

## Internet Taxation: A Software Solution

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### Overview

1. The growth of Internet commerce has presented policy makers with a host of complex new issues over the last few years, from encryption to broadband access. One of the most vexing problems, however, is not a new issue, but an age-old one: taxation. On the one hand, free-market libertarians argue that online retail transactions should stay beyond the reach of the Tax Man (and if new technologies would sound the death knell for nearly all government, so much the better). On the other hand, state and local officials, in particular, view the Internet as a tide that will erode local and regional tax bases with devastating consequences as more and more sales move from the brick-and-mortar retailers on "Main Street" to the ether of Cyberspace.
2. Federal lawmakers have rightly taken a deliberate, go-slow approach to the problem. The Internet Tax Freedom Act of 1998 wisely imposed a three-year moratorium on new "discriminatory" taxes on the Internet.[1] and created the Advisory Commission on Electronic Commerce to study the Internet taxation issue.[2] The nineteen-member commission, which has three representatives from the federal government, eight from state and local government, and eight from the electronic commerce industry, will report its findings to Congress in the spring of 2000.
3. In the interim, several Internet tax bills have been introduced in Congress. In January of this year, Senator Bob Smith (R-NH) introduced S. 328.[3] a bill that would make the moratorium permanent. In July, Senator Ernest Hollings (D-SC) introduced S. 1433, which would impose a five percent national sales tax on all remote sales, including Internet, mail-order catalogues, and by phone.[4] The Smith bill has been referred to the Commerce Committee, while the Hollings bill was referred to the Finance Committee, but no other actions have been taken on either. We believe that neither bill adequately addresses the issue and that a third way is needed with regard to Internet taxation.
4. The Internet Tax Freedom Act prohibits the creation of new state, local, or federal taxes on Internet access or electronic commerce until October 2001.[5] Therefore, as the Advisory Commission works to fulfill its mandate, now is the time to move beyond simplistic rhetoric and dire warnings, and to explore viable solutions to what the Progressive Policy Institute (PPI) believes should be the obvious conclusion: states and municipalities should be able to tax Internet sales.

### Principles

5. Policy makers should adhere to three key principles as they craft a system for taxation of remote sales over the Internet:
  - Fairness.**
    6. As is stipulated in the Internet Tax Freedom Act, any solution should apply not only to Internet transactions, but also to all remote transactions, including mail order and telephone-based sales.[6] Otherwise, the system would unfairly discriminate against e-commerce. Conversely, not taxing remote transactions, including e-commerce, unfairly discriminates against traditional face-to-face transactions that are taxed.
  - Simplicity.**
    7. The solution should not place an innovation-stifling burden on the digital economy. It should be easy for lawmakers to implement and even easier for businesses to use. (In fact, it should add value to the economy by introducing new opportunities for companies engaged in electronic commerce.) And, as is stipulated in the Internet Tax Freedom Act, any solution should be technology-neutral.[7]
  - Limited Scope.**
    8. Sales should be taxed, but use of the Internet itself should not. In other words, Congress should prohibit taxing data transmissions (through "bit taxes"), network services (through Internet Service Provider taxes), or anything else that would amount to a tax on the medium itself.
    9. The advent of e-commerce should not be viewed as a threat or a potential windfall for state and local governments' tax bases. Assessing taxes on Internet sales should, all else being equal, have no effect on state and local tax revenues—what is lost as a result of decreasing face-to-face sales will be offset by gains from increasing online sales. Moreover, states and localities should continue making their own decisions about the relative weight of sales tax rates, and other tax rates, just as they always have. A federally imposed system should simply provide a framework to enable that process in remote transactions.

### What's at Stake?

10. Some who advocate taxing Internet sales argue that not doing so is unfair to "Main Street" businesses—and further risks putting them out of business. But while the first argument is fair, the second misses the point. The goal of public policy should not be to protect or insulate any business or industry from changes in the marketplace. Public policy should certainly focus on ensuring that workers dislocated in the churning of the new economy have access to skills training and other assistance to make the transition into new jobs, but it definitely should not try to erect barriers to protect existing businesses that may lose out in the digital marketplace. If consumers choose Internet sellers over Main Street sellers and some of the latter go out of business, that is simply a result of healthy competition in the marketplace, leading to increased economic efficiency and added value for consumers. For example, while large category-killer retail chains (in sectors such as books, hardware, and electronics) have caused many small, independent companies to go out of business, they have also led to a significant boost in retail productivity and lower prices for American consumers. The same will be true on the Internet, where an increasingly digital economy will disrupt existing patterns of business. The bottom line is that e-commerce, even if it is subject to sales tax, will lead to lower prices and higher value, and hence effectively higher real incomes for Americans.
11. On the other side of the spectrum are those who mistakenly argue that applying sales taxes would be tantamount to regulating the Internet. In their view, subjecting purchases conducted over the Internet to sales tax is the same as taxing the Net itself. These are some of the same cyber-libertarians who would desperately like to believe that the advent of the Internet is the harbinger of the practical demise of government altogether.
12. In the end, however, clearly state and local governments should be able to tax sales transacted over the Internet, if for no other reason than as a matter of fairness. Why should sales conducted over the Internet be exempt from taxes levied at a corner hardware store? That would be the functional equivalent of subsidizing e-commerce companies at the expense of traditional brick-and-mortar companies. Public policy should do everything possible to grow the Internet and the digital economy, but the steps it takes must be fair.
13. In a recent study, Ernst & Young LLP estimated that sales and use taxes not collected from Internet sales in 1998 amount to less than \$170 million, representing one-tenth of one percent of total state and local government sales and use tax collections.[8] Therefore, the study rightly concludes that there is time to carefully construct a fair, efficient, and easily administrable tax system for state and local governments in the Twenty-first Century. In fact, the drafters of any new federal legislation may want to provide for a several-year period to craft and test any solution before implementation.

### A Complex Problem?

14. Many who have debated this issue have made it more complicated than it needs to be. Some cite the difficulty of locating the nexus in online transactions. They ask: If the consumer is in California accessing the Internet through Virginia-based America Online and the seller is in Washington, with distribution facilities in Oregon and servers somewhere else, who gets to levy the tax? Some argue that sales taxes on the Internet would result in thousands of taxing authorities in the United States, creating a tangle of tax schemes. They rightly argue that Web merchants should not have to file tax forms and collect different taxes at separate rates for every jurisdiction where a customer is located.
15. The simplest solution that best addresses the concerns of states and municipalities in this regard, is to levy sales taxes according to the location of the buyer. State law already offers precedent for this approach. Buyers are legally required to pay "use taxes" (equivalent to the sales tax rate in their state) on all remote purchases where the seller does not have a physical nexus in the buyer's state.[9] But few people are aware of this requirement, and even fewer pay the use taxes.

### The Software Solution

16. Among those who believe that sales taxes must be imposed on Internet sales for fairness and fiscal responsibility reasons, there are some who propose the seemingly simple solution of a uniform national sales tax on all remote sales, with the revenues proportionately allocated among the various local jurisdictions.
17. But there are two problems with this approach. First, a flat national tax on e-commerce alone would create unfair biases both for and against e-commerce. In states that have no sales taxes it would create an unfair bias against e-commerce, and a bias in favor of e-commerce in states where the regular sales tax rate is higher than the national rate on e-commerce. Second, a federally imposed sales tax denies states the right to create and manage their own tax structures. For example, states could combine low, or non-existent sales taxes with higher property or income taxes, or some other combination.
18. We propose a different solution, one that uses the technology of the medium, and that is ultimately fairer for states and local governments. The system would work as follows: An organization (perhaps the Federation of Tax Administrators) would contract out to develop software that listed the state and local sales tax rates on all categories of items for all state and local tax districts in the nation. Retailers would download the free "shareware" software over the Internet. The system would be technologically neutral, designed to be incorporated easily into commercial web sites running on any computing platform. When a consumer makes an online purchase, the software would check the tax rates in the area to which the consumer has the product shipped. If the product is software or music that is downloaded instead of physically shipped, the tax would be determined according to the consumer's home or work address, as appropriate. The software would then display the tax rate along with all other charges, as on any standard receipt. When the consumer makes the purchase, he or she would simply pay the full amount (purchase price, sales tax, shipping and handling, etc.) electronically, most likely by credit card. The software would include routing numbers for each sales tax jurisdiction bank account, and the merchant's software would automatically transfer the sales tax funds via electronic funds transfers directly to the government bank account(s). For example, if a merchant collected \$600 in sales tax from residents in a particular county in a particular state, where the state sales tax is four percent and the local is two percent for a total tax of six percent, the software would remit \$400 to the state's bank account (along with an electronic form that lists the merchant's name and other pertinent information), and \$200 to the county bank account.

19. One of the main benefits of a system like this is that it would allow state and local governments to maintain their independent discretion in determining tax rates. Obviously, this would mean that tax rates will continue to fluctuate over time. Therefore, for this system to work, state and local governments would have to be able to update the master system on an annual basis with their current tax rates. Retailers, in turn, will have to regularly download the latest versions of the software.
20. Contrary to the dire predictions of the cyber-libertarian crowd, such a software system could actually add value for online consumers. For example, if the system were developed with open source code (that is, with the core programming instructions freely available to anyone), personal finance software developers could write compatible programs to help consumers keep track of their online spending, perhaps by automatically filing "e-receipts" under appropriately defined categories on their home computers.

### Beyond the Internet, Beyond the United States

21. The Internet Tax Freedom Act directed the Advisory Commission on Electronic Commerce to ensure that any recommendation submitted to Congress apply to all forms of remote commerce, not just to e-commerce conducted over the Internet.[10] This is as it should be. A system that taxed e-commerce but not other remote transactions would be neither fair nor economically efficient. Such a system would essentially penalize the channel, giving consumers incentive to exploit the differences to find the best prices (e.g., finding the item to purchase online, and then ordering by phone to avoid paying a sales tax). Clearly, the same rules should apply to all remote sales. Therefore, in order for a software-driven system to work properly, there will need to be several versions of the software, allowing easy integration into any business back office computer systems. Furthermore, for small businesses without complex order processing systems, a database of state and local sales tax rates will need to be available for use over the Internet. Small business owners should simply be able to go to a Web site, plug in an address, and find the appropriate tax rate for a sale to a customer in that location. Once this system is developed and effectively implemented in the United States, the U.S. government should work through the World Trade Organization, the Organization for Economic Cooperation and Development, and other appropriate bodies to reach world consensus on this sort of software mechanism for collecting and remitting local, regional, and national sales taxes.

### Conclusion

22. As a matter of fairness and fiscal responsibility, remote sales should not be beyond the reach of state and local tax jurisdictions, regardless of whether they are conducted over the Internet or through catalogues. Further, those state and local jurisdictions should not have to cede their independent authority to a federally mandated flat sales tax system. Therefore, the most logical solution is to use the same tools that enable e-commerce to construct an easy-to-use mechanism for businesses, consumers, and governments alike to operate in the digital economy of the Twenty-first Century.

## Footnotes

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[\*\*] Randolph Court is a technology policy analyst at the Institute.

[1] Pub. L. No. 105-277, § 1101, 112 Stat. 2681-719 (codified in 47 U.S.C. 151 Note); *see also*, Taxing the Internet, Democratic Leadership Council, Washington, DC, April, 29, 1998. <http://www.dlcppi.org/briefing/b980429.htm>.

[2] § 1102, 112 Stat. At 2681-722; *see also*, <http://www.ecommercecommission.org>.

[3] S. 328, 106th Cong. (1999).

[4] S. 1433, 106th Cong. (1999).

[5] § 1101(a), 112 Stat. At 2681-719.

[6] § 1102(g)(2)(D)(ii), 112 Stat. At 2681-723.

[7] *Id.*

[8] Robert J. Cline and Thomas S. Neubig, The Sky is not Falling: Why State and Local Revenues Were Not Significantly Impacted by the Internet in 1998, Ernst & Young LLP, Economics Consulting and Quantitative Analysis, June 18, 1999 (The study did not include business-to-business sales taxes lost, claiming that most are either not subject to taxes or already pay a use tax. However, many small business online purchases are subject, and the companies do not pay use taxes. Therefore, the \$170 million figure probably underestimates the true revenue loss).

[9] In cases where the seller has nexus, the buyer must pay sales tax.

[10] 1102(g)(2)(D)(ii), 112 Stat. At 2681-723.

## Author Biographies

**Rob Atkinson** joined the Progressive Policy Institute (PPI) in October 1997 to head up its new Technology, Innovation, and the New Economy Project. Previously he served as executive director of the Rhode Island Economic Policy Council and as a senior analyst and project director at the former Congressional Office of Technology Assessment (OTA). While at OTA, he directed The Technological Reshaping of Metropolitan America, a report examining the impact of the information technology revolution on America's urban areas. Dr. Atkinson has a Ph.D. in City and Regional Planning from the University of North Carolina at Chapel Hill. He has testified numerous times before Congress, has been an invited speaker at conferences around the world, and has been published extensively on economic development and technology policy.

**Randolph Court** joined PPI in June 1998 as a policy analyst for the Technology, Innovation, and the New Economy Project. He was previously a business reporter for Wired News in San Francisco, covering the computer and telecommunications industries in Silicon Valley. Court was also a researcher and freelance writer for the Red Herring, a San Francisco magazine covering the business of technology. He received his Master's degree in journalism from the University of California at Berkeley in 1997. He has also worked as a general assignment reporter for the San Diego Daily Transcript and received his undergraduate degree in American Studies from the University of California at Santa Cruz in 1992

## Discussion

Name: John Fraser Title: Managing Director Affiliation: Kroll Associates	Why isn't marketplace pressure sufficient? Is the regulation necessary, or will consumers who desire anonymity learn to use anonymizer services and not use services that fail to protect the customer's identity?
Name: Christopher Gatewood Title: Editor in Chief Affiliation: Va J L & Tech	Currently there seems to be a lack of consistent reporting, or at least awareness, to site visitors as to the privacy policies of a given Internet service. The question becomes whether that gap is best filled by regulation, or if we wait for reporting mechanisms and anonymizer programs to catch up.
Name: Richard W. Boone Jr. Title: Editor-in-Chief Affiliation: Va J L & Tech	The crux of this proposal seems to be the increased procedural safeguards that require judges to scrutinize the underlying merits of a claim before a subpoena is issued. In many instances this is impossible to do without allowing the plaintiff some discovery. Moreover, procedural and ethical requirements are already in place that prevent attorneys from filing meritless suits and abusing discovery. If these requirements are not enough, it does not seem that additional rules would be any more effective.