SALES TAX AND E-COMMERCE IN THE UNITED STATES

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The purchase of goods and services through the net poses great challenges to jurisdictions willing to tax them.

The Internet makes harder for the Fiscal Administration to determine the location of buyers and sellers. Even though agents can be located, companies can move to low-tax jurisdictions from where they can provide their services. Electronic money renders transactions much more difficult to trace and prevents the taxman to use banks and other middlemen that usually collaborate with the Administration in enforcing tax laws.\(^1\) If the indirect taxation of traded physical goods across borders is complicated, the taxation of electronically downloadable products is even more problematic.

In the case of the US, foreign tax competition on sales tax does not pose such a threat, since interstate e-commerce is, in practice, not in theory, basically exempt.

The Current Regulation of the Sales Tax on Interstate E-Commerce Transactions

The applicable legal principles regarding e-commerce taxation were inherited from mail-order taxation. Two Supreme Court rulings on tax disputes involving mail-order companies shipping goods to other states have configured the regulation of interstate e-commerce taxation. In 1967, the Court ruled that “states could not require an out-of-state company to collect a sales tax on goods coming into the state unless the company had a physical presence or “nexus” within that state”. This decision was reaffirmed by the Court in 1992, in the famous Quill Corp. (a big catalogue seller) v. North Dakota case. The Supreme Court’s argument used in the 1967 case was that it was too burdensome for the out-of-state seller to discover what tax the customer should pay.\(^2\)

Some States have introduced a “use tax” that obliges residents that have bought goods outside their State of residence to pay an equivalent amount to what the sales tax would have been. However, this tax is almost impossible to enforce and relies on the “good faith” of the taxpayer (except for specific goods, such as automobiles, that must be registered), that most of the times, ignores his duty to file this tax. In fact, “America’s so-called “tax-free e-commerce” really amounts to mass tax evasion”.\(^3\) This difficulties

\(^1\) The Economist, *Taxes slip through the Net*, May 29th 1997
\(^2\) The Economist, *The end of taxes?*, Sep 21st 2000
\(^3\) The Economist, *The happy e-shopper*, Jan 27th 2000
have lead to some States (such as New York), to approve use tax charts that can be employed by the taxpayers to estimate the use tax owed according to their federal adjusted gross income. This non-enforceable tax, sometimes awkwardly filed at the same time as the income tax (like in the case of New York), seems to be a desperate effort of some States to not to lose revenue from inter-state electronic transactions.

Even though the Supreme Court ruling prevents States from requiring an out-of-state company to collect sales tax unless they have a nexus within the state, some states have tried to promote “voluntary” collections from the out-of-state sellers. However, the studies⁴ do not seem to support the idea that online vendors will voluntarily collect sales taxes for states out of the one of their residence basically due to the lack of incentives and to the high compliance costs they face.

**The Need for Reforms**

Some authors⁵ have suggested in the past a moratorium on enforcement of Internet sales taxes in the short run, on the grounds “that the costs of maintaining the status quo are small and the benefits of nurturing the Internet seem to be somewhat concentrated in the short run”. In 1998, the revenue loss was estimated to be 0.05 percent of total tax revenue, a not too alarming figure. However, at the rapid pace online sales have been expanding, the problem has become increasingly worrying.

On the other hand, the longer the state of the art is prolonged, the more accustomed consumers get to buy online without paying taxes. In the future, politicians could face strong opposition to change the status quo. The ex-governor of Utah, Michael Leavitt, put it this way: “We may have only two more Christmas shopping seasons before it is too late”.⁶

A taxation system should try to be neutral, this is, distort the consumer’s decisions as little as possible, minimizing efficiency losses. In this sense, economic theory suggests that homogeneous goods should be taxed equally. However, some authors⁷ have suggested that “if the price elasticities of Internet customers and retail customers are very different it may actually be efficient to allow those with high elasticities to have lower rates. … [T]he least distortive tax would be the one with high rates on those people who would not change their behavior. Thus, relatively low tax rates on electronic commerce may be desirable since empirical evidence suggests that those individuals who avoid tax by purchasing goods over the Internet tend to be highly price responsive”.

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Nevertheless, a study\textsuperscript{8} that looked at the desirability of preferential taxation of electronic commerce from the optimal taxation perspective concluded that uniform tax treatment of traditional and electronic commerce is more desirable than tax preferential taxation of electronic commerce. The study concluded that zero tax rates for e-commerce were far away from optimal and that optimal tax rates tended to cluster around the rate applied to traditional commerce. The main cause for optimal moderate preferential treatment of sales over the Internet was high administrative and compliance costs. However, the study states that the uniform taxation solution should not be overridden by optimal taxation concerns, especially if technological advances or simplification of the tax such as the one proposed under the Streamlined Sales Tax Project are able to reduce administrative and compliance costs with the e-commerce sales tax.

Therefore, on the grounds of efficiency, there is a clear need to reform the current system in order to implement a uniform taxation of goods sold over traditional channels and through the internet.

A taxation system also has to be fair. Although the concept of “fairness” implies normative judgments, there is a basic consensus over two notions of equity. Horizontal equity means that taxpayers that have the same condition should be treated equally, while vertical equity means that taxpayers that have different ability to pay should be treated differently (and most people agree that the taxpayers better off should pay more taxes than the taxpayers that have less ability to pay).

In this sense, almost all the studies\textsuperscript{9} conducted have criticized the exemption of e-commerce from the equity perspective. Since online purchasers are far more wealthier than people that do not have internet access, not taxing online purchases is considered by most authors a regressive policy, even though, its regressiveness is acknowledged to be declining over time, since the number of Internet adopters is accelerating dramatically.

Therefore, from the equity perspective, a need for reform is also required to tax uniformly traditional and electronic commerce.

A tax system should also be easy and economical to administer. This is, it should minimize the cost of compliance to the taxpayer and the cost of collection for the fiscal administration. The more complicated a tax is, the more compliance costs impose on the taxpayers, and the more likely they are to evade the tax. On the other hand, the more complicated a tax system is, the higher cost of collection for the administration, and the more difficult is to enforce the tax.


Many research projects have highlighted the high compliance cost that would imply for an online seller to determine, collect and send the tax to the state of residence of the buyer. Cornia, Sjoquist and Walters (2004) estimate the firms’ compliance cost in a 3 percent and calculate double that amount for vendors operating in multiple taxing jurisdictions. This is due in part to the great number of different sales tax across the country. As the Supreme Court noted in Quill, while there may be only 45 states with sales taxes, there are more than 6,000 state and local jurisdictions with such taxes, with heterogeneous tax bases and rates.

Even though vendors could benefit from technological advances to ease their compliance burden, allowing monitoring sales made by remote vendors, identifying the taxability of the products purchased as well as the point of purchase or location of the buyers, some concerns on customer privacy have been raised, since the Administration could have access to a record of the purchases a customer made.

Enforcing a sales tax by a State on an out-of-state company is illegal, according to the Supreme Court, and, as we have seen, enforcement of the parallel use tax is so difficult that relies on the voluntary payment of the buyer, that often ignores his duty.

Therefore, also from the perspective of easiness and inexpensive administration, reforms of this tax are also needed.

**First Steps towards a Reform**

States facing a revenue loss initially reacted by establishing taxes on internet access, which led to the enactment of the 1998 Internet Tax Freedom Act, a law that prevents federal, state and local governments from taxing Internet access and interdicts other types of taxes over the Internet such as email taxes, bit taxes and bandwidth taxes. It has been thrice extended by the United States Congress since its original enactment. The most recent extension was in 2007 and extended the moratorium until 2014.

Due to the high compliance costs the sellers would have to face if they voluntarily collected the sales tax for the state of destiny of the merchandise, several states have initiated efforts to simplify their sales and use taxes, creating the Streamlined Sales Tax Project (SSTP) in the year 2000. Some scholars have also backed up the need for this coordination among states.

Enough states clustered around this agreement would make Congress pass a legislation that allowed the seller to collect the tax for the state where consumption is made. Since studies prove that is not likely that firms will voluntarily collect the tax (if it could be

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possibly called that, since a tax that cannot be enforced resembles more a donation to the public administration than a tax), this legislation seems the only way to carry out collections from out-of-state companies.

From every perspective there is a need to accomplish deep reforms on the sales and use tax in the state and local jurisdictions.

Different proposals were forwarded in 1999 to the Advisory Commission on Electronic Commerce, set up by Congress under the 1998 Internet Tax Freedom Act: Congressman John Kasich advocated no taxation of anything sold online, Mc Lure, of the Hoover Institution, stood up for a tax to be levied on household consumption of all goods and services, whether sold online or offline, in or out of a state, Michael Leavitt, the ex-governor of Utah, proposed a voluntary scheme that would both simplify the system and pass responsibility for tax collection to a “trusted third party”, such as a credit-card firm.14

However, after the submission of the report by the Advisory Commission, Congress has not taken any significant step towards a reform of the sales and use taxes. In this sense, Hellerstein (1997)15 proposes that Congress should legislate in order to allow the seller to collect the tax for the state where consumption is made.

The Design of a More Efficient, Equitable and Cheap Indirect Taxation System

As commented above, from an efficiency perspective, goods sold online and the ones sold through traditional channels should be taxed homogeneously. The equity principle also advocates for this homogeneous taxation.

The easy and economical to administer taxation principle suggests that there should be a certain harmonization among jurisdictions, that should apply a common tax base, exemptions and definition of taxpayers.

Also, goods should be homogeneously taxed according to either an origin or a destination principle. In this sense, in my opinion, the origin principle should be implemented, on the grounds that it is far easier to apply by the taxpayers (since they only have to worry about applying a single tax rate and declare the tax to a single administration) and the states could enforce it in a more efficient way.

The problem with the origin principle, that was also the one chosen by the EU in the VAT 6th Directive to be applied to the intracomunitarian transactions, is that it raises political concerns about resources flowing from low-income jurisdictions to far richer states that usually have greater export sectors. For this reason, even though the 6th VAT Directive establishes a transitional phase that will ease the evolution to the definitive

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14 The Economist, The happy e-shopper, Jan 27th 2000
application of the principle of origin, *de facto*, the principle of destination is the common rule when the buyer is not a final consumer. However, when the buyer is a final consumer, the difficulties to enforce the tax across borders made the EU to adopt an origin principle. A final consumer in Italy buying a book from a German bookstore would have to pay German VAT.

A second problem would be that the principle of origin would fit with difficulty in the US fiscal system. In my opinion, although is not the one of a Constitutional expert, Congress could enact a law that established the origin principle under the Commerce Clause. However, it is true that nobody is currently contemplating the possibility of levying such a tax, a *rara avis* in the US fiscal tradition.

Enforcement of a tax based on a destination principle, however, faces great challenges. It is doubtful that states out of the residence of the company would be able to carry out audits across their border. Even if this was possible, fifty examination procedures, one for every state a company sold to, would pose a far too big burden to taxpayers. The state of residence could also examine every other state’s revenues. However, even though technology would be able to ease the taxpayers’ compliance costs as we have seen before, it is uncertain that it would relieve the examination ones. This is, technology could allow the taxpayer to know the tax base, rate and exceptions to apply to every consumer located across the country, but then the fiscal administration should have the tools to verify that what the taxpayer had declared is true, and the task of examining sales to fifty jurisdictions is not an easy one.

The enforcement issue is a key one to address efficiency and equity concerns. The use tax lesson shows us that a generalized tax evasion has similar economic consequences to a tax exemption. Therefore, whatever the implemented tax is, it is essential that it is enforceable.

Even though some efforts have been made, states are still far away from an agreement on a country-wide harmonized system, especially taking into account that states such as Alaska, Delaware, Montana, New Hampshire and Oregon, do not levy a sales tax.

Therefore, the need for Congress to legislate the matter under the Commerce Clause seems unavoidable if a good indirect taxation system is to be implemented in the US. If an origin principle is not considered suitable for the US fiscal system, Congress should legislate according to the previously mentioned Hellerstein’s proposal, allowing the seller to collect the tax for the state where consumption is made, making sure that states have all the necessary enforcement tools.

Whether Congress will accomplish such a task, at least in the short term, seems unclear, since such a reform would be perceived as a tax increase. Also, unless enough states support this legislation, Congress would have very little incentive to force states to levy such a tax, especially when they are the ones that are losing revenue.