

# Create a Fair and Simple Tax for E-Commerce

BY DANIEL CASTRO | FEBRUARY 2012

---

*Congress should pass legislation that authorizes states to require out-of-state sellers to collect and remit sales taxes, but it should do so without imposing any undue burden on these sellers.*

---

In 1984, CompuServe introduced its “Electronic Mall” as the first major retail e-commerce platform. Since then, online sales have grown to be a key part of the U.S. economy. In 2009, e-commerce retail sales totaled \$145 billion and represented approximately 4 percent of total retail sales.<sup>1</sup> Many of the taxes on these online sales go uncollected, for reasons discussed below. This has created an uneven marketplace because brick-and-mortar retailers do collect sales taxes. The time has come to correct this imbalance. In this report we propose three broad principles—fairness, simplicity and parity—that should guide the development of federal online sales tax legislation. We also offer specific guidance on how such legislation should be crafted.

## BACKGROUND

The debate over taxing out-of-state sellers is not new. The U.S. Supreme Court ruled in *Quill Corp. v. North Dakota* 504 U.S. 298 (1992) 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.<sup>2</sup> The Supreme Court reasoned that with over 6,000 different tax jurisdictions in the United States, each with its own rules and tax policies, imposing taxes on out-of-state businesses “might unduly burden interstate commerce.”<sup>3</sup> As a result, states have been unable to tax online retailers that lack a physical presence in the state. The inability to require out-of-state sellers to collect and remit sales taxes has resulted in substantial losses in tax revenue for states. One study estimates that in 2010, uncollected state and local sales tax from e-commerce amounted to approximately \$8.6 billion.<sup>4</sup> With

---

state budget shortfalls exceeding \$530 billion between 2009 and 2012, states are more determined than ever to obtain from Congress the right to collect taxes on e-commerce sales by out-of-state retailers.<sup>5</sup>

Certainly there are compelling reasons not to require out-of-state retailers to collect taxes on e-commerce transactions. First, as the Supreme Court ruling noted, the cost of complying with the various rules and regulations from thousands of tax jurisdictions could 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 fourteen times more for a traditional superstore than for an online bookseller.<sup>6</sup> And downloading music or movies instead of 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-commerce sales have increased approximately twenty-four times faster than non-e-commerce retail sales.<sup>7</sup> As a result, many states, facing budget shortfalls and fiscal pressure, have set their sights on e-commerce in their search for new opportunities to increase state revenues. State officials argue that this would not create new taxes, only better enforce existing tax requirements. 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 remote sellers are forced to collect sales tax, they have an unfair price advantage over brick-and-mortar retailers.

Absent Congressional authority for states to require out-of-state retailers to collect and remit sales taxes, it will be difficult for states to collect these taxes. In an effort to gain Congressional approval, 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, forty-four 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).<sup>8</sup> As of February 2012, twenty-four states—comprising 33 percent of the country's population—have passed SSUTA legislation and such legislation was pending in at least nine other states.<sup>9</sup>

---

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. Some California retailers had argued that their online divisions should not be subject to state sales taxes because these divisions were legally distinct entities. In response, California issued an administrative ruling in 2001 that in-state retailers with separate online operations were not exempt from collecting sales tax. 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.<sup>10</sup> In 2010, Colorado passed HB 1193, which requires out-of-state retailers who are not collecting sales tax to provide consumers and the Colorado Department of Revenue with an end-of-year report showing all purchases that were not taxed.<sup>11</sup> The goal of this law is to increase tax compliance for out-of-state purchases that consumers often do not report. The U.S. District Court suspended enactment of the law pending a legal challenge.<sup>12</sup>

## **PRINCIPLES FOR A FAIR AND SIMPLE TAX ON E-COMMERCE**

Congress should allow states to require out-of-state sellers to collect sales tax, but it should only grant this authority under a framework that ensures that states create and maintain a fair and simple tax system that does not unduly burden out-of-state sellers. 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.

ITIF has previously argued that 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.<sup>13</sup> Many states have enacted a host of laws and regulations that systematically discriminate against online businesses in favor of local businesses, such as car dealers, realtors, optometrists, pharmacists and liquor stores.<sup>14</sup> While taxes and regulations have traditionally been addressed separately, these two issues are intimately linked. Both taxes and regulations should be based on what was purchased, not how it was purchased. While ITIF retains its conviction that state-enacted barriers to e-commerce should be eliminated, given the continued pressure on Congress to pass e-commerce sales tax legislation, it is worth offering some recommendations on how to proceed.

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:** Any solution should avoid placing innovation-stifling burdens on the digital economy. Legislation should include explicit requirements for simplification across all states, not just within a state, so that out-of-state retailers are not subject to different rules and regulations from each of the fifty states. In addition, Congress should exempt small, out-of-state retailers from requirements to collect and remit sales taxes.
- **Parity:** The goal should be to establish parity in the collection costs between out-of-state retailers and single-jurisdiction retailers.<sup>15</sup> 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.

Federal legislation should have no impact on state tax rates. States and localities should continue to set their own sales tax rates, just as they always have. The purpose of federal legislation should be to provide a framework so that states can require out-of-state sellers to collect and remit sales taxes in a fair and simple process.

### **CRAFTING A FAIR AND SIMPLE SALES TAX FOR E-COMMERCE**

Three pieces of legislation were introduced in Congress in 2011 to allow states to tax online sales. In July 2011, Sen. Durbin (D-IL) and Rep. Conyers introduced the Main Street Fairness Act, S. 1452 and HR 2701, respectively. The Main Street Fairness Act outlines specific requirements that the SSUTA must include and authorizes states that participate in the SSUTA to require out-of-state retailers to collect sales tax for their states. In October 2011, Rep. Womack (R-AR) introduced the Marketplace Equity Act, HR 3179, which authorizes states to require out-of-state sellers to collect sales taxes if they implement a set of tax code simplification requirements. In November 2011, Sen. Enzi (R-WY), along with a number of co-sponsors including Sen. Durbin, introduced the Marketplace Fairness Act, S. 1832, which authorizes states that join the SSUTA to collect sales tax from out-of-state retailers, but does not impose many requirements on the SSUTA. The Marketplace Fairness Act also authorizes states that implement a set of alternative simplification requirements to require out-of-state retailers to collect sales tax.

As shown in Tables 1 and 2, there are key differences among the competing bills. In particular, the various bills have different requirements for the level of simplification required for state tax codes, the enforcement mechanisms to ensure that states comply with the spirit of the law, and the concessions made to remote sellers to fairly compensate them for the additional costs of compliance.

Legislation should ensure that states are granted authority to tax remote sellers only if they truly simplify their tax code. Neither the Marketplace Equity Act nor the alternative simplification provisions of the Marketplace Fairness Act would require states to use common rules and definitions as the SSUTA would require. Instead, each state would be required to use common definitions only within the state, not across all states.

	Main Street Fairness Act	Marketplace Equity Act	Marketplace Fairness Act
<b>Requirements to participate</b>	State must join the SSUTA. In addition, at least ten states (with at least 20 percent of the population of states imposing a sales tax) must join the SSUTA, and the SSUTA must include minimum simplification requirements	State must enact minimum simplification requirements	State must join the SSUTA or state must enact alternative minimum simplification requirements
<b>Small seller exemption</b>	As determined by the SSUTA Governing Board (currently gross annual revenue less than \$500,000)	Gross annual receipts less than \$1 million nationally or \$100,000 in the state	Gross annual receipts less than \$500,000
<b>Tax rate</b>	Destination rate (state + local)	State must require remote sellers to pay either 1) a single, blended sales tax rate (state + est. local); 2) the maximum state rate (state only, no local); or 3) the applicable destination rate (state + local) provided that the state provides software and liability protection for errors  If state provides a lower tax rate on food and drugs, then state may require the lower rate for online sales too	Destination rate (state + local)  Must provide thirty day notice of local tax rate changes
<b>Effective date</b>	First day of calendar quarter at least six months after the SSUTA Governing Board determines conditions have been met	First day of calendar quarter at least 6 months after state files a public notice that it has enacted the minimum requirements	SSUTA: First day of calendar quarter at least ninety days from enactment of Act  Alternative: First day of calendar quarter at least six months after state implements minimum simplification requirements
<b>Enforcement provisions</b>	If the SSUTA requirements cease to be met, then all states lose authority  If a state ceases to meet Member State requirements, then the state loses authority	If a state no longer satisfies requirements of legislation, then the state loses authority	If a state no longer satisfies requirements of legislation, then the state loses authority
<b>Judicial review</b>	Governing Board determines whether requirements of legislation have been met  Court determines whether rulings by the Governing Board are arbitrary, capricious, an abuse of discretion or not in accordance with law	Court determines whether requirements of legislation have been met	Court determines whether requirements of legislation have been met

Table 1: Overview of e-commerce sales tax legislation, 2011

	Main Street Fairness Act	Marketplace Equity Act	Marketplace Fairness Act
<b>Centralized, multistate registration system</b>	Yes	No	No
<b>Uniform definitions of products and exemptions</b>	Yes	No	No
<b>Common tax bases for all local jurisdictions within a state</b>	Yes	Yes	Yes
<b>Uniform rules for sourcing transactions</b>	Yes	Yes. Sourcing based on delivery address or customer billing address.	Yes. If a SSUTA Member State, then the SSUTA sourcing rules apply. If a non-SSUTA Member, then sourcing based on delivery address, customer address, billing address, or seller's address.
<b>Provide software and services to remote sellers to identify applicable tax rates to the state</b>	No	Only for states requiring sellers pay destination tax rate	Yes
<b>Uniform rules for certification of software and service providers</b>	Yes	No	No
<b>Uniform rules and requirements for bad debt, rounding, tax returns, sales tax holidays, refunds and credits relating to customer returns and exchanges</b>	Yes	No	No
<b>A single state-level administration for state and local sales taxes</b>	Yes	Yes	Yes
<b>A single sales tax return for remote sellers for the state</b>	Yes	Yes	Yes
<b>Provide a taxability matrix</b>	Yes	No	No
<b>Liability protection for sellers that make errors due to incorrect information provided by the state</b>	Yes	Only for states requiring sellers to pay destination tax rate	Yes
<b>A single audit for all local taxing jurisdictions within a state</b>	Yes	No	Yes
<b>A single audit for all Member States</b>	Yes	n/a	No
<b>Establish minimum compensation requirements for expenses incurred by sellers to administer, collect and remit taxes</b>	Yes	No	No

Table 2: Simplification requirements of e-commerce sales tax legislation, 2011

---

To receive authority to require out-of-state retailers to collect sales tax, states should be required to join the SSUTA. Without federal legislative requirements, states will not create consistent definitions and rules. State tax authorities are like philosophers who spend countless hours in esoteric debate. Instead of opining on questions like “what is the nature of reality?” they are discussing questions like “what is the nature of candy?” For example, according to the SSUTA, a Snickers bar is considered to be candy but a Twix bar is not (the difference being that a Twix bar has flour in it). It would be a mistake to allow each state to set its own definitions and rules as a basis for taxation. We certainly do not need fifty different definitions of candy.<sup>16</sup>

Federal legislation should ensure that remote sellers are not unduly burdened with additional compliance costs. The principle way to achieve this is through tax code simplification that creates uniform requirements across all states. This should include common definitions of products and exemptions, uniform rules for sourcing transactions, and standard procedures for handling bad debt, rounding, tax returns, sales tax holidays, and refunds and credits relating to returned or exchanged products. Requiring common definitions will greatly simplify the administration burden on sellers, while still giving states and localities the freedom to set their own tax rates. States should be required to publish this information in a standardized taxability matrix, made freely available to sellers and service providers. Legislation should also ensure that sellers and service providers are not held liable for errors that result from incorrect information published by the state in the taxability matrix. Software and service providers should also be certified for all states, rather than on a state-by-state basis. Sellers should be able to use a single, online multi-state system to electronically register, file tax returns and remit payments. Sellers should not be subject to multiple audits; rather a single audit should be used by all states.

Remote sellers should also be compensated for the costs associated with complying with out-of-state tax collection and audits. The appropriate compensation for retailers should include not only a portion of the costs to prepare and file sales tax returns, but also a portion of the expenses associated with integrating certified software into online stores and other back office systems. In addition, the states participating in the SSUTA should be required to continue to provide certified software at no cost to sellers to integrate with their e-commerce platforms. Retailers using software certified by the state should not be liable for any mistakes made by that software. In addition, requiring states to pay for the use of certified software might also encourage states to develop tax policies that are more efficient to implement. Finally, Congress should establish a *de minimis* rule to exempt small out-of-state sellers from the obligation to collect and remit the sales taxes. Retailers with less than \$1 million in average annual receipts should receive a small seller exemption.

Federal legislation should create a framework ensuring that if states receive authority to require out-of-state sellers to collect taxes, states will uphold their end of the deal. This means not only creating specific simplification requirements as described above, but also including an effective process for determining whether the SSUTA reflects the simplification requirements and whether a state has met the requirements of the SSUTA. In addition, a similar process should be created for stripping this authority from states that no longer comply with the SSUTA criteria. While the SSUTA Governing Board currently

---

is responsible for making these types of determinations, it is not the appropriate entity for ultimately deciding whether the SSUTA or Member States are in compliance with the simplification requirements. The problem is that the SSUTA Governing Board has no incentive to simplify the tax code. The Governing Board consists primarily of state tax administrators whose goal is to maximize state tax revenue. While the Governing Board might be the best entity to make an initial determination, Congress should also grant a private right of action so that rulings can be challenged and subject to judicial review by the courts. The standard for review should not be merely whether the Governing Board's actions are arbitrary and capricious, but whether the SSUTA and Member states have properly implemented the requirements of the legislation.

## CONCLUSION

Since not taxing e-commerce sales unfairly discriminates against traditional, brick-and-mortar companies, Congress should seek to find a balance that allows states and municipalities to collect taxes on out-of-state sales without imposing an undue burden on these retailers. In the end, however, state and local governments clearly should be able to tax sales transacted over the Internet (or by phone or mail), if for no other reason than as a matter of fairness. Just as ITIF has argued strongly that brick-and-mortar stores should not be favored, the converse is also true.<sup>17</sup> 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 process must be fair. This means that public policy should not be designed to protect or insulate any business or industry from changes in the marketplace, whether they sell online or on Main Street. Instead it should focus on ensuring that individuals who lose their jobs as a result of these changes have access to skills training and other assistance to transition into new jobs. 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, while 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 is true of the Internet's digital economy, which increasingly disrupts 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.

---

## ENDNOTES

---

1. U.S. Census Bureau, "U.S. Census Bureau: E-Stats," May 26, 2011, <http://www.census.gov/econ/estats/2009/2009reportfinal.pdf>.
2. *Quill Corp. v. North Dakota* 504 U.S. 298 (1992).
3. Ibid.
4. Donald Bruce, William F. Fox, and LeAnn Luna, "State and Local Government Sales Tax Revenue Losses from Electronic Commerce," The University of Tennessee (April 13, 2009), <http://cber.utk.edu/ecomm/ecom0409.pdf>.
5. Elizabeth McNichol, Phil Oliff and Nicholas Johnson, "States Continue to Feel Recession's Impact," Center on Budget and Policy Priorities, January 9, 2012, <http://www.cbpp.org/cms/index.cfm?fa=view&id=711>.
6. "Energy" in *Digital Quality of Life: Understanding the Personal and Social Benefits of the Information Technology Revolution*, Robert Atkinson and Daniel Castro, eds., Information Technology and Innovation Foundation (October 2008) <http://www.itif.org/files/DQOL-11.pdf>.
7. U.S. Census Bureau, "2009 Quarterly E-Commerce Report," <http://www.census.gov/retail/mrts/www/data/html/09Q4table4.html>.
8. "Frequently Asked Questions," Streamlined Sales Tax Governing Board, Inc., n.d., <http://www.streamlinedsalestax.org/index.php?page=faqs>.
9. Ibid.
10. Jacqui Cheng, "Amazon kills affiliate program in Colorado thanks to taxes," *Ars Technica*, March 2010, <http://arstechnica.com/tech-policy/news/2010/03/amazon-kills-affiliate-program-in-colorado-thanks-to-taxes.ars>.
11. "Sales Tax Requirements," Amazon.com, n.d., <http://www.amazon.com/gp/help/customer/display.html?nodeId=468512>.
12. Ibid. See also, "Internet Sales/Non-Collecting Retailers," Department of Revenue, State of Colorado, February 7, 2011, <http://www.colorado.gov/cs/Satellite/Revenue/REVV/1251581938320>.
13. Robert Atkinson and Daniel Castro, "Closing the E-Commerce Sales Tax Loophole," Information Technology and Innovation Foundation, May 20, 2010, <http://www.itif.org/files/2010-sales-tax.pdf>.
14. See for example, Daniel Castro, Robert Atkinson and Stephen Ezell, "Embracing the Self-Service Economy," Information Technology and Innovation Foundation (April 2010), <http://www.itif.org/files/2010-self-service-economy.pdf> and Daniel Castro, "A Healthy Dose of Skepticism on NY's Pharmacy Bill," *Innovation Policy Blog*, August 27, 2011, <http://www.innovationpolicy.org/a-healthy-dose-of-skepticism-on-nys-pharmacy>.
15. "Report to Congress," Advisory Commission on Electronic Commerce, April 2000, [http://govinfo.library.unt.edu/e-commerce/acec\\_report.pdf](http://govinfo.library.unt.edu/e-commerce/acec_report.pdf).
16. While software can be used to automate many processes, it cannot always be used to classify goods according to different definitions.
17. See for example, James H. Johnston and Robert D. Atkinson, "Power of Attorneys: Will the Organized Bar Thwart the Emergence of Online Law?" Information Technology and Innovation Foundation, July 10, 2006, <http://www.itif.org/files/powerofattorneys.pdf> and Robert D. Atkinson, "Public versus Private Restraints on the Online Distribution of Contact Lenses: A Distinction without a Difference," Information Technology and Innovation Foundation, July 20, 2006, <http://www.itif.org/files/contactlens.pdf>.

---

## **ACKNOWLEDGEMENTS**

The author wishes to thank the following individuals for providing input to this report: Rob Atkinson. Any errors or omissions are the author's alone.

## **ABOUT THE AUTHOR**

Daniel Castro is a Senior Analyst with the Information Technology and Innovation Foundation. His research interests include health IT, data privacy, e-commerce, e-government, electronic voting, information security and accessibility. Before joining ITIF, Mr. Castro worked as an IT analyst at the Government Accountability Office (GAO) where he audited IT security and management controls at various government agencies. He has a B.S. in Foreign Service from Georgetown University and an M.S. in Information Security Technology and Management from Carnegie Mellon University.

## **ABOUT ITIF**

The Information Technology and Innovation Foundation (ITIF) is a Washington, D.C.-based think tank at the cutting edge of designing innovation strategies and technology policies to create economic opportunities and improve quality of life in the United States and around the world. Founded in 2006, ITIF is a 501(c) 3 nonprofit, non-partisan organization that documents the beneficial role technology plays in our lives and provides pragmatic ideas for improving technology-driven productivity, boosting competitiveness, and meeting today's global challenges through innovation.

**FOR MORE INFORMATION CONTACT ITIF BY PHONE AT 202.449.1351, BY EMAIL AT MAIL@ITIF.ORG, OR ONLINE AT WWW.ITIF.ORG.**