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The Impact of the Internet Tax Freedom Act on State Revenues

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ABSTRACT

The Internet Tax Freedom Act, passed by the U.S. Congress, is both a result of and a potentially important influence on the growth of electronic commerce. This paper examines the impact of the moratorium imposed by the legislation prohibiting the collection of taxes on Internet commerce. Its significance with respect to business-to-business and business-to-consumer commerce is documented by analysis of current sales activities.

The paper also explores the potential impact on a variety of sales categories if the moratorium is extended beyond the current three-year period of effect. The discussion illustrates how continuing the force of the legislation will have an increasingly significant effect on both states, which depend on sales tax revenue, and participants in Internet commerce.

Introduction

The rising level of Internet buying and selling signals the promise of electronic commerce as a viable channel through which anyone can acquire and distribute products and services. Moreover, the fact that a large number of start-up and established companies are developing online capabilities for Internet related commerce suggests that activity in this channel will continue to grow significantly, with widespread support from private and public sectors alike.

At the same time, a controversy has emerged concerning the manner in which Internet commerce should be treated for tax purposes. Proponents of one position suggest that Internet commerce should be taxed in the same manner as traditional commerce. A strongly supported opposing position calls for "hands-off" treatment by tax authorities.

In order to understand the merit of these opposing views, an investigation was conducted to determine the impact of a tax/no tax decision on state government revenues in the United States. This paper summarizes the results of that investigation. As will be shown, any decision on taxation will become increasingly significant as the volume of Internet related commerce continues to grow.

Internet Taxation

In 1998, the U.S. Congress passed the Internet Tax Freedom Act (ITFA). The legislation calls for a moratorium on the imposition of new taxes by state government as follows:

No State or political subdivision thereof shall impose any of the following taxes during the period beginning on October 1, 1998, and ending 3 years after the date of the enactment of this Act--
(1) taxes on Internet access, unless such tax was generally imposed and actually enforced prior to October 1, 1998; and
(2) multiple or discriminatory taxes on electronic commerce.

Hence, in contrast to a widely held view, Internet commerce *is currently taxable*. Those transactions that were taxable before the emergence of Internet commerce are still taxable by state governments, whether carried out over the Internet or at a conventional commerce site. Moreover, new taxes can be imposed on Internet commerce during the period of the moratorium so long as they are also imposed on traditional commerce.

On the other hand, ITFA prohibits state governments from passing legislation to impose *any new* taxes on Internet commerce that could be classified as *discriminatory taxes*, that is, imposed only on Internet transactions.

Many sales are subject to an excise tax, i.e., a tax based on the amount of the transaction, unless the items purchased are used as "inputs" to a product or service (in which cases there is no tax so as to avoid double taxation; the item and its inputs are taxed when sold). In-state sales are subject to a well-understood *sales tax*. (Note: although the individual or company making the sale is actually assessed the tax—hence the term *sales* tax—it is generally passed along to the buyer.)

Purchases made from out-of-state sources are subject to a *use tax*, a destination tax that is remitted to the government in the state where the product or service is delivered. States generally levy taxes on both types of sales at equivalent rates.

Hence *business and consumer purchases* are taxable regardless of whether they are made from in- or out-of-state sellers. The collection of taxes on purchases made from businesses that are out-of-state are governed by Federal and constitutional laws (e.g., *National Bellas Hess v. Illinois* and *Quill Corp. v. North Dakota*). These laws prohibit states from requiring out-of-state sellers to *collect* use taxes unless the company has a physical presence, or *nexus*, in the state, regardless of the specific product or service purchased.

State revenue authorities have been sensitive to this matter for quite some time, for they are unable to collect taxes that they are due when consumers buy, through

catalogs, from sellers of clothing, books, music, and information technology products, and other consumer goods.

Therein lies the concern that state governments have about sales through Internet commerce: Revenue authorities feel that when Internet companies can sell and deliver goods into a state, and the state is unable to collect taxes, it results in a revenue loss. Moreover, if the tendency of buyers to acquire goods and services from Internet-based sellers grows, states worry that their revenue loss will skyrocket.

In spite of the concern expressed by some state agencies, there is also interest in making the current ITFA-established moratorium permanent. Proponents want to see the Internet as a tax-free channel that stimulates unlimited growth of electronic commerce.

Methodology

In order to understand the implications of a permanent moratorium on Internet commerce, an analysis of current and projected Internet transactions was conducted. Two questions were included in this investigation:

1. How important are general sales tax revenues to states?
2. How significant is the threat of lost tax revenues due to a prohibition on taxing Internet sales?

Impact on State Revenues

In order to determine the impact of ITFA on states, the latest available annual revenue sources of all 50 states, individually and collectively, was examined. (Additional tax levies at the local level are not included in this analysis.) As illustrated in Table 1, the principal sources of revenue are incomes taxes (corporate and individual), general sales taxes, and license taxes (1997-1998 annual revenue sources—the latest currently available). General sales tax revenue accounts for 1/3 of the revenue of the states.

Due to the importance of this revenue category, it must be concluded that any legal or regulatory action that affects sales tax revenue in a significant manner is extremely important to the ability of a state to provide necessary citizen services. Moreover, if the IFTA moratorium, or a permanent moratorium, on taxation of Internet sales affects general sales tax revenue in a significant manner, it will harm the state.

Significance of Internet Tax Moratorium

Having established the importance of sales taxes, it is essential to determine the extent to which states are losing revenue as a result of the IFTA moratorium. This investigation sought to determine the *worst-case* revenue loss and to assess its significance. Moreover, it sought to understand the extent of the actual loss, currently, and the potential loss if Internet commerce volume continues to grow as projected.

Table 1
State Revenue Sources, 50 states

Revenue Category	Amount (000)	Percentage of Revenue
Property Taxes	10,661,670	2.40%
General Sales Tax and Gross Receipts	156,061,702	32.86
Selective Sales Tax (Fuel, Tobacco, Alcohol, etc.)	71,343,139	15.02
License Taxes (Motor vehicle, business licenses, etc.)	29,682,659	6.25
Individual Income Taxes	161,249,928	33.95
Corporate Income Taxes	31,108,628	6.55
Other Taxes	14,882,838	3.13
TOTAL	**474,990,564**	**100%**

Source: *State Government Tax Collections, Fiscal Year 1997-1998*

Taxation of Business-to-Business Sales

This question can only be properly addressed by reviewing sales to business and sales to consumers separately. Sales to business, whether made by in state or out-of-state firms are taxable (as either sales taxes or use taxes). Businesses are required to pay tax levies on all non-production purchases for which the seller did not collect the tax. While there is no evidence regarding what percentage of use tax owed by business is actually collected, routine "sales tax" compliance audits assist in enforcement. Hence, it can be reasonably assumed that a high level of sales and use tax collection is occurring from business, whether the sales occur through conventional channels or via Internet Commerce.

Information technology research organizations have uniformly identified the largest portion of electronic commerce transactions to occur between businesses. IDC, a widely respected information technology research firm (International Data Corp., 1999) reported that in 1988, business-to-business transactions accounted for 70 percent of the estimated $50 billion in electronic commerce (i.e., $35 billion in taxable transactions).

Combining the IDC analysis with knowledge of state compliance levels, it can be concluded that the great majority of Internet Commerce transactions are currently subject to taxation and that the states have it within their power to collect those taxes. In this area, then, ITFA has not had an effect.

Taxation of Business-to-Consumer Sales

The other portion of electronic commerce, consisting of business-to-consumer sales, comprises 30 percent of all online sales. Using IDC research, it is estimated that business-to-consumer sales in 1998 were $15 billion. However, the taxable base of Internet consumer sales does not include all of the $15 billion sales volume. To apply a tax estimate to this figure would produce misleading and inaccurate results.

Before determining possible revenue losses to the states, three adjustments must be made: (1) eliminate sales that are not taxable; (2) eliminate Internet sales that are now taxable and for which the states collect sales taxes; (3) eliminate sales for which states typically do not collect taxes, taxable or not, regardless of whether they are conducted over the Internet or through traditional commerce channels.

Items in adjustment category #1, not subject to taxation, include online investment and personal finance transactions, airline and travel tickets, and subscriptions are not subject to taxation. Items in adjustment category #2 include (at a minimum) automotive, food, and beverage sales because the seller has nexus in the state. Items in this adjustment category do not represent state revenue loss. Items in category #3 are characterized mainly by catalog-related sales. Since, as discussed above, states do not normally collect use taxes on these sales, (i.e., the revenue is already lost to the states) it is inappropriate to consider them as new revenue losses when the sales occur through a different (i.e., Internet) channel. Data to fully document the level of sales in this category are not available.

Table 2 summarizes the online transactions by consumer sales category. The fact that travel, financial services, and event ticket sales are not taxable, and other categories where the seller is likely to have a nexus reduces the taxable base by more than 40 percent. Further reductions can be made because of the trade-off with catalog sales. *Conservatively*, it can be concluded that less than 50 percent of consumer sales conducted over the Internet are taxable or produce a new revenue loss from not being taxed due to ITFA provisions.

In order to determine the actual revenue loss for reported online sales, it is necessary to apply a sales tax rate. Although rates vary between the 46 states and the District of Columbia that collect tax, a nationwide average of 5.1 percent (Vertex, 1999) can be applied to the adjusted Internet consumer sales of $ 7.5 billion which translated into a nationwide loss of $382.5 million in tax revenue, or an average of $8.1 million per state (See Table 3). Hence it is concluded that the loss of state sales tax revenue as a result of ITFA moratorium is no more than 2.4 percent of current sales taxes.

The impact of a permanent moratorium can be projected using equivalent allocation of online transaction value to each sales category in Table 2. IDC projections indicate that business-to-consumer sales in 2003 will account for 14 percent of the expected $1.317 trillion in Internet commerce sales, or $184.38 billion. Applying conservative estimates of taxable sales and using the same national sales tax average results in an estimated tax loss of $4.7 trillion, or $100 million per state.

An additional undetermined factor in this analysis is the extent to which firms currently having nexus in a state will, though organization restructuring and "spin-offs," set up organizations that do not have nexus. There is no available evidence on which to base an estimate of the likelihood of such occurrences. However, any such occurrences will result in further revenue loss to states.

Table 2
Online Consumer Sales Transactions

Consumer Sales Category	**% of Consumer Internet Sales $**	**Revenue** (000)	**Status Notes**
Computer hardware /software	19.47%	$2,920,498	High % catalog sales
Travel	19.20%	$2,879,935	Not taxable
Financial services	15.68%	$2,352,623	Not taxable
Collectables	14.33%	$2,149,811	
Music/video	4.87%	$730,124	
Books	4.60%	$689,562	
Clothes/ sporting goods	4.33%	$648,999	High % catalog sales
Flowers/cards/gi fts	4.33%	$648,999	
Department stores	3.79%	$567,875	
Event tickets	3.52%	$527,312	Not taxable
Consumer electronics	2.43%	$365,062	High % catalog sales
Automotive	1.35%	$202,812	Taxable
Home/garden	1.08%	$162,250	
Toys	0.54%	$81,125	
Food/wine	0.49%	$73,012	Food generally not taxed

Source: Shop.org; Boston Consulting Group

Table 3
Estimated Loss of Sales Tax Revenue for Internet Consumer Sales

Description	1998	2003
Consumer sales on net (IDC data)	$15,000,000,000	$184,380,000,000
1/2 of sales are taxable	$7,500,000,000	$92,190,000,000
Tax loss at 5.1% tax rate	$382,500,000	$4,701,690,000
Tax revenue loss per state (average)	$8,138,298	$100,035,957

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Conclusion

Since there is little question that the volume of Internet commerce will grow, the impact of shielding these transactions from sales taxes will increase in importance. The current impact on state sales tax revenues, at the most conservative levels, can be argued to be barely noticeable within overall state budgets. However, it is evident that the importance of taxation will increase dramatically and at a very rapid rate.

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