Research

Taxing Online Sales: Key Features of Reforming The Collection of Online Sales Taxes

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SALES TAXES AND THE INTERNET ECONOMY

As access to the Internet has increased, so has Internet-based commerce. Retailers, both large and small, greatly expand their potential customer base and offer the opportunity for their customers to effectively peruse their shelves from the comfort of home. Indeed online sales have become an increasingly significant share of overall retail sales going from 5.71 percent of the total $3.613 trillion of retail sales in 2003 to 8.86 percent of the total sales figure of $5.068 in 2013.[1]

As this feature of the modern retail economy has expanded, the challenge of collecting taxes due on online interstate commercial activity has strained state revenue services. At present, online retailers are not required to collect sales taxes on out-of-state sales. This does not eliminate the tax liability on a given transaction, but rather poses a major challenge to the collection of tax owed under state and local law. As internet commerce has expanded, the revenue lost to state and local budgets through uncollected interstate retail sales (including catalogue sales) amounted to $23.3 billion in 2012. This is a significant sum. By comparison, across states, between FY 2008-2013, states closed a cumulative $527.7 billion budget gap, primarily through program reductions.[2] Flagging revenue collections might also lead to other tax increases that could prove more damaging to state economies.

CURRENT LAW

The current status of online sales and use taxes can be traced to a 1992 Supreme Court decision, *Quill Corp. v. North Carolina (Quill)*, which held that out-of-state retailers do not have to collect sales taxes for states in which they do not have “nexus” (usually defined as a physical presence within a state). Under *Quill*, Congress would have to pass legislation that allows states to require retailers without a physical presence in a given state to collect sales taxes from consumers in that state. The federal legislation suggested by the court would not impose a new tax but would address the collection issue raised in *Quill*.

Some retailers already voluntarily collect sales taxes from out-of-state customers. Consumers are supposed to pay use taxes for purchases from out-of-state vendors that do not voluntarily collect sales taxes, but largely do not, which is the source of the lost revenue.

KEY DESIGN ISSUES IN ONLINE SALES TAX REFORM: DESTINATION VS. ORIGIN SOURCING

Destination sourcing

On May 6, 2013, the U.S. Senate passed the Marketplace Fairness Act (MFA), S. 743, by a vote of 69-27.[3] The MFA authorizes states that pursue certain reforms and simplification measures to require out of state retailers to collect and remit the due sales tax. The MFA requires that states provide the necessary software to calculate the due tax for the appropriate jurisdiction. It also exempts retailers with less than $1 million in out-of-state sales.

Underpinning the MFA is the concept of destination sourcing, which places the tax burden on the consumer – the "destination" of the sale. For example, a business based in Kentucky selling a good to someone in Texas collect and remit the Texas sales tax. This is conceptually the most appropriate approach to a consumption-based tax, as it identifies the tax burden on the consumer and subjects that activity to the state tax laws in which that consumer lives. This also avoids "taxation without representation" and more directly engages a taxpayer with the budgetary environment and policies of their home state.

The downside is that under a destination-sourced regime, each subject business would necessarily have to comply with sales tax requirements in each state and jurisdiction in which it has customers. This has a burden associated with the scale and complexity of the various state taxes. Still, this should not be overstated, as efforts at simplification, and developments in software could obviate much in the way of the administrative burden.

Origin sourcing

An alternative approach is to identify the tax burden with the physical location of the business making the sale. For example, a business based in Kentucky selling a good to someone in Texas collect and remit the Kentucky sales tax. This is a simpler approach insofar as it would require each business to comply with only one sales tax regime—those in its state and local jurisdiction. Origin sourcing is already used by Texas and Virginia to determine sales taxes for cross-county transactions.

However, there are significant downsides to an origin approach as well. An origin-sourced tax regime could have dramatic impacts on the structure of state budgets. First, it might induce a "race to the bottom" by incentivizing retailers to avoid sales taxes by moving their operations from high-tax states to those without sales taxes. According to some tax experts this could be accomplished relatively simply and purely as a function of tax avoidance.[4] There is also serious risk associated with how to define and enforce "origin" in a federal law that presents further opportunities to game the system. Moreover, states would not receive the full revenue of their sales taxes, leaving holes in their state budgets – either because only low-tax states' amounts were collected or because pressures forced the state to reduce or eliminate its sales tax. Either way, states would shift to a reliance on higher state and local income and property taxes.

Finally, there are broader conceptual challenges to an origin-sourced system as well. States would be able to tax residents of other states, meaning that those subject to a tax cannot elect the leaders who set the tax (*i.e.*, "taxation without representation"). Those same elected leaders set the sales tax based both on the tax rate and the tax base, or taxability of particular items (e.g. clothing, food, and pharmaceuticals). Taxability designations vary between jurisdictions, just as rates vary, based on policy priorities set by the state and local governments. An origin-sourced system would impose both new rates and new taxability burdens on consumers who would not have recourse through the electoral process.

A similar approach to a purely origin based tax would require the collection of taxes by seller, and according to the sales tax laws governing the location of the seller, which would then be remitted to the location of the buyer. This approach, known as hybrid origin-sourcing, seeks to address some of the flaws in origin sourcing, and to address some of the challenges of a destination sourced tax regime, largely the administration burden of a seller complying with multiple tax jurisdictions. In any new tax collection regime, particularly relative to one in which owed taxes are simply not collected, there will be some additional burden. It is therefore essential that they be mitigated, but mitigated consistent with optimal policy design. A hybrid-origin system suffers from the same deficiencies as an origin-sourced approach insofar as such an approach would retain the presumption that incidence of the tax is the seller, rather than the purchaser. This retains the incentive to administratively locate the nexus of the sale in a low or no-tax state and divorces the consumer from the polity imposing the taxes, resulting in taxation without representation.

[1] http://www.census.gov/retail/