IRET Congressional Advisory

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TAX REFORM TO HANDLE THE E-TAX CONTROVERSY

The House of Representatives has passed a bill to provide a five year extension of the current ban on new Internet taxation and to eliminate Internet access taxes in the 10 states that currently have them. The bill is good policy and should be adopted by the Senate.

Some states have raised a separate issue concerning the difficulty of collecting use taxes from their residents on their out-of-state purchases over the Internet or from catalogue companies. The states would like to force out-of-state vendors to collect these taxes for them. The issue is not settled in the House bill, nor should the Senate try for a quick fix on the question. The best solution to the sales and use tax issue would be to scrap income and sales taxes in favor of a consumed income tax at the federal and state levels.

> ***The House of Representatives has passed a bill to provide a five year extension of the current ban on new Internet taxation... The bill is good policy and should be adopted by the Senate.***

What Is Covered. The moratorium extension enjoins states from imposing excise taxes on access to the Internet through 2006 and eliminates such taxes in the ten states that already impose them. It also prohibits states from imposing **higher** taxes on goods purchased on the Internet than they charge on goods purchased in-state.

It is perfectly reasonable for the federal government to outlaw state taxes on access to and use of the Internet, which is a national (indeed, international) network, and to forbid **differential** taxation of out-of-state purchases (for example, a 5% sales tax on in-state purchases, and a 7% use tax on out-of-state purchases) that would be a barrier to interstate commerce. Such a ban should be made permanent, and should eliminate any existing access taxes "grandfathered" by the current moratorium.

What Is Not Covered. The moratorium does not prohibit states from enacting and trying to collect sales taxes (called use taxes) on out-of-state Internet purchases by their residents as long as the rates are the same as on in-state "brick and mortar" purchases and in-state Internet purchases. There is no reason for the federal government to ban non-discriminatory state use taxes on out-of-state purchases of goods over the Internet, and the proposed moratorium would not do so. State representations to the contrary are wrong.

Neither, however, does the bill assist the states in collecting their use taxes on out-of-state purchases, and that is what the states would like to change. It is not clear, however, that national enforcement of sales and use taxes is the best solution to the problem.

The Sales Tax Leads To Trouble. All but four states impose a sales tax, as do many smaller jurisdictions (totaling over 30,000 entities). Businesses bear the cost of collecting the taxes for the jurisdictions in which they operate. The types of goods covered and the tax rates vary widely from

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state to state, and the imposition of sales taxes on services is spotty.

States also impose a use tax on goods purchased by their residents outside of the state through mail order catalogues, over the Internet, or by driving across a state line. Use taxes are supposed to equalize the tax on in-state and out-of-state spending by state residents so as not to put local "brick and mortar" vendors at a competitive disadvantage with respect to out-of-state vendors, catalogue shippers, or Internet sellers. Residents are supposed to report their purchases and submit the equivalent of the home state sales tax to the state taxing agency. Few comply.

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Some states would like to force out-of-state businesses to collect their use taxes for them. The Supreme Court has ruled, however, that a state may not compel an out-of-state business with no "presence" or "nexus" within the state to collect its sales or use tax, a chore which the Court labeled as excessively burdensome due to the large number of jurisdictions with varying tax rates on varying definitions of taxable items. In e-commerce, it may also be difficult to determine where a particular service was performed and consumed.

It is not clear, however, that national enforcement of sales and use taxes is the best solution to the problem... The best solution to the sales and use tax issue would be to scrap income and sales taxes in favor of a consumed income tax at the federal and state levels.

Some states' governors and tax officials are using the Internet tax controversy as a means of calling attention to the difficulty of collecting use taxes, and are seeking federal assistance in finding a way around the Supreme Court ruling. The National Governors Association is proposing to set up an interstate collection agency run by a so-called "trusted third party" to make it easier for remote vendors to collect use taxes, and then require them to do so. In exchange, the states are promising to attempt to harmonize and simplify their various sales tax rates and definitions of covered purchases to make it easier for businesses, especially small businesses, to comply.

With that approach in mind, the House also passed a non-binding resolution that calls on the states to simplify their sales and use taxes to make them easier for out-of-state sellers to deal with in the future. Of course, there is no guarantee that the promised simplification will be achieved, or that the cost of compliance can be kept manageable. In fact, there may be a better way of dealing with the problem.

Tax Consumption, But Not At the Cash Register. The problem with the sales tax is not that it taxes consumption. Taxing the amount of income that people spend is the best tax base, because it does not impose a bias against income that is saved or invested to generate further income, as does the income tax.

The problem with the sales tax is one of administration and enforcement stemming from picking the wrong point of collection for the consumption tax. The sales tax is not the clean, simple, easy-to-administer-and-comply-with tax that its proponents claim.

It is inherently simpler to tax each person or household once a year (as with the income tax) than to tax him or her every time he or she goes shopping, which may be a thousand times a year per household. Instead of collecting a tax on consumption at the cash register, it should be collected directly from the citizens.

The Solution Is a Consumed Income Tax. States should adopt a consumed income tax to replace their sales taxes, use taxes, and income taxes. Under a consumed income tax, state residents would report their income, subtract their net saving for the year (and any other allowable deductions), and pay tax on the remainder, which is what they consume. They could then take their remaining after-tax income and spend it anywhere, any way, and on anything they like, without giving the state any concerns about uneven or incomplete coverage of the tax. Spending out-of-state and spending in state would be equally taxed without imposing a difficult collection burden on businesses.

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The Federal Income Tax Should Also Be Replaced By A Consumed Income Tax. States could adopt a consumed income tax on their own, but the switch would be greatly facilitated if the federal government were to adopt a consumed income tax as well to replace the federal income tax. Many states base their income taxes on the federal definition of taxable income, and having both levels of government adopt the same type of tax would simplify compliance for tax-payers and financial institutions.

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Financial institutions currently report the taxable interest, dividends, and capital gains that are required for filling out the federal income tax forms. Under a consumed income tax, these same institutions would instead report a taxpayer's net additions to or withdrawals from his or her saving or brokerage accounts instead of these income flows. If the federal government made the switch to a consumed-income tax too, only one type of report would have to be compiled and sent to the taxpayers, and taxpayers would only have to calculate one kind of taxable income.

One of many possible variations on a consumed income tax is illustrated in the attached tax forms. (See Appendix.) Individuals would report earnings and other receipts, and subtract net saving and other allowable deductions — here, investment in human capital formation (education outlays), other taxes paid, charitable contributions, etc. There would be a personal or family allowance. A tax would be imposed on the remaining consumption. (The rate shown is a flat rate, but it could be made progressive.) The base of this tax would be similar to that of many state retail sales taxes, plus spending on services which states now find hard to tax.

A consumed-income tax would eliminate the income tax bias against saving, promote investment and productivity, raise wages and employment, and enable people to provide more easily for a secure retirement. It would be far simpler to comply with than the current income tax with its complicated treatment of capital gains and business income. And the consumed income tax would end the Internet tax controversy. Everyone would benefit.

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A switch to a consumed income tax could also solve a pending international tax issue. The European Union is displeased that their citizens can order goods from America over the Internet and escape the value added taxes (VAT) that those countries impose. They want U.S. firms of all types and sizes to register with European tax authorities and collect and remit the VATs to the various EU nations. This is the same type of collection burden that U.S. states would like to impose on out-of-state businesses. This collection burden would be particularly hard on small U.S. exporters. If, instead, all the nations involved switched to consumed income taxes, these cross- border collection problems would vanish. The alternative may be some form of highly undesirable globalized tax collection agency that would threaten personal freedom and national sovereignty.

Stephen J. Entin
President and Executive Director

Note: Nothing here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before the Congress.

APPENDIX

Form 1040: Individual Tax Form, Consumed Income Tax	
1. Sum of: Labor compensation, pension receipts, taxable social security, transfer payments (from W-2 forms, etc.).	$33,000
2. Net saving (+) or net withdrawals from saving (-) (from Schedule B).	$3,000
3. If line 2 is net saving (+), subtract the dollar amount from line 1; if line 2 is net withdrawal from saving (-), add the dollar amount to line 1.	$30,000
4. Other itemized deductions from Schedule A.	$10,000
5. Subtract line 4 from line 3.	$20,000
6. Personal allowance times number of taxpayers and dependents: _$5,000_ x __2__ =	$10,000
7. Subtract line 6 from line 5. This is your taxable income.	$10,000
8. Tax from table (or, line 7 times 20%).	$ 2,000
9. Amount withheld, from W-2, plus estimated tax payments.	$ 2,100
10. Amount due (+) or amount overpaid (-) (line 8 less line 9). If amount is due, pay Internal Revenue Service.	- $ 100
11. If overpaid, fill in: Amount to be refunded _$100_; or Amount to be applied to estimated tax ______.	

Schedule A, Itemized Deductions	
1. Sum of individual payroll tax (from W-2), state and local income tax withheld (from W-2) and estimated state and local tax less refunds from previous year, and local property taxes.	$ 5,000
2. Gifts, contributions.	$ 1,000
3. Qualified tuition, training expenses.	$ 4,000
4. Total. Enter on Form 1040, line 4.	$10,000

Schedule B, Saving	
List net saving (+) or withdrawals (-) from financial institutions reported on 1099 forms.	
First National Bank	-$1,000
Merrill Paine Schwab	+$4,000
Total (if greater than zero, this is net saving; if less than zero, this is a net withdrawal). Enter on Form 1040, line 2.	$3,000