

**THE INTERNET TAX DEBATE:
ASKING THE CORRECT QUESTIONS**

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“Are you willing to pay more in personal income taxes or property taxes so that Internet sales can be sales tax free?”

“Should the states simplify their sales tax systems regardless of the Internet issue?”

“How simple is simple?”

I. TRADEOFFS

Do you want to be taxed or would you prefer to remain tax-free? It is hard to imagine anyone answering, “I would prefer to be taxed, please!” Of course, when a survey asks whether or not the Internet should be “tax-free,” anyone surveyed is going to answer that they want the Internet to remain tax-free. But that is not the correct question. It is not a choice between all or nothing, rather it is a choice about how we are taxed. Taxation provides the means to pay for services required within a society. It is the cost of civilization. While there may be arguments about the level and purposes of spending, the end result is that there will be some level of expenditure.

State citizens continually argue about this tax or that tax, and whether the tax is “good” or “bad” in various contexts. In the end, each state selects a system of taxation to raise the revenue necessary to fund the services authorized by the citizens through their elected representatives. Some states have elected to raise that revenue through a sales tax, and others have decided to use a different source of revenue. If the sales tax fails to raise sufficient revenue, the state must either reduce services or raise revenue through another type of tax. Of course, that is where the debate over collecting tax on the Internet comes into play.

I believe it is important to distinguish between replacing lost revenue and raising new revenue. Many of the commentators on this subject lump these issues together because of the long-term debate over

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“remote sellers.” From a practical view, they may end up being addressed at the same time, but I would argue that the motivation of many state officials is to protect what they have now. The idea that Internet taxes could raise revenue from remote sellers that are not currently required to collect the sales tax may be attractive to the states, but states are more concerned about what is happening to their current tax base. In addition, if revenue were received from remote sellers, there is no reason to believe that the states would automatically increase spending. Recent history suggests that states would likely use the additional revenue to reduce the rates for all taxpayers.

Why are the states worried about their tax base? Some “Internet experts” claim that sales over the Internet are not large today and the majority of growth in sales will be in business-to-business transactions. If business-to-business transactions on the Internet were to become tax exempt, the potential loss of sales tax revenue from these transactions alone would be sufficient to put a large dent in state revenues. Other “experts” claim that retail sales will be in the billions. So, who is right? There has already been a growth in retail sales that has exceeded projections made as recently as last year. Another indicator could well be that current Internet company valuations are only supportable by assuming a rapid expansion in retail sales. Either the low growth projections or the market valuations are wrong. Finally, some say that even if sales are lost, this should not concern the states. After all, the coffers are full, the sun is shining and “what, me worry?” is the song of the day. However, state officials well remember that the same tune was being sung in 1988 and many of those officials suffered through the subsequent 1989 to 1993 recession.

State policymakers are generally pragmatic and recognize that the good times will not continue forever. They also know that if the sales tax fails to perform, any lost revenue will need to be raised from other taxes. That is a big problem! To which taxes would the states turn? Any replacement would likely entail the personal income tax or property tax, but citizens dislike those taxes even more than they do the sales tax. How do I know citizens prefer the sales tax? I have participated closely with the New Hampshire Legislature as it has struggled with the school finance issue. Over the past two years, over twenty separate taxing proposals have been considered by the Legislature and a number of polls have been taken of New Hampshire citizens about taxes. None of the taxes receives majority support, but the sales tax is consistently at the top of the choices.

Therefore, the question is not sales tax or nothing. The real question is which type of tax to select. If not the sales tax, then what

other tax? Retail sales will continue to expand rapidly over the Internet with a corresponding impact on state sales tax revenues. The combination of sales shifting to the Internet, along with the slowdown in the economy which will occur, will require citizens and legislators to make those difficult choices sooner rather than later.

II. SIMPLIFYING THE SALES TAX SYSTEM

This is one of those issues that has a life of its own. Tax administrators have long recognized that it was to their advantage to simplify the sales tax system. Unfortunately, a number of efforts to simplify the sales tax, spearheaded primarily by the Multistate Tax Commission ("MTC"), were derailed by the need to change established laws and regulations. Not every legislature saw the need to make the changes and a number adopted the attitude, "If you wish to sell in this state, you will have to learn to live by our rules." In addition, local government perceived these efforts at simplification as attempts to limit their ability to raise needed revenue. This conflict between the various levels of government should not be underestimated. Efforts to simplify the sales tax system in any manner will have to take into account the concerns of municipal and county governments. State legislators will be reluctant to incur the wrath of local officials without good reason.

As difficult as it is to believe, the Internet was in its infancy in 1996. Many new Internet businesses and their tax advisors were asking the states for guidance on a number of tax issues. Key issues at this early stage of Internet development were telecommunications taxes on Internet access fees and whether or not Internet related activity would lead to a nexus between a state and a remote seller. Most states were not prepared to answer those questions because they had not thought them through or did not have knowledge of how the Internet worked.

Internet businesses, concerned with the answers they were getting from some of the states, initially approached the Federation of Tax Administrators ("FTA") to cooperatively address the emerging issues. Tax administrators and businesses wished to follow the very successful model of the Electronic Data Interchange ("EDI") Task Force, which was comprised of business members and their representative organizations, the Committee on State Taxation, the Tax Executives Institute, and the Institute for Professionals in Taxation, along with the FTA and the MTC. The EDI Task Force dealt with issues surrounding electronic records and audits in the electronic world. The task force had a full agenda of emerging issues, so the decision was made to form a new group under the sponsorship of the National Tax Association

("NTA"). Membership in the new group was expanded to include academics and officials from all levels of government, and the business group composition changed to reflect the Internet industry and remote sellers.

By the end of the first meeting it was obvious to all that sales tax simplification was a valid issue. Questions about how to achieve that simplification and what tradeoffs would be required to gain support for simplification would dog the task force throughout its existence. I think that all levels of government now agree that simplification makes sense for both states and businesses, regardless of the challenges posed by the Internet. However, these Internet-related issues provide a unique opportunity to achieve real simplification. When remote sales were only catalog companies, the amount of sales tax lost did not provide the threat necessary to get the various levels of government to work together. The advent of the Internet and predictions of billions of dollars in sales over the Internet was enough to get everyone's attention.

So does that mean that simplification is important in itself? Yes. We need to recognize that businesses are really working for the states (even if unwillingly) and it is important to make their duties as simple as possible. Unfortunately, simplification is elusive because the cost-benefit advantages are not readily apparent to legislatures. Revenue departments need businesses to appear before them and say this or that is necessary and important to change. The businesses approaching the legislatures need to be both home-grown and national. Believe it or not, many in-state businesses lobby legislatures for their own special sales tax provisions. Obviously, every special in-state benefit contributes to the complexity faced by multi-state businesses.

III. HOW SIMPLE

I am biased because of the success of the EDI Task Force, but I believe that everyone would have benefited from the NTA Task Force if business had not made an end run to Congress to obtain a moratorium. Once some of the businesses represented felt that Congress would take care of them, there was no incentive to reach an agreement. Those businesses that continued to work toward simplification were hindered by the others from reaching any sort of meaningful compromise. The biggest obstacle to achieving simplification today is the belief by many Internet businesses that Congress will save them from taxation. Ironically, technology makes simplification much more achievable, yet businesses that owe their existence to technology deny its capabilities when it comes to taxes.

The question is whether or not this unique opportunity to simplify the sales tax system in this country will pass by because of the efforts of various businesses to carve out special tax advantages. The states have started the effort to develop a "zero burden tax system." This is a good effort, but it is tremendously large and complex in scope. There are a number of actions that could be taken to simplify the current sales tax systems, but they are not feasible without the support of the business community. The previous efforts of the EDI Task Force have shown that when business and the government sit down in good faith, many seemingly intractable problems can be solved. "One rate per state" or a common set of definitions may not be the only ways to go. There are a number of interesting proposals that have been advanced to simplify sales taxes and there is no reason to believe that the rapid development of technology will not provide even more options.

IV. CONCLUSION

No one wants to pay taxes and many businesses would be much happier if they were relieved of the burden of collecting sales and use taxes. However, it is not practical to believe that taxes are going to disappear. States will still need to build the infrastructure and train the workers that these very same businesses need. Businesses, both Internet-related and traditional brick-and-mortar, need to look at the larger picture and view this as a unique opportunity to change the antiquated sales tax system. Right now the states are trying to do it on their own. It is going to be difficult to achieve this working alone. No one today can say what type of system will be used to replace a decimated sales tax system. I wonder if one day these businesses may be saying, "We won, but that is the bad news!"