ILLINOIS ECONOMIC
AND
FISCAL COMMISSION

A BRIEFING ON:

INTERNET TAXATION
ISSUES AND IMPACTS

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INTRODUCTION

The Commission has begun to look at potential problems that the proliferation of the Internet may have on current as well as future sales tax revenues for state and local governments. At issue is the possible erosion of the sales tax base due to the difficulty associated in collecting taxes on such "remote" sales. The impending question is, "With the Internet growing at an almost exponential rate, will state and local governments soon be facing a crash in sales tax revenues?"

The short answer, which will be elaborated on later, is that while Internet sales have some impact on sales revenue at both the state and local level, that impact probably has not yet reached significant levels. However, as Internet activity continues to grow, the impact of Internet sales on tax revenues also will grow and inevitably force governments to examine closely the issue so as to minimize the erosion in their sales tax revenue.

BACKGROUND

Before getting into specifics, due to the relatively short history of the Internet, it may prove beneficial to examine the background of the issue. Sales taxes were born from the Great Depression when the main source of revenue for state and local governments, property taxes, collapsed with property values. In 1930, Mississippi became the first state to levy taxes based on the sales of goods. By the end of the 1930s, twenty-three other states had begun using the sales tax as a revenue source. Illinois enacted a sales tax in 1933. Currently, sales tax receipts comprise approximately one-quarter of Illinois general funds revenue. In 1999, only four states did not impose sales taxes: Delaware, Montana, New Hampshire and Oregon.

When interstate transportation improved from the 1950s to the 1960s, sales of goods increasingly began crossing state lines. States began levying a use tax on goods bought out-of-state, but used in their state. Merchants did not want the responsibility to collect these taxes and remit them back to the states. The same difficulties seen with taxing the Internet today can be traced back to the taxing of mail-order sales. In 1967, the U.S. Supreme Court issued a decision in National Bellas Hess, Inc. vs. Department of Revenue of Illinois and held that sales and use taxes may not be imposed on a seller whose only connection with residents of that state is by mail or common carrier. The Court agreed with the company that the tax collection responsibilities imposed on it by Illinois violated the requirement that a company have sufficient connection with a transaction for the state to exercise its taxing powers. In the majority view, there was insufficient "nexus," or connection, for states to require tax collection where there was no actual physical presence by the seller. The Court also ruled that requiring firms to collect and remit taxes constituted an unconstitutional burden on interstate commerce.

In a subsequent 1992 Supreme Court case, Quill Corporation vs. North Dakota, the Court ruled that while the "nexus" argument was no longer applicable as justification for prohibiting collection of taxes, the argument that such a requirement imposed a burden on interstate commerce was reaffirmed. States are prohibited from enforcing statutes requiring out-of-state sellers to remit state and local sales and use tax. The Court referred the issue to Congress for resolution. Justice White did dissent in part by stating that we are using "an anachronistic notion of physical presence" in today's economy, and that the nexus rule has loopholes. But even more importantly, Justice White questioned the rationale of perpetuating "a rule that creates an interstate tax shelter for one form of business—mail-order sellers—but no countervailing advantage for its competitor", especially since the Commerce Clause was made to put the players on a level playing field.

The mail-order industry benefited greatly from the Supreme Court decisions. In 1995 a Federal Trade Commission investigation found and stopped 13 mail-order companies from advertising incorrectly that out-of-state sales were tax-free. Figures from 1994 show that states lost $3.3 billion on uncollected use taxes based on $58 billion of sales where no tax was collected on mail-order purchases. At the time, this was a small fraction of the tax base, and there was little concern over the slow-growing mail-order business. But with the entrance of the Internet onto the scene, states have started to worry. If the Internet gets the same treatment as the mail-order business, and grows exponentially as Internet sales reportedly have, then states could see a meaningful decrease in tax revenues. Some states rely heavily on sales and use taxes for revenue, including states that don't levy an income tax—Florida, Nevada, South Dakota, Tennessee, Texas, Washington, and Wyoming.

INTERNET TAX FREEDOM ACT (ITFA)

In October of 1998, the U.S. Congress approved H.R. 4328, later signed as Public Law 105-277, and more commonly known as the Internet Tax Freedom Act (ITFA). The Act establishes certain guidelines and various moratoriums on aspects of Internet commerce. Briefly, the Act does the following:

- Creates a 3-year moratorium on special taxation of the Internet and prohibits governments from taxing Internet access (i.e. the monthly charge that persons pay to such services as America Online), unless such taxes were already in force on or before October 1, 1998.

- Places a 3-year moratorium on multiple and discriminatory taxes on electronic commerce and bars governments from imposing taxes that would subject buyers and sellers of electronic commerce to taxation in multiple states. It also protects from taxation, for the duration of the moratorium, goods or services that are sold exclusively over the Internet with no comparable off-line equivalent.

- Establishes the Advisory Commission on Electronic Commerce, which is charged with studying electronic commerce tax issues. The Commission is to report back to Congress after 18 months on whether electronic commerce should be taxed, and if so, how they can be taxed in a manner that ensures such commerce won't be subject to special, multiple, or discriminatory taxes.

- Pronounces that no taxes would be levied on the Internet by the federal government.

- Declares that the Internet should be a tariff-free zone**.** The act calls on the Clinton Administration to work aggressively through world organizations to keep electronic commerce free from tariffs and discriminatory taxes. It also asks the Commerce Department to keep Congress informed on barriers hindering the competitiveness of U.S. businesses engaged in electronic commerce abroad.

Many governmental entities feel that the Act unfairly limits their taxing authority and will result in lost revenues. Those proponents of the Act argue that the Internet is still in a state of infancy and that any taxing structure at this juncture would severely retard its growth. They feel the Act is needed to allow time for study of these issues as they believe electronic commerce is inherently susceptible to multiple and discriminatory taxation in a way that commerce conducted in more traditional ways is not.

ISSUES INVOLVED IN TAXING THE INTERNET

- **To Tax or Not to Tax**

  There are several taxing issues that have been voiced by proponents and opponents alike. The issue getting the most focus is whether to collect sales and use taxes on goods and/or services sold over the Internet. Some of the confusion with the sales and use tax issue is that many people view it as a new tax. Sales and use taxes on goods and services are already in place in many state and local governments. It is not required that a seller who does not have a physical presence ("nexus") in a state collect the taxes because it is considered an undue burden on the seller. The taxpayer is required to honestly pay the taxes on what has been purchased by reporting it on his/her tax returns because this tax liability remains whether collected by the seller or not. On 1998 Illinois tax returns, only 4,127 returns reported $722,000 in sales and use taxes voluntarily paid by taxpayers. In short, the problem is one of collection, rather than liability.

  Revenues to state and local governments are being lost due to the lack of an effective way to collect sales and use taxes on purchases made over the Internet. State officials are worried that with the fast growth of the Internet and its competition with "Main Street" business, revenues will decrease in large amounts in the coming years. With a decrease in revenue, government-funded services could suffer, which in turn may force states to raise taxes in other areas.

Another issue involves taxing Internet Service Providers. Only ten states had been taxing Internet access when the ITFA became law—Connecticut, Iowa, New Mexico, North Dakota, Ohio, South Carolina, South Dakota, Tennessee, Texas, and Wisconsin. Both Connecticut and South Carolina have decided not to collect their tax during the time of the moratorium.

Telecommunications taxes have come up as another topic to be discussed. Even though Internet Service Providers are allowed to recover the cost of the telecommunications services they purchase through charges to their customers, they feel this is an unfair tax.

A final issue is that sales over the Internet have blurred geographic boundaries as well as the definitions of goods and services. When a customer downloads software from the Internet and pays for it on-line, how should that be taxed?

- **Fairness**

Fairness To Consumers: Consumers who cannot afford a computer and/or the Internet will still go to what are referred to as Main Street stores, and will have to pay sales taxes, whereas those purchasing over the Internet would not.

Fairness to Main Street Businesses: Main Street businesses must collect sales taxes. If a Main Street business is regional or nationwide, it must collect sales taxes in all of the states and localities where it has stores. Even if they sell on-line, they must collect sales and use taxes where they have nexus. This puts them at a disadvantage from Internet-only businesses that do not have physical presence in most states. From their perspective, it is unfair that they are forced to collect the sales taxes for their goods and interpret the many state and local government tax structures while Internet-only businesses do not face the same administrative burdens. Main Street businesses have a different viewpoint of discriminatory taxes--that it is discriminatory that certain types of business do not have to collect sales tax while others do. To them, this gives the Internet an unfair advantage because customers feel they will save money if they shop over the Internet. The sales tax on an item such as a $2,500 computer could cost more than shipping and handling. In Illinois, a $90 shipping and handling fee is cheaper than the state sales tax (6.25%) equaling $156.25. From the consumer's perspective, the choice to buy the computer on-line has saved him over $65, even more if additional local sales tax is figured. As suggested above, the consumer is not likely to file for these taxes on their tax return, and the taxes will remain uncollected.

Fairness to Internet businesses: From the "E-tailers" perspective, tax collecting is a burden because state and local governments have different taxes and varied definitions on what is to be taxed. They feel that they are already at a disadvantage because they charge the customer shipping and handling. Opponents of taxing the Internet say that the collection of existing sales taxes on Internet purchases could

reduce the number of on-line buyers by 25% and on-line spending by 30%. According to Internet Strategy & Investment, "Internet stocks began their geometric rise immediately after Congress passed a three-year moratorium on taxing the Internet". Opponents to the tax also state that the Internet offers Main Street businesses opportunities to reach out-of-state and foreign markets, and to reinvent themselves, while allowing small businesses a chance to compete with major players.

- **State autonomy vs. Federal intervention**
  Many government related groups also see this fight as a question of state rights--governing themselves without the intervention of the Federal government. If the Federal government decides to restrict the taxing of the Internet, then the states will lose one of the most important powers they have. According to the Executive Director of the National Conference of State Legislatures, William Pound, "This may be the most important issue that states have faced in a generation." Ultimately, the states must live with the consequences of the decisions that will be made, many of which they may have no control over.

- **Nexus**
  Physical presence ("nexus") of a business in a state helps in determining their requirement to collect the sales and use tax in a state. Some Main Street businesses are setting up separate subsidiaries for on-line shopping to avoid the nexus requirement of collecting sales and use taxes. If a company's website is a separate business without nexus in a state, they would not be required to collect sales and use taxes. If a company tries this approach then they are not supposed to advertise their web site in their stores and they are not supposed to accept returns of items sold over the Internet at their stores.

  Some opponents to taxing the Internet have suggested weakening the nexus rules to make it more difficult for a company to have a physical presence in a state. However, proponents like the District of Columbia Tax Revision Commission have recommended changes to tax laws to treat electronic presence the same as physical presence and to treat electronic sales the same as physical sales.

- **Tax law complexity/administrative burden**
  Most existing tax laws were made decades ago and are not easily applied to modern technologies. When many state and local governments tax sales there are different rates to follow. Each of these governments has their own definition of sales and goods, taxes them differently, and has their own tax-exemption process and groups. Businesses are also subject to different tax filings and audits from each of these governments.

  One of the concessions that has been offered by the proponents of taxing the Internet is to simplify state sales taxes. States could do more by standardizing tax

rates, simplifying goods and services definitions, and making exempt purchases and exempt organizations uniform. With the simplification of the sales tax, there would be less control by governments, and the states would have to share some portion of the new tax with local governments.

- **State Surpluses**
  It has been reported that states are running a surplus now from the record economic growth of the past few years. The Internet has contributed to that growth and the creation of high-tech, high-paying jobs. Groups that oppose a tax on the Internet say that taxes of any kind will slow the growth of the Internet and therefore slow the national economy. At the last ACEC meeting, Governor Janklow of South Dakota said that these huge surpluses are not true, and that this shouldn't even enter into the issue. He states that South Dakota will have to raise the sales tax to make up for lost revenue. If the tables were turned and taxes were collected for Internet sales, his state could lower the sales tax.

- **Employment**
  The Taxpayers' Federation of Illinois states that if Main Street businesses are hit hard and if the Internet replaces them, then existing employment opportunities in Illinois will change. "Reduced retail sales employment…would in part be replaced by increased employment by warehouses, order processing centers and delivery services. In 1998, retail trade establishments employed one out of every six Illinoisans with an average of 980,000 jobs or 16.6% of total state employment."

THE ADVISORY COMMISSION ON ELECTRONIC COMMERCE

The Advisory Commission on Electronic Commerce, created by the Internet Tax Freedom Act, has received over 30 proposals from political and economic groups, businesses and individuals. (Web sites where you can view these proposals include: **www.ecommercecommission.org/** and **www.ecommercetax.com.)** The Commission has focused their debate on four proposed plans:

1. ACEC member Governor Leavitt (R-Utah) sponsored the tax simplification plan offered by the National Governor's Association. The tax system would be voluntary and be a zero-burden collection system by the remote seller. A trusted third party would collect and remit the tax at the time of the on-line sale. This has been described as a carrot and stick approach. The "carrot" to voluntarily be a part of this system is that the tax is collected by someone else, therefore, vendors have no responsibility and will not be subject to audit by the states. The "stick" is, if you aren't a part of this system there is the threat of audit and the possibility that vendors will be held liable for uncollected back taxes. Another "stick" involves direct actions by the states to collect the sales and use taxes from citizens, which could reflect back on the vendor negatively.

An important aspect of this plan is that it requires no federal legislation and it is voluntary for both vendors and states. The states would have to pay for it and would have less power to change their tax base and rates whenever they want, but they would no longer incur costs for enforcement and audits. It could be considered a win-win situation if:

- E-tailers are serious in their contention that the main reason they don't collect the tax is due to its being too cumbersome;
- the states are willing to give up a little autonomy in return for getting sales and use taxes collected; and
- local governments are willing to trust the state to share the taxes collected since they will lose control of that aspect.

This system could also be used for off-line sales. This would put Main Street businesses on the same playing field to be taxed the same in the simplified tax system, and allow them to benefit from the tax collection services of the trusted third party.

Opposition to this plan says that the trusted third party would hurt on-line privacy, could distort the collection process, and would cost businesses a lot of money to link their internal accounting systems into the external tax collection system.

2. Governor Gilmore (R-Va.), the ACEC chair, offered his own plan of a tax-free Internet. His plan for a tax-free Internet is for remote business-to-consumer purchases, and would raise the standard of nexus to a substantial physical presence in a state. Certain kinds of physical presence in a state would not be considered nexus: salespeople present only to solicit sales, an affiliate, use of an Internet service provider to host a Web site, or presence of intangible assets. His plan includes an exemption from sales tax charges for Internet access services and the elimination of the current 3% federal excise tax on telecommunications services. Gilmore's plan would also offer federal funds for voluntary simplification of state tax rules, eliminate international tariffs on e-commerce, and relax welfare rules to allow states to provide computers and Internet access to needy families.

   Governor Gilmore's plan is similar to one introduced previously by Congressman John Kasich (R-Ohio). Kasich's plan was criticized by the committee when it was found that a customer could walk into a store, choose the item, and then order it on-line from a computer in the store to avoid paying any sales or use taxes. If most chain stores would move to this system, then the sales tax base would definitely erode.

   At the last meeting of the ACEC, the defenders of a tax-free Internet said that businesses on the Internet have no advantage over Main Street businesses, yet cited that if the Internet were forced to collect the tax, it would decrease on-line sales by 24%. David Pottrock, head of Charles Schwab, pointed out that these two

statements contradict one another—if there were no advantage why would there be a decrease in sales if the tax collection were enforced?

3. Commission member Dean Andal, chair of California's State Board of Equalization, offered a plan where the federal government would legislate to raise the standard for state nexus. He would use Public Law 86-272, which covers nexus for state income tax, and expand it to cover nexus for sales and use taxes. The plan is to make certain what nexus is, but to make it more difficult for a vendor to have nexus in a state, therefore, not requiring them to collect the sales and use tax. Others on the ACEC felt that this would increase litigation, and felt that it does nothing for state and local governments.

4. Grover Norquist offered a plan to eliminate the 3% federal excise tax on telecommunications (which raises over $3 billion dollars a year). Clinton officials on the Commission said that if this tax were eliminated it would cause an increase in other taxes or a decrease in federal spending.

The Advisory Commission on Electronic Commerce is polarized on whether to tax the Internet. It will take 13 of the 19 members (a 2/3 vote) to agree on a course of action to recommend to Congress. Other issues that the commission is waiting to vote on, but appear to have potential agreement are:

- requiring no international tariffs from any country on the Internet,
- barring taxes on Internet access,
- excluding digitized goods from being taxed, and
- eliminating the 3% federal excise tax on communications and simplifying telecommunications taxes.

The next ACEC meeting will be held March 20-21, in Dallas, Texas. The Commission will be finalizing the options upon which they will vote and offer to Congress.

NATIONAL CONFERENCE OF STATE LEGISLATURES MODEL LEGISLATION

The National Conference of State Legislatures has endorsed model legislation for the simplification of sales tax collection. This legislation, if adopted, would allow states to enter into discussions on developing a voluntary, streamlined, multi-state system for the collection and administration of existing sales and use taxes. This legislation also incorporates the "streamlined sales tax system for the 21st Century" proposal developed by the NCSL and the National Governor's Association. This system is voluntary for states and sellers and would be phased in over 6-8 years. The NCSL will submit this model legislation to legislative leaders of each state in hopes of it being enacted by some states this legislative session.

Simplification, as outlined in this proposal, would include uniform product codes, sourcing rules, procedures for exempt transactions, and definitions for tax laws. It would also limit the frequency with which state and local governments could change the tax rate. There would be no change in nexus definitions, and there would be no need for federal action. The long-term goal is to achieve one classification system for products, one set of definitions on exemptions, and a one-stop audit process for state and local governments. All changes to the system would go through a consensus board made up of representatives of the states. There would be zero-burden for the seller who would code the address for a trusted third party to protect the consumer's privacy. The trusted third party would deal with all tax related issues—calculating, collecting, reporting, and paying the taxes—using advanced technology. The states would pay the trusted third party per transaction, and these funds would be used to reimburse sellers for integrating their systems with the third party collection system.

INTERIM ACTIONS BY STATES, THE EUROPEAN COMMUNITY, ETC.

- **States not collecting Internet taxes**
  Both Connecticut and South Carolina, who could continue taxing Internet service providers under the grandfather provision of the ITFA, decided to comply with the Internet Tax Moratorium. California has passed its own Internet Tax Freedom Act which also establishes a three-year moratorium on targeted Internet taxes within the state. The state's tax agencies are not seeking to aggressively assert sales or income tax jurisdiction merely on the basis of a company's "electronic presence" on a server in California.

  A Virginia law effective July 1, 1998, granted retail sales and use tax exemptions for charges for Internet access and sales of software via the Internet. New Mexico signed a law in March of 1998 giving exemption to utility service providers and Internet Service Providers for telecommunications related to Internet services.

- **States aggressively collecting sales and use taxes**
  The Michigan Department of Treasury has begun collecting taxes from all mail-order and Internet purchases made in the state. They will change their tax forms to encourage taxpayers to report the amount of sales tax they owe for on-line purchases. (According to the Michigan Senate Fiscal Agency, the losses from Internet and catalog sales could reach $200 million dollars in 2000, and approximately $900 million in 2005.) Twelve southeastern states have banded together to share information gathered by tax collectors from local businesses on out-of-state sales. This information helps states track unpaid sales and use taxes due from their citizens. (Over the last ten years these states have collected $70 million using this system.)

At the December ACEC meeting, South Dakota Governor Janklow has suggested that his state stop UPS trucks as they enter the state, note which packages have been purchased free of tax, and then send bills to consumers. This was countered by Ted Waitte, chief executive of Gateway Computer, who said that if this happens the consumer will be angry with the vendor for not making it clear that tax on the equipment would be payable. Florida state troopers actually do stop furniture trucks and note the value of the items. If the consumer does not remit the tax in a certain time frame, the state sends them a bill for the use tax, plus interest and penalty fees.

- **Pending legislation prohibiting Internet-related taxes**
  South Carolina has pending legislation that would prohibit a tax or fee on the Internet or interactive computer services. New York and Wisconsin are considering legislation to exempt Internet access from being taxed. Alabama has legislation pending (SB 59) that would exempt Internet access charges from the state's telecommunications service tax.

- **Action by Main Street businesses**
  Some major retailers like Wal-Mart, Kmart and Best Buy are making deals with Internet partners (AOL, Yahoo, and Microsoft, respectively). The deal is that the Main Street stores will advertise for their Internet partner to the customer base that may not have the Internet or a computer yet, while the Internet partner gives prominent advertising space to the Main Street business.

  Owners of the Galleria mall in Saint Louis, MO, tried (but failed) to prohibit its 170 retail tenants from displaying any "signs, insignias, decals or other advertising devices that promote or encourage the purchase of merchandise via e-commerce".

- **Action by the European Community**
  The European Community will collect a Value Added Tax (VAT) on sales of digital products and services. They are moving to a system where the VAT is collected where these products and services are consumed. They will tax European Union (EU) vendors on sales within the EU but not outside of the EU. They will also require non-EU vendors to register with one EU tax authority for all of their EU sales or vendors could use a trusted third party to collect the tax. They feel they will succeed since the vast majority of sales will come from relatively few vendors including Time-Warner, Disney, Microsoft, Amazon, America Online, Sony, etc. It will be easy to enforce because none of these companies would risk having one of their officers arrested at Heathrow Airport on tax evasion. (Even if small vendors will not comply, they make a cumulatively small part of the EU market; but if they advertise in the EU, they can be tracked.)

EFFECT ON ILLINOIS

It is difficult to determine the impact that electronic commerce, specifically on-line retail sales, will have on the sales tax revenues of Illinois. There are many types of commerce taking place over the Internet, but most Internet sales estimates refer to two types of commerce—"business-to-business" and "business-to-consumer" transactions.

Business-to-business transactions are those in which one business buys products from or sells products to another business. The merchandise sold to a business will generally be resold; this merchandise is not taxable. Approximately 80% of on-line sales are believed to be business-to-business transactions.

It is estimated that 20% of on-line transactions are **business-to-consumer** sales. This category includes travel, financial services, groceries/beverages, books, music, and insurance. Travel and financial services are considered intangible in the State of Illinois, and are, therefore, not subject to sales and use tax. Illinois local governments tax groceries and beverages. Only a small percentage of business-to-consumer transactions are subject to state sales and use tax. These will be referred to as "taxable business-to-consumer sales".

In one of the most comprehensive studies to date, a recent report from Ernst & Young, The Sky Is Not Falling: Why State and Local Revenues Were not Significantly Impacted By The Internet in 1998, concluded that "$2.6 billion or only 13% of total e-commerce retail sales have potential sales and use tax collection issues. Applying state and local sales and use tax rates to the potential tax base results in sales and use tax erosion of less than $170 million in 1998. This is only one-tenth of one percent of total sales and use taxes collected by all state and local governments."

The Ernst & Young report outlined several important reasons why tax revenues have not been significantly impacted:

Of the 20% of Internet sales considered business-to-consumer sales, an estimated 63% are intangible services purchased over the Internet (including travel and financial services) or fully/partially exempt products (such as groceries and prescription drugs). These categories are generally not subject to full state and local sales and use taxes. This leaves approximately 37% of business-to-consumer online sales to be considered fully taxable.

This category of taxable sales is reduced by the fact that sales and use taxes are remitted by e-commerce sellers and buyers on 4% of e-commerce sales. In addition, the Ernst & Young report suggests that the substitution of e-commerce purchases for sales from other sellers (i.e. mail-order) does not result in reduced sales and use tax. The report estimates that sales and use tax would not be collected on the 20% of online taxable sales that substitute for another remote sale. This revenue loss already is

considered in a different category; it would not be accurate to attribute the revenue loss to electronic commerce.

Ernst & Young determined that tax is not collected on 13% of total Internet sales, resulting in the aforementioned revenue loss of $170 million in 1998. The average state and local tax rate of 6.5% was applied to this figure to estimate the total national revenue loss. To estimate Illinois' portion of the total loss, 4.5% (Illinois' approximate share of national economic activity) was applied to the national revenue loss figure (see tables on next page).

There are no accurate figures of on-line sales. Several groups have compiled estimates of on-line sales for 1999 and the next several years. While their estimates vary, each estimate suggests that the volume of on-line shopping will continue to grow significantly.

The tables on the following page include estimates for 1999 and 2002. Each represents a range of estimates in which the high estimate is double the amount of the low estimate. This reflects the great speculation about the growth of electronic commerce.

TABLE 1: Estimates of 1999 On-line Sales and Loss of Revenue ($ in Millions)		
	Range of Estimates	
	LOW	**HIGH**
Business-to-Consumer Sales	$18,000.0	$36,000.0
TAXABLE Business-to-Consumer Sales	$6,660.0	$13,320.0
Less 4% of sales where taxes are paid	-$720.0	-$1,440.0
Less 20% of sales that substitute for other remote sales*	-$3,600.0	-$7,200.0
REVISED Taxable Business-to-Consumer Sales	$2,340.0	$4,680.0
Estimate of Total Revenue Loss: U.S.	$152.1	$304.2
Estimate of Revenue Loss: ILLINOIS	**$6.8**	**$13.7**
Estimated State Share (80%)	$5.5	$11.0
Estimate Local Share (20%)	$1.4	$2.7

TABLE 2: Estimates of 2002 On-line Sales and Loss of Revenue ($ in Millions)		
	Range of Estimates	
	LOW	**HIGH**
Business-to-Consumer Sales	$75,000.0	$150,000.0
TAXABLE Business-to-Consumer Sales	$27,750.0	$55,500.0
Less 4% of sales where taxes are paid	-$3,000.0	-$6,000.0
Less 20% of sales that substitute for other remote sales*	-$15,000.0	-$30,000.0
REVISED Taxable Business-to-Consumer Sales	$9,750.0	$19,500.0
Estimate of Total Revenue Loss: U.S.	$633.8	$1,267.5
Estimate of Revenue Loss: ILLINOIS	**$28.5**	**$57.0**
Estimated State Share (80%)	$22.8	$45.6
Estimate Local Share (20%)	$5.7	$11.4

*Substitution of e-commerce purchases for sales from other remote sellers (mail order, telemarketers, etc.) does not result in reduced sales and use tax. In essence, if sales tax is not being collected from mail-order establishments now, and those sales become Internet sales, the loss in tax revenue can be counted only once. The Ernst & Young study indicated that a conservative estimate of 60% of e-commerce purchases would have otherwise been made by phone or mail order.

SOURCES: Ernest & Young, Boston Consulting Group, Forrester Research, Chicago Tribune.

CONCLUSION

As detailed in an article by the National Conference of State Legislatures, Can the Sales Tax Survive Cyberspace?, there are three possible outcomes to this debate. The first is for Congress to make the Internet a "tax-free" zone, taking the decision out of the hands of state government and creating a major new tax loophole for firms with Internet sales. A second option is inaction by both Congress and the states, allowing remote sales to escape taxation. In time this could seriously reduce state revenues in this area. The third possible outcome would be for the states to act. One suggestion that has been offered would be to simplify the sales tax by requiring one flat tax per state, the proceeds of which would be shared with local governments. There could also be standardization of states' definitions for taxable goods and services, and exemptions. Another alternative is the use of a third party to collect the taxes for businesses (Internet and Main Street alike) from consumers. Perhaps one or more of these changes could lead to the collection of use taxes on remote sales. All of these proposals are being considered by the Advisory Commission on Electronic Commerce, which will give a final report to Congress in the spring of 2000.

Not surprisingly, governments at all levels are becoming increasingly concerned that one of their most consistent streams of revenue, sales and use taxes, may be threatened by the rapid increase of Internet sales. Exacerbating their concerns is the relatively recent passage of the Internet Freedom Act, which in essence establishes a moratorium on the taxation of the Internet. While estimates vary in regards to the impact that Internet sales are having on sales tax receipts, it appears that the current impact is not that significant. However, given the extreme growth potential of the Internet, that situation could quickly change and governments at all levels may begin to feel the impact of lost sales revenue in just a few years.

Revrpt/2000 Internet Taxation Report

BACKGROUND

The Illinois Economic and Fiscal Commission, a bipartisan, joint legislative commission, provides the General Assembly with information relevant to the Illinois economy, taxes and other sources of revenue and debt obligations of the State. The Commission's specific responsibilities include:

1) Preparation of annual revenue estimates with periodic updates;

2) Analysis of the fiscal impact of revenue bills;

3) Preparation of "State Debt Impact Notes" on legislation which would appropriate bond funds or increase bond authorization;

4) Periodic assessment of capital facility plans; and

5) Annual estimates of the liabilities of the State's group health insurance program and approval of contract renewals promulgated by the Department of Central Management Services.

The Commission also has a mandate to report to the General Assembly ". . . on economic trends in relation to long-range planning and budgeting; and to study and make such recommendations as it deems appropriate on local and regional economic and fiscal policies and on federal fiscal policy as it may affect Illinois. . . ." This results in several reports on various economic issues throughout the year.

The Commission publishes two primary reports. The "Revenue Estimate and Economic Outlook" describes and projects economic conditions and their impact on State revenues. "The Illinois Bond Watcher" examines the State's debt position as well as other issues directly related to conditions in the financial markets. The Commission also periodically publishes special topic reports that have or could have an impact on the economic well being of Illinois.

These reports are available from:

Illinois Economic and Fiscal Commission
703 Stratton Office Building
Springfield, Illinois 62706
(217) 782-5320
(217) 782-3513 (FAX)

Reports can also be accessed from our webpage:

http://www.legis.state.il.us/commission/ecfisc/ecfisc_home.html