TALKING TAXES

Should States be Allowed to Tax Internet Sales?

Retail trade has been transformed by the emergence of the Internet. As the popularity of "e-commerce" (that is, transactions conducted over the Internet) has grown, policymakers have engaged in a heated debate over how—if at all—state taxes should apply to these Internet-related transactions. This debate is of critical importance for state lawmakers because sales taxes comprise close to a quarter of all state tax revenues. This policy brief focuses on one important area of this debate: whether state governments should be allowed to apply their sales tax to items that are purchased over the Internet.

The Problem: States Can't Collect Sales Tax on Remote Sales

The growth of Internet-based retail trade is only the latest recurrence of a structural problem with state sales taxes: the increasing importance of "remote sales." Remote sales are retail transactions, such as catalog orders or telephone sales, in which the seller has no "physical presence"—that is, property or employees—in the state of the purchaser. A series of U.S. Supreme Court decisions, most recently *Quill v. North Dakota* (1992), have found that states cannot require remote sellers to collect sales taxes purchases in states where they do not have a physical presence. As a rationale for this decision, the Court cited the complexity of state and local sales tax systems. The Court argued that with so many states, counties, and municipalities levying different taxes at different rates with different tax bases, forcing retailers to figure out the appropriate tax to collect on sales to each jurisdiction would impose an unacceptable administrative burden on these sellers. (States can, however, require consumers to pay tax on these remote sales, and every state with a sales tax has now enacted a special "use tax" to achieve this. But the use tax is difficult to enforce, and rarely paid by individual consumers.)

Solutions: Simplification and State Action

The Supreme Court's *Quill* decision also indicated that the problem of sales tax complexity could be resolved. The Court noted that there are sound public policy reasons to try to collect taxes on remote sales: even businesses that engage only in mail-order or Internet sales in a state still benefit from the public services that make these transactions possible—and should help to pay the cost of providing these services. The Court suggested that if Congress chose to do so, it could pass legislation that would allow states to require sales tax collection on remote sales, and hinted that Congress would be more likely to pass such legislation if state lawmakers took immediate steps to simplify the current maze of tax bases and tax rates.

In recent years, state governments have responded to the Supreme Court's mandate by cooperating to simplify their sales tax rules. The Streamlined Sales Tax Project (SSTP) was formed by representatives of most state governments to develop a plan to simplify sales tax structures. In 2002, these representatives agreed on model legislation, called the Streamlined Sales and Use Tax Agreement (SSUTA), designed to be enacted by each state legislature. The agreement became legally binding (in states

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enacting it) in 2005. As of July 2008, nineteen states are full members of the Agreement and three states have associate member status. However, the states remain powerless to require the collection of sales taxes on remote sales until Congress acts to enable them. Bills have recently been introduced in Congress that would allow states to collect sales tax on remote sales, but these bills have failed to advance.

Some states are refusing to wait for Congressional action and are moving forward on their own. Legislation passed in New York in April 2008 seeks to ensure that Internet retailers that do business through local agents collect sales taxes, though companies such as Amazon and Overstock are challenging the legislation in court. If the legislation survives court challenges estimates are that closing this loophole will generate nearly $50 million in revenue for the state. Other states may be able to clarify existing sales tax law to prevent companies that do business both over the Internet and in conventional settings from shirking their sales tax responsibilities and only paying sales tax on purchases made from traditional stores.

Some companies have indicated that neither federal nor state action may be necessary, and are actively collecting tax on their Internet-based sales. The Chief Executive of Netflix has 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."

Why Should Internet-based transactions be taxed?

From a tax fairness perspective, Internet-based sales should be treated in the same manner as other retail transactions. That is, retail transactions that are taxable when sold by "bricks and mortar" retailers should also be taxable when sold over the Internet. There are several reasons for taking this approach:

- Exempting e-commerce transactions is **unfair to "bricks and mortar" retailers**– that is, retailers who sell their products in conventional stores rather than over the Internet. Retailers who choose (or are forced) to sell their wares primarily in a "bricks and mortar" setting rather than making sales over the Internet effectively charge higher prices than Internet-based companies.
- Exempting e-commerce transactions is **unfair to consumers**. Consumers who are unable to access the Internet are unfairly disadvantaged by having to pay sales taxes on their purchases.
- Exempting e-commerce **reduces state sales tax collections** as the importance of the Internet continues to grow. The commonly cited estimate of this revenue loss, by researchers at the University of Tennessee, is that state and local governments lost $45.2 billion in sales tax revenue to remote sales in 2006, revenue loss is expected to increase to as much as $54.8 billion in 2011.

Next Steps: Federal and State Governments Must Each Play a Role

The loss of sales tax revenue to e-commerce is a problem that will only get worse. States participating in the Streamlined Sales Tax Project have taken steps to simplify their tax systems in anticipation of Congressional action that has yet to happen. Cash-strapped states are following the court battle in New York. Until the federal government or states act, it is certain that the discriminatory treatment of e-commerce will continue to the disadvantage of "bricks and mortar" retailers.

To find out more about this issue, contact ITEP at (202) 299-1066