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Recommended Citation

Gamage, David; Thimmesch, Adam; and Shanske, Darien, "Consumer-Based Use Tax Enforcement and Taxpayer Compliance" (2017). *Articles by Maurer Faculty*. 2646.

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Consumer-Based Use Tax Enforcement And Taxpayer Compliance

**by Adam Thimmesch, David Gamage,
and Darien Shanske**

Reprinted from *State Tax Notes*, October 23, 2017, p. 319

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In this edition of *Academic Perspectives on SALT*, the authors present part 2 of their argument regarding consumer-based use tax enforcement by addressing issues such as the psychology around taxpayer compliance and taxpayer privacy concerns.

This article is the second in a series arguing for a modified approach to the state use tax — one in which states focus greater compliance efforts on consumers and their individual use tax obligations. Our prior article addressed the economic and rule-of-law considerations that

support that approach.¹ That article showed (1) that states will leave a significant amount of tax revenue uncollected if they focus their enforcement efforts primarily on vendors, and (2) that states' current enforcement postures threaten to undermine the reciprocal relationship between the governing and the governed that is the basis for our system of laws. This article continues the latter theme and focuses on that reciprocal relationship from a compliance angle.

Tax compliance is a function of many factors — from existing penalties and enforcement mechanisms to subjective feelings of fairness and internalized norms of conduct. The state use tax is not immune from those factors, nor are the effects of the use tax system confined to use tax compliance. This article explores those effects by discussing existing research on tax compliance and evaluating how inadequate enforcement of use taxes against consumers can undermine well-recognized motivators of tax compliance.

We will also explain in this article why the move by some states to adopt use tax notice and reporting statutes is strengthening the case for greater consumer-based use tax enforcement efforts. Those statutes offer state governments new tools for improving consumer-based use tax compliance. It is crucial for the state governments that adopt those statutes to use those tools. Failure to do so could undermine the rule of law, generate adverse economic and distributional effects, and threaten general tax morale and tax compliance.

¹ Adam Thimmesch, David Gamage, and Darien Shanske, "The Case for Consumer-Based Use Tax Enforcement," *State Tax Notes*, Sept. 11, 2017, p. 1049.

Enforcement, Psychology, and Tax Compliance

States' current focus on getting vendors to collect their use taxes is sensible as an administrative matter, but generates the economic and rule-of-law problems discussed in our prior article. Moreover, as we will explain in this article, inadequate consumer-based enforcement has the potential to erode taxpayers' motivations to comply with their tax obligations more generally. The relationship between use tax nonenforcement and tax compliance is complicated, but both academic research and real-world evidence suggest that an important link exists.

To begin the analysis, it is well established that many factors go into individuals' decisions of whether to comply with the law.² A familiar model of compliance is the cost-benefit (or deterrence) model under which taxpayers weigh the benefits of evading tax against the costs of evading. That requires an assessment of the likelihood that evasion would be caught and the penalties that would be imposed if it were. That model predicts that taxpayers will choose to comply if the expected value of noncompliance is negative after making that calculation. Conversely, taxpayers will choose noncompliance if that expected value is positive.³

The deterrence model provides substantial insight into why people comply with tax laws, but most scholars agree that the deterrence model does not tell the entire story. Scholars have generally concluded that compliance is also a function of factors that may not show up in a traditional cost-benefit analysis, at least to

some extent. Those factors include psychological influences, including one's view of the legitimacy of the government's authority.⁴

Determining the Legitimacy of the Government's Authority

Many factors appear to impact individuals' determinations regarding the legitimacy of the government's authority. One such factor is the perceived trustworthiness of the government making the particular command. In assessing that, people may consider whether the government acts with the right motivations and whether government officials perform their duties competently.⁵ People may also consider whether the government enforces the law against those who do not comply.⁶ Coercion of that sort is important because it signals competency and protects complying taxpayers from feeling like "suckers" while others free ride.⁷

Another factor that appears to impact individuals' legitimacy determinations is the fairness of the processes used by the government, or at least the individuals' perception of that fairness.⁸ The concept of procedural justice recognizes that people want to be treated neutrally, honestly, consistently, politely, and respectfully.⁹ Research suggests that perceptions of fairness in government processes are even

⁴ See, e.g., Tom R. Tyler, *Why People Obey the Law* at 25–27 (Princeton University Press 2006); Margaret Levi et al., "Conceptualizing Legitimacy, Measuring Legitimizing Beliefs," 53 *Am. Behav. Scientist* 354, 354–56 (2009) (hereinafter Levi, *Conceptualizing Legitimacy*). See generally Levi et al., "The Reasons for Compliance with the Law," in *Understanding Social Action, Promoting Human Rights* ch. 4 (2012) (hereinafter Levi, *Reasons for Compliance*). We alluded to this issue in our earlier article when we discussed how states' current postures regarding use tax enforcement are inconsistent with general rule-of-law considerations and the reciprocal relationship that exists between the government and the governed. Thimmesch, Gamage, and Shanske, *supra* note 1, at 1053.

⁵ Levi, *Conceptualizing Legitimacy*, *supra* note 4, at 356.

⁶ Levi, *Reasons for Compliance*, *supra* note 4, at 73; Levi and Audrey Sacks, *A Comparative Series of National Public Attitude Surveys on Democracy, Markets, and Civil Society in Africa* at 12, 15–16 (Afrobarometer, Working Paper No. 74, 2007), available at http://www.afrobarometer.org/files/documents/working_papers/AfropaperNo74.pdf.

⁷ Levi, *Reasons for Compliance*, *supra* note 4, at 73.

⁸ Levi, *Conceptualizing Legitimacy*, *supra* note 4, at 356; Paul Mason, Steven Utke, and Brian M. Williams, "Why Pay Our Fair Share? How Perceived Influence Over Laws Affects Tax Evasion," at 24–25; and Tyler, *supra* note 4, at 175.

⁹ *Id.*

² The literature on compliance is voluminous. See generally Thimmesch, "Testing the Models of Tax Compliance: The Use Tax Experiment," 2015 *Utah L. R.* 1083, 1088–1105 (2015).

³ Leandra Lederman, "The Interplay Between Norms and Enforcement in Tax Compliance," 64 *Ohio St. L.J.* 1453, 1463–1466 (2003).

more important than their outcomes when it comes to predicting future compliance.¹⁰ For example, having a procedurally fair audit may be more important to a taxpayer than winning that audit, at least when it comes to deciding whether to report accurately in the future.¹¹ Americans might dislike paying tax, but they seem to *really* dislike feeling that they have been treated unfairly by the government.

The Use Tax and the Legitimacy of State Government

The research discussed above suggests that many states' current approaches to use tax enforcement are problematic. As we discussed in our prior article, states instruct residents to pay their use taxes and threaten sanctions for noncompliance. But many states then take only limited actions to follow through and actually enforce the tax against individual consumers. That incongruity not only creates rule-of-law issues, but could also be perceived as the government being dishonest or incompetent. Neither is good, and neither promotes trust in government. The limited enforcement of use taxes also results in a procedurally unjust administration of the tax laws. It results in the use tax functioning as an effective tax on honesty that treats the honest as suckers.¹² That is the result of administrative choice, not legislative judgment, and it can have a negative impact on voluntary compliance for the reasons noted above.¹³

Inadequately enforcing use taxes against individual consumers could also create unfair distributional results. To begin to understand why, consider that many taxpayers appear to be unaware of the use tax or erroneously have come to believe that major categories of purchases — such as all e-commerce purchases — are tax exempt. Those taxpayers then evade the use tax

unknowingly. Because state governments take limited enforcement actions against individuals, most of those taxpayers never learn that they have inadvertently been committing tax evasion.

By contrast, another group of taxpayers comes to learn about the use tax, perhaps from their tax return preparers or because they have tax-aware social networks. From those same sources, those taxpayers may also learn about the limited enforcement of the use tax. Some of those taxpayers will then choose to comply with their use tax obligations, potentially making them feel like suckers while also generating unfair distributional results for them. Other taxpayers may decide to commit tax evasion, based on the low probability of that tax evasion being detected.

Yet another group of taxpayers may learn about the use tax — perhaps from the instructions on state tax returns or from other government sources — but without learning about its limited enforcement. Remember that states' guidance suggests that reporting use tax is every bit as important as reporting wage income, so a taxpayer looking for guidance from the state will be uninformed about the limited enforcement of the use tax.¹⁴

As another example of how a taxpayer might come to learn about the use tax, but not about its limited enforcement, one of us (Thimmesch) has participated in training for the Volunteer Income Tax Assistance program in which state representatives stressed the importance of informing clients about their use tax obligations and asking them about their online purchases. While that approach is certainly correct as a matter of law, it has the potential to create adverse distributional consequences. Absent greater efforts to increase use tax compliance more generally, it is problematic to focus compliance efforts on those who are among the least well-off.¹⁵ State sales and use taxes are already regressive.

¹⁰This work has been extended specifically to tax compliance with generally positive results. See Thimmesch, *supra* note 2, at 1099–1101.

¹¹Eric Kirchler, *The Economic Psychology of Tax Behavior* at 84-85 (2007).

¹²Levi, *Reasons for Compliance*, *supra* note 4, at 73.

¹³See also Brian T. Camp, "The Play's the Thing: A Theory of Taxing Virtual Worlds," 59 *Hastings L.J.* 1, 23 (2007) (noting that voluntary compliance suffers when the government "makes suckers out of compliant taxpayers by imposing requirements that are practically unenforceable against noncompliant taxpayers").

¹⁴Taxpayers can also get this message more actively from the states. At least one state confronts taxpayers with a pop-up addressing use tax if they download their tax return from the state's website. 2016 Michigan Individual Income Tax Return MI-1040, Michigan Department of Treasury (Rev. 06-16).

¹⁵To qualify for assistance, a taxpayer must generally make less than \$54,000, have a disability, or have limited ability to speak English. See Internal Revenue Service, *Free Return Preparation for Qualifying Taxpayers*.

Encouraging use tax compliance in a manner that disproportionately affects the least well-off would unjustly magnify that impact.

Some of those concerns might appear overblown simply because most consumers seem to be unaware of their use tax obligations.¹⁶ A consumer unaware of the tax would be hard-pressed to react negatively to its nonenforcement. However, to the extent that is so, it is equally true that those considerations will become even more critical for states to consider as they take efforts to increase consumer awareness of the tax. This discussion thus suggests that states should combine efforts to increase consumer knowledge of the use tax with efforts to better enforce that tax against those who do not comply. Failing to do so has the potential to backfire by raising awareness of a taxing authority that does not have the ability to enforce the laws on the books.

About Use Tax Notice and Reporting Statutes

At the cutting edge of efforts to increase sales and use tax compliance are use tax notice and reporting statutes. Under those statutes, vendors that do not collect sales and use taxes are required to instead provide notice and information reports to both consumers and the state.¹⁷ Colorado was the first to adopt that method, and others have followed suit.¹⁸ The Multistate Tax Commission is also working on a model statute structured like the Colorado law.¹⁹

That approach generally involves the imposition of three different requirements on vendors that do not collect a state's use tax. First, those vendors must inform consumers about their use tax obligations at the point of sale. Second, the

vendors must mail their customers an annual summary of their purchasing activity. Third, the vendors must provide a summary of that activity to the state.²⁰

Those notice and reporting statutes seem to be focused on promoting individual use tax compliance and are thus responsive to the concerns we have raised. As a general matter, we support state efforts to adopt those statutes, partially for the reasons we articulate in this series of articles.

However, raising awareness of the use tax is only part of the story. As we have emphasized, increased awareness ought to be tied to increased enforcement. We are thus concerned about whether Colorado and the other states considering use tax notice and reporting approaches are planning to make use of those new tools to improve their consumer-focused enforcement efforts.

Especially worrisome to us is the possibility that some state governments may be interested in those tools only as cudgels for encouraging remote vendors to switch to collecting sales and use taxes, and that some states therefore might not intend to use the information provided by those new statutes to improve consumer-based enforcement efforts. Such an approach might seem sensible if one starts from the assumption that only vendor-based collection of the use tax matters. Yet, as we have explained in this article and in our prior article, that perspective is incorrect. A significant use tax collection gap would likely remain even with the passage of something like the Marketplace Fairness Act, and suppressing the mainsprings of tax compliance could have untoward effects more broadly.

State governments can at least justify their limited consumer-based enforcement of use taxes on the grounds of administrative difficulty. We argue that those grounds do not justify current enforcement practices and that state governments should take further measures to enforce use taxes against consumers even in the absence of adopting use tax notice and reporting statutes. But for the states that adopt notice and reporting statutes, the excuse of administrative difficulty

¹⁶Thimmesch, *supra* note 2, at 1116 n.216.

¹⁷Those requirements are particularly attractive because they manage to avoid the physical presence requirement of *Quill Corp. v. North Dakota* (504 U.S. 298 (1992)). *Direct Marketing Association v. Brohl*, 814 F.3d 1129, 1146 (2016).

¹⁸See La. Leg., H.B. 1121 (2016 Reg. Sess.); Vt. Gen. Ass., H.B. 873, section 26 (2015-2016 Sess.); Vt. Gen. Ass., H.B. 516, section 23 (2016-2017 Sess.); and Wash. Leg., H.B. 2163, section 205 (2017 2d Spec. Sess.). For prior work considering the implications of Colorado's efforts, see Gamage and Shanske, "The Implications of CSX and DMA," *State Tax Notes*, May 11, 2015, p. 445; Gamage and Devin Heckman, "A Better Way Forward for State Taxation of E-Commerce," 92 *B.U. L. Rev.* 483, 523-25 (2012); and Gamage and Shanske, "The Saga of State 'Amazon' Laws: Reflections on the Colorado Decision," *State Tax Notes*, July 16, 2012, p. 197.

¹⁹See Multistate Tax Commission, "Use Tax Information Working Group."

²⁰*Id.*

rings more hollow, as those states will in fact be receiving much of the information they need to enforce the tax. In addition, those statutes, by design, will make the use tax more visible and thus the lack of enforcement more obvious. Thus, for those states, continuing to inadequately enforce use taxes against consumers would more clearly and dramatically undermine the rule of law and threaten general tax morale and compliance.

Moreover, there is an additional challenge posed by notice and reporting statutes that ought to be taken into account in considering compliance: Those statutes potentially create privacy concerns. The regular collection of purchasing data is a significant increase in a state government's surveillance of taxpayers' everyday activities, and states should be aware that this could have negative effects on compliance as well. As discussed above, research suggests that taxpayer compliance is at least partially built on trust in the government and taxpayers' beliefs regarding the legitimacy of the government's authority. If taxpayers believe that the reporting requirements are illegitimate or an unfair encroachment on their privacy, they could respond in kind by putting less effort into complying with their tax obligations.

Of course, different people think about privacy in different ways. Some think that privacy is dead, while others argue that privacy is even more important in today's world. We cannot settle those debates here. What we can do here is suggest that privacy can be understood as a set of expectations regarding the flow of information in particular contexts.²¹ When those norms change — whether because of the disclosure of information to a new party, the disclosure of information in a new way, or a change in how information is protected — some may feel a loss of privacy.²² Even when those feelings of privacy loss might be justified by society's pursuit of other worthy causes (such as tax enforcement), that does not

change the fact that some will experience the loss nonetheless.

Use tax notice and reporting statutes would seem to be strong examples of actions that harm privacy under that conception, whether they result in any *legal* privacy violation.²³ An annual summary of purchasing activities provided to the state represents a significant change to the norms of information flow in the context of online commerce, and it is safe to suggest that at least some individuals will perceive privacy loss from such a report. States should thus consider the potential impact on taxpayers' views regarding legitimacy and, correspondingly, on taxpayers' motivations to voluntarily comply.²⁴

To be clear, our concerns with notice and reporting statutes do not indicate that we think they are a bad idea.²⁵ Instead, our analysis is meant to demonstrate how a quite sensible attempt to increase vendor compliance can create problems for individual compliance. That would not matter if individual compliance did not matter, but we have argued that it does. Thus, we conclude that any state considering the adoption of notice and reporting statutes should also consider improved consumer-focused compliance efforts.²⁶ If states do not make use of the tools that notice and reporting statutes provide to improve consumer-focused compliance efforts, then it becomes much harder to justify the loss of privacy that will be felt by at least some individuals, and the resulting harm to the rule of law and to tax compliance.

²³ On balance, and depending on the details of the statute, we think those statutes can pass muster, but, again, that is not the key from a compliance perspective. For further discussion, see Scott W. Gaylord and Andrew J. Haile, "Constitutional Threats in the E-Commerce Jungle: First Amendment and Dormant Commerce Clause Limits on Amazon Laws and Use Tax Reporting Statutes," 89 *N.C. L. Rev.* 2011 (2011).

²⁴ As we noted in our prior article, that is increasingly important as taxing authorities attempt to catch up to a changing economy. See Thimmesh, Gamage, and Shanske, *supra* note 1, at 1052 (noting the challenges of the "gig economy" for tax compliance).

²⁵ On that point, it would demonstrate a great deal of chutzpah for remote vendors to complain about notice and reporting statutes on the two grounds we articulate, as it is those vendors' unwillingness to collect the use tax, even as it becomes ever easier and cheaper to do so, that has been the impetus for states to craft those statutes. As Paul Krugman has explained, "The traditional definition of chutzpah says it's when you murder your parents, then plead for clemency because you're an orphan," see "Maestro of Chutzpah," *The New York Times*, Mar. 2, 2004.

²⁶ States should also consider finding ways to assuage privacy concerns.

²¹ Professor Helen Nissenbaum calls that "contextual integrity." Nissenbaum, "Privacy as Contextual Integrity," 79 *Wash. L. Rev.* 119 (2004); see also Dan Solove, "Conceptualizing Privacy," 90 *Calif. L. Rev.* 1087, 1127-28 (2002) (arguing that privacy is best understood in "specific contextual situations").

²² Nissenbaum, *Privacy in Context* 141-47 (2010).

Conclusion

Through this article and our prior article in this series, we have built the case for a modified approach to the state use tax. Our proposed approach would take consumer compliance more seriously. To be sure, the task of improving consumer-based compliance may be difficult. Yet that task is worth undertaking. Efforts to improve consumer-based compliance would have economic benefits, would support the rule of law, and could promote voluntary compliance more generally. Overall, that is a project worth the candle, and our next article in this series will provide concrete examples of consumer-centric approaches that states could take that are backed by academic and field research. ■

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