples.com.

I thank you, Mr. Chairman, for holding this hearing to review the recommendations of the Advisory Commission on Electronic Commerce. I am pleased to have the opportunity to offer some thoughts and specific concerns on the issue of Internet taxation.

Let me say at the outset that Staples supports the goals of States and most of our Nation's Governors to develop a system of taxation that provides uniformity, simplicity and fairness to all retailers, regardless of whether transactions occur in stores or on the Internet.

We are very concerned, however, that the current moratorium and the proposed extension of the moratorium passed by the House last week will serve to make the Internet a very unfair market from a taxation perspective.

As a first priority, I would like to clear up a common misconception about taxes on the Internet. Despite the recent assertions of some Members of Congress and the media, the Internet is not tax-free. The Internet tax moratorium that was extended by the House last week does not preclude the imposition and collection of State and local sales and use taxes. The Internet Tax Freedom Act, contrary to its misleading title, merely mandates a moratorium on the ability of State and local governments to impose new taxes on Internet services or electronic commerce. Nevertheless, reputable media sources such as National Journal in its May 13th issue proclaimed in a headline, "House Extends Ban on Internet Taxes," and NBC Today Show news announced that the Internet would be tax-free for five more years. Local and Internet retailers, so-called "brick and click" retailers, are still required to assess and collect sales taxes on Internet purchases when the purchased items are shipped to a State where the retailer has a store or other facility. Consequently, local merchants that sell on the Internet must collect sales taxes in States where they have a physical presence, while those retailers who sell only on the Internet largely escape State sales taxation.

This "physical presence" test was reconfirmed in a 1992 Supreme Court decision, Quill v. North Dakota. Ironically, Staples has since acquired Quill, an office supplies direct marketer. We wish that we could simply assert that the litigant was wrong, but unfortunately, such an assertion would not change the state of the law.

To explain our concerns, let me offer an example of how Internet taxation affects "brick and click" companies. If a Staples Internet purchaser lives in Chairman Houghton's home State of New York, Staples is required to charge the purchaser 8 percent State and local sales tax for any Internet purchase because Staples has a "physical presence" in New York. If you buy these same items from a so-called "pure-play" Internet retailer, one that has no retail stores or facilities in any States, or just one or two States, you are not charged sales tax because the Internet retailer does not have a physical presence in New York. This effectively means that New York consumers are getting up to an 8 percent discount from Internet retailers that do not charge sales tax. This also means that companies that have made investments in New York are being penalized on their Internet to New Yorkers for having made that investment.

Staples has made investments of stores or distribution centers in many States—44 States as of today. This means that most consumers are paying sales taxes—if they live in a State that has a sales tax—when they purchase from Staples on the Internet. When one considers where to buy thousand-dollar-plus computer equipment, fax machines, office furniture, or other high value merchandise,

this 4 to 8 percent "discount" is likely to make a difference in a person's purchasing decision.

Of course, even if one decides to purchase goods from a pure-play Internet retailer that does not charge sales tax because it does not have a physical presence in the State of the purchaser, that State probably applies a use tax which is required to be remitted to the State in lieu of a sales tax on goods where sales tax has not been collected. However, a number of Governors have testified before Congress about the significant difficulties they face in enforcing this use tax; thus, these Internet goods remain virtually sales-tax free. Most States simply do not have the desire or the resources to conduct home inspections to determine if goods have been purchased without payment of a sales and use tax.

If Congress moves to extend the current moratorium, as the House did last week, we believe that the only fair and equitable solution in the short term is to expand the moratorium to include all existing sales and use taxes on Internet transactions so that the Internet Tax Freedom Act truly lives up to its name. Extending the Internet tax moratorium without addressing this taxation inequity will perpetuate an unfair advantage to Internet pure-play retailers. We simply ask for a level playing field. Otherwise, retailers which sell locally and on the Internet will continue to be at a significant competitive disadvantage.

As I said at the beginning of my testimony, Staples certainly understands and supports the position of State and local officials that the sales tax base must be protected to ensure adequate funding for State and local government. We cannot, however, be subsidizing our Internet competitors who compete for the same customers that we do in a given State simply because we have invested in facilities and people in that State. The enactment of the Internet Tax Freedom Act, without the revisions we have suggested, will result in the Congress aiding and abetting efforts to circumvent nexus or physical presence through the creation of questionable corporate tax mechanisms for the sole purpose of avoiding sales tax on Internet sales. Such a result would not only be poor tax policy; it would create chaos, as the Internet would simply be unfair to those who have already made substantial investments in States.

[The prepared statement follows:]

Statement of Jeanne Lewis, President, Staples.com, Framingham, Massachusetts

Mr. Chairman and Members of the Committee, my name is Jeanne Lewis. I am the President of Staples.com and I am honored to be here today to testify on behalf of Staples, the office supplies superstore, and our e-commerce business Staples.com.

I thank you Mr. Chairman for holding this hearing to review the recommendations of the Advisory Commission on Electronic Commerce. I am pleased to have the opportunity to offer some thoughts and specific concerns on the issue of Internet taxation. Let me say at the outset that Staples supports the goals of states and most of our nation's Governors to develop a system of taxation that provides uniformity, simplicity and fairness to retailers, regardless of whether transactions occur in stores or on the Internet.

We are very concerned, however, that the current moratorium and the proposed extension of the moratorium passed by the House last week will serve to make the Internet a very unfair market from a taxation perspective.

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This "physical presence" test was reconfirmed in a 1992 Supreme Court decision *Quill* v. *North Dakota*. Ironically, Staples has since acquired Quill, an office supplies direct marketer. We wish that we could simply assert that the litigant was wrong, but, unfortunately, such an assertion would not change the state of the law.

To explain our concerns, let me offer an example of how Internet taxation affects brick and click companies: If a Staples Internet purchaser lives in Chairman Houghton's home state of New York, Staples is required to charge the purchaser 8% state and local sales taxes for any Internet purchase because Staples has a "physical presence" in New York. If you buy these same items from a so called "pure-play" Internet retailer (one that has no retail stores or facilities in any states or just one or two states), you are not charged sales tax because the Internet retailer does not have a physical presence in New York. This effectively means that New York consumers are getting up to an 8% discount from Internet retailers that do not charge sales tax. This also means that companies that have made investments in New York are being penalized on their Internet sales to New Yorkers for having made that investment.

Staples has made investments of stores or distribution centers in many states −44 states as of today. This means that most consumers are paying sales taxes (if they live in a state that has a sales tax) when they purchase from Staples on the Internet. When one considers where to buy thousand-dollar plus computer equipment, fax machines, office furniture or other high value merchandise, this 4–8% "discount" is likely to make a difference in a person's purchasing decision.

Of course, even if one decides to purchase goods from a pure-play Internet retailer that does not charge sales tax because it does not have a physical presence in the state of the purchaser, that state probably applies a use tax which is required to be remitted to the state in lieu of a sales tax on goods where sales tax has not been collected. However, a number of Governors have testified before Congress about the significant difficulties they face in enforcing this use tax, thus these Internet goods remain virtually sales-tax free. Most states simply do not have the desire or the resources to conduct home inspections to determine if goods have been purchased without payment of a sales and use tax.

If Congress moves to extend the current moratorium, as the House did last week, we believe that the only fair and equitable solution in the short-term is to expand the moratorium to include *all existing* sales and use taxes on Internet transactions so that the Internet Tax Freedom Act truly lives up to its name. Extending the Internet tax moratorium without addressing this taxation inequity will perpetuate an unfair advantage to Internet pure-play retailers. We simply ask for a level playing field. Otherwise, retailers which sell locally and on the Internet will continue to be at a significant competitive disadvantage

As I said at the beginning of my testimony, Staples certainly understands and supports the position of state and local officials that the sales tax base must be protected to ensure adequate funding for state and local government. We cannot, however, be subsidizing our Internet competitors who compete for the same customers that we do in a given state simply because we have invested in facilities and people in that state. The enactment of the Internet Tax Freedom Act, without the revisions we have suggested, will result in the Congress aiding and abetting efforts to circumvent nexus or physical presence through the creation of questionable corporate tax mechanisms for the sole purpose of avoiding sales tax on Internet sales. Such a result would not only be poor tax policy, it would create chaos as the Internet would simply be unfair to those who have already made substantial investments in states.

Chairman HOUGHTON. All right. Thank you very much. Very good, Ms. Lewis.

Mr. Duncan?

STATEMENT OF HARLEY T. DUNCAN, EXECUTIVE DIRECTOR, FEDERATION OF TAX ADMINISTRATORS

Mr. DUNCAN. Thank you very much, Mr. Chairman and members of the committee. I appreciate the opportunity to be with you to present the views of the Federation of Tax Administrators on the issues of the taxation of electronic commerce. My name is Harley Duncan; I am the Executive Director of the Federation of Tax Administrators, which is an association of the State tax administration agencies in the 50 States, the District, and New York City.

My primary message to you today is that the issue of collection of sales and use tax on remote sales, whether those are accomplished via mail order, catalogue, phone, or the Internet, is a serious and pressing issue for State and local governments and it is one that Congress does need to attend to. We think that the continued lack of ability to collect tax on remote sales where the vendor is not required to collect because they don't possess a physical presence has three significant impacts on State and local governments.

The first is the erosion of the sales tax base, or the pure monetary issue. Work done by Bill Fox and Don Bruce at the University of Tennessee indicates that by the year 2003, the amount of uncollected sales tax will exceed $20 billion. That's both with respect to sales to individuals as well as sales to businesses. That will amount to over 4 percent of the total tax revenues in States like Florida, Nevada, South Dakota, Tennessee, and Texas that rely on the sales tax as opposed to an income or other significant tax.

In addition to the base issue, there is the one of the unlevel playing field that Mr. Ledger and Ms. Lewis have spoken to very well. Basically, what you have under the current situation is a government-sanctioned and government-maintained competitive disadvantage that faces a fixed-base retailer that is required to collect tax, while those who operate outside the State are allowed to sell without the collection of tax. We don't think that can or should be sustained over the long term.

The final impact is one of erosion of our Federal system. The sales tax is the single tax that States reserve primarily unto themselves to carry out their mission in the Federal system. If that tax is weakened by base erosion through electronic commerce and other forms of remote sales, we think that the Federal system will be weakened and that States will not be able to carry on their appropriate and proper role in the system.

We think the solution to the issue of collection of tax on remote sales is relatively straightforward. Congress should exercise the authority that the Court has said is its under the Commerce Clause, reiterated in the Quill case, to authorize States to require remote sellers to collect sales and use tax on goods and services that they sell into the State. We believe an important part of that change in the nexus threshold should be one that shifts from physical presence to an economic presence. In other words, there should be a

threshold above which you are required to collect on sales into a State at a dollar-denominated sales threshold; if you are below that on a national basis, you collect only where you are based. In other words, we shift from a physical standard to an economic standard. We think that's consistent with what the Court has said. It is appropriate and proper. In addition, it is very consistent with an increasingly digital and borderless world.

The second part of the solution has to be that any expanded duty to collect has to be accompanied by significant simplification of the current sales tax system. The complexities of the current system, that you've heard discussed, are indeed accurate; it is a complex system, and Congress is well within its right to require States to simplify if they expect that the duty to collect is going to be extended to remote sellers.

The second part of the message I would like to communicate to you today is that I think States are indeed serious about the simplification and are working today to undertake that. We have started a project that now has 30 States involved in it, really trying to look at a three-pronged attack on the complexity of the current system. One is some structural simplifications and common definitions across items that might be in the base or out of the base, and simplification of rates and changes in other aspects of the law. The second is to promote greater use of technology in collecting the tax, and to provide safe harbors for sellers that use that technology so that they are held harmless on audit. And a third part of it is for the States to pay for the system.

We think the combination of those sorts of simplifications and an expanded duty to collect is an appropriate one.

Just a comment on the work of the Advisory Commission on Electronic Commerce. I think most State and local officials have come to the reluctant conclusion that Congress should reject the recommendations contained in that report. Forty-two Governors have written, seeking that. Other State and local officials have, and a hundred academic economists have. There are three principal reasons for it.

The first is, it contains a series of unwarranted tax preemptions that will seriously affect State and local fiscal conditions. The second is that it fails to deal in any meaningful fashion with this remote sales tax collection issue. And third, it is really an assault on the federalism and the sovereignty of the States that puts significant control over State and local taxes in the hands of the Congress, and it is one that you will have to continue to exercise if you take it on once.

Thank you.

[The prepared statement follows:]

Statement of Harley T. Ducan, Executive Director, Federation of Tax Administrators

Mr. Chairman and Members of the Committee:

My name is Harley Duncan. I am Executive Director of the Federation of Tax Administrators. The Federation is an association of the principal state tax administration agencies in the 50 states, D.C., and New York City. Thank you for the opportunity to appear before you today on the general subject of the state and local tax issues involved with electronic commerce.

The policy of our organization in this area has been established generally in two resolutions adopted by our members at the June 1999 Annual Meeting in Milwau-

kee, Wisconsin. The first resolution advocates simplification of state sales and use tax structures and administration as a prelude to requiring collection of sales and use taxes by all sellers above a de minimis sales volume threshold, regardless of whether they have a physical presence in the taxing jurisdiction. The second resolution contains a general position against federal preemption of state tax sovereignty and tax authority.

In this testimony, I would like to achieve five goals:

- Provide a high-level overview of the essential features of state and local sales and use taxes;
- Outline the primary state and local tax issues associated with electronic commerce;
- Identify the expected revenue impact on states and localities of electronic commerce;
- Outline a general approach to an appropriate resolution of the issue; and
- Review the reasons that many state and local officials have called on Congress to reject the so-called 'majority report' of the Advisory Commission on Electronic Commerce.

Basics of State and Local Sales and Use Taxes

Forty-five states plus the District of Columbia levy a sales and use tax. In addition, local governments in approximately 30 states are authorized to impose a local sales tax. In all but four states (Alabama, Arizona, Colorado and Louisiana), these local taxes generally "piggyback" on the state tax base and are collected by the state tax administration agency on behalf of the local government.[1] Sales tax rates range from 3 percent to 7 percent at the state level; local option rates generally run from 1 to 2 percent. The "average" state and local tax rate in the U.S. is roughly 6.0–6.5 percent.

Every state with a retail sales tax also levies a "compensating use" tax, often simply referred to as the use tax. A use tax is levied on all taxable goods and services that are used and consumed in the taxing state if there has not been paid an appropriate sales tax. Thus, goods and services on which no sales tax has been collected are subject to the compensating use tax.

The sales tax is a consumption tax that is applied on a destination basis, meaning the tax is applied in and remitted to the jurisdiction in which delivery of the good or service is taken or where it is to be used or consumed. [Receiving goods at the time of sale is considered taking delivery. The point of delivery is presumed to be the jurisdiction in which consumption occurs.] Goods and services traveling through multiple jurisdictions or involving multiple jurisdictions are still taxable only in the state of consumption or use.

A seller may not be required to collect use tax on goods shipped to a buyer in another state unless there is a sufficient "nexus" or level of contact between the seller and the state of the buyer. The U.S. Supreme Court has held that for an out-of-state seller to be required to collect use tax on goods and services sold into a state, the seller must have some physical presence in the state of the buyer, either directly or through the activities of a representative.[2] If the sales or use tax is not collected by the seller because of the lack of a requirement to do so, the buyer is still responsible for payment of the use tax directly to the state in which the good or service is used or consumed.

Tax Issues Raised by Electronic Commerce

Collection of Tax on Remote Electronic Commerce Sales

In terms of potential revenue effect, the largest and most immediate issue raised for state and local governments is, by far, the potential increased sales tax base erosion caused by the explosion in electronic sales[3] on which no sales or use tax is collected because the seller has no nexus with the state in which the buyer resides. In many ways, electronic commerce can be likened to the longstanding issue of mail order or catalog sales in which state and local use tax is not collected because the

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[1] In these 4 states, local governments administer their sales taxes independently of the state. There may be differences in the state and local tax base, and returns, remittances, etc. are filed directly with the local governments.

[2] *Quill Corporation v. North Dakota,* 504 U.S. 298, 112 S.Ct. 1904, 119 L.Ed.2d. 91 (1992); *National Bellas Hess, Inc. v. Dept. of Revenue of Illinois,* 386 U.S. 753, 87 S.Ct. 1389, 18 L.Ed.2d. 505 (1967).

[3] This includes sales of both digital products and, more importantly, tangible goods via electronic means.

seller has no physical presence or nexus with the state. This is particularly true of the sale of tangible goods where it is only the medium through which the transaction is conducted that differs, not the nature of the product.

The remote sales tax collection issue arises because of the U.S. Supreme Court decision in *Quill Corp. v. North Dakota* (1992), upholding its decision of 25 years earlier in *National Bellas Hess v. Illinois Department of Revenue* (1967). The Court held that, under the Commerce Clause, a taxing state could not require an out-of-state seller whose only contacts with the state were the solicitation of orders by catalog and shipping goods by common carrier or U.S. mails to collect use tax on goods shipped into the state. Without such a physical presence, the Court held, requiring a seller to comply with the sales tax laws of each jurisdiction and the large number of local tax rates would create an undue burden on interstate commerce.[4]

The combination of the *Quill* physical presence rule with the advent of electronic commerce exposes state and local sales tax system to a potentially large erosion of the tax base. A hallmark characteristic of the Internet is its ability to allow a seller to market directly to individual consumers on a worldwide basis while, at the same time, minimizing the physical facilities necessary to undertake such efforts. As a consequence, the exposure of state and local sales tax systems to remote sales is magnified exponentially.

The issue is not limited only to purchases by individual consumers. State and local sales and use taxes generally apply to purchases by businesses where the item purchased is for use and consumption by the business itself, rather than for resale or incorporation into an item being resold to another consumer. Where tax is not collected by the seller (because of nexus reasons), the purchaser is to accrue and remit tax on its purchases. Use tax compliance among businesses is substantially better than among individuals because many of them routinely accrue tax and they are routinely subject to audit. Nonetheless, the noncompliance in the area of business purchases should be expected to increase as more sellers use the Internet to accomplish what once took sales personnel and in-state facilities.

The consequences of a rapidly growing volume of retail transactions going effectively untaxed (even though the tax is owed by the consumer) are several: (1) Erosion of the retail sales tax base and revenue stream; (2) Violation of a principle of tax neutrality because sales of identical goods are taxed differently based only on the location of the seller; (3) Unfair competition with Main Street and other businesses required to collect tax on their sales; (4) Growing concerns about the long-term viability of the sales tax as a mainstay in the state and local tax structure.

That is to say, the issue goes well beyond that of the amount of revenues available to states and localities although that too is an important issue. There is an important issue of the competitive disadvantage faced by fixed-base retailers and others who are required to collect tax. The threat to their survival from this built-in, government-sanctioned disadvantage is real. Likewise, the long-term threat to the sales tax as a whole cannot be overstated. If a tax is seen as increasingly unfair because some have to pay and some do not (and the only reason for the difference is the manner in which a purchase is made), the end result may be demands to repeal the tax for everyone.

Complexity of the Current System

Another effect of electronic commerce has been to shine a spotlight on the complexity of the current sales and use tax system and its administration for sellers, particularly those operating on a multistate basis. As efforts to address the remote sales issue are undertaken, they run head-long into the complexity of the current system, and the "undue burden" it places on sellers required to comply. Discussions of the state and local tax issues associated with electronic commerce naturally include a discussion of ways in which the current system can be simplified and made more uniform across states.[5] Likewise, any resolution of the remote sales issue will necessarily entail substantial simplification of the tax.

The complexity arises from the simple fact that the sales tax has been developed as a stand-alone tax in each state without a great deal of regard for the degree to which it conforms to similar taxes in other states. This is natural since when sales

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[4] Some observers argue that the *Quill* and *Bellas Hess* decisions require a seller to have a "substantial physical presence" in the taxing state before it can be required to collect tax. The *Quill* decision does not use the phrase "substantial physical presence" it requires a "substantial nexus" with the taxing state, and says that nexus is satisfied if the seller maintains a physical presence in the taxing state.

[5] For an extensive discussion of the types of simplifications that have been discussed, see the Final Report, National Tax Association Communications and Electronic Commerce Tax Project, supra.

taxes were developed, most retail activity was confined to a single state. As a result, there are differences in tax bases across states, differences in administrative laws and procedures as well as differences in filing, returns and remittances.

Another aspect of complexity in the current system is the extent to which local option sales taxes are used. Over the last 30 years, in an effort to reduce reliance on property taxes, states have increasingly authorized local governments to levy sales taxes (often only after approval by the voters). Local governments in 30 states now levy sales taxes. While the base and administration are generally piggybacked on the state sales taxes, the rate varies across some localities. The result is considered complex by multistate sellers that are required to identify the jurisdiction into which an item is being sold, determine the appropriate tax rate, and account for tax collected in each local jurisdiction.

Impact of Electronic Commerce on State and Local Tax Revenues

There have been several studies done of the impact of electronic commerce on state and local revenues.[6] The most comprehensive has been prepared by Donald Bruce and William Fox, two University of Tennessee economists.[7] Bruce and Fox use forecasts of electronic commerce sales into the future (2003) to look at the expected near-term magnitude of the impact. They also try to estimate the impact in both the business-to-consumer (B2C) and the business-to-business (B2B) markets. They also account for the current impact of mail order sales on state revenues and the substitution of e-commerce sales for mail order as well as the "natural" decline in state tax bases due to a shift to services in the economy.

The results of the Bruce and Fox analysis can be summarized as follows.

- In 2003, the total amount of state and local sales and use taxes going uncollected due to electronic commerce is projected to be $20.1 billion. The 'incremental' (i.e., sales newly shifted to electronic commerce) impact is estimated at $10.8 billion, of which about 70 percent is from B2B sales.
- On a state-by-state basis, the projected total state and local revenue impact due to e-commerce ranges from $31.8 million in Vermont to $2.8 billion in California. The expected impacts exceed $1 billion in each of New York, Texas and Florida.
- Expressed in terms of total tax revenues, the revenues not collected due to e-commerce range from 4.9 percent of total taxes in Texas to 1.5 percent in D.C. It is over 4 percent in each of Florida, Nevada, South Dakota, Tennessee and Texas.
- On average, states would have to raise their sales tax rates by 0.5–0.75 percentage points to maintain constant revenues in 2003, i.e., to offset the impact of e-commerce on tax receipts.

Potential Solution To Remote Sales/Use Tax Collection

Policy Objectives

Congressional activity to address the issue of electronic commerce and remote sales should, in my estimation, focus on several policy objectives, including:

- Ensure that the tax system is neutral across all types of sellers, regardless of the channels through which they choose to market;
- Preserve the sovereignty of states to design their tax systems to fit their own circumstances , particularly as to the taxes employed, items to be taxed and tax rates;
- Promote substantial simplification and greater uniformity across states so as to minimize the burden imposed on sellers to comply, particularly smaller retailers;
- Foster the use of advanced technology in administration of and compliance with the sales tax system; and
- Protect the privacy rights of consumers

Expanded Duty to Collect

From a tax administrator perspective, the answer to the potential erosion of the sales tax base by electronic and other remote commerce seems clear. Congress should use its authority under the Commerce Clause to authorize states to require

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[6] See, for example, Robert Cline and Thomas Neubig, "The Sky is Not Falling." (published by the E-Commerce Coaliton) which projects that in 1998, the net impact of electronic commerce was to reduce state and local revenues by about $170 million. Forrester Research estimates that the comparable number for 1999 was $500 million. Both of these analyses examine only business-to-consumer sales.

[7] Donald Bruce and William F. Fox, "E-Commerce in the Context of Declining State Sales Tax Bases," (mimeo) February 2000. [To appear in a forthcoming edition of the National Tax Journal.]

sellers without a physical presence in the state to collect use taxes on goods and services sold into the state. Included within the authorization should be a requirement that states accomplish meaningful simplification of the sales tax and its administration as well as a de minimis threshold stated in terms of a dollars-denominated sales threshold below which a seller would not be required to collect tax for multiple states.[8]

There are at least two types of federal legislative vehicles that could be used to implement a system such as that outlined here. First, Congress could pass a law simply authorizing those states that modified their sales tax law to meet certain standards to require remote sellers above the *de minimis* threshold to collect tax. Congress has considered similar legislation in recent years.

Alternatively, Congress could authorize states to form an interstate sales tax compact and authorize states that join the compact to require remote sellers to collect tax on goods and services sold into the state. A requirement of participation in the compact would be to adopt a sales and use tax law that met certain standards of simplification and uniformity that Congress considered necessary. Such a compact could achieve the same or greater simplification and uniformity objectives as federal legislation and leave a greater proportion of the details to the states. It could also provide a framework for ensuring continued uniformity and simplification over time.

The Federation has not expressed a preference for one vehicle over another. We would urge the Congress to include an examination of the appropriate vehicle as it considers this issue

Simplification and Uniformity—Streamlined Sales Tax Project

States and localities recognize that concomitant with any expanded duty to collect use taxes there must be a significant simplification and improvement in uniformity in state and local sales taxes and their administration. In an economy that is increasingly multi-jurisdictional, it is necessary for states to cooperate in the design and administration of their taxes so as to facilitate commerce and to reduce compliance burdens for the increasing number of multistate sellers. Simplification also has rewards for fixed-base retailers.

States have initiated a project called the "Streamlined Sales Tax System for the 21st Century." The Project is intended to overhaul the existing sales and use tax system to better accommodate interstate commerce, especially the changes presented by electronic commerce. The Project is aimed at developing a substantially simplified sales and use tax system while employing emerging technologies to remove or reduce the burden on sellers for collecting the taxes, with the states contributing substantially to the financing of the streamlined system. There are approximately 30 states participating in the Project at this time. Further information on the Project membership and organization is available at www.streamlinedsalestax.org.

There are four key aspects to the Streamlined Sales Tax system being developed.

Strategic Simplifications. The Project is developing a series of simplifications that will substantially reduce the burden associated with sales and use tax collection. Among the primary simplifications are uniform definitions of items that may be included in a tax base, simplified and uniform exemption administration, repeal of the "good faith acceptance" rule for exemption certificates, uniform sourcing rules, limitations on local tax rate changes, simplified returns and remittances and centralized registration. The simplifications being addressed are primarily those that have been identified as most critical by fixed-base and electronic commerce retailers.

Use of Advanced Technologies. A second major component of the project is the use of emerging technologies to reduce the burden on sellers. A number of companies provide technology and services to assist sellers in calculating the taxes due on a given sale. The range of services offered varies from a simple tax calculator to compiling and filing returns and tax remittances. The aim of the project is to "certify" qualifying technology vendors as offering a service that meets the requirements of state sales tax law. Sellers that use certified technology would then be provided a "safe harbor" against future audit assessments for any failure attributable to the certified software.

Paying for the system. The project is committed to financing as much of the system as it reasonably can for sellers. The primary method of financing sellers' participation will be through vendors' compensation—i.e., allowing sellers, or their tax

[8] Sellers below the threshold level might be required to collect only on sales within the state(s)in which they operate or simply remit tax on all sales to that state. Such an approach would avoid placing undue burdens on the smallest sellers. A sales threshold *de minimis* would eliminate a large amount of litigation that occurs currently regarding what constitutes nexus and the required level of contact with a taxing state.

service providers, to retain a portion of the sales and use tax collected as compensation for collection of the tax.

Privacy concerns. Provisions will be included in all aspects of the project's work to ensure that personal information is not unnecessarily gathered and is not improperly used by persons engaged in the tax administration process. Tax administration agencies will not come into possession of personal identifying information for an individual paying tax at the time of a transaction. Tax calculation service providers will be prohibited from using personal information for any non-tax-administration purpose.

Rationale

Beyond the protection of the state and local revenue base, an expansion of the duty to collect sales and use tax under a simplified administrative system promotes several tax policy goals and strengthens federalism.

- It promotes neutrality in the tax system by treating all purchases of the same or similar products similarly, regardless of the seller.
- It will promote equity among sellers and eliminate an 'unfair' competitive advantage now enjoyed by remote sellers who are not required to collect tax compared to the Main Street/shopping mall seller who is required to collect.
- It recognizes that the current approach of each state independently administering its own tax is inefficient and imposes undue burdens on multistate sellers. It recognizes that multistate cooperation and uniformity are required to promote simplification and avoid other more dire consequences such as federal intervention.
- By strengthening the sales tax, it will also strengthen our system of federalism. If the largest single state and local revenue source is crippled, the strength of states and localities as partners in that federal system is weakened.

"MAJORITY REPORT" OF THE ADVISORY COMMISSION ON ELECTRONIC COMMERCE

The Internet Tax Freedom Act created the Advisory Commission on Electronic Commerce (ACEC). The Commission was to be a balanced representation of the public and private sector interests at stake in the issue of taxation of electronic commerce. Its mission was to undertake a thorough study of the federal, state and local tax issues associated with the taxation of electronic commerce and to make recommendations to Congress for ways to resolve those issues. Any recommendations to Congress were required to have the support of two thirds of the Commission members.[9]

Shortcomings of the Report

Many state and local officials have been forced to conclude that the Commission fell woefully short of its goal. Forty-two governors have written to the leadership of the Congress asking that they reject the Commission report.[10] Over 100 academic economists have also signed a letter criticizing the report as reflecting inappropriate and misguided tax policy. State and local officials see four major shortcomings in the ACEC report.

Unlevel Playing Field. Rather than promoting neutrality across marketing channels and creating a level playing field for all retailers, the ACEC recommendations further tilt the playing field against fixed-base retailers and others currently carrying the state and local tax burden. The ACEC recommendations would open many new opportunities for firms to actively engage in business in a state without incurring tax obligations. As such, they exacerbate, not eliminate, the competitive disadvantage faced by fixed-base retailers and other taxpayers.

Failure to Address Remote Sales. The ACEC report fails to address in any meaningful way the remote sales tax collection issue outlined earlier. The report would have required states and localities to develop and implement a series of mandated simplifications, which process would have been followed by an elongated, inconclusive and likely negative review of whether tax collection obligations should be extended to remote sellers.

Preemption of State Sovereignty. If adopted, the recommendations of the ACEC would constitute a frontal assault on the sovereignty and authority of states to determine their own tax structures. It would have, for the first time in our nation's history, placed nearly complete authority over the details of state tax law in the

[9] The Commission's report was presented to Congress in April 2000. It is available at the Commission Web site www.ecommercecommission.org.

[10] See testimony of Gov. Michael O. Leavitt before the Committee on Commerce, U.S. Senate, April 12, 2000.

hands of the U.S. Congress. As such, the report showed little understanding of federalism or the role of the states in the federal system.

Unwarranted Tax Preferences. The report recommends, with little or no justification in most instances, that Congress preempt state tax authority in several key areas. These areas include an exemption for Internet access charges and all digitally delivered goods and services as well as their tangible counterparts. In addition, the report calls for Congress to enact a federal law mandating that a series of activities (commonly carried on by electronic commerce firms) could not be considered to constitute nexus for sales and use or business activity taxes. Taken together, these nexus carve-outs would enable electronic commerce firms to engage in a wide range of activities within a state without being required to meet tax obligations in the state and would exempt a considerable portion of their content and activities from tax. Estimates are that the combination of the tax preferences included in the ACEC report, discussed in more detail below, would reduce current law state and local tax revenues by as much as $25–30 billion per year.

Further Discussion

Internet access. The majority report recommends making permanent the Internet Tax Freedom Act's moratorium on any transaction taxes on the sale of Internet access, including taxes that were grand fathered under the ITFA. At present, the following 11 states impose the sales tax (or a similar gross receipts tax) on such charges: Connecticut, Hawaii, New Hampshire, New Mexico, North Dakota, Ohio, South Dakota, Tennessee, Texas[11] , Washington State and Wisconsin.[12] In each case, the tax is part of a broader based tax (e.g., sales tax) and is not a levy targeted specifically at Internet charges. The impact of this repeal of the grandfather clause is approximately $75 million per year, according to information submitted by the states to FTA.

There are three additional issues that must be considered in any permanent or long-term moratorium: (1) Dealing with other services that may be bundled with access; (2) The addition of substantial amounts of content to a package including access; and (3) Apparent competitive issues that arise as Internet telephony technology improves and takes hold.

Digitized goods and their counterparts. The majority report recommends a tax exemption for "sales of digitized goods and products and their non-digitized counterparts." Such preemption would do substantial damage to the tax base of a number of states. Twenty-eight states currently consider downloaded software to be taxable, and nineteen states consider downloaded information to be taxable. About fifteen states tax a broad category of "electronic information services."

An exemption for "digitized goods and products" would logically apply to all subscriptions to on-line databases and information services, on-line publications, on-line photos and movies, and a variety of services that produce digitized products (e.g., photo finishing). And, if taxing the "non-digitized counterparts" of digitized goods and products were also preempted, states and localities would lose the ability to tax all sales of newspapers, books, music and CDs, periodicals, photos, software, movies, cable services, etc.

In one estimate, including the states of Florida, Texas, Washington and Wisconsin, this provision would reduce state and local sales tax revenues by over $1 billion per year in just these four states. Another estimate sets losses of state and local tax revenues at $5.7 billion per year.

Nexus standards. The majority report purports to attempt to "clarify" the circumstances under which a seller has a sufficient nexus, or connection, with a state to be required to collect and remit sales and use taxes and to report and pay business activity taxes to that state, by listing nine activities that, individually or in combination, would not establish nexus for that seller in the state. The net effect of these nexus "carve-outs" would be to allow a firm, especially electronic commerce firms, to engage in a wide range of activities in the state, either directly or indirectly through affiliates and representatives, without incurring a direct tax obligation or a sales/use tax collection responsibility. As such, they would further tilt the playing field against fixed-base retailers.

Space does not allow a full explication of all the potential ramifications. A few examples should, however, suffice to demonstrate the issues.

• The report would prohibit the consideration of the relationship between an out-of-state seller and an affiliate with a physical presence in the taxing state as a basis for establishing nexus, which opens up the potential for an "Internet kiosk" arrangement. That is, a seller could establish kiosks in the stores of an affiliate through

[11] Tax is imposed only on amounts over $25 per month.

[12] Certain cities in Colorado and Arizona also apply their tax to such charges.

which goods are ordered from the seller and, if the goods were delivered from outside the state, the seller would not be required to collect tax. (For example, a barnesandnoble.com kiosk inside a Barnes and Noble store.)

• The report would prohibit the consideration of the use of telecommunications services from an in-state provider in making a nexus determination. This prohibition would create a safe harbor by which a telecommunications provider could be acting as the representative of a seller, a situation that would create nexus under current law. In addition, the prohibition creates opportunities for resellers of telecommunications to operate in the state without establishing nexus.

The report would prohibit states from considering the ownership of intangibles in the state as a factor in determining income tax nexus, as states now do. With this restriction in place, a financial services company could conduct its entire menu of operations with every person in a state -i.e., it could make loans, hold accounts receivable, finance purchases, etc. -without tax obligations. In addition, to the extent that a physical presence was considered desirable, it could use an affiliate to perform the services and still avoid any tax liability for the income arising from that state.

Conclusion

Any serious effort to address the state and local tax issues associated with electronic commerce must confront the issue of sales/use tax collection by remote sellers. State tax administrators believe that the exercise of congressional authority to require remote sellers with sales in excess of a specified threshold to collect tax on goods and services sold into a state is appropriate and necessary for the long-term survival of the sales/use tax. It also represents sound tax policy that promotes neutrality in the treatment of similarly situated taxpayers and eliminates a competitive disadvantage faced by retailers that currently collect tax.

States recognize that an expansion of the duty to collect must be accompanied by substantial simplification and improved uniformity in the sales tax and its administration. They have begun in earnest to address that task through the Streamlined Sales Tax Project.

The Report of the Advisory Commission on Electronic Commerce unfortunately, in the opinion of most state and local officials, does not further the goals of sound tax policy and administration in this area. Instead, it contains recommendations for substantial preemption of state tax authority that are not only detrimental to the fiscal position of states and localities, but will likewise cement into place the unlevel playing field facing fixed-base retailers and other current taxpayers.

Federation of Tax Administrators

Statement of Federal Grants and Contracts Received
FY 1998–2000
Filed in Accord with House Rule XI, Clause 2(g)(4)
Fiscal Year Ending June 30

	1998	1999	2000 (est.)
Federal Highway Administration—Development and Presentation of Training Courses on Motor Fuel Tax Evasion and Investigation	$20,000	$25,000	$25,000
Federal Highway Administration—Contract to develop and implement an Internet-based electronic filing application of International Fuel Tax Agreement returns	$185,000	$51,000	−0-

Chairman HOUGHTON. Thanks very much, Mr. Duncan.
Okay, Mr. Nebergall?

STATEMENT OF MARK E. NEBERGALL, PRESIDENT, SOFTWARE FINANCE AND TAX EXECUTIVES COUNCIL

Mr. NEBERGALL. Thank you, Mr. Chairman, and good afternoon. My name is Mark Nebergall and I am the President of the Software Finance and Tax Executives Council, or SoFTEC. On behalf of my members I thank you for the opportunity to testify this after-

noon on the report of the Advisory Commission on Electronic Commerce.

SoFTEC is a new organization, formed to address public policy issues for the software industry in areas of tax, finance, and accounting. SoFTEC's members have long been interested in the issue of taxation of electronic commerce. SoFTEC's members make software that enables the Internet to operate, and they use the Internet as a means to efficiently distribute their products.

Mr. Chairman, the beauty of the Internet is that it enables all vendors, both small and large, to access global markets with minimal capital investment. Small vendors in small towns can compete with large vendors for customers, wherever the customer may be. However, the imposition of multi-State tax compliance obligations in the current form would pose an insurmountable barrier to small vendors. Congress must not relax the current rules that prohibit States from imposing tax collection and remittance obligations on out-of-State vendors with no taxable presence, unless it is certain that the cost of compliance by small-and medium-sized vendors would be minimal.

All parties to the debate over collection and remittance of sales taxes agree that the current system is much too complex. Indeed, the Supreme Court in the Quill decision has ruled that the current system constitutes an impermissible burden on interstate commerce in violation of the Commerce Clause of the Constitution.

SoFTEC believes that the focus in the near term should be on making the system of multi-State taxation of remote sellers simple and uniform. Only when the system has been made simple and uniform should Congress give any consideration to relaxing the current rules.

In short, Mr. Chairman, SoFTEC advocates simplification now, perhaps taxation later.

The question rises as to how to achieve a simple and uniform State sales and use tax system. We believe that the Advisory Commission hit upon the ideal mechanism in recommending that the task be given to the National Conference of Commissioners on Uniform State Laws, or NCCUSL. NCCUSL is an organization over 100 years old whose sole mission is the creation and enactment of uniform State laws. While its crowning achievement is the Uniform Commercial Code, it has been responsible for drafting such laws as the Model Probate Code, the Uniform Trade Secrets Act, and dozens of other model and uniform State acts.

Mr. Chairman, SoFTEC believes that any simple and uniform State sales and use tax law must be developed with the participation of both taxpayers and tax collectors. Without such participation, such a proposed law cannot be assured of the level of support necessary for enactment. SoFTEC is confident that the transparent and open procedures used by NCCUSL to draft uniform and model State laws would ensure that both taxpayers and tax collectors have been put into the drafting. Indeed, SoFTEC believes that NCCUSL would not report a proposed uniform law unless it was certain that it had the support of all constituent parties.

Mr. Chairman, it is true that the recommendation that NCCUSL undertake drafting a uniform sales and use tax act did not receive a supermajority of the Advisory Commission. However, one thing

is clear: all of the Commissioners supported the notion that a simple and uniform system is essential. They only disagreed on the details.

SoFTEC supports the recommendation of 11 Commissioners that NCCUSL is best suited to craft a proposed uniform State sales and use tax act.

Mr. Chairman, the majority of the Commission also suggested that Congress establish a second commission to oversee the work of NCCUSL and to pass judgment on whether its work product would constitute a system simple enough to eliminate the burden on interstate commerce. SoFTEC does not support the creation of a second commission for such a purpose. We are confident that NCCUSL's process is so open and transparent that oversight is not necessary.

Also, while a proposed law may look simple on paper, the proof of its simplicity is in the actual practice. No consideration should be given to overturning Quill until it is clear that the new system truly is simple and workable.

Mr. Chairman, a majority of the Commissioners also recommended that Congress clarify the standards to be used to determine when a business had a taxable presence or nexus in a State, both for sales and use tax collection purposes and for business activity tax purposes. The current physical presence standard has proven to be imprecise. Many States exploit this imprecision by claiming nexus where none exists, creating uncertainty. SoFTEC supports the recommendation that Congress enact bright line rules for determining when a business has taxable presence in a particular State.

Mr. Chairman, this concludes my testimony, and again I thank the subcommittee for inviting me to testify this afternoon, and I welcome any questions that you or other members of the subcommittee might have, and I bequeath any excess time to the people to use more of theirs. [Laughter.]

[The prepared statement follows:]

Statement of Mark E. Nebergall, President, Software Finance and Tax Executives Council

Good afternoon Mr. Chairman and members of the Subcommittee. My name is Mark Nebergall and I am the President of the Software Finance and Tax Executives Council. My members and I thank you for the opportunity to testify on the report to Congress of the Advisory Commission on Electronic Commerce.

SoFTEC is an organization comprised of the major software companies of the United States and its mission is to provide software industry focused public policy advocacy on tax and finance issues. Taxation of electronic commerce is an issue in which software companies have long held a keen interest. We make the software that enables the Internet to operate efficiently and also use it a low-cost mechanism to distribute software to customers worldwide.

SoFTEC advocates policies that promote fair and efficient interstate and international taxation of goods and services contracted for and delivered using the Internet. The cornerstone of these policies is neutrality of tax treatment. Because the work of the Advisory Commission on Electronic Commerce (ACEC) touched on these issues, we followed its work very closely.

Given the Commission's uncertain start, we initially held out little hope that it would ever reach agreement on the important issues. We were surprised when a coalition of business and government commissioners formed and came to agreement on a comprehensive set of proposals. While these proposals did not receive a supermajority of the Commissioners as required by the enabling legislation and therefore did not rise to the level of a formal recommendation, in our view, the Commission

made strides in articulating reasonable proposals for interstate and international taxation of electronic commerce.

SoFTEC applauds the House of Representatives for passing HR 3709 by an overwhelming margin. This legislation would extend the moratorium of the Internet Tax Freedom Act for an additional 5 years and would completely eliminate state taxes on Internet access charges, both of which were included in the ACEC's majority report. However, as we explain below, the Congress has much work ahead of it in terms of tackling simplification and taxable presence issues. My testimony this afternoon will focus on these other elements of the majority report of the ACEC.

SoFTEC's Overarching Policy Position:

As noted above, SoFTEC advocates policies that promote fair and efficient interstate and international taxation of goods and services contracted for and delivered using the Internet. The cornerstone of these policies is neutrality of tax treatment. Before discussing the proposals contained in the ACEC's report, we thought it important to provide some explanation of what we mean by neutrality of tax treatment.

SoFTEC members firmly believe that similar transactions ought to be taxed similarly and that the method of distribution of a product should have no impact on its tax treatment. Today, many products are marketed with catalogs where orders are taken either by phone, telefax or the mail. Such vendors typically have only one physical location and their products are shipped to customers all over the world. The Commerce Clause of the United States Constitution generally insulates these direct marketers from any obligation to collect transaction taxes from their customers and remit those taxes to another state where the customer resides. SoFTEC's members believe that there should be no difference of tax treatment merely because an order for a product was placed using the Internet instead of the telephone or the mail.

Because of the multitude of state sales and use tax systems, the Supreme Court ruled that forcing an out-of-state mail order vendor with no physical presence in a state to collect and remit taxes would impose an impermissible burden on interstate commerce in violation of the Commerce Claus. Indeed, large firms with physical presence in many states find it quite expensive to meet their multistate tax collection and remittance obligations. The costs of these multistate tax obligations would put the marketing of products from a single location to customers in many states out of reach of small and medium sized vendors.

SoFTEC also advocates neutrality of tax administrative burden. Small Main Street vendors selling products over the counter typically are required to collect sales taxes from their customers on a single tax rate. Further such vendors have but one set of tax rules to learn and abide imposed by a single tax authority. SoFTEC believes that if this burden borne by the small Main Street vendor could be replicated for the multistate vendor, then the constitutional infirmities to imposing a collection and remittance obligation would be reduced. Of course, the only way to achieve neutrality of administrative burden is through simplification and unification of the state sales and use tax systems of the several states.

The problem of complexity of the state sales and use tax is not new. Since at least the 1960's, states have been on notice that their system of sales and use taxation of interstate commerce was too complex and burdensome. The Willis Commission report and the Supreme Court's decision in *National Bellas Hess* provided adequate notice that reform was in order. The message was reiterated in 1992 with the Supreme Court's decision in *Quill v. North Dakota*. Despite the passage of time and the adequacy of the notice, the States have made no movement towards simplification and unification of their sales and use tax systems. It is only with the advent of the Internet as a medium of commerce and the potential for revenue loss that has galvanized the states into considering simplification.

SoFTEC supports Congressional intervention in the area of simplification and unification of state sales and use taxes. We believe that it is within Congress' role to create an environment in which a workable simplification plan can be developed and implemented. We also believe that any such effort should include participation by both taxpayers and tax collectors. We are suspicious of any process that seeks to develop a simplified and uniform sales and use tax system that excludes taxpayer input.

I now turn to the elements of the ACEC's majority report that touch upon the issues of tax simplification.

A. NCCUSL

The majority's report (pp. 19–20) proposes a process for developing a simple and uniform sales and use tax system. Specifically, the report suggest that Congress recommend that the National Conference of Commissioners on Uniform State Laws (NCCUSL) undertake the task of drafting a uniform sales and use tax act. We believe that this proposal has merit and should be explored further.

NCCUSL is an organization, more than 100 years old, comprised of state appointed commissioners who come together to craft uniform and model state legislation. The commissioners themselves are lawyers in private practice, judges, state legislators, and academics. Each state has appointed several commissioners and there are roughly 300 of them. Their most well-known and widely adopted uniform act is the Uniform Commercial Code (UCC), parts of which have been adopted in almost every state.

NCCUSL's practice is to appoint a drafting committee to develop a proposed uniform or model act. The meetings of the drafting committees are open to the public and their participation in the drafting process is encouraged. Once the drafting committee has completed its work (usually after several meetings over an 18–24 month period), the full commission considers the draft and if accepted, it is released to the state legislatures for their consideration and passage. Frequently, the full commission sends a draft back to the drafting committee for more work. NCCUSL will not approve an act and release it to the states unless it believes that the act has the support of all of the effected parties.

SoFTEC endorses the ACEC's majority recommendation that NCCUSL's process be used to develop a simplified and uniform sales and use tax act. Their process ensures the participation of all interested parties and it leaves ultimate decision making regarding the details to the NCCUSL drafters. Our belief is that the insertion of a neutral third-party between the various business and government groups would facilitate the drafting process.

B. A Second Advisory Commission

The ACEC majority recommendation also suggests the appointment of another federal advisory commission to oversee the NCCUSL drafting process and to assess whether NCCUSL's final product meets the goals set by Congress. We do not believe another federal advisory commission on this subject is necessary. NCCUSL has long established and transparent procedures for drafting uniform and model legislation and we do not believe oversight by a federal advisory commission is necessary or desirable. In addition, because NCCUSL is not likely to release any uniform sales and use tax act unless it believes it has the support of both business and government, an assessment by a federal advisory commission of whether the Congressionally mandated goals have been achieved is not necessary.

The proposed federal advisory commission also is to render an assessment whether NCCUSL's uniform sales and use tax act is simple enough that states that adopt it should be permitted to enforce tax collection and remittance obligations against out-of-state sellers. We do not believe it appropriate for an advisory commission to be making such an assessment prior to enactment by states of such a system and before taxpayers and tax collectors have some experience operating under such a system. At the end of the day, it is for Congress or the courts to decide when the collection and remittance burden on out of state vendors is no longer so heavy as to be constitutionally infirm.

SoFTEC does not support the creation of a federal advisory commission to oversee the development of a simplified and uniform state sales and use tax act.

C. Digital Products

The majority recommendation of the ACEC's report suggests that Congress prohibit, for a period of five years, on the imposition of state sales and use taxes on digital goods and their non-digital equivalents. This would bar states from imposing a sales or use tax on transactions in digital products (such as software, music, video, data, books) both interstate and intrastate. It also would bar states from imposing a sales or use tax on nondigital equivalents of digital products. This would mean that states could not require local bookstores, record stores, or computer stores from collecting sales taxes from their customers on sales of these products. The recommendation to exempt digital products from the sales and use tax is based on a recognition that enforcement is difficult. It would be very easy to locate digital product delivery servers beyond the reach of the taxing authorities. The recommendation

to exempt nondigital equivalent products from sales taxes was based on an attempt to achieve neutrality of tax treatment with the digital versions.

SoFTEC does not support the exemption for digital products and their nondigital equivalents. We know of no tax policy that favors exempting such products. An exemption for these types of products violates SoFTEC's bedrock principle that equivalent transactions should be treated similarly. The fact that digital products can be delivered using the Internet, in our mind, is not justification for an exemption.

TAXABLE PRESENCE

The ACEC's majority report recommends that the rules for determining when a company has a taxable presence in another state be clarified for both business activity tax purposes and for purposes of imposing a sales or use tax collection and remittance obligations. SoFTEC supports these recommendations.

Today, businesses face tremendous uncertainty as to when their activities within a state might trigger tax obligations. The physical presence standard set by the *Quill* case is imprecise. State tax administrators are increasingly creative in their claims that business activities give rise to physical presence. In the sales and use tax context, it must be remembered that the customer is the taxpayer and the vendor merely the collection agent for the state. If the vendor has a collection obligation but nevertheless fails to collect the tax from the customer, the vendor becomes liable for the tax. The vendor will have little recourse by way of recovering the tax from the customer after the transaction has been completed. When a state makes a claim against a business based on some new theory of physical presence, the business must decide whether to litigate the claim or settle. Many times, the amount involved does not justify the costs of litigation. Thus, the validity of the state's legal theory avoids a test in court.

The same is true with regard to business activity taxes, which include taxes on gross or net income or franchise taxes. A state may make a claim that an out of state vendor has a taxable presence and should file an income tax return and allocate a portion of its income to that state. Software companies frequently receive claims that because they license their products to customers in their state, they have a taxable presence and should file income tax returns and pay income taxes. We have even seen states claim that because a software company provided its customers with telephone support, and because some customers were in the state and could reach the telephone support center in another state, the company had a sufficient presence to trigger an income tax return filing obligation. If the ability of in-state customers to reach an out-of-state vendor by telephone is sufficient to give rise to a tax return filing and tax payment obligation, then every business would have a taxable presence in every state.

The states vigorously oppose any clarification of the standards for determining when a business has a taxable presence. They claim improper infringement of states rights. However, the Constitution gives the Congress plenary power in this area. Indeed, Congress exercised that power in the area of income taxation of multistate business when it enacted P.L. 86–272 in 1959. Given the states' continued abuse of their taxing power by making frivolous claims against nonresident taxpayers, we believe it appropriate for the Congress to intervene and set bright line standards. The factors set forth in the ACEC's report are, we believe, appropriate for consideration.

CONCLUSION

The ACEC and its staff worked very hard in trying to reach a consensus on the details of a coherent plan for taxation of remote sales. While they did not reach a consensus within the meaning of the Internet Tax Freedom Act, the Commissioners nevertheless moved the ball forward with regard to many of the items set forth in the majority's report. We are hopeful the Congress will roll up its sleeves and complete the work the ACEC only started.

Mr. Chairman, this concludes my remarks and I stand ready to answer any questions you or the other members of the subcommittee might ask. Thank you again for the opportunity to testify this afternoon.

Chairman HOUGHTON. Well, thanks very much, Mr. Nebergall. That was great.

Now, Mr. LoGalbo?

STATEMENT OF JOHN R. LOGALBO, VICE PRESIDENT, PUBLIC POLICY, PSINET, ASHBURN, VIRGINIA

Mr. LOGALBO. Mr. Chairman, Mr. Ranking Member, members of the subcommittee, thank you for the opportunity to appear before you this afternoon. I am John LoGalbo, Vice President of Public Policy for PSINet.

PSINet is an Internet supercarrier. We've built a global electronic commerce infrastructure over our own optical fiber, satellite, wireless, and web hosting facilities. We serve more than 2 million users across 27 countries, and we offer the entire range of Internet services—primarily to business customers, but also to other ISPs and to telecom carriers.

Today I would like to focus on one of the proposals in the report of the Advisory Commission on Electronic Commerce, to make permanent the moratorium on Internet access taxes. Let me illustrate for the subcommittee some of the tax issues presented by one of PSINet's typical service offerings, what we call a "virtual private network" or "VPN."

A VPN ties together several offices of a single company, often located in different States, over broadband circuits using Internet protocols. The first issue we face, in those States that currently tax Internet access, is which part of our service is considered access, and which part is considered traditional telecommunications? This is important, because telecom services are excluded from the moratorium. If we bundle those services together—as we must—then we are faced with attempts to tax the entire cost of the bundled service, including the tax-exempt access portion.

Second, our business customers typically look to us for value-added services that build on the basic connectivity provided by the VPN. These include firewalls, encryption, packet filtering, and monitoring security over the network. Several States go beyond taxing access and impose taxes on what they call "enhanced" Internet services, not only the ones I've just mentioned but also Web hosting, Website design, and server-based applications like e-mail.

Third, we find that telecom and access taxes have a tendency to build on one another, so that the customer ends up paying a tax on other taxes. For example, Federal and State excise taxes can be built into the base for computing State sales taxes.

Fourth, in many States, manufacturing equipment is exempt from sales tax because it is used as a business asset to create products that are taxed when they are sold to the consumer. A very few States extend this resale exemption to telecom equipment, but almost none of them do so for Internet Service Providers. Even when the resale exemption is available, ISPs sometimes face a form of double taxation. When we buy a circuit to build the customer's network, we pay sales tax on that purchase; and when we deliver the circuit as part of the Virtual Private Network, the customer pays that tax again.

Finally, whenever we deliver an integrated network solution to businesses across several State lines, we encounter the astonishing complexity of State and local sales taxes in multiple jurisdictions. The most commonly-cited figure is over 7,500 separate taxing jurisdictions, each with its own tax rates, its own definitions of taxable

goods and services, and its own filing requirements and exemptions.

The point is that the fine line between Internet access and other services, particularly for business customers, is becoming blurred. ISPs are increasingly drawn into the administration not only of sales taxes on access, but also Federal, State, and local telecommunications taxes. A recent report observed that a full-service telecom provider, operating nationwide, would be required to file 55,748 tax returns a year, with total effective tax rates exceeding 20 percent in 10 States, with Texas topping the list at 28.56 percent.

In our view, taxing Internet access is like building a toll booth on the on-ramp to the information superhighway.

Thank you very much for the opportunity to be here. I will be happy to answer any of your questions.

[The prepared statement follows:]

Statement of John R. LoGalbo, Vice President, Public Policy, PSINet, Ashburn, Virginia

Mr. Chairman, Mr. Ranking Member, members of the Subcommittee, thank you for the opportunity to appear before you this afternoon. I am John LoGalbo, Vice President of Public Policy for PSINet. More than 10 years ago—before the Internet became a household word, long before the proliferation of "dot.com" companies, certainly before anyone conceived of billions of dollars of commercial activity riding on a stream of electrons—PSINet's chairman and founder, Bill Schrader, had a vision of the future of telecommunications. That vision was founded on the realization that every kind of communication—voice, text, pictures, sound, video—can be "digitized," broken up into electronic pulses, carried anywhere in the world over diverse paths, and reassembled into its original form at the destination. The key was the ability to carry data over a new kind of robust, inexpensive network that crossed all proprietary boundaries—without regard to operating systems, network protocols, or physical communications media. Bill Schrader formed PSINet as the first company to attempt to transform that vision into a commercial reality, on a global scale, and he has succeeded beyond anyone's wildest expectations (except perhaps his own).

Today PSINet is an Internet Super Carrier, having built a global e-commerce infrastructure over our own optical fiber, satellite, Web hosting, and switching facilities. We serve more than two million users in 800 metropolitan areas in 27 countries on five continents, offering a full suite of retail and wholesale Internet services through wholly-owned PSINet subsidiaries.

At the heart of all PSINet services is our advanced Internet Protocol (";IP") network. Connected to over 900 points-of-presence (";POPs") worldwide, and designed for nearly unlimited growth, the PSINet network is one of the primary backbones that comprise the Internet.

We are building our e-commerce Web hosting centers, designed to support critical Internet applications in secure, managed environments, in key financial and business centers around the world. Our eight hosting centers (in New York City, northern Virginia, Los Angeles, Tokyo, Toronto, Geneva, London, and Amsterdam) are ideal for e-commerce applications. By the end of 2000, our plans call for 24 centers with two million square feet of revenue-producing space to be completed or under development. At present PSINet hosts many of the most highly visible and complex Web sites in the world.

With the acquisition of Transaction Network Services in 1999, PSINet is now at the forefront of the high-growth, high-margin world of electronic commerce. As purchases and transactions migrate to the web, companies need to be able to tap into a network that can process them efficiently and safely. TNS is the leading worldwide provider of e-commerce data communications solutions, handling more than 19 million transactions daily from two million businesses.

Finally, as an Internet Super Carrier, PSINet provides the ideal infrastructure to support other companies offering Internet services. We are, in effect, the Internet Service Providers' ISP, supporting a full spectrum of dial-up and dedicated access services, security solutions, Web hosting, e-mail and fax applications that can be privately labeled and sold to end-users by ISPs, telecommunications carriers, or any group with a large customer or membership base. As part of PSINet's partnership

with the NFL's Baltimore Ravens—which includes naming rights for PSINet Stadium at Camden Yards—we created the first affinity ISP in professional sports history.

The report of the Advisory Commission on Electronic Commerce, submitted to the Congress in April, makes significant recommendations with respect to ISPs. The Subcommittee has asked that we address those that relate to Internet access, and that would specifically impact ISPs.

The Advisory Commission, by a vote of 11 Yeas to 1 Nay, with 7 Abstentions, proposed to make permanent the current moratorium on any transaction taxes on the sale of Internet access, including taxes that were grandfathered under the Internet Tax Freedom Act. We strongly support this majority proposal of the Advisory Commission and we look forward to a permanent ban on Internet access taxes. At this point, we express our appreciation to the House of Representatives for the vote taken last Wednesday to extend the moratorium on Internet access taxes for a five-year period. In addition, we thank the House for its foresight in rescinding the grandfather clause for the nine states who currently impose taxes on Internet access. The margin of approval in the House −352 to 75—is very heartening to those of us in the Internet and telecom sector.

PSINet believes that a permanent ban on Internet access taxes is a substantial, but only preliminary, step toward the type of radical simplification and reform of traditional tax systems that must take place if those systems are to continue to function in the coming decades without suppressing the technological dynamism that powers the American economy.

When we refer to Internet access, generally we think of consumer-oriented, modem-based, "narrowband" dial-up access from a home PC, for prices ranging from $9.95 to $29.95 per month, sometimes at a flat rate and sometimes with an additional premium for hours of usage above a certain level.

My goal, however, is to illustrate for the Committee the type of Internet access that PSINet has always focused on—the provision of more complex, dedicated, high-bandwidth access to businesses, often accompanied by additional value-added services. The issues we confront when dealing with the tax systems of states and localities in that context are similar to that of other backbone providers and business-oriented ISPs. It is very difficult to separate taxes on Internet access from the plethora of other taxes to which we are subject, particularly as we utilize our IP-optimized network to take on some of the functions of traditional telecommunications companies.

Let me use as an example one of PSINet's core service offerings to business customers—our "virtual private network" (VPN) solutions, known as PSINet IntraNet.. . . In the past, businesses seeking to tie together the private data networks of geographically dispersed offices have had to rely on traditional wide-area networking, requiring them to lease expensive, dedicated telephone circuits running between each remote office location. Building on our extensive backbone network, PSINet can offer secure and reliable data connections between remote offices at a fraction of the cost of traditional dedicated networks. Customers need only purchase circuit connections between each office and the nearest PSINet POP (instead of circuits spanning thousands of miles between the offices themselves). We carry the customer's data traffic between remote offices over our own backbone network, but we isolate it from traffic on the public Internet by means of frame relay technology or, for more advanced services, by encryption.

Typically, a customer seeking a VPN solution is also concerned about network security, since the data traffic between headquarters and satellite offices may include highly sensitive confidential and proprietary business information. If the customer's objective is to extend its exchange of data with its business suppliers or customers over a VPN (known as an "extranet"), the security concerns may be even greater. PSINet offers additional services—beyond the basic "connectivity" solution—to address these issues, by means of firewalls, packet filtering, encryption technologies, and other value-added security services. Many of these solutions include hardware, software, on-site and remote service and maintenance components, in addition to connectivity.

Let's examine the tax implications of this fairly straightforward package of services. Since the moratorium was enacted, nine states continue to tax Internet access (Connecticut, Hawaii, Ohio for commercial customers, New Mexico, North Dakota, South Dakota, Tennessee, Texas, and Wisconsin). The District of Columbia, Iowa, and South Carolina have—wisely, in our view—repealed their Internet access taxes after the moratorium went into effect. Which of the services offered in this VPN package fall under the definition of "Internet access" in the Internet Tax Freedom Act? Perhaps because the answer is unclear, several states now impose tax on some or all "enhanced" Internet services, including not only network security but also

Web hosting, Website design, application service provider (";ASP") offerings, and others.

The industry is also finding that there can be dramatic state and local tax implications depending on how basic ISP access services are "bundled" together with other value-added services. Specifically, a service may be exempt if invoiced to the customer on a stand-alone basis but taxable if bundled with other services. Many business customers are moving away from simple dial-up access to higher-bandwidth connections using dedicated circuits, digital subscriber lines ("DSL"), cable modems, and other means—and ISPs, naturally, are providing those connections as part of a package. Where there is a separate charge for connectivity, most states are likely to tax it (since "telecommunications" are expressly excluded from the definition of "Internet access" under the Internet Tax Freedom Act). Where connectivity is bundled with Internet access into a single charge, states may attempt to tax the entire charge, including the otherwise exempt access fees.

Not only are connectivity charges subject to telecommunications taxes, but installation charges, disconnect fees, and associated charges face varying tax treatment among the states and localities. These traditional telecom categories introduce extraordinary levels of complexity and expense, with over 300 types of taxes and fees potentially applicable, at combined rates that reach and (in some cases) exceed 20%.

The interaction of multiple taxes adds insult to injury. Frequently taxes build on one another, where the base for calculation of one tax may include other taxes applied to that service—thereby assessing a "tax on tax." Federal and state excise taxes, for example, could be built into the base for computation of a state sales tax.

Similarly, there are too frequent instances of pyramiding of tax—payment of tax at both the wholesale and retail levels—which increase bottom-line service costs to the customer. For instance, while 13 states allow telecommunications companies a sales tax exemption on equipment used to deliver their services, only New York and, to a very limited extent, Virginia do so for Internet Service Providers. ISPs generally cannot avail themselves of resale exemptions with respect to the telecom connectivity services provided as a necessary part of the offer of Internet access. One concrete example is Connecticut, where regulations flatly deny a resale exemption even where a dedicated circuit is resold directly to the customer. As such, an ISP may pay tax on the lease of a circuit from the customer to its POP, then be forced to bill its customer for the tax again when it passes through the circuit cost.

Finally, which jurisdictions are entitled to impose their specific array of taxes on which portions of the entire package of services (the VPN and security services, in our example)? By definition, a virtual private network spans several locations, usually with the headquarters or "hub" in one state and the satellite or remote offices in others. Tangible products (such as routers) may be shipped to specified locations and taxed there, but the services (such as connectivity, remote monitoring, and network design) may span a variety of jurisdictions—each with its own tax rates, its own definitions and rules for determining the amount of the overall transaction applicable to its jurisdiction, and its own exemption requirements—many of which may be contradictory or inconsistent with those of other jurisdictions.

A recent report noted that a full service telecommunications provider operating nationwide would be required to file 55,748 tax returns a year, with total effective tax rates exceeding 20% in ten states (with Texas topping the list at 28.56%).[1]

It is difficult to overstate the burden these complexities place on ISPs as the tax collection agents for these overlapping tax systems—not to mention their customers, as they attempt to sort out the taxes included in their bills. As another tax expert observed in a recent authoritative study:

[C]ompared to other advanced industrialized nations, the sales tax in the United States is complicated by the large number of state, county, and local jurisdictions that impose sales and use taxes. Currently, 45 states and the District of Columbia impose sales or use taxes at the state level. . . .In addition to the states, approximately 7,500 counties, cities, towns, transportation districts, and other special local jurisdictions impose sales or use taxes on transactions occurring within their borders.

. . .By contrast, in the European Union, there are only 15 countries and generally only 15 different national value-added tax rates. There are no local or county value-added tax rules or rates to be complied with.[2]

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[1] Committee on State Taxation's Fifty State Study and Report on Telecommunications Taxation, p. 5 (September 7, 1999).

[2] Karl Freiden, Cybertaxation: *The Taxation of E-Commerce* (Chicago: Arthur Andersen LLP, 2000), p. 82.

A fair assessment of the value of Internet access taxes should therefore take into consideration the negative effects that saddling U.S. companies with these administrative costs may inflict on their competitiveness in the global economy.

Besides going a short distance to reduce the burdens and costs of collection on ISPs, a permanent moratorium on Internet access taxes would have an immediate positive impact by reducing the costs of Internet access for both consumers and businesses. Reducing access costs is a quick and obvious way to boost American competitiveness and to lower the "Digital Divide" that threatens to exclude from the information economy those citizens with fewer resources to spend on computers and Internet connectivity.

Making the moratorium permanent and applying it to Internet access taxes previously excluded by the grandfather clause would not threaten state and local revenues in any significant way. States could radically simplify and decrease the telecom taxes that are now imposed on the channels by which Internet access is delivered to their citizens—telephone lines, wireless transmissions, and cable television and satellite communications -and still maintain substantial revenue from these sources. Income taxes, both corporate and individual, from income generated by the growth of electronic commerce would be unaffected. Sales and use taxes on most in-state purchases would continue to be collected. Revenue losses from abolishing Internet access taxes and decreasing other telecom taxes would therefore be minimal.

There is much more to the Advisory Commission's report, of course, than the recommendation that all Internet access taxes be subject to a permanent moratorium. PSINet supports both the Formal Findings and Recommendations of the Commission and the policy proposals adopted by the majority of the Commissioners.

Significantly, the Commission's report observed that it is early to predict the trends and outcomes of many aspects of e-commerce as it continues its development, and that empirical assessments of these trends are just beginning to be made.

We are grateful to the Chairman and this Subcommittee for their leadership in holding these hearings, and for extending this opportunity to PSINet to present its perspective. We hope you will continue to look to PSINet to work with you on the issues arising from tax policies, electronic commerce, and the Internet.

We look forward to answering any questions you may have.

Chairman HOUGHTON. Thanks very much, Mr. LoGalbo.

Ms. Dunn, would you like to ask some questions?

Ms. DUNN. Thank you very much, Mr. Chairman.

And thank you very much, panel; you have been fascinating in your comments.

I wanted to address my comment to you, Mr. Duncan, because I think that you are familiar with Washington State's system of taxation. We rely on the State sales tax. There has been an issue of grandfathering other taxes, however, into the system, and just recently when we passed the moratorium last week, Washington State's B&O tax came into question. I am wondering, with your background, if you could talk a bit about whether it would be affected as we move through these changes.

Mr. DUNCAN. There is no clear answer as to whether the B&O tax would be preempted under the prohibition on Internet access taxes. In speaking with representatives from Washington State in the Department of Revenue, looking at the tax and looking at the way the Internet Tax Freedom Act is written, I have come to the conclusion—and I think they have come to the conclusion—that the tax is at risk. It is a gross receipts tax that applies to a wide range of businesses, including the provision of Internet access services. As a gross receipts tax, it is a price-based tax, or it effectively operates as a price-based tax, and economically, the incidence of that tax is exactly the same as a sales tax. So it looks and acts, for all purposes, like the sales tax that most people are concerned with. That's point A.

Point B, if you look to the definition of "tax on Internet access" in the Internet Tax Freedom Act, it certainly doesn't provide any exclusion for any type of tax such as the B&O tax. And for that reason I think the people at the State level have been concerned that it is certainly at risk because it is not spoken to specifically, and traditionally when we have talked about those States that were included in the grandfathering, the Washington B&O tax was included.

Chairman HOUGHTON. Congressman McDermott?

Mr. MCDERMOTT. Thank you, Mr. Chairman

I had an interesting experience, and I want to ask Mr. Ledger a question. I went to a camera store, and the manager got to talking to me about this Internet tax business. He said a man came in, looked at about seven cameras, and tried out all the lenses and everything, and then he wrote down the numbers very carefully and left. He said he went home to buy them over the Internet because he could save 8.3 percent as opposed to buying them there in the city.

Now, is it possible for me to come into your furniture store and get the numbers of the Sealy Posturepedic Mattress that I want, and then go home and buy it over the Internet?

Mr. LEDGER. Yes, sir. You could also go to the PX with a friend and have them buy it for you, tax-free.

Mr. MCDERMOTT. Is there anything in your store that can't be bought over the Internet?

Mr. LEDGER. Perhaps some art, some specific lamps, but major pieces of furniture can be bought over the Internet. They have been doing that for a good many years—not on the Internet, but over the telephone. It is well known that people come in and shop our stores, use our sales people's time, take down numbers, fabrics, and go back and use the Internet or use the telephone to order furniture tax-free.

Mr. MCDERMOTT. Okay.

That brings me to the second question. Ms. Lewis, you talked most about this issue, and I want to understand this question of nexus. Maybe you and Mr. Duncan can work it out for me.

I am sitting in D.C. at my computer, and I order from amazon.com $500 worth of books. Their offices are in Seattle, but their warehouse is in Portland, Oregon. If I have them sent to me here in D.C., will I pay the tax as opposed to having them sent to me in Seattle—theoretically, if they were collecting the tax?

Ms. LEWIS. I can speak about Staples. We charge tax based on the "ship to" location.

Mr. MCDERMOTT. So it is assumed that when I buy something over the Internet, I am at the place where it's shipped to, is that correct?

Ms. LEWIS. No. You tell us where you need it shipped to; otherwise, we wouldn't be able to get it to you.

Mr. MCDERMOTT. But I'm not physically there. I'm just shipping it somewhere.

Ms. LEWIS. Correct.

Mr. MCDERMOTT. So you use the "ship to" as where I am, as far as you're concerned?

Ms. LEWIS. Yes.

Mr. MCDERMOTT. Is that correct?

Mr. DUNCAN. That's right, sir. The sales tax is a destination-based tax. You want to tax the consumption where it occurs, and the rule that is generally applied is that the "ship to" address is presumed to be the point at which it is used, so the tax will be applied—and the nexus rules will be applied—based on the "ship to" address. In your example, shipping from—whether it's Portland with amazon.com or Seattle—if amazon.com does not have a physical presence in the District, I presume that they would not be required in any way to calculate tax on that transaction. It would be up to you to report it directly to the D.C. Office of Tax and Revenue as a use tax.

Mr. MCDERMOTT. And are the offices of the company considered a "physical presence" or whatever that term was you used, or is it actually where the books are, in a storehouse, in a storeroom?

Mr. DUNCAN. We're talking all one entity, amazon.com, all one entity. They would be required to collect tax wherever they would have a physical presence. So if they had their offices in Washington, a warehouse in Kansas, a warehouse in Oregon, they would be required to collect on their shipments to Washington State and to Kansas regardless of whether they came out of Washington, Oregon, or Kansas—wherever they have that physical presence on their own behalf, or through the activities of a representative on their behalf.

Mr. MCDERMOTT. So, Staples, do you have people in every State?

Ms. LEWIS. Pretty much, yes. We are nationwide.

Mr. MCDERMOTT. So you are at a disadvantage, not being just in one or two places?

Ms. LEWIS. That's right. Our customers are taxed almost across the board, across the States, across the country. And the pure-play competition who have limited or minimal physical presence across the country does not charge tax, and we feel it puts us at a disadvantage.

Mr. MCDERMOTT. Thank you, Mr. Chairman.

Chairman HOUGHTON. Okay, thanks.

I would like to mix it up a little bit. I mean, we're talking back and forth here, but you all have such different ideas. Let me just give you an example.

Mr. Duncan, you talked about a Streamlined Sales Tax.

Mr. Nebergall, how do you feel about that?

Mr. NEBERGALL. Well, my members are all for simplification, and the Streamlined thing sounds like a movement towards simplification. My concern about the Streamlined Project that Mr. Duncan referred to is that it is not a cooperative effort between taxpayers and tax collectors. My understanding is that they conduct most of their meetings behind closed doors and they do not allow anyone except their own members to participate in those activities.

Chairman HOUGHTON. You would like to comment on that, Mr. Duncan?

Mr. DUNCAN. Yes, please, Mr. Chairman. Thank you.

The Streamlined Project is a project of States, principally State and local government tax administrators, trying to develop a simplified system. It is not, however, a closed project. Each project meeting has a part that is open to the public; testimony can be

taken, people can ask to attend. There are workgroup sessions that are closed, but people can be invited to provide input.

The final thing is that the product that we come up with, which we expect to have done in April, will be released with widespread public input.

The primary reason that we have taken this approach is that we have probably spent now on the order of half a dozen years in discussions and negotiations with people in the mail order business, the retail industry, and the electronic commerce industry, taking input and negotiating and discussing what it is that we ought to do to simplify the tax. We thought it was time to get down to the task of deciding what should be done, seeing how we can actually implement these simplifications, and no longer engage in some prolonged negotiations, and that's why we have chosen the model that we have.

Mr. MCDERMOTT. Mr. Chairman, could I ask a follow-up question?

Chairman HOUGHTON. Absolutely.

Mr. MCDERMOTT. If you come to a uniform rate or some kind of simplified national schedule—let's say, 5 percent across the Nation, a State can charge up to that—is it possible, then, for there to be a two-tiered system in a State—I pay 8.2 percent in King County because that's what the retail sales tax is right now, and 5 percent if I buy it over the Internet?

Let me give you the reason I raise it. In our State we have a Constitution that says everything has to be taxed at a uniform rate, all property has to be at the same rate. We can't have an income tax because we can't have a graduated—we can have a flat income tax, but not a graduated income tax, because everybody has to be taxed at the same rate.

Now, if you set up this two-tier, I wonder what kinds of problems you create.

Mr. DUNCAN. The recommendations that we intend to come out of the Streamlined Project will have to go—first, our primary focus is on State legislatures, and they will have to be passed into law, particularly if you do something with rates. They will have to be subject to State legislative action. And if it were to contravene a State Constitution, then it simply couldn't be done.

Now, under Federal law or Federal Constitutional interpretation, I believe you could have one rate on over-the-counter transactions and one rate on interstate transactions, or transactions coming in from out-of-State, as long as the one on the ones coming in from out-of-State was lower than the lowest one in the State. But if that doesn't pass Constitutional muster at the State level, it can't be done.

The focus that we have is really to try to do two things. One is to promote some simplification of those local rates, but the second is to try to accommodate the differing local rates as much as possible through advanced technology. Coupled with that, though, would be a safe harbor for the sellers. In other words, if they use certified technologies, make the good faith effort to get it right, they're not held up by an audit if they get it wrong.

Chairman HOUGHTON. All right. Is that okay, Jim?

Mr. MCDERMOTT. Okay.

Chairman HOUGHTON. Fine.

One other question. I would like to have three people involved here.

Mr. LoGalbo, you talked about "pyramiding." I'm not really quite sure what you mean, but maybe you could explain it.

Also, I would like to ask Mr. Honaker and Mr. Ledger what they feel about this. Why don't you explain it, and then I'd like to get a comment.

Mr. LOGALBO. When I referred to pyramiding of taxes, I was referring to the example that I used where we're selling a service to our customer, and necessarily as part of that service we are purchasing telecom circuits from other providers, like Bell Atlantic or a regional Bell operating company. We pay taxes on that circuit when we purchase it, because we want to be a one-stop shop for our customer. We don't want the customer to have to purchase something that is essential for us to provide our Internet service to the customer.

So we purchase the circuit; we pay tax on it; we then pass it through at no additional charge to the customer as part of our Internet service. The customer has to pay tax on that same circuit again, in some States.

The other aspect of pyramiding is building-in excise taxes, for example, at the Federal and State levels, into a State sales tax. So we are paying taxes on taxes.

These are just a couple of small examples of the phenomenon of telecom taxes in general, and other witnesses before you today have talked about how telecom taxes are taxed almost at the rates of sin taxes on alcohol and tobacco. It seems to me that telecommunications is a great aspect of the coming economy and it performs a fantastic service to citizens and residents, and why it should be taxed in a manner that is almost punitive is a question that I think this Committee might want to address.

Chairman HOUGHTON. Thank you very much.

And now, in true political style, you can answer that question or you can make a statement, anything that you like, in this regard.

So, Mr. Honaker and Mr. Ledger, I just want to give you a chance to express yourselves, and Mrs. Honaker, also.

Mr. LEDGER. I spoke first, so I will yield to my friends to the left.

Chairman HOUGHTON. All right.

Go ahead.

Mr. HONAKER. I can't speak for all small businesses; I can just speak for us.

My father was a pioneer aviator, and he didn't have a background in business, but he did leave me with one thought which I didn't understand until I was older: if you understand what people want or need, you will be successful.

If we take that one thought that he left me with, the small business today has a problem with fraud. If we can tie this together—and credit card fraud is a big, big problem for them, for us—if we tie that in to when they use charges, the technology is there today to have zero fraud over the Internet. We can use the credit card system to tie the tax rates, the tables, the matrix all to it, and it gets added on to their credit card statements, so that the individual small businesses do not have to worry about the multitudes—they

put on that they bought $100 worth of merchandise; it goes through all the checks and balances in the gateway; and then when the credit card people have the statement, they see that it's an over-the-Internet buy. They go to their 9-digit ZIP Code and place the appropriate amount for that tax.

Now, that takes care of Staples, the furniture stores, they all have the same—it doesn't overburden the small businesses with how to calculate each of those, and it takes care of the small business fraud problem. So you make the small businesspeople happy. For us—for Margaret and me—I don't mind paying our local sales tax on everything we sell if you can solve the fraud problem. And it's there; we just need the Government's help to make it happen.

Chairman HOUGHTON. Okay. Thanks very much.

Mr. Ledger?

Mr. LEDGER. Sir, I am against access taxes, buy taxes, anything of that nature. I just want a level playing field. If I'm supposed to collect sales tax in Texas, I want people that are selling products to my fellow Texans to collect the tax and remit it back to my State. It's simple.

Chairman HOUGHTON. All right.

Well, thank you so much. We really appreciate your being able to be with us and your thoughts. We will take a look at them and study them and inwardly digest them. Thank you very much.

Chairman HOUGHTON. Now I am going to call the next panel: Mr. Victor Gomperts, who is Vice President, Tax Administration, Bell Atlantic in New York; Mr. Brent Wilkes, who is Executive Director of League of United Latin American Citizens; and Mr. James Martin, President, 60 Plus Association, Arlington, Virginia.

Well, gentlemen, thank you very much for being with us.

Mr. Gomperts, would you proceed, please?

STATEMENT OF VICTOR GOMPERTS, VICE PRESIDENT FOR TAXES, BELL ATLANTIC CORPORATION, NEW YORK, NEW YORK

Mr. GOMPERTS. Yes, sir, thank you. Good afternoon, Mr. Chairman, Mr. Coyne, Mr. Portman. My name is Victor Gomperts. I am Vice President for Taxes for Bell Atlantic Corporation. Thank you for inviting me to testify before you this afternoon.

Although I speak only on behalf of Bell Atlantic today, there is a broad coalition of interests, of which Bell Atlantic is a member, that I believe would agree with my comments. This coalition includes consumers, computer and high technology associations, small businesses, communications providers, unions, and groups representing minority and ethnic interests, and is working actively with Mr. Portman and Mr. Matsui to pass H.R. 3916. Two of my colleagues from the coalition are present also on the panel this afternoon.

Over 100 years have passed since the Communications Excise Tax was originally enacted in 1898 to help fund the Spanish-American War. At that time, it was considered a luxury tax. Over the years the tax has been labeled a "war tax," a "luxury tax," and finally, a "deficit reduction tax." It is the only significant Federal excise tax that is neither dedicated to a trust fund for a particular governmental purpose, nor considered a tax on a product whose

consumption Government wishes to discourage for public policy reasons, such as alcohol and tobacco.

Obviously, we can no longer justify the tax for funding a war or for taxing a luxury. Moreover, if deficits exist, they should be funded by general revenue taxes, not special industry taxes. Therefore, I believe there is no public policy reason to continue its imposition. In fact, there are many good reasons to repeal it as soon as possible.

One of the principal reasons to repeal this tax is that it is extremely regressive. Under one measure of tax fairness, the "ability to pay" principle, tax burdens should be distributed among taxpayers in proportion to their ability to pay. Low income Americans pay a higher percentage of their income to the telecommunications excise tax than do middle-or upper-income individuals. Thus, this excise tax falls disproportionately on the poor and is indeed regressive and unfair.

If the tax were repealed, it would annually save consumers over $5 billion, with the benefit extending to 94 percent of American families. As the tax is regressive, the proportional benefit to the poor would be greater than average.

A second way to measure fairness is to look at the benefits derived from the tax. The benefit principle holds that the burdens of a tax should be distributed according to the benefits that taxpayers receive from the public goods and services those tax revenues provide. This is the case with many excise taxes that are used for trust funds for particular purposes, like highways or airports. But the benefit principle does not apply to the 3 percent Federal excise tax, since the revenues simply go to fund general Government services.

Another principle of tax fairness is that taxes should apply equally to comparable transactions. There is the potential that comparable services provided to customers using different technologies may not be subject to excise tax. For example, will the tax be applied equally to telephony provided by telephone companies, such as my company; cable companies; and Internet providers, all of who are capable today of providing telephone service?

The result is that a traditional telecommunications provider like Bell Atlantic may collect a discriminatory tax from our customers that our competitors may not collect on comparable services. This is the so-called level playing field concept that has been discussed by many previous speakers today.

Telecommunications has become one of the most dynamic sectors of the economy and will continue to be so for the foreseeable future. The new high-tech services are more price-sensitive than basic telephone service. Today's tax burden, Federal, State and local, on the typical telephone consumer averages almost 20 percent of their monthly bill, and can be as high as one-third of their bill. Taxes are definitely a deterrent to use of these services, including the Internet.

Repealing the 3 percent Federal excise tax will be an important statement by Congress that taxes imposed on engines of growth and technology, like the Internet, are counterproductive. We are confident that should Congress make that statement, it would cer-

tainly help us approach States and local governments to follow suit.

The telecommunications tax is also complex and costly to administer. There are numerous exemptions that apply to certain classes of customers and to various types of services. For many of the exemptions, the customer must file annual certificates that must be retained by the telephone company and made available to the IRS on audit. Obtaining, storing, and recovering these documents is a significant burden.

In conclusion, in the subcommittee's announcement of today's hearing it stated that the focus of the hearing would be on matters within the Ways and Means Committee's jurisdiction contained in the ACEC report. The ACEC recommended repeal of the Federal excise tax. Your committee has clear jurisdiction over this tax and should exercise that jurisdiction once and for all to eliminate it.

Thank you.

[The prepared statement of follows:]

Statement of Victor Gomperts, Vice President for Taxes, Bell Atlantic Corporation, New York, New York

Good afternoon, Mr. Chairman, Mr. Coyne, and other distinguished Members of the Subcommittee. My name is Victor Gomperts. I am the Vice President-Taxes for Bell Atlantic Corporation. Thank you for inviting me to testify before you this afternoon. Although I speak only on behalf of Bell Atlantic today, there is a broad coalition of interests (of which Bell Atlantic is a member) that I believe would agree with my comments. This coalition includes: consumers, computer and high technology associations, small businesses, communications providers, unions, and groups representing minority and ethnic interests and is working actively with Messrs. Portman and Matsui to pass H.R. 3916.

Eleven years ago, I testified before the full House Ways and Means Committee on behalf of the United States Telephone Association to urge that the 3% Federal excise tax on telecommunications services *not* be extended permanently. Despite our efforts at that time, the tax was made permanent the year after I testified as part of a package of "deficit reduction" tax increases. For all the reasons I will discuss today, I am optimistic that this time the result will be different.

Over one hundred years have passed since a communications excise tax was originally enacted in 1898 to help fund the Spanish-American War. At that time it was considered a "luxury" tax that applied to less than 2,000 access lines then in existence. Over the years the tax on telecommunications has ranged from 1% to 25% and has been labeled a "war" tax, a "luxury" tax, and finally a "deficit reduction" tax. It is the only significant federal excise tax that is neither dedicated to a trust fund for a particular governmental purpose, nor considered a tax on a product whose consumption government wishes to discourage for public policy reasons (such as tobacco or alcohol). Obviously, we can no longer justify the tax for funding a war or for taxing a luxury. Moreover, if deficits exist, they should be funded by general revenue taxes, not special industry taxes. Therefore, I believe there is no public policy reason to continue its imposition. In fact there are many good reasons to repeal it as soon as possible.

Regressivity and Fairness

One of the principal reasons to repeal this tax is that it is extremely regressive. Under one measure of tax fairness (the "ability to pay" principle), tax burdens should be distributed among taxpayers in proportion to their ability to pay. Unless a tax is intended to discourage consumption, one might presume that for a tax to be "fair" it should at least be proportional to income and not regressive in nature. A number of scholarly works (including the 1987 Treasury Report, the 1990 Congressional Budget Office Report, and a recent paper by George Washington University Professor Joseph Cordes) demonstrate that low-income Americans pay a higher percentage of their income to the telecommunications excise tax than do middle or upper-income individuals. Thus, this excise tax falls disproportionately on the poor and is indeed regressive and "unfair."

Today, telecommunications is a necessity, one that the poor, the elderly, and the infirm literally require as a lifeline to the world. To continue to impose a flat-rate

regressive consumption tax on this segment of the economy is poor public policy. If the tax were repealed, it would annually save consumers over $5 billion with the benefit extending to 94% of American families. As the tax is regressive, the proportional benefit to the poor would be greater than average.

A second way to measure fairness is to look at the benefits derived from the tax. This "benefit" principle holds that the burdens of a tax should be distributed according to the benefits that taxpayers receive from the public goods and services those tax revenues provide. This is the case with many excise taxes that are used for trust funds for particular purposes, like highways or airports. But the benefit principle does not apply to the 3% Federal excise tax since the revenues simply go to fund general government services.

Competitive Neutrality

A third principle of tax fairness is that taxes should apply equally to comparable transactions. With regard to the telecommunications excise tax, there is a great potential for disparities in treatment. New technologies and new providers are dramatically increasing the potential for inconsistent application of this tax. Today, there are thousands of new providers of telecommunications services, like cable companies, satellite companies, and Internet providers. There is the potential that comparable services provided to customers using different technologies may not be subject to the excise tax. For example, will the tax be applied equally to telephony provided by telephone companies, cable companies, and Internet providers? The result is that a traditional telecommunications provider like Bell Atlantic may collect a discriminatory tax from our customers that our competitors may not collect on comparable services. This puts many companies at a competitive disadvantage.

Technology and Growth

Telecommunications has become one of the most dynamic sectors of the economy and will continue to be so for the foreseeable future. No longer do consumers look to their phone companies solely for basic telephone service. Our customers now demand high speed Internet connections; Internet service; call waiting; voicemail; long distance; wireless; wireless data; and many other services. These high tech services are more price sensitive than basic telephone service. Today's tax burden (federal, state, and local combined) on the typical telephone consumer averages almost 20% of their monthly bill and can be as high as a third of their bill. Taxes are definitely a deterrent to the use of these services, including the Internet. Repealing this 3% Federal tax would be an important statement by Congress that taxes imposed on engines of growth and technology like the Internet and telecommunications are counterproductive.

America is clearly the technology leader in the world, and other markets are watching our transition from a heavily regulated utility regime to a more competitive telecommunications industry. We need to set an example to minimize taxation on technology rather than to allow stifling taxes to continue. Every time we introduce innovative products, this broad tax applies to our services. For example, wireless technology, which was introduced in the middle and late eighties, is now a significant part of the base for this tax. If Congress fails to repeal this tax, the introduction of new technologies could be adversely affected by the high rate of telecommunications taxes.

Complexity and Administration

The telecommunications excise tax is also complex and costly to administer. Over the years we collected this tax, which is levied on our customers, by adding an additional 3% to their phone bills. You might think this is an extremely easy tax to administer that happens to bring in lots of revenue. However, there are numerous exemptions that apply to certain classes of customers and to various types of services that make it very difficult and costly to administer. For example, the news media is exempt from the tax, but only on long distance service used to collect or disseminate the news. For many of the exemptions, the customer must file annual certificates that must be retained by the telephone company and made available to the IRS on audit. Obtaining, storing, and recovering these documents is a significant burden.

There are other administrative issues associated with measuring the base for this tax. For example, in some jurisdictions the tax will apply to local 911 fees, while in others it does not. The tax applies to many state and local taxes, but not to others. Applying all of these rules is a complex undertaking, and if there is a discrepancy, we must deal with the IRS or with irate customers.

Conclusion

In the Subcommittee's announcement of today's hearing, it stated that the focus of the hearing would be on matters within the Ways and Means Committee's jurisdiction contained in the Advisory Commission on Electronic Commerce (ACEC) report and related topics. The ACEC recommended the repeal of the Federal excise tax. Your Committee has clear jurisdiction over this tax and should exercise that jurisdiction once and for all to eliminate it.

I will be more than happy to answer any questions you might like to ask me.

Chairman HOUGHTON. Thanks very much.

Mr. Wilkes?

STATEMENT OF BRENT A. WILKES, EXECUTIVE DIRECTOR, LEAGUE OF UNITED LATIN AMERICAN CITIZENS

Mr. WILKES. Good afternoon, Mr. Chairman, Mr. Coyne, Mr. Portman. My name is Brent Wilkes, and I am the National Executive Director of the League of United Latin American Citizens. We are the largest and oldest Hispanic organization in the United States. I am pleased to be before you today to talk about an effort to repeal the 3 percent Federal excise tax on telephone services.

This is a regressive tax that disproportionately affects the Hispanic community. I am here today to express support for H.R. 3916, which was introduced by Representatives Portman and Matsui, to repeal the Federal excise tax on telephone services.

Today there are over 35 million Hispanics living in the United States. Hispanics are more likely than average Americans to have relatives and friends who live outside the United States. Not surprisingly, Hispanics are heavy users of long distance and other telecommunications services. In some Sates, long distance bills for Hispanic families average twice that of non-Hispanic families.

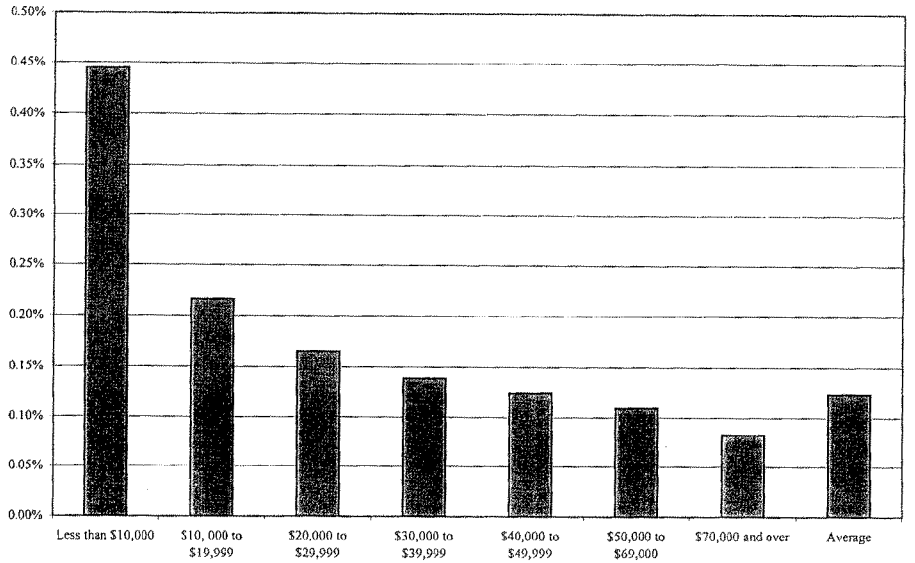
The increased use of long-distance services as a means to keep in touch with family and friends—not as a luxury—is an added burden. Because Hispanic families tend to pay disproportionately higher phone bills, Hispanics also tend to pay this Federal excise tax on telephone services in disproportionately higher amounts. And because Hispanic households have median incomes that are only 65 percent of non-Hispanic white households, the burden on low-income Hispanic families is disproportionately greater as well.

These are reasons why the Hispanic community feels strongly about the repeal of this regressive tax.

I have a chart that is entitled, "Savings per Income Class as a Percentage of Income After Taxes if the Telephone Excise Tax was Repealed in 2000," which I would like to submit for the record.

[The referenced chart follows:]

Savings per Income Class by Family Income before Taxes, if the Telephone Excise Tax was Repealed in 2000, as % of Income after Taxes



Source: Pricewaterhouse Coopers LLP's estimates based on data from the Consumer Expenditure Survey, the Current Population Survey, and the Joint Committee on Taxations.

Savings by State and Income Class if the Telephone Excise Tax was Repealed in 2000

(in 000's)

Item	Total	Family Income Class: Less than $10,000	$10,000 to $19,999	$20,000 to $29,999	$30,000 to $39,999	$40,000 to $49,999	$50,000 to $69,999	$70,000 and over
Savings per Family ($ per year)		**$25**	**$31**	**$39**	**$45**	**$51**	**$59**	**$80**
Savings per Income Class	**$5,500,000**	**$450,365**	**$637,448**	**$662,757**	**$628,730**	**$548,516**	**$908,893**	**$1,663,291**
Alabama	$ 83,933	$ 8,412	$ 10,789	$ 10,282	$ 7,983	$ 8,461	$ 17,538	$ 20,469
Alaska	$ 13,517	$ 725	$ 1,069	$ 1,550	$ 1,290	$ 1,366	$ 2,499	$ 5,018
Arizona	$ 89,815	$ 8,394	$ 13,222	$ 13,119	$ 9,586	$ 8,958	$ 13,851	$ 22,686
Arkansas	$ 45,376	$ 6,001	$ 7,828	$ 7,266	$ 7,104	$ 3,989	$ 5,762	$ 7,425
California	$ 659,154	$ 58,380	$ 75,304	$ 74,102	$ 70,201	$ 57,895	$ 103,363	$ 219,909
Colorado	$ 89,804	$ 6,009	$ 8,242	$ 11,234	$ 11,264	$ 9,152	$ 13,832	$ 30,073
Connecticut	$ 73,109	$ 4,479	$ 6,880	$ 6,279	$ 8,334	$ 6,176	$ 10,368	$ 30,593
Delaware	$ 15,441	$ 892	$ 1,359	$ 1,865	$ 1,816	$ 1,411	$ 2,588	$ 5,510
District of Columbia	$ 12,463	$ 1,459	$ 1,381	$ 1,786	$ 1,704	$ 1,285	$ 1,618	$ 3,229
Florida	$ 310,336	$ 29,323	$ 45,018	$ 43,228	$ 39,117	$ 29,115	$ 48,999	$ 75,536
Georgia	$ 153,576	$ 12,964	$ 14,736	$ 17,894	$ 21,504	$ 15,093	$ 29,022	$ 42,363
Hawaii	$ 23,804	$ 2,298	$ 2,480	$ 2,801	$ 2,560	$ 2,774	$ 4,142	$ 6,748
Idaho	$ 23,291	$ 1,794	$ 3,344	$ 3,513	$ 3,171	$ 2,545	$ 3,845	$ 5,080
Illinois	$ 245,573	$ 17,404	$ 23,999	$ 26,455	$ 26,609	$ 23,855	$ 42,927	$ 84,322
Indiana	$ 118,928	$ 8,661	$ 12,706	$ 15,252	$ 15,227	$ 14,400	$ 22,219	$ 30,465
Iowa	$ 57,553	$ 4,170	$ 7,719	$ 7,695	$ 7,398	$ 6,737	$ 9,174	$ 14,661
Kansas	$ 53,508	$ 4,177	$ 7,257	$ 6,238	$ 7,142	$ 5,341	$ 8,191	$ 15,162
Kentucky	$ 77,835	$ 7,225	$ 10,407	$ 8,354	$ 9,185	$ 6,832	$ 12,953	$ 22,879
Louisiana	$ 84,236	$ 8,902	$ 10,319	$ 11,459	$ 7,757	$ 10,741	$ 12,203	$ 22,855
Maine	$ 25,789	$ 2,060	$ 3,586	$ 4,203	$ 3,420	$ 3,188	$ 3,662	$ 5,670
Maryland	$ 115,824	$ 5,863	$ 12,452	$ 11,611	$ 9,421	$ 13,086	$ 21,079	$ 42,312
Massachusetts	$ 138,140	$ 11,061	$ 12,365	$ 15,085	$ 15,234	$ 12,023	$ 21,522	$ 50,850
Michigan	$ 204,709	$ 15,601	$ 21,120	$ 25,452	$ 22,628	$ 19,372	$ 35,841	$ 64,695
Minnesota	$ 99,176	$ 5,444	$ 10,988	$ 9,198	$ 11,707	$ 10,636	$ 16,506	$ 34,697
Mississippi	$ 48,633	$ 6,304	$ 6,579	$ 7,042	$ 6,548	$ 5,659	$ 7,488	$ 9,014
Missouri	$ 108,488	$ 8,836	$ 12,189	$ 14,385	$ 10,405	$ 13,177	$ 19,537	$ 29,958
Montana	$ 17,169	$ 1,732	$ 3,020	$ 2,675	$ 2,072	$ 2,049	$ 2,545	$ 3,076
Nebraska	$ 33,064	$ 2,783	$ 4,647	$ 4,031	$ 4,135	$ 3,440	$ 4,757	$ 9,271
Nevada	$ 36,675	$ 2,284	$ 4,398	$ 4,487	$ 4,587	$ 3,887	$ 6,680	$ 10,351
New Hampshire	$ 25,254	$ 1,538	$ 2,485	$ 3,497	$ 2,978	$ 2,206	$ 4,258	$ 8,292

Item	Total	Family Income Class: Less than $10,000	$10,000 to $19,999	$20,000 to $29,999	$30,000 to $39,999	$40,000 to $49,999	$50,000 to $69,999	$70,000 and over
Savings per Family ($ per year)		**$25**	**$31**	**$39**	**$45**	**$51**	**$59**	**$80**
Savings per Income Class	**$5,500,000**	**$450,365**	**$637,448**	**$662,757**	**$628,730**	**$548,516**	**$908,893**	**$1,663,291**
New Jersey	$ 170,892	$ 10,529	$ 13,150	$ 12,977	$ 16,522	$ 14,941	$ 25,962	$ 76,811
New Mexico	$ 32,312	$ 3,713	$ 4,227	$ 5,211	$ 4,345	$ 3,106	$ 4,653	$ 7,057
New York	$ 371,194	$ 35,147	$ 41,038	$ 40,214	$ 41,684	$ 31,312	$ 58,207	$ 123,592
North Carolina	$ 152,001	$ 12,249	$ 17,866	$ 21,669	$ 18,238	$ 13,897	$ 23,990	$ 44,092
North Dakota	$ 11,899	$ 1,170	$ 1,745	$ 1,666	$ 1,756	$ 1,023	$ 2,211	$ 2,328
Ohio	$ 228,619	$ 16,786	$ 25,759	$ 29,453	$ 27,159	$ 23,832	$ 41,059	$ 64,572
Oklahoma	$ 64,702	$ 6,402	$ 8,670	$ 9,994	$ 9,545	$ 8,025	$ 7,977	$ 14,088
Oregon	$ 70,627	$ 5,435	$ 10,015	$ 8,595	$ 7,258	$ 6,271	$ 12,375	$ 20,678
Pennsylvania	$ 245,129	$ 17,488	$ 28,688	$ 29,241	$ 26,646	$ 26,636	$ 43,634	$ 72,795
Rhode Island	$ 21,166	$ 1,975	$ 2,707	$ 2,321	$ 2,179	$ 1,617	$ 2,956	$ 7,412
South Carolina	$ 74,206	$ 5,374	$ 9,328	$ 9,606	$ 8,950	$ 8,332	$ 10,295	$ 22,321
South Dakota	$ 13,936	$ 1,987	$ 1,865	$ 2,160	$ 1,571	$ 1,370	$ 1,829	$ 3,154
Tennessee	$ 106,508	$ 9,623	$ 16,022	$ 16,370	$ 12,002	$ 12,096	$ 18,308	$ 22,086
Texas	$ 370,744	$ 35,355	$ 46,266	$ 43,858	$ 44,093	$ 39,606	$ 62,281	$ 99,284
Utah	$ 37,988	$ 1,963	$ 3,688	$ 4,064	$ 4,882	$ 3,891	$ 7,529	$ 11,970
Vermont	$ 12,557	$ 955	$ 1,788	$ 1,767	$ 1,677	$ 1,480	$ 2,012	$ 2,876
Virginia	$ 146,566	$ 9,847	$ 13,976	$ 19,429	$ 13,831	$ 13,390	$ 23,741	$ 52,352
Washington	$ 128,846	$ 7,795	$ 13,934	$ 12,926	$ 13,271	$ 16,775	$ 22,799	$ 41,348
West Virginia	$ 34,374	$ 4,676	$ 4,947	$ 4,563	$ 4,332	$ 4,465	$ 4,991	$ 6,400
Wisconsin	$ 112,242	$ 5,807	$ 12,609	$ 13,386	$ 15,402	$ 10,662	$ 21,636	$ 32,741
Wyoming	$ 9,325	$ 914	$ 1,272	$ 1,250	$ 1,303	$ 940	$ 1,476	$ 2,170

Source: PricewaterhouseCoopers LLP's estimates based on data from the Consumer Expenditure Survey, the Current Population Survey, and the Joint Committee on Taxation.

Mr. WILKES. What this chart clearly shows is that low-income Americans disproportionately pay a higher percentage of their income in this Federal excise tax.

When you add taxes by State and local governments to the Federal excise tax, the combined taxes on telephone services can be as high as 32 percent. In California, all telephone taxes equal 20 percent. At those levels, taxes take a real bit out of the monthly budgets of low-income families. Congress should take the lead in ameliorating this regressive burden by repealing the 3 percent Federal excise tax on telephones.

Thanks to our strong economy, Congress will consider several tax cut proposals this year. The FETT should be Congress' first priority because it provides a similar amount of tax relief to Americans of all income levels. Throughout its 102-year history, the off-and-on nature of the tax on telephone services shows that this justification has been a wartime tax or in times of budget deficits. Those times, thankfully, have passed. We should not keep a tax that is unjustified simply because we are so charmed by the revenues it continues to raise.

The FETT is a regressive, outdated tax, and the LULAC has encouraged its membership, as part of a broader coalition, to seek to repeal this tax. We thank you for your support of H.R. 3916 and hope that you report it favorably out of the committee.

One last point. Our organization has been one of the leading Hispanic organizations seeking to address the digital divide. We have been setting up community technology centers all across the United States, and we have encouraged our members to get on line. I think cost is a major obstacle to our community for getting on line, and we believe that this is one tax that Congress can repeal that will go a long way toward helping to addressing the digital divide.

Thank you.

[The prepared statement follows:]

Statement of Brent A. Wilkes, Executive Director, League of United Latin American Citizens

Good afternoon, Mr. Chairman, Mr. Coyne, and distinguished Members of the Ways and Means Subcommittee on Oversight. My name is Brent Wilkes, and I am Executive Director of the League of United Latin American Citizens. I am pleased to be before you today to talk about an effort to repeal the three percent federal excise tax on telephone services. This is a regressive tax that disproportionately affects the Hispanic community. I am here today to express support for H.R. 3916, which was introduced by Representatives Portman and Matsui, to repeal the federal excise tax on telephone services.

Today there are 35 million Hispanics living in the United States. Hispanics are more likely than average Americans to have relatives and friends who live outside of the United States. Not surprisingly, Hispanics are heavy users of long distance and other telecommunications services. In some states, long distance bills for Hispanic families average twice that of non-Hispanic families.

The increased use of long distance services as a means to keep in touch with family and friends, not as a luxury, is an added burden. Because Hispanic families tend to pay disproportionately higher phone bills, Hispanics also tend to pay this Federal Excise tax on telephone services in disproportionately higher amounts. And because Hispanics have incomes that are often below the national average, the burden on low-income Hispanic families is disproportionately greater as well. These are the reasons why the Hispanic community feels strongly about the repeal of this regressive tax.

When you will look at the chart attached Savings per Income Class as a Percentage of Income after Taxes if the Telephone Excise Tax was Repealed in 2000,it is

very clear that the federal excise tax on telephone services hits those who can least afford it hardest.

When you add taxes by state and local governments to the Federal Excise Tax, the combined taxes on telephones can be as high as 32 percent. In California all telephone taxes equal 20 percent. At those levels, these taxes take a real bite out of the monthly budgets of low-income families. Congress should take the lead in ameliorating this regressive burden by repealing the three percent federal tax on telephones.

There are many budget priorities that Congress will debate this year that are important to the country as a whole, as well as to the Hispanic community. Many of them we support. But we should not in a time of budget surplus choose to fund these priorities on the backs of telephone bills, because that is a particularly regressive tax that falls hardest on those who can least afford to pay. Throughout its 102 year history, the off and on nature of the tax on telephone services shows that its justification has been as a war-time tax or in times of budget deficits. Those times, thankfully, are passed. We should not keep a tax that is unjustified, simply because we are so charmed by the revenues it continues to raise.

The FETT is a regressive outdated tax and the LULAC has activated its members as part of a broader coalition that is working to repeal this tax. We thank you for your support of H.R. 3916 and hope that you will report it favorably from the Committee.

Chairman HOUGHTON. Thanks very much.

Now, Mr. Martin.

STATEMENT OF JAMES L. MARTIN, PRESIDENT, 60 PLUS ASSOCIATION, ARLINGTON, VIRGINIA

Mr. MARTIN. Thank you, Mr. Chairman, Mr. Coyne, Mr. Portman. I am Jim Martin, President of the 60 Plus Association; 60 Plus has, on average, about 1,000 to 1,200 members per Congressional District, working against taxes that affect seniors and their families.

Indeed, our slogan at 60 Plus is "tax fairness for seniors," and this Congress, thus far, has been very "senior-friendly"—for instance, in abolishing the earnings limit that was essentially a 33 percent tax on seniors' benefits. And I believe the best is yet to come, now that this Congress is once again poised to provide tax relief for seniors as it considers H.R. 3916, a truly bipartisan bill that does the right thing for those living on fixed incomes by repealing the antiquated 100-year-old Federal excise tax on telephones.

I repeat, this bill is strongly bipartisan, coauthored by your colleagues, Mr. Portman and Mr. Matsui, and by an impressive array of Republicans and Democrats, as well as the distinguished members here today as cosponsors, and 60 Plus has sent a letter to your colleagues endorsing H.R. 3916.

As the head of a senior citizens group, let me put this issue into some historical perspective, if I may. I worked on Capitol Hill about 38 years ago; I came here to work on the Hill, and I've seen a lot of taxes come, I like to say, but not very many go. And I think the time for this tax to go has surely come.

While it was considered a temporary luxury tax back in 1898 to fund the Spanish-American War, when few owned telephones, telephones are a necessity now, so this tax is clearly regressive in that those on lower and fixed incomes, such as senior citizens, pay a disproportionately higher part of their available funds. Thus it makes

it more expensive for seniors who may be calling their children, their grandchildren, or—perhaps even more importantly—calling their pharmacy.

The FETT, if it were repealed today, would mean about a $1.1 billion tax cut just for families headed by a person age 65 or older. Mr. Chairman, we have a chart that we submitted for the record, but repealing it in your State alone would mean about an $85.5 million tax cut for seniors.

I have submitted for the record an outline of the history of this temporary tax and how it has been repealed, reimposed, reduced, increased, ad infinitum. Its temporary status over 100 years, if I might conclude here, reminds me of a story about President Nixon who recalled that as a young Navy Lieutenant during World War II, there were temporary trailers and wooden offices built down on the Washington Mall grounds to process incoming and outgoing military personnel. Well, by the time that he was elected and inaugurated in 1969, those temporary buildings had become permanent, if you will, providing an ugly eyesore for visitors to our Nation's Capital. The newly-elected President Nixon ordered them razed, restoring the beauty of the Mall.

So it is long past time, I believe, to disconnect the temporary 102-year-old telephone tax, and 60 Plus hopes that you will report H.R. 3916 favorably from committee and move swiftly to pass this bill. I am looking forward to sending that senior-friendly message into all 435 Congressional Districts at an early date. On behalf of those of us who are 60 Plus, I thank you for your time.

[The prepared statement follows:]

Statement of James L. Martin, President, 60 Plus Association, Arlington, Virginia

Good afternoon, Mr. Chairman, Mr. Coyne, and distinguished Members of the Ways and Means Subcommittee on Oversight. My name is Jim Martin. I am the President of the 60 Plus Association. The 60 Plus Association has more than 500,000 citizen-lobbyists working against taxes that affect seniors and their families.

Indeed, our slogan at 60 Plus is "tax fairness for seniors" and this Congress, thus far, has been very "senior friendly," for instance, in abolishing the earnings limit that was essentially a 33% tax on seniors' benefits. Now this Congress is poised, I believe, to once again provide tax relief for seniors as it considers H.R. 3916, a truly bipartisan bill that does the right thing for those living on fixed incomes by repealing the antiquated 100 year old federal excise tax on telephones.

I am here today on behalf of all seniors who support H.R. 3916 co-authored by Representatives Rob Portman (R–OH) and Robert Matsui (D–CA). 60 Plus has written a letter endorsing H.R. 3916 and urging support for H.R. 3916.

When the tax was imposed in 1898 to fund the Spanish American war, it was intended as a "temporary" luxury tax on telephones. Today the telephone is essential to so many seniors in so many ways. Seniors rely on the telephone to provide essential emergency services and for regular consultation with physicians. Just as important, the telephone is the main source of contact with family members.

As the head of a senior citizens group, let me put this issue into historical perspective. Having worked on or around Capitol Hill since 1962, 38 years, I've seen a lot of taxes come, but not many go. The time for this tax to go has surely come. Considered a "luxury" back in 1898 when few owned telephones, it is clearly regressive in that those on lower and fixed incomes, such as senior citizens, pay a disproportionately higher part of their available funds. Thus, it makes it more expensive for seniors who may be calling their children, their grandchildren, or perhaps even more importantly calling their pharmacy.

The FETT is no longer a tax on luxury items. In fact the FETT is a regressive tax that hits older Americans who live on fixed incomes the hardest. If the FETT were repealed today it would mean a $1.1 billion tax cut for families headed by a

person aged 65 or over. Mr. Chairman, repealing the FETT would mean an $85.6 million dollar tax cut for seniors in your State of New York. These savings can be used to pay for medicine, food or other necessities that are a burden on those with a fixed income. There are plenty of reasons to eliminate the FETT.

Let me just cite a few:

• If a family started in 1940 to save the direct amount of tax they've been required to pay since then, they'd have $25,000 in savings today.

That is enough money to pay off a home mortgage for many seniors or pay Medicare deductibles or for prescription drug coverage.

• If a small "five and dime" with four business lines in 1940 started saving the direct amount of telephone tax they've been forced to pay all these years, the store would have $88,000 available in that fund.

Perhaps it would be helpful if I submitted for the record an outline of the history of the federal excise tax on telephone services. (see attached)

It's "temporary" status over 100 years ago reminds me of a story by President Nixon upon taking office in 1969. He recalled that as a young Navy Lieutenant after World War II there were "temporary" trailers and wooden offices built down on the Washington mall grounds to process the paper work of departing and arriving military personnel. Some 25 years later, these "temporary" buildings had become permanent, providing an ugly eyesore for visitors to our nation's capitol. Newly elected President Nixon had them razed, restoring the beauty of the mall.

So it's long past time to disconnect the "temporary" 102 year old telephone tax!

We thank you for your support of H.R. 3916 and hope that you will report it favorably from the Committee and move swiftly to pass this important legislation.

From the Spanish American War Till Today—
the "Temporary" Telephone Excise Tax Endures

Major Moments in FET History—The Tax That Won't Go Away

1898—*Temporary* tax on telephone services adopted to help fund the Spanish American War.
1914—The long distance *luxury* telephone tax is imposed at a rate of one cent per call with the purpose of paying for some of the costs of World War I.
1916—The tax is *repealed.*
1917—Tax is *reinstated* at a rate of five cents per call once the United States enters the war.
1918—Tax is *expanded* to cover additional telephone services.
1924—The telephone excise tax is *repealed.*
1932—The tax is *reinstated* at per-call rates ranging from 10 cents to 20 cents, depending on the cost of the call.
1942—Tax rate is *changed* to a flat 20 percent rate.
1943—Tax rate is *increased* to 25 percent.
1954—Tax rate is *reduced* to 10 percent.
1959—Tax rate is *slated to expire* in 1960.
1960–64—Expiration schedule is *delayed* annually.
1965—As part of the excise tax reform project, the 10 percent communications excise tax is *scheduled to be phased out* over three years.
1966—Phase-out *delayed* for one year.
1968—Phase-out *restructured* to conclude in 1973.
1969—Phase-out *delayed* for one year.
1970—*Schedule replaced* by a ten year plan beginning in 1973.
1973—Phase-out *begins.*

1981—Excise tax down to 1 percent but elimination is *deferred*. One percent is *extended* through 1984.
1982—Tax rate is *increased* to 3 percent with elimination in 1985.
1984—Three percent rate is *extended* through 1987.
1987—Three percent rate is *extended* through 1990.
1990—Three percent Excise tax *made permanent* in 1990.

Chairman HOUGHTON. Thanks very much, Mr. Martin.
Mr. Coyne?
Mr. COYNE. Thank you, Mr. Chairman.

I want to thank each of the panelists for their testimony, and ask Mr. Gomperts this. Bell Atlantic's telephone bills are extremely complicated, very difficult to understand, even for the average person. There isn't a week that goes by when I go back to the district that there aren't senior citizens who come and tell me about the very complicated nature of the monthly telephone bill that they get, and I'm sure that Mr. Martin's organization receives inquiries about that problem as well.

Is there anything that Bell Atlantic can do to make them more simplified and easier to understand, particularly for senior citizens?

Mr. GOMPERTS. The telephone bill itself is considered by Bell Atlantic as an important marketing tool. It's not just a bill. The company is extremely cognizant of exactly the type of issues you have just discussed. There is an ongoing effort—in fact, there is a whole group committed to this—to simplifying that bill. Periodically you would notice that the bill does come in with a new format, in an effort to simplify it. But just like bank statements, there is a certain amount of information that must appear on that bill, and there is no way to condense it or aggregate it at a higher level. For instance, all the local calls, all the toll calls if the bill reflects toll calls, all the regulatory fees, regulatory surcharges, State taxes, local taxes, the Federal excise tax—for at least a short period longer, until it is repealed—all these items are required to be on the bill.

I think that it's just the nature of the animal that it can't ever be as simple as the constituency would like to see it. But given that, the marketing people realize that this is a competitive issue, the bill, and as we move into long distance service as a local telephone company, starting in New York—and hopefully soon to follow in Pennsylvania, your jurisdiction—we are making every effort to simplify the bill even more. But I can't tell you that it will ever be as simple as a 3-or 4-line statement; it's always going to be somewhat complicated for the reasons that I have stated.

Mr. COYNE. Well, the complaints that I get are not so much about each itemized line item. I understand that they have to be on there. But the descriptions and terminology that go beside each charge are something that people have a very, very difficult time understanding.

Mr. GOMPERTS. In many cases—

Mr. COYNE. And what they do is come to us, who they feel have some influence over what can be done about the problem, and tell us they just don't understand their phone bill.

Mr. GOMPERTS. In many cases that terminology that you refer to has its origin with the Public Utility Commission in the State. They will label a particular charge, for whatever purpose motivates them, with a title, like "subscriber line charge." Now, the average person wouldn't have a clue as to what a subscriber line charge is. The Public Utility Commission labels the charge as a certain description; we are required, when we put that on the bill, to in fact mirror the Public Utility Commission law that describes that charge.

I think your point is well taken, though, and I will certainly bring back to the company the notion that we should make every

effort to try to put these terms in real English so that the customers can understand what they're being charged for, and that it doesn't just mirror the statutory language of the Public Utility Commission, which is often the origin of those charges.

Mr. COYNE. Well, as you indicate, you are trying to be customer-friendly, and you use your telephone bills, your monthly bills, to try to attract the good will of the customers that you serve. So it would seem to me, then, that if the PUC or whatever jurisdiction is mandating that these charges be on there, and these descriptions be on there, maybe you could even go a little bit further and put a line below it to put it in English, what that particular charge is.

Mr. GOMPERTS. I think your point is well taken, Mr. Congressman, and I will certainly bring that point back to the company.

Mr. COYNE. Thank you.

Chairman HOUGHTON. Mr. Portman?

Mr. PORTMAN. Thank you, Mr. Chairman.

Again, late in the hearing here, I want to thank the Chairman for letting us get into "tax on talking" and having a hearing on it. Your testimony is excellent and I appreciate the work that you all do at the coalition. Mr. Coyne and Mr. Houghton are both cosponsors of this legislation; in fact, the vast majority of the members of this committee who would normally sit here during a full committee hearing—and a markup which is going to take place tomorrow, I believe—will be supportive of it. So I feel as if we have a very good opportunity this year to finally drive a stake into the heart of the "temporary luxury tax" put in place for the Spanish-American War back in 1898. It turns out that the Spanish were tougher than we thought. [Laughter.]

Mr. PORTMAN. But I do have a few questions that would be important to get on the record, if you all would indulge me a little bit, because I know some of these answers are pretty obvious, but I think it's important that we create a record here.

The first one is—I guess, Mr. Gomperts, you're the best one to respond to this—how can we be sure that telephone companies won't turn around and raise their rates to make up the difference between this 3 percent excise tax that's in place now, and the repeal that we would all like to see?

Mr. GOMPERTS. As a practical matter, and as a matter of law, that is impossible. The regulatory regime in place now in every State where Bell Atlantic operates is something which is commonly called "price cap." This is distinguished from previous regulatory regimes which were in place for 100 years, which were rate-based rate-of-return, where the company used to compute its investment, and then the State Commission would allow a fair return on that investment, and then that total dollar amount would then be spread among all consumers.

The new regulation, which is "price cap," fixes the price that the company can charge the consumer for its monthly service. That price can only be changed if the company can bring forth a showing that there has been an increase in so-called "exogenous costs," and the company is then allowed to reflect those exogenous cost increases in its rates—with an offset, however, for productivity. So it's a netting process that allows the company to increase rates.

The reduction or the repeal of the Federal excise tax under State law would not be an occasion to raise rates—

Mr. PORTMAN. In fact, it should be just the opposite, and in fact—I want to get to the next question, which is that your administrative costs should be reduced, as well as the 3 percent excise tax on the consumer?

Mr. GOMPERTS. That's exactly true. In fact, the excise tax, as you pointed out, Mr. Portman, is not really a tax on the company at all. It is a tax on the consumer. With the repeal of the excise tax, we would just take the last line on the bill—which I think is in pretty good English; it says, "3 percent Federal excise tax"—and we would just eliminate that line, and with that we would eliminate 3 percent of the bottom line of the phone bill. There is no way that we would raise the bill to compensate for that and to, in effect, redirect that money to Bell Atlantic. That money would no longer be collected from the consumer, and would be in their pockets to spend on other goods and services in the economy. And again, predominantly that money would go to lower-income individuals, and certainly to residence customers versus business customers.

Mr. PORTMAN. Right. The bulk of it is among residence individuals, not businesses, which is a good point to be made.

You had begun to answer the second question by talking about the impact of repeal on the economy, but as you indicated, your company, Bell Atlantic, and other companies pass this along to the consumer. One of the questions that I sometimes get asked by my colleagues is, because these companies don't even pay this tax, why do they care about it? Why does Bell Atlantic care about getting this tax repealed?

Mr. GOMPERTS. Well, I think there are several different answers to that question, and I will take it from two different perspectives. One is the corporate perspective, and then there's the perspective of the consumer, our customer.

From the corporate perspective, this tax increases the cost of our services. Our service is unlike basic telephone service, which has a fairly low elasticity of demand, meaning you could raise the price and still have everyone stay with you. The new generation of high-tech services have much greater elasticities of demand, and if you raise the price, you will have people not buy your service—or if you cannot lower the price, you will in effect discourage people from acquiring that service, which will obviously impact the company's revenues.

The second point from the corporate side is that there is a tremendous burden in administering this tax for the IRS or for the Federal fist. We must collect it from the customers and remit it on a very regular basis. In fact, we bill it and collect it and remit it before we ever get the money from the customer. So we actually remit the tax on a "when billed" basis, and we don't actually get the money from the customer until an average of 25 to 30 days later. So we're actually out of pocket for that money for that period of time.

But beyond that, the other issue has to do with the whole evolution of the Internet and other high-tech services. The marketplace today is demanding that they be presented one-stop shopping, or a bundled rate, for all the services they want to consume. For

instance, what we're getting from our marketing data is that customers would like to be charged a flat rate—let's say, $88 a month—and then they could have all they could eat, all the local, all the long-distance, all the video on demand, all the wireless, all the high-speed Internet connections.

In order to package rates and meet customer demand—and that is the way the market is moving—it is impossible under the present tax structure because by bundling all of the elements I have just described, you would be combining taxable services, such as local, with nontaxable excise services, such as Internet access. And as a result, you would taint the entire bundle and make it taxable. Our rates would in effect go up to the end consumer because of the incremental tax.

Mr. PORTMAN. That's very helpful. I appreciate that.

I want to get a chance to ask Mr. Wilkes and Mr. Martin a question, but let me just say that to me one of the incredible things that came out of the Advisory Commission hearings was the statistic that major telephone companies are filing something like 100,000 tax returns annually, and there is a compliance burden here, obviously, at the company level which is also passed on to the consumer. There are also, as you say, other administrative issues that the Federal Government has to deal with, including the IRS. And finally, as you say, this is a tax imposed on growth, and this interest of the consumer in bundling is one that is consistent with the fact that we are increasingly turning to e-commerce and want, as consumers, to see that done as efficiently as possible. So this is a bigger issue than just telephones; it's about whether telecommunications is going to continue to be that driving engine of our economic growth.

If I could quickly ask, Mr. Chairman, about the impact on—Mr. Wilkes, your group, and you talked about the fact that Hispanic households on average have higher telephone bills. I assume part of that is long-distance calls. Can you perhaps expand a little on why it is that your organization is so interested in this issue?

Mr. WILKES. Certainly. That's exactly correct. Hispanics on average, in many States, are using twice the level of long-distance services of other populations. So we think that's a disservice to our community because our community is about 65 percent of the median income. So when you look at the community that is least able to pay the tax, in some cases we have to pay almost double the tax that other communities are paying. So it is really kind of socking it to the poor in this case.

Mr. PORTMAN. It is also a tax that hits small businesses disproportionately, and to the extent that you represent small businesses—which I know that you do—it's something that I assume you have a special interest in as well.

Mr. WILKES. We certainly do. The Hispanic community has a tremendous growing small business population, so that's been very beneficial. But it does impact small businesses as well. These are folks who can least afford to pay this tax, so we would like to see it removed.

Mr. PORTMAN. Mr. Martin, I see from your testimony that there is a $1.1 billion impact on seniors annually, and the fact that is a disproportionate impact, and that seniors depend on the telephone

for health care needs, for food needs, for staying in touch with their relatives and loved ones who take care of them, since often they are bound to their apartments or homes. I think that's a very important aspect of this that we need to get on the record.

Could you expand a little bit more on why this is a disproportionate impact on seniors?

Mr. MARTIN. Sure. Well, you've covered it, and as Mr. Wilkes point out, too—my membership, by the way, they're not wealthy, that I personally know of. These are lots of low-income seniors—

Mr. PORTMAN. Not like Ted Turner. [Laughter.]

Mr. MARTIN. I would say to that, by the way, Mr. Portman, we've talked about that before; the resemblance of Mr. Turner. I have a son who goes to school in Atlanta. When I go down there, the upshot is I get the best seat in the house. [Laughter.]

Mr. MARTIN. The downside is, everybody expects me to pick up the tab. [Laughter.]

Mr. MARTIN. I would add, though, sir, that clearly seniors—shut-ins, if you will—the phone is a necessity. It's their link to the outside world in many, many cases, as you just pointed out—not just their children or grandchildren, but their friends. It is their true link to the outside world. It is a necessary tool that they have to have. So clearly, it impacts them.

Mr. PORTMAN. Well, I really appreciate your being part of the coalition, and you, Mr. Wilkes, and your organization. This has been a bipartisan—almost nonpartisan, I would say—effort from the start as well, and I appreciate the efforts of Mr. Coyne and Mr. Matsui and others to make it so. I think this is one that we ought to go ahead and finish off. The war is over; it's time to celebrate. [Laughter.]

Mr. PORTMAN. Thank you, Mr. Chairman

Chairman HOUGHTON. Thank you.

I just have one question of Mr. Gomperts which affects the rural taxpayers. You said there was sort of a disproportionate impact on them. Could you break that down, just very quickly?

Mr. GOMPERTS. Yes. The reasoning behind that, and the statistics that I've been shown, is that rural taxpayers, because of the geography and the distance that their phone calls have to travel, they are mostly making long-distance telephone calls because of the distances, and a higher proportion of their telephone calls vis-a-vis people living in inner cities are long-distance calls. And as a result, they are bearing a higher proportionate burden of the excise tax, where local calls are flat-rated.

Chairman HOUGHTON. All right. Thanks very much.

Well, gentlemen, thank you. I certainly appreciate your testimony, your thoughts, and your patience.

[Whereupon, at 4:53 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

Statement of American Federation of State, County and Municipal Employees, AFL CIO

The American Federation of State, County and Municipal Employees (AFSCME) submits the following statement for the hearing record expressing our concern over the non-collection of sales taxes on remote purchases.

The originally-enacted Internet Tax Freedom Act (47 U.S.C. 151) imposed a three-year ban, ending September 30, 2001, on any new state and local taxes on Internet

access and multiple or discriminatory taxes on electronic commerce. During this time, the Commission was to make recommendations for dealing with taxation of the Internet. Unfortunately, this Commission failed to complete its work and make any official recommendations. As a result, state and local governments are suffering from the non-collection of sales taxes on remote purchases.

In our opinion the practical effect of this law has been to exacerbate the existing de facto tax-exempt status of most such remote sales that result from the inability of states to collect sales taxes from purchases made by state residents from Internet and catalog sales. As a result, AFSCME believes that the moratorium should be allowed to expire in September 2001 and *not* be extended through calendar year 2006. More importantly, we believe there needs to be some affirmative action taken by Congress to ensure the collection and enforcement of collection of sales taxes already owed on remote purchases.

While the states are demonstrating that they can attack this challenge in a constructive and cooperative fashion, more action needs to be taken immediately. State and local governments already may be losing on the order of $5 billion in sales tax revenues annually from their inability to tax most mail-order sales. With Internet sales growing rapidly, these governments could be losing an additional $15–20 billion annually by 2003 if Internet purchases remain effectively tax-exempt. Revenue losses would continue to mount thereafter, as Internet sales grow over time.

The loss of state and local tax revenue significantly impairs the ability of states and localities to meet demands for education funding and other critical services such as public safety and transportation. This scenario is particularly troubling in the context of education. There is agreement that primary and secondary education in the United States is in need of constant improvement so that our children receive the foundation that will allow them to fill the demand for high-skilled, well-educated workers in the information economy. Improving the education system requires investment. In fact, state education budgets consume 35 to 40 percent of state revenues. It is ironic that the Internet, the very tool fostering today's high-tech explosion, stands to play a pivotal role in the states' inability to fund the desperately needed improvements in the education system.

Main Street retailers are also at risk of losing considerable business to remote sellers so long as they must add sales tax to their prices at the cash register while Internet and mail-order merchants can sell tax-free. There is evidence that this tax advantage is already distorting retail competition by compelling large retail chains to reorganize their operations solely to be able to compete with their tax-exempt Internet rivals. As this disparity comes into sharper focus, it will not only result in lost tax revenues, but it will also harm communities.

For these reasons, AFSCME supports stronger enforcement and more active collection of existing sales tax due on remote purchases. Accordingly, we call upon Congress to take swift and effective action.

Statement of Dan R. Mastromarco, Argus Group, Alexandria, VA, on behalf of Americans for Fair Taxation

Dear Mr. Chairman and Members of the Subcommittee on Oversight:

On behalf of the Americans for Fair Taxation (AFT), I am pleased to submit this testimony to discuss tax issues relative to the internet and electronic commerce. AFT is a nonpartisan grass roots organization that supports the FairTax national sales tax plan (H.R. 2525). As you know, the FairTax was the subject of a recent hearing before the full Committee. The FairTax would repeal all income based Federal taxes, including personal and corporate income taxes, self-employment and payroll taxes, capital gains and death taxes, and replace these multiple and often hidden taxes with a visible, single rate national sales tax. The FairTax would effectively remove any tax on savings and investment, on exports, on educational expenditures and on charitable contributions. It would apply only to the final retail purchase of new goods and services and not business-to-business (B2B) purchases.

This Committee should be applauded for highlighting the Commission's findings,[1] and for stressing the need to ensure multiple and discriminatory taxes are not imposed on the internet. Congress is rightfully consumed with ensuring the internet is not dashed on the shoals of ill-conceived Federal tax policy. There should be no

[1] Advisory Commission on Electronic Commerce, established by the Internet Tax Freedom Act (ITFA), Title XI of the Omnibus Appropriations Act of 1998 (P.L. 105–277) to examine issues related to Internet taxation.

new taxes on the internet. However, as tax-writers, the Members of this Committee have an equally important obligation. You have an obligation to transcend the impassioned rhetoric that has characterized the debate over internet taxation to address the very real problems that the income tax system will increasingly bring to electronic commerce.

Often, we hear the catchphrase phrase "don't tax the internet." It has become a mantra. However, if you look beyond the rhetorical flourishes, you will find one disturbing reality: that the internet is already heavily taxed today. Investors in internet companies are taxed on their income multiple times. They are taxed when they invest. The companies are taxed on their earnings—resulting in lower profits, higher prices goods or lower wages to workers. They must still pay state and Federal income tax on the income from sales of goods and services. The shareholders are taxed on their dividends and capital gains. Internet company employees are taxed on their wages with both payroll and income taxes. Internet companies are taxed again when they buy goods and services since producer prices reflect hidden taxes imposed upstream. Through the combination of double and treble taxation of savings and investment income and high marginal rates, we already impede the internet. We are driving internet business offshore, not though new taxes through the same old multiple and discriminatory taxes we refuse to reform.

Despite this reality, some appear to take the phrase literally. In their zeal to be knighted protectors of the internet, some policymakers flirt with abandoning the primary economic directive in tax policy -neutrality.

Most of us who believe the internet is an efficient vehicle for conveying information would hardly argue that the internet needs to be subsidized (provided with corporate welfare if you will) beyond other means of conveying information or transacting business. If policymakers subscribe to the importance of leveling the competitive playing field, tax policy should strive to be indifferent to the internet: it simply ought to neither subsidize it nor punish it. Sound tax policy must follow sound economic policy. Internet sales should be treated no differently than other forms of purchase or informational dissemination.

But perhaps most importantly, the superficial rhetoric of the debate has not been entirely benign: it has ignored that reliance on an income tax itself will itself, ironically, sow the seeds of extensive internet regulation. The internet and income tax cannot peacefully coexist. This will become increasingly apparent as the internet matures. In the digital age, income can be moved around the world at the speed of light (or rather a key punch). Therefore, if the Committee seeks to ensure "no new taxes on the internet," and "no new regulation of the internet," either the Committee must look to fundamental tax restructuring of our extraterritorial tax system or it must become an unwitting accomplice in a slow drift toward total regulation of the internet. The latter would be ironic given the ostensible support for freedom on the internet.

As every American is now learning, the information-age opens a new chapter in world history. The internet is already assured of its prominent place. The internet is empowering entrepreneurial firms to compete where huge capital outlays were once necessary. It is stimulating entrepreneurial spirit unmatched since the gold rush. Each day businesses small and large seek to insinuate the internet into the very fiber of our economy. Every place information exchange adds value, from education, to comparing mortgage interest rates, to buying music, the internet will bring the promise of greater prosperity, greater options, lower cost, higher quality goods and services and yet more innovation. The transformations the internet has brought to the marketplace of goods, services and ideas are but a glimpse of its potential as new applications of this technology matriculate into every corridor of the global marketplace.

The phrase "don't tax the internet," however, is not worthy of the Digital Age. It is the political equivalent of saying "taxes bad; internet good; taxes on internet bad." This testimony discusses the problems commonly overlooked by the political side of the internet tax debate. It recommends that the best possible tax system in the Digital Age, and the system most consistent with the Digital Age, would be a broad-based consumption tax (the FairTax national sales tax plan) which eliminates the tax on savings and investment. The FairTax would stimulate the growth of the internet industry by lowering marginal rates through expanding the taxable base, taxing income only once and imposing a single rate. It will enhance the export of American manufactured goods and American services, as opposed to the export of internet jobs, by untaxing exports. It would give internet companies the highest form of neutrality possible -it would impose a zero rate of tax. It will eliminate the need for internet regulation and intrusions into privacy because it would eliminate the need to track the capital gains, investment income and savings of individuals.

It will encourage harmonization of state law to make enforcement simpler. The FairTax is fundamental tax reform worthy of the Digital Age.

I. The Internet Will Make Income Tax-Based Systems Obsolete

Let us begin by discussing how the internet will facilitate flight capital. Those who are schooled in tax revenue statistics might point out a disturbing trend in tax enforcement: our current tax system is not faring too well. According to the IRS' Commissioner's Annual Report, more than $200 billion—20 percent of all income taxes collected—are evaded. Another $100 billion is overpaid. Tax evasion has increased almost 70 percent as a function of GDP over the last decade. Tax evasion represents more than 2 percent of GDP or nearly one good year of economic growth. We all pay about 20 percent more than we need to because cheaters do not pay. Because more and more taxpayers view the system as unfair, compliance is decreasing further.

Despite this poor compliance rate, we may have reached the limits of what we are willing to pay in pecuniary and non-pecuniary costs to increase compliance. More than 34 million civil penalties are assessed each year, 2 million accounts are levied and more than 1 billion information returns are filed. Individual returns request information so invasive that we must confess more of our private lives to the IRS than we would tell our children. Every few years, the Congress parades the victims in the public view, so that we might all criticize a thankless agency charged with enforcing the complex laws that are really at the root of the problem. Every few years, we enact yet another penalty reform or episode of the Taxpayer Bill of Rights. Most policymakers now know the inescapable truth: the genesis of the problem is the income tax system itself.

So how will our current tax system fare when the internet has fully bloomed? What will be the extent of tax evasion under the internet? The short answer is that the internet may soon make international tax evasion a household sport, dwarfing the current evasion rates.

As Dr. Richard Rahn (former Chief Economist of the U.S. Chamber of Commerce) points out in his book, "The End of Money:"

In order to understand what is about to happen, remember that the revolution taking place in electronic commerce means that banks and other organizations will be able to create their own money for transactional or investment purposes and literally move these monies around the globe at the speed of electrons. The definition of money as a government-created legal tender will become less and less relevant.

Things that can be transformed instantaneously into something else and moved to anyplace in the world with no paper or electronic trail will become nearly impossible to tax. By using public key cryptography, one can have electronic bank notes certified without the issuer knowing to whom they were issued. And smart cards used as an electronic purse can have the same anonymity as paper cash.

And what may become even more obsolete is the vast body of statutes, court cases, regulations, revenue rulings, private letter rulings and other pronouncements that try to define "income" or the many nuances of international law, including personal holding company , passive foreign investment company income and Subpart F provisions. Under the internet, once offshore, income is free to tour the world without a passport or a visa.

To take a simple illustration, assume you are a wealthy individual whose income is totally dependent upon stock dividends. Between golf rounds, you invest over the internet with electronic money. The internet account is held by your bank in the Turks and Caicos, which provides a prison term and a hefty financial penalty for one who dares to merely inquire into the ownership of your account. Your account is also encrypted under constantly evolving encryption systems that make numbered accounts anachronistic. As your income comes in, the electronic bank sends you the money which you download onto your computer and then transfer to your smart card. You can pay your bills. Only you decide what electronic and paper records to create and keep. You can imagine that the Turks and Caicos bank account might also be a trust which invests directly in U.S. business.

In the Digital Age, it will be as easy to move or create a financial portfolio anywhere in the world with total anonymity—as easy as logging on to your computer. The internet will be the host to trillions of transactions that shift capital around the world in nanoseconds, both encrypted as to the owner, anonymous because of the sheer volume of transactions and protected from disclosure by the many willing tax havens of the world. Moreover, income includes both income from business and individuals, as well as income from investment and savings.

When taxpayers can easily avoid reporting particular types of income or transactions with no danger of being caught, than our tax will become, quite literally, voluntary. This world is not far off. The first to evade will be those who are creating

inbound transactions into the United States, nonresidents with whom we have but a tangential fiscal relationship. Next will be those with capital to invest or profits to disguise, wealthier Americans or those wanting to launder monies. Before long, our tax system will depend upon those who pay out of a sense of public duty and those who are paid in wages (working class Americans).

II. An Income Tax System Virtually Guarantees An Attempt at Extensive Regulation of the Internet

The government can respond in one of two ways to the eventuality of an intolerable level of tax evasion on such non-egalitarian terms. Because of the difficulty in enforcing the income tax, we can impose record levels of financial regulation so that global transactions are monitored or we can adapt new rules to accommodate the new reality.

If the Congress chooses the former, Americans will have to be willing to relinquish their right to privacy over the internet. Non-U.S. internet companies with no minimum contacts with the U.S. must be willing to freely exchange information with the U.S. government.

Think about the vast resources that will be required to routinely obtain the most rudimentary information needed for the enforcement of an income tax (such as one's social security number). Our State Department will have to work round the clock to secure information exchange agreements and to improve upon the ones in effect. Today, we have fewer than 50 bilateral tax treaties, and while information exchange is ostensibly part of them, most Nation's do retain their secrecy laws and they have adopted or signed on to evidentiary and letters rogatory procedures which make it difficult if not impossible to obtain financial information on transactions or income.[2] In fact, it is already happening. The OECD plans to, inter alia, develop new information technology capabilities that will permit both the "detection of suspicious online transactions and verification of the customer" and "to ensure that electronic commerce technologies, including electronic payment systems, are not used to undermine the ability of revenue authorities to properly administer tax law."[3]

The truth is that many countries in the world promote themselves as tax havens. They consider their barrage of nondisclosure rules the ramparts of a noble sanctuary for flight capital. The rules are not only a symbol of sovereignty, but a bona fide source of income—tourism, if you will, for electronic money. This Committee might note that the Caribbean Basin Initiative made a condition of favorable treatment the signing of a disclosure of information agreement. Of course, the illusive concept of a tax haven is itself a problem. As once stated by Professor Harvey Dale, a tax haven is any land mass visible at low tide. If we are to enforce the income tax in the electronic age and on a global scale, we will need access to information in each of these tax havens and the constantly good relations necessary for intergovernmental cooperation.

For this reason, some believe the future tax will simply not include financial capital (productive savings) because financial capital will always elude regulators. Regulation will not succeed because those who are developing the means of evasion -in partnership with world secrecy laws—will be one step ahead of those who are tying to restrict it. The cost of trying to enforce taxation of highly mobile financial capital probably will exceed the revenue collected and certainly will exact a price in terms of lost efficiency and lost privacy rights that exceeds the benefits of their continued taxation. We will have transformed the internet into a vehicle for financial crimes by unnecessarily insisting on taxing savings and investment. We will have developed the most extensive net of regulations and checks and international agreements in an attempt to chase financial butterflies.

III. A National Sales Tax Will Be Much More Enforceable

How can the Congress adapt our tax system to the new reality? We suggest that it must do so by adopting fundamental tax reform that is consumption-based, and

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[2] For example, see the "CONVENTION ON THE TAKING OF EVIDENCE ABROAD IN CIVIL OR COMMERCIAL MATTERS" (Concluded March 18, 1970). The signators of this convention sought to improve mutual judicial co-operation in civil or commercial matters, by allowing a State to request the competent authority of another Contracting State to provide evidence intended for use in judicial proceedings however evidence cannot be obtained unless the underlying actions was contemplated or commenced. This means that it is not available to mere auditors and it is not available in a criminal action until after indictment -even though the information is needed for indictment.

[3] See, for example, Financial Action Task Force on Money Laundering (Released February 3, 2000) at http://www.oecd.org/fatf/pdf/2000typ-en.pdf</SPAN></SPAN> and http://www.oecd.org//publications/pol—brief/9701—POL.HTM#14.

that does away with taxation of savings and investment and the need to move it outside of the U.S.

First, consumption is a more conspicuous base for taxation than is income. While a determined tax evader can easily place income out of reach, it is much harder to place the sale of goods and services out of reach. While income, its timing and its source are complicated legal concepts that can be nothing more than the entry in an electronic ledger, consumption often involves tangible transport of goods and a paper trail. The future tax base will have to rely on real and tangible property or payments for tangible services or goods. Taxes tied to real property or tangible personal property or the sales of goods and services to the public are much more difficult to evade.

Second, taxes tied to the operation of businesses dealing with the public or with many business customers are more easily enforced because of the necessarily public and open nature of such businesses. A study conducted in California by a member of the Franchise Tax Board (Ernest Dronenberg) showed that 85 percent of the sales taxes were collected by 15% of the retailers. Hence, the vast majority of retail sales are by large established firms.

Third, under the FairTax plan, much of the problem areas of enforcement that would still apply to a consumption tax—are simply eliminated. While imports can be captured at the border, consumption B2B is not taxable under the FairTax -only personal consumption at final retail sale. Exports are not taxable. Used goods are not taxable. Hence, the vast amount of internet sales would simply not be of enforcement concern.

Certainly, some services sold over the internet will cause continuing enforcement concern. For instance, an attorney or an architect might send a product to a client over the internet. Potential problems exist anytime there is a conveyance of intellectual property where the internet is the medium of exchange. However, this form of tax evasion can occur today and with higher marginal rates and therefore a greater reward for cheating. Moreover, many of these businesses are registered and sales tax audits would reveal these discrepancies. Equally important, the clients would have to enter in to the necessary conspiracy in most of these cases. Remember, the sales tax is a withholding tax.

The FairTax would have greater enforceability, greater compliance with less intrusiveness. Administrators can focus resources on far fewer taxpayers, with far fewer opportunities to cheat, far smaller incentives to do so, and a far greater chance of getting caught if they do. The incentive to cheat is dramatically reduced because marginal tax rates are the lowest they can be under any sound tax system. Therefore, cheaters profit far less from cheating. Second, it will be easier to catch cheaters, since the number of tax filers will drop by as much as 90% as individuals are removed entirely from the tax system, requiring enforcement authorities to monitor far fewer taxpayers. Third, simplicity and visibility add to enforcement. In the internet age, the more than 211 million taxpayers can cheat in the privacy of an office and bury their cheating in the unnavigable 7,000 code sections with plausible deniability that the taxpayer, preparer, or even the IRS itself even understood the law. If one is willing to evade the law (as opposed to avoid, evasion is the violation of a known legal duty), the internet will provide the getaway vehicle. The FairTax increases the likelihood tax evasion would be uncovered and leaves little room to hide between honesty and outright fraud. The only question asked of retailers is: how much did you sell to consumers?

IV. A Territorial Income Tax System Will Export Investment and Internet Jobs

If we try to tax savings and investment, we will have the unintended effect of driving money offshore. U.S. dollars will be expatriated to tax havens around the world, where they will be invested in foreign plants, facilities and infrastructure. Moreover, our insistence on an income tax will not only encourage the expatriation of investment dollars offshore in the search of tax free returns, it may drive internet business itself offshore.

This will occur two ways: legally and illegally. Internet business may be driven offshore for tax planning purposes. Current tax law provides that income effectively connected with a U.S. trade or business is taxed under the U.S. taxing laws. The Internal Revenue Service has taken the position that the mere demonstration of product and solicitation of orders is considered to be engaged in the trade or business in the U.S. But how should a foreign internet provider and marketer of goods and services be taxed when the only advertisement is that the solicitation appears on a global web? An argument can be advanced that the global web is not a U.S. trade or business since there is no presence in the U.S., and no office based here. The Congress will be disinclined to impose Federal tax on such transactions in an international environment when it denies the ability ot states to impose out-of-state

taxes. Certainly, the sales would be so treated if a fixed place of business were required by the income tax treaties. If that is the case, then sales into the U.S. will be legally income tax free, whereas sales by U.S.-based firms will be subject to tax. This will discriminate against American manufacturing facilities by encouraging the location of internet businesses offshore as tax free zones. It might also be noted that the difficulty of determining the ownership of the internet business and the elimination of the need for a fixed location makes adherence to the extraterritorial tax system effectively optional.

V. The Objective of Internet Tax Policy Needs to Be Better Understood

The National Sales Tax Will Untax the Internet

There is a great deal of misunderstanding inherent in the catch phrase "don't tax the internet." Some use the phrase so loosely that they clearly imply any item sold though the use of a telephone line or a modem, or a DSL line, should be magically tax free. In other words, retailers who sell through brick and mortar facilities should pay tax, but retailers who sell through a web site should for some reason be exonerated from tax. Somehow the medium of transporting information over a personal computer is worthy of tax exemption but over-the-counter sales are not?

Of course, if this were literally true, it would raises numerous tax administration questions on a national level. If "internet transactions" were not to be taxed, how do we determine if a sale went through the internet. If a retailer uses a point of sale device that dials up a computer, is that the internet? What if the product is discovered on a web site, but the buyer calls up to order?

There is also a small problem in the truthfulness of the economic assertion. Today, as we discussed, the internet is taxed heavily. There are excise taxes on telephone calls, of course, that were the subject of the Commission's report; but there are also the full host of general revenue taxes. There are, of course, the corporate income tax that every company involved in internet sales pays. This includes the income paid by the retailer, the software manufacturer, the internet provider, the hardware manufacturer, the phone companies and others. There is the individual income tax that the shareholders in the companies pay. There is the payroll taxes paid by the employees of the companies. There are capital gains taxes paid by investors in these companies. If the Congress truly wanted to exempt the internet from taxation, it would have to repeal a growing portion of the Federal tax base today.

Finally, such a view implies a serious breach in understanding sound economic principles that should underlie internet tax policy. In truth, despite its deification, the internet is simply a means of communicating information in the same manner as the telephone which preceded it, shoppers networks on television or mail order catalogues. If the internet is more efficient, than why does it need special subsidies?

Some commentators have used the enthusiasm for the moratorium against internet taxes to seek to advance an erroneous argument that a national sales tax would "tax the internet." Sometimes they suggest that this is a constitutional issue. These arguments are advanced mainly by supporters of an alternative tax plan, like Majority Leader Dick Armey's hybrid subtraction method VAT (aka flat tax).

However, a Federal national sales tax has nothing to do with state sales taxes. Moreover, it would clearly tax the internet far less than either the flat tax or current law. That is because both of these plans tax the business itself, as well as the wages of the employees, and both impose hidden costs on internet companies when they buy goods and services for resale.

Most importantly, that is not what the legislation recently passed by the House provides. The Internet Tax Freedom Act which recently passed the House in revised form imposes a moratorium on internet access taxes, bit taxes and multiple or discriminatory taxes. It would prohibit taxes on the internet except for taxes on net income, fairly apportioned business licenses taxes and fees and sales taxes to the extent those sales taxes would be imposed on mail-order sales from the same vendor.

A national sales tax is not only consistent with the spirit and letter of the moratorium, it is far more consistent with the spirit and letter of the moratorium than any other tax plan. Under the Fair Tax, sales made over the internet or mail order sales would be subject to federal tax just like any other vendor selling new goods and services for final consumption. However, while the FairTax taxes the purchase of new goods for final consumption, the FairTax would untax the internet companies themselves. There would be no more tax on the income received from internet sales. There would be no more tax on the dividends and earnings of internet companies. There would be no tax on the capital gains of internet companies or for those investors who sell their stock.

Moreover, the Fair Tax would adhere to the fundamental rule of economic policy -neutrality. It would treat mail order and internet sales like any other sales. Sales made over the internet or through the mail are subject to the same tax as sales made on main street. A good or service should not be tax preferred or tax disadvantaged because it is sold or delivered to a consumer in a particular way.

A National Sales Tax Will Harmonize Onerous State and Local Sales Tax Laws

Finally, the FairTax will work to alleviate the primary burden imposed by states on internet sales: a balkanization of state and local sales tax laws. It will do so by fostering harmonization of state juridical taxation issues and bases by providing a single, national standard. As the states have conformed to the Federal definition of Adjusted Gross Income in order to ease administrative costs on the states for tax collection, the states would be expected to conform to the Federal sales tax base, eliminating the concern over double taxation.

In fact, the FairTax will rectify the central problem sought to be addressed by the internet moratorium. The FairTax envisages that the states will be the primary administrators of the national sales tax. States that conform to the federal sales tax base and become part of national sales tax system would be able, for the first time since National Bellas Hess, to require vendors to collect and remit sales tax on mail order and internet sales into their state. The federal government would facilitate information sharing and enforcement cooperation and among the states. States that were not part of the federal system would, however, be unable to collect sales tax on mail order sales into their state.

In *National Bellas Hess, Inc. v. Department of Revenue of Illinois,* 386 U.S. 753 (1967), the Supreme Court ruled that a State's attempt to require an out of state mail-order house to collect and remit use tax on goods purchased for use within the State was a violation of the Due Process Clause of the Fourteenth Amendment and the Interstate Commerce Clause of the U.S. Constitution. In Quill Corporation v. North Dakota, 112 S. Ct. 1904 (1992), the Court overruled National Bellas Hess in part by ruling that an out of state mail-order house may have the "minimum contacts" with a State required by the Due Process Clause yet lack the "substantial nexus" required by the Commerce Clause. In Quill, the Court noted that "our decision is made easier by the fact that the underlying issue is not only one that Congress may be better qualified to resolve, but also one that Congress has the ultimate power to resolve." Both Quill and its predecessor, *Bella Hess,* made clear that under the Commerce clause states can still tax out-of-state income as long as the Federal government pre-empts the jurisdictional issue though legislation. The Federal government has done this many times in the past with respect to air, rail and bus transportation and other matters.

The FairTax would not explicitly provide that preemption. However, it would encourage states to harmonize their rules, ensure no overlapping taxation and reduce the burden on out-of-state sellers.

Conclusion

Mr. Chairman: the incongruity between an extra-territorial income tax system (as exists in the United States) and the internet will soon become obvious. Without substantial intrusions into our financial privacy and without heavily regulation, the internet will make an already precarious tax system totally voluntary. The internet enables capital to moved around the world with the click of a button. In this environment, anyone who has the desire to, can escape taxation. This Subcommittee must look beyond the popular rhetoric best explained by the phrase "don't tax the internet" to better understand that we already seek to regulate the internet under a tax system that resembles the information age's equivalent of the passenger pigeon. Moreover, if this committee fears special internet taxes or regulations, this Committee should consider what types of rules would need to be in place in order to enforce a tax system based on income.

The FairTax national sales tax will help to neutralize tax policy so that economic decisions over the vitality of the internet will not be based on Congress's choice of winners and losers. The FairTax would harmonize rules so that the internet is not doubly taxed, but can compete head to head against brick and mortar retailers. The FairTax will help to head-off onerous tax regulations that will be required if the income tax remains in place.

While the civilian sector's use of the internet will bring greater prosperity and convenience to Americans, this Committee should never forget that the technological innovations of the 21st Century are in stark contrast to our anachronistic notions of 19th century tax policy. Sound internet tax policy must reflect sound economic policy.

Statement of Andrew F. Quinlan, Executive Director, CapitolWatch

On behalf of CapitolWatch and its 250,000 supporters, I thank you for the opportunity to submit a statement on the general topic of state and local taxes on the Internet. CapitolWatch supports the current five-year moratorium on all Internet taxes, and endorses a permanent ban on Internet taxes, including state and local sales taxes. We endorse a permanent ban, for among other reasons, because there is no connection, or nexus, on which to fairly base these taxes without harming American e-commerce's competitive edge.

CapitolWatch, and its 250,000 supporters, firmly believe that the Internet should remain free of sales and use taxes.

BACKGROUND

States and other local jurisdictions do not have a sufficient nexus, or connection, with Internet companies—whose only contact with the jurisdictions is the fulfillment of an order for a customer—to support sales or use taxes. Any system of sales and use taxes placed on the Internet by various state and local authorities would be Unconstitutional, unwieldy, and discriminatory. Therefore, CapitolWatch feels that Congress should codify the Supreme Court decision in *Quill v. North Dakota* in order that the Internet and the economy can continue to grow and prosper without fear of destructive efforts to over-regulate it.

In Quill the Supreme Court ruled that: "a vendor whose only contacts with the taxing State are by mail or common carrier lacks the 'substantial nexus' required by the Commerce Clause." Although *Quill* was written about direct mail companies, Internet companies are very similar in that they still rely on the mail or common carriers to ship their merchandise to the states. For example, the merchandise could be a plane ticket FedExed or a teddy bear sent through the United States mail. The added contact of the phone line to the customers does not constitute a sufficient Constitutional nexus as the Court also wrote: "we expressed 'doubt that termination of an interstate telephone call, by itself, provides a substantial enough nexus for a State to tax a call.'" Furthermore, a customer viewing a company's Internet Web site has been effectively granted a license to view its software as the Court discussed when it stated: "We therefore conclude that Quill's licensing of software in this case does not meet the 'substantial nexus' requirement of the Commerce Clause."

THE NEED TO MAKE QUILL LAW

More important than the fact that the Commerce Clause clearly makes taxing the Internet Unconstitutional, are the reasons the Court felt so strongly. For the Court has explicitly stated that only Congress can make laws regulating interstate commerce. As long as Congress is considering such laws, it is important that they remember the reasons for the Quill decision and how those reasons are even more valid today.

THE EXPLOSION OF TAXING JURISDICTIONS

The Commerce Clause's nexus requirement is a "means for limiting state burdens on interstate commerce." Any sales or use tax on the Internet would severely burden the Internet and would only get worse as times goes on. An example commonly cited is the difficulty associated with complying with the differing tax laws of multiple jurisdictions. Opponents counter that the states could pass a uniform sales tax. Forgetting for the moment the problems of obtaining the agreement of all 50 states on such a tax—let alone imposing such a tax on those four states that currently have no sales tax—the 50 states constitute just a few of the taxing jurisdictions in the United States today. The number is growing at such an alarming rate that it would be difficult for any Internet company, small or large, to comply with all the rules.

For example, in the 1965 case *National Bellas Hess, Inc. V. Illinois* the Supreme Court stated that: "For if Illinois can impose such burdens, so can every other State, and so, indeed, can every municipality, every school district, and every other political subdivision throughout the Nation with power to impose sales and use taxes. The many variations in rates of tax, in allowable exemptions, and in administrative and record-keeping requirements could entangle National's interstate business in a virtual welter of complicated obligations to local jurisdictions with no legitimate claim to impose 'a fair share of the cost of the local government. "' The *Bellas Hess* court added that: "Local sales taxes are imposed today [1965] by over 2,300 local-

ities." By 1992, the time of the Quill case, the number of jurisdictions had almost tripled. The Court wrote: "North Dakota's use tax illustrates well how a state tax might unduly burden interstate commerce.On its face, North Dakota law imposes a collection duty on every vendor who advertises in the State three times in a single year. Thus, absent the Bellas Hess rule, a publisher who included a subscription card in three issues of its magazine, a vendor whose radio advertisements were heard in North Dakota on three occasions, and a corporation whose telephone sales force made three calls into the State, all would be subject to the collection duty. What is more significant, similar obligations might be imposed by the Nation's 6,000-plus taxing jurisdictions.

A mere eight years later, today the number of taxing jurisdictions has risen to over 7,600, another 25% increase. Even worse, the Advisory Commission on Electronic Commerce wrote that there are over 30,000 potential taxing jurisdictions. Thus, the fears of the burden on interstate commerce, which the Supreme Court expressed in 1965, are even more valid today then at the time they were first mentioned.

THE COST AND CONCLUSION

The cost of such taxes would be devastating. For small firms doing business in the 46 states with sales taxes, the cost could be as high as 87% of the sales taxes collected, according to a report by Ernst & Young. Robert Cline, director of state and local tax policy for Ernst & Young, calls computing sales taxes across state lines "a horror show for retailers."

Such sales taxes would also have the effect of discriminating against the Internet. A traditional brick and mortar business has to comply with one sales tax, while an Internet business would have to comply with 7,600 a year. This would effectively destroy electronic commerce and halt the Internet in its tracks. According to statistics accumulated by Institute for Policy Innovation, in 1994—the year Netscape made the Internet browser famous—states collected $123 billion in sales taxes. In 1995, as the first real e-commerce transactions started taking place, states collected $132.2 billion in sales taxes. Each year since, as the amount of electronic commerce taking place over the Internet grew, state revenues rose—$139.4 billion in 1996, $147.1 billion in 1997, and $155.3 billion in 1998. The Internet has been such a driving force behind the new economy that it helped provide the states with an $11 billion in surpluses in 1998.

Therefore, Congress should follow the well-reasoned logic of the Supreme Court and pass a law permanently banning the application of sales and use taxes on the Internet. The Subcommittee on Oversight of the Ways & Means Committee should get the ball rolling and exercise their jurisdiction and pass a law banning sales taxes on the Internet and thus codify Quill.

CapitolWatch would be glad to answer any additional questions that the committee may have and may be contacted at 202–544–2600 or visit us on the Web at "http://www.CapitolWatch.

Statement of Deloitte & Touche LLP

Mr. Chairman and Members of the Subcommittee:

Deloitte & Touche LLP appreciates this opportunity to present its views on the numerous issues encompassing the taxation of electronic commerce to the Oversight Subcommittee of the House Ways and Means Committee.

Deloitte & Touche is a one of the world's leading business advisory firms with 28,000 people in more than 100 cities in the United States and operations in over 130 countries. Deloitte & Touche serves nearly one-fifth of the world's largest companies as well as large national enterprises, public institutions and fast-growing companies.

INTRODUCTION

On October 1, 1999, Deloitte & Touche hosted a group of leading policymakers, economists, accountants, and attorneys from throughout the country at University of California, Berkeley to examine policy options concerning e-commerce taxation. Consequently, a report was drafted to help the Commission and Congress understand the issues involved and to provide criteria for assessing and evaluating the many different ideas, proposals, and methods for "fixing" the taxation of electronic commerce.

The advent of the Internet and e-commerce is revolutionizing the way individuals communicate, changing the way government interacts with and provides services to its citizens, and altering the way business operates—particularly with respect to the sale of goods and services to other businesses and to consumers. This dynamic evolution means there are many different constituencies involved in this debate, including state and local governments, traditional "brick and mortar" businesses, "dot.coms," financial intermediaries and consumers. The testimony presented here captures the key points of the Berkeley report by providing a framework of issues and questions that the Subcommittee should review when considering different proposals.

BACKGROUND

The dramatic increase in e-commerce and Internet usage is changing businesses operations, creating new sources of revenue, and eclipsing traditional laws and practices. At the heart of this new medium is the fundamental issue of sales and use tax collection.

State governments fear erosion of the state sales tax base. State sales tax collections rank second only to property tax and there is concern that a massive migration of companies to the Internet will reduce state and local revenue. Just as the Internet has forced businesses and individuals to address new challenges, it will also require state and local governments to reassess the fundamentals of sales and use tax imposition and collection.

On the other hand, vendors and consumers would not welcome an expansion of inefficient and burdensome sales and use taxes applied to Internet sales by remote vendors. State sales tax is inefficient and burdensome in its application to remote vendors. The complexity of compliance, tax base definitions, rates, and the sheer number of jurisdictions are only a few of the problems making sales tax an undue burden on vendors. For example, large multistate corporations often waste valuable resources to file tens of thousands of returns each year, merely to remain compliant.

PROPOSAL CRITERIA

Several proposals before Congress are intended to address some or all of the many issues presented in this debate. The proposals range from simply extending the current moratorium on multiple and discriminatory taxes on electronic commerce for an additional five years to completely replacing the sales and use tax collection systems of each state with a single streamlined "Interstate Sale and Use Tax Compact" adopted by all 50 states.

As the Subcommittee examines these various issues, Deloitte & Touche suggests that a set of criteria be used to assess each proposal. The questions stated below are broken down into six general areas: simplification, taxation, burden on sellers, international aspects, technology, and government autonomy. These questions represent guidelines for further research and discussion and establish a baseline of criteria that the Subcommittee should address as it considers the feasibility of each proposal. The Subcommittee will find few if any clear answers. It must, however, consider all of these issues if it seeks to find a balanced and acceptable solution.

Simplification

Clarification: Does the proposal fundamentally simplify the existing system of sales tax collection? (Examples include common definitions, clarification of nexus standards, and a single tax rate per state.) A new system should be characterized by simplicity, uniformity, neutrality and efficiency.

Definition: Does the proposal define, distinguish, and propose to tax information, digital goods, and services provided electronically over the Internet? Tax systems that lack clear definition may increase compliance and enforcement costs on businesses.

Compliance and Record Keeping: Does the proposal permit or require standardization of record keeping requirements and tax return information? Compliance costs and record keeping requirements impose a tremendous burden on businesses. Typical compliance burdens include identifying each taxing jurisdiction, defining various products for tax purposes, determining exemptions, defining the tax base, and establishing sourcing rules. Moreover, tax returns vary widely from state to state; return and payment due dates vary from quarterly to monthly; and there is no central registration point for uniform application registration that covers all sates. Further complicating matters is the fact that taxpayers are subject to separate audit by all states—and, in some instances, by separate cities and counties.

Standardizing these requirements would enhance simplification, increase the productivity of technological solutions, and reduce the compliance burden on busi-

nesses. Any new tax system should allow time for companies to modify their tax and accounting systems. Any broadening of the collection responsibilities should include compensation for vendors, protection against penalties for good-faith compliance efforts, and sufficient lead-time to implement changes to business processes and systems.

Audit Protection: Does the proposal protect against wasteful multiple audits? Auditing to curb tax evasion is a necessary component of any tax system. However, multiple audits are economically difficult to justify and result in an increased tax burden. A new system should coordinate audits, which would lead to increased economic efficiency.

Multiple Jurisdictions: Does the proposal provide for a single uniform system of assessing and collecting sale and use tax? Costs to comply with multiple taxing jurisdictions include increased labor, training, computer systems, audits, and others. Frequent changes to tax rules and forms can make compliance complicated and costly, and software systems designed to assist compliance can be expensive to implement and maintain.

TAXATION

Tax Burden: Does the proposal impose new or increased taxes on Internet access or Internet sales? Does it result in new taxes on consumers? Would the proposal reduce or increase telecommunication taxes? Does it reduce or increase taxes, licensing fees, or other charges on services designed for access to or use of the Internet?

Revenue Base: What will the impact of the proposal be on the revenue base of federal, state, and local governments? Changes in tax revenue generally must be offset immediately or in the future by expenditure or other revenue changes in government budgets. The net impact of a particular policy should take into account additional effects of likely revenue or expenditure offsets. Additionally, revenue estimates resulting from implementing changes to current sales tax systems should take into consideration changes in behavior by both consumers and businesses.

Physical Presence: Does the proposal impose any tax related burdens. Does the proposal impose licensing or reporting requirements, collection obligations, or other fees on parties other than those with a physical presence in a particular state or political subdivision?

Uncertainty: Does the proposal provide the tax certainty necessary for effective business planning? Does each proposal address the current uncertainty surrounding sales and use tax obligations, which results in businesses structuring contracts and making capital investment decisions solely for the purpose of reducing taxes. Often, such behavior is economically inefficient. Proposed changes to the existing tax system should be structured to reduce incentives to avoid sales and use tax obligations. In evaluating various tax policy options, consideration should be given to how business behavior may change.

BURDEN ON SELLERS

Compliance Burden: Does the proposal remove the financial, logistical, and administrative compliance burdens of sales and use tax collections from sellers?

Discrimination: Does the proposal treat purchasers of like products or services the same when implementing a new policy or system? Does the proposal discriminate against out-of-state or remote vendors or among different categories of vendors?

One question that is not yet fully answered is the extent, if any, to which sales growth from e-commerce transactions have drawn sales from traditional mail order and retail businesses. If e-commerce sales are substituting for other sales, then there is a potential for revenue loss. However, if consumers continue to purchase goods at retail stores and through mail order catalogues as well as making online purchases, then the potential for revenue loss is not as great. This question will be difficult to answer until studies measuring the revenue impact of each category of consumer goods are conducted—for example, comparing book sales of "Main Street" stores with sales of online stores.

Small Business Exception: Does the proposal include any special treatment with respect to small, medium-sized, or start-up businesses? Compliance costs can be far greater and the tax burden far more onerous for small businesses. The establishment of de minimus rules would help limit the negative impact on small businesses.

INTERNATIONAL ISSUES

Competitiveness: Does the proposal enhance U.S. global competitiveness? Can the proposal be scaled to the international level?

International Conformity: Does the proposal conform to international tax systems, including those that are based on source rather than on destination? Is the proposal harmonized with the tax systems of U.S. trading partners?

With growing international economic integration, households and businesses have ever-greater opportunities to choose foreign vendors for the products they seek. Failure to extend any sales or use taxes imposed on U.S.-based vendors to foreign vendors would result in a competitive disadvantage for U.S. vendors.

TECHNOLOGY

Feasibility: Is the proposal technologically feasible, utilizing widely available software to enable tax collection? What are the initial costs of this new collection system and the costs required for updating the new system? Who would bear those costs?

Privacy: Does the proposal protect the privacy of purchasers? From an economic standpoint, it should be recognized that a trade-off between efficient collection and administration of a new tax system and privacy of consumers may be necessary. This is particularly true if the new tax collection system is operated by a third party.

GOVERNMENT AUTONOMY

Constitution: Is the proposal constitutional? The constitutionality of a proposed method is a question of law, not economics. It should be noted, however, that a positive relationship often exists between good laws and economics of efficiency.

Sovereignty: Does the proposal protect the sovereignty of states and Native Americans? How does the proposal treat local governments' autonomy and their ability to raise a greater or lesser amount of revenues depending on the needs and desires of their citizens?

CONCLUSION

Long-term solutions to this issue will not be resolved easily or quickly. The ultimate approach to e-commerce taxation requires thoughtful consideration of the many ways such policies affect e-commerce vendors, the industry, state and local governments, consumers, and the global economy.

Deloitte & Touche supports the Subcommittee's efforts to work towards an equitable solution that satisfies the many parties involved in this debate.

For additional information, please contact Martin McClintock, Managing Partner, National E-Business Tax Services Group at 408.920.2430 (e-mail: mmcclintock@dttus.com) or Richard Prem, Partner, National E-Business Tax Services Group at 415.783.4518 (e-mail: rprem@dttus.com).

Statement of Frank G. Julian, Operating Vice President and Tax Counsel, Federated Department Stores, Inc., Cincinnati, OH

INTRODUCTION

Federated Department Stores, Inc. ("Federated") is pleased to present its views on certain aspects of the collection of state and local sales and use tax on Internet sales to the Subcommittee on Oversight of the Committee on Ways and Means of the U.S. House of Representatives.

The author of this presentation is Frank G. Julian, Operating Vice President/Tax Counsel for Federated. Federated is one of the nation's leading department store retailers. Headquartered in Cincinnati, Ohio, it operates more than 400 department stores in 33 states under the names of Bloomingdale's, Macy's, Lazarus, The Bon Marché and others. Federated also has a significant direct mail catalog and electronic commerce business with its Fingerhut, Bloomingdale's By Mail, Macy's By Mail and Macys.com subsidiaries.

Although Bloomingdale's By Mail, Macy's By Mail and Macys.com are each separate subsidiaries, they collect sales tax on sales into any state where Bloomingdale's and Macy's, respectively, have department stores.

SUMMARY OF POSITION

Federated supports the "Majority Policy Proposal" contained in the April, 2000 Report to Congress submitted by the Advisory Commission on Electronic Commerce (the "ACEC").

Moreover, Federated believes that the myriad of state and local sales tax systems that are in place today are too complex; these systems should be substantially simplified and made more uniform. Federated also believes that all sellers that are required to collect sales tax should receive a collection allowance from the respective states to compensate them for the costs of collecting sales tax.

Finally, Federated believes that Congress should not pass any legislation that would give states the right to require sellers without physical presence in a state to collect that state's sales tax unless and until (i) the states substantially simplify their sales tax systems and make them more uniform, (ii) such simplification has been fully and fairly evaluated by an objective group, and (iii) all sellers are assured that they will receive a reasonable collection allowance for collecting sales tax.

DISCUSSION

The ACEC hearings raised an awareness, in an unprecedented manner, of the level of complexity burdening the current sales tax system. Even though the ACEC could not reach a two-thirds majority on the nexus issue, there was near universal agreement that the 46 different state sales tax systems are in dire need of substantial simplification.

Federated collects and remits over $1 billion per year in sales tax for the state and local governments where it does business. It incurs substantial costs in collecting and remitting these taxes, and in administering the many audits that follow. Substantial simplification of the sales tax systems will make it much easier for the states to administer and enforce the tax, and will make it much easier for sellers to comply with the tax.

Set forth below are just a few examples of some of the burdensome complications and complexities of the current system:

1 *Determination of Taxable Items.* Determining the taxability of certain categories of products, such as clothing, food and medicine, is extremely complicated for a multi-state business. Several states exempt these items, in whole or in part, but the states all have different definitions and/or interpretations for the same general exemption. As a leader in the apparel industry, Federated is most familiar with the challenges imposed by the clothing exemptions. There are nine states with permanent or temporary clothing exemptions. Handkerchiefs, for example, are considered clothing, and thus exempt, in five of these states, but are not considered "clothing," and thus taxable, in the remaining four. The software that is available today cannot accurately determine the taxability of all articles of clothing in these nine states, because each state has its own set of peculiar rules. To accurately tax an article of clothing in a multi-state environment, the retailer must assign one of dozens of "clothing product codes" to each and every item, or SKU, which that retailer sells. Whether you are an e-commerce retailer with 30,000 SKU's, or a department store with 3 million SKU's, the current compliance burdens are overwhelming. It is critical for the states to adopt single, uniform definitions of food, clothing and medicine, so that the "product code" decision is a simple choice. Although development of new software is also important, the key to success lies in simplification and uniformity.

2. *State and Local Tax Rates.* There are currently over 7,000 different state and local jurisdictions across the country that impose a sales tax. Although there is software available that can determine, with a reasonable degree of accuracy, the tax rate by Zip Code, there are many Zip Codes in which more than one sales tax rate applies. Before states are permitted to require remote sellers to collect sales tax, there should only be one sales tax rate per state. Moreover, as a matter of fairness and equity, this rate should apply to in-state sales as well as to remote sales. It would be grossly unfair to consumers as well as sellers if the states are permitted to impose one rate for sales made by remote commerce and another rate for sales made in local stores.

3. *Collection Allowance.* It is extremely expensive for sellers to collect and remit sales tax. Studies have shown that the cost to collect sales tax is typically greater than 3% of the tax collected. However, of the 45 states with a sales tax, only seven provide for an uncapped collection allowance of over 1%. As a matter of fundamental fairness, all sellers should receive a reasonable and adequate collection allowance for the sales taxes they are required to collect.

4. *Exempt Customers.* The sales tax systems should be able to accommodate purchases by customers that are entitled to various types of exemptions in a manner that does not impose burdens on either the seller or the customer. A non-exhaustive

list of these exemptions includes: purchasers with resale certificates, purchasers with direct pay permits, sales to charitable organizations, sales to religious organizations, sales to foreign diplomats, certain sales to Native Americans, sales to governmental agencies, etc.

5. *Privacy of Customers.* Maintaining customer privacy will be critical to the success of a sales tax system, particularly for sales made over the Internet. Under no circumstances should a retailer ever be required to disclose the name and/or address of its customers to the states or to any agent of the states.

6. *Third Party Gift Sends.* Under current law, if a person who lives in California, for example, orders a gift to be sent directly to a third party in New York, neither state may impose a sales or use tax on the transaction. California has no authority to tax the transaction because neither title nor possession of the merchandise was transferred to the buyer in California. New York cannot impose its tax on the buyer because the buyer lacks nexus in that state, and it cannot impose its tax on the recipient of the gift since the recipient did not pay any consideration for the merchandise. A sales tax system will be constitutionally flawed if it is unable to recognize this type of transaction.

7. *Applicability to Mail Order and Check Sales.* The position of many who have commented on this issue presumes that all payments are by credit card, which, in fact, is not the case. A substantial portion of direct marketing customers pay by check, and for certain market segments, checks and money orders remain the preferred method of payment for a majority of customers. Sales tax systems must address the many difficulties associated with these type of sales.

This is far from an exhaustive list of the problems sellers face under the current sales tax systems or of the elements that need to be implemented before "substantial simplification" can be deemed to have occurred. These examples, however, make it clear that the existing sales tax systems are in dire need of substantial simplification. Moreover, Federated believes that there should be an independent, objective evaluation of any simplification adopted by the states before Congress passes any legislation that would permit states to require sellers without physical presence in a state to collect that state's sales tax. Finally, states should not be permitted to require sales tax collection unless they provide for a reasonable and meaningful collection allowance to the sellers that collect the tax.

Statement of International Council of Shopping Centers, Alexandria, VA

The International Council of Shopping Centers (ICSC) appreciates this opportunity to present its views to the Oversight Subcommittee of the House Ways and Means Committee on the need to apply existing state sales and use taxes to electronic commerce.

ICSC is the global trade association of the shopping center industry. Its 40,000 members in the United States, Canada and more than 70 other countries around the world include shopping center owners, developers, managers, investors, lenders, retailers and other professionals. The shopping center industry contributes significantly to the U.S. economy. In 1999, shopping centers in the U.S. generated over $1.2 trillion in retail sales and over $47 billion in state sales tax revenue, and employed over 11 million people.

Simply stated, ICSC believes that all goods, regardless if they are purchased over the Internet, via catalog or in traditional retail stores, should be subject to the same state and local tax collection requirements. One form of commerce should not receive preferential tax treatment over another. Unfortunately, existing tax law is structured to favor electronic commerce over sales made in local retail stores.

Contrary to popular belief, it is not the existing moratorium on Internet taxes that precludes states from requiring out-of-state retailers to collect sales and use taxes on their behalf. Instead, it is a 1992 Supreme Court case, Quill v. North Dakota, that held that remote merchants are not required to collect sales and use taxes for states in which they do not have substantial physical presence or "nexus." The moratorium—which expires in October 2001—applies only to access charges and new, multiple and discriminatory taxes on electronic commerce.

ICSC does *not* support the enactment or implementation of Internet access charges, or new, multiple or discriminatory taxes on electronic commerce. Instead, we believe that existing sales and use taxes should be collected uniformly on all types of retail sales. The taxes which states should be able to require remote sellers to collect are not new taxes. Instead, they are existing use taxes which buyers are currently obligated to remit to their state and local governments. However, as a

practical matter, most individuals are either unaware of their tax obligations, or simply do not bother to comply.

ICSC supports electronic commerce and believes it should be fostered. In fact, many traditional brick-and-mortar retailers are incorporating Internet commerce into their businesses in order to obtain new customers and better serve existing ones. However, as a matter of fairness and sound tax policy, Internet-based retailers should not receive a competitive advantage over traditional brick-and-mortar merchants simply because electronic commerce is a new and growing form of transacting business.

Although the extent to which Internet sales will displace traditional retail sales is unknown at this time, the competitive tax advantage that Internet-based retailers currently enjoy could negatively affect many local retailers, shopping centers and their communities in the near future. Not only would traditional retailers sell fewer goods, but their employees would suffer from reduced working hours, wages or layoffs.

In addition, state and local governments would receive less sales tax revenues that go to provide essential public services (i.e., education, police and fire protection, road repairs). Governments that rely heavily on sales tax revenues would either have to cut back on such services or increase other taxes on local businesses and residents, such as property and income taxes. If governments decide to increase sales tax rates to make up for lost revenues, lower-income individuals would have to pay an even higher disproportionate share of their income on sales taxes since they are less likely to own computers and purchase products on-line.

It is this reason why many state and local governmental organizations support a level playing field for all types of retail sales. These government groups include the National Governors Association, Council of State Governments, National Conference of State Legislators, U.S. Conference of Mayors, National Association of Counties, National League of Cities and International City and County Management Association.

Our critics assert that electronic commerce is a new and growing industry and, therefore, should not be saddled with "old world" sales tax collection requirements. They say we should not kill the goose that lays the golden egg. Our response is that, while electronic commerce is a growing and important part of our economy, subjecting it to the same sales tax collection requirements that traditional merchants have been subject to for decades would not harm its growth or vitality. Electronic commerce will continue to flourish, regardless of whether or not sales and use taxes are imposed on it.

These critics also claim that forcing Internet retailers to collect sales and use taxes for the thousands of state and local taxing jurisdictions across the country would be too burdensome on electronic commerce and cannot be done. We agree that all businesses, especially small businesses, should not be overburdened by sales tax collection requirements and that state and local governments need to simplify their sales tax systems. However, inexpensive software exists today that can assist electronic retailers in determining how much sales and use taxes needs to be collected on their out-of-state sales.

Another argument made by our opponents is that states and localities are flush with cash and do not need to tax electronic commerce. While it is true that most state and local governments are currently enjoying budget surpluses, there is no guarantee that this economic prosperity will last indefinitely. (In fact, Kentucky and Tennessee are currently experiencing budget deficits. Their Governors strongly believe that collection of their states' use taxes would be extremely beneficial to their economies.) If and when our economy softens, many state and local governments, as well as traditional merchants, could suffer significant financial harm, especially if electronic commerce continues to displace traditional sales tax bases.

ICSC is disappointed that the Advisory Commission on Electronic Commerce failed to reach agreement that all retailers should be on a level playing field with regard to state and local sales taxes. Even more so, we are disappointed at the process of the Commission itself. To begin with, even though a traditional local retailer was supposed to be represented on the Commission, no such individual was appointed.

Second, the Commission sent a report to Congress that was agreed to by only 10 out of 19 Commissioners, clearly short of the 13 votes that was required under the *Internet Tax Freedom Act.* Third and most importantly, the majority report fails to address the level playing field issue.

Instead, it recommends (although not through an official "finding" or recommendation") that Congress permanently extend the moratorium on Internet access charges, extend for five years the moratorium on multiple and discriminatory sales taxes, repeal the 3-percent telecommunications excise tax, establish special

"nexus" carve-outs for Internet-based businesses, and create sales tax exemptions (such as those on "digitized" goods and their "non-digitized" counterparts) that would directly benefit the "business caucus" members of the Commission.

ICSC does not oppose the actual substance of the current moratorium (e.g. its ban on Internet access charges and new and discriminatory taxes). However, we are deeply concerned that the longer the moratorium is extended, the more difficult it will be for Congress to level the playing field for all retailers with regard to existing sales and use taxes. Therefore, we oppose legislation, such as the *Internet Nondiscrimination Act* (H.R. 3709), that would extend the moratorium for five years but not subject Internet merchants to the same tax collection requirements as traditional retailers. ICSC, however, would support legislation that provides for a short-term extension of the moratorium (e.g., two years), so long as it also allows states that simplify their sales and use tax systems to require remote sellers to collect and remit use taxes to such states.

The U.S. Supreme Court has recognized Congress' authority to enact legislation that would allow state and local governments to require out-of-state retailers to collect sales and use taxes. Therefore, we urge Congress to enact legislation that would level the playing field among Internet-based and traditional retailers.

Thank you for this opportunity to express our views on this very important matter.

Statement of Joint Venture: Silicon ValleyNetwork, San Jose, CA

SUMMARY OF APPROACHES FOR APPLYING SALES & USE TAXES TO E-COMMERCE
PREPARED BY THE JOINT VENTURE TAX POLICY GROUP

Purpose: The following chart lists eleven approaches representing the types of suggestions for resolving issues of applying sales and use taxes to e-commerce. The approaches are not listed in any particular order. The approaches are analyzed using five criteria that are important to both governments and businesses. The criteria are also not listed in any particular order. The criteria are applied to each of the approaches to indicate the following:

\+ Has a positive impact on meeting this criteria
o Does not appreciably help or hinder meeting this criteria
− Has a negative impact on meeting this criteria

This analysis is intended to provide an objective perspective to understanding and distinguishing various options for applying sales and use taxes to e-commerce. Ideally, this analysis will help to identify a shorter list of approaches -or a combination of approaches that should be further explored.

This analysis only addresses sales and use taxes. E-commerce also raises issues for telecommunications taxes, utility user taxes, and income taxes. To obtain a summary of the approaches, the explanation for the rating (+/o/−) assigned, and a list of observations about the approaches, visit the Joint Venture Tax Policy Group's web site at: "http://www.jointventure.org/i tiatives/tax/tax.html .

Approach/Criteria	Simplifies compliance over multiple jurisdictions	Provides an effective mechanism for collection of tax on purchases from remote vendors	Provides for consistent application of sales and use taxes for all types of commerce	Allows state and local governments to set their own tax system	Does not discriminate against any type of commerce
A. Allow the Internet Tax Freedom Act's moratorium to expire in October 2001	o	o	o	+	+
B. Extend the current federal moratorium on new taxes permanently	o	o	o	−	−
C. Legislatively define nexus (taxable presence) at the federal level for sales and use tax purposes	+	−	+	o	+

Approach/Criteria	Simplifies compliance over multiple jurisdictions	Provides an effective mechanism for collection of tax on purchases from remote vendors	Provides for consistent application of sales and use taxes for all types of commerce	Allows state and local governments to set their own tax system	Does not discriminate against any type of commerce
D. Allow states to collect sales and use tax from remote vendors (reverse Quill)	–	o	+	+	+
E. Have a third party serve as the collector of sales and use taxes	+	o	+	o	+
F. Exempt all or a portion of e-commerce from sales and use taxation	o	o	–	–	–
G. Create federal level tax for remote e-commerce and mail order sales	o	o	+	–	+
H. Apply the origin basis (vendor location) to all sales and use taxes	o	+	+	+	o
I. Simplify existing sales and use tax systems	+	o	o	o	+
J. Educate consumers about the use tax and encourage states to collect it from residents who buy from remote vendors	+	o	+	+	+
K. Resolve issues of applying sales and use taxes to e-commerce in the broader context of improving existing sales and use tax systems	+	+	+	o	+

MINI-GLOSSARY

Moratorium—Refers to the federal Internet Tax Freedom Act (ITFA) which imposes a 3-year moratorium (from 10/1/98 through 10/21/2001) on state and local taxes on Internet access, unless the tax was generally imposed and actually enforced before October 1, 1998. The moratorium also prohibits state and local governments from imposing multiple or discriminatory taxes on e-commerce [Public Law 105–277, 10/21/98]

Nexus—Sufficient nexus must exist in order for a state to subject a vendor to sales and use tax collection obligations. Nexus may be thought of as a connection between the vendor and state such that subjecting the vendor to the state's sales tax rules is neither unfair to the vendor nor harmful to interstate commerce. These two requirements of fairness to the vendor and no impediment to interstate commerce stem from the U.S. Constitution—respectively, from the Due Process Clause and the Commerce Clause. Both of these requirements must be satisfied before a state may impose sales and use tax collection responsibilities on a vendor.

Quill Decision—In this 1992 decision, the U.S. Supreme Court held that North Dakota could not impose use tax collection obligations on an Illinois merchant with no physical presence in the state because it would be contrary to the Commerce Clause. [*Quill Corporation v. North Dakota,* 504 U.S. 298 (1992)]

Remote Vendor—A vendor that does not have a presence in the state for tax purposes. For example, today, vendors must have a physical presence in a state in order for the state to impose use tax collection obligations on them.

Use Tax—This tax complements a state's sales tax and is imposed at the same rate. A use tax generally applies when a taxpayer buys a taxable item outside of the state for use inside the state. For example, when a resident buys a book from a remote vendor, the resident is responsible for submitting the use tax to the state taxing agency.

WHY E-COMMERCE RAISES TAX ISSUES

E-commerce represents a new business model. As such, it creates some challenges to tax systems that were designed with a different model in mind. Two key reasons help explain why e-commerce raises tax issues:

1. Location—Existing tax systems tend to determine tax consequences based on where the taxpayer is physically located. The e-commerce model enables businesses to operate with very few physical locations.

2. Nature of products—E-commerce allows for some types of products, such as newspapers and music CDs, to be delivered in digitized (intangible) form, rather than in tangible form. Digitized products may not be subject to sales tax in some states. Also, the ability to deliver digitized products, as well as services over the Internet also reduces the need for physical locations, thus creating fewer taxing points.

WHO CARES ABOUT SALES AND USE TAXES?

Sales and use taxes are significant revenue sources for 46 of the U.S. states plus the District of Columbia and most other cities. Sales and use taxes represent about 33% of tax revenues for the states, on average. However, the percentage of revenues derived from sales and use taxes varies tremendously among the states. For example, in Nevada, it represents about 85% of the revenue base, 57% for Florida, 21% for New York, and 32% for California.

For California cities, sales and use taxes represent the largest source of general revenues at 27%.

MYTHS & REALITIES

Myth: The ITFA exempts e-commerce transactions from taxation.

Reality: The ITFA provides a temporary moratorium on state and local taxes on Internet access, and multiple or discriminatory taxes on e-commerce. The ITFA preserves state and local taxing authority to the extent a particular tax is not covered under the moratorium. Thus, sales and use taxes still apply to sales of taxable items made via e-commerce.

Myth: The ITFA prevents states from imposing use tax collection obligations on remote sellers.

Reality: The 1992 Quill decision prevents states from imposing use tax collection obligations on remote sellers, not the ITFA.

Myth: Loss of sales and use taxes on e-commerce transactions will not hurt state and local governments. Other revenue sources exist.

Reality: The impact of the loss of sales and use tax revenues varies across jurisdictions. In California, sales and use taxes represent 32% of tax collections at the state level, and for cities, these taxes represent 27% of general revenues. For states without an income tax, the loss is even more significant. Even in states with a corporate and personal income tax, most local governments neither have an income tax nor receive income tax revenue from the state government.

Joint Venture: Silicon Valley Network (www.jointventure.org) is a civic incubator working to ensure that all people in our region have opportunity to succeed in the new economy. Joint Venture introduced to Silicon Valley a model of regional collaboration that is now being replicated across the United States and around the globe. A non-profit organization, Joint Venture is supported by 120 investors representing government, community organizations and industry.

Joint Venture's Tax Policy Group consists of individuals from high tech industry, government, and academia who analyze various state and federal tax rules and proposals to consider the impact to local governments and high tech industries. The Group's current work encompasses international tax reform, worker classification, R&D incentives, major federal tax reform, incentives for donations of technology to K–14, and sales tax issues of electronic commerce. The Group works to promote better understanding of tax and fiscal issues of significance to the Silicon Valley economy, through distribution of its reports and quarterly Tax and Fiscal Newsletter, sponsorship of seminars and discussion forums, and submission of testimony to legislators and tax administrators.

For further information about e-commerce taxation issues and a more detailed explanation of the chart on the reverse side, please see http://www.jointventure.org/initiatives/tax/tax.html.

TAX POLICY GROUP POSITION:
HOW TO ADDRESS TAXATION ISSUES RAISED BY E-COMMERCE

We recommend that the following points be considered in evaluating any legislative proposal to address taxation of electronic-commerce.

1. Treat E-Commerce the Same as Other Forms of Commerce

E-commerce is commerce and in most situations, existing taxation rules adequately address its tax treatment. Thus, strong consideration must be given to any legislative proposal that calls for modifying an existing rule or creating a new rule to address e-commerce transactions, including specifically exempting e-commerce from taxation that applies to other forms of commerce.

2. Changes Must Not Solely Remedy E-Commerce Issues

Our existing sales and use tax had several flaws prior to today's discussions about e-commerce and taxation. Sales and use taxes are regressive, they are a cascading tax, in most states they apply primarily to tangible personal property, there are numerous definitions and special rules and multiple rates that make the system complex, and these taxes cannot be collected from remote vendors, such as mail order or e-commerce businesses. Thus, it would be useful to work on resolving these problems as a whole, rather than isolating the debate to e-commerce. In addition, the global context of e-commerce and taxation must be considered.

3. It's Not Just a Sales Tax Issue

While most e-commerce taxation discussions of the past few years have focused almost exclusively on sales and use taxes, issues also arise for income taxes and telecommunications taxes that must also be explored at the same time.

4. Any Tax Law Changes Must Adhere to Constitutional Principles

Any proposal that is contrary to case law or Constitutional principles should not be considered because enactment of such a law is doomed to court challenge and results in time lost that could have been used to improve the tax system.

5. Local Services Depend on Sales & Use Taxes

For California cities, sales and use taxes represent the largest source of revenue at 27%, a significant portion of which is from business-to-business sales. The issue of sales taxes and the Internet constitute a "double whammy" in that it has the potential to reduce both sales taxes from consumer purchases as well as taxes from business-to-business transactions. This illustrates why local governments are concerned about maintaining sales and use tax revenues that provide core services.

6. There is a Need to Improve California's Fiscal Structure

There is a critical need to examine California's existing fiscal structure in a meaningful manner so that a long-term fiscal strategy can be developed for both state and local governments. This approach will better ensure that tax structures provide both adequate and appropriate revenues to allow for continued economic growth and prosperity.

Why this Issue is Important to Silicon Valley—The Internet and e-commerce are significant elements of the Silicon Valley economy. Many of the companies that enable e-commerce to flourish are located in Silicon Valley. Thus, issues surrounding taxation of e-commerce are a concern for many businesses, individuals, and local governments in Silicon Valley. Joint Venture has been actively involved in seeking to improve our current tax system, including ensuring that it does not hurt the competitiveness of businesses or the fiscal strength of local governments.

More Information: See http://www.jointventure.org/initiatives/tax/taskforce.html.

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DOT.COMMERCE, DOT.TAXES AND LOCAL.GOVERNMENT
PREPARED BY THE JOINT VENTURE TAX POLICY GROUP

Sales taxes and the Internet is one topic that most Americans have heard about, but few of us have a clear understanding of the specific issues or how they might be addressed by various legislative proposals. Similarly, local government services affect everyone, yet their relationship to sales and use taxes is not well known. This article summarizes how sales and use taxes and other revenues relate to local services for citizens and businesses.

The funding of local services

Most California cities rely on four to six primary revenues that fund basic city services, such as fire, police, libraries and parks. As shown below, the primary tax revenues are sales taxes, property taxes, utility users taxes, vehicle license fees, franchise fees, and hotel occupancy taxes.

Typical Revenue Sources for California Cities

Revenue Source	Typical Share of All Revenues	Range, Various Cities
Sales and Use Taxes	30%	13 – 43%
Property Tax	19%	7 – 32%
Utility User Tax	16%	5 – 26%
Vehicle License Fees	14%	6 – 25%
Franchise Fees	6%	2 – 9%
Hotel Occupancy Tax	6%	1 – 15%

Sales and use taxes have eclipsed property taxes as the largest revenue source for cities. This trend is the result of Proposition 13 limits on property taxes, and the diversion of a number of traditional "local taxes" (e.g., liquor license fees and cigarette taxes) to the State. Today, only 14% of property tax revenue is allocated to cities while 16% is allocated to counties, 13% to special districts and 52% to the State.

In 1993, the California Legislature created the Educational Revenue Augmentation Fund (ERAF), which diverted about 18% of property taxes that formerly went to cities, counties, and certain local districts. In 1999, for example, ERAF diverted $2.8 billion from counties, $537 million from cities, and $285 million from special districts to the State.

Another aspect of local revenues that is not well known is how little of the sales taxes we pay at the register is used for local government services. In Santa Clara County, where the sales tax rate is 8.25%, 15% of sales tax revenues fund transportation services and regional transportation improvement measures, and 12% goes to the city where the sale occurred. The remaining 73% goes to the State, where it is used for prisons, education, and other programs.

Beyond the challenge of maintaining existing revenue sources is the difficulty of establishing new revenue sources to meet increasing service demands. State limitations have made it more difficult for cities to create a more diversified tax base (for example, Proposition 218, the "Right to Vote on Taxes Act," a1996 initiative, requires a vote of the people to approve new taxes or increase existing taxes). One of the adverse effects of these limited alternatives is that cities are much more dependent on sales tax revenues to meet increasing demands for municipal services.

Implications of sales and use taxes as the major source of local revenue

Some critics would point out that increasing reliance on sales and use taxes can lead to "fiscalization of land use," whereby cities may feel compelled to seek or even compete for new developments that produce new sales taxes. For instance, a city may approve a development that generates considerable traffic or the need for infrastructure and services in return for needed revenues. If that revenue is later diverted or reduced, the city must still contend with the long-term impacts of servicing the land use decision.

Sales taxes are a fairly volatile revenue source. One aspect of this is tied to changes in the economy: a general drop in retail sales will affect local stores, or changes in a particular industry may cause a major industrial business to no longer be viable, causing a loss in city revenues. Also, when an industrial sales tax generator, such as a software company or an equipment manufacturer, relocates its designated "point of sale" to a facility in another city but otherwise continues to operate its local facility as before, the community has to deliver the same level of service with less revenue.

The link between e-commerce, sales and use taxes, and local services

The issue of sales and use taxes and the Internet constitutes a "double whammy" in that it has the potential to reduce revenues from both consumer purchases as well as from business-to-business transactions. For many cities, business-to-business revenues often equal or exceed business-to-consumer revenues, particularly in the Internet economy where software and equipment sales are a major part of the local

tax base. Internet sales are subject to sales and use taxes—*except* when there is an *electronic delivery* of a product rather than a tangible product such as a CD ROM (some have suggested that the tax code definition of "taxable sale" be amended to be consistent with the transfer of anything that would constitute a "copy" under a software licensing agreement).

The Congressional "Internet Tax Freedom Act" (ITFA) doesn't change any of this. Contrary to popular belief, the ITFA does not eliminate Internet-related sales and use taxes. All sales and use taxes established and in effect prior to ITFA continue to apply, much like sales taxes on catalog sales. The ITFA created a moratorium on new taxes on Internet access, although very few state or municipal governments have even proposed these.

For local governments, the Internet sales tax issue comes down to this: maintaining current rules by which retail and business-to-business transactions provide sales and use tax revenues to fund local government services. Most Internet sales were taxable before ITFA and are still taxable today, and cities are trying to hold on to this fundamental revenue source as they provide services to the "new economy."

All of this illustrates why local governments and business are concerned about maintaining sales and use tax revenues that provide core services. Under California's existing tax structure, the lion's share of city revenues already comes from businesses, and a decline in these revenues would impact the ability of cities to provide the basic services expected by citizens and businesses alike.

A more detailed analysis and summary for addressing Internet sales tax and related tax reform issues can be found at http://www.jointventure.org/initiatives/tax/taskforce.html.

[An additional attachment is being retained in the Committee files.]

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