

DEPARTMENT OF AGRICULTURAL ECONOMICS

Taxing Electronic Commerce

Issues for Local Governments and Retailers

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The purchase of retail goods over the Internet, commonly called electronic commerce or 'e-commerce,' has exploded in the past several years. Forrester Research, a leading market research company, forecasts on-line consumer retail sales will reach \$150 billion by 2003. This figure is based on an amazing 84 percent annual growth rate between 1999 and 2003.

The dramatic growth in electronic commerce has caused concern among retailers and local governments. On-line consumer sales, unlike locally purchased goods, are currently not subject to any sales or use tax. Retailers argue they are losing revenue as consumers replace local merchants with on-line merchants who have the price advantage of no sales tax. Local governments fear that the rise in e-commerce will drain their coffers of much needed sales and use tax revenues as consumers choose to shop on-line rather than on main street.

As electronic commerce continues to grow, both retailers and local governments will increase their focus on the issue of taxing electronic commerce. As with any issue, the debate over taxing electronic commerce has both opponents and proponents.

Those groups in favor of taxing electronic commerce cite the revenue losses to local governments and retailers. They also argue that remote sellers have an unfair price advantage over local merchants who are required to collect sales tax.

Opponents of taxing the Internet downplay the revenue loss projections to local governments and retailers. They argued that the rapid growth in Internet technology and e-commerce is partially due to the fact that no sales tax currently applies to on-line purchases.

Opponents also acknowledge that while on-line commerce sales may appear large in absolute terms, they currently account for less than 1 percent of total

retail sales.¹ Opponents claim that the threat of revenue losses to e-commerce should force local governments to become more fiscally responsible and cut unnecessary spending rather than further expand the scope of their tax collecting powers.

Regardless of the current arguments for or against the taxing of electronic commerce, there are several broad issues concerning e-commerce and taxation that local officials and

retailers should be made aware of when discussing public policy on the issue. This article provides an overview of the major current issues surrounding e-commerce and taxation.

Imposing Sales and Use Taxes on E-Commerce — Current Problems

If local governments fear a revenue loss from electronic commerce, why can't these governments simply impose a sales and/or use tax on electronic commerce? One major problem is that of 'nexus,' or physical presence, required for sales taxation. Currently, 46 states including Kansas impose a sales tax on retail goods. Thirty-one of these states have a local tax option, which allows local governments to levy sales taxes in addition to the state tax rate. According to states' statutes, the seller is required to collect and remit the sales tax. However, a state's ability to collect sales tax from out-of state sellers is limited by the commerce clause of the U.S. Constitution. Under this clause, a seller is required to have a sufficient presence in a state (nexus) before that state can require the seller to remit the sales tax.

¹ Source: U.S. Bureau of the Census, *Monthly Retail Trade Survey*, March 2000.

For normal retail sales within Kansas, for example, nexus is not a problem because the retailer has a physical presence within the state. In fact, most local retail sales are made with the buyer and seller meeting face to face.

Electronic commerce, however, occurs on an interstate or international level. Buyers and sellers can be in different states or countries. When a resident purchases a product over the Internet from a retailer outside of the resident's state, by law the remote retailer is not required to collect and remit sales tax revenues back to that state.

The question of what constitutes a 'sufficient presence' has been a problem for local governments. States have previously argued that although companies may not have a physical presence within a state, an economic presence should be sufficient grounds for collecting and remitting sales tax revenues.

Economic presence was argued to exist through the U.S. mail and other common carriers like UPS and FedEx. However, the *Quill vs. North Dakota* (112 U.S. 298) decision in 1992 by the U.S. Supreme Court ruled that a seller did not have nexus when its only contact with a state was through the U.S. mail or other carriers. A retailer must have a physical presence within a state, whether it be all the retailer's operations or just certain divisions such as shipping or distribution, in order to be required to collect and remit sales tax revenues. So if a Kansas resident purchases a product from L.L. Bean, which is located in Maine, L.L. Bean is not required to collect and remit Kansas sales tax revenues. If, however, L.L. Bean had a physical presence in Kansas L.L. Bean would be required to collect and remit Kansas sales tax; regardless of the location of the on-line purchase.

To overcome the nexus problem regarding sales taxation, many states impose a use tax that is equal in value to the state's sales tax rate. When a remote seller does not collect a state's sales tax, consumers who make remote purchases are required to pay a use tax on the value of their remote purchase. In Kansas, a use tax is imposed "for the privilege of using, storing, or consuming within this state any article of tangible personal property." (K.S.A. 79-3703).

However, collecting use tax revenue from consumers is a problem, regardless of whether consumption occurs locally or on-line. Because most businesses are aware of this use tax and are subject to audits, the reporting and collection of use tax from businesses is

not a problem. What is a problem is that most consumers are not aware of the use tax, so the tax revenue goes uncollected. Furthermore, there is little incentive for consumers to remit this tax, as enforcing this tax at the individual consumer level would be next to impossible. So although most states, including Kansas, have a use tax to overcome the nexus problem arising from the sales tax, the ignorance of consumers regarding the existence of this tax, the high costs of enforcing this tax, and the extremely low probability of detection from not remitting the tax all currently make the use tax an ineffective alternative to collect lost sales tax revenues.

The Internet Tax Freedom Act (ITFA) is another reason state and local governments cannot apply taxes to electronic commerce. The ITFA, passed by Congress in 1998, placed a 3-year moratorium on the imposition of new taxes on Internet access and electronic commerce. Congress recently extended the ITFA until 2006. The ITFA, however, does not restrict the rights of states to apply sales and use taxes to on-line commerce, since these are not new taxes in those states already levying them. Its primary goal regarding sales taxes is to prevent states from applying sales taxes to categories of e-commerce that have no physical counterpart or applying discriminatory sales taxes on Internet commerce that do not apply to, say, catalog sales.

Even if state and local governments could tax e-commerce, a system of tax reporting and collection would have to be developed that made the process cost-effective and easy to use in order to prevent widespread tax evasion. Currently there are more than 6,400 different state and local taxing jurisdictions in the United States. Sellers would have to know at the time an order was placed what the state and local sales tax rate, if applicable, is for the buyers locality. Several databases are being developed that contain tax rate information for every ZIP code in the United States. Based on the buyer's shipping address, which creates further problems if this is different from their place of residence, the software will automatically compute the applicable tax that is due. Sellers could then electronically remit the tax revenue to the state's treasury.

The rule of nexus and the current inability of state governments to collect use taxes are primary obstacles to imposing and collecting tax revenue from e-commerce. Other problems include the Internet Tax Freedom Act and technological considerations regarding

tax collecting in an electronic environment. To overcome the nexus and use tax problems, many states including Kansas belong to multistate committees whose goal is to solve the nexus and use tax problem. In addition, the Kansas Senate recently passed Senate Bill 560 to allow discussion of a streamlined sales tax collection process, which considers nexus, and use tax problems associated with mail order and e-commerce. This senate bill, along with various multistate committees, discusses plans to inform consumers of the use tax law and forward requests to out-of-state businesses to remit voluntarily Kansas sales tax. With voluntary remittance of Kansas sales tax revenues by remote sellers and informing consumers of the use tax law, officials in Kansas think they have taken the first steps toward solving several problems associated with taxing electronic commerce.

Mail order vs. Electronic Commerce - What is The Difference?

The nexus problem applies to mail order as well as electronic commerce. Regardless of how the remote purchase is made, a phone-call to a 1-800 number listed in a catalog or a sale placed over the Internet, the rule of nexus applies equally to mail order as well as electronic commerce.

If nexus has been a problem for mail order sales tax collections, why are states so concerned with nexus now? Although mail order has been popular for decades and states have always been concerned with revenue losses from mail order sales, the dramatic increase in electronic commerce has states fearing the revenue loss will be significant. States' fears may be justified when one looks at the history of mail order sales and electronic commerce. Mail order sales amounted to \$55 billion in 1998 (U.S. Census Bureau), historically increasing a few percentage point annually.

Electronic commerce, while still in its infancy, has grown exponentially since its birth several years ago. Annual increases of 70 to 80 percent a year are common. If the growth in electronic commerce continues, on-line consumer retail sales will dwarf mail order sales. States fear that if electronic commerce and Internet technology becomes too large and complex, it will become too difficult and costly for states to impose sales taxes on remote electronic sales.

Revenue Losses to Local Governments and Retailers

The greatest concern of local governments and retailers is revenue loss from electronic commerce. Local retailers fear that residents will replace main street with the Internet, and local governments fear this substitution will cause dramatic reductions in sales tax revenues. One recent study has attempted to quantify the revenue losses to local retailers using national consumer survey data gathered by Forrester Research.² This study found no statistically significant evidence that e-commerce is pulling sales away from local retailers. The results using national data do not imply that certain states, localities, or business may be significantly impacted by electronic commerce.

Another recent study estimates sales tax revenue losses from electronic commerce for each of the 50 states to the year 2003.³ On average, nearly 3 percent of state tax revenues are projected to be lost to electronic commerce in 2003. The estimate for Kansas was 2.85 percent, implying a tax revenue loss to electronic commerce totaling \$113 million using current levels of total tax revenue.

These studies suggest that officials should keep several important factors in mind when estimating potential revenue losses. Currently, officials follow a simple procedure to estimate the sales tax revenue losses due to electronic commerce. They first assume that their given county or state accounts for a certain percentage of electronic retail sales in the United States, say 1 percent in the case of a state, to arrive at a dollar amount for electronic commerce. The sales tax loss is then found by multiplying the dollar amount of electronic commerce by the sales tax rate. This final number is the estimated sales tax loss due to electronic commerce. Following this procedure, the National Governors Association has estimated that, given a \$300 billion projected level of e-commerce by 2002 (both consumer and business commerce), state and local governments will lose up to \$20 billion in tax revenues.

² Goolsbee, Austan and Jonathan Zittrain. "Evaluating the Costs and Benefits of Taxing Internet Commerce." *National Tax Journal*, vol. 52, no. 3 (September 1999): 413-428.

³ Bruce, Donald and William F. Fox. "E-Commerce in the Context of Declining State Sales Tax Bases." Center for Business and Economic Research, The University of Tennessee, February 2000.

This technique tends to overstate the revenue losses to retailers and local governments for several reasons. First, most business to business purchases are tax-exempt, so a substitution to on-line business purchases will not result in a tax revenue loss because the purchases were not taxed initially. Second, this analysis assumes that all retail sales purchased on-line could have been purchased locally. If a consumer buys a product over the Internet that was not available locally, then local governments and retailers are not losing any revenue. However, in this case it is often perceived that state and local governments are losing revenue to on-line purchases. The fact is that these entities are *not gaining additional revenue* rather than losing revenue. There is no revenue loss because the product would not have been purchased locally anyway. This is a key distinction that is often missed in policy debates regarding the taxation of e-commerce.

Similarly, the type of products purchased via the Internet also should be considered when estimating revenue losses. This data is only available at the national level. Nevertheless, according to a 1998 survey by the Boston Consulting Group (BCG), roughly 15 percent of on-line purchases involve food products. For those states that exempt food from the sales tax, these states would not suffer a revenue loss from on-line food purchases because the food would not be taxed if it were bought locally. BCG also found that financial and travel services accounted for roughly 40 percent of on-line sales. These categories do not result in revenue losses for states because, as in the case of food, no sales tax applies.

According to BCG, computers and computer products account for nearly 25 percent of on-line purchases. Many computer sellers on-line already pay sales tax because they have nexus due to the presence of in-state repair services or shipping warehouses. In addition, BCG estimates that a large portion of computer buyers who now purchase via the Internet used to purchase computers via mail-order. If electronic commerce is a substitute for mail-order, there is still no revenue loss to local governments because the mail order purchase is not taxable.

Considering the type of products purchased on-line and their local availability, a re-estimation of the National Governors Association forecasted revenue loss reveals that state governments will lose roughly \$157 million in sales tax revenues.⁴ Clearly if one

considers the types of products purchased and their local availability the estimated losses from electronic commerce are much lower (\$20 billion vs. \$157 million). This suggests that state officials should be aware that estimates of revenue losses obtained by a simply multiplication of retail losses and tax rates can lead to a significant overestimation of sales tax revenue losses.

E-commerce could possibly affect non-sales tax revenue sources. For example, if a produce is purchased on-line that is available locally but is exempt from the sales tax, there can still be a tax loss to state and local governments through property taxes (loss of establishments) and income taxes (fewer employees or employees with lower incomes) if consumers substitute from local commerce to electronic commerce. Conversely, those local businesses that also sell their products on-line to local or national consumers will have higher business incomes, thus increasing business tax revenues to local governments. Thus, e-commerce can positively or negatively impact local businesses and governments through other tax sources besides the sales tax. These factors along with the types of products being purchased on-line should be taken into account by government officials when estimating any possible revenue losses due to electronic commerce.

Summary

The rise of electronic commerce has received the attention of local governments and retailers. Given the current tax-free status of on-line purchases, local governments and retailers fear a decrease in revenues from traditional retail sales. Although the idea of taxing e-commerce has its proponents and opponents, many state and local governments have begun to look at the myriad of issues surrounding taxation in an electronic environment. The problem of nexus and the inability to enforce use tax laws currently limit state and local governments' abilities to tax e-commerce. The Internet Tax Freedom Act also prevents any new taxes on e-commerce, at least in the short run.

While many state and local governments have begun estimating sales tax losses, the most common technique used can often overstate revenue losses because it does not consider the types of products being purchased and their local availability. These estimates also rely on national data on consumers' buying habits and assume national patterns hold true at the state and local level as well. There is currently no state or local level data on

⁴See note 1.

consumers' on-line and local retail shopping behavior. State and local governments could sponsor and conduct detailed surveys of consumers' buying behavior in order to assess the impacts of e-commerce on local retailers and governments accurately.

Regardless of the magnitude of any possible revenue losses, many states including Kansas have passed legislation and joined multistate committees to discuss strategies regarding the taxation of electronic commerce. Officials hope that an early response to the problem of taxing e-commerce will provide a solution before e-commerce and Internet technology become so large that imposing a system of taxation would be impossible. Whether state and local governments will actually tax electronic commerce in the near future remains to be seen.

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