

Internet Taxes, “Main Street Fairness” & the Origin-Based Alternative

by [Adam Thierer](#) on August 2, 2011 · [3 Comments](#)

The debate over the imposition of sales tax collection obligations on interstate vendors is heating up again at the federal level with [the introduction](#) of S. 1452, “**The Main Street Fairness Act.**” [\[pdf\]](#) The measure would give congressional blessing to a multistate compact that would let states impose sales taxes on interstate commerce, something usually blocked by the Commerce Clause of the U.S. Constitution. Senator Dick Durbin (D-IL) introduced the bill in the Senate along with Tim Johnson (D-SD) and Jack Reed (D-RI). The measure is being sponsored in the House of Representatives by John Conyers (D-MI) and Peter Welch (D-VT). At this time, there are no Republican co-sponsors even though Sen. Mike Enzi was rumored to be a considered co-sponsoring the measure before introduction.

Without any Republicans on board the effort, the measure may not advance very far in Congress. Nonetheless, to the extent the measure gets any traction, it is worth itemizing a few of the problems with this approach. My Mercatus Center colleague Veronique de Rugy and I have done some work on this issue together in the past and we are planning a short new paper on the topic. It will build on this lengthy Cato Institute paper we authored together in 2003, “[The Internet Tax Solution: Tax Competition, Not Tax Collusion.](#)” The key principle we set forth was this: “Congress must.. take an affirmative stand against efforts by state and local governments to create a collusive multistate tax compact to tax interstate sales.” “It would be wrong,” we argued, “for members of Congress to abdicate their responsibility to safeguard the national marketplace by giving the states carte blanche to tax interstate commercial activities through a tax compact. The guiding ethic of this debate must remain tax competition, not tax collusion.”

Proponents of simply extending current sales tax collection obligations to interstate sales will claim that the so-called “[Streamlined Sales and Use Tax Agreement](#)” (SSTUA) they want Congress to bless has solved the compliance cost and complexity problem associated with taxing “remote” interstate sales. Yet, as I pointed out in my recent *Forbes* essay, “[The Internet Taxman Cometh](#),” this 200-page “simplification” effort remains a Swiss cheese tax system, however, riddled with loopholes and complexities that could burden vendors, especially mom-and-pop operators. America’s estimated 7,400 local jurisdictions still have many different definitions and exemptions that complicate the sales tax code. For example, is a cookie a “candy,” (which is taxed in most jurisdictions) or a “baked good,” (which is typically tax-exempt)? Thus, forcing online vendors to collect local taxes would create significant burdens on interstate commerce.

This is not to say there aren’t some legitimate tax “fairness” arguments in play here. It really is unfair that “Main Street” vendors are burdened with significant tax collection responsibilities while others are not. But “fairness” cuts many ways. It’s also unfair and

unconstitutional to require out-of-state vendors to collect sales taxes on behalf of a jurisdiction where they have no physical presence. After all, at least in theory, those who are taxed should expect to receive some benefit for it. Interstate vendors receive no benefit but bear all the cost.

To the extent we want to “level the playing field,” therefore, one approach is to cut or eliminate sales taxes on in-state vendors. Of course, that’s a tough pill for many states and localities to swallow. If they got their profligate spending habits under control, however, that might be easier.

Another alternative would be the creation of a national Internet sales tax that would avoid the complexity problem by imposing a single rate and set of definitions on all vendors. But that just opens the door to a new federal tax base, which would grow to be burdensome in other ways at a time when American consumers and companies are already over-taxed. I doubt the idea would get much traction in Congress, anyway.

Perhaps the best alternative would be to switch the sourcing methodology for state sales tax collection obligations from destination-based to “origin-based.” Stated differently, the rule would be “you can tax your own exports, not the imports from other states.” Here’s how Veronique and I summarized an origin-based solution in our old Cato paper:

under an origin-based sourcing rule—also referred to as a “seller state,” “vendor-state,” or “source-based” rule by some scholars—all interstate sales through all channels (traditional stores or cyber-retailers) would be taxed at the point of sale (meaning the company’s “principal place of business”) instead of at the point of destination, if the state or locality chooses to impose a tax. All goods within a given state or locality would be taxed at the locally applicable rate no matter how they were purchased and no matter where they were consumed. This option would take care of most of the problems posed by the destination-based methodology that is favored by most state and local policymakers today.

Specifically, an origin-based sourcing rule would have the following advantages:

- **Minimize the burden on sellers** by requiring sellers to know and abide by the tax rates and regulations within their principal place of business instead of the rates and definitions of thousands of different taxing jurisdiction.
- **Ensure tax parity between Main Street vendors and interstate sellers.**
- **Do away with the need for a multistate collection arrangement such as the SSTUA** by eliminating any need to trace interstate transactions to the final point of consumption.
- **Remove nexus uncertainties and constitutional concerns**, because only companies within a state or local government’s borders would be taxed.
- **Largely remove any need for continued reliance on the use tax** because all transactions would henceforth be sourced to the origin of sale and collected immediately by the vendor at that point.

- **Respect buyers' privacy rights** by eliminating the need to collect any special or unique information about a buyer, and by not using third-party tax collectors to gather information about buyers.
- **Respect federalism principles** and enhance jurisdictional tax competition by permitting each state to determine its own tax policies and encouraging healthy state-by-state tax rivalry.
- **Preserve local jurisdictional tax authority** where a harmonization proposal like the SSTUA plans would create a de facto national sales tax system and run roughshod over local governments.
- Because it is more politically / constitutionally feasible it **may maximize the amount of tax collected for states** by making compliance easier and incorporating activities that are currently untaxed.

Please see the old Cato paper for more details and answers to potential objections, but I hope it's clear why an "origin-based" solution offers a sensible way to break the current logjam and achieve tax "fairness" in the process.

Some states officials will object to the vigorous tax competition spawned by an origin-based sourcing rule. But that's a feature, not a bug! Tax competition is good for consumers and the continued vitality of American federalism. A multistate tax compact, by contrast, would encourage tax collusion and let states too easily raise rates on interstate sales.

Moreover, I think it bears repeating that state officials have been at this for 15 years and still not found a way to truly simplify their sales taxes and get around constitutional limitations on the taxation of interstate activity. An origin-based system, therefore, may offer them the *only* way for them to finally tax the Internet and interstate sales. I'd prefer they scale back their taxing ways, of course, but to the extent they insist on pushing out the boundaries of their tax authority, an origin-based solution — not the "Main Street Tax Fairness Act" — is the only sensible, constitutional way for them to do so.