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How Can States Collect Taxes Owed on 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 state sales taxes should be applied to these transactions. This debate is of critical importance for state lawmakers because sales taxes comprise close to a third of all state tax revenues.

States Can't Require Remote Sellers to Collect Sales Taxes

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 like catalog and Internet 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 on purchases in states where they do not have a physical presence. States can, and do, require their residents to self-report the sales taxes they owe on those purchases. But requirements of this type are basically unenforceable, and sales made over the Internet therefore tend to escape taxation in practice.

In handing down its ruling in *Quill*, the Court cited the complexity of state and local sales tax systems. The Court argued that with so many states and localities levying applying different tax rates to 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.

Why Should Taxes Be Collected on Internet Sales?

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 taxed when sold by “brick and mortar” retailers should also be

taxed when sold over the Internet. There are several reasons for taking this approach:

- Failing to collect tax on e-commerce transactions is **unfair to “brick and mortar” retailers**—that is, retailers who sell their products in conventional stores rather than over the Internet. While retailers who sell their wares in a “brick and mortar” setting are required to assist in the enforcement of existing sales tax laws, Internet retailers are dodging that responsibility and instead offering their customers an opportunity to commit sales tax evasion.
- Failing to collect tax on e-commerce transactions is **unfair to law-abiding taxpayers**. While all sales are legally subject to sales taxes, most online shoppers fail to pay the taxes they owe because they are either unwilling to do so, or unaware that the responsibility to do so even exists. Individuals who shop in traditional retail outlets, as well as online shoppers who dutifully pay their sales taxes, are stuck paying proportionally more of the sales tax than would otherwise be the case. This arrangement is particularly unfortunate for low-income taxpayers, who are often unable to access the Internet.
- Failing to collect tax on e-commerce transactions **reduces state sales tax collections** by an increasing amount 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 \$8.6 billion in sales tax revenue in 2010, and will lose as much as \$11.4 billion in 2012.

How Important is Tax Simplicity?

In its ruling in *Quill*, the Supreme Court acknowledged that there are sound public policy reasons to collect taxes on remote sales, and indicated that the concerns that led to its ruling could be resolved by federal and state lawmakers. 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 their sales 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 enacting it) in 2005. As of July 2011, twenty states are full members of the Agreement and four 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 due to the anti-tax attitudes of many in Congress, as well as a more general apathy toward this uniquely state-level problem.

It's also worth noting that the complexity concerns raised by the Court appear to be rapidly disappearing as technology improves. Major retailers with 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.com 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 Chief Executive Officer 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."

State Action to Expand Sales Tax Collection Requirements

Some states are sensibly refusing to wait for Congressional action and are moving forward on their own with limited steps to expand the number of retailers that must collect sales taxes. New York led the charge on this effort when it enacted new legislation in 2008 requiring Internet retailers that work in partnership with New York businesses to collect sales taxes. Since its enactment, the law has generated some \$250 million for the state, and similar laws have been enacted in six more states: Arkansas, California, Connecticut, Illinois, North Carolina, and Rhode Island. Amazon.com and other major online retailers have responded to these new laws in an increasingly aggressive manner, including lawsuits in Illinois and New York, and the filing of a ballot initiative to repeal California's new law (For more detail, see "**States Should Not Allow Amazon.com to Bully Them into Forgoing Sales Tax Reform**").

But traditional "brick and mortar" retailers of all sizes have recently become more vocal in supporting efforts to require sales tax collection by online retailers, and state lawmakers across the country appear to be listening to their pleas for a more level playing field.

Comprehensive Reform Must Come from the Federal Government

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 order to hasten Congressional action on this topic, while other states have taken more direct steps to increase the number of retailers that must collect sales taxes. Until the federal government enacts a law allowing states to require that all Internet retailers collect sales taxes, however, there is no doubt that the discriminatory treatment of e-commerce will continue, and that "brick and mortar" retailers, law-abiding taxpayers, and state tax collections will suffer as a result. 📌