TALKING TAXES

Should States be Allowed to Tax Internet Sales?

In the past decade, retail trade has been transformed by the emergence of the Internet. As the popularity of "e-commerce" (that is, retail 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 more than a third 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 long-standing structural problem with state sales taxes: the increasing importance of "remote sales." These 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. A series of U.S. Supreme Court decisions, most recently *Quill v. North Dakota* (1992), have found that states cannot require retailers to collect sales taxes on items purchased from remote sellers. 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 very difficult to enforce, and is rarely paid by individual consumers.)

The Solution: Sales Tax Simplification

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 in April of 2000 by representatives of most state governments to develop a plan to simplify sales tax structures. In November of 2002, these representatives agreed on model legislation, called the Streamlined Sales and Use Tax Agreement (SSUTA), designed to be enacted by each state legislature. Under the terms of the agreement, this legislation will become legally binding (in states enacting it)

Policy Brief #2 ©2005

Funding for this Policy Brief was provided by the Annie E. Casey Foundation

when 10 states representing 20 percent of the U.S. population enact it. Some states have already passed laws to implement the SSUTA. However, even after the requisite number of states pass this legislation, the states will still be powerless to require the collection of sales taxes on remote sales until Congress acts to enable them. Although bills have recently been introduced in Congress that would allow states to collect sales tax on remote sales, these bills have so far failed to advance.

Internet-based sales should be treated in the same manner as other retail transactions. Failing to do so puts "bricks and mortar" retailers and low-income consumers at a competitive disadvantage.

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 must charge more for the same products than an Internet-based firm.
- 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 Internet retail sales probably increases the regressivity of state and local sales taxes as better-off taxpayers are able to avoid these taxes through Internet purchases.
- Exempting e-commerce will dramatically **reduce state sales tax collections** as the importance of the Internet continues to grow. The most commonly cited estimate of this revenue loss, by researchers at the University of Tennessee, is that state and local governments nationwide lost up to $15.5 billion in sales tax revenue to remote sales in 2003, rising to as much as $21.5 billion in 2008. While this impact is limited to states with general sales taxes, and varies from state to state depending on the importance of sales taxes as a revenue source, the University of Tennessee analysis estimates that nationwide, states with sales taxes will lose more than six percent of their total state tax revenue to e-commerce losses by 2011.

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

As states continue to grapple with historically high budget deficits, the ongoing loss of sales tax revenue to e-commerce is a problem that will only get worse, and states can do little to prevent it in the short run. States participating in the Streamlined Sales Tax Project have taken important steps to simplify their tax systems in anticipation of Congressional action to permit state sales taxation of e-commerce—but Congress has not yet taken such action. Until federal lawmakers remedy this inequity in state sales tax structures, the discriminatory treatment of e-commerce will continue to put "bricks and mortar" retailers—as well as low- and middle-income taxpayers who are less likely to use the Internet as a medium for retail transactions—at a disadvantage, while making the budgeting process even more difficult for cash-strapped states.

To find out more about this issue, contact ITEP at (202) 626-3780