

Internet Sales and State Taxes: Policy Issues

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With the holiday shopping season in full swing, many consumers will choose to buy gifts through online retailers rather than brick-and-mortar shops. While some consumers may choose to shop on the Internet for convenience, some might also be attracted to shopping online by the apparently lower prices, which do not always include sales and use tax. Customers who do not pay sales or use tax to the vendor are typically required to remit the tax to their home state. Customer compliance with this requirement, however, is very low.

In certain instances, the taxes are not included in the online prices due to constitutional limitations on the states' authority to require that out-of-state sellers collect them. In 1992, the Supreme Court held in *Quill v. North Dakota* that the dormant Commerce Clause prohibits states from imposing tax collection obligations on sellers without a [physical presence](#) in the state. Importantly, Congress [has the authority](#) under the [Commerce Clause](#) to pass legislation that would allow states to compel vendors to collect the taxes even without a physical presence. Congress has not yet used this authority, although legislation has been introduced (discussed below).

Two public policy issues are typically raised concerning the effects of current law. First, the differential tax treatment of similar items creates an economic distortion that affects producer and consumer decisions. Remote sellers may locate operations based on potential sales and use tax consequences, not traditional market factors. Additionally, consumers may choose out-of-state vendors to evade taxes.

Second, current law limits the ability for state and local governments to require the collection of sales and use taxes on goods and services that would otherwise be subject to such collection if sold by a local vendor. This is particularly a significant issue for states that rely relatively more on general sales tax as part of their overall revenue mix.

A [widely cited 2009 University of Tennessee study](#) estimated that 25% of taxes due on e-commerce sales in 2007 went uncollected, causing state and local governments to lose \$7.2 billion in tax revenue in 2007, the first year of their baseline forecast. The study's authors assume \$2.5 billion in e-commerce sales in 2007, with taxes due only on a small share of that amount related to final sales and other taxable business-to-business (B2B) transactions. The study's authors forecasted that the annual state and local revenue loss from untaxed e-commerce transactions would be \$11.2 billion or

\$12.7 billion by 2012 (depending on the growth of taxable e-commerce transactions). The estimates are limited to some uncertainties in their data and assumptions regarding (a) the share of transactions subject to tax, and (b) compliance rates on taxable transactions.

The vast majority of e-commerce sales are [made by sellers in manufacturing and wholesale trade industries](#), which are more likely to be intermediate business-to-business (B2B) inputs. Although some of these intermediate goods are taxed by the states or are sold directly to final consumers, generally it is the case that inputs to final business products are not subject to state and local sales and use taxes.

Sales and use tax compliance is likely higher for registered items (such as automobile sales) or highly perishable or timely items (such as flowers for delivery) that would not typically be shipped across state borders. Alternatively, compliance for consumer goods (like electronics, houseware, and apparel) might be lower.

In the 114th Congress, two bills were introduced to allow states to require that remote sellers collect taxes based on the buyer's location (sometimes called the destination principle): the Marketplace Fairness Act of 2015 (MFA; [S. 698](#)) and the Remote Transactions Parity Act of 2015 (RTPA; [H.R. 2775](#)). In order to use the authority, states would have to join the [Streamlined Sales and Use Tax Agreement](#) or meet minimum tax simplification requirements specified in the bills. One key difference between the bills is their exemptions for "small sellers." The [MFA contains a permanent exemption](#) for firms with annual U.S. remote sales of \$1 million or less in the preceding year. The [RTPA's exemption](#) is temporary, with the initial threshold set at total remote and non-remote sales of \$10 million or less (although it would not apply to entities utilizing an electronic marketplace to make sales to the public). The RTPA exemption is phased out over the four years beginning after a state's tax collection authority comes into effect. Another key difference between the bills is that the RTPA contains limits, not included in the MFA, on the states' ability to audit remote sellers.

In August 2016, Representative Bob Goodlatte released a draft proposal that would partially base the taxation of remote transactions on the seller's location (called the origin principle). Under the [Online Sales Simplification Act of 2016](#), states could impose or require the collection of sales and use taxes by a remote seller only if the state (1) is the "origin state," which is generally where the seller has the greatest number of employees; and (2) participates in the state tax clearinghouse created under the act. The tax would be applied using the origin state's tax base, but imposed at the tax rate of the "destination state" (typically where the purchaser is located). The taxes would be distributed, using the clearinghouse, to the destination state. States would be required to meet minimum tax simplification requirements and be limited in their ability to audit remote sellers. The proposal does not have a small seller exception.

Finally, the No Regulation Without Representation Act of 2016 ([H.R. 5893](#)) would take a different approach by codifying the Court's holding in *Quill*. Specifically, states would be prohibited from requiring that remote sellers collect taxes or report sales-related information unless the sellers have a "physical presence" in the state, as defined in the bill.