

BACKGROUND

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Taxing Online Sales: Should the Taxman's Grasp Exceed His Reach?

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Abstract

The proposed Marketplace Fairness Act of 2013 would allow state governments to force retailers located in other states to collect their sales taxes. The act is meant to equalize the tax burdens between so-called brick-and-mortar retailers and their online counterparts, but, rather than equalize, the proposal would create new disparities and impose new burdens, to the detriment of small online businesses and American consumers. Approved by the Senate in May, the legislation has received a more skeptical reaction in the House of Representatives. For good reason: Increasing the reach of state tax authorities is simply a bad idea. Congress should hit the "delete" button on such ill-advised notions.

As a general rule, whenever Congress starts talking about "fairness," Americans should hold on tight to their wallets. The Marketplace Fairness Act (S. 743, H.R. 684) is no exception. The bill, which would allow a state to force retailers located in other states to collect its sales taxes, is meant to equalize the tax burdens between so-called brick-and-mortar retailers and their online counterparts. But, rather than equalize, the proposal would create new disparities and impose new burdens, to the detriment of small online businesses and American consumers. Approved by the Senate in May, the legislation has received a more skeptical reaction in the House of Representatives. That is for good reason: Increasing the reach of state tax authorities is simply a bad idea. Congress should click the "delete" button on such ill-advised notions.

KEY POINTS

- Legislation now pending in Congress—the misnamed Marketplace Fairness Act (MFA)—would allow state tax authorities to reach across state lines to require online retailers to collect sales taxes for them.
- The proposal would supercede a long-standing Supreme Court decision that such authority would improperly burden interstate commerce.
- Current law provides no exemption for sales conducted via the Internet; sales taxes for a large portion of Internet commerce are already routinely collected.
- Subjecting retailers to mandates from 46 or more jurisdictions would impose significant burdens on smaller firms.
- The MFA would violate principles of federalism, imposing "regulation without representation," because retailers would be subject to burdens imposed by states in which they have no presence or political voice.

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Background. Since the 1930s, sales taxes have been a significant source of revenue for states and localities. Currently, 45 states impose statewide sales taxes.¹ In addition, roughly 10,000 cities, counties, and special districts impose their own local sales taxes, each with their own rates, rules, and definitions. The total cost to taxpayers: \$242.7 billion in fiscal year (FY) 2012,² just over 30 percent of all state and local revenue.

Although sales taxes are assessed on consumers, the duty of collecting them generally falls to retailers, who are required by law to remit the revenue to state and local tax authorities. This system is relatively straightforward for transactions where the buyer and seller are in the same state. But requiring an out-of-state seller to collect taxes for another state is another matter. Courts have long limited the power of state taxing authorities to force sellers in other jurisdictions to do this job.

These limits were defined by the Supreme Court in its 1992 decision in *Quill v. North Dakota*.³ In this case, the state of North Dakota argued that the Quill Corporation, a mail-order firm based in Illinois, was required to collect sales taxes from North Dakotans who bought items through Quill's catalog. Quill had no stores, warehouses, or staff in North Dakota, but the state argued that the retailer had to collect North Dakotan sales taxes anyway.

The Supreme Court soundly rejected North Dakota's claims, ruling that unless the firm had a physical presence, or nexus, within the state, North Dakota could not require Quill to collect its taxes. Such extra-territorial reach, the Court concluded, would place an undue burden on interstate commerce. As expressed by the Court in an earlier case on the same issue:

The many variations in rates of tax, in allowable exemptions, and in administrative and

record-keeping requirements could entangle the [out-of-state retailer's] interstate business in a virtual welter of complicated obligations to local jurisdictions.... The very purpose of the Commerce Clause was to ensure a national economy free from such unjustifiable local entanglements. Under the Constitution, this is a domain where Congress alone has the power of regulation and control.⁴

Nothing in the *Quill* decision or earlier precedents singled out online transactions for special treatment. In fact, e-commerce barely even existed in 1992. Since then, however, e-commerce has grown remarkably, totaling \$186 billion for the U.S. in 2012. Still, this was only about 10 percent of all retail commerce.⁵

As online commerce grew, state tax authorities increasingly bristled under the limits imposed by *Quill*. Brick-and-mortar retail businesses also complained about the perceived advantage granted to their online competitors.

Marketplace Fairness Act. For over a decade, critics of the *Quill* decision have pushed Congress to overturn it, without success.⁶ This year, however, buoyed by the decision of leading Internet-based retailer Amazon.com to drop its long-standing support of *Quill*, many see a chance to finally change the law. In May, the Senate passed legislation to that effect, dubbed the Marketplace Fairness Act (MFA). It has not yet been taken up by the more tax-averse House of Representatives.

The legislation would authorize states to "require all sellers...to collect and remit sales and use taxes with respect to remote sales sourced to that State." This expanded authority would apply to all retailers with one million dollars or more in remote online sales, could only be exercised if the state has signed an interstate compact known as the Streamlined

1. A 46th state, Alaska, has locally imposed sales taxes, but no statewide levy. Delaware, Montana, New Hampshire, and Oregon have no sales taxes.

2. Sheila O'Sullivan, Lynly Lumibao, Russell Pustejovsky, Tiffany Hill, and Jesse Willhide, "State Government Tax Collections Summary Report: 2012," Governments Division Briefs, April 11, 2013, <http://www2.census.gov/govs/statetax/2012stcreport.pdf> (accessed June 13, 2013).

3. 504 U.S. 29 (1992).

4. *National Bellas Hess v. Illinois*, 386 U.S. 753 (1967).

5. Thad Reuter, "E-Retail Jumps 15% in 2012," Internet Retailer, February 7, 2013, <http://www.internetretailer.com/2013/02/07/e-retail-spending-jumps-15-2011> (accessed June 13, 2013). Total excludes food, gas, and automotive purchases.

6. Adam D. Thierer, "The NGA's Misguided Plan to Tax the Internet and Create a New National Sales Tax," Heritage Foundation *Background* No. 1343, February 4, 2000, http://thf_media.s3.amazonaws.com/2000/pdf/bg1343es.pdf.

Sales and Use Tax Agreement, or has taken certain specified steps on its own to streamline its sales tax rules.

Two primary arguments are offered for giving state tax collectors the “long-arm” authority provided by the Marketplace Fairness Act. The first is fiscal: State and local officials argue that the current limits deprive them of needed revenue. The second is based on competitive equality. The current system, many retailers argue, gives online retailers an artificial advantage compared to non-Internet based competitors. Neither argument stands up to scrutiny.

The idea that Internet sales are free from taxation is a myth. A significant portion of online purchases are already being taxed.

Myth of the Tax-Free Internet. Underlying both arguments is a widespread belief that the Internet is a tax-free zone. But the idea that Internet sales are free from taxation is a myth. A significant portion of online purchases are already being taxed. In fact, according to one recent survey, half of all consumers said they paid sales taxes on their most recent online purchase.⁷ This is not only because retailers collect taxes from customers in their home state, but also because many have a presence in multiple states, requiring them to collect taxes in each. Using 2008 data, one study found that 17 of the 20 largest online sellers—ranging from Office Depot to Apple—had retail stores or other facilities

nationwide, and collected taxes in all or almost all 46 states that impose sales taxes.⁸

Even Amazon.com collects taxes for nine states, representing close to 40 percent of all U.S. residents. It is expected to soon be collecting taxes for many more, as it expands its physical distribution network throughout the country.⁹ The Internet retailers who do not collect taxes for out-of-state tax authorities are mostly small and mid-size enterprises, ranging from a few well-known sites, such as Overstock.com, to individuals selling used clothing or collectibles on eBay.

The amount of revenue forgone to state treasuries—and saved by consumers—due to *Quill’s* protections is in dispute. A 2009 University of Tennessee report estimated the total amount of uncollected tax revenue due to Internet sales to be as much as \$11.4 billion in 2012.¹⁰ Adding in “lost” revenue from catalog sales, the National Conference of State Legislatures puts the total at \$23 billion per year.¹¹

These figures may seriously overstate the forgone revenue, however. A 2010 study by economists Jeff Eisenach and Robert Litan puts the figure for online sales at only \$4.8 billion in 2012, about 2 percent of total sales tax revenue.¹² This lower total is supported by recent smaller-than-expected revenues in California and New York, both of which had recently amended their sales tax rules to cover more online sellers. The additional revenue raised was a fraction of what had been expected.¹³

Whatever the amount, state governments are already making plans for new revenue should the MFA become law.¹⁴ While some states, such as Missouri and Wisconsin, are considering tax cuts elsewhere to offset the new tax revenue, most states are likely to use it to fund new spending or to avoid

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7. Paul Demery, “Half of Online Shoppers Pay Sales Tax Already,” *Internet Retailer*, May 14, 2013, <http://www.internetretailer.com/2013/05/14/half-online-shoppers-pay-sale-taxes-already> (accessed June 13, 2013).
 8. Jeffrey A. Eisenach and Robert E. Litan, “Uncollected Sales Taxes on Electronic Commerce: A Reality Check,” Empiris, LLC, February 2010.
 9. Amazon.com, “About Sales Tax on Items Sold by Amazon.com,” <http://www.amazon.com/gp/help/customer/display.html?nodeId=468512> (accessed June 13, 2013).
 10. Donald Bruce, William F. Fox, and LeAnn Luna, “State and Local Sales Tax Revenue Losses from Electronic Commerce,” University of Tennessee, April 13, 2009, <http://cber.bus.utk.edu/ecomm/ecom0409.pdf> (accessed June 13, 2013).
 11. Jon Kuhl, “States Have a \$23 Billion Sales Tax Loophole and Congress Is Considering a Bill to Close It,” National Conference of State Legislatures, March 2012, <http://www.ncsl.org/issues-research/budget/tapping-into-online.aspx> (accessed June 13, 2013).
 12. Eisenach and Litan, “Uncollected Sales Taxes on Electronic Commerce.”
 13. Korey Clark, “SNJC Spotlight: Online Sales Tax Push Continues Despite Disappointing Returns,” *State Net Capitol Journal*, Vol. XXI, No. 7 (March 11, 2013), http://www.statenet.com/capitol_journal/03-11-2013/html (accessed June 13, 2013).
 14. Amy Schatz, “States Bank on Online Sales Tax,” *The Wall Street Journal*, May 20, 2013.
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budget cuts. But that hardly makes the revenue necessary. As a fiscal matter, the need for new revenue from Internet taxation should be evaluated with the same skepticism as any other tax increase.

Supporters of the legislation, of course, maintain that this is not a tax increase, pointing out that the tax is already due under current law. In fact, in most states, individual consumers are required to pay “use taxes” directly to the state if a retailer does not collect sales tax at the time of purchase. These obligations are notoriously hard to enforce, and in practice use taxes are rarely remitted. The MFA would bring in this revenue. Should the MFA be enacted, taxpayers will pay more taxes. That is a tax increase regardless of how it is labeled.

Creating New Disparities. The second argument put forward by supporters of the Marketplace Fairness Act is competitive equality: the need for a “level playing field” among retailers. Under the current rules, a brick-and-mortar retailer and an online retailer selling the very same item are treated differently. The first must add taxes to the sales price, while the latter does not. Critics of *Quill* claim that this situation unfairly distorts the market.

Certainly, tax policy should treat like businesses alike. Policymakers should not be picking winners and losers in the marketplace. Selected firms should not receive preferential treatment because the government favors their business model or the technology they employ. But current sales tax policy provides no such exemption for online vendors—it simply prevents state tax collectors from expanding their reach beyond their borders. And, the Marketplace Fairness Act, rather than equalize treatment of retailers, would introduce a new disparity as remote sellers struggle to deal with the tax laws of some 10,000 jurisdictions and 46 state tax authorities.¹⁵

This would be no light burden. While the legislation does require states to provide retailers with free

software for managing tax compliance, that software need only cover the individual state. Retailers are left on their own to get nationwide software, unless they want to integrate 46 individual software packages. No compensation is offered for recurring costs incurred by retailers, such as accounting services or online tax management services.

In addition, internal staff time would be needed for an array of tasks, including handling claims by tax-exempt customers, fielding inquiries from tax authorities, and addressing the inevitable glitches.

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Even the simple act of classifying the item being sold can be problematic, with thousands of idiosyncratic distinctions and definitions through each state’s tax code. In Wisconsin, the Wisconsin flag as well as the U.S. flag is not subject to tax. All other flags are taxable. Unless they are bundled with flagpoles, in which case the rules change yet again.¹⁶

Similarly, candy is defined—under the “streamlined” sales tax agreement, as “a preparation of sugar, honey, or other natural or artificial sweeteners in combination with chocolate, fruits, nuts or other ingredients in the form of bars, drops, or pieces.” But sellers beware: “‘Candy’ shall not include any preparation containing flour and shall require no refrigeration.” Thus defined, states still vary on whether the concoction is taxable or not.¹⁷

The problems do not end with the sale. Each of the 46 state tax authorities with which retailers

15. There are several conflicting estimates of the number of tax jurisdictions in the United States, ranging from 7,600 (CCH) to 14,500 (Avalara). The most often cited number, 9,646, comes from a July 2011 estimate by Vertex, Inc. It is a constantly moving target, however. Vertex estimates that in 2012, 167 new sales tax districts were created, and that 259 jurisdictions made changes in their sales tax rates. For a discussion of the varying estimates, see Glenn Kessler, “McConnell’s Claim that There Are ‘Nearly 10,000’ Tax Codes Nationwide,” *The Washington Post*, April 29, 2013, http://www.washingtonpost.com/blogs/fact-checker/post/mconnells-claim-that-there-are-nearly-10000-tax-codes-nationwide/2013/04/26/a6b3bef4-aeaa-11e2-a986-ee837b1888b_blog.html (accessed June 13, 2013).

16. Letter from eMainStreet Alliance to the Hons. Bob Goodlatte (R-VA) and John Conyers Jr. (D-MI), May 29, 2013, <http://s3.amazonaws.com/atrfiles/files/files/eMainStreetAllianceLetterOpposingMFA.pdf> (accessed June 13, 2013).

17. Stephen Maguire, “State Taxation of Internet Transactions,” Congressional Research Service, May 7, 2013.

would have to deal directly require tax returns to be completed, on an annual, quarterly, or even weekly basis. To ensure that it is all done correctly, sellers would be subject to audits from each of 46 states. (If tax authorities on Indian reservations are included—as they are in the MFA as passed by the Senate—the number of tax forms and potential audits jumps to the hundreds.)

These burdens could be quite substantial, especially for smaller online retailers. The legislation attempts to address this concern by establishing a \$1 million threshold. But even at that size, sellers are unlikely to have dedicated accounting staffs to devote to tax administration. That means staff would have to be pulled from other tasks to handle tax issues, or the work would be contracted out at a cost in the thousands of dollars.

Justin Krauss, owner of a firm called Garage Flooring, which has about \$1 million in annual revenue, says that initial startup costs of putting systems in place for multistate tax collection would run about \$40,000. Continuing costs—largely for an outside tax software provider—would run another \$4,000 per year.¹⁸ That does not count internal staff time.¹⁹

The initial cost would be particularly high for retailers in states without a sales tax of their own. These sellers would have to set up a collection and remittance system from scratch, a task that their own state policymakers had decided they should not have to bear.

That is real money to a small business, even those that exceed the \$1 million revenue threshold in the MFA. Profit margins in retail businesses are quite low, 3.4 percent according to one recent report.²⁰ That translates into only \$34,000 for a firm with \$1 million in revenue. That leaves little room to absorb additional expenses. The costs of tax collection are “coming out of somebody’s paycheck,” said Krauss of Garage Flooring. “That’s a Christmas bonus that’s not being received.”

Non-Internet mail-order firms, which would also be subject to the legislation, would find their burden even heavier. For catalog sales, there is no software fix—the consumer must fill out a form; providing the necessary information on 10,000 possible tax jurisdictions may require more print space than the catalog itself.

Regulation Without Representation. Of course, if states wish to impose such costs on their retailers, that is their prerogative. In the American federal system, states can regulate the activity of firms within their borders. But the Marketplace Fairness Act would allow states to regulate the businesses of *other* states. Retailers would be subject to edicts and mandates from states with which they have no connection. And because they have no connection, state politicians would have little reason to worry about the effect of their taxes on the retailers. Economically, the costs—from job losses to reduced investment—that result from the burdens imposed on retailers would be borne by the home state, not the taxing state. Politically, there would be little reason for out-of-state politicians to care—as the owners and employees would not vote in the taxing state’s elections.

Such “regulation without representation” is antithetical to the principles of federalism in the Constitution, and the ideals of representative democracy in general. Some MFA supporters have dismissed such objections as old-fashioned. According to one MFA advocate, “the law today is a 20th-century interpretation of an 18th-century document.”²¹ But the 18th-century principles at stake here are far from outdated: The accountability that they ensure is as important—or more important—today as it was 225 years ago.

Conclusion. The Marketplace Fairness Act offers a deceptively simple solution to a complex problem. While promising to level the retail tax playing field, it likely will create more uneven burdens, while bulldozing fundamental principles of

18. Jose Pagliery, “Online Retailers Call Internet Sales Tax a ‘Nightmare,’” *CNNMoney*, May 8, 2013, <http://money.cnn.com/2013/05/07/smallbusiness/internet-sales-tax/index.html> (accessed June 13, 2013).

19. These costs are consistent with those experienced by The Heritage Foundation itself, which collects sales taxes for items sold on its website.

20. Figure is for privately held companies. Sagemworks, “Private Companies See Double-Digit Sales Growth,” *The Private Company Report*, April 30, 2013, https://www.sagemworks.com/pdf/_04292013.pdf (accessed June 13, 2013).

21. Ann Zimmerman, Greg Bensinger, and John D. McKinnon, “Shopping Tax-Free on the Web Nears End,” *The Wall Street Journal*, April 25, 2013, http://online.wsj.com/article/SB10001424127887324743704578445220306876996.html?mod=WSJ_hps_LEFTTopStories (accessed June 13, 2013).

federalism. Congress should decline to go down this dangerous path.

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