E-COMMERCE TAXES: TWO MORE YEARS TO DECIDE

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ABSTRACT

The collection of sales tax is straightforward in traditional retail stores, but no so with online sales. With the advent of the Internet and its rapid growth, e-commerce sales taxation has emerged as an important issue and challenge. On Nov 15, 2001, the U.S. Congress extended a moratorium on new Internet taxes until 2003 giving us a chance to either come up with a fair and universal taxation method or not levy Internet taxes altogether.
Keywords: ecommerce taxes, internet sales taxes, online taxation

INTRODUCTION

Taxes--Just the thought of them can still get American taxpayers up in arms. In fact, the country was established because the colonists would not tolerate the idea of taxation without representation. However, as much as much we do not like taxes, they are a fact of life. The federal government makes us pay income taxes; our businesses have to pay corporate taxes, and if we want to buy a big luxury item like a boat or car, we are forced to pay an excise tax. But it is not just the federal government that is taxing us; depending on where we live, we might be subject to state and city income taxes, and anyone who owns property is subject to property taxes. But one type of tax that almost everyone has to pay is sales tax. States have the right to levy and collect taxes on goods and services sold within their borders and use these revenues to provide support services, basic community infrastructures, and resources for public welfare, such as law enforcement, emergency services, and schools.

While the payment of sales tax is nothing new, the way people are shopping is. The advent of the Internet or "new" economy has presented challenges to the way sales are taxed. The Internet allows anyone to make purchases from anywhere in the world any time of the day. How do you tax goods purchased online from consumers who do not reside in the state where the vendor is? In what state did the sales transaction legally or actually take place? Which state and/or locality is entitled to the tax revenue from the transaction? Where is an Internet company based? Where is corporate headquarters? Where does it keep inventory? Without having answers to these questions, it is hard to pin down how and where to tax somebody. What is clear is that sales and use taxes are obsolete for funding state services. They were developed 100 years ago when people shopped exclusively in their own neighborhoods. Tax collection procedures are extremely cumbersome in today's e-commerce environment and present a hindrance in the collection of sales taxes.

But what exactly is meant by e-commerce, and how big is this new form of retailing? In many congressional commissions and task forces it is defined as "any transaction conducted over the Internet or through Internet access, comprising the sale, lease, license, offer, or delivery of property, goods, services, or information, whether or not for consideration, and includes the provision of Internet access" (13). Internet commerce and the dotcom mania have captured a large percentage of consumer dollars. According to the commerce department, during the fourth quarter of 1999, consumers spent over $5.3 billion in online sales, which accounted for 64 percent of the total retail sales for the quarter (4). According to Jupiter Communications, online retail spending increased from $12.3 billion in 1999 to $24.1 billion in 2000 and was expected to hit $34 billion in 2001 (8)(9). The Forrester Group predicts that seven per cent of U.S. retail sales, or $184 billion, will take place over the Internet by 2004 (5). Yet another group puts the number at $278 billion by 2005 (13).

This issue of how to tax sales conducted over the Internet has been in the minds of government officials for more than ten years, and as challenges and potential problems became apparent, Congress took a reactive position. On October 21, 1998, the U.S. Congress enacted the Internet Tax Freedom Act (ITFA), which imposed a three-year moratorium on new Internet sales taxation. It also created a 19-member Advisory Commission on Electronic Commerce (ACEC), which was given the mission to explore the issues, gather evidence, and report back to Congress whether E-commerce should be taxed, and if it can be, how can it be taxed without being subject to special, multiple, or discriminatory taxes. The members included representatives from all levels of government as well as individuals involved in e-commerce, traditional retailers, and consumer groups. After 18 months and more than $1.4 million tax dollars spent on the study, the commission's report was delivered in April of 2000. Formal findings and recommendations did not, unfortunately, reflect freshness of approach or innovation (10). The commission was unable to reach a consensus on the most difficult issues, including the critical questions of state sales and use taxes. Few concrete recommendations were offered in the report, with the most definitive portion of the proposal that an additional five-year extension be given after the 2001 tax moratorium expired. The lack of groundbreaking recommendations highlights even more the complex nature of the issue.

On November 15, 2001, the U.S. Senate extended a ban on Internet taxes until November 2003. Many people expected the moratorium to be extended because the existing sales and use tax system is already very complicated, and expanding it to include e-commerce sales taxes would have made it even more so. While much has been debated, and we are closer to a resolution, it is far from settled. The difficulties encountered by the 19-member ACEC commission attest to that. With the new two-year extension Congress has gone in two directions:

1. One way is to use the next two years to keep talking about the issue, with the hope of reaching consensus or an acceptable resolution. Out of all the possible alternative solutions presented and analyzed over the years, the "streamlined sales tax systems" (s?) has been the one with more chances of acceptance. State and local government, Main Street retailers, and some politicians support this proposal.
2. To make the ban permanent, in essence repeal Internet sales tax entirely. This position is supported primarily by e-commerce retailers and many anti-tax government and IT industry leaders.

This article will further analyze these two alternatives and discuss the advantages as well as the challenges presented by each.

Clearly there are two opposing groups on each side of the issue. The groups that support Internet taxes are the Main Street business groups that demand fairness in competing with their online counterparts and state and local governments who want to tap into this new source of revenue to support services, infrastructure, and resources for the public good. After all, there is a lot at stake. The projected tax loss for the year 2002 is $2.5 billion (6), and according to a report to Congress by the Advisory Commission on Electronic Commerce, it could be $3.5 billion dollars by 2003 if e-commerce is exempt from sales tax (14) and $8 billion by 2004 (5). Though online business-to-customer sales currently account for only 2% of total sales tax proceeds, it is estimated that it could reach 10% by 2007 (5).

Dotcom companies, and many federal, state, and business leaders who feel that sales and local taxes will choke off the growth of e-commerce and will have a negative impact on the economy, hold the anti-tax position. In addition, they argue that current laws are too cumbersome and costly to comply with. Some economists estimate that e-commerce sales would be as much as 30 percent lower if Internet sales were taxed. A survey at the University of Chicago found that people are shopping on the Internet based on cost and that they purchase more goods online if they face high local sales taxes (5).

Sales tax, and more importantly what is referred to as "use" tax, is at the crux of this debate. Most of it has to do with the concept of nexus. Simply put, nexus implies a minimum contact with a state to trigger a tax collection responsibility on behalf of the merchant selling the goods in State A from purchaser in State B" (2). Only merchants who have a nexus or physical presence in the consumer's state are required to collect taxes. Physical presence can include any office, store, distribution center, sales office, agent, salesman, or representatives. Thus, sales tax is due on Internet sales only when the customer and merchant are in the same state; otherwise use tax is due. With use tax, the burden is on the buyer to remit this tax payment in lieu of the sales tax. Buyers are largely non-compliant with the use tax requirement and the requirement is rarely enforced (6).

The issue of taxing "remote sales" through the use tax is not new. Mail order and catalog sales tax exemptions result from decisions by the U.S. Supreme Court stating that it would be an undue burden on marketers to have to handle administrative costs and paperwork required to collect and disburse sales taxes to 50 states. The physical presence/nexus requirement is based on two important decisions--the 1967 National Bellas Hess decision and the 1992 Quill decision. Again, as long as the seller doesn't reside in the same state as the buyer, the seller isn't required to collect sales tax. In this case only use taxes can be collected, and for all practical purposes, few if any buyers actually pay it. Many feel that the same philosophy should apply to e-commerce, as there is no difference between catalog orders and other types of online sales transactions. The Internet crosses state boundaries, so state and local governments have no jurisdiction. A seller may be a computer server, which is easily moved. It may have no legal address, so its physical presence is elusive (14).

To make matters worse, many large brick-and-mortar retail establishments like Wal-Mart, The Gap, and Circuit City have also created Internet businesses that are separate and distinct from their physical counterpart in order to take advantage of the Supreme Court decisions and avoid use tax. For instance, Barnes and Noble launched its Web site through a subsidiary and kept both entities separate. Stores in the states where the Web site has no office cannot promote it or give full refunds for books bought on the Internet because the stores could then be seen as acting as sales agents for the Web sites, thus creating a nexus. Books bought through the Internet do not pay taxes except in New York where the Web sites have physical offices (12). Border.com meanwhile took a far more risky approach The company set up a separate company for its Web site, but also markets it in all its stores, charging taxes to customer in only two states where its Internet operations have a physical presence. When asked whether Border.com was violating tax laws, the vice-president for Internet operations noted "So long as there's no physical presence of Border.com in our stores, such as having Internet terminals in the stores, there is no nexus"(12).

The Need for a Fair and Universal Taxation System

The main reason traditional retailers and business groups oppose a permanent ban on Internet taxes, as mentioned earlier, is the argument that allowing e-commerce transactions to be exempt from sales tax makes it hard for them to compete. They feel it is important that a level playing field be maintained between Main Street and online retailers. It is also suggested that since tax exemption reduces the cost of doing business for Internet retailers, it makes the companies more attractive to venture capital investors (6). Opponents of the IFTA law have also argued about what they have termed a digital divide. They feel it is a case of blatant discrimination that affluent consumers who have access to the Internet and plenty of credit to purchase goods would be the ones primarily benefiting from the law, while those from a lower economic group would be forced to shop at local retail stores and be hit with the tax burden. A study from the U.S Commerce Department showed that households with incomes of $75,000 or more were 20 times more likely to have Internet access at home than lower income levels. The study went on to say that those households with incomes less than $25,000 would pay more sales taxes from making traditional purchases (1).

However, the biggest obstacle to overcome for those supporting Internet taxes would be the administrative nightmare for retailers if they had to collect sales tax on every sale. The current tax system recognizes over 30,000 tax jurisdictions, and that is only in the United States; within these jurisdictions, there are more than 7,000 separate state and local tax rates that cover all goods and services. States also have different rules to calculate whether an item is taxable or not (4) (11). In Florida, for example, clothing is taxable, except for a brief period in August to encourage back-to-school shopping, but in Massachusetts, clothing is not taxable, unless it costs over $250 for a single item. A retailer in Florida or Massachusetts would know these tax rules, but a company in Wyoming selling clothes would not normally know this.

A 1999 study by Ernst and Young estimates that it would cost a small multi-state retailer with collection responsibility in one state 7% of sales paid in collection costs; in 46 states costs would rise to 54% and 87%. With almost 7,500 taxing jurisdiction in the U.S. with different tax bases and administration rules, this could get very confusing and complex (3). Sales and use taxes are even more complex in considering the taxable status of downloaded materials, tracking payments made with electronic cash, the lack of details on the location of the buyers, and many other details.

It is acknowledged and concluded by the various committees and proposals that any solution to the e-commerce taxation problem must meet several goals, including tax simplification to reduce aggregate administrative cost, no double taxation, no disclosure of personal information, and no unfair disadvantage (14). Others contend that whatever solution is ultimately decided, it should include the following provisions: one-stop multi-state registration, uniform deductions, uniform sourcing of sales rules, uniform format for tax returns and exemption procedures, certified tax compliance software, compensation for tax collection costs, exemption for small sellers, state-level administration of the tax, and a single rate of tax per state on remote sales (13). Overall, the solution should address the concepts of simplification, equity, universality, timeliness, and clarity (6).

During the analysis and meetings of the ACEC Commission, several proposals were offered but failed to receive the required support of two-thirds of the commissioners. Solutions like a seller-based tax, a buyer-based tax with seller as the collector, or even a national sales tax with the federal government allocating revenue to each state have been proposed. So far, the one that has received the most support from groups inside and outside of ACEC and is seen as a compromise is the Streamlined Sales Tax Project (SSTP), which calls for a drastic simplification of local sales-tax regulations.

Some 38 states and the "Big Seven," a group of government associations, are participating in the SSTP project, and it represents the most plausible and viable proposal at hand. The states would gain authority to compel remote vendors to collect and remit sales and use taxes in exchange for which the states would adopt compliance simplification. The goal of the proposal is to create a simpler, more uniform, and fairer system that reduces the burden imposed on retailers while preserving state and local sovereignty (4). This proposal incorporates a "real-time" tax system and centers on using tax software to calculate and charge sales taxes and hiring third party vendors to make it work. The system adds an additional step to the typical credit card transaction, which would be the sales tax, and this amount would be collected by a third party. In addition the third party will provide the data associated with the tax, transmit the tax to the appropriate state, and be subject to audit. The states would pay to have the system set up by charging a small fee for each transaction (4)(11).

> The SSTP would establish a central database that would let an e-commerce company use a customer's zip code to look up the correct sales tax schedules for his state and locality. It would standardize the definitions of such terms as "garment" and "food products." It would require states and municipalities to update their sales tax rates at a predictable time at the beginning of each calendar quarter. It would provide e-commerce companies with a standard procedure for remitting sales tax proceeds to the states. It would set up a certification procedure for software products and service providers that are qualified to administer sales tax collection (11).

The SSTP represents a sweeping reform of sales tax law. However worthy the proposal may be, there are some major challenges and a significant amount of pressure to overcome. First, it is thought that around 20 states would need to sign on to the project to convince Congress to make retailers collect the tax. Furthermore, there is always is the reluctance of state and local tax jurisdictions to agreeing to a unified tax system and give up control over tax rates and tax collection procedures. What has been seen in the past is that states have not been able to resist the temptation to try to make a uniform system better and in doing so altering it so it is no longer uniform (15). The other challenge is whether the states want to allow third party vendors to assume one of the most basic functions and rights of state government--collecting taxes.

Tax-free Internet

Those in favor of the ITFA claim that this digital divide is actually the direct result of over taxation. If the states abolished sales tax on computers and software, more lower income people would be able to afford them, and this would narrow the so-called digital divide. However, as history shows, the federal government has long been in favor of taxing most those who can best afford it, and that is why the government chose not to release online businesses from their obligation to collect the federal excise tax on Internet purchases of airline and cruise ship tickets, firearms, and luxury cars. While the digital divide may separate the haves from the have-nots economically, e-commerce has helped to open a world of opportunity to rural areas. The Internet and e-commerce businesses have been instrumental in bringing advanced telecommunication services to people who live great distances from shopping centers. Those living in these areas now have access to all kinds of information technology at affordable prices, and this has been key in allowing them access to untaxed goods on the net (5). Besides, it is argued that the main reason people shop via the Internet is not to save on paying the sales tax but because of the convenience, vast selection of merchandise, and added services that retailers can offer their customers. In fact, many people will see something in a mail order catalog, shop the Internet for best price, but wind up buying it from a traditional retail store after they go to look at the product in person.

Some e-commerce experts caution that because the Internet is still in its infancy, taxation could jeopardize its development. The growth is due in part to the lack of taxes, and since e-business has helped the economy, taxing e-commerce may actually lower tax collection (4) (14) (15). They also question whether e-commerce really takes business away from traditional retailers since many as discussed before now engage in e-commerce and even set up separate entities to avoid sales tax, yet they have the advantage of being tied to a traditional retail store for such things as returns. The use of the Web site stores is further encouraged by the posting of signs in the retail locations and the companies offering specials available only online.

CONCLUSION

The Internet Tax Freedom Act expired in October 2001, but it was renewed by Congress until November 2003. Obviously the government still realizes the importance of allowing e-commerce the opportunity to grow without additional burdens. But there remain many issues to resolve before a permanent solution can be determined and made into law.

There is no way to predict with certainty how this issue will be resolved, but one thing is clear, the ultimate decision should reflect sound tax policy and a level playing field. No form of business should be preferred; no unnecessary impediment to business should be permitted, and taxation without representation should be disallowed. What this suggests is that the level playing field will require sales taxes to be collected by all sellers using a much simpler mechanism or not collected at all. The government will have to adopt an “all or none” approach to Internet taxes. Either all 50 states tax e-commerce at about the same rate or prohibit taxes entirely.

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