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RADICAL REFORM OF THE STATE SALES AND USE TAX: ACHIEVING SIMPLICITY, ECONOMIC NEUTRALITY, AND FAIRNESS

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I. INTRODUCTION

America is focusing on the wrong issues in debating the taxation of electronic commerce — if it is debating the issues at all. Some (e.g., Senator John McCain and Congressmen John Kasich and John Boehner) are suggesting that all electronic commerce should be exempt from sales tax — a patently absurd idea, because it would gut the sales tax.[1] Others more appropriately are debating whether vendors making "remote sales," those that cross state lines, should be required to collect and remit use tax, the tax levied on the purchasers in such transactions (but rarely collected from consumers) because states lack the power under our Constitution to levy sales tax on the transactions. Recognizing that the answer to that question will not be positive — and it should not be — unless the state sales and use taxes are simplified,

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1. The McCain bill would prohibit "sales or use taxes for domestic or foreign goods or services acquired through electronic commerce." S. 1611, 106th Cong. (1999). The Boehner and Kasich bill contains similar prohibitions. *See* H.R. 3252, 106th Cong. (1999). Since all would amend the Internet Tax Freedom Act (ITFA), they incorporate by reference the following language from the ITFA: "Electronic commerce — The term 'electronic commerce' means any transaction conducted over the Internet or through Internet access, comprising the sale, lease, license, offer, or delivery of property, goods, services, or information, whether or not for consideration, and includes the provision of Internet access." Internet Tax Freedom Act, H. R. 3529, 105th Cong. (1998). It would be simple to conduct transactions, including those made over the counter, in such a way as to qualify for the exemption.

some are asking what kind of simplification would be required to gain the *imprimatur* of either the U.S. Congress or the U.S. Supreme Court. It is uncertain whether the Court would condone an expanded duty to collect use tax, even if the taxes were simplified. In addition, it is unclear procedurally, as well as politically, how to gain congressional support for an expanded duty to collect. The National Governors' Association ("NGA") has suggested that a combination of moderate simplification, technology, and state assumption of the costs of compliance would allow a "voluntary" solution that would bypass these sticky issues.[2]

America should seize the opportunity to replace the archaic and anarchic sales tax "system" inherited from the industrial age with a streamlined system that is appropriate for the 21st century. Doing so will require radical reform, not tinkering. There will be some loss of state sovereignty, but not over anything that matters. The benefits — simplification, economic neutrality, fairness, and preservation of state (and perhaps local) sovereignty over sales tax rates — are far more important.

The Article does not present the arguments that sales to households conducted via electronic commerce — and, indeed, other forms of remote commerce — should be subject to tax (provided there is adequate simplification), as I have done that elsewhere.[3] These views are not idiosyncratic, as indicated by an "Appeal for Fair and Neutral Taxation of Electronic Commerce" that has been signed by more than 170 academic tax specialists.[4]

This Article presents the case for radical reform. It begins by describing briefly an ideal sales tax and defects of the current system. Following a description of proposals to "tinker" with the system, it indicates in broad terms how to eliminate the defects. The last section comments briefly on the most difficult problem — and the one that is

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2. *See* Michael O. Leavitt, *Streamlined Sales Tax System for the 21st Century* (visited June 1, 2000) <http://www.ecommercecommission.org/proposal.htm>.

3. *See Federalism in the Information Age: Internet Tax Issues: Hearing Before the Senate Comm. on the Budget*, 106th Cong. (2000) (statement of Charles E. McClure, Jr., Senior Fellow, Hoover Institution, Stanford University). *See generally* Charles E. McLure, Jr., *The Taxation of Electronic Commerce: Background and Proposal*, *in* PUBLIC POLICY AND THE INTERNET: PRIVACY, TAXES, AND CONTRACTS (Nicholas Imparato ed., 2000); Charles E. McLure, Jr., *Rethinking State and Local Reliance on the Retail Sales Tax: Should We Fix the State Sales Tax or Discard It?*, 2000 BYU L. REV. 77 (2000).

4. *See Federalism in the Information Age: Internet Tax Issues: Hearing Before the Senate Comm. on the Budget*, 106th Cong. (2000) (attachment to statement of Charles E. McClure, Jr., Senior Fellow, Hoover Institution, Stanford University).

unique to electronic commerce — sales of digital content. The Appendix contains a more detailed description of my proposal (and its rationale), which I presented to the Advisory Commission on Electronic Commerce ("ACEC") at its December meeting in San Francisco.[5]

II. A SALES TAX SYSTEM FOR THE 21ST CENTURY

A sales tax should generally exhibit several key characteristics.[6] Fortunately — and unlike the situation in many debates on tax policy — these characteristics are largely complementary; that is, meeting one objective commonly furthers other objectives, rather than impeding their achievement. I elaborate on this point in Section V.

Taxation of only consumption. First, only sales to consumers should be taxed; all sales to business should be exempt (or tax collected on sales to business should be allowed as a credit against tax on sales, as under the value-added tax). Collection of tax on sales to business distorts a variety of economic decisions, including the choice of whether to buy or self-produce taxed inputs, where to locate production, and — if capital goods are taxed — whether or not to save and invest. Exemption of all sales to business would be far simpler than the present system of basing exemption on the buyer's use of the product.

Destination-based taxation. Second, tax should be imposed, to the extent possible, by the jurisdiction where consumption occurs, not where production occurs (stated differently, at the destination of sales, not the origin of sales).[7] Destination-based taxation requires that

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5. *See* Charles E. McLure, Jr., Presentation Before the ACEC (Dec. 15, 1999), *available at* <http://www.ecommercecommission.org/sanfran/tr1215.htm>. In this Article, I am somewhat less generous to the NGA proposal than I was before the ACEC. Some of the notes to the Appendix contain comments on the original proposal.

6. *See generally* Charles E. McLure, Jr., *Taxation of Electronic Commerce: Economic Objectives, Technological Constraints, and Tax Law*, 52 TAX L. REV. 269 (1997) [hereinafter *Taxation of Electronic Commerce*]; Charles E. McLure, Jr., *Electronic Commerce, State Sales Taxation, and Intergovernmental Fiscal Relations*, 50 NAT'L TAX J. 731 (1997); Charles E. McLure, Jr., *Electronic Commerce and the Tax Assignment Problem: Preserving State Sovereignty in a Digital World*, 14 ST. TAX NOTES 1169 (1998); Charles E. McLure, Jr., *Achieving a Level Playing Field for Electronic Commerce*, 14 ST. TAX NOTES 1767 (1998); Charles E. McLure, Jr., *Electronic Commerce and the U.S. Sales Tax: A Challenge to American Federalism*, 6 INT'L TAX & PUB. FIN. 193 (1999).

7. Cross-border shopping — buying products over-the-counter in one subnational jurisdiction for use in another — inevitably interferes with the achievement of this objective. It is likely to be much more problematic at the local level than at the state

exports from a state not be taxed and that imports be taxed like local sales.

A destination-based tax has several advantages. It is more likely than an origin-based system to reflect where public services are consumed. For example, schools provide benefit where people live, not where the products they buy are produced. It is also less likely to distort the location of economic activity. Finally, an origin-based system is likely to engender a "race to the bottom" (via industry-specific exemptions or a zero tax rate) if imposed on foot-loose activities like many of those related to electronic and other remote commerce, such as servers and call centers.[8]

Uniform taxation. Third, the sales tax of a given state should be imposed at uniform rates on a broad (comprehensive) base; that is, there should be few exemptions or special rates, if any.[9] This approach minimizes the need for merchants and tax administrators to distinguish between taxed and untaxed products, avoids distortions of consumer choices, and allows low tax rates.

Simplicity. Fourth, taxation should be as simple as possible, consistent with the achievement of other objectives. I have already mentioned the simplicity benefits of uniform taxation of all sales to households and exemption of all sales to business. The criterion of simplicity has important implications for the harmonization of taxes imposed by states and localities: tax bases, tax laws, regulations, and administrative procedures should be similar from state to state, if not identical. If all states employed the same tax base, a vendor making over-the-counter sales in one state would automatically know whether a sale to a customer in another would be taxable or exempt in the state of destination. Similarly, if laws and regulations were uniform across the nation, familiarity with the laws of one state would provide familiarity with the laws of other states. Finally, there should be de

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8. *See* Wade Anderson & Andrew Wagner, *Guidelines for Establishing An Origin-Based Sales Tax*, 18 ST. TAX NOTES 915 (2000) (proposing a scheme that would avoid a "race to the bottom" in setting tax rates). Anderson and Wagner's proposal, however, would encourage location of foot-loose economic activities in states that have no sales tax. In addition, it is not an origin-based tax in the usual sense of the term, since states of origin do not keep the revenue from the tax.

9. The only argument for exemptions that has any substance is the desire to reduce tax on low-income individuals. It is not persuasive in states where refundable income tax credits can be used to offset the burden of the sales tax. Exemptions of, for example, food and clothing are extremely blunt and inefficient instruments, considering the complexity and shrinkage of the tax base they entail.

minimis rules that excuse those making only small amounts of sales from the duty to collect tax.[10]

Transparency. Fifth, taxation should be transparent, so citizens know the cost of government. Taxes should not be hidden, as when sales to business are subject to tax.

Sovereignty of state and local governments. Sixth, state governments should be able to exercise sovereignty over the level of tax rates applied to the consumption of their citizens. Similarly, it would be desirable if local governments could also exercise autonomy over tax rates.

A further comment on sovereignty. The above criteria differentiate between state and local control of sales tax rates and control of other aspects of the sales and use tax. Control over tax rates is crucial if citizens are to control the size of state and local government. It is much less important that states — and especially localities — have sovereignty over details of the tax base (what is taxed and what is exempt), other aspects of the tax law, and administrative procedures; such sovereignty is antithetical to the achievement of simplicity for vendors doing business in multiple states, especially those engaged in remote commerce. I return to this point in the next section.

A note on nexus. Nexus — whether a remote vendor has sufficient presence in the taxing state to justify a duty to collect use tax — is not mentioned above, although it is at the center of the current controversy over the taxation of electronic and other remote commerce. This omission is entirely appropriate. If, and only if, the system is simple enough, there should be no distinction between local vendors and remote vendors — provided, of course, that sales of the latter exceed a de minimis amount. The proposals in section IV reflect this proposition.

III. DEFECTS OF THE PRESENT SYSTEM

The present sales and use tax system fails to satisfy any of the first five criteria set forth in the previous section. Some proposed solutions would eliminate the autonomy of local governments in determining tax rates. I consider that issue in the next section.

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10. This statement is deliberately vague; it could apply only to remote vendors or to local merchants, as well. In the case of remote vendors, the de minimis threshold should depend on the degree of simplification achieved; the more simplification, the lower the threshold could be. For the proposal offered here, the threshold could be quite low.

Taxation of sales to business. It has been estimated that an average of forty percent of the revenues from sales and use taxes are derived from sales to business.[11] The distortions inherent in the taxation of business inputs may have been tolerable in the "old" (pre-digital) economy, which did not function with the efficiency ascribed to it by the standard economics textbook. Tax-induced distortions will be increasingly troublesome in the "new" economy, which will be far more efficient. I think of the difference in pouring a handful of sand in the gears of an ancient clock with wooden gears, compared to letting a few grains of sand into the works of a fine Swiss watch. The old economy — like the old clock — is much more forgiving than the new. State lawmakers should note that, by taxing sales to business, they are putting local business at a competitive disadvantage relative to businesses in other states.[12]

Lack of uniformity. The sales taxes of the individual states are far from uniform in their application to different products. Although most tangible products are taxed in all sales tax states, many products may not be taxed in a given state. Moreover, most states do not tax services and intangible products.[13] If all sales to consumers were taxed uniformly, tax rates could be substantially lower.

Lack of transparency. The cost of government is substantially understated because of the taxation of sales to business, which is unknown to most consumers. If, for example, the average tax rate is 6 percent and 40 percent of tax revenues come from sales to business, the true tax rate is closer to 10 percent.[14]

Complexity. State sales and use taxes are incredibly complicated.[15] There are two aspects to this complexity: the complexity experienced

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11. *See* Raymond J. Ring, Jr., *Consumers' Share and Producers' Share of the General Sales Tax*, 52 NAT'L TAX J. 79 (1999).

12. In thinking about this issue, one should ignore the taxes that other states may impose on their business by taxing business inputs. The objectives should be to allow exports from the state to occur tax-free and to levy the same local taxes on local products as on imports from other states. If business inputs are taxed, both objectives are compromised, regardless of what other states do.

13. Telecommunications and electric utilities are an exception to this generalization; they are commonly subject to taxation that far exceeds that on other goods and services.

14. The artificial reduction in rates that results from the hidden taxation of business inputs is in no way comparable to the artificial increase in rates resulting from the exemption of many products. Whereas the former is hidden, the latter is obvious.

15. *See* Robert J. Cline & Thomas S. Neubig, *Masters of Complexity and Bearers of Great Burden: The Sales Tax System and Compliance Costs for Multistate Retailers*, 18 ST. TAX NOTES 297 (2000).

by merchants who operate in only a single state and the complexity experienced by those that operate in more than one state.[16] Although I focus on the latter, the former is not unimportant. Fortunately, any sensible solution to the latter is likely also to reduce the former.

To understand the nature and magnitude of the problem, the reader should consider the plight of a merchant considering making sales throughout the country. There are four readily identifiable sources of complexity: interstate differences in the tax base, interstate differences in the tax treatment of sales to business, interstate differences in laws (aside from the tax base) and procedures, and the need to determine the local destination of sales within some states, to apply the proper local tax rate, and to earmark payments to the appropriate local jurisdictions. I consider the first three of these sources of complexity here and the fourth in Section V.

First, whether a given item is taxed or exempt depends on the law of the destination state. The varied tax treatment of peanuts — depending on whether they are raw, roasted, salted, freeze-dried, caramel-coated, etc. — is often cited as an example of excessive distinctions. There are many other examples, however, especially in the treatment of food and clothing.[17] The distinction between tangible products (generally taxable) and intangible products and services (generally exempt) also creates headaches, especially since some states try to shoe-horn new products into old categories. It is hardly surprising that the U.S. Supreme Court — first in *National Bellas Hess, Inc. v. Department of Revenue*[18] and later in *Quill Corp. v. North Dakota*[19] — found that it would be an unreasonable constraint on interstate trade to require remote sellers to collect use tax unless they had a physical presence in the taxing state.[20]

16. I ignore the complexity that is found in the small number of "home-rule" states that allow local governments to deviate from the state tax base. It is axiomatic that this source of complexity should be eliminated by prohibiting all such deviations. This elimination could require revisions of the constitutions of some states.

17. A gift basket that contains cheese, crackers, and a knife may contain one, two, or three taxed products, depending on the law of the state of destination. *See* JOHN F. DUE & JOHN L. MIKESELL, SALES TAXATION: STATE AND LOCAL STRUCTURE AND ADMINISTRATION ch. 4 (1994); *see also* Cline & Neubig, *supra* note 15, at 303 (noting that states have recently started exempting purchases of particular products made during certain periods; for example, children's clothes purchased during August).

18. 386 U.S. 753 (1967).

19. 504 U.S. 298 (1992).

20. This is not the only reason that the Court decided *National Bellas Hess* and *Quill* as it did. In both cases the Court noted the number of local jurisdictions that levied sales and use taxes or might have the authority to do so. *See National Bellas Hess*, 386

Second, layered on top of these interstate differences in the tax base are interstate differences in the tax treatment of sales to business of products that would be taxable if sold to households.[21] All states exempt sales of goods to be resold. Beyond that, diversity reigns; for example, some states exempt products to be physically incorporated in taxable products, while others also exempt products to be used directly in producing taxable products. The draft "uniform exemption certificate" prepared by the Multistate Tax Commission is far from uniform.[22] It would apply to only 36 of the 46 states that levy sales tax.[23] In addition, there are 25 footnotes and the following warning at the end, ". . . seller must exercise care that the property or service being sold is of a type normally sold wholesale, resold, leased, rented or incorporated as an ingredient or component part of a product manufactured by buyer and then resold in the usual course of its business."[24] In other words, whether a given product would be taxed when sold to a business depends on the use the customer intends to make of the product — something the seller may not be in a good position to know or to verify, especially if the seller is located several thousand miles away.[25]

Finally, in addition to the problems just described, there are interstate differences in laws and procedures. A merchant must register, file returns, and remit taxes in each state in which it has a duty to collect use tax. Moreover, there is a risk of being audited by each state. Such diverse and duplicative procedures may impose a significant burden, even for merchants that make over-the-counter sales in multiple states. For purely remote vendors there would be a particularly onerous burden, because the laws governing registration, filing, and payment vary from state to state. These problems could be greatly ameliorated by de minimis thresholds. The states, however, provide virtually no meaningful thresholds for remote vendors.

U.S. at 760; *Quill*, 504 U.S. at 313.

21. *See* DUE & MIKESELL, *supra* note 17, ch. 3.

22. *See* Multistate Tax Commission, Uniform Sales & Use Tax Certificate (Aug. 9, 1999) <http://www.mtc.gov/news&vws/cert8_99.PDF>.

23. Counts of the number of states that levy sales taxes commonly include the District of Columbia. Five states (Alaska, Delaware, Montana, New Hampshire, and Oregon) do not levy general sales taxes.

24. *Id.* at 2.

25. Cindy Oakes of the Tax Department of Dell Computer Company has emphasized the complexity of collecting use tax on sales to business customers. Dell does not collect use tax on sales to non-business customers. *See* Cindy Oakes, Testimony before the ACEC (Dec. 15, 1999) <http://www.ecommercecommission.org/sanfran/tr1215.htm>.

Failure to tax interstate imports. Because of the complexity of this system, including the need to attribute sales to local jurisdictions, the U.S. Supreme Court ruled in *National Bellas Hess*[26] and *Quill*[27] that a state could not require a remote vendor to collect its use tax unless the vendor had a physical presence in the taxing state. While some such nexus rule is entirely reasonable and necessary to prevent an unacceptable burden on interstate trade,[28] these decisions create a competitive advantage for remote vendors relative to local merchants — a situation that is untenable from an economic point of view.[29] Moreover, the de facto exemption of remote sales undermines the revenue potential of the sales and use tax, or requires tax rates needed to raise a given amount of revenue to be slightly higher than if all remote sales were taxed. As electronic commerce increases the ability of remote vendors to compete., both of these problems will become increasingly important Exactly how important depends on whether or not nexus rules are relaxed, as the majority of the ACEC has proposed.[30]

IV. TINKERING

The way to eliminate the defects described in the previous section is implicit in the ideal system described in Section II. I turn to the required reforms in the next section. First, I discuss briefly several approaches that I think do not go far enough; at the risk of being unfair, I am tempted to characterize them as merely tinkering with the existing

26. 386 U.S. 753, 758 (1967).

27. 504 U.S. 298, 315 (1992).

28. This is not to say that the physical presence test is the proper one — only that more than the minimal presence required for nexus under the Commerce Clause is appropriate to prevent an unreasonable burden on interstate trade.

29. Given the ubiquity of fallacious arguments, whether because of honest error or disingenuousness, it is appropriate to address the argument that local vendors really experience no competitive disadvantage because of the need of remote vendors to pay costs of transportation. This argument confuses two issues: whether transportation costs prevent remote vendors from displacing local sales (they may) and whether it is appropriate to consider transportation costs as an offset against taxes in thinking about competitive advantage (it is not). Hardly anyone would suggest that a tax imposed on cars produced in America, but not on cars imported from abroad, would not put American car manufacturers at a competitive disadvantage, just because imported cars must cross the ocean (or at least the Canadian border); that argument, however, is exactly analogous to the one under discussion. It is not obvious why those who make this argument single out transportation costs to offset against taxes. The fundamental point is that one should consider whether a given tax discriminates between two ways of providing the same product, taking account of all the costs of each.

30. Estimates of revenue effects universally ignore these effects.

system.[31] These are the approaches considered by the National Tax Association Communication and Electronic Commerce Tax Project ("NTA")[32] and the proposal of the National Governors' Association ("NGA").[33] Rather than describing those alternatives in full, I concentrate on the six issues mentioned in Section II. Note, however, that the following discussion does not directly correspond to the categories employed in Sections II and III.

Sales to business/transparency. Both the NTA and NGA proposals are silent on the need to eliminate tax on sales to business. Neither of the proposals would eliminate this source of complexity and economic distortions, nor would they reveal the hidden tax burden implicit in taxing sales to business.

Uniformity of base. Both the NTA and NGA projects would hold sacrosanct the power of the individual states to determine their sales tax bases. The NTA considered the possibility of proposing a uniform menu of products; each state could indicate whether it would tax each product. Although there was mention of the need for a similar menu describing treatment of sales to business, the issue was not discussed. The NGA seems to have had the use of menus in mind, but this is not clear.

Complexity. Although the use of a uniform menu would be an improvement over the present situation, substantial complexity would remain. The menu might contain 10,000 products — or more. Moreover, any product that would be taxed if sold to consumers might be exempt if sold to a business, depending on its intended use. The NGA would address this complexity in two ways: through a

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31. The proposals approved by the majority of the ACEC do not deserve detailed attention. Because the majority had different objectives (self-interest of the business members and the ideological viewpoints of the government representatives who voted with them), the proposals do not seriously address any of the six issues discussed in Section II. Here, in a nutshell, is what they would do: (1) taxation of sales to business: silent, (2) comprehensive tax base: narrows the tax base, (3) complexity: mixed (reduces uncertainty by narrowing nexus; increases uncertainty by exempting digital products and tangible equivalents), (4) destination-based taxation: expands preference for remote vendors, (5) transparency: not much effect, except to the extent higher taxes on sales to business are required to replace lost revenues, and (6) state sovereignty/local autonomy: reduces autonomy by reducing the tax base. The majority report was submitted in direct contradiction to the statutory requirement of a two-thirds majority. *See generally* Advisory Committee on Electronic Commerce, *Proposals*, (visited June 1, 2000) <http://www.ecommercecommission.org/proposal.htm>.

32. *See* NATIONAL TAX ASS'N COMM. & ELEC. COM. TAX PROJECT, FINAL REPORT (Sept. 1999) <http://www.ntanet.org/ecommerce/final.pdf>.

33. *See* Leavitt, *supra* note 2.

technological fix involving the use of trusted third parties and compensation of vendors for the remaining costs of compliance. Aside from the economic distortions it implies, this approach is faulty on two counts: (1) threats to privacy inherent in the trusted third party approach, and (2) the social costs inherent in the needless sacrifice of attainable simplicity, which would be merely papered over by shifting such costs from vendors to state governments.

Destination-based taxation. The basic purpose of the NGA proposal — and of those members of the NTA Project who actually sought a solution — was an expanded duty to collect use tax, in exchange for reduction of compliance burdens.

Technological fixes. The NTA Project considered three ways of simplifying compliance and administration. The "base-state" approach would be patterned after the International Fuel Tax Agreement, under which truckers register, file returns, and pay taxes on motor fuels in only one state or a participating Canadian province. The base state would distribute information and revenue to other states (the latter through a multistate clearinghouse). Whereas the base-state approach works well for the relatively simple case of excises on motor fuels, it probably would not work satisfactorily for sales and use taxes, in the absence of substantial uniformity of tax bases, laws, and administrative procedures, since tax administrators in each state would need to know the tax base and tax law of every other state to administer their taxes.

The "real-time" system would rely on links between merchants and remote computers — operated, for example, by financial institutions — for application of relevant taxes, transmittal of information on transactions, and matching of transactions information with applicable state tax bases. It raises concerns about privacy because it would require communication of vastly more information than is now transmitted for the processing of credit-card charges.

The NGA would rely on "trusted third parties" to process transactions, somewhat like the "real-time" approach. It would rely heavily on software that exists or could be prepared for the purpose; in either case, the software would be made available at public expense. This approach creates concerns about privacy.

State sovereignty/local autonomy. Whereas the NGA would maintain local autonomy over local sales and use tax rates, the NTA group was split over whether it would be necessary to restrict tax rates to one per state — in effect, by having a uniform local tax rate.

Summary. In short, the NTA Project and the NGA proposal both focused primarily on gaining just enough simplification to justify an expanded duty to collect use tax. Neither seriously addressed the fundamental problems described above: taxing business purchases, the lack of a comprehensive tax base, or the complexity and lack of transparency implied by these attributes. They each addressed the question of one-rate-per-state differently.

V. ACHIEVING THE IDEAL

To achieve the ideal described in Section II would require radical reform of the state sales and use taxes, not just tinkering and technological fixes; indeed, with the type of reforms I advocate, technological fixes would be useful, but they might not be essential. In this section, I discuss primarily the tax treatment of sales of tangible products. I turn to the much more difficult problem of taxing intangible products (digital products downloaded from the Internet) in the next section.

Exempt all sales to business. The exemption of all sales to business would have several obvious benefits, aside from achieving the economically correct result. It would greatly simplify compliance and administration. Moreover, it would force state and local governments to become more honest about the cost of government.

The primary weakness of this proposal is the need for the vendor to know whether the buyer is eligible to make tax-exempt business purchases. Presumably this weakness would be a problem primarily in the case of relatively small businesses, or, more accurately, household purchases masquerading as business purchases. The key would be linking audit of sales and use tax exemptions to federal income tax deductions; no sales or use tax exemptions should be allowed for purchases that do not qualify for income tax deductions.

Uniform taxation of sales to consumers. There are two aspects of uniformity in the taxation of sales to consumers: uniformity within a state and uniformity across states. The first would eliminate existing distortions of consumer choices and allow a revenue-neutral reduction in rates. The second aspect is perhaps more important, as it would simplify compliance for multistate vendors. The objective is to allow a multistate vendor to know the tax base of all states simply by knowing the base of one state. This requires uniformity of the base, not merely a uniform menu from which states can choose their tax bases.

Uniform laws and procedures. Achieving the maximum simplification for the multistate enterprise would require unification of laws and procedures. Ideally the sales tax laws of all states — and their corresponding regulations — would be made uniform in a manner resembling the Uniform Civil Code. Vendors would be allowed to register, file returns, and make payments in only one state, which would then pass on information and revenue to other states. Joint audits would be conducted on behalf of all states. With a tax law that is essentially uniform in all respects except rates, a base-state system becomes feasible.

De minimis rules. Meaningful de minimis rules could reduce substantially, and perhaps eliminate, any complexity for small vendors that is not eliminated by the uniformity described above. This reduction is important for political reasons, as well as being required as a matter of sensible public policy. It would disarm those who warn that "mom and pop" e-commerce firms would confront a maze of complexity if asked to collect use taxes on remote sales. Firms with de minimis sales to a state would not be required to collect the state's use tax.

Expanded duty to collect state use tax. With the type of simplification described above (exemption of sales to business, a uniform tax base adopted by all states, uniform laws and procedures, and a de minimis threshold), an expanded duty to collect state use tax would not be unreasonable, as it would not greatly burden interstate trade. Remote vendors would know the tax base and the laws and procedures in all states because they would be the same in all states. All that would be required is to record the state to which sales are made and later remit the appropriate amount of tax to the base state. The base state then would distribute the tax among the various states. The playing field would be level in two respects: remote vendors would collect the same tax that local merchants collect, and the compliance costs of remote vendors would approximate those of local vendors. The only difference would be the need for remote vendors to record the destination of sales, but it does not seem that this would impose a major compliance burden. If it did, vendors' discounts could be adjusted to compensate accordingly. To the extent that tax collections are higher than they otherwise would be because of the taxation of remote sales, tax rates could be cut.

Note that this solution does not depend on a technological solution. Clearly a vendor with a computer could handle the accounting and produce the spreadsheet showing taxes collected on behalf of customers in various states more easily than a vendor operating without a computer. The solution proposed here, however, could be implemented without computers, at least if there were only one rate per state.

A fall-back position: uniform suboptimality. The proposals to eliminate all tax on sales to business and to tax all sales to consumers uniformly imply enormous changes that are politically questionable. A fallback position would be for all the states to agree on the same, non-comprehensive tax base and identical rules for taxation of sales to business. While this would needlessly sacrifice economic benefits, simplification, and transparency, it would at least achieve the objective that a merchant in any state would know the tax base of every other state.

The remaining question: Is local autonomy possible? The previous discussion referred deliberately to an expanded duty to collect state sales and use taxes, thereby begging the question of whether local tax rates can continue or "one rate per state" is required. This is an issue on which I am somewhat agnostic. Clearly, one rate per state is simpler. On the other hand, one rate per state involves enormous loss of local fiscal autonomy, not to mention important practical problems in the short run; for example, the fact that sales tax revenues have been pledged to retire bonds. My own guess is that, with the radical simplification proposed above, it would be possible for remote vendors to trace sales to local jurisdictions and apply and remit the applicable sales and use taxes, especially if the states were willing to compromise a bit, for example, by condoning the use of postal ZIP codes to assign taxpayers to local taxing jurisdictions. In such a situation, a minimal technological fix would be necessary. However, without simplification, there is a needless layer of complexity to ask vendors to deal with.

An alternative would be to allow local variations in sales tax rates, but not use tax rates. The result would be far from elegant, but it would probably work. Such an alternative system would encounter the most trouble in states having a wide range of sales tax rates. No single selection of a use tax rate — such as the highest sales tax rate, lowest rate, or average rate — would be truly satisfactory in those states.

Complementariness of proposals. The various elements of the radical reform proposed here all contribute to the achievement of important objectives. Eliminating tax on sales to business contributes to simplicity and transparency, as well as economic neutrality. Taxing all consumption spending avoids economic distortions and is much simpler than differentiating between products. Together these reforms make it reasonable to impose an expanded duty to collect use tax on remote vendors and avoid the distortions and inequities inherent in preferential taxation of remote commerce. Moreover, it is probably possible to accommodate local choice of sales and use tax rates, an important component of local fiscal autonomy.

VI. TAXATION OF DIGITAL CONTENT

Taxation of digital content downloaded from the Internet raises questions that do not arise — or that arise in much attenuated form — in the case of tangible products. There are at least two distinct problems: (1) the difficulty of locating the destination of digital content sold by domestic vendors and (2) the risk that untaxed foreign competition will undermine the competitive position (as well as tax revenues) of the United States in markets for these products.

Sourcing sales of digital content. With current technology the vendor of digital content may not know the location of its customers.[34] The NTA Project considered the possibility of using the billing address of the buyer to determine the putative destination of digital content. I believe that this idea would work, although I recognize that there are a number of concerns, including privacy issues and the possibility that consumers would use fake mailing addresses in no-tax states (with remailing of credit card bills) to evade the tax.[35] An alternative, which might be used only as a backstop if the mailing-address regime fails, would be application of a nation-wide tax to only this type of commerce, with revenues distributed among states through the use of a formula — what Hellerstein calls a "throwaround rule."[36]

International sales of digital content. Digital content sold over the Internet by foreign vendors poses additional problems. Unlike tangible products, digital content does not stop at the customs house or the post office. Moreover, digital content can be bought using money that cannot be traced; for example, stored value cards similar to pre-paid telephone cards, digital cash downloaded from the Internet, or

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34. *See* Walter Hellerstein, *State Taxation of Electronic Commerce*, 52 TAX L. REV. 425, 487–94 (1997); James Eads, et al., *National Tax Association Communications and Electronic Commerce Tax Project Report No. 1 of the Drafting Committee*, 13 ST. TAX NOTES 1255 (1997). The classic cartoon showing one dog saying to another as they sit before a computer, "[o]n the Internet no one knows you are a dog," tells only half the story; for present purposes it is more important that no one knows the location of the dog.

35. Much has been made of the fact that someone traveling with a laptop computer can download content while away from home. This problem does not seem to be particularly important despite the difference in the treatment of tangible products bought over-the-counter while traveling (taxed where bought) and intangible products downloaded while traveling (sourced to the purchaser's mailing address).

36. *See* Walter Hellerstein, 52 U. MIAMI L. REV. 691, 704–05 (1998). The analogy is to the throwback rule employed under state income tax systems to attribute, or "throwback," to the state of origin sales that would otherwise be attributed to states that lack jurisdiction to tax corporate income. *See id.* at 703–04.

credit/debit cards issued by financial institutions located in tax-haven countries. Where these conditions are found together, tax administration may be virtually impossible. The fear of competition from foreign vendors of digital content leads some to conclude that it may be necessary to exempt all sales of digital content. That conclusion raises the specter of needing to exempt all tangible products that compete with digital content to preserve technological neutrality. The majority of the ACEC took this position in the Commission's final report. Exempting so much of the modern economy — including software, music, video, games, and publishing — would have a devastating impact on revenues, not to mention economic neutrality and equity.

Detailed consideration of these issues is not possible in this article. I offer the following ideas for discussion. International cooperation among economically advanced countries, for example, among members of the Organisation for Economic Cooperation and Development ("OECD"), might be adequate to handle the threat that tax-free digital content would be marketed from foreign countries. Sales from abroad by subsidiaries of U.S. corporations need not be beyond the reach of state taxing authorities. This consideration is important because it implies that it may be necessary for Americans to create a foreign "dot.com" company to avoid a duty to collect use taxes. Cooperation with other member countries of the OECD might prevent tax-free exploitation of American markets by either firms operating or resident in those countries or the subsidiaries of firms resident in the OECD. Issues such as those described in the first part of this Section would be encountered. In this case, a "throwaround" approach might be more appropriate than the mailing address approach suggested for domestic use. The primary problem would thus seem to involve firms that (a) operate in countries that do not belong to the OECD, such as developing countries and tax-haven countries, but (b) are not subsidiaries of firms that are resident in the OECD. Although this problem should not be dismissed lightly, it is probably not great enough to exempt all digital content and similar tangible products.

The degree of international cooperation implied by the "solution" just described would be troubling to many. Yet the alternative seems to be an unacceptable situation in which digital content, and perhaps tangible substitutes therefor, is exempt from taxation.

VII. POLITICAL OBSTACLES

I am not naive enough to believe that it will be easy to achieve the radical reforms proposed here. This Section mentions a few of the enormous political obstacles to doing so, distinguishing between (a) obstacles to "mere" interstate uniformity and an expanded duty to collect use tax and (b) obstacles to the more ambitious objective of uniformity based on the conceptually correct solution outlined and advocated above.

Interstate uniformity/expanded duty to collect. The first and most obvious obstacle is the community of remote vendors, both traditional and electronic, that has vested interests in the status quo, in which their interstate sales are effectively exempt. The second obstacle is the community of state legislators and governors that, in the name of state sovereignty, defends the right to legislate the minutiae of state sales tax bases. Interstate uniformity would certainly require sacrifice of some of this state sovereignty. Depending on the resolution of the question of local tax rates, local governments officials may also resist reform. The third obstacle is inertia — the fact that it is easier to continue with "business as usual" than to undertake reform, especially when state coffers are full. A fourth obstacle is the lack of political institutions for the simultaneous reform of the sales and use taxes of all the states, or at least of enough states to form a critical mass. The National Conference of Commissioners on Uniform State Laws ("NCCUSL") may play a pivotal role in formulating a policy that could be adopted by the states; I discuss this below. A fifth obstacle is the difficulty of gaining congressional approval of an expanded duty to collect, even if there is a multistate agreement for uniformity. Congress does not seem to be prone to grant the states the power to require remote vendors to collect use tax, which the public would probably interpret as a tax increase, even though the tax liability already exists. A sixth obstacle is posed by those who prefer taxes that are defective over taxes that are technically superior on the grounds that "good taxes are bad taxes" and "bad taxes are good taxes."

Of course, not all oppose an improved sales and use tax system. "Main Street" merchants should be the strongest proponents of reform, which would simultaneously increase the likelihood that the remote vendors with whom they compete will be required to collect use tax and ease compliance burdens of multistate merchants. State and local government officials and tax administrators also support a policy that allows a given amount of revenue to be raised with a given tax rate. This coalition should be a powerful voice for reform. Even some established remote vendors might support reforms that clarified nexus standards and established a uniform sales and use tax system, because of the reduction in both audit exposure and pressure to do business in artificial ways that avoid nexus.[37]

Uniformity based on the conceptual ideal. The prospects for uniformity based on the conceptually correct solution described here are even more remote. Governors and legislators do not want to give up the power to define the tax base, even if many of the distinctions they legislate are senseless. Service industries, many of which are currently exempt, will not want to be subject to tax. Those who want business to "pay its way" will oppose eliminating the tax on sales to business. While there may be a constituency for uniformity, is there a constituency for the conceptually correct result?

Again, reform should have advocates. Most obvious are the "Main Street" merchants in all states that must decipher the needless complexity that is inherent in the senseless distinctions found in current law and the many firms that pay tax on their purchases, as well as the suppliers that sell to them. Also, conservatives should generally favor elimination of tax on sales to business, because it would make the cost of government more transparent.

The role of NCCUSL. The National Conference of Commissioners on Uniform State Laws, which drafts uniform laws to be considered for adoption by the states, may play an important role in this drama. While perhaps not totally free of political influences, NCCUSL is certainly more insulated than are state legislators and governors.

Experience with the Uniform Division of Income for Tax Purposes Act ("UDITPA") does not inspire confidence that the states would adopt a uniform sales tax act if NCCUSL were to draft one. Many income-tax states have not adopted UDITPA and some that have adopted it have done so with substantial modifications. States, however, might be willing to accept a uniform sales and use tax statute to generate the political pressure required to overcome congressional reluctance to act.[38]

NCCUSL is charged only with drafting laws that are *uniform*, but it may be driven to consider laws that are *based on the conceptual ideal.*

37. *See* McLure, *Taxation of Electronic Commerce*, *supra* note 6, at 403–06 (discussing joint state-industry initiatives).

38. The discussion in the text reflects an assumption that efforts to gain sanction for an expanded duty to collect would concentrate on federal legislation, rather than the U.S. Supreme Court. This does not mean that the states will not attempt to convince the Court to revisit *Quill*, if ever they achieve greater uniformity.

For the reform of state sales and use taxes, the conceptual ideal is the only objective benchmark against which to judge alternatives.

APPENDIX: THE PREREQUISITE FOR AN EXPANDED DUTY TO COLLECT USE TAX ON REMOTE SALES[1]

I. PREFACE

The existing state sales and use taxes are a product of their time — a time when *local merchants* sold primarily *tangible products* almost exclusively to *local customers*. They are not suited to the 21st century, when *services and intangible products* will be much more important than tangible products, and *remote sales* of tangible products and *digitized content*, especially via *electronic commerce*, will be increasingly important. The most obvious problem is complexity:

- Each of the forty-six states that levy sales taxes (including the District of Columbia) chooses its own tax base, with no requirement that the base — or even what might be in the base — be uniform across the nation.

- Each state decides what should be exempt when purchased by businesses.

- Each state sets its own administrative requirements and procedures, including registration, filing of tax returns, payment, audit, and appeals.

- Roughly 7,000 local jurisdictions also levy sales and use taxes.

- Most local jurisdictions levying sales taxes choose their own tax rates.

- Local jurisdictions in some states do not follow the state definition of the tax base.

1. The author presented an earlier draft of this proposal to the Advisory Commission on Electronic Commerce ("ACEC") at the Commission's meeting in San Francisco on December 15, 1999. *See* Charles E. McLure, Jr., Presentation Before the ACEC (Dec. 15, 1999), *available at* <http://www.ecommercecommission.org/sanfran/tr1215.htm>.

- Boundaries of local jurisdictions do not correspond to postal ZIP codes.

- Local governments change their tax rates from time to time, making it difficult for taxpayers[2] to know the current rate.

Because of this complexity, the U.S. Supreme Court, in 1967[3] and again in 1992,[4] ruled that a remote vendor could not be required to collect use tax on sales to customers in a state where it lacks a physical presence (a "nexus"). The result is loss of state and local tax revenue, unfair competition for "Main Street" merchants, and discrimination against those who patronize those merchants, instead of remote vendors — problems that the growth of electronic commerce will aggravate. Sound public policy demands that remote vendors, including those engaged in electronic commerce, collect use tax on their sales if those sales exceed a de minimis amount.[5] As Ronald Reagan said in 1981, "[t]he taxing power of government must be used to provide revenues for legitimate government purposes. It must not be used to regulate the economy or bring about social change." But an expanded duty to collect makes sense only if there is radical simplification of the state sales and use tax system. This proposal describes a system that would meet this objective.[6] The proposal is intended to be revenue neutral in each state and locality; tax rates would be raised or lowered as required to maintain revenues, but not increase revenues.

II. THE PROPOSAL: SUMMARY STATEMENT

This Section outlines a number of primary proposals, which are described in detail and justified in the next section.

2. The term "taxpayer" is used (somewhat inaccurately) for both vendors who are legally liable for sales taxes and vendors who (actually or potentially) collect use taxes that legally are due from their customers.

3. *See* National Bellas Hess, Inc. v. Dep't of Revenue, 386 U.S. 753 (1967).

4. *See* Quill v. North Dakota, 504 U.S. 298 (1992).

5. Address Before a Joint Session of the Congress, 17 WKLY. COMP. PRES. DOCS. 131, 137 (Feb. 18, 1981).

6. The annex containing the required certification that the proposal satisfies the criteria announced by the ACEC is omitted. For the annex, see the version of the proposal on the ACEC website at <http://www.ecommercecommission.org/proposal.htm>.

I. There would be a single uniform nationwide base for sales and use tax.
   A. The base would consist of all consumption spending by households.
      1. Tangible products, services, and intangibles would pay the same tax.
      2. Local merchants and remote vendors would collect the same tax.
   B. All business purchases would be exempt in all states.
      1. There would be a nationally uniform exemption certificate.

II. Compliance would be simplified and made less costly for vendors (two options):
   A. Forms and payments would be filed with one state ("base-state approach").
      1. De minimis rule would eliminate the duty of some to collect use tax.
      2. Realistic vendors' discounts would facilitate zero-cost compliance.
   B. Trusted third parties ("TTPs") would calculate/remit tax ("TTP approach").
      1. Taxpayers would be subject to joint audits on behalf of all states.

III. Software would be used to determine the situs of sales and state and local tax rates.
   A. States would certify software and provide it without charge to vendors or TTPs.
   B. A hold-harmless clause would protect vendors who rely on the software.

In addition to these primary proposals, there are several fallback positions that some may find more politically realistic. The primary proposals provide a benchmark against which to judge other proposals the ACEC may receive, as well as the fallback positions. Because the proposed system is vastly simpler than conceptually defensible alternatives, the need for simplification may drive decisionmakers toward it, despite the conventional wisdom that it is politically unrealistic.

III. THE PROPOSALS: DETAILED DESCRIPTION AND ANALYSIS

A. The Tax Base: General

1. Proposal A.

All states would define the tax base identically. All sales to households in a state would be subject to tax, whether sold by local merchants or remote vendors, unless there were agreement among all states to exempt certain items (e.g., prescription drugs). Services and intangible products would be subject to tax, when bought by households. Special taxes on telecommunications would be eliminated.

Rationale. The tax base would be defined uniformly in all states to simplify compliance and administration. Remote vendors would need to deal with only one definition of the tax base, instead of forty-six (or more, considering local taxes). All sales to households would be taxed to prevent erosion of the tax base, simplify the system (e.g., no need to distinguish taxable and exempt food or clothing), avoid distortion of consumer choices, and treat those who buy from local merchants the same as those who buy from remote vendors. The enormous difficulty in gaining agreement on what should be in the uniform tax base suggests acceptance of the conceptually correct solution: taxing all consumption spending. Worth special note is the avoidance of "indistinct distinctions," such as those between certain tangible products (e.g., shrink-wrapped software, music CDs, and video cassettes) and virtually identical intangible products (software, music, and videos) downloaded from the Internet. Such distinctions complicate administration and compliance and have no economic justification. Including services and intangible products in the tax base would allow reduction of tax rates. There is no justification for special taxes on telecommunications.

Discussion. Problems with the proposal are primarily political. In addition to the loss of state fiscal sovereignty implied by a uniform tax base, there would be serious opposition to taxation of services and intangible products, even in a revenue-neutral context.

2. Fallback A1.

States might be allowed to choose their own tax bases, but be required to define what is or is not to be subject to tax identically. Conceptually there would be a "menu" of commonly defined products, beside which each state writes "taxable" or "exempt." Computerized "look-up tables" would indicate whether each product is taxed in each state. Bar codes could indicate the product category into which most tangible products fall. To be practical, there should be only a few well-defined product categories — perhaps no more than a dozen. Local jurisdictions should not be allowed to deviate from the state tax base.

Rationale. The primary proposal involves a radical departure from present practice, in which states choose their own tax bases. The fallback combines greater uniformity than current law with greater state fiscal sovereignty than the primary proposal.

Discussion. A menu of potentially taxed products might contain as many as 10,000 products, depending on the degree of aggregation of products. Look-up tables with 460,000 cells (one for each of 10,000 items in 46 states) are conceptually feasible, but perhaps impractical; they would certainly be impractical for catalog sales if the purchaser desires to know the tax due when placing an order. Unless categories were chosen extremely carefully, "indistinct distinctions" and attendant problems would remain.

3. Fallback A2.

It may be politically expedient to provide an exemption for Internet access purchased by households.[7] Purchases of Internet access by businesses would be exempt under the conceptually correct tax treatment of business purchases, considered below.

Discussion. There is little justification for exempting Internet access by households. An exemption would complicate compliance and administration, because Internet access is commonly bundled with other (presumably taxable) products, and have adverse distributional implications.

B. The Tax Base: Exemption of Business Purchases

1. Proposal B

The conceptually correct way to treat business purchases is for all states to treat them identically by exempting them. Exemption would

7. There seems to be no reason to exempt all fees for Internet access paid by households. An exemption equal to the cost of basic service would probably suffice to meet concerns about aggravating the digital divide. It would also largely eliminate questions involving bundling of exempt Internet access with taxable access to content and other services.

achieve the same result as under the value added tax system used in the European Union, where businesses receive a credit for tax paid on purchases. A uniform exemption certificate should be used throughout the nation.[8]

Rationale. Uniform treatment of business purchases would simplify compliance and administration; remote sellers would need to know only one set of rules, not forty-six. The so-called "uniform" exemption certificate drafted by the Multistate Tax Commission is not uniform, because state laws are not uniform. Under a truly uniform system, sellers would not need to judge the eligibility of their customers to make tax-free purchases, depending on the use of the product, as now. *Exemption of business purchases* would eliminate defects of the present system: discrimination among products, distortion of production decisions, incentives for vertical integration, and a tax cost that cannot be recovered on exports. While exemptions for business purchases (initially available only for resale) have been expanded over time, they remain far from comprehensive. Thus the purchases of some sectors are taxed, while those of others are exempt. The proposal would eliminate all such discrimination.

Discussion. Problems with the proposal are primarily political. In addition to the loss of state fiscal sovereignty, elimination of all business purchases from the tax base would necessitate increasing tax rates to maintain revenue in a revenue-neutral context.[9]

2. Fallback B

States could continue to decide whether or not to exempt various types of business purchases but be required to define the various types of business purchases that might be exempt identically. As in Fallback A1, conceptually there would be a menu of commonly defined types of business purchases, beside which each state writes "taxable" or "exempt." Computerized "look-up tables" would indicate tax treatment in each state. To be practical, there should be only a few well-defined

8. Eligibility for exemption of business purchases could be based on federal income tax law: a purchase would be exempt from sales and use tax if (and only if) it qualifies for a federal income tax deduction (or depreciation allowance, etc.). Since this eligibility is all that need be addressed in a uniform exemption certificate, eligibility could be certified simply by checking a box on a paper order form of clicking on a box in the order form on a website.

9. If this were the only change, average rates would rise substantially. Taxing services would create an offsetting tendency for rates to fall.

categories — perhaps no more than a half-dozen. Use of "direct pay" by business customers should be expanded.

Rationale/discussion. This alternative achieves much — but not all — of the simplification of the conceptually ideal proposal, without as much loss of state sovereignty or reduction of tax bases. The adverse economic effects of the present system would remain, but each state would have the option of exempting all categories of business purchases to attract business. Direct pay, which would not be needed under the primary proposal, would reduce the need for vendors to determine whether sales to businesses are for exempt uses.

C. *Sourcing/Situsing of Sales and Local Tax Rates*

The situs of remote sales determines the local tax rate to be applied and the jurisdiction that receives tax revenue from a sale. It is thus convenient to consider local tax rates together with the situs of remote sales.

State sales taxes are based on the destination of sales — or would be, if remote sales were taxed and business inputs were exempt. Unlike origin-based taxation, destination-based taxation avoids distortion of the location of economic activity. Moreover, private consumption is generally a reasonable proxy for the consumption of public services. The conceptually correct way to determine the situs of remote sales is thus to attribute them to the state and locality of destination of the sale.

1. Proposal C

Software would be used (a) to determine the state and local tax rates that should be applied to remote sales of particular products and (b) to prepare the reports containing the information needed by states to channel revenues to the appropriate local jurisdictions. Such software would contain rules — to be applied uniformly across the nation — needed to determine the situs of sales not involving tangible products (e.g., for services and telecommunications).

Discussion. The proposal implements destination-based taxation and provides local governments with autonomy over the tax rate, which would be applied to both sales by local merchants and remote sales. Several qualifications are appropriate. First, states should certify software and enact hold-harmless rules to protect remote vendors from relatively minor and unintentional errors resulting from good-faith reliance on such software, including those that result from the software vendor's failure to update rate tables. Local governments should bear the burden of informing providers of software of changes in rates. Second, such software can be used only for sales to customers that are willing to allow the vendor to calculate the tax and add it to the bill. A special regime may be needed for those who remit by check or money order when placing an order. It might be based on the one-rate-per-state fallback position discussed below.

2. Fallback C

Business representatives argue that remote sales should be attributed, or "sourced," only to the state level, claiming that it is impossible to determine accurately the local situs of remote sales. Local governments could set *sales tax* rates, but there would be only one *use tax* rate per state, and states would be responsible for allocating revenue from use tax among their local jurisdictions.

Discussion. The fallback would retain local autonomy over local *sales tax* rates, but eliminate autonomy over local *use tax* rates. Local jurisdictions would receive revenues from taxes on sales by local merchants, but depend on sharing of revenues from the statewide local use tax. This arrangement would allow local jurisdictions to meet their obligations under debt covenants that dedicate revenues from local sales tax to debt service. Local governments imposing sales tax rates well below the statewide local use tax rate might compensate local residents for excess use tax on remote purchases. Where local sales tax rates exceed the statewide use tax rate, discrimination against local merchants would remain.

D. Unallocable Sales

1. Proposal D

Remote sales that cannot be allocated to a state — because remote vendors do not know the location of a buyer of digitized content — and remote sales that fall below the de minimis threshold would be subject to a national substitute use tax, revenues from which would be shared with the states, perhaps on the basis of estimated consumer spending in the state.[10]

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10. The substitute use tax would be implemented by the states, not the federal government. In the text, the word "among" thus replaces "with," which might give the impression that the substitute use tax would be imposed by the federal government.

Rationale/discussion. It is not satisfactory to attribute unallocable sales to the state of origin of remote commerce; doing so creates an incentive to locate operations in states with no sales tax. Billing addresses can be used to determine the location of some customers, but not all. The need for the national substitute use tax is one advantage of having a nationally uniform state sales tax base, which would be used as the base of that tax. States that have no sales tax (or rates well below the national tax) could refund the national tax (or the difference in rates) to their residents. Technological developments may make this provision unnecessary.

E. Administrative Aspects

Administration of state sales and use taxes should be simpler and more uniform throughout the nation. Two options deserve attention.

1. Proposal E1: The Base State Approach

Taxpayers would collect use tax in all states where sales exceed de minimis amounts. But they would file a single form to register in all states and another to pay tax due in all states. Forms might be filed in the state in which the firm has its commercial domicile (the "base state") or with a multistate agency. The base state or multistate agency would forward revenues to states where sales occur, which would divide revenues among local jurisdictions, on the basis of information provided by taxpayers. There would be joint audits on behalf of all states and a common appeals process.

Discussion. Tax authorities in each state would need to know the tax laws of all other states. This system would thus work best if there were a common definition of the tax base. It would not work in the absence of a common menu of potentially taxable products.

2. Proposal E2: Use of Trusted Third Parties.

This approach would shift compliance from the vendor to a trusted third party ("TTP"). The TTP would calculate tax and remit it to states where sales are made, with an indication of the division of revenues among local jurisdictions.

Discussion. Further analysis is needed to determine whether the base-state approach or the TTP approach is more promising.

F. Zero-Cost Compliance

1. Proposal F

Implementation of a destination-based sales tax requires remote vendors or TTPs to use sophisticated and expensive software. State governments should provide the software at no cost. There is precedent for such as system; for example, when Canada introduced the VAT, it subsidized purchase of new cash registers. Under the base-state approach vendors' discounts should be set to defray costs of compliance, but they might not be needed under the TTP approach. These costs can be quite high, as a percentage of revenues, for small vendors.

G. De Minimis Rule

1. Proposal G

It may be desirable to have a de minimis rule; vendors with total remote sales below a certain level would be relieved of the need to participate in the base-state system or utilize a TTP

Discussion. From an economic point of view, making sales in a state, rather than physical presence, should be the test of nexus. Yet it may be unreasonable or uneconomical to require firms with small remote sales to participate in the regular system. Of course, there might be relatively little need for a de minimis rule if all the primary proposals made here were adopted.

IV. CONCLUDING REMARKS

Because the proposals made here form a package, comments on the entire package are appropriate.

A. The Integrity of the Proposals

Taken together the primary proposals would radically simplify state sales and use taxes and make it reasonable to impose an expanded duty to collect use tax. If proposed changes are omitted or replaced by the fallback positions, there would be substantially less simplification — so much less that an expanded duty to collect might become questionable. If there were a menu of taxable products, instead of a uniform and comprehensive base, the software needed to implement use taxes would be more complicated and expensive, classification of products would be more controversial and onerous, state certification of software and a hold-harmless provision would be problematic, the base-state approach and use of TTPs might be infeasible, and the de minimis threshold would need to be higher. The severity of problems would depend on the level of aggregation of the menu. Moreover, it is unlikely that technological neutrality would be maintained in constructing the menu. If there were not even a uniform menu from which states would choose their tax base, it seems unlikely that enough simplification could be achieved to justify an expanded duty to collect.

B. The Question of State Sovereignty and Local Autonomy

Some will attack some of these proposals (e.g., the proposal for a uniform tax base) as an unwelcome intrusion on state fiscal sovereignty. That view loses sight of the larger picture. The state sovereignty that was possible when local merchants sold primarily tangible products almost exclusively to local customers is no longer possible, or at least not a realistic alternative, as it implies enormous complexity for remote vendors and thus the legal inability to tax remote sales, including those in electronic commerce. These proposals represent an attempt to craft a compromise between the need for revenue and the power to set state tax rates — arguably higher orders of state sovereignty — and control over the tax base — arguably a less important aspect of sovereignty. They also attempt to retain local autonomy over local sales and use tax rates.

C. The Need for Federal Legislation

In theory it might be possible for the states to act cooperatively to implement a system such as that proposed here without federal legislation. If they did, the Supreme Court might eliminate the physical presence test of nexus. In fact, history does not inspire confidence that the states would act in this way, and the Court might not respond as predicted, even if they did. In any event, unacceptable uncertainty would still be likely. Thus it seems almost certain that federal legislation would be required to implement the proposals made here. Rather than requiring that states adopt the proposals (the "stick" approach), legislation could allow an expanded duty to collect only for states that adopt the proposals (the "carrot" approach).