

THE COLLECTION OF OUT-OF-STATE SALES TAXES: MYTH VS. REALITY

THE ISSUE: A group of the nation’s governors, state legislators and state tax administrators are asking the United States Congress to require catalog companies, online retailers and live television shopping networks to collect sales taxes from their customers, even if they live in states where the retailers have no operations. While all retailers must collect taxes on sales in a state where they have a physical presence, the Supreme Court has held that it would be a burden on interstate commerce to force retailers to collect and remit taxes for sales in states where they are not located.

Nevertheless, legislation has been proposed in each of the past seven Congresses that would reverse decades of history and legal precedent preventing out-of-state sales tax collection, and another bill is being circulated for cosponsors by Senator Mike Enzi (R-WY). It would impose on all states and all retailers the provisions of the now voluntary Streamlined Sales Tax Agreement (SSTA). SSTA proponents have touted this measure as a simplified, streamlined method for collecting sales tax. Unfortunately, the reality is far different – the SSTA promises to increase significantly the complexity and compliance burdens for interstate sellers.

Before Congress acts, let’s compare the **MYTHS vs. REALITY** of the Streamlined Sales Tax Agreement:

MYTH #1: Internet sales are tax-free.

REALITY: Internet sales are subject to tax, just as storefront, catalog and telephone order sales are subject to tax.

Internet sales already are subject to sales tax, just like catalog and telephone order sales. All retailers, whether online or on Main Street, are required to collect sales tax on goods delivered in any state where the retailer has a physical presence or “nexus.” That is why you pay sales tax on catalog or online orders from a company that owns and operates stores in your home state.

Consumers are obligated to pay a “use tax” on purchases even if the seller is not required to collect the sales tax.¹ States have complained for decades that few consumers pay use taxes on purchases from out-of-state sellers, even though nearly all business purchasers do pay use taxes for catalog, telephone or Internet purchases out-of-state. Nevertheless, most states have done little to educate consumers about their use tax obligation or to provide them with an easy mechanism for compliance. This suggests there may not be enough revenue involved for the states to invest time and resources in its recovery.

¹ A use tax is a type of excise tax assessed upon tangible personal property purchased by a resident of the assessing state, regardless of where the purchase took place. The use tax typically is assessed at the same rate as the sales tax that would have been owed (if any) had the same goods been purchased in the state of residence.

MYTH #2: The Supreme Court has said Congress can approve tax collection by out-of-state companies.

REALITY: However, the Supreme Court said *National Bellas Hess* still is good law and collection requirements may impose a burden on interstate commerce.

Two Supreme Court cases have shaped the law on sales tax collection. In 1967, the Court in *National Bellas Hess*² determined that the interstate commerce clause of the Constitution bars a state from compelling an out-of-state retailer from collecting taxes on sales to its residents. A quarter century later, the Court in *Quill*³ said *National Bellas Hess* remains good law – and the state of North Dakota cannot compel *Quill* to collect taxes from North Dakota purchasers.

The Court in *Quill* concluded that collection is a burden on interstate commerce and continued to endorse the importance of a bright-line rule for out-of-state retailers. The decision was guided by the principles that taxes must be fair and nondiscriminatory, that there must be substantial nexus with the jurisdiction and a relationship between the tax and any state-provided services.⁴

However, the Supreme Court went on to say that Congress is free to disagree with the Court's conclusions regarding the burden on interstate commerce, and even cited instances in which the Congress previously has considered the impact on interstate commerce when it rejected legislation that would have given the states authority over remote sellers.⁵

The states again have elected to mount a campaign, in coordination with Main Street retailers, to persuade Congress that requiring remote sellers to collect taxes is not a burden on interstate commerce. Before they can do this they first must demonstrate to Congress that they are capable of and committed to simplifying compliance, reducing multiple rates and reaching common agreement on the definition of taxable items – real simplification and a real reduction of the burden on interstate commerce. Thus far, the states have only been able to characterize this as a goal – a goal they are far from reaching under the current Streamlined Sales and Use Tax agreement.

MYTH #3: Uncollected sales taxes from online sales create fiscal hardships for state budgets.

REALITY: States are enjoying some of the largest revenue increases in recent history and are discussing ways to “cut” state taxes.

According to the U.S. Bureau of the Census, the states received \$155.4 billion in tax revenues in the second quarter of 2005, an increase of 10 percent over

² *National Bellas Hess, Inc. v. Illinois Department of Revenue*, 386 U.S. 753 (1967).

³ *Quill Corporation v. Heitkamp*, 504 U.S. 298 (1992).

⁴ *Id* at 311.

⁵ *Id* at 317-18.

the same period last year.⁶ *USA Today* recently reported, “Soaring state tax collections have created momentum for tax cuts in 2006, when most governors and legislators will face voters. State and local revenue rose 7.2 percent in the first nine months of this year, the biggest jump since 1990, according to the U.S. Bureau of Economic Analysis. Nearly every state is considering tax cuts. Smaller cuts aimed at property taxes, business taxes and sales taxes on food are under consideration.”⁷

During the late 1990s, states asked for more taxing authority, specifically to export their sales taxes across state boundaries by requiring out of state sellers, with no connection to a particular state, to collect sales tax on goods mailed to the state. The states’ appeals grew even louder as the national economy entered a recession, and increased state spending began to outpace tax revenues. State tax officials were quick to point to e-commerce as a cause of fiscal problems, and foretold huge future tax losses based on forecasts of geometric growth in e-commerce sales.

Five years later, state tax revenues have more than recovered and some states want to give some tax revenue back to curry voter support.

MYTH #4: E-Commerce cost the states \$15.5 billion in tax revenue in 2003.

REALITY: The amount of uncollected sales tax from online sales has been grossly exaggerated.

Two University of Tennessee professors estimated in a 2001 study supported by state officials that uncollected sales tax revenue would reach \$26.3 billion in 2003, and \$50.4 billion in 2008.⁸ By 2004, the professors had revised their earlier estimates downward and projected \$15.5 billion in uncollected sales taxes in 2003 and \$21.5 billion by 2008.

Data on Internet sales from the Census Bureau of the U.S. Department of Commerce shows that the e-commerce impact on state sales tax revenue is minor, amounting to less than 20 percent of the estimate in the revised 2004 University of Tennessee study. Based on the Census Bureau data, the amount of uncollected sales tax in 2008 is estimated to be just \$3.7 billion,⁹ compared to the University of Tennessee estimate of \$21.5 billion.

The 2004 estimate by Professors Bruce and Fox that “lost” state collections in 2008 would range between \$22 and \$33 billion in sales taxes would be *four times greater than possible*, according to the Census Bureau statistics. Census Bureau surveys of 11,000 retailers estimate that total retail e-

⁶ U.S. Census Bureau, National Totals of State Tax Revenue.

⁷ “Outlook good for tax cuts by states,” *USA Today*, Friday, November 18, 2005.

⁸ “State and Local Sales Tax Revenue Losses from E-Commerce: Updated Estimates,” Donald Bruce, Ph.D. and William F. Fox, Ph.D., Center for Business and Economic Research, The University of Tennessee, September 2001.

⁹ “A Current Calculation of Uncollected Sales Tax Arising from Internet Growth,” Peter A. Johnson, Ph.D., Senior Economist, The Direct Marketing Association, March 2003.

commerce will reach \$70 billion in 2005 – which could generate, at most, sales tax revenues of \$5 billion.¹⁰

MYTH #5: The Streamlined Sales Tax agreement makes everything simple.

REALITY: The plan proposed by proponents of the SSTA will make commerce more complicated for merchants and consumers.

To start with, mandatory tax collection under the SSTA would cause thousands of merchants throughout the United States to be confronted with the entirely new obligation of collecting tax for over 7,500 local tax jurisdictions (including school districts, transportation districts, sanitation districts, sports arena districts, etc.) This will create an enormous increase in the complexity of doing business for interstate marketers –certainly not a move towards simplification.

To make matters worse, the drafters of the SSTA failed in their original mission to reduce the number of tax jurisdictions. Under the terms of the SSTA, the number of tax rates could actually increase to over 15,000 (each tax jurisdiction is permitted to have two rates).¹¹

Similarly, the SSTA failed to reach its goal of uniform definitions for taxable products. Instead, the SSTA allows each state to create its own “gray area” with respect to every term defined in the Agreement. Individual states only have to use “substantially the same language.” This is an invitation to confusion and litigation.¹²

For consumers, the confusion and complexity may be even more problematic. Shoppers who pay by check for catalog purchases (a common form of payment among the elderly and low income wage earners) must self-compute the applicable state and local sales tax for each jurisdiction to which a mail order purchase is sent. Again, these are major new burdens—not simplification.

¹⁰ U.S. Department of Commerce Press Release of February 24, 2005. "Quarterly Retail E-Commerce Sales 4th Quarter 2004," available at www.census.gov/mrts/www/data/html/04Q4.html. Revenue calculated using average sales tax rate of 6.5%.

¹¹ Streamlined Sales and Use Tax Agreement as Amended and Adopted on November 12, 2002 (“NCSL, 11/12/02 Agreement”), section 308 (member states may impose a single additional rate on food, food ingredients and drugs) available at www.streamlinedsalestax.org.

¹² Streamlined Sales and Use Tax Agreement as Amended and Adopted on November 12, 2002 (“NCSL, 11/12/02 Agreement”), section 327 (member states shall adopt terms in substantially the same language) available at www.streamlinedsalestax.org.

MYTH #6: E-commerce is hurting “Main Street” retailers.

REALITY: E-commerce is the best hope for Main Street retail to compete.

For decades, Main Street retailers have lost sales to suburban shopping malls and big-box stores. And in the early days of the Internet, retailers feared additional competition coming from online sellers.

Ironically, online sales have become the best hope for success of Main Street retailers, since it enables them to reach millions of customers who would never visit their storefronts. The reality is that *the Internet is helping Main Street to compete*.

For example, Blue Moon Galleries has a warehouse and store—located on Main Street—in Waynesboro, Virginia. Blue Moon does a decent walk-in trade, but most of their sales come from a website store and through other online channels such as Amazon and Google. Online sales growth enabled Blue Moon to buy their building and increase employment, right there on Main Street.

On eBay, there are over 700,000 sellers building small businesses based on e-commerce. For example, David Hardin, owner of Shoetime & esavz is a true believer in small business. David used eBay to revolutionize his 23-year-old, family-operated, wholesale shoe business into a successful online shoe listing company.

David admits he knew nothing about eBay until a young man walked into his office and suggested eBay as a possible venue to sell his inventory. As an experiment, David and his family listed 50 pairs of shoes on eBay. These early sales were successful, and quickly developed into his company, "Shoetime," which now boasts over 73,000 positive eBay transactions from more than 57,000 unique individuals.

Recently, David expanded his business again, opening both an eBay drop-off franchise and "eSAVz," a company that specializes in developing and marketing software to help eBay sellers run high-volume consignment, charity and fundraising businesses.

MYTH #7: Streamlined sales tax will level the playing field between traditional retailers and retailers who sell online.

REALITY: The SSTA will tilt the playing field against retailers who sell over the Internet and through catalogs.

In fact, the SSTA would unfairly discriminate against remote sellers. First, the burdens are much greater for remote sellers who must compute, collect and remit tax for thousands of jurisdictions, as compared to an in-state retailer who collects at just one tax rate. Second, a direct marketer must “eat” the difference if a customer fails to remit the correct tax when paying by check – a problem that traditional retailers do not confront. Third, in-state retailers benefit from a wide variety of state and local government services and programs (including tax incentives) that are not available to out-of-state

merchants. Fourth, delivery charges on Internet and catalog purchases usually exceed the amount of sales tax on those same goods – so the remote seller has no price advantage.

MYTH #8: The states have simplified their sales tax laws so Congress now should pass a law to require retailers to collect out-of-state sales taxes.

REALITY: Only a handful of states have adopted the Streamlined Sales Tax Agreement – even if they have agreed to change their sales tax laws very little – the pressure to keep the status quo is very strong in the states.

To attract as many states as possible to sign the Streamlined Sales Tax Agreement, the National Governors' Association set the bar very low – the new agreement becomes effective if only 10 states representing 20 percent of the U.S. population agreed to its terms.¹³ But many of the states behind the SSTA found their initial proposed agreement to be too restrictive, so they have watered down many simplification requirements for participation that would have provided more fair treatment to out-of-state companies.

The Supreme Court in *Quill* said that Congress could determine whether a requirement that out-of-state sellers collect and remit sales taxes would burden interstate commerce. To encourage retailer support, the agreement initially promised that participating states would adopt one tax rate, simplify their definitions of taxable goods, reduce the cost and burden of tax collection – including reporting and auditing requirements, provide an effective and enforceable procedure to assure state compliance with the Agreement, and establish an independent tribunal to oversee compliance by member states. Finally, the participating states agreed to provide retailers with tax compliance software.¹⁴

Promise versus performance:

- **ONE RATE PER STATE:** Under pressure from states with multiple tax rates, the SSTA now permits each state to adopt a “single additional rate.” Thus, with 7,500 sales tax jurisdictions in the U.S., there could be as many as 15,000 tax rates to administer.¹⁵

¹³ SSTP Press Release of November 12, 2002. “States Approve Sales Tax Simplification Agreement; Legislatures Poised for Consideration,” available at www.streamlinedsalestax.org.

¹⁴ SSTP Press Release of October 3, 2005. “Sales Tax Simplification Agreement Becomes Effective Today and Launches Key Element: Amnesty Program,” available at www.streamlinedsalestax.org.

¹⁵ Streamlined Sales and Use Tax Agreement as Amended and Adopted on November 12, 2002 (“NCSL, 11/12/02 Agreement”), section 308 (member states may impose a single additional rate on food, food ingredients and drugs) available at www.streamlinedsalestax.org.

- **UNIFORM DEFINITIONS:** The Agreement now only requires that states adopt definitions that are “in substantially the same language” and are “not contrary to the meaning of” the definitions contained in the Agreement.¹⁶
- **ADMINISTRATIVE BURDEN:** The SSTA rejected adoption of a uniform sales tax return, a proposal for joint audits by more than one state at a time, and a requirement for a single registration agreement.¹⁷
- **ENFORCING STATE COMPLIANCE:** The National Conference of State Legislatures pushed for diluting the requirement in the first draft Agreement that states “must comply.” Now the SSTA says that a state is in compliance if “the effect of its laws, rules regulations and policies is substantially compliant.”¹⁸ Each state revenue department may interpret how the Agreement applies to its state. In fact, many participating states have “reinterpreted” the Agreement on their own terms in their implementing legislation.
- **COMPLIANCE SOFTWARE:** After promising for years to develop implementing software, the SSTA states are no closer to its development, and some software designers have questioned whether this goal can be implemented.

To date, only 13 states have fully adopted the SST Agreement, representing just 19.4 percent of the U.S. population.¹⁹ Five other states have said they would adopt the agreement by 2008.²⁰ Yet, the SSTA states are pressing Congress to require sellers in every state – even in states without a sales tax – to collect sales taxes for member states.

¹⁶ Streamlined Sales and Use Tax Agreement as Amended and Adopted on November 12, 2002 (“NCSL, 11/12/02 Agreement”), section 327 (member states shall adopt terms in substantially the same language) available at www.streamlinedsalestax.org.

¹⁷ Member states will purportedly revisit the issue of developing a uniform return See SSTA, section 318(D)(4) and section 401(C).

¹⁸ Streamlined Sales and Use Tax Agreement as Amended and Adopted on January 27, 2001 (“NCSL, 1/27/01 Agreement”), available at www.streamlinedsalestax.org.

¹⁹ STTP Press Release of October 3, 2005. “Sales Tax Simplification Agreement Becomes Effective Today and Launches Key Element: Amnesty Program,” available at www.streamlinedsalestax.org.

²⁰ SSTA Press Release of October 3, 2005. “Sales Tax Simplification Agreement Becomes Effective Today and Launches Key Element: Amnesty Program,” available at www.streamlinedsalestax.org.