

Chicago Fed Letter

The debate on Internet sales taxation

The advent and expansion of the Internet have brought the issue of the application of state and local sales taxation to Internet, telephone, catalog, and other “remote sales” to the forefront of the policy debate. Under current law, states cannot require corporations without a substantial presence within their borders to collect and remit sales taxes. While all states do require residents to remit the taxes owed in the form of use tax payments, few people send in use tax forms, rendering remote sales essentially tax-free. The revenue loss due to the lack of taxation on Internet sales has been minimal thus far; however, states are concerned that the growth of the Internet will lead to a substantial drain on revenue. In this *Fed Letter*, I describe the debate on the tax treatment of Internet commerce and potential solutions the states might pursue.

In 1998, general sales taxes were one of the two largest sources of state revenue, the other being the income tax. In total, states received \$156 billion in general sales tax revenues, representing just below one-third of state tax revenues. Revenue structures vary dramatically from state to state (see figure 1). While the average state sales tax rate in January 2000 was 4.6%, sales tax rates range from 0% (in Alaska, Delaware, Montana, New Hampshire, and Oregon) to 7.0% (in Mississippi and Rhode Island). In numerous states, localities charge additional rates.¹ In addition, states have different tax bases or items that are subject to taxation. Tax bases tend to vary along two dimensions. First, many states treat food and drugs differently from other goods by taxing them at a different

rate or by totally exempting them from taxation. Second, all states exempt some business to business transactions because the sales tax is intended as a tax on consumption.

During the past 25 years, state sales tax bases have been rapidly declining.² However, legislated increases in sales tax rates have largely compensated for the declining base. The combination of these two forces has left the average revenue contribution from sales taxes essentially unchanged at 31% of total state tax revenues for the past three decades (Census Bureau data from *Survey of State Government Finances*). The decline in the tax base has been attributed to three factors: the growth in legislated exemptions for products such as food and drugs; growth in consumption in the largely untaxed service sector; and the increase in remote sales. Purchases in this last group are not truly tax-free but taxes on them are very difficult to collect.

All states with a sales tax have a corresponding use tax. The use tax requires state residents to pay the equivalent sales tax amount on goods purchased from vendors without a state presence directly to the revenue department. These purchases can occur either when a resident is visiting a different state or nation or when a resident makes a purchase by mail, phone, or Internet. Use taxes are notoriously difficult to collect from consumers except on major items that need to be registered in the home state such as cars, boats, and airplanes. Businesses have historically been more likely to pay their obligations motivated by, in part, concern about use tax audits.

Taxation and remote sales

In a series of opinions, the Supreme Court has ruled that states cannot compel firms without a “substantial nexus” within the taxing state to collect and remit use taxes. (The most important cases are *National Bellas*

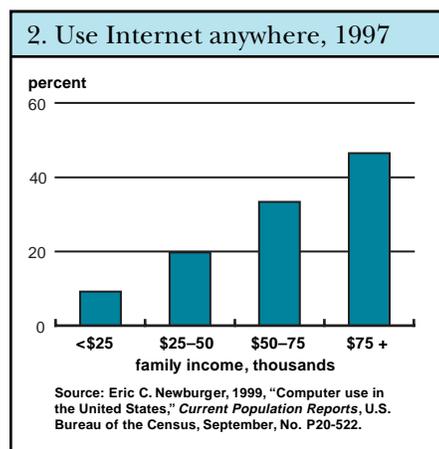
1. Sales taxes in the Seventh District and the nation, %

	State tax rate (1/1/00)	Food and prescription drugs (1/1/00)	Sales tax base, % of income (1996)	Sales tax, % of tax revenues (1998)
Illinois	6.25	1.0	32.2	28.3
Indiana	5.0	0.0	46.4	32.5
Iowa	5.0	0.0	44.3	31.8
Michigan	6.0	0.0	45.5	34.9
Wisconsin	5.0	0.0	47.8	27.3
7th District average	5.5	—	43.2	31.0
50 state average	4.6	—	49.5 (45 states)	31.2
50 state median	5.0	—	47.8 (45 states)	31.6

Sources: Tax rates and food and drug exemptions from the Federation of Tax Administrators, available on the Internet at http://www.taxadmin.org/fta/rate/tax_stru.html, accessed on May 3, 2000. Sales tax base as a percent of personal income from Donald Bruce and William F. Fox, 2000, “E-commerce in the context of declining state sales tax bases,” University of Tennessee, Knoxville, working paper, February. Sales tax receipts from U.S. Bureau of the Census, “State government tax collections data by state,” available on the Internet at <http://www.census.gov/govs/statetax/98tax.txt>, accessed on May 3, 2000.

Hess, Inc. v. Department of Revenue of Ill., 386 U.S. 753, and Quill Corp. v. North Dakota, 504 U.S. 298.) "Substantial nexus" has been interpreted to mean a physical presence, and precludes states from requiring vendors whose only connection to the state is by mail, phone, or Internet to remit taxes. In their 1992 decision in Quill, the court ruled that requiring out-of-state vendors to collect the use tax created an unconstitutional burden on interstate commerce because "[t]he many variations in rates of tax, in allowable exemptions, and in administrative and record-keeping requirements could entangle National's [the plaintiff] in a virtual welter of complication obligations." At the same time, the ruling indicated that such taxation is not unconstitutional per se and would be permissible if authorized by Congress.³ It is important to note that the Supreme Court's decision in Quill only related to the ability of states to compel vendors to collect and remit use taxes; it did not render the use tax itself unconstitutional.

The sales tax is widely viewed as regressive. The exclusions for drugs and food have been justified on the grounds that they reduce regressiveness. However, the exemption for Internet sales makes the sales tax even more regressive because wealthier people are far more likely to have Internet access. Figure 2 plots Internet use by family income among individuals 18 and older in October 1997.⁴ While the regressiveness of the current no-tax



situation is troubling, it is not in itself sufficient reason to begin taxing Internet sales because states can (and do) reduce the regressiveness of their overall tax code through different means, especially through changes in the income tax.

The second issue with the lack of taxation on Internet sales is that it reduces the money available for state provision of necessary government services. Thus far, state losses have been very minimal; Internet sales represented just 0.64% of retail sales in the fourth quarter of 1999.⁵ Estimates of state tax losses due to e-commerce vary from \$170 million in 1998 (according to an Ernst and Young report) to \$1 billion in 1999 (National Conference of State Legislatures). Even the larger of these estimates is very small when taken in the context of the \$475 billion in state tax collections in 1998. However, as the Internet grows, so will state losses. In the most comprehensive analysis of the revenues that will be lost by state governments due to e-commerce, Bruce and Fox (2000) estimate that states will lose approximately \$10.8 billion in 2003 (see figure 3).

Some commentators argue that with balances and revenues currently at high levels, most states do not need the money. While it may be true that states can afford to cut their taxes, this does not imply that allowing the Internet to continue to be a tax haven is the best use of tax reduction dollars. States have a decent record of cutting taxes in the presence of excess funds. State tax cuts in 1999 alone reduced estimated total tax collections for FY 2000 by \$7.2 billion or 1.7% of revenues.⁶

The third major issue with the lack of sales tax is that it distorts numerous economic decisions, including consumers' decisions on where and how to make purchases and business decisions on location and corporate structure.

States' inability to enforce the use tax makes purchases on the Internet less expensive than equivalent purchases on Main Street.⁷ Price-sensitive

3. Losses from not taxing Internet

District state	State revenue loss, 2003	State tax changes, 2003
Illinois	1.58	0.39
Indiana	1.47	0.26
Iowa	1.43	0.27
Michigan	1.55	0.31
Wisconsin	1.22	0.27

Notes: Column one shows the state revenue loss as a percent of total state taxes. Column two shows the increase in sales tax rate needed to maintain constant revenue.
Source: Bruce and Fox (2000).

consumers who do not plan to pay their use tax may choose to purchase an item on the Internet that they would otherwise have bought from a local retailer. In a careful analysis of Internet sales, Austan Goolsbee of the University of Chicago estimates that applying sales tax to the Internet would reduce the number of online shoppers by 24%.⁸

The sales tax issue also gives firms an incentive to locate in low population or low tax jurisdictions so as to minimize the taxes they need to pay on behalf of their customers. While there is no direct research on Internet firm location, some anecdotal evidence points to a location effect. In an article naming Amazon founder Jeff Bezos Person of the Year, *Time* magazine writes of Amazon's warehouse in Coffeyville, Kansas, "[h]alf a dozen warehouses like it have been strategically placed in low- or no-sales-tax states around the U.S."⁹

Firms also have an incentive to structure in order to minimize the number of states in which they have a presence substantial enough to require remittance of taxes. For example, unlike Amazon which has no retail outlets, Barnes and Noble has stores in 49 states. To get around the disadvantage of needing to charge sales tax to nearly every purchaser, Barnes and Noble created barnesandnoble.com as a separate company operated by Barnes and Noble. In other ways, the companies are not distinct entities, many of their officers are the same, and the website provides information on the stores.

The company decided to make it official policy that the stores not accept returns on web purchases so that the web company's assertions of lack of nexus would not be challenged.

Finally, the current situation is unpalatable because it makes the numerous Internet shoppers who do not remit sales taxes unwitting tax cheats.

Those who support the continuation of the Internet as a sales tax haven have tended to rely on both theoretical and practical arguments. The theoretical position holds that an "infant industry" should be given some (financial) room to develop. This view, espoused by Steve Forbes,¹⁰ only holds if the Internet's growth would be substantially hampered if taxes were applied to online sales. This is unlikely.

The practical argument against taxation is the same as that made by the Supreme Court: Internet commerce on taxable items could be dampened if Internet firms were truly required to submit use taxes to the 45 states with use taxes and the thousands of localities in the 27 states where local rates also apply to use taxes. This is especially true because these numerous jurisdictions also have different tax bases and different registration requirements.

Elements of a solution

In the Internet Tax Freedom Act (ITFA) of 1998, Congress created the Advisory Commission on Electronic Commerce (ACEC) to consider the future of Internet taxation. Although the ACEC was unable to generate the two-thirds majority needed to submit an official finding to Congress, the proposals submitted by the commission's three caucuses—business, anti-tax, and government—helped to clarify the debate. Below, I detail the elements of a solution, relying in part on the proposals of the ACEC caucuses.

Simplification

The first step toward collecting tax on Internet sales is to create a simplified mechanism for collecting and remitting sales tax that is sponsored and paid for by the states. Interestingly,

all three ACEC caucuses suggested some form of sales tax simplification. Whether such a streamlined collection requires dramatic sales tax simplification or only sophisticated software provided to vendors or credit card companies is an open question. The main concern is that taxation should be easy to implement and not prohibitively costly to the vendors.

Equity and universality

The same product should be taxed equally when purchased by Internet, mail order, or in a retail store to avoid distorting the decisions of consumers and firms. In addition, the submission of taxes should be mandatory rather than voluntary. (The government caucus proposed experimenting with voluntary agreements with retailers.) Such universality would most likely require congressional action.

Timeliness

A program should be put in place as quickly as possible. The business caucus of the ACEC recommended extending the tax moratorium in the ITFA for an additional five years, a plan endorsed 352-75 by the U.S. House of Representatives. However, the sooner taxes are put into place, the sooner the distortion to firm location and structure decisions will end. These decisions may be difficult to change once they are made. In addition, as consumers grow accustomed to sales-tax-free Internet shopping, taxes will become more difficult to implement.

Clarity

Numerous nexus-related lawsuits have arisen in order to determine whether retailers are required to remit taxes. These lawsuits are costly to governments and businesses. In order to avoid additional lawsuits, any restrictions on sales taxation should be as explicit as possible. The business caucus proposed a permanent exemption from sales tax for "digitized goods and their non-digitized counterparts." This exemption is troubling because the

definition of non-digitized counterparts could be subject to a wide variety of interpretations.

Revenue neutrality

The business caucus plan also recommends that methods be developed to maintain revenue neutrality once remote sales enter into the tax base. This is not an essential feature of a solution to the Internet tax situation. However, a revenue neutral solution would attract a broader base of support.

Conclusion

On May 10, 2000, the U.S. House voted to extend the Internet tax ban for another five years. The Senate has not yet voted upon the measure. As the debate intensifies, three important things could occur. First, the states could work toward developing a more streamlined tax system. A system that made it possible for remote sellers to deal with only one agency or tax code would greatly reduce the burden on remote sellers. Second, the states could cultivate allies within the business community to put additional pressure on Congress. Traditional brick and mortar retailers have yet to add their substantial political muscle to the debate. The fact

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that such a small percentage of retail sales occur on the Internet highlights the fact that corporations that need to remit taxes and are disadvantaged still far outnumber those with only an online presence. With easier filing requirements, the large e-commerce corporations may also begin to support applying the sales tax to remote purchases. As these companies get larger, they will generate nexus in more states and will be at a disadvantage relative to smaller suppliers. They may also wish to avoid the constant threat of nexus-related lawsuits. Third, as states increase efforts to enforce use tax collections, voters may become more uncomfortable with the use tax situation and prefer to deal with firms that directly remit use tax payments. These forces may lead Congress to enact a permanent solution to the remote sales tax issue.

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¹Revenue information from U.S. Bureau of the Census, "State government tax collections data by state," Internet at www.census.gov/govs/statetax/98tax/txt. State and local sales tax rates from Sales Tax Institute, "Sales and use tax rates," at www.salestaxinstitute.com/Sales%20Tax%20Rates.htm.

²See Bruce and Fox, 2000, cited in figure 1, and Robert J. Cline and Thomas S. Neubig, 1999, "The sky is not falling: Why state and local revenues were not significantly impacted by the Internet in 1998," Ernst and Young Economics Consulting.

³In *Quill*, the court reversed its earlier decision that the taxation of remote sales violated the due process clause of the Constitution, as well as the commerce clause. This is important because Congress could not authorize states to collect a tax that violated due process, while it has explicit constitutional authority to regulate interstate commerce.

⁴More recent data from Forrester Research shows that online shoppers have average household incomes over twice that of individuals without PCs and Internet access.

⁵U.S. Department of Commerce, 2000, "Retail e-commerce sales for the fourth quarter reach \$5.3 billion, Census Bureau reports," March 2, Internet at <http://www.census.gov/mrts/www/current.html>.

⁶National Conference of State Legislatures, 2000, "State tax actions 1999," February, Internet at www.ncsl.org/programs/fiscal/sta99sum.htm.

⁷Internet shoppers are usually required to pay shipping and handling charges, which often cancel out the benefit of not paying the sales tax. Main Street consumers also pay shipping and handling costs, factored into the retail price.

⁸Austan Goolsbee, 2000, "In a world without borders: The impact of taxes on Internet commerce," *Quarterly Journal of Economics*, forthcoming.

⁹*Time*, 1999, "Amazing Person.com," December 27, Internet at www.time.com/time/poy/index.html.

¹⁰CNET News.com, 1998, "Forbes: No Net taxes for 5 years," Internet at <http://news.cnet.com/news/0-1005-200-328821.html?tag=st>.

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