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State and Local Taxes and the Streamlined Sales and Use Tax Agreement

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Steven Maguire
Specialist in Public Finance
Government and Finance Division

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Summary

State sales and use taxes are consumption taxes that are levied according to the destination principle. The destination principle prescribes that taxes should be paid where the consumption takes place. A *sales* tax that is collected by vendors at the point of sale implicitly assumes consumption takes place near the point of transaction. *Use* taxes, in contrast, are levied on products consumers purchase from out-of-state vendors over the telephone or Internet. The rate of tax is based on the destination principle, in this case, the delivery address. Sales and use taxes are almost always the same rate in a given jurisdiction.

Under current law, states cannot reach beyond their borders and compel out-of-state vendors (without nexus — i.e., physical presence — in the buyer's state) to collect the use tax owed by state residents. The Supreme Court has ruled that requiring remote vendors to collect the use tax would pose an undue burden on interstate commerce. States are concerned because they anticipate gradually losing more sales tax revenue, as the growth of Internet commerce allows more residents to buy products from vendors located out-of-state and evade use taxes. Estimates put this loss at approximately $8 billion in 2003. Congress is involved because interstate commerce typically falls under the Commerce Clause of the Constitution.

Congressional action on the remote collection issue is uncertain. Opponents of remote vendor use tax collection cite the complexity of the myriad state and local sales tax systems and the difficulty vendors would have in collecting and remitting use taxes. Proponents would like Congress to change the law and allow states to require out-of-state vendors without nexus to collect state use taxes. These proponents acknowledge that simplification and harmonization of state tax systems are likely prerequisites for Congress to consider approval of increased collection authority for states.

A number of states have been working together to harmonize sales tax collection and have created the Streamlined Sales and Use Tax Agreement (SSUTA). The SSUTA member states hope that Congress can be persuaded to allow them to require out-of-state vendors to collect taxes from customers in SSUTA member states. In the 110th Congress, S. 34 (Senator Enzi) and H.R. 3396 (Representative Delahunt) would grant SSUTA member states the authority to compel out-of-state vendors in other member states to collect sales and use taxes.

A related issue is the "Internet Tax Moratorium." The moratorium prohibits (1) new taxes on Internet access services and (2) multiple or discriminatory taxes on Internet commerce. Congress has extended the "Internet Tax Moratorium" twice. The most recent extension expires November 1, 2007. The moratorium is distinct from the remote use tax collection issue, but has been linked in past debates. For more on the Internet tax moratorium, see CRS Report RL33261, *Internet Taxation: Issues and Legislation*, by Steven Maguire and Nonna Noto.

This report will be updated as legislative events warrant.

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Introduction

State governments rely on general sales and use taxes for approximately one-third (32.9%) of their total tax revenue — approximately $213 billion in FY2005. Local governments derive 11.2% of their tax revenue — approximately $50 billion in FY2005 — from local sales and use taxes.[1] Both state and local sales taxes are usually collected by vendors at the point of transaction and levied at a percentage of a product's retail price. Alternatively, use taxes, typically levied at the same rate, are often not collected by the vendor if the vendor does not have nexus (loosely defined as a physical presence) in the consumer's state. Consumers are required to remit use taxes to their taxing jurisdiction. Compliance with this requirement, however, is quite low.

State and local governments are concerned that the expansion of Internet commerce — the Census Bureau of the Department of Commerce estimated that Internet commerce jumped 20.7% from the second quarter of 2006 to the second quarter of 2007 — will gradually erode their tax base.[2] This concern arises in part because the U.S. Supreme Court ruled out-of-state vendors are not required to collect sales taxes for states in which they (the vendors) do not have nexus.[3] In hopes of stemming the potential loss of tax revenue, several states are participating in an initiative to simplify and coordinate their tax codes — called the Streamlined Sales and Use Tax Agreement (SSUTA). The member states hope that Congress could be persuaded to allow them to require out-of-state vendors to collect taxes from customers in SSUTA member states.

Congress has a role in this issue because interstate commerce, in most cases, falls under the Commerce Clause of the Constitution.[4] Congress will likely be asked to choose between taking either an active or passive role in the debate. In the 110th Congress, S. 34 (Senator Enzi) and H.R. 3396 (Representative Delahunt) would grant SSUTA member states the authority to compel out-of-state vendors to collect sales

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[1] U.S. Bureau of the Census, "State and Local Government Finances: 2004-05," available online at [http://www.census.gov/govs/www/estimate.html].

[2] U.S. Census Bureau, "Quarterly Retail E-Commerce Sales 2nd Quarter 2007," Aug. 16, 2007, available online at [http://www.census.gov/mrts/www/data/pdf/07Q2.pdf].

[3] This legal status is shaped by two decisions regarding remote collection: *National Bellas Hess, Inc. v. Department of Revenue of Illinois*, 386 U.S. 753 (1967) and *Quill Corporation v. North Dakota*, 504 U.S. 298 (1992).

[4] U.S. Constitution, art. 1, sec. 8.

and use taxes. A more passive approach by Congress could involve states implementing the SSUTA without congressional approval. State enforcement of remote collection would likely face legal challenges, and the outcome of these legal challenges is uncertain. This report intends to clarify significant issues in the remote sales tax collection debate, beginning with a description of state and local sales and use taxes.

State and Local Sales and Use Taxes

In 1932, Mississippi was the first state to impose a general state sales tax.[5] During the remainder of the 1930s, an era characterized by declining revenue from corporate and individual income taxes, 23 other states followed suit and implemented a general sales tax.[6] At the time, the sales tax was relatively easy to administer and raised a significant amount of revenue despite a relatively low rate.[7] Given the relative success of the sales tax in raising revenue, 45 states and the District of Columbia added the sales tax to their tax infrastructure by the late 1960s. The last of the 45 states to enact a general sales and use tax was Vermont in 1969.[8]

Components of the Sales and Use Tax

The revenue generated by a sales and use tax, assuming a given level of compliance, depends on the base of the tax and the tax rate. The narrower the base the higher the rate required to raise an equivalent amount of revenue. States often have similar consumption items included in their tax base, but they are far from uniform. Tax *rates* can also vary considerably, depending on the state's reliance on other revenue sources.

Tax Base. The sales tax, which is considered a consumption tax, is perhaps better identified as a transaction tax on tangible personal property. Expenditures on most services, such as medical services, are typically excluded from the state sales tax base.[9] In most states (31), groceries are also exempt from the sales tax or taxed at a lower rate (another seven states, see **Table 1**). A true consumption tax would

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[5] Mississippi added a *use* tax, the companion to the sales tax, in 1938. A use tax is a tax on the use of a product. In the early years of the sales tax, states began with general sales then added the use tax. Eventually, states adopting a sales tax included the use tax in the enacting legislation.

[6] William F. Fox, ed., *Sales Taxation: Critical Issues in Policy and Administration, Sales Tax Trends and Issues*, by Robert Ebel and Christopher Zimmerman (Westport, CT: Praeger, 1992), pp. 3-26.

[7] The highest sales tax rate in 1934 was 3%, which was considered quite high at the time. Today, in some Alabama jurisdictions, the combined state and local tax rate can be as high as 12.0%.

[8] The five states without a state sales and use tax are Alaska, Delaware, Montana, New Hampshire, and Oregon. Alaska allows local jurisdictions to impose a local sales tax.

[9] For example, only two states, Hawaii and New Mexico, tax medical services.

include all income that is not saved, including personal expenditures on grocery food and services.[10]

Table 1. State and Local General Sales and Gross Receipts Taxes as Percent of Total Personal Income, by State, FY2005

State (*italics* =no state income tax)	Grocery Food (Taxable or Exempt)	GSGR State & Local Tax Revenue in FY2005 ($ millions)	State Personal Income 2005 ($ millions)	GSGR Tax as Percent of Personal Income 2005
(a)	(b)	(c)	(d)	(e)
Alabama	T	3,533	134,736	2.62%
Alaska	—	157	23,588	0.67%
Arizona	E	7,026	178,706	3.93%
Arkansas	T	3,328	74,059	4.49%
California	E	37,575	1,335,386	2.81%
Colorado	E	4,391	174,919	2.51%
Connecticut	E	3,268	165,890	1.97%
Delaware	—	0	31,218	0.00%
District of Columbia	E	847	30,739	2.76%
Florida	E	20,079	604,131	3.32%
Georgia	E	7,664	282,322	2.71%
Hawaii	T	2,137	43,913	4.87%
Idaho	T	1,128	40,706	2.77%
Illinois	T[a]	8,361	462,928	1.81%
Indiana	E	5,001	195,332	2.56%
Iowa	E	2,160	93,919	2.30%
Kansas	T[b]	2,520	90,320	2.79%
Kentucky	E	2,605	117,967	2.21%
Louisiana	E[c]	5,678	111,167	5.11%
Maine	E[d]	935	40,612	2.30%
Maryland	E[e]	2,890	234,609	1.23%
Massachusetts	E	3,891	279,860	1.39%
Michigan	E	8,074	331,349	2.44%
Minnesota	E	4,269	191,175	2.23%
Mississippi	T	2,589	72,862	3.55%
Missouri	T[f]	4,859	181,066	2.68%
Montana	—	0	27,122	0.00%
Nebraska	E	1,768	57,885	3.05%

[10] A common identity in the economics of income accounting is the following: C=Y-S. Or, consumption (C) equals income (Y) less saving (S). Thus, income less savings is total consumption.

State (*italics* =no state income tax)	**Grocery Food (Taxable or Exempt)**	**GSGR State & Local Tax Revenue in FY2005 ($ millions)**	**State Personal Income 2005 ($ millions)**	**GSGR Tax as Percent of Personal Income 2005**
(a)	**(b)**	**(c)**	**(d)**	**(e)**
Nevada	E	3,062	86,224	3.55%
New Hampshire*	—	0	49,356	0.00%
New Jersey	E	6,552	381,466	1.72%
New Mexico	E[g]	2,155	53,714	4.01%
New York	E	21,101	771,990	2.73%
North Carolina	E[h]	6,242	269,203	2.32%
North Dakota	E	479	19,899	2.41%
Ohio	E	9,650	365,453	2.64%
Oklahoma	T	2,930	106,119	2.76%
Oregon	—	0	117,497	0.00%
Pennsylvania	E[i]	8,258	433,400	1.91%
Rhode Island	E	844	37,923	2.23%
South Carolina	T[j]	3,031	120,123	2.52%
South Dakota	T	834	25,201	3.31%
Tennessee[k]	T[l]	7,569	184,443	4.10%
Texas	E	20,248	744,270	2.72%
Utah	T[m]	2,182	68,039	3.21%
Vermont	E	315	20,362	1.55%
Virginia	T[n]	4,047	283,685	1.43%
Washington	E	10,645	223,232	4.77%
West Virginia	T[o]	1,095	47,926	2.29%
Wisconsin	E[p]	4,300	183,948	2.34%
Wyoming	E[q]	682	18,981	3.59%

Sources: Column (b) and notes, CCH State Tax Handbook 2007, p. 533-534; columns (c) and (d), U.S. Bureau of Census; and column (e), author's calculations.

a. Taxed at reduced rate of 1%
b. Limited tax refund available to disabled, elderly, and low-income households
c. Exemption applies to food sold for preparation and consumption in the home
d. Exemption limited to "grocery staples"
e. Sales of food for consumption off-premises exempt when sold by a substantial grocery or market business, where at least 10% of all food sales are sales of grocery or market foods
f. Taxed at reduced rate of 1.225%
g. Receipts from sales of food at a retail food store may be deducted from gross receipts
h. Exempt from state sales taxes but subject to local sales taxes
i. Type of food and location of sales determine taxability
j. Effective Oct. 1, 2006, the state rate on unprepared food that can be purchased with federal food stamps is reduced from 5% to 3%
k. Only capital income included in the personal income tax in New Hampshire and Tennessee
l. Taxed at reduced rate of 6%
m. Effective Jan. 1, 2007, reduced rate of 2.75% imposed on food and food ingredients. In a bundled transaction involving both food and another item of tangible personal property, the rate is 4.75%
n. Taxed at a reduced rate of 1.5% plus the local rate of 1.0%
o. Effective Jan. 1, 2006, taxed at the reduced rate of 5%
p. Some snack foods may be excluded from the exemption
q. Food for domestic home consumption is exempt from July 1, 2006, through June 30, 2008

Business-to-business transactions are often exempt from the retail sales tax, particularly in cases where the purchaser is using the good as an input to production. These transactions are exempt because including the transactions could lead to the "pyramiding" of the sales tax. For example, if a coffee shop were to pay a retail sales tax on the purchase of coffee, and then impose a retail sales tax on coffee brewed for the final consumer, the total sales tax paid for the cup of coffee would likely exceed the statutory rate. Products that a business purchases for resale are typically not assessed a retail sales tax for a similar reason. If a coffee shop buys beans only for resale, levying a sales tax on the wholesale purchase of the beans and then on the retail sale would more than double the statutory rate. The tax treatment of business purchases is not uniform across states. According to recent estimates, approximately 18% of business purchases are taxable depending on the state.[11]

Many individuals and organizations are also exempt from state sales taxes. Entities wishing to claim the sales tax exemption are often issued a certificate indicating their tax-free status and are required to present this certification at the point of transaction. Non-profit organizations, such as those whose mission is religious, charitable, educational, or promoting public health, often hold sales tax-exempt status.

The SSUTA would establish a system where states would use common definitions for goods and services. Once a uniform definition is established, states would then indicate whether the good or service is taxable. In addition, states would identify which entities would be exempt from paying sales taxes (e.g., non-profit or religious organizations).

Tax Rate. The second component of a sales tax is the tax rate applied to the base, described in the previous section. In 35 states, local governments piggy-back a local sales tax (which often varies among localities within the state) on the state sales tax; 10 states and the District of Columbia levy a single rate (see **Table 2**), with no local taxes. Some states in the group of 35 may collect a uniform local tax along with the state tax and send the local revenue share back to the localities. This structure would look like a single rate to the consumer because vendors typically do not differentiate between the state and local share. For example, vendors in Virginia levy a 5.0% sales tax on purchases and remit the entire amount to the state. The state then sends what would have been raised by a 1.0% tax back to the local jurisdiction where the tax was collected. The state of Virginia keeps the remaining 4.0%.

Mississippi, New Jersey, Rhode Island, and Tennessee have the highest *state* sales tax rate of 7.0%. In 2006, however, Alabama had the highest potential *combined state and local* rate of 12.0%. Residents in high sales tax rate jurisdictions could gain from Internet purchases (and tax evasion) more than those in low tax rate states. Recognizing this potential revenue drain, many high-rate states have stepped up efforts to inform consumers of their responsibility to pay use taxes on Internet and

[11] Robert Cline, John Mikesell, Tom Neubig, and Andrew Philips, "Sales Taxation of Business Inputs," *Council on State Taxation Special Report*, Jan. 25, 2005.

mail-order catalog purchases.[12] As suggested earlier, states with high rates — and whose residents have a greater incentive to evade taxes — are exposed to greater potential revenue losses from the growth of Internet commerce. Because of the greater potential losses, these states are more likely to support reforms that help maintain their sales and use tax revenue base.

Table 2 presents the sales tax rates for the 50 states and the District of Columbia and includes the top local rate. Also reported in **Table 2** is the reliance (as measured by CRS) of state and local governments on the general sales (or gross receipts, typically levied against the vendor) tax. Even though gross receipts taxes have more in common with traditional business taxes, the Bureau of the Census has traditionally combined them with general sales taxes.[13] Depending on the state law and the vendor, revenue generated by Internet transactions with out-of-state purchasers may or may not fall under the gross receipts tax.[14] State and local governments in Tennessee, Washington, and Arkansas rely on sales tax revenue for over 40% of total tax revenue.

Table 2. State and Local Sales Tax Rates and Reliance on Sales Tax Revenue, FY2005

State	State Rate	Top Local Rate	Total S & L Tax Revenue ($ millions)	GSGR S & L Tax Revenue ($ millions)	GSGR Tax as % of Total	Rank
(a)	**(b)**	**(c)**	**(d)**	**(e)**	**(f)**	**(g)**
Alabama	4.000	8.000	11,687	3,533	30.2%	12
Alaska	n/a	7.000	2,947	157	5.3%	47
Arizona	5.600	5.125	18,331	7,026	38.3%	7
Arkansas	6.000	5.500	8,054	3,328	41.3%	3
California	6.250	2.500	146,617	37,575	25.6%	23
Colorado	2.900	7.000	15,681	4,391	28.0%	16
Connecticut*	6.000	n/a	18,897	3,268	17.3%	40
Delaware	n/a	n/a	3,277	0	0.0%	48
District of Columbia	5.750	n/a	4,297	847	19.7%	35
Florida	6.000	1.500	59,864	20,079	33.5%	11

[12] For example, see Chris Micheli, "California Strengthens Sales/Use Tax Collections," *State Tax Notes*, Dec. 15, 2003, pp. 964-965.

[13] The Bureau of the Census also collects data on excise taxes and selective sales. We do not report these receipts because they are typically collected at the wholesale level, not at the point of retail transaction. For example, the gasoline excise tax is typically paid by the carrier (tanker truck) at the point of collection (the end of the pipeline), not at retail sale.

[14] Under a gross receipts tax (GRT), a vendor remits a designated percentage (e.g., 5% in New Mexico) of monthly gross receipts (or sales revenue) to the state. A gross receipts tax is different from the sales tax because the vendor — not the purchaser — is legally responsible for paying the tax. Under the sales tax, the vendor acts as the collection agent for the taxing jurisdiction and is not technically "paying" the tax; the buyer is paying the tax.

State	State Rate	Top Local Rate	Total S & L Tax Revenue ($ millions)	GSGR S & L Tax Revenue ($ millions)	GSGR Tax as % of Total	Rank
(a)	(b)	(c)	(d)	(e)	(f)	(g)
Georgia	4.000	3.000	27,486	7,664	27.9%	18
Hawaii	4.000	0.500	5,524	2,137	38.7%	6
Idaho	6.000	3.000	4,183	1,128	27.0%	19
Illinois	6.250	3.000	49,138	8,361	17.0%	41
Indiana*	6.000	n/a	21,337	5,001	23.4%	25
Iowa	5.000	2.000	9,705	2,160	22.3%	30
Kansas	5.300	3.000	9,385	2,520	26.8%	20
Kentucky*	6.000	n/a	12,262	2,605	21.2%	31
Louisiana	4.000	6.750	14,302	5,678	39.7%	4
Maine*	5.000	n/a	5,220	935	17.9%	39
Maryland*	5.000	n/a	23,899	2,890	12.1%	46
Massachusetts*	5.000	n/a	28,757	3,891	13.5%	44
Michigan*	6.000	n/a	35,295	8,074	22.9%	27
Minnesota	6.500	1.000	20,957	4,269	20.4%	32
Mississippi	7.000	0.250	7,491	2,589	34.6%	9
Missouri	4.225	4.750	17,374	4,859	28.0%	17
Montana	n/a	n/a	2,723	0	0.0%	48
Nebraska	5.500	2.000	6,586	1,768	26.8%	21
Nevada	6.500	1.250	9,044	3,062	33.9%	10
New Hampshire	n/a	n/a	4,320	0	0.0%	48
New Jersey*	7.000	n/a	42,557	6,552	15.4%	42
New Mexico	5.000	2.875	6,069	2,155	35.5%	8
New York	4.000	5.000	111,108	21,101	19.0%	36
North Carolina	4.500	3.000	27,307	6,242	22.9%	28
North Dakota	5.000	2.500	2,121	479	22.6%	29
Ohio	5.500	2.000	41,715	9,650	23.1%	26
Oklahoma	4.500	6.000	10,073	2,930	29.1%	15
Oregon	n/a	n/a	11,107	0	0.0%	48
Pennsylvania	6.000	1.000	46,019	8,258	17.9%	38
Rhode Island*	7.000	n/a	4,500	844	18.8%	37
South Carolina	6.000	2.000	11,801	3,031	25.7%	22
South Dakota	4.000	2.000	2,104	834	39.6%	5
Tennessee	7.000	2.750	15,993	7,569	47.3%	1
Texas	6.250	2.000	69,134	20,248	29.3%	14
Utah	4.750	3.600	7,304	2,182	29.9%	13
Vermont	6.000	1.000	2,575	315	12.2%	45
Virginia	4.000	1.000	27,659	4,047	14.6%	43

State	State Rate	Top Local Rate	Total S & L Tax Revenue ($ millions)	GSGR S & L Tax Revenue ($ millions)	GSGR Tax as % of Total	Rank
(a)	(b)	(c)	(d)	(e)	(f)	(g)
Washington	6.500	2.400	22,974	10,645	46.3%	2
West Virginia*	6.000	n/a	5,551	1,095	19.7%	34
Wisconsin	5.000	1.000	21,404	4,300	20.1%	33
Wyoming	4.000	2.000	2,672	682	25.5%	24

Sources: State and local sales tax rate data in Columns (b) and (c) are from the Sales Tax Institute, [http://www.salestaxinstitute.com/sales_tax_rates.print.jsp]. Columns (d) and (e): U.S. Bureau of Census. Column (f) and (g): author's calculations.

* Identifies the 10 states that do not have a local sales tax

Economic Issues

During the debate about so-called "streamlining" legislation, there are several economic issues Congress may consider: (1) How will the SSUTA influence the economic efficiency and equity of state tax systems? (2) What will be the impact of changes in the treatment of Internet transactions on states that are more reliant on the sales tax? (3) What will the potential revenue loss be, absent changes in the treatment of Internet transactions? A summary of these issues follows.

Efficiency. A commonly held view among economists is that a "good" tax (or more precisely, an efficient tax) minimizes distortions in consumer behavior. Broadly speaking, economists maintain that individuals should make the same choices before and after a tax is imposed. The greater the distortions in behavior caused by a tax, the greater the economic welfare loss. A sales tax levied on all consumer expenditures equally would satisfy this definition of efficiency. As noted earlier, however, under the current state sales tax system, all consumption expenditures are not treated equally. The growth of tax-free Internet transactions, both business-to-business and business-to-consumer, will likely amplify the efficiency losses from altered consumer behavior.

An alternative theory concerning economic efficiency in sales taxation is referred to as "optimal commodity taxation." Under an optimal commodity tax, the tax rate is based on (or determined by) what is termed the price *elasticity* of demand for the product (sometimes called the "Ramsey Rule"). Products that are price *inelastic*, meaning quantity demanded is unresponsive to changes in price, should be levied a higher rate of tax. In contrast, products that are price *elastic* should have a lower rate of tax. If products purchased over the Internet are relatively more price elastic, then the lower tax rate created by effectively tax-free Internet transactions may improve economic efficiency as behavioral changes are reduced. However, the price elasticity of products available over the Internet is difficult to measure and the efficiency gain, if any, is suspected to be small.[15]

An additional economic inefficiency arises if vendors change location to avoid collecting sales taxes. The location change would likely result in higher transportation costs. In the long run, it is conceivable that the higher transportation costs would erode the advantage of evading the sales tax.[16]

For example, consider a Virginia consumer who wants to buy a set of woodworking chisels. The local Virginia hardware store sells the set for $50 (including profit). An Internet savvy hardware store in Georgia is willing to sell the same chisel set for $52 inclusive of profit and shipping costs. So, before taxes, the local retailer could offer the chisels at a lower price. The marginal customer, who is indifferent between the two retailers before taxes (even though the Internet is more expensive, it is more convenient), is therefore just as likely to buy from the Internet retailer as from the local retailer.[17]

Virginia imposes a state and local sales tax of 5.0%, thus yielding a final sales price to the consumer of $52.50. Given the higher relative price inclusive of the tax, the marginal consumer, along with many other consumers, would likely switch to buying chisels from the Georgia-based Internet retailer (assuming these consumers do not feel compelled to pay the required Virginia use tax on the Internet purchase). The diversion from retail to the Internet in response to the non-collection of the use tax represents a loss in economic efficiency. The additional $2 in production costs ($52 less $50) represents the efficiency loss to society from evading the use tax.[18]

Note that if in the absence of sales and use taxes, the Internet vendor in the above example may yield to market forces and close up shop. However, if the Internet vendor continues to operate even without the tax advantage, it could be the case that consumers are willing to pay higher prices for the convenience of Internet shopping. If this were true, then the higher "production costs" for Internet vendors would not necessarily result in an efficiency loss.

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[15] Equity has both horizontal and vertical components. A tax is defined as horizontally equitable if people of equal circumstances pay equal taxes. A tax is defined as vertically equitable if people with a greater ability to pay carry a greater tax burden than those less able to pay. An optimal commodity tax would likely violate accepted principles of vertical equity.

[16] Dennis Zimmerman, "The Internet Sales Tax Debate: Sorting Through the Economic Issues," paper prepared for the 94th Annual Conference, National Tax Association, Baltimore, MD, Nov. 8-10, 2001.

[17] The pre-tax absolute price difference between the two retailers is unimportant. The Internet price inclusive of shipping could actually be lower before taxes. The application of the use tax makes the local retailer's product *relatively* more expensive, regardless of what the prices were before taxes.

[18] Shipping costs can be thought of as a cost of production. The local retailer probably also paid shipping costs to have the product on the shelf. Those costs are included in the price of the good. Because the local retailer likely bought in bulk, the shipping cost per unit would be considerably lower than the Internet retailer.

Equity. The sales tax is often criticized as a regressive tax — a tax that disproportionately burdens the poor.[19] Assuming Internet shoppers are relatively better off and do not remit use taxes as prescribed by state law, they can avoid paying tax on a larger portion of their consumption expenditures than those without Internet access at home or work.[20] Consumers without ready Internet access are not afforded the same opportunity to "evade" the sales and use tax. In this way, electronic commerce may arguably exacerbate the regressiveness of the sales tax, at least in the short run. As computers and access to the Internet become more readily available, the potential inequity arising from this aspect of the "digital divide" could diminish.

Equity issues also arise with respect to businesses. Currently, local retailers are required to collect sales taxes for the state at the point of sale. Internet retailers, in contrast, are not faced with the administrative burden. Thus, two otherwise equal retailers face different state and local tax burdens. In relatively high tax rate states, this disparity may be significant. As noted above, consumers in these high tax rate states have a greater incentive to purchase from out-of-state vendors, exacerbating the tax burden differential.

Differential Effect Among States. The growth of Internet-based commerce will have the greatest effect on the states most reliant on the sales and use tax. In addition to having more revenue at risk, high reliance states also face greater efficiency losses because of their generally higher state tax rates. As noted earlier, higher rates drive a larger wedge between the retail price inclusive of the sales tax and the Internet price and thus exacerbate the efficiency loss from the sales tax. States with low rates (and less reliance) would tend to have a smaller wedge between the two modes of transaction. States with both a high rate and high reliance would tend to recognize the greatest revenue loss from a ban on the taxation of Internet transactions.

Based upon CRS calculations of state and local sales tax revenue as a portion of total tax revenue, the state and local governments of Tennessee, Washington, and Arkansas are the most reliant on the sales and use tax.[21] In those states, over 40% of total tax revenue is derived from the sales tax; this result is not surprising. Washington and Tennessee do not have comprehensive personal income taxes and Arkansas has a relatively high 11.5% combined sales tax rate. Ordinal rankings of sales tax reliance appear in the last column of **Table 2**. Note that six of the seven

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[19] A regressive tax collects a smaller percentage of income as income increases. Economists will usually avoid normative questions of what is equitable because such a statement implies an interpersonal comparison of utility.

[20] Goolsbee and Zittrain (1999) found that the average Internet user had on average two more years of education and $22,000 more in family income than non-Internet users.

[21] In addition, those three states were well above the average state tax rate in the United States of just over 5.3% (of the 45 states with a state sales tax and the District of Columbia). The state tax rates for those three states were as follows: Washington, 6.5%; Florida, 6%; and Tennessee, 7%.

states with a sales tax *and* no income tax are in the top 14 on the reliance index.[22] The third column (c) of **Table 2** reports the highest local sales tax rate for those states that levy local sales taxes.

Revenue Loss Estimates. Economists Donald Bruce and William Fox estimated in July 2004 that the "new e-commerce" loss in 2003 was approximately $8 billion.[23] "New e-commerce," as measured by Bruce and Fox, is the lost revenue from states not collecting the use tax on remote Internet transactions. This estimate excludes purchases made over the telephone or through catalogs that would have occurred anyway. An earlier Government Accountability Office (GAO) report estimated that the revenue loss in 2003 from Internet sales would be between $1.0 billion and $12.4 billion.[24] The wide range of the GAO estimate reflects the degree of uncertainty on the size of the potential state and local revenue loss from e-commerce.

The rapid growth of electronic commerce is exhibited by data provided by the U.S. Bureau of Census and could imply that the state and local revenue loss will grow over time. According to retail survey data from the U.S. Department of Commerce, "the third quarter 2004 e-commerce [sales] estimate [$17.6 billion] increased 21.5% from the third quarter of 2003."[25]

The Streamlined Sales and Use Tax Agreement

The entity that drafted the original Streamline Sales and Use Tax Agreement (SSUTA), the Streamlined Sales and Use Tax Project (SSTP), was created in 2000 by 43 states and the District of Columbia. These states and the District of Columbia wanted to simplify and better synchronize individual state sales and use tax laws. Its stated goal was to create a simplified sales tax system so all types of vendors — from traditional retailers to those conducting trade over the Internet — could easily collect and remit sales taxes. The member states believe that a simplified, relatively uniform tax code across states would make it easier for remote vendors to collect sales taxes on goods sold to out-of-state customers. The SSTP was dissolved once the SSUTA became effective on October 1, 2005.[26] The latest amendments to the SSUTA were

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[22] New Hampshire and Alaska are not included in the seven because neither has a state-level sales tax. Wyoming, the seventh, is 24th on the reliance index.

[23] Donald Bruce and William F. Fox, "State and Local Sales Tax Revenue Losses from E-Commerce: Estimates as of July 2004," *University of Tennessee Center for Business and Economic Research*, July 2004, p.5.

[24] U.S. General Accounting Office, *Sales Taxes: Electronic Commerce Growth Presents Challenges; Revenue Losses Are Uncertain*, GAO Report OCE-00-165 (Washington: June 30, 2000), p. 21.

[25] U.S. Census Bureau, Monthly Retail Surveys Branch, Nov. 19, 2004, available at [http://www.census.gov/mrts/www/data/pdf/04Q3.pdf].

[26] Jeffery A. Friedman and Charles C. Kearns, "Federal Streamlined Sales Tax Legislation Introduced in Senate," *State Tax Notes*, Jan. 16, 2006, pp. 131-136.

approved September 20, 2007, and included definitions of digital products and candy. The following is a brief description of the agreement as of this writing.

Description of the SSUTA

Under the SSUTA, member states request that remote sellers voluntarily collect sales taxes on items purchased by customers outside their home state. Vendors in participating states who voluntarily collect the sales tax would be offered amnesty for previously uncollected taxes. Participating states have agreed to share the administrative burden of collecting taxes to ease tax collection for sellers. The states' obligations under the SSUTA include the following requirements.[27]

Standard Definitions of Products. States participating in the SSUTA must define all goods in the same way.[28] For example, in many states, food is exempt from taxation, whereas candy is taxable. A common definition of candy (or food) must be agreed upon to implement a streamlined sales tax regime. Each state retains the choice over whether or not the item is taxable. Local governments in a state must use the same tax base and definitions.

Simplified Tax Rates. In many states, local jurisdictions tax goods at different rates. This complication is mostly remedied under the SSUTA, as each state will be permitted only one state tax rate (with an exception for a second state rate on food and drugs).[29] Each state can add one additional local jurisdiction rate, based on ZIP code.[30] The member state must maintain a catalogue of rates for all ZIP codes. For ZIP codes with multiple rates, an average rate for that ZIP code would apply.

Standard Rate Sourcing Rules for Cross-jurisdictional Sales. Sourcing rules have not yet been finalized under SSUTA. It has been proposed that for sales within a member state between local jurisdictions, the vendor would collect the sales tax at the rate applicable for the *vendor* location. This is identified as "origin" sourcing. For sales into a member state from an out-of-state vendor, the vendor levies a tax at the agreed upon statewide rate applicable in the destination state. This is identified as "destination" sourcing.

There is some debate about the "sourcing" aspect of the SSUTA. The single statewide rate, which is set by each member state, would be a combined state and local rate. If the combined statewide rate is the state rate plus an average of local rates, it is possible that some consumers will pay a higher combined tax rate than is required. It has been proposed that the member states would be required to include a provision in the implementing legislation that would allow consumers that "overpay" to receive a credit for overpayments.

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[27] For more information, see [http://www.streamlinedsalestax.org].

[28] Section 302 of the SSUTA.

[29] Section 308 of the SSUTA.

[30] Section 305 of the SSUTA.

Simplified Administration. Businesses will no longer file tax returns with each state (and sometimes local) government where they conduct business, as is often the case where the SSUTA has not gone into effect.[31] Instead, sales taxes will be remitted to a single state agency. Thus, states will bear some of the administrative cost of the technology employed to implement the new system. Vendor compensation is still under negotiation.

Which States Are in the SSUTA?

As of this writing, 15 states were in full compliance with the terms of the SSUTA and are identified as "members." Another seven states are "associate members." Only the member states will have taxes collected by remote vendors. The following is a listing of the status of SSUTA adoption in each state.

Member States. As of January 1, 2008, there will be 17 member states that have changed their sales tax laws to fully conform with the agreement: Arkansas, Indiana, Iowa, Kansas, Kentucky, Michigan, Minnesota, Nebraska, New Jersey, North Carolina, North Dakota, Oklahoma, Rhode Island, South Dakota, Vermont, West Virginia, and Wyoming.

Associate Member States. At present, five states have begun implementing all the requirements of the project and are considered associate members: Nevada, Ohio, Utah, Tennessee, and Washington. These five states will become full members when they adopt into law all the rules and regulations that accompany full membership. Other states and the District of Columbia are participating as advisors, but are not close enough to qualify as either full or associate members.

Non-participating States. The following states are not participants because they do not levy a statewide sales tax: Alaska, Delaware, Montana, New Hampshire, and Oregon). Colorado levies a statewide sales tax but has chosen not to participate. Alaska does allow some localities to levy a local sales tax, but these localities are not represented in the SSUTA compact.

The Stakeholders. The streamlined sales tax enjoys the support of the National Governors Association (NGA). The NGA has endorsed the SSUTA with hopes that the agreement will address the Supreme Court's concerns about the burden on interstate commerce of collecting remote taxes. The association believes that requiring remote vendors to collect sales and use taxes under a new, simplified system will survive legal challenges. The official statement of the NGA follows:

> Governors call on the federal government to enact legislation to require remote vendors to collect sales and use taxes on sales of taxable products destined for each state adhering to the agreement.[32]

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[31] Section 319 of the SSUTA.

[32] National Governors Association, "EC-12. Streamlining State Sales Tax Systems," Mar. 5, 2007. The statement is available online at [http://www.nga.org].

The NGA support is shared by other state and local government organizations, including the National Conference of State Legislatures (NCSL), the Federation of Tax Administrators (FTA), and the Multistate Tax Commission (MTC).

Support also comes from large retailers who must collect sales taxes and believe the current system provides an unfair advantage to Internet retailers who do not collect such taxes. Many large brick-and-mortar companies with a strong Internet presence generally comply with guidelines like those under SSUTA and generally collect taxes on remote sales. Several retailers, however, are taking the middle ground in this debate. They understand the states' desire to more efficiently collect sales tax revenue in a fair manner, but they ask for greater simplification and increased vendor compensation from the states for collecting state sales taxes.

Opponents of SSUTA legislation include state and local governments who feel the administrative obstacles to streamlined sales taxes are too costly to overcome and may actually exceed the potential revenue gain. These governments suggest that increased compliance with use tax laws may better be achieved through elevated consumer awareness and more enforcement activities. In addition, some business groups maintain that the collection requirement, even with streamlining, would still be too burdensome.

Also opposing the SSUTA are several anti-tax groups who see the SSUTA as a new tax burden rather than a simplification of the current tax system.[33] Anti-tax groups also argue that states compete to attract businesses and customers through lower tax rates and that this competition is good for consumers.

SSUTA Legislation in the 110th Congress

In the 110th Congress, S. 34 (Senator Enzi) and the companion legislation in the House, H.R. 3396 (Representative Delahunt), would grant SSUTA member states the authority to compel out-of-state vendors in member states to collect sales and use taxes.[34] Both bills would respond to the Supreme Court's recommendation in *Quill Corporation v. North Dakota* that Congress act, under the commerce clause, to clarify state sales tax collection rules. More specifically, the legislation would allow states that have fully adopted the SSUTA to collect sales taxes from sufficiently large businesses, even if those businesses do not have a nexus in the state. A "sufficiently large business" is defined in the legislation as one with nationwide sales of greater than $5 million.

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[33] Americans for Tax Reform, "The Streamlined Sales Tax Proposal: A Tax Increase Under the Radar," Policy Brief, Undated material available on the Internet at [http://www.atr.org/content/pdf/2005/dec/120704ot_SSTPpb.pdf].

[34] The U.S. House Small Business Subcommittee on Regulatory Reform and Oversight held an oversight hearing on the streamline legislation, S. 2152 and S. 2153, on Feb. 8, 2006. The submitted witness testimony is available from the subcommittee website at [http://wwwc.house.gov/smbiz/hearings/databaseDrivenHearingsSystem/displayHearings.asp?congress=109].

Under S. 34 and H.R. 3396, Congress would grant authority to states to compel out-of-state vendors to collect sales taxes, on the condition that 10 states comprising at least 20% of the total population of all states imposing a sales tax have implemented the SSUTA.[35] The legislation also includes additional requirements for administering the new sales tax system after the SSUTA adoption threshold has been achieved. These requirements include, but are not limited to

- a centralized, one-stop multi-state registration system
- uniform definitions of products and product-based exemptions
- single tax rate per taxing jurisdiction with a single additional rate for food and drugs
- single, state-level administration of sales and use taxes
- uniform rules for sourcing (i.e., the tax rate imposed is based on the origin or destination of the product)
- uniform procedures for certification of tax information service providers
- uniform rules for filing returns and performing audits
- reasonable compensation for sellers collecting and remitting taxes
- simplification of telecommunication service taxes by member states by July 1, 2010

The SSUTA includes these provisions, though some modifications to the SSUTA or the legislation may be necessary for enactment.

[35] S. 34, Sec. 4(a)(2).