Collecting Sales Taxes Owed on Internet Purchases

Retail trade has been transformed by 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 and local sales taxes should be applied to these transactions. This debate is of critical importance for states as sales taxes comprise close to one-third of all state tax revenues and hundreds of billions of dollars in retail spending is now occurring online.

States Often Cannot Require Remote Sellers to Collect Sales Taxes

The growth of Internet-based retail trade has exacerbated a long-running structural problem with sales taxes: states’ inability to require that sellers collect the taxes owed on “remote sales.” Remote sales are retail transactions in which the seller has no “physical presence”—that is, property or employees—in the state of the purchaser. Previously, this issue was confined largely to purchases made through mail-order catalogues, though with the boom in online shopping the importance of remote sales has grown dramatically.

A series of U.S. Supreme Court decisions, including 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 generally 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 applying different tax rates to different tax bases, forcing retailers to figure out the appropriate tax to collect on sales in each jurisdiction would impose an unacceptable administrative burden on sellers.

Recently, however, the Court has suggested that it may be open to revising its stance on the “physical presence” test. In Direct Marketing Association v. Brohl (2015), Supreme Court Justice Anthony Kennedy wrote that the “legal system should find an appropriate case for this Court to re-examine Quill.” To provide such a case, Alabama and South Dakota recently attempted to require sales tax collection from retailers lacking a physical presence inside their states’ borders. Both of those requirements prompted swift lawsuits that, if brought before the Supreme Court, could potentially end in a decision that would allow states to begin collecting sales taxes from most or all remote 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 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. The result is a built-in price advantage for Internet-based retailers at the expense of companies with actual stores in the communities in which they do business.

- **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 and seniors who are less likely to have reliable access to the Internet and/or a means of making online payments.
The revenue loss associated with failing to collect tax on e-commerce transactions is large and likely to grow. State and local governments are losing billions of dollars in sales tax revenue each year because taxes are going uncollected on many purchases made over the Internet. At the turn of the century, e-commerce made up less than 1 percent of retail sales. Today that figure is 8 percent, and rising.

How Important is Tax Simplicity?

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 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 November 2016, twenty-three states are full members of the Agreement. However, the states remain limited in their ability to require the collection of sales taxes on remote sales until Congress acts to enable them to do so. Bills have been repeatedly introduced in Congress that would allow states to collect sales tax on remote sales. In 2013 the Senate passed such a bill (the “Marketplace Fairness Act”) for the first time, but that bill failed to advance in the House.

It is 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, such as Wal-Mart and Home Depot, already collect sales taxes on sales made over the Internet in addition to those made inside their physical stores. And after years of skirting sales tax collection requirements, the nation’s largest e-retailer, Amazon.com, is now collecting tax from most of its U.S. customers. The company still refuses to do so in more than a dozen states where it lacks a physical presence, however.

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. They 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 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 hundreds of millions in revenue for New York. Similar laws have been enacted in other states.

Unfortunately, Amazon.com and other major online retailers have responded to some of these laws by cutting ties with in-state businesses to avoid having to collect sales taxes. This development underscores the fact that the federal government will need to step in before this problem can be fully solved.

Comprehensive Reform Must Come from the Federal Government

The loss of sales tax revenue to e-commerce is a problem that is likely to worsen. States participating in the SSTP have taken steps to simplify their tax systems to encourage Congressional action, while other states have taken more direct steps to increase the number of retailers that must collect sales taxes. Until either Congress or the Supreme Court acts to allow states to require that all Internet retailers collect sales taxes, however, there is no doubt that the preferential treatment of e-commerce will continue, and that “brick and mortar” retailers, law-abiding taxpayers, and state tax collections will suffer as a result.