INSTITUTE ON TAXATION AND ECONOMIC POLICY

Policy Brief

Informing the debate over tax policy nationwide

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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. 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, 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 National Conference of State Legislatures estimates that state and local governments are currently losing $23 billion in sales tax revenue each year.

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 2013, twenty two states are full members of the Agreement and two states have associate member status. However, the states remain limited in their ability to require the collection of sales taxes on remote sales until Congress acts to enable them. Bills have been repeatedly introduced in Congress that would allow states to collect sales tax on remote sales, and in 2013 the Senate passed such a bill for the first time. That bill, called the Marketplace Fairness Act, has yet to advance in the U.S. House.

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 Wal-Mart and Home Depot, already collect sales taxes on sales made over the Internet, in addition to those made inside their physical stores. Similarly, Amazon.com has begun to collect tax in a growing number of jurisdictions as it expands its physical footprint into more states in order to speed delivery times. 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 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 the state and similar laws have been enacted in nine more states: Arkansas, California, Connecticut, Georgia, Illinois, Kansas, Minnesota, North Carolina, Rhode Island, and Vermont. Unfortunately, Amazon.com and other major online retailers have sometimes responded to these laws by cutting ties with in-state businesses in order to avoid having to collect the tax. This development underscores the fact that Congress must 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 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.