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Closing the E-Commerce Sales Tax Loophole

BY ROB ATKINSON AND DANIEL CASTRO | MAY 20, 2010

Across the nation, states are facing a budget crisis as the recession has caused a steep decline in the amount of state revenue. Forty-eight of the fifty states face a budget shortfall cumulatively totaling $196 billion in 2010, or approximately 29 percent of state budgets.[1] Not surprisingly, in the face of such fiscal woes, states are searching for new opportunities to increase state revenue and many have set their sights on e-commerce. We believe that Congress should grant states the authority to require Internet retailers to collect sales tax on e-commerce under a simplified tax system provided that states also agree to eliminate restrictive regulations hurting e-commerce.

This issue is not new. In 1992, the U.S. Supreme Court ruled in *Quill Corp. v. North Dakota* that states cannot require a retailer to collect sales and use taxes for in-state customers unless the retailer has "nexus", e.g., a physical presence in their state.[2] The Supreme Court reasoned that with over 6,000 different tax jurisdictions in the United States, taxes on out-of-state businesses "might unduly burden interstate commerce."[3] The estimated losses resulting from their inability to require out-of-state sellers to collect and remit sales taxes are substantial. In 2010, uncollected states and local sales tax from e-commerce will total approximately $8.6 billion.[4] As a result, state are even more determined than ever to obtain from Congress the right to collect taxes on e-commerce sales by out-of-state sellers.

Certainly there are compelling reasons to not require retailers to collect taxes on out-of-state e-commerce transactions. First, as the Supreme Court ruling alluded to, the cost of complying with the various rules and regulations from thousands of tax jurisdictions would be prohibitively expensive for most remote retailers. Second, e-commerce is generally energy efficient and many argue that government should use price signals to encourage energy-efficient consumer behavior. For example, the energy involved in selling $100 of books is 14 times more for a traditional superstore than for an online bookseller.[5] And downloading music or movies instead or purchasing them at a store eliminates many energy consuming activities such as driving to a store, shipping from the wholesaler to the retailer, and producing the physical media and media cases.

However, there is also an argument to be made in favor of requiring retailers to collect sales tax on out-of-state e-commerce. State and local officials view the Internet as a tide that has eroded local and regional tax bases with devastating consequences as more and more sales move from the brick-and-mortar retailers on "Main Street" to the ether of cyberspace. Indeed, over the past decade retail e-com-

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merce sales have increased approximately 24 times faster than non-ecommerce retail sales.[6] Moreover, state official argue that these are not new taxes but rather better enforcement of existing taxes. In most states, consumers are required to pay use taxes on items purchased out-of-state, but states have limited ability to enforce this requirement. Requiring merchants to collect the tax is the only realistic way for states to obtain this tax revenue. In addition, brick-and-mortar stores argue that they face unfair competition from out-of-state Internet (and catalog) retailers that do not have to collect sales tax. Unless Internet retailers are forced to collect sales tax, they can undercut brick-and-mortar retail prices simply by not collecting sales tax.

In an effort to gain Congressional approval for taxing out-of-state e-commerce sales, states have made a concerted effort to develop a streamlined taxing system. In 1998, the National Governors Association adopted a policy that expresses the willingness of states to simplify their sales taxes with the expectation that, in exchange, the federal government would provide these states with the authority to require larger out-of-state sellers, including Internet vendors, to collect sales taxes for the states. In November 2002, 44 states and the District of Columbia approved the Streamlined Sales and Use Tax Agreement (SSUTA), a framework for a simplified state sales and use tax system. The SSUTA includes uniform tax definitions, uniform and simpler exemption administration, rate simplification, state-level administration of all sales taxes, and uniform sourcing (e.g., where the sale is taxable).[7] As of May 10, 2010, twenty-three states—comprising 33 percent of the country's population—have passed SSUTA legislation and legislation was pending in at least 10 other states.[8]

In the absence of Congressional action on the SSUTA, some states have pursued other means to force Internet retailers to collect sales taxes. For example, states have taken action to more broadly define nexus for the purpose of tax liability. In 2001, California issued an administrative ruling that in-state retailers with separate online operations were not exempt from collecting sales tax. For example, the retailer Borders Book and Music had argued that its online counterpart, Borders.com, should not be subject to California state sales taxes because it was a legally distinct entity. Other states, such as New York, have passed laws stating that if an out-of-state retailer has in-state affiliates (i.e., organizations that place links on their website to the retailer and receive a commission for referred sales), then the out-of-state retailer satisfies the nexus requirement outlined by the Supreme Court. Other states, including Rhode Island, North Carolina and Colorado have passed similar laws. In response, Amazon.com, the largest online retailer affected by these laws, has banned individuals and organizations from these states (except New York) to participate in its affiliate program.[9] Finally, just this year Colorado passed HB 1193 which requires out-of-state retailers that do not collect sales tax to provide consumers and the Colorado Department of Revenue with an end-of-year report showing all purchases that were not taxed.[10]

Congress should find a balance between these conflicting factors that allows states and municipalities to tax Internet sales without imposing a burden on out-of-state online retailers and also promotes greater e-commerce. A key way to do this is to require states to eliminate discriminatory taxes on Internet access and protectionist laws limiting e-commerce. All states have given in to pressure from brick- and-mortar businesses and have passed legislative or regulatory provisions that limit the right of consumers to purchase certain products and services online. For example, it is illegal in all 50 states for a consumer to purchase a car from the manufacturer over the Internet. In addition, a number of states have passed discriminatory taxes on broadband Internet services, both wired and wireless. As such Congress should not grant states the right to tax Internet sales unless they have first eliminated discriminatory taxes on Internet access and protectionist laws and regulations that discriminate against e-commerce (unless the states can make a clear and compelling argument that discriminatory laws or regulations are required for consumer protection). Linking the rights of states to collect tax on Internet sales to the elimination of protectionist laws and discriminatory taxes on Internet access is likely to be a net benefit for consumers, as the additional taxes consumers would pay could be more than offset by savings from purchasing lower-cost goods and services online.

ESTABLISH A FAIR AND SIMPLE TAX ON E-COMMERCE

States rightly argue that tax laws need to evolve to allow them to require out-of-state sellers without nexus to collect and remit taxes on Internet sales to state residents. Neither Internet retailers nor brick-and-mortar retailers should receive preferential tax treatment.

Policymakers should adhere to three key principles as they craft a system for taxation of out-of-state sales over the Internet:

- **Fairness:** Any solution should apply not only to Internet transactions but to all out-of-state transactions, including mail-order and telephone-based sales. Otherwise, the system would unfairly discriminate against e-commerce. Conversely, not taxing out-of-state transactions, including e-commerce, unfairly discriminates against traditional face- to-face transactions that are taxed.
- **Simplicity:** The solution should not place an innovation-stifling burden on the digital economy. It should be easy for lawmakers to implement and even easier for businesses to use. In addition, Congress should establish a minimum level of sales should be established; retailers that made sales in the past year above that de minimus level would be required to collect and remit the sales taxes to qualified states. Finally, any solution should be technology-neutral.
- **Parity:** The goal should be to establish parity in the collection costs between out-of-state retailers and single-jurisdiction retailers.[11] One way to achieve this would be to require that states provide reasonable compensation to out-of-state retailers for expenses related to collecting and remitting sales tax. States should also be responsible for paying for the use of a certified tax collection software service provider for these retailers. Moreover, any retailer using a service provider that has been certified by the participating states to calculate sales tax would not be liable for sales tax mistakes processed by that provider. This requirement would encourage states to develop an efficient mechanism to allow retailers to collect and track sales tax, such as an open-source software library that developers can integrate into different e-commerce software packages.

The advent of e-commerce should not be viewed as either a threat or a potential windfall for state and local governments' tax bases. Assessing taxes on Internet sales should, all else being equal, have no effect on state and local tax revenues—what is lost as a result of decreasing face-to-face sales will be offset by gains from increasing online sales. Moreover, states and localities should continue making their own decisions about the relative weight of sales tax rates, and other tax rates, just as they always have. A federally imposed system should simply provide a framework to enable that process in remote transactions.

ELIMINATE TAXES ON INTERNET ACCESS

Before granting states the authority to tax out-of-state Internet retailers, Congress should require states to eliminate taxes on Internet access, both wired and wireless.

First, Congress should make permanent the current moratorium on taxes for Internet access. Internet access is not a luxury service for most Americans, but rather it is a key enabler of commerce, education, government services and civic participation. Given that Internet access is a prerequisite for participating in our digital society, Congress should prohibit states from placing barriers that prevent Americans from getting online. The Internet Tax Freedom Act (ITFA), which expires in 2014, should be made permanent.

Second, Congress should eliminate the grandfather clause in the ITFA, which allows certain states and local jurisdictions to impose taxes on Internet access. Although the ITFA prohibits states from imposing new taxes on Internet access, it contains a grandfather clause which allows those states and local jurisdictions that had implemented taxes on Internet access before 1998 to continue to tax Internet access. Nine states currently impose taxes under the grandfather clause: Hawaii, New Hampshire, New Mexico, North Dakota, Ohio, South Dakota, Texas, Washington and Wisconsin.[12] The Congressional Budget Office (CBO) estimates that these states collectively receive $80 to $120 million annually in taxes on Internet access.[13] When states tax Internet access, they receive all of the financial benefit of the tax, but the net social cost of lower rates of Internet access extends beyond the states' borders to affect the entire nation. States that continue to tax Internet access under the grandfather clause are essentially free riders that happened to get "lucky" by imposing a tax on Internet access before 1998. The prohibition on taxes on Internet access should be consistent across all states and not reward states that early on imposed taxes on Internet access. Congress should also clarify the ITFA, if needed, to ensure that mobile broadband and wireless data services cannot be taxed and that any existing taxes on these services be eliminated.[14] In particular, Congress should seek to eliminate any discriminatory taxes on wireless data services.[15]

ELIMINATE PROTECTIONIST LAWS AND REGULATIONS THAT HARM E-COMMERCE

Congress should not allow states to tax out-of-state Internet retailers without first requiring states to dismantle the web of protectionist laws and regulations that unfairly discriminate against out-of-state e-commerce companies in favor of in-state brick-and-mortar companies. To date, taxes and regulations have been addressed separately, but these two issues are intimately linked. Taxes and regulations should be based on what was purchased, not how it was purchased.

In the old economy, people purchased most goods and services through companies or professionals located in their state. With the exception of a small mail-order catalogue industry, most consumers could not buy from out-of-state sellers unless they traveled to their physical location. Today, the rise of e-commerce has enabled Americans to buy a wide array of goods and services from sellers located in different states, without going through a local middleman. Using the Internet to bypass these bricks-and-mortar middlemen can bring dramatic savings to consumers. Selling homes on the Internet can reduce agent commissions by half. Buying a car directly from the manufacturer could lead to a savings of thousands of dollars. Buying contact lenses online can save anywhere from 10 percent to 40 percent of the cost of buying from an optometrist.[16] In short, e-commerce holds the key to boosting productivity growth in a host of industries and reducing costs for consumers. Moreover, e-commerce is important not just because it saves consumers money, but also because it gives them more choices. Consumers are no longer dependent upon local businesses to stock the products or provide the services they want, and can instead use the Internet to find what they need.

In the old economy buyers and sellers met face-to-face in the same location and so states were the logical nexus to apply industry-specific consumer protection laws and regulations. However, many of these laws and regulations that previously may not have been barriers when most commerce was intra-state, now unintentionally hinder e-commerce. In other cases, the protectionist laws are no accident: politically well-connected middlemen have been able to pressure state legislators and governors to provide them protections in the face of new competition. In all cases, the simple fact that national e-commerce businesses are subject to 50 different state laws can raise their business costs significantly. Some illustrative cases include the following:

- Car dealers have succeeded in getting laws passed in all 50 states making it illegal for automobile manufacturers to sell vehicles directly to the consumer, including over the Internet.
- Realtors have tried to shut out Internet-based brokers to protect their 6 percent sales commissions.[17]
- Optometrists have worked with contact lens manufacturers to prevent online lens sellers from getting products.[18]
- Wine wholesalers have opposed direct online sales from wineries and out-of-state retailers.[19]

The middlemen argue that they are protecting the public interest. Car dealers only wanted to protect the consumer from unscrupulous manufacturers. Optometrists say they are only trying to protect consumers from eye damage. Beer and wine wholesalers are only trying to protect youth from purchasing alcohol.[20] However, the reality is that states can design regulatory regimes that protect consumers without squashing competition. For example, states can allow direct purchases over the Internet while requiring that wine or beer shipments use a carrier that requires proof of legal drinking age upon delivery. In most cases, the claims of consumer risk are just a smokescreen for protectionism. The fact that consumer groups have opposed many of these protectionist practices, including the auto dealer franchise and contact lens restrictions, suggests that these laws and regulations are not designed to protect consumers, but rather to protect producers and limit competition. The growth of state laws and regulations that protect incumbent bricks-and-mortar companies from e-commerce competitors is a serious obstacle to the growth of e-commerce.

States want to have their cake and eat it too. On the one hand, they want to level the tax playing field between Main Street merchants and Internet businesses by asking Congress to grant permission to require remote sellers to collect sales taxes. At the same time, invoking states' rights and federalism, they vociferously resist any attempts by the federal government to preempt state laws and regulations that protect politically powerful incumbent state businesses at the expense of out-of-state e-commerce competitors. We believe that the time is ripe for a grand Internet bargain: Congress should grant states the right to require remote sellers to collect and remit sales taxes, but only if states eliminate all discriminatory rules and laws designed to protect in-state bricks-and-mortar companies from e-commerce competitors. If states want the right to level the tax playing field, they should have the responsibility of leveling the regulatory playing field as well. The fairness principle should be applied not just to taxation but also to other regulatory barriers.

Before giving the states the right to require remote sellers without nexus to collect and remit sales taxes, Congress should insist on a quid pro quo that states also eliminate or revise laws and regulations that unfairly discriminate against e-commerce companies. This will first require identifying the range of laws and regulations that are discriminatory and protectionist. We propose that any federal sales tax legislation also create an Internet tax commission, which will have three main roles: 1) identifying protectionist legislation and regulations that states need to eliminate or reform; 2) certifying that states have eliminated these barriers; and 3) certifying that states have created a streamlined sales and use tax system. Once states that collectively account for 20 percent of the U.S. population in states with sales taxes have eliminated these barriers and developed a streamlined tax system, they would gain the ability to require remote sellers to collect sales taxes. Any additional states could join if both requirements have been fulfilled. To ensure that states do not reinstate protectionist laws once they gained the right to tax e-commerce sales, the legislation should charge the FTC with certifying on a biennial basis that states are complying with the requirements. Failure to comply would result in states losing their authority to require out-of-state retailers to collect sales tax.

Some might argue that such an approach violates states' rights. But the legislation would not require states to change their laws. If a state chooses to keep protectionist laws, it may be able to get around constitutional issues and do so, but it would not be allowed to force out-of-state sellers to collect sales tax. States should not be allowed to have it both ways.

Congress has the opportunity to create a progressive solution to the problem of Internet taxation that will not only allow states to collect sales taxes on remote sales -- thereby leveling the playing field with remote sellers -- but will also dramatically slash the barriers to e-commerce at the same time. If states are going to get the ability to tax remote sales, the least they can do is eliminate their extensive barriers to interstate e-commerce.

CONCLUSION

Not taxing e-commerce sales unfairly discriminates against traditional, face-to-face transactions; however, the purpose of collecting taxes on e-commerce should not be to try to save local jobs. The goal of public policy should not be to protect or insulate any business or industry from changes in the marketplace. Public policy should certainly focus on ensuring that individuals who lose their jobs have access to skills training and other assistance to transition into new jobs, but it should not try to erect barriers to protect existing businesses that may lose out to digital competition. If consumers choose Internet sellers over Main Street sellers and some of the latter go out of business, this is simply a result of healthy competition in the marketplace, leading to increased economic efficiency and value added for consumers. For example, just as large category killer retail chains (in sectors such as books, hardware, and electronics) have caused many small, independent companies to go out of business, they have also led to a significant boost in retail productivity and lower prices for American consumers. The same will be true on the Internet, where an increasingly digital economy will disrupt existing patterns of business. The bottom line is that e-commerce, even if it is subject to sales tax, will lead to lower prices and higher value, and hence effectively higher real incomes for Americans.

In the end, however, clearly state and local governments should be able to tax sales transacted over the Internet, if for no other reason than as a matter of fairness. Why should sales conducted over the Internet be exempt from taxes levied at the corner store? That would be the functional equivalent of subsidizing e-commerce companies at the expense of traditional brick-and-mortar companies. Public policy should do everything possible to grow the Internet and the digital economy, but the steps it takes must be fair.

ENDNOTES

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