Statement of

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Introduction

Chairman Goodlatte, Ranking Member Conyers, and distinguished members of the committee, thank you for the opportunity to submit testimony regarding the issue of Internet sales tax collection. My name is Andrew Moylan and I am senior fellow and outreach director for the R Street Institute, a relatively new free market think tank with offices in Washington; Tallahassee, Fla.; Austin, Tex.; and Columbus, Ohio. R Street supports free markets; limited, effective government; and responsible environmental stewardship. It strives to craft pragmatic solutions to domestic policy challenges involving regulation, public health, the environment, tax reform and the federal budget.

I have spent a great deal of time in recent years working on Internet sales tax issues, both at R Street and with my previous employer, the National Taxpayers Union. I believe strongly that passage of legislation like S. 743, the so-called Marketplace Fairness Act (MFA), would undermine basic principles of sound tax policy, impose unequal collection burdens on businesses and constitute a substantial burden on interstate commerce

However, I also believe there is a solution to address the concern that current law is inadequate while maintaining important tax policy protections. It also meets Internet sales tax principles laid out by Chairman Goodlatte late last year. The solution is to extend the simple "origin sourcing" collection standards already in use nationwide for brick-and-mortar sales to all remote sales as well. This would ensure that all retail sales are governed by the same straightforward rules, requiring tax collection based on the physical location of the business, not the residence of the buyer.

Current Law

Before discussing the failures of the Marketplace Fairness Act and the contours of an origin-sourcing solution, I'd like to summarize the law as it stands today. Current law prevents tax authorities from forcing a retailer of any type to collect and remit its sales tax unless it has a tangible physical presence in the state. In other words, only a legitimate physical presence in a state triggers collection requirements. This rule applies equally to traditional brick-and-mortar sellers as well as online-only and so-called "brick-and-click" businesses that sell through retail locations and over the Web.

The rule is the result of a 1992 Supreme Court case, *Quill v. North Dakota*, where a Delaware-incorporated office supplier with no presence in North Dakota was found to have no obligation to collect and remit on the latter state's behalf. The court held that extraordinary sales tax complexity would render the interstate commerce burden of mandatory collection on out-of-state businesses too great to be constitutionally permissible.

Though states cannot compel non-resident businesses to collect and remit their sales tax, individual customers who reside in states with a sales tax are required to pay "use tax" in lieu of conventional sales tax on items purchased in other states. The use tax regime, which relies on self-reporting, is seen as ineffective, in part because most taxpayers are simply unaware of their obligations. This makes enforcement of use tax difficult, expensive and hugely unpopular, since

it would require intrusive audits of a state's residents to determine legitimate use tax obligations. As a result, states have been clamoring for the federal government's permission to instead allow them to force out-of-state businesses to collect their sales taxes, a change that would represent a dramatic expansion of state taxing authority and would untether tax policy from the basic limiting principle of physical presence. *Quill* has served to protect consumers and businesses on whom the legal requirement to collect and remit sales taxes would be placed from substantial compliance burdens imposed by overeager revenue agents in "foreign" states.

Passage of the MFA or similar legislation would enhance states' audit and enforcement power such that it would no longer end at their borders. It would give states license to enforce tax rules on businesses outside their jurisdiction, resulting not just in damage to Internet-based businesses but substantial compliance and interstate commerce burdens that could threaten to dent our fragile economic recovery.

To understand why origin sourcing is a superior solution, however, requires a discussion of the many problems inherent in the MFA.

Marketplace Fairness Act Dismantles Vital Taxpayer Safeguard

Contrary to the claims of proponents, current law is not a "loophole" implemented in a deliberate attempt to advantage Internet retailers. Instead, the *Quill* decision drew on and emphasized a bedrock foundational principle of tax policy: the physical presence standard. Simply stated, this standard generally prevents tax entities from extending their authority beyond their physical borders. As a result, businesses and taxpayers alike are shielded from predatory tax administration ploys that might seek to target non-residents for revenue.

The physical presence standard is a strong protection from overzealous tax collection tactics and a fundamental safeguard in American tax policy. It is broadly accepted as the appropriate boundary which states must observe when asserting tax prerogatives. Physical presence is a constraint on tax collectors that applies to most areas of tax policy, including business earnings and individual income taxes.

As but one example of the wide-ranging relevance and respect given to the physical presence standard, in the 112th Congress, the House unanimously passed H.R 1864, the Mobile Workforce State Income Tax Simplification Act. This legislation, which unfortunately never received Senate consideration, would have prevented states from requiring income tax filing or withholding from workers unless they reside or work in a given state for more than 30 days in a calendar year. This common sense criterion would prohibit unfair income tax filing requirements on non-residents and at its core is the wise counsel of the physical presence standard.

Another example of the importance of physical presence in tax policy is H.R. 2992, Chairman Goodlatte's Business Activity Tax Simplification Act. He has for years championed this important legislation, on which this committee held a hearing just two weeks ago, that would strengthen definitions of what constitutes a physical presence in direct response to overly-aggressive state efforts to assert tax authority over companies that do not have substantial nexus.

The MFA would erase the physical presence standard for remote retail sales, while ostensibly maintaining it for brick-and-mortar sales. The result, as outlined further in this testimony, would be an abandonment of limits on taxing powers that have served our federal system so well for decades, even centuries.

In fact, S. 743's language makes very clear how it would place the physical presence standard on the slippery slope to extinction. Section 3 of the bill reads like an admission that the legislation could have grave implications for taxpayers, insisting that it is not intended to affect tax, nexus or licensing and regulatory requirements, respectively, in subsections (a) – (c). In other words, the bill's authors promise that its language strips away the physical presence protection *only* for sales taxes and not for other levies and that it doesn't open businesses up to regulatory interventions in states where they have no physical presence.

While it is true that the bill's plain language does not empower states to untether other policies from the physical presence protection, the bill does establish a precedent that aggressive states could use to expand their reach. If states were empowered to enforce their *sales* tax obligations on non-resident businesses, it seems just a matter of time before some will attempt to enforce *other* tax obligations on non-resident businesses, as well.

For example, if Utah-based Overstock.com does 15 percent of its sales to California residents, the state might well argue that it is entitled to impose California business tax obligations on an equivalent share of Overstock's profits. A state like New York could assert that, if non-resident businesses must collect sales tax for items sold to New Yorkers, they also should comply with New York consumer product and labor regulations for items sold to New Yorkers. The slope toward state power unbounded by geography the MFA would create is slippery indeed.

Marketplace Fairness Act Would Yield "Unlevel" Playing Field

MFA proponents argue their bill is intended to "level the playing field" between brick-and-mortar and remote retailers. In reality, it would do the opposite. While the legislation would require sellers to collect sales tax on every remote sale, it would do so with a different and unequivocally harsher set of rules than exist for brick-and-mortar sales.

Passage of the MFA would mean states could strong-arm remote sellers into complying with the more than 9,600 separate sales tax rates that exist across the country, not to mention the 46 states with sales taxes that can issue their own unique set of edicts and definitions.[1] S. 743 would concoct a "destination-based" sourcing regime that compels sales tax collection based on the location of its customer. An online business would have no choice but to quiz each and every customer on their residence, decipher the appropriate rates for their locality and remit what is collected to a distant tax agency.

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[1] Tax Foundation, "Sales Tax Rates in Major U.S. Cities," Accessed March 2, 2014. http://taxfoundation.org/article/sales-tax-rates-major-us-cities

But when a brick-and-mortar retailer makes a sale in one of its stores, it doesn't have to jump through any of those hoops. When a customer checks out at a register, they are not quizzed about their residence and then charged the prevailing rate in that locality. That's because brick-and-mortar retailers effectively operate on an "origin-based" sourcing rule, one that collects tax based upon the location of the business rather than the location of the consumer. Even states that technically operate their tax regimes under destination-based sourcing rules for traditional retail sales tend to short-circuit them: they attempt to mimic origin-based sourcing by assuming that the "point of delivery" of an item is not where its customer lives but where it gets handed back to the customer at the cash register.

This clever bit of maneuvering allows brick-and-mortar retailers across the country to operate on a system whose compliance, at least as far as tax laws are concerned, can be relatively straightforward. Each business charges the prevailing sales tax where it is located to all of its customers, regardless of their eventual destinations. The MFA would deny that administrative convenience to remote retailers by pressing them into a cross-examination process for each and every customer.

S. 743 Imposes Tremendous Compliance and Interstate Commerce Burdens

Because they would now answer to 9,600 tax jurisdictions across the country, remote retailers would have to shoulder heavy overhead costs just to meet their new tax-collection liabilities. In fact, the MFA essentially acknowledges its imposition of major expenses and complexity by including an exemption for businesses that have less than $1 million of annual remote sales. This provision makes clear that even sponsors and supporters feel compliance would exact an unbearable toll on small sellers.

Unfortunately, S. 743's paltry exemption level (by comparison, the Small Business Administration threshold for defining a small business is $30 million in sales) would do little to ease the suffering of smaller businesses, which would face greater relative competitive disadvantages as a result of the bill. A PricewaterhouseCoopers study found that businesses with between $1 million and $10 million in sales would face compliance costs nearly 2.5 times larger than those endured by firms with more than $10 million in sales.[2] The smaller the business, the greater the proportion of sales siphoned off just to navigate this maze of extremely complicated sales taxes.

Industry data suggests the specialty retail sector (which includes businesses like Bed, Bath & Beyond and Amazon.com) enjoys an average net profit margin of just 4 percent[3], while catalog and mail-order retailers (which include eBay and Overstock.com) average 2 percent[4]. A hypothetical business with $1 million of remote sales would earn $20,000 to $40,000 of profits on those sales. A business with a $20,000 operating margin would be hard-pressed to comply with rates from thousands of tax jurisdictions without severe damage to their business.

[2] PriceWaterhouseCoopers, "Retail Sales Tax Compliance Costs: A National Estimate," Accessed March 2, 2014. http://netchoice.org/wp-content/uploads/cost-of-collection-study-sstp.pdf
[3] Yahoo! Finance, "Industry Center – Specialty Retail," Accessed March 2, 2014. http://biz.yahoo.com/ic/745.html
[4] Yahoo! Finance, "Industry Center – Catalog & Mail Order Houses," Accessed March 2, 2014. http://biz.yahoo.com/ic/739.html

Some companies would collapse under the weight of these compliance loads, and others would either have to raise prices substantially (which is difficult to impossible to do in any competitive market) or find other ways to cut costs, such as through layoffs, in order to make ends meet. Congress has the duty and authority to prevent states from enacting policies that significantly harm interstate commerce. Paradoxically, S. 743, would encourage such damage at an especially fragile time for our economy.

Tax Simplification Efforts Have Largely Failed

Much of the movement behind the MFA has been justified by the argument that sales tax codes are being simplified across the country. While the Streamlined Sales Tax Project (SSTP) and other efforts have expended much energy on this worthy task, the sad fact is that state sales taxes today are more complex than ever. The number of tax jurisdictions has steadily risen in the years since SSTP's inception and our nation is nowhere close to the sort of uniformity and ease of administration the project sought to create.

For a glimpse into the reality of sales tax complexity, consider the dilemma of determining when ice cream is a baked good for Wisconsin's tax purposes. Former Forbes.com writer Josh Barro discussed a bulletin from the Wisconsin Department of Revenue seeking to clarify the tax treatment of ice cream cake.[5]

> If I understand the memo correctly, the rules are as follows. Ice cream cake is a taxable prepared food if you make it yourself, but not if you're just reselling the cake. However, if the cake contains real cake layers, it's a non-taxable baked good no matter who made it, so long as the amount of cake exceeds the amount of ice cream. (No, really: Example 9 is a cake with two cake layers and one ice cream layer, which is tax exempt; Example 10 is a cake with one cake layer and two ice cream layers, which is taxable because it doesn't contain enough cake.) If you buy a cake from someone and then decorate it yourself, it's taxable no matter how much flour it contains. And if you slice any cake and serve it in individual servings, or if the cake consists of fewer than four servings, or if the customer is going to eat the cake on the premises at your business, or if you give the customer utensils with his cake, it's a taxable prepared food, though you may be exempt from that last one if the sale of prepared foods is incidental to your business.

This offers a vivid illustration of the challenge of tax complexity: the exceedingly difficult work of establishing how a given item is defined. Different localities have different answers, each of which may yield different tax obligations. MFA proponents claim there are modern software solutions to address the difficulties of compliance, but that is like saying that TurboTax has solved our mind-numbingly complex federal income tax code. The computing power to do the math has existed for decades but the ice cream cake conundrum can't be solved with software alone.

[5] Forbes.com, "Want to Sell an Ice Cream Cake? Just Fill Out These Simple Forms," Accessed March 2, 2014. http://www.forbes.com/sites/joshbarro/2012/04/03/want-to-sell-an-ice-cream-cake-just-fill-out-these-simple-forms/

Marketplace Fairness Act Violates All of Chairman Goodlatte's Principles

Last year, Chairman Goodlatte released a commendable list of seven important principles to guide any future action on Internet sales taxation: tax relief, tech neutrality, no regulation without representation, simplicity, tax competition, states' rights and privacy rights. Sadly, the MFA violates every one of these principles.

Goodlatte Principle	Marketplace Fairness Act
1. Tax relief - Using the Internet should not create new or discriminatory taxes not faced in the offline world. Nor should any fresh precedent be created for other areas of interstate taxation by states.	Businesses would face new and more burdensome tax collection requirements for online sales. MFA would constitute precedent for undermining or eliminating the physical presence standard in other areas of taxation and regulation.
2. Tech Neutrality – Brick & mortar, online and brick & click businesses should on equal footing. The sales tax compliance burden on online Internet sellers should not be less, but neither should it be greater than that on similarly situated offline businesses.	MFA would deliberately advantage brick-and-mortar over remote sales by allowing in-person transactions to have tax collected under dramatically simpler origin-sourcing rule, while online transactions would have tax collected under an extremely complex destination-sourcing rule.
3. No Regulation Without Representation – Those who would bear state taxation, regulation and compliance burdens should have direct recourse to protest unfair, unwise or discriminatory rates and enforcement.	Under MFA, businesses would be subject to regulation, audit and enforcement actions in states where they have no presence whatsoever, constituting regulation without representation.
4. Simplicity – Governments should not stifle businesses by shifting onerous compliance requirements onto them; laws should be so simple and compliance so inexpensive and reliable as to render a small business exemption unnecessary.	MFA entails enormous complexity, forcing businesses to comply with thousands of complex and ever-changing sales tax rates. Its small business exemption, though paltry, is evidence that sponsors recognize the burden and wish to protect smaller operations from its ravages.
5. Tax Competition – Governments should be encouraged to compete with one another to keep tax rates low and American businesses should not be disadvantaged vis-a-vis their foreign competitors.	Because it would allow states to target non-resident businesses, MFA encourages higher rates that can be extracted from entities with no recourse to challenge or lower them.
6. States' Rights – States should be sovereign within their physical boundaries. In addition, the federal government should not mandate that states impose any sales tax compliance burdens.	MFA obliterates the concept of state powers limited by geographical borders, allowing them to extend their tax authority into any state in the nation, including those without sales taxes.

7. Privacy Rights – Sensitive customer data must be protected.	MFA requires exchanging enormous amounts of personal data to enable auditing and enforcement, raising the prospect of privacy violations and leaks of sensitive information.

Where MFA Fails, Origin Sourcing Succeeds

The MFA guts an important limiting principle that a state may tax and audit only those entities within its borders; imposes an unlevel playing field for brick-and-mortar and remote sales; creates substantial compliance and interstate commerce burdens; and relies on the flawed notion that software can allow for easy compliance with thousands of ever-changing sales tax codes nationwide.

An origin-sourcing rule, however, affirms the physical presence standard by clarifying that states can only enforce tax collection and audit obligations on resident businesses, imposes precisely the same collection standard on remote sales as it does on brick-and-mortar sales, entails minimal compliance obligations and eliminates the need for complex software integration by specifying that collection and remittance for a given business will only be for the tax authorities in that locality.

Comparing a federal origin sourcing rule to the seven Goodlatte principles yields a very different story indeed.

Goodlatte Principle	Origin Sourcing
1. Tax relief - Using the Internet should not create new or discriminatory taxes not faced in the offline world. Nor should any fresh precedent be created for other areas of interstate taxation by states.	Businesses would face the same collection standard for all sales, whether in-person, via Internet or mail-order. Physical presence standard would be affirmed as the appropriate rubric for imposing tax-collection obligations.
2. Tech Neutrality – Brick & mortar, online and brick & click businesses should on equal footing. The sales tax compliance burden on online Internet sellers should not be less, but neither should it be greater than that on similarly situated offline businesses.	Origin sourcing would not punish a business for availing itself of the Internet with a more burdensome collection standard. Instead, it would ensure that all sales are treated precisely the same for tax-collection purposes, leveling the playing field between technologies and business models.
3. No Regulation Without Representation – Those who would bear state taxation, regulation and compliance burdens should have direct recourse to protest unfair, unwise or discriminatory rates and enforcement.	Because it affirms the physical presence standard, origin sourcing would ensure that no business faced regulation without representation. The only tax authorities to which a business would be liable would be those for its physical location, where they have administrative and political recourse.

4. Simplicity – Governments should not stifle businesses by shifting onerous compliance requirements onto them; laws should be so simple and compliance so inexpensive and reliable as to render a small business exemption unnecessary.	Origin sourcing is radically simple, allowing most businesses to seamlessly comply simply by running remote sales through the same system as in-person sales. The burden of doing so would be so minimal that a small business exemption would not be necessary.
5. Tax Competition – Governments should be encouraged to compete with one another to keep tax rates low and American businesses should not be disadvantaged vis-a-vis their foreign competitors.	Origin sourcing provides for healthy tax competition between states, encouraging them to compete with one another to create and maintain attractive climates for business location.
6. States' Rights – States should be sovereign within their physical boundaries. In addition, the federal government should not mandate that states impose any sales tax compliance burdens.	Origin sourcing affirms appropriate limits on state taxing power, ensuring that only the home state has authority to enforce tax collection obligations on its businesses.
7. Privacy Rights – Sensitive customer data must be protected.	Origin sourcing entails fewer exchanges of sensitive information with fewer entities, since each business would deal just with its local tax authorities, not dozens across the country where data might become compromised.

How Origin Sourcing Rules Work

As mentioned, an origin sourcing rule requires collection of applicable sales tax based on the physical location of the seller, as opposed to requiring collection based on the physical location of the buyer.

Imagine that a Texas resident makes a purchase over the Internet from a single-location Massachusetts-based retailer. Because the business does not have a physical presence in Texas, current law does not require any sales tax be collected on the item (though the buyer will owe use tax directly to Texas). This is relatively simple for the business to administer, since their lack of storefront, distribution or staff in Texas makes clear they have no substantial nexus with the state that would trigger any collection requirement. It does, however, raise concerns for some policymakers, since the use tax the individual owes is almost certainly not going to be paid.

Under a destination sourcing rule, such as that effectively countenanced by the MFA, the Massachusetts business would be required to quiz the customer as to their residence, look up and accurately apply the appropriate Texas tax rate for the item, and then remit the collected dollars to the appropriate tax authority, despite the fact that they have no presence themselves in the Lone Star State. It would also open them up to audit and enforcement actions from that distant tax authority.

Under an origin-sourcing rule, the Massachusetts company would simply collect tax based on the Bay State jurisdiction where their business is located, regardless of where the customer resides. As a result, the seller need only be familiar with and accountable to the rules and enforcement actions of the jurisdiction in which they're located.

Where Origin Sourcing Already Applies

Origin sourcing is not at all a novel concept. In fact, it governs the vast majority of retail sales today. Virtually all state laws are structured so that collection on in-person sales effectively mimics an origin-sourcing rule. As previously mentioned, they do this by assuming that the "destination" of the good for purposes of sourcing is the counter at which the customer receives it. Brick and mortar retail businesses are not asked to interrogate their customers to determine whether they reside in a different state or locality. The simplicity inherent in this rule means that there are no hoops to jump through to determine in which of America's many taxing jurisdictions the customer resides and how to apply its unique code to the sale.

Though it surprises some to hear, this structure governs more than than nine out of every 10 sales made from businesses to consumers in the United States today. Despite popular perception of Web dominance, U.S. Census Bureau data shows that only 6 percent of all sales are currently transacted over the Internet.[6] Mail-order sales represent an even smaller share. Though the segment is clearly growing at a rapid rate, the reality is that retail is still predominantly conducted in stores across the country and that will remain the case for years, perhaps decades, to come.

In addition to all brick-and-mortar retail sales, origin sourcing prevails to one degree or another for *intrastate* remote sales in at least 17 states that contain more than half of America's population: Arkansas, Arizona, California, Iowa, Illinois, Missouri, North Carolina, Ohio, Oklahoma, Pennsylvania, Rhode Island, Tennessee, Texas, Utah, Virginia, and Washington. In each of these jurisdictions, most remote transactions completed between a resident and a business located in the same state will have tax collected based on the seller's location, not the buyer's.

In other words, origin sourcing is already the overwhelmingly dominant mode of sales tax collection in the United States, covering substantially all transactions conducted in physical retail outlets (which themselves comprise more 90 percent of total retail sales) as well as intrastate remote retail sales for roughly half the country. As such, the "universe" of business-to-consumer sales for which destination sourcing reigns is really quite small. In seeking to expand its use to cover all remote interstate sales, the MFA relies on an outmoded collection standard that is unworkable on a national scale.

The United States is by no means alone in its extensive reliance on origin sourcing. The European Union also takes advantage of its simplicity by employing it for value-added tax collection on business-to-consumer services performed across member-country borders, in

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[6] U.S. Census Bureau, "Quarterly Retail E-Commerce Sales, 4th Quarter 2013," Accessed March 2, 2014. http://www.census.gov/retail/mrts/www/data/pdf/ec_current.pdf

order to ease the burden of collection and remittance obligations. The same is true of tangible goods sold from business-to-consumer, below certain sales thresholds.[7] The American Enterprise Institute's Michael Greve covers the E.U.'s grappling with cross border taxation policy extensively in his brilliant book, *Sell Globally, Tax Locally.*[8]

Interestingly, E.U. countries use destination sourcing as something of a protective measure against non-E.U. countries that sell services to consumers that reside in the union. A U.S. business selling to a consumer in the European Union would be required to collect and remit the value-added tax on a complex destination sourcing rule, forcing them to comply with dozens of different rates, while an E.U. business selling to the very same consumer would simply collect the rate for its home country. This makes collection simpler for E.U. businesses, turning destination sourcing into a sort of protectionist cudgel used against foreign competitors.

The Federal Role in Origin Sourcing

If this committee or this Congress considers any changes to federal law relating to Internet sales tax collection, I believe it should do one simple thing: pass legislation stating clearly that an origin-sourcing rule is the only permissible standard for state taxation of interstate remote sales. All other methods, including the destination-sourcing scheme embodied in the MFA, would be effectively pre-empted.

Structured in such a way, a federal origin-sourcing rule contemplates a role for Congress not at all dissimilar to the one laid out in the Marketplace Fairness Act, though the policies themselves are of course quite different. What MFA does is set out the conditions under which states may assert authority to tax remote interstate sales, as well as the conditions under which they may *not* assert that authority.

The MFA's federal intervention would empower states to assert their tax power on remote interstate sales if they become members of the Streamlined Sales and Use Tax Agreement or if they abide by a separate set of minimum simplifications. However, it also sets out conditions under which states would *not* be permitted to do so, indicating that taxation of remote interstate sales would be impermissible if they failed to meet either of the aforementioned standards. Even if they do indeed meet one of the standards, taxation of businesses with remote sales less than $1 million would be impermissible in any case.

An origin-sourcing rule would actually be much less prescriptive for states than would MFA. It would simply say that states may only tax interstate remote sales if they do so on an origin-sourced basis. If a state meets that standard, it may apply tax to interstate transactions, but it would be under no other obligations to the federal government beyond existing laws and regulations.

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[7] European Commission Taxation and Customs Union, "Where to tax?," Accessed March 2, 2014. http://ec.europa.eu/taxation_customs/taxation/vat/how_vat_works/vat_on_services/

[8] Michael Greve, *Sell Globally, Tax Locally* (Washington, DC: The AEI Press, 2003)

For example, states would be perfectly free to define a sales tax base as wide or narrow as they please. Similarly, they would be perfectly free to set sales tax rates as high or low as they please, including the freedom to choose not to have a sales tax at all. In fact, states could decide to use destination sourcing for *intrastate* sales if they felt it was best. The only constraint on state tax power in a federal origin sourcing rule would be on states seeking to assert tax authority over interstate remote sales, which would have to operate on an origin basis in order to avoid the compliance and interstate commerce nightmare of a destination regime for such transactions.

Importantly, any federal legislation specifying origin sourcing as the appropriate standard should establish some baseline protections against manipulation or deception from businesses that might seek to avoid tax collection. For example, the language should establish basic definitions of origin that prevent companies from setting up shell operations.

Guidance can be found in states where origin sourcing exists for intrastate remote sales. Virginia specifies that the origin of an item is the "location at which the order was first taken[9]," while Texas establishes origin at the location from which the item is shipped[10]. Congress might consider blending these approaches or perhaps seeking input from other areas of tax law, like business activity taxes, which establish clear rules for defining origin.

A federal rule should also specify that items on which sales tax has been collected, regardless of origin, may not also be subjected to duplicative use tax. It is highly unlikely that states would choose to aggressively enforce use taxes in such a way given that the failures of that system have led to this very hearing, but federal guidance would be helpful in preventing potential abuses. The only reason a state might attempt to employ a redundant use tax is as a form of protectionism against out-of-state businesses and products and thus Congress has a clear role in pre-empting such behavior.

It also may be necessary for an origin-sourcing law to specify that legal proceedings related to the matter be handled in federal court, as opposed to on the state level.

Why the Case Against Origin Sourcing is Weak

I believe strongly that origin sourcing is the appropriate frame for Internet sales taxation, but it is not without its detractors. Some big-box retailers, in particular, have waged a subtle lobbying battle against it for months. Though they mount occasionally vigorous opposition to the concept, their arguments simply don't hold up to scrutiny.

The first and most important defense against attacks on origin sourcing is to point to the fact that it already applies to the overwhelming majority of retail sales in the country, including substantially all brick-and-mortar sales. While no system is perfect, origin sourcing has served brick-and-mortar retail just fine for decades.

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[9] Virginia Department of Taxation, "Guidelines for the Retail Sales and Use Tax Changes Enacted in the 2013 General Assembly Session," Accessed March 2, 2014. http://goo.gl/X0IvzC

[10] Texas Comptroller of Public Accounts, "Guidelines for Collecting Local Sales and Use Tax," Accessed March 2, 2014. http://window.state.tx.us/taxinfo/taxpubs/tx94_105.pdf

In other words, origin sourcing is either inherently problematic or it's not. If it is, then intellectual consistency dictates that we must scrap virtually the entire retail sales tax collection structure in place today in favor of a destination rule requiring retailers to quiz their customers and comply with far-away tax authorities. If it's not, opponents must articulate why it works perfectly well for in-person sales but somehow won't for remote sales.

Race to the Bottom

Opponents of origin sourcing claim it would set off a "race to the bottom," whereby businesses would rush to locate in non-sales tax states (or foreign countries) in order to avoid having to collect. This is unlikely for a host of reasons. First, sales tax collection is but one burden faced by a business. While taxes clearly have strong influence on both individual and firm behavior, any company must weigh its sales tax burden against other levies, like income and property taxes. In addition, it must consider factors like a quality labor pool, access to transportation infrastructure, proximity to suppliers and many others. Any location decision is likely to balance all of the aforementioned factors.

Consider a business in the Pacific Northwest. It could decide between two very different tax systems in Washington state, which has no income tax and high sales taxes in some areas, and Oregon, which has no sales tax and high income taxes. It is not at all obvious that every rational firm would choose to locate in Oregon, given the choice, because their business model may benefit more from Washington's climate.

In addition, there's nothing stopping the race to the bottom today. An online retailer wishing to avoid collection obligations under current law has the same incentive today to locate in a non-sales tax state as they would under a federal origin sourcing rule. It could escape collection in other states without triggering any in its new home state, since the one place where it would have physical presence has no sales tax at all. In reality, however, relatively few businesses have done so, precisely because location decisions are much more complicated.

Furthermore, to the extent that businesses *do* decide to make location decisions on the basis of beneficial tax climates, that's a good thing. Consumers and taxpayers benefit from states competing with one another to attract businesses, jobs and economic activity with modest and comprehensible tax burdens. Congress should encourage tax competition because it disciplines state budgeting and allows the "laboratories of democracy" concept to flourish.

In my view, the much more likely scenario than the wholesale flight of retailers to New Hampshire or Montana is that sales tax issues could affect location decisions on the margin in a given region. For example, in the Washington, D.C, metro area, one might see businesses deciding to locate in relatively lower-tax Virginia over Maryland.

Taxation Without Representation

A criticism often heard of origin sourcing is that it amounts to taxation without representation. This stems from a fundamental confusion about who, exactly, bears the burden of sales taxes.

Though the levy is ostensibly tied to an individual's purchase and theoretically gets passed on to the consumer, the reality is that businesses are, for all intents and purposes, the "taxpayer" as it relates to sales tax.

Consider what happens if a state believes there is a shortfall in sales tax collections. In such a case, that state will not come to the consumer to recoup the dollars, it will come to the seller. The business is legally liable for all sales tax collection, regardless of whether or not they collected enough from their customers, and any shortfall would be adjudicated through an audit on and be paid for by said business. So while it's true that the *economic* incidence of sales tax is borne by the individual, the *legal* incidence is borne entirely by businesses.

In fact, in many places, the sales tax is defined as a "business privilege" or "transaction privilege" tax. Arizona's Department of Revenue describes their sales tax thusly:

> The Arizona transaction privilege tax is commonly referred to as a sales tax; however, the tax is on the privilege of doing business in Arizona and is not a true sales tax. Although the transaction privilege tax is usually passed on to the consumer, it is actually a tax on the vendor.[11]

The sales tax is a tax administered by business in much the same way corporate income tax is. In both cases, the economic burden is borne entirely by individuals. With sales tax, that economic burden is passed on directly when an item is paid for. With corporate taxes, the burden manifests itself either in the form of higher prices, lower wages or fewer jobs for workers or reduced returns for shareholders. And in both cases, the legal incidence of the tax is borne entirely by the business, on which all requirements for compliance fall.

States' Rights

Another common refrain is that origin sourcing violates fundamental concepts of states' rights by undermining their ability to tax purchases made by their residents. This, too, is rooted in the aforementioned misunderstanding of who the "taxpayer" really is. Though a state's resident may make a purchase, it is *another* state's business that has the legal obligation to collect and remit the sales tax and be subject to audit and enforcement actions.

What this criticism attempts to defend is the notion that states should have the unfettered right to tax businesses in any state across the country. In effect, it yearns for the days of the Articles of Confederation, when states were empowered to enact deleterious protectionism in the form of unbounded tax and regulatory authority. The result of that failed experiment was a new federal charter which explicitly empowered the federal government to head off such actions.

The Commerce Clause of the Constitution and subsequent jurisprudence gives Congress the clear power to pre-empt state actions that impede the flow of interstate commerce. Though

[11] State of Arizona Department of Revenue, "Transaction Privilege Tax Licensing," Accessed March 2, 2014. http://www.azdor.gov/Business/TransactionPrivilegeTax.aspx

Congress must take care to exercise this power judiciously, it is my view that an origin-sourcing rule is fully consistent with its precepts. A destination-sourcing rule, such as that embodied in the MFA, would entail such disruption and cost to interstate commerce that Congress would be justified in pre-empting such rules by passing a law establishing origin sourcing as the only acceptable means of tax collection on interstate remote sales.

A perfect example of Congress exercising this power is the Internet Tax Freedom Act. Originally passed in 1998 and most recently renewed by unanimous votes in both the House and Senate in 2007, this legislation acts as a federal prohibition on any state or local taxation of Internet access or imposition of discriminatory Internet-only taxes, such as a levy on bandwidth. Congress recognized the danger inherent in states singling out the Internet for harsh tax treatment and moved to foreclose their legal authority to do so, lest such efforts stifle the flourishing of a technology that has since provided incalculable benefits to the economy and standards of living.

A more recent example is the Wireless Tax Fairness Act, H.R. 2309 in this current Congress. This legislation has been sponsored by 219 Members, including many on this committee, and passed the House by a voice vote in 2011. It would establish a five-year moratorium on state imposition of discriminatory tax rates on wireless phone and data services. This too is a federal pre-emption of state law in service of the higher goal of preventing harm to interstate commerce, as few markets are more interstate in nature than wireless service.

States' rights are important and all-too-often trampled by an overzealous federal government. They should indeed be sovereign entities free of unnecessary federal meddling. But the Constitution made clear that their rights, especially as it relates to taxation, end at the border and an origin-sourcing rule would underscore that protection.

Conclusion

S. 743, the Marketplace Fairness Act, is detrimental to the interests of taxpayers, businesses and sound tax policy. There are other ways, like uniform origin-based sourcing, to address this matter without trampling on vital pro-taxpayer checks and balances and without burdening interstate commerce by foisting unworkable schemes on remote sellers. Simply treating remote sales in the same way that we already treat brick-and-mortar sales would level the playing field in an honest way.

While the policy points away from the MFA and in the direction of origin sourcing, it is worth mentioning the politics of the issue do much the same. Last year, the R Street Institute joined with the National Taxpayers Union to commission a poll testing public attitudes on Internet sales tax issues, where we found strong and surprisingly widespread 57 percent opposition to an MFA-like scheme.[12]

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[12] R Street Institute and National Taxpayers Union, "Is Congress Listening? The Peril of Ignoring Public Opinion on the Internet Sales Tax Issue," Accessed March 2, 2014. http://www.rstreet.org/wp-content/uploads/2013/09/Internet-Sales-Tax-Is-Congress-Listening.pdf

Republicans were opposed by a 39-point margin, independents by a 22-point margin, and even Democrats by a four-point margin. Virtually every demographic, region, income level and vote behavior showed strong margins of dislike for the plan. And it wasn't just knee-jerk reaction to the "T" word; by better than a 3-to-1 margin, respondents correctly identified current law and by roughly 2-to-1 margins, they gravitated toward anti-MFA arguments when put head-to-head in a neutral manner against pro-MFA statements.

No Congress should govern by poll alone, but this data proves that not only is a destination-sourcing scheme like the MFA bad policy, it is profoundly bad politics as well. That should send a strong message to this committee that America is engaged on this issue and that only something like an origin-sourcing rule to truly level the playing field can pass muster with them. Thank you for the opportunity to submit this testimony today and I welcome any questions from members.