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E-Commerce: Recent Developments in State Taxation of Online Sales

Joyce Beebe, Ph.D., Fellow in Public Finance

Online retail giant Amazon recently announced that it would voluntarily start collecting sales taxes in four additional states—Hawaii, Idaho, Maine, and New Mexico—making the company a nationwide state sales tax collector.¹ This marks the culmination of an interesting evolution of company policy, because until recently, Amazon was one of the fiercest opponents of online sales tax.² Some observers have suggested that this signifies a change in Amazon's business model over the last few years. Its early success was partly attributable to keeping online purchases tax free; however, in recent years, Amazon has distinguished itself by offering faster and expedited deliveries through services such as Amazon Prime and Amazon Prime Air. A 2015 estimate shows that, on average, Amazon Prime shoppers spent about \$700 more per year than non-Prime shoppers.³

WHAT EXACTLY IS E-COMMERCE AND HOW LARGE IS ITS SIZE TODAY?

There are numerous online merchants like Amazon in today's rapidly developing digital economy. According to a recent publication by the Organisation for Economic Co-operation and Development (OECD), the digital economy is increasingly becoming fully integrated into the world economy; it would be difficult, if not impossible, to ring-fence the digital economy from the rest of the economy for tax purposes. Among several types of business models

identified by OECD, e-commerce is defined broadly as "the sale or purchase of goods or services, conducted over computer networks by methods specifically designed for the purpose of receiving or placing orders."⁴ If further segregating it by sales channels, there are business-to-business (B2B), business-to-consumer (B2C), and consumer-to-consumer (C2C) models of e-commerce. Despite the public's familiarity with B2C or C2C models, B2B is the largest among the three in terms of total sales.

Widespread access to the internet contributes significantly to the growth of e-commerce. Other factors, such as the development of technically sophisticated online platforms and the proliferation of mobile devices, further enhance buyers' online purchasing experiences.⁵ According to the U.S. Census Bureau, e-commerce sales have been growing at a rapid rate over the last decade. The 2015 sales were estimated to be \$6.6 trillion in the manufacturing, wholesale, retail, and service sectors, among which the retail sector sales were \$340 billion.⁶ E-commerce has expanded rapidly both in terms of transaction volume and sales amount.⁷

THE STATES NEED REVENUE

Sales Tax

The sales tax is an important source of revenue at the state level.⁸ Although its importance varies by state, in aggregate, sales tax has been the second-largest source



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of state tax revenue, only after the personal income tax. In 2016, sales tax accounted for 31 percent of total state tax revenue, whereas personal income tax accounted for 37 percent of total revenue. In states where there is no personal income tax, the sales tax is more prominent: in Texas and Florida, sales tax represented 62 percent and 57 percent of state tax revenues in 2016, respectively.⁹

Over the last four decades, the aggregate sales tax base across all states has contracted, creating financial issues for states that rely heavily on sales taxes. Some research¹⁰ has attributed this base reduction to several potential reasons: first, sales tax generally applies to tangible goods but to only a limited set of services. Second, both state policies exempting certain items such as food and clothing and occasional statewide tax holidays have also contributed to the base shrinkage. Finally, the growth of remote sales¹¹ and the limited extent to which they are taxed contributed to the erosion of the tax base.¹²

Use Tax

It is worth introducing sales tax's close cousin, use tax, before discussing recent legal developments. Every state that has enacted a sales tax simultaneously or subsequently enacted a corresponding use tax. When a buyer purchases taxable goods from a remote seller without paying sales tax because the seller does not have "nexus" within the state, the buyer is required to remit a use tax on taxable goods to the state of residence to put the purchase on equal footing with other in-state buyers who paid taxes. From a tax perspective, nexus generally refers to a sufficient level of connection between the taxing state and the taxpayer or third-party collection agent such that the state has the power to impose tax on the taxpayer or the collection agent. Use taxes shift the responsibilities for tax remittance from the seller to the buyer in cases where the tax is not collected by the seller. In other words, if use taxes are perfectly enforced at the correct sales tax rate, then use taxes paid by the consumer on remote sales will be equivalent to the sales taxes paid on the same purchase from

a local retail store. The use tax complements sales tax and serves as a backstop for the potential loss of tax revenue.

The issue is that this equivalence only happens in a perfect world—state and local use tax compliance is very weak, especially at the household or consumer level. Simply imagine that consumers have to report use taxes on tax returns for all purchases made from remote vendors, and it is probably not hard to understand why compliance is low. In certain studies, revenue collected from a use tax barely covers the costs of administering the tax.

Supreme Court: Physical Presence

Any discussion of online sales tax would not be complete without mentioning the *Quill* decision. In 1992, the U.S. Supreme Court ruling in *Quill Corp. vs. North Dakota*¹³ precluded states from imposing a sales tax collection obligation on remote retailers that do not have a physical presence in the state. In other words, nexus arises only when the vendor has a physical presence in a state. In addition to establishing the physical presence rule, the Supreme Court also noted that Congress has the power under the Commerce Clause of the U.S. Constitution to overrule this decision legislatively.

Many states view *Quill* as outdated and assert that it prevents them from collecting sales tax revenue from remote vendors, which leads to substantial revenue loss. According to a joint publication by the National Conference of State Legislatures (NCSL) and the International Council of Shopping Centers (ICSC), in collaboration with the University of Tennessee, states lost an estimated \$23.3 billion in uncollected sales and use tax revenue from all remote sales in 2012. For 2015, the potential revenue loss increased to \$29.6 billion. The study then considered Amazon's enhanced collection efforts in a larger number of states, and concluded that the uncollected sales and use tax would decline to approximately \$25.9 billion,¹⁴ which would account for about 9 percent of the 2015 state sales tax revenue.¹⁵ The potential amount of revenue injection, combined with Amazon's recent decision to voluntarily

collect sales tax nationwide, encouraged states to take additional actions to pursue these revenues.¹⁶

FEDERAL LEGAL DEVELOPMENTS

What has Congress done to resolve the *Quill* issue? In short, not much, but not for lack of trying. A raft of competing remote sales tax proposals was introduced in Congress over the last few years; some were even introduced multiple times. A short summary is presented below:

The **Marketplace Fairness Act** (MFA, most recently reintroduced in April 2017¹⁷) and the **Remote Transactions Parity Act** (RTPA, reintroduced in April 2017¹⁸) differ in the details but are similar in nature. Both bills would allow states to tax sales by remote sellers if the states are members of the Streamlined Sales and Use Tax Agreement (SSUTA),¹⁹ or meet certain requirements that simplify the compliance process. Both proposed bills provide exemptions to small remote sellers and require destination-based sourcing, which means the tax rate is calculated based on the location of the buyer.

The **No Regulation Without Representation Act** was introduced in July 2016. As the name suggests, this legislation would prevent states from taxing sellers lacking a physical presence, essentially codifying *Quill*. This legislation would specifically establish thresholds for *de minimis* physical presence, where “physical presence” does not include referral agreements, presence for less than 15 days in a taxable year, product delivery in-state by a third party, or internet advertising services not exclusively directed toward or exclusively soliciting in-state customers.²⁰

Finally, a discussion draft, the **Online Sales Simplification Act** (OSSA) specifies a hybrid origin-based system that calculates the taxation of remote purchases based on the seller’s location, but at the tax rate of the consumer’s location. In other words, the seller’s location would determine if a tax would be collected by that state, but the tax rate would be calculated based on the buyer’s location. The states would have to participate in a state clearinghouse that would determine

a single statewide rate to be applied by a remote seller on purchases sent to that state.

STATES TAKE MATTERS IN THEIR OWN HANDS

States have been active while waiting for a congressional solution, and, not surprisingly, moving toward greater taxation of e-commerce. Generally, these approaches include redefining the nexus and imposing comprehensive notice and reporting requirements.

“Kill *Quill*”—Nexus Redefined

Over the last few years, states have launched numerous administrative procedures or enacted legislation in hopes of creating an appropriate case for the U.S. Supreme Court to review and overturn *Quill*. Because the Supreme Court did not specifically define physical presence, most online merchants, including Amazon in the company’s early years, interpret “physical presence” loosely as a fixed place of business, comparable to brick-and-mortar stores. Therefore, *Quill* is the strongest legal defense cited by opponents of expanded online sales taxation. Several states, maneuvering between pushing the boundaries of the physical presence rule and trying to assert their taxation rights, have created expanded interpretations of nexus—click through nexus, economic nexus, and affiliate nexus.

Click through nexus generally means the use of online referrals or links by an in-state resident to redirect customers to the remote seller’s website. In 2008, New York State enacted a “click through nexus” provision, specifying that if a seller enters into a commission agreement with a New York State resident for referring customers to the remote seller via a link on the resident’s website, the seller has created a taxable presence in New York. The remote seller is therefore required to collect and remit sales taxes for sales to New York State customers. This was challenged by two major online retailers and eventually ended with the U.S. Supreme Court denying the merchants’

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petition to review New York State Court of Appeals' decision in 2013, upholding the state's click through nexus statute.

Inspired by the New York State provision, Illinois enacted its own click through nexus statute in 2011 and was challenged by an online marketing and advertising operator, Performance Marketing Association (PMA), in 2013. The Illinois Supreme Court did not directly address the U.S. Commerce Clause argument made by PMA and instead ruled based on federal law, declaring that certain clauses may be discriminatory against e-commerce for violating the Internet Tax Freedom Act (ITFA). The State of Illinois subsequently redrafted the statute by expanding the prior version to include referrals made not only through websites, but also through print publishers and broadcasters.²¹ The click through nexus has been in Illinois law since the correction was made.²²

*Affiliate nexus*²³ was introduced by Louisiana in 2016 to expand the definition of dealers subject to sales and use taxes. Under this law, "dealer" includes any person who sells similar products as a Louisiana retailer under a similar name and similar intellectual property, solicits business through an agent with a Louisiana nexus, holds a substantial ownership interest (over 5 percent) in a Louisiana retailer, or is more than 5 percent owned by a Louisiana retailer.

Economic nexus is viewed as a more direct contradiction of the physical presence rule in *Quill* than the other expanded interpretations of nexus, and the two major economic nexus cases in Alabama and South Dakota are still pending in court. State and local tax practitioners anticipate that one of these two might be a suitable case for U.S. Supreme Court review.

Alabama adopted economic nexus rules in 2015. In essence, if a retailer sells more than \$250,000 of tangible goods to Alabama customers and conducts certain additional activities in the state, such as having a franchisee or licensee operating under the seller's name or soliciting orders through TV advertisements under contract with an in-state cable TV operator,²⁴ an economic

nexus is established and the remote seller needs to collect and remit tax to the Alabama Department of Revenue. As expected, an online retailer challenged the law, claiming the law violates the physical presence standard set by *Quill*.²⁵ However, the case is unlikely to go to trial until fall 2017.

South Dakota adopted a similar statute, specifying that an online retailer with a sales threshold of more than \$100,000 per year or over 200 transactions essentially created an economic nexus even if there is no physical presence.²⁶ This case is currently awaiting review by the state's Supreme Court, and it is highly anticipated that the losing party will seek U.S. Supreme Court review.

Notice and Reporting Requirements

Colorado led the trend in developing comprehensive reporting and disclosure requirements. Under state rules enacted in 2010, remote sellers with gross sales of over \$100,000 must either voluntarily collect and remit sales tax on sales to Colorado taxpayers or file a comprehensive report on sales to Colorado taxpayers with the Colorado Department of Revenue. This report needs to show the total dollar amount of a buyer's purchases along with other information, including shipping and billing addresses. In addition, remote sellers also need to notify Colorado buyers that they may have duties to pay use taxes on their purchases, and the sellers also must send annual purchase summaries to Colorado buyers.

In 2012, Direct Marketing Association (DMA²⁷) challenged the Colorado law and, after the U.S. Supreme Court decided not to review an appeal filed by DMA, the U.S. Tenth Circuit Court of Appeals held that Colorado's law did not violate the Commerce Clause of the U.S. Constitution. The Tenth Circuit pointed out that *Quill's* standard does not apply in its ruling since the reporting rules do not require the collection of taxes.

In response to the growing number of states with reporting requirements,²⁸ the Multistate Tax Commission's (MTC) use tax information reporting work group is researching certain relevant issues and plans to develop a model sales and use tax notice and reporting statute. For example, it is not

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immediately clear for online marketplaces like eBay whether the third party vendors or the marketplace providers should bear the reporting responsibility. In addition, the work group is considering expanding the scope of reporting to include short-term rentals such as Airbnb.²⁹

Despite the proactive approaches developed by states, certain states' attempts to advance their online sales tax bills in 2017 failed to gain sufficient support from either lawmakers or the governor: New York,³⁰ Minnesota (House File 4, vetoed by Governor Mark Dayton in May 2017), Texas (S.B. 1713),³¹ Tennessee (H.B. 261), New Mexico (H.B. 2), Mississippi (H.B. 480), and Utah (S.B. 83).

SHOULD WE TAX E-COMMERCE JUST LIKE OTHER SALES?

The economic literature examining sales taxation of online purchases generally finds two key factors to consider: behavioral responses and compliance costs.³²

Several studies find large behavioral responses to sales tax on online transactions. In other words, people who avoid taxes by making purchases online are highly price sensitive.³³ In addition, there is evidence showing that if online transactions are taxed just like local sales, people will move away from these online purchases, and the magnitude of their behavioral change might be bigger than if they faced the same amount of tax increase on in-store purchases. Larger behavioral changes entail higher efficiency costs to the economy. Because taxes on e-commerce have a greater distortionary effect than taxes on in-store sales, a lower tax on e-commerce is justified to ensure equi-proportionate changes, which is more desirable from an efficiency perspective.

From a compliance costs perspective, these tax collection requirements essentially impose additional costs on buyers and sellers and therefore induce behavioral changes. To avoid sales tax responsibilities, sellers could engage in entity isolation and avoid creating any nexus in certain states, and buyers could disguise their locations by having items delivered to a low-tax state instead of in their state of residence.

Indeed, some research has shown that uniform tax treatment between online and traditional sales is more desirable if the administrative and compliance costs are low. The research also finds that a significant preferential tax or exemption for online sales is unlikely to be desirable.³⁴ This highlights the importance of compliance costs for e-commerce—to gain wider acceptance of online sales tax, it is critical to ensure that compliance costs are maintained at a reasonable level.

Technology improvements, such as advances in tax compliance software, would ease the compliance burdens, and the two federal proposals (MFA and RTPA) did require states to provide taxpayers with compliance software so they can comply with the law.

Compliance Costs: Empirical Evidence

Online merchants' biggest challenge against e-commerce taxation is the compliance costs. There are not a lot of studies that estimate the exact dollar amount of these costs. However, existing studies generally indicate that, as a percentage of taxes collected, smaller firms incur a heavier burden than their larger counterparts.

A 2007 study of sales tax compliance costs indicated that these costs did not increase significantly with the number of nexus states.³⁵ Compliance costs are about 3 percent of taxes collected on average,³⁶ but they are not evenly distributed across firms of different sizes—the sales tax compliance costs were 13.5 percent of taxes collected for small retailers, 5.2 percent for median retailers, and 2.2 percent for large retailers. These numbers translate to 0.82 percent, 0.32 percent, and 0.13 percent of taxable sales for small, median, and large retailers, respectively. In other words, the compliance costs will represent a larger share of profits for smaller sized firms.³⁷

WHAT IS NEXT?

All four parties—states, the U.S. Supreme Court, Congress, and merchants—involved in the online sales tax discussion have large interests at stake: many states continue to face budget shortfalls, and the fiscal

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reality prompts these states to target online sales tax to meet revenue needs. The U.S. Supreme Court has previously indicated the potential need to revisit *Quill*. However, it has turned down multiple cases in part to avoid legislating from the bench. Congress has the power to resolve the issue, and some states hope that Congress will mandate a solution to end this prolonged legal battle. Finally, the merchants, both online and traditional ones, have distinct positions on this issue. What could happen next, and what are the consequences?

One possibility is that Congress may reach an agreement before any case reaches the U.S. Supreme Court. Any congressional agreement that would grant states the authority to tax remote sales would also involve simplifications in state sales tax systems and enhanced coordination across states, which would alleviate compliance burdens. However, Congress has many other major proposals on its plate, such as an overhaul of the tax code and a repeal and replacement of the Affordable Care Act, which may prevent any online sales tax agreement from being formulated in 2017.

Another possibility is that the U.S. Supreme Court accepts a case for review and ultimately makes a decision modifying *Quill*. However, if the Supreme Court simply rules that *Quill* is unconstitutional, it still is not immediately clear how online retailers are going to be taxed and whether Congress is going to take action at that point. On the other hand, if the Court upholds *Quill*, states may continue to pursue other creative extensions of the sales tax nexus, or impose reporting requirements as in the Colorado law.

Before any resolution is reached, one thing is certain. States will either continue to push for the ability to tax remote sellers, mandate that non-collecting remote vendors report buyers' purchases to the states, encourage online merchants to voluntarily collect and remit sales taxes to the states, or even start asking the third party merchants who use other sellers' online marketplace platforms to pay sales taxes. Some will be successful, while others will keep state courts busy.

ENDNOTES

1. Darla Mercado, "The holiday is over: Amazon will collect sales taxes nationwide on April 1," *CNBC*, March 24, 2017, <http://www.cnbc.com/2017/03/24/the-holiday-is-over-amazon-will-collect-sales-taxes-nationwide-on-april-1.html>. "Nationwide" refers to the 45 states where there is a state sales tax. Amazon will also collect sales taxes in the District of Columbia and Alaska. Alaska does not have statewide sales tax, but its cities have municipal sales taxes that Amazon will collect.

2. Chris Isidore, "Amazon to start collecting state sales taxes everywhere," *CNN*, March 29, 2017. <http://money.cnn.com/2017/03/29/technology/amazon-sales-tax/index.html>.

3. Jonathan Hadad, "E-commerce & Online Auctions in the U.S.," *IBISWorld Industry Report 45411a*, IBISWorld, April 2017.

4. Organisation for Economic Co-operation and Development, *Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project (Paris: OECD Publishing). The business models identified by this publication include e-commerce, online payment services, app stores, online advertising, cloud computing, high frequency trading, and participative network platforms. We focus our discussion on e-commerce in this brief.

5. IBISWorld, "E-commerce sales," *IBISWorld Business Environment Report*, IBISWorld, May 2016.

6. U.S. Census Bureau, *E-Stats 2015: Measuring the Electronic Economy* (Suitland, MD: U.S. Census Bureau), May 24, 2017. <https://www.census.gov/content/dam/Census/library/publications/2017/econ/e15-estats.pdf>.

7. An industry analysis reported that the e-commerce and online auction industry is expected to generate \$394 billion in revenue in the United States in 2017. See Jonathan Hadad, "E-commerce & Online Auctions in the U.S."

8. Many local governments also rely heavily on general sales tax as a major revenue source. However, because their

taxing authority generally comes from the state, we focus our discussion on the state level in this brief.

9. Lucy Dadayan and Donald Boyd, *State Revenue Report #106* (New York: The Nelson A. Rockefeller Institute of Government), March 2017, http://www.rockinst.org/pdf/government_finance/state_revenue_report/2017-03-09-srr_106.pdf.

10. See, for example, David Agrawal and William Fox, “Sales Tax in an E-commerce Generation,” *International Tax and Public Finance* (September 2016): 1–24. doi:10.1007/s10797-016-9422-3; William Fox, “Sales and Excise Taxes,” in *Oxford Handbook on State and Local Finance*, eds. Robert Ebel and John E. Peterson (Oxford University Press: New York, 2012); and Michele E. Hendrix and George Zodrow, “Sales Taxation of Services: an Economic Perspective,” *Florida State University Law Review* 30 (Spring 2003): 411–433.

11. Remote sales generally include e-commerce (online) and mail order (catalogue) sales, and e-commerce sales are more than twice as large as the mail order sales.

12. Agrawal and Fox, “Sales Tax in an E-commerce Generation.”

13. *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992). Quill Corporation was acquired by Staples, Inc. in 1998 and has been one of Staples’ subsidiaries.

14. *Uncollected Sales and Use Tax from Remote Sales: Revised Figures (March 2017)* (Washington, D.C.: National Conference of State Legislatures; New York: International Council of Shopping Centers), http://www.efairness.org/files/Updated_Sales_Tax_Loss_Report.pdf.

15. Total sales tax revenue figure taken from: Lucy Dadayan and Donald Boyd, *State Revenue Report #106* (New York: The Nelson A. Rockefeller Institute of Government, March 2017).

16. At the time this brief was being drafted, Amazon announced its acquisition of Whole Foods Market on June 16, 2017. Although the final corporate structure is unclear at this point, this may potentially create nexus for Amazon in more states.

17. The MFA, often referred to as the e-fairness law, was also introduced

in 2011, 2013, and 2015. See <http://marketplacefairness.org>.

18. The RTPA was first introduced in 2015.

19. SSUTA is a multi-state effort to simplify sales and use tax collection and administration by retailers and states. It encourages remote sellers to collect taxes on sales to customers living in the member states. A seller that registers under the Agreement must collect sales and use tax for all member states. For details, see <http://www.streamlinedsalestax.org/>.

20. Gale Cole, “Bill to fight online sales tax introduced in Congress,” *Avalara, Inc.*, July 18, 2016. <https://www.avalara.com/blog/2016/07/18/bill-to-fight-online-sales-tax-introduced-in-congress/>.

21. Pub. Act 098-1089.

22. For a detailed discussion about the timeline of the legal development of these cases, see Bill Cunningham, Mo Bell-Jacobs, Brian Kirkell, and Catahrin Del Re, *What is the deal with sales and use taxes on remote purchases?* (Chicago: RSM, LLP), July 28, 2016, <http://rsmus.com/what-we-do/services/tax/state-and-local-tax/sales-and-use-tax/whats-the-deal-with-sales-and-use-tax-on-remote-purchases.html>.

23. The distinction between click through nexus and affiliate nexus is not exactly consistent across different data sources. Some articles viewed click through nexus as part of a broadly defined affiliate nexus.

24. A detailed description is included in Alabama Code Title 40. Revenue and Taxation §40-23-68. <http://alisondb.legislature.state.al.us/alison/codeofalabama/1975/40-23-68.htm>.

25. *Newegg Inc. v. State of Alabama*, Department of Revenue, Alabama, Tax Trib., No. 16-613, status conference 4/20/17.

26. *South Dakota v. Wayfair, Inc.*, D.S.D., No. 3:16-CV-03019, 1/17/17.

27. DMA is now Data & Marketing Association, a trade organization for data-driven marketers.

28. Vermont, South Dakota, Oklahoma, Kentucky, Tennessee, and South Carolina have similar reporting requirements.

29. Multistate Tax Commission, Use Tax Information Reporting Work Group, <http://www.mtc.gov/Uniformity/Project-Teams/Model-SU-Notice-and-Reporting-Statute>.

30. Governor Andrew Cuomo proposed a measure that would require online marketplaces to collect sales taxes when they facilitate sales to New Yorkers from sellers in and outside of the state. This measure was opposed by the Senate.

31. In Texas, the Senate approved a modified version of the bill that originally intended capture the online sales, now requesting State Comptroller to study the sales and use tax compliance. This bill did not pass House before the end of the 85th legislative session.

32. Most literature did not distinguish between the local government's administrative costs and the companies' compliance costs; we generally refer to these costs as "compliance costs" in this brief.

33. Agrawal and Fox, "Sales tax in an e-commerce generation." For a complete list of studies reviewed by Agrawal and Fox, see page 5 of the study.

34. George Zodrow, "Optimal Commodity Taxation of Traditional and Electronic Commerce," *National Tax Journal* (2006) 59: 7-31.

35. PriceWaterhouseCoopers, "Retail Sales Tax Compliance Costs: A National Study," Joint Cost of Collection Study, June 1, 2007.

36. Donald Bruce and William F. Fox. *An Analysis of Internet Sales Taxation and the Small Seller Exception* (Washington, D.C.: Office the Advocacy, Small Business Administration), November 2013.

37. Smaller retailers are retailers with annual sales of more than \$150,000 but less than \$ 1 million, median retailers are retailers with annual sales of more than \$1 million but less than \$10 million, and large retailers are retailers with annual sales of over \$10 million. All data cited from the PwC study, which was based on 2003 information.

AUTHOR

Joyce Beebe, Ph.D., is a fellow in public finance at the Baker Institute. Her research focuses on tax reforms in the U.S. and computable general equilibrium modeling of the effects of tax reforms. Her other research interests include wealth accumulation over a person's lifetime and, generally, how public policies influence decision-making.

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