How Federal Tax Reform Can Help or Hurt State and Local Governments

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"Tax Reform: What It Means for State and Local Tax and Fiscal Policy"

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Thank you for the opportunity to submit this written testimony. My name is Matt Gardner and I am the Executive Director of the Institute on Taxation and Economic Policy (ITEP), a Washington-DC-based nonprofit research group. ITEP's research focuses on federal and state tax policy issues with an emphasis on the goals of sustainability, transparency and fairness in the tax laws.

Federal tax reform can affect state and local taxes in several ways. The federal government can create, repeal or change tax expenditures in a way that is passed on to the states because virtually every state has tax rules linked to the federal rules. The federal government can subsidize state and local governments' ability to raise taxes and can subsidize their ability to borrow funds to finance capital investments. Finally, the federal government can regulate state and local governments' ability to raise taxes in a way that coordinates and harmonizes their tax rules or in a way restricts their taxing power and makes their tax systems more complex.

My testimony makes four points.

1. Federal tax reform can provide state governments an opportunity to improve their finances by repealing or reducing tax expenditures.

2. The federal income tax deduction for state and local taxes is indeed a tax expenditure that reduces the amount of revenue collected by the federal personal income tax, but in many ways is more justified than many other tax expenditures.

3. The federal government's practice of not taxing the interest income on state and local bonds is an inefficient way to subsidize state and local governments, and the President's proposal to extend Build America Bonds would mitigate this problem.

4. When lawmakers consider legislation intended to coordinate tax rules among the states, they must distinguish proposals that will truly achieve this result (like the Marketplace Fairness Act) from those that simply restrict states' taxing powers at the behest of corporate interests (like the Business Activity Tax Simplification Act).

Federal Tax Reform Can Provide State Governments an Opportunity to Improve Their Finances

Federal tax reform can have a major impact on state and local taxes and revenues most obviously because virtually every state has tax rules that are linked to the federal rules. For example, many states have personal income taxes and corporate income taxes that have the same "base" as the federal personal income tax and corporate income tax, which is another way of saying they follow the federal rules to define what income is taxable. This is true even though these states have their own rate structures, which are not linked to federal income tax rates in any way.

A federal tax reform that eliminates or reduces many of the deductions and exclusions used in calculating federal income taxes would automatically do the same for most state governments, but state income tax rates would be left unchanged because they are not linked to the federal rules. This would, of course, increase state revenues unless states subsequently act to reduce their tax rates or make some other changes.

Indeed, this is what occurred following the Tax Reform Act of 1986. Provisions of the 1986 act that closed federal income tax loopholes expanded the income tax base for states. Some states responded by cutting their tax rates while others used the increased revenues to finance public investments.

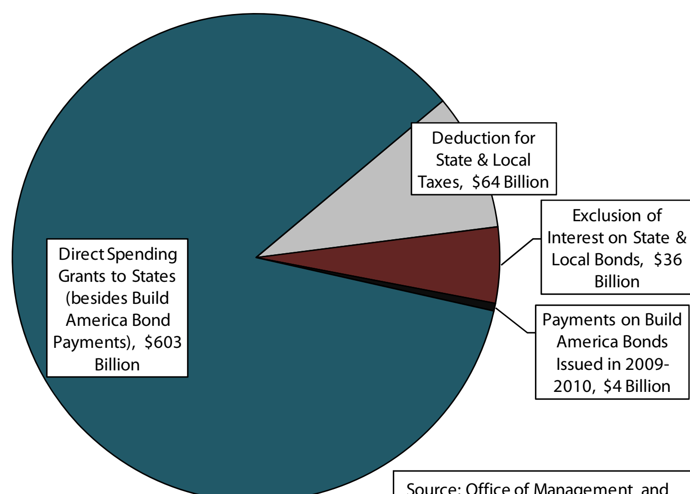
This could be particularly important today, as state governments have just experienced the greatest drop in revenue on record. For the fiscal year that is about to begin, 30 states projected budget gaps (some of which have already been closed) totaling $49 billion. Ten states still have budget gaps (totally $3.7 billion) for the current fiscal year.[1]

These gaps are small compared to the $530 billion in budget gaps the states faced and closed over the preceding four years. However, federal aid from the economic recovery act enacted in winter of 2009 has come to an end, and the resulting drop-off in spending at the state and local level serves as an anti-stimulus to the economy, potentially slowing down the recovery. The state governments' experience during the recession also begs the question of whether or not their existing tax systems — most of which are linked to federal rules — are sufficient to weather the next economic downturn.

The Federal Income Tax Deduction for State and Local Taxes Has Significant Justifications

When taxpayers calculate their federal personal income taxes, they are allowed to itemize deductions (that is, deduct certain expenses from their income to calculate taxable income) or take the standard deduction if that is greater than the sum of their itemized deductions. One of the itemized deductions that reduces federal taxable income the most is the deduction for state and local taxes.

Federal Subsidies to State and Local Governments in 2011, by Type



Source: Office of Management and Budget, Analytical Perspectives,

Like many deductions, exclusions, credits and preferential tax rates, the deduction for state and local taxes is listed as a "tax expenditure" in reports compiled annually by the Congressional Joint Committee on Taxation and the Treasury

[1] Elizabeth McNichol, Phil Oliff and Nicholas Johnson, "States Continue to Feel Recession's Impact," Center on Budget and Policy Priorities, updated March 21, 2012. http://www.cbpp.org/cms/index.cfm?fa=view&id=711

Department. That means that the deduction is defined by analysts as a subsidy that is paid through the tax code rather than as a direct payment from the government.

The deduction for state and local taxes paid is often seen as a subsidy for state and local governments because it effectively transfers the cost of some state and local taxes away from the residents who directly pay them to the federal government. For example, if a state imposes a higher income tax rate on residents who are in the 35 percent federal income tax bracket, that means that each dollar of additional state income taxes reduces federal income taxes on these high-income residents by as much as 35 cents.[2] The state government may thus be more willing to enact the tax increase because its high-income residents will really only pay 65 percent of the tax increase, while the federal government will effectively pay the remaining 35 percent.

1. Tax Expenditure or a Way to Define Taxable Income?

Viewed a different way, the deduction for state and local taxes is not a tax expenditure at all, but instead is a way to define the amount of income a taxpayer has available to pay federal income taxes. State and local taxes are an expense that reduces one's ability to pay federal income taxes in a way that is generally out of the control of the taxpayer. A taxpayer in a high-tax state has less income to pay federal income taxes than a taxpayer with the same pre-tax income but residing in a low-tax state.

Most other itemized deductions are for expenses that the taxpayer has more control over, like home mortgage interest or charitable giving.

2. Addressing Spillover Effects of State and Local Public Investments

Another argument in favor of the itemized deduction for state and local taxes paid is that the public investments funded by state and local taxes produce benefits for the entire nation. This can be seen as a justification for the deduction for state and local taxes paid because it encourages state and local governments to raise the tax revenue to fund these public investments that the jurisdictions might otherwise not make.

For example, state and local governments provide roads that, in addition to serving local residents, facilitate interstate commerce. State and local governments also provide education to those who may leave the jurisdiction and boost the skill level of the nation as a whole, boosting the productivity of the national economy. State and local governments may have an incentive to provide less of these public investments than is optimal for the nation because the benefits partly go to those outside the jurisdiction.

It is probably impossible to quantify exactly what fraction of the benefits of public investments accrue to those outside the jurisdiction instead of those residing in the jurisdiction, but it seems unreasonable to deny the existence of these "spillover" effects.

The federal government also directly subsidizes (with direct cash payments) state and local governments to encourage them to make these public investments. Indeed, 85 percent of the federal subsidies to state and local jurisdictions in 2011 took the form of direct spending rather than tax subsidies.[3]

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[2] The Alternative Minimum Tax (AMT) and the "Pease" limitation on itemized deductions can, in some cases, limit the savings a high-income individual would otherwise derive from the itemized deduction for state and local taxes paid.
[3] Office of Management and Budget, Analytical Perspectives, Budget of the United States Government, Fiscal Year 2013, pages 252-253, 302. http://www.whitehouse.gov/omb/budget/Analytical_Perspectives/

3. Prioritize Repeal of Most Regressive Tax Expenditures First

One approach for lawmakers contemplating tax reform is to prioritize repeal of tax expenditures based on how regressive they are. This would be in keeping with special attention Congress and the public have lately paid to income inequality and tax fairness. Under this approach, it is not obvious that lawmakers would prioritize repeal of the deduction for state and local taxes, for two reasons.

First, as already explained, it might make sense to view the deduction for state and local taxes paid not as a tax expenditure, but as a way to help define income. Second, even if one does view the deduction as a tax expenditure, repeal of another category of tax expenditures (the tax preferences for investment income) would take a far higher priority.

Share of Tax Increase from Repealing Federal Tax Expenditures in 2012

Income Group	Deduction for State and Local Taxes Paid	Preferential Income Tax Rate for Capital Gains & Dividends
Lowest 20%	0%	0%
Second 20%	0%	0%
Middle 20%	3%	1%
Fourth 20%	14%	4%
Next 15%	37%	10%
Next 4%	17%	14%
Top 1%	29%	71%
ALL	100%	100%

Source: Institute on Taxation and Economic Policy (ITEP) microsimulation tax model, May 2012

For example, 29 percent of the benefits of the deduction for state and local taxes will go to the richest one percent of taxpayers this year, and 46 percent will go to the richest five percent of taxpayers. This means the deduction certainly benefits the rich disproportionately. However, the special, low income tax rate for capital gains and stock dividends is much more skewed toward the rich, with 71 percent of the benefits going to the richest one percent of taxpayers and 85 percent of the benefits going to the richest five percent of taxpayers. The fact that this income tax preference for capital gains and stock dividends has a very weak policy rationale, combined with its extremely regressive impact, should prompt lawmakers to prioritize its repeal as part of tax reform.[4]

Unfortunately, many proposals offered as "tax reform" would repeal or limit the deduction for state and local taxes paid (and other itemized deductions) but leave in place or even expand the income tax preferences for investment income.[5] This is exactly backwards.

Federal Subsidies for State and Local Debt Would Be More Efficient Under the President's Build America Bonds Proposal

In general, the federal personal income tax does not tax interest payments made by state and local governments to their bondholders. State and local governments are therefore able to pay a lower interest rate to bondholders, who will accept a lower interest payment because it will not be taxed.

Unfortunately, the amount of money that state and local governments save by paying lower interest rates is less than the amount of revenue that the federal government loses. In other words, the personal income tax exclusion for tax-exempt bond interest is an inefficient way to subsidize state and local governments because the subsidy to the state

[4] For more details, see Citizens for Tax Justice, "Policy Options to Raise Revenue," March 8, 2012. http://ctj.org/pdf/revenueraisers2012.pdf

[5] For example, the budget plan devised by Republican House Budget Committee Chairman Paul Ryan would reduce or eliminate unspecified deductions and tax credits but leave in place the tax preference for capital gains and stock dividends. See Citizens for Tax Justice, "Ryan Budget Plan Would Cut Income Taxes for Millionaires by at Least $187,000 Annually and Facilitate Corporate Tax Avoidance," March 22, 2012. http://www.ctj.org/pdf/ryanplan.pdf Other proposals go further. For example, during his 2012 presidential campaign, former Republican House Speaker Newt Gingrich proposed a "flat tax" that would actually have two rates, zero percent for capital gains, stock dividends and interest and 15 percent for other income, and would not allow a deduction for state and local taxes paid.

and local governments is less that the amount of revenue that the federal government loses. The difference is a windfall to bondholders.

This occurs because most of the bondholders have a marginal income tax rate of 35 percent (because they are high-income individuals or corporations that pay the 35 percent corporate income tax rate) who could be motivated to buy the bonds if the interest paid on them was enough to at least equal the interest income they would receive from ordinary bonds after paying income taxes on that income. But state and local governments often find that they need to make the bonds attractive to individuals with lower marginal tax rates, and thus pay interest at rates that are higher than needed to attract the majority of their bond holders (those with a marginal tax rate of 35 percent). The majority of the bondholders are thus getting a benefit in excess of what would be necessary to motivate them to buy the bonds.

In his written testimony for this committee, Frank Sammartino of the Congressional Budget Office explains,

> "In 2009, the average yield on (taxable) high-grade corporate bonds was 5.3 percent, and the average yield on tax-exempt municipal bonds of similar creditworthiness was 4.6 percent—a difference of 0.7 percentage points, or approximately 13 percent of the taxable return. That 13 percent also represents the marginal tax rate at which an investor would be indifferent between purchasing a taxable bond yielding 5.3 percent and a tax-exempt bond yielding 4.6 percent."

Sammartino goes on to cite studies showing that most of the bondholders are taxpayers with a marginal tax rate that is much higher than that and, as a result, about 20 percent of the revenues foregone by the federal government are a subsidy to these bondholders rather than to the state and local governments issuing the bonds. [6]

This problem would be remedied under the President's proposal to revive and reform Build America Bonds, a special type of bond that state and local governments were allowed to issue in 2009 and 2010 under the economic recovery act enacted in the winter of 2009. The interest paid on these bonds is not excluded from the income of the bondholders. Instead, the federal government simply makes a payment of a certain percentage of the interest payments to the state and local governments. The government issuing the bonds can afford to pay interest at market rates, and the subsidy takes the form of a direct payment that goes entirely to the state or local government. The bonds are also attractive to some tax exempt entities (like pension funds) that have no incentive to buy the state and local bonds that pay interest at lower rates but are tax-free.

The direct payments made from the federal government to the state and local issuers of the bonds issued in 2009 and 2010 equal 35 percent of the interest paid, which was particularly generous and was intended to help state and local governments weather the recession. The proposal included in the President's most recent budget plan would make Build America Bonds permanently available and would provide state and local bond issuers direct payments equal to 28 percent of the interest paid to bondholders. The Obama administration estimates that this is the rate at which encouraging a switch from traditional tax-exempt bonds to Build America Bonds would be roughly revenue-neutral for the federal government.[7]

A key point about this proposal is that it is roughly revenue-neutral precisely because it would replace a wasteful tax subsidy with a better targeted subsidy that is provided through direct spending by the federal government.

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[6] Frank Sammartino, "Federal Support for State and Local Governments Through the Tax Code," Testimony Before the Committee on Finance, April 25, 2012. http://finance.senate.gov/imo/media/doc/Testimony%20of%20Sammartino.pdf

[7] U.S. Treasury Department, "General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals, February 2012, page 11. http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2013.pdf

Technically, federal tax revenue will rise (because there will be fewer taxpayers benefiting from the income tax exclusion for interest on state and local debt) and federal outlays will rise (because payments will be made directly from the federal government to the state and local governments). But from a budgetary and economic perspective, little will have changed except that the subsidy will be more efficiently targeted at the state and local governments it is intended to help.

This point has not been fully understood. For example, the Finance Committee ranking Republican, Senator Orrin Hatch of Utah, said at the hearing on this topic on April 25 that the President's Build America Bonds proposal would result in "an increase in taxes of $63 billion" over ten years and that "this would naturally increase the size of the federal government by $63 billion" over ten years.

This view fails to recognize that the federal government can provide the exact same type of subsidy through the tax code or through direct payments. Changing a tax subsidy into a direct payment is simply paying the subsidy in a different, potentially more efficient way. In the case of state and local bonds, the current subsidy provided through the tax code is less efficiently targeted to the intended recipients (state and local governments) than would be the case if the subsidy were provided as direct payments (payments made from the federal government to state and local jurisdictions to offset part of their interest expense).

Lawmakers Must Distinguish Proposals to Coordinate and Streamline State and Local Taxes from those Intended Only to Restrict Them

Congress frequently considers proposals for regulating state and local tax administration. These proposals can either facilitate state and local governments' exercising their taxing authority in a fair, efficient way, or limit their taxing authority and complicate taxes in response to heavy lobbying from multistate corporations and other special interests. While some proposals to coordinate tax rules between state and local governments would ease efficient collection of taxes, many of these proposals are simply ways to restrict state and local taxes at the behest of corporations and other powerful interests. Lawmakers need to distinguish between the two.

1. Taxing the Income of Corporations and Other Businesses

When determining the extent to which a state can tax the income of a particular business under current law, the first question is whether or not the business has sufficient contacts with the state to be taxed at all (whether the business has sufficient "nexus" with the state to be taxed by it). The second question is how states allocate among themselves the income of those businesses that do have sufficient nexus to be taxed.

In the 1950s and 1960s, Congress hindered states from answering the first question in a sensible way, but nonetheless helped states answer the second question in a sensible way.

Under Public Law 86-272, enacted in 1959, Congress declared that a business selling physical goods in a state would not have sufficient "nexus" with the state to justify being taxed unless the business had a "physical presence" (generally meaning property or employees) in the state. This meant that a state could not tax a company's income if that company did not have stores or physical operations in a state but solicited orders for sales of goods to be shipped from outside the state.

This physical presence standard has done more harm than good. The so-called "Business Activity Tax Simplification Act (BATSA)" would extend the same standard to businesses with income from other types of sales (sales of services or intangible products) into a given state, and would wreak havoc on state tax collections for reasons that will be explained below.

While the 1959 act unnecessarily and restrictively defined the "nexus" a company must have in order for a state to tax its income, it left open the question of how exactly states should tax the income of those businesses that do have sufficient nexus. To explore this question, the act established a special subcommittee known as the Willis Committee that actually did help states coordinate their tax collection efforts in an efficient way.

The Willis Committee Report is an example of Congress facilitating coordinated and efficient tax collection among the states without actually enacting any federal legislation. Rather, the Willis Committee's very suggestion that Congress should enact legislation to fairly apportion business income to states based on certain factors prompted most of the states with a corporate income tax to adopt a similar proposal known as the Uniform Division of Income for Tax Purposes Act (UDITPA).[8]

The basic idea behind UDITPA is that a business with sufficient nexus with a given state will have a portion of its income taxed by that state based on the percentage of property, payroll and sales in the state. While there might be many ways, in theory, to define the proportion of income a multistate business earned in a particular state, this method is the most straightforward and fairest way. If each state adopted UDITPA and continued to follow it, then each portion of a multistate business's income would be taxed once, and only once.

In recent years, states have strayed from the basic principles behind UDITPA by altering their apportionment formula (by, for example, double-weighting the sales factor) or by replacing it entirely with a single-factor formula relying on sales alone. Many states have been convinced that companies will be more willing to locate headquarters or operations within their borders if having payroll and property in the state does not increase the percentage of the company's income subject to state taxes.[9]

This has made state tax collection more complicated, less efficient, and less fair. A company in State A might be subject to State A's corporate income tax under an apportionment formula that considers three factors (the percentage of property, payroll and sales in the state) but if State A adopts a single-factor formula based on sales, some of the company's income could escape taxation entirely.

This can happen because the company sells many of its goods to a state that does not have a corporate income tax or a state where the company does not have any physical presence, meaning it lacks the sufficient "nexus" to be taxed by that state. The possibility of such "nowhere" income (income that is not taxable in any state) is obviously very attractive to multistate corporations, which lobby states to enact single-factor formulas based on sales.[10]

It is quite ironic that one of the witnesses at the April 25 Finance Committee hearing on this topic claimed that states have strayed from the basic three-factor apportionment formula in order to "grab" income from other states. States have strayed from the three-factor formula mainly at the behest of corporations that understood this would enable their tax avoidance.[11] Congress should be very careful that any proposal to coordinate state taxes on business income move us back to the simple, straight-forward three-factor apportionment formula rather than away from that formula.

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[8] Joe Huddleston and Shirley Sicilian, "The Project to Revise UDITPA," from the Proceedings of the New York University Institute on State and Local Taxation, 2009. http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Minutes/The%20Project%20to%20Revise%20UDITPA.pdf

[9] Institute on Taxation and Economic Policy, "Corporate Income Tax Apportionment and the 'Single Sales Factor,'" August 2011. http://www.itepnet.org/pdf/pb11ssf.pdf

[10] Institute on Taxation and Economic Policy, "'Nowhere Income' and the Throwback Rule," August 2011. http://www.itepnet.org/pdf/pb39throw.pdf

[11] The result, as highlighted in a December 2011 report by my organization, is that an astonishing number of Fortune 500 corporations are finding ways to avoid paying any state corporate income taxes despite being hugely profitable. See Institute on Taxation and Economic Policy and Citizens for Tax Justice, "Corporate Tax Dodging in the Fifty States, 2008-2010," December 7, 2011. www.ctj.org/corporatetaxdodgers50states

Unfortunately, the most prominent pending legislation in this area would move the country in the wrong direction by further restricting the level of "nexus" of business must have with a state in order for its income to be taxed by that state.

This legislation is the so-called Business Activity Tax Simplification Act (BATSA), H.R. 1439. This legislation would make state and local taxes on businesses dramatically more complex, increase litigation related to business taxes, increase government interference in the market and reduce revenue to state and local governments by billions of dollars each year.[12]

Even if the "physical presence" standard made any sense, it would not matter under H.R. 1439 because it is not the standard set out in the bill. The bill has many "safe harbors" which are essentially loopholes allowing large corporations with lobbying clout to avoid state and local taxes even though they have what any rational person would call a "physical presence" in the jurisdiction.

For example, under BATSA, a company that sends a full-time worker into another state each day to install equipment could be subject to that state's taxes. However, if the company created two subsidiaries which each provided half of the equipment and which each hired the worker to perform the installations, the state would not be able to tax the business under BATSA.

The state would also be unable to tax a business if the employee was only sent into the state 14 days each year, or if the company created several subsidiaries that each hired the employee and sent him or her into the state for just 14 days each year.

If the company warehoused items in the state before shipping them to customers, one would think this constitutes "physical presence," but under BATSA it might not. Items could be warehoused in the state by a second company that ships them to customers and this second company could also be exempt from the state's business activity taxes under the exception for third-party "fulfillment" activities.

Perhaps the most outrageous abuses would occur when a company is actually based in the state in question. Such a company might create subsidiaries in other states (states without business activity taxes) and transfer trademarks and logos to them. The company would then pay royalties to those subsidiaries for the use of the trademarks and logos, and these payments would reduce or even wipe out the income reported to the state where the company is based. Most states currently have laws that allow them to tax the out-of-state subsidiaries receiving royalties in this scenario, but BATSA would nullify those laws so that this type of tax avoidance would increase dramatically.

The various intricacies of BATSA that would encourage more aggressive tax planning would naturally lead to increased litigation. Besides that, some of the safe harbors in BATSA are not defined at all, which will certainly leave state and local governments no choice but to call upon the courts to interpret the provisions of the law when companies manipulate them.

For example, even a company that has physical property and employees in a state will not have a "physical presence" there under BATSA if the property and employees are only used to carry out "limited and transient business activity," which is left undefined. It's difficult to imagine how this ambiguity would *not* lead to increased litigation.

[12] For more details on the problems with the Business Activity Tax Simplification Act, see Michael Mazerov, "Proposed 'Business Activity Tax Nexus' Legislation Would Seriously Undermine State Taxes on Corporate Profits And Harm the Economy," Center on Budget and Policy Priorities, updated April 13, 2011. http://www.cbpp.org/cms/index.cfm?fa=view&id=424

Perhaps some lawmakers may comfort themselves with the notion that despite all of these problems, in the end BATSA will mean the government has a lighter hand in the economy because businesses will be taxed by fewer state and local governments.

To the contrary, BATSA is the ultimate example of government picking "winners and losers" among businesses competing against each other. BATSA would create artificial advantages for very large, multi-state companies that conduct most of their business online or over the phone and which have the resources to engage in the type of tax avoidance schemes already described.

2. Requiring Businesses to Collect Sales Taxes on Interstate Sales

Whereas the previous section of this testimony addressed the extent to which a state can tax a multistate business's income, another question is the extent to which a state can require a multistate business to collect sales taxes. This question has nothing to do with taxes on the business's income, but merely asks whether or not the business must take the administrative step of collecting sales taxes that its customers are required to pay.

In a jurisdiction that imposes a sales tax, a business that sells a product from a physical store is required to collect the sales tax from the buyer. The sales tax is not paid by the seller but by the buyer, whose total purchase price includes the sales tax as well as the underlying retail price of the product. The business that sells the product is merely required to collect the tax and pass it on to the state or local government.

However, when a person in the state buys a product online, the state is often unable to require the business selling the product to collect the sales tax because the business does not have a physical presence in the state. This level of "nexus" (the connection that a business must have with a state before the state can require it to collect sales taxes) was imposed not by Congress but by the U.S. Supreme Court's interpretation of the Commerce Clause in a 1992 decision.[13]

Under the Supreme Court's decision, Congress can decide to grant the states the authority to require out-of-state businesses to collect sales taxes on sales into their jurisdictions. This would make it far easier for state and local governments to adapt to the internet age.

The question is not whether or not sales taxes should be imposed, but who has responsibility for collecting them and delivering them to the state or local government. In states with sales taxes, internet purchases (and other purchases from out-of-state businesses) are subject to the sales tax, but the buyers themselves are required to calculate the sales tax and send it to the state or local government. (In these cases the tax is technically called a "use tax.") But these rules are unenforceable. Needless to say, almost no one who buys a product from Amazon thinks to calculate their sales taxes and send a payment to their state or local government.

A bill before Congress would allow states to require internet sellers and other out-of-state sellers to collect sales taxes in return for states simplifying their sales taxes. The legislation, the Marketplace Fairness Act, S. 1832, is an example of a federal proposal that really would help states coordinate their tax rules and collect revenue in a more efficient way. In order to benefit from the law, states would be required to conform their sales tax laws to the Streamlined Sales and Use Tax Agreement (SSUTA) (which was forged by representatives of several states to harmonize sales tax rules) or take other steps to simplify their sales taxes.

Currently twenty states are full members of SSUTA and four states have "associate member" status, meaning they are on their way to becoming full members. SSUTA does not restrict member states' power to set their own sales tax rates

[13] *Quill Corporation v. North Dakota* (U.S. 1992).

or even their power to determine the base of their sales tax (which sales are subject to the sales tax) but requires them to use uniform definitions to define the sales tax base. This addresses the complexity that motivated the Supreme Court's 1992 decision — the complexity that would otherwise be faced by multistate business with sales in several jurisdictions with different sales tax rules.[14]

New technology, combined with the harmonized sales tax rules under SSUTA, would make it relatively easy for internet retailers to determine what sale taxes apply in a customer's jurisdiction. We know this because major retailers that have a "physical presence" in numerous states, like Best Buy and Barnes and Noble, already collect sales taxes on sales made over the internet, in addition to those made inside their physical stores. Similarly, Amazon collects sales tax on behalf of a huge number of merchants located all around the country that sell via its website, though it mostly refuses to do so on items it sells directly. Netflix's CEO summed up the reality of the tax complexity problem when he said, "We collect and provide to each of the states the correct sales tax. There are vendors that specialize in this... It's not very hard."[15]

Opponents of the Marketplace Fairness Act have incorrectly labeled it a tax hike. The bill doesn't actually create a new tax, nor does it raise an existing one. Rather, it merely creates a mechanism to collect taxes that have always been owed.

Failing to collect these taxes creates two major problems. First, states are losing out on badly needed revenue. Second, traditional brick and mortar stores are at a competitive disadvantage when their customers have to pay a tax that online shoppers are able to evade. There is no reason for large online retailers like Amazon to have this sort of competitive advantage — which exists only because of tax law — over businesses that operate in traditional, physical stores.

As an extreme example of this second problem, in many instances customers will go so far as to examine and "try out" merchandise at stores, only to return home and purchase the same product online in order to evade their sales tax responsibility. It's no surprise then that numerous organizations representing retail owners, such as the Retail Industry Leaders Association (RILA), support the bill.[16]

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[14] Institute on Taxation and Economic Policy, "How Can States Collect Taxes Owed on Internet Sales?" July 2011. http://www.itepnet.org/pdf/pb2quill.pdf
[15] Id.
[16] Joint Statement of Senators Michael B. Enzi, Richard J. Durbin, Lamar Alexander, Tim Johnson, John Boozman, Jack Reed, Roy Blunt, Sheldon Whitehouse, Bob Corker, Mark Pryor for Hearing: Tax Reform: What It Means for State and Local Tax and Fiscal Policy, April 25, 2012.