University of Mississippi

eGrove

Guides, Handbooks and Manuals

American Institute of Certified Public Accountants (AICPA) Historical Collection

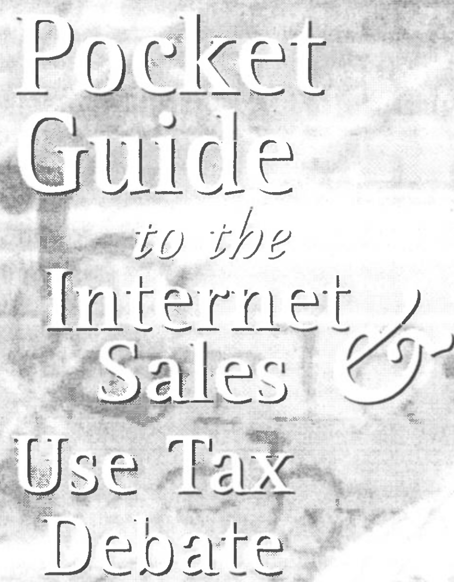
2000

Pocket Guide to the Internet Sales & Use Tax Debate

American Institute of Certified Public Accountants (AICPA)

Follow this and additional works at: https://egrove.olemiss.edu/aicpa_guides

Part of the Accounting Commons



Pocket Guide *to the* Internet Sales & Use Tax Debate

What Is the Debate About?

Due to the rapid growth of online sales, states are concerned that their sales/use tax revenues will decline significantly and jeopardize the level of services that state and local governments can provide to their citizens. "Main Street" businesses are equally concerned that they will not be able to compete with their online counterparts because they must continue to collect sales tax — resulting in a total price to the consumer as much as 5% to 9% higher than the cost if purchased from a remote seller. On the other side of the argument are remote vendors. They do not want to be burdened with the obligation of collecting a tax for a jurisdiction it has no physical contact with, particularly because there are numerous jurisdictions (approximately 7,500)[1] with varying and complex laws.

Background

Generally, when an individual makes a taxable purchase at a store, the store collects the sales/use tax and remits it to the state. When an individual makes a taxable purchase from a catalogue or online, often the vendor does not collect the sales/use tax. The reason that the vendor does not collect the sales/use tax is because the vendor is not physically present in the state where the purchaser resides; the vendor does not have "nexus." When a vendor does not collect the sales/use tax, the purchaser is responsible for filing a use tax return and paying the applicable use tax. However, this use tax reporting responsibility is not well understood by individual purchasers and consequently most do not comply. Currently, the cost to enforce the use tax on individuals is not economical; consequently the enforcement is almost non-existent.

A company that has "physical presence" in a state (for example, a warehouse or a store) has "nexus" and is required to collect that state's sales tax. This physical presence standard was articulated first in 1967 by the U.S. Supreme Court in the *National Bellas Hess*[2] case and was reaffirmed in 1992 in the *Quill*[3] decision. The physical presence standard is viewed as a clear "bright-line test" to define when a company must collect sales/use tax on behalf of a state/local government. Although it is referred to as a "bright-line test", in many instances the line is anything but bright. Consequently, there are many cases that focus on "how much" physical presence causes nexus and "what" activities cause nexus. For example, does attendance at a trade show cause nexus? Does a contractual arrangement with another company within a state cause nexus?

The physical presence standard has developed because of the concern for the burden on interstate commerce if all state and local governments could require any business

[1] Masters of Complexity and Bearers of Great Burden: The Sales Tax System and Compliance Costs for Multistate Retailers, Ernst & Young, September 1999

[2] *National Bellas Hess, Inc v. Dept. of Revenue of State of Illinois*, 386 U.S. 753 (1967)

[3] *Quill Corp. v. North Dakota*, 504 U.S. 298, 112 S.Ct. 1904 (1992)

selling within their borders to collect the sales/use tax for their jurisdictions. Under the Commerce Clause of the United States Constitution, Congress is the only body that has the authority to burden interstate commerce. It is for this reason that states cannot require remote vendors to collect sales tax on their behalf.

The sales tax collection debate between states and remote vendors has been going on for decades in the mail order industry and now has become a national issue due to the growth of Internet sales. States want the right to compel remote vendors (located outside their jurisdiction) to collect their sales tax. However, remote vendors do not want to be burdened with the obligation of collecting a tax for a jurisdiction it has no physical contact with, particularly because the laws in each state and locality often differ greatly.

Forty-five states and the District of Columbia have a sales and use tax. There are also thousands of local governments that assess a local sales/use tax. Each state and local government sets its own tax rate and these rates often vary between states and localities. Additionally, the items subject to sales/use tax are different for each jurisdiction (for example, clothing is taxable in some states and not in others). The system is further complicated by the numerous and varying definitions (for example, a scarf may be defined as clothing in one state and not taxable, but as an accessory in another state and taxable).

While Internet vendors have a valid concern regarding the burden that would be imposed on them if they were required to collect sales/use tax for every state and local government, "Main Street" businesses also have a valid concern. Main Street is concerned with the competitive advantage the online world has. Specifically, because online vendors do not have to charge a consumer sales/use tax (in most states), the cost to the consumer is often approximately 5% to 9% cheaper. In a world that is becoming increasingly competitive, a 5% to 9% price differential may influence the buyer to make the purchase online from a vendor that doesn't charge tax. Main Street businesses want their online counterparts to be required to collect sales/use taxes. This is often referred to as "leveling the playing field."

Statistics[4]

States With Sales/Use Tax	45 States and District of Columbia
Localities With Sales/Use Tax	7,500
Average Percentage of State Budget	24.8%*
Annual Dollars Collected in the U.S.	$237 Billion*
Uncollected Sales/Use Tax on Internet Sales	$525 Million*

* Figures are based on studies conducted for the year ended December 31, 1999.

[4] Advisory Commission on Electronic Commerce, Report to Congress, April 2000.

Internet Tax Freedom Act (ITFA)

A federal law, ITFA, was enacted in October 1998 which provided a three-year moratorium on 1) any *new* taxes on Internet access and 2) multiple or discriminatory taxes on electronic commerce. The ITFA also established the Advisory Commission on Electronic Commerce (see below) to study the issues surrounding taxation and the Internet and to report back to Congress on their findings.

The ITFA did not place a moratorium on the imposition or collection of sales and use tax on taxable purchases made over the Internet. Since sales/use taxes are not *new* taxes, the sales/use tax laws are still in effect despite the IFTA. Consumers are legally required to pay either a sales tax to the vendor or self-assess a use tax on any taxable purchase.

Advisory Commission on Electronic Commerce (ACEC)

This commission was established by the ITFA for the purpose of studying the issues of taxation and the Internet. The ACEC issued a report to Congress in April 2000. Some items in the report received a two-thirds majority vote that was needed to make a formal recommendation to Congress. However, all of the items in the report related to sales and use tax received only a simple majority vote (11 of 19). The highlights of the sales and use tax section of the report are as follows:

- Extend moratorium for five years and prohibit taxation of sales of digitized goods and their non-digitized counterparts.
- Clarify factors that would not in and of themselves establish physical presence for the purpose of determining nexus to impose collection obligations with that state.
- Encourage states and local governments to work with the National Conference of Commissioners on Uniform State Laws (NCCUSL) in drafting uniform sales and use tax laws that would simplify the system. Maintain a parity of collection costs (net of vendor discounts) between remote sellers and comparable single-jurisdiction vendors.
- Establish a new advisory commission for oversight of NCCUSL's efforts to create a uniform system.

Examples

1) Mary Smith, an Illinois resident, purchased a living room set from an online furniture company located in North Carolina. The price of the furniture was $10,000. The online store did not charge Mary sales tax since it had no physical presence in Illinois and was therefore not required to administer Illinois sales/use taxes. Mary should file a use tax return with Illinois reporting this purchase and remitting the use tax which is due.

2) Mary Smith, an Illinois resident, purchased furniture from Main-Street Furniture in her hometown. The price of the furniture, including sales tax, was $10,625 since the vendor was required to charge her Illinois sales tax.

3) ABC Company, a multi-state retailer of tools, decides to sell its products over the Internet in addition to its retail stores. The company set up a new division (not a separate legal entity) for this purpose. The company must collect sales/use taxes in each state in which it currently has a physical presence since the structure of its Internet sales engine is a division and not a separate legal entity.

4) DEF Company, a multi-state retailer of books, decides to sell its products over the Internet in addition to its retail stores. The company set up a new legal entity for this purpose ("def.com"). The company will generally be required to collect sales/use taxes only in those states in which def.com has a physical presence and not all of the states in which DEF Company has retail stores.

Questions & Answers

1) Under the current law, is the Internet a "tax free zone"?

   No, taxable purchases made over the Internet are subject to a use tax if sales tax is not collected by the vendor.

2) Are states losing revenue due to purchases of taxable items on the Internet?

   Yes, to the extent that these purchases would have otherwise been made in a local store, and individuals are not paying the use tax that is due, the states are losing revenue. Local stores would collect sales tax and remit it. Remote sellers like "dot-com" companies without physical presence in the state are not required to collect and remit use tax. The state must rely upon the citizen to properly declare, report, and pay the use tax due on an annual return. Few citizens understand the use tax and consequently, may not report and remit the tax due.

3) Would requiring Internet vendors to collect sales and use tax in all states put them at a competitive disadvantage?

Yes and no. To the extent that they are "Mom & Pop" online vendors, they would be at a competitive disadvantage due to the cost of the higher compliance burden associated with complying with the laws of potentially 7,500 jurisdictions, compared to their "Main Street" counterparts that have to comply with the laws of only one state. To the extent that they are "big" online vendors, they would not be at a competitive disadvantage. Complying with the laws of potentially all the jurisdictions would put them on a "level playing field" with "big Main Street" retailers that currently have to comply with the laws of all these jurisdictions due to their physical presence.

4) Do companies that have stores and sell over the Internet collect sales tax on Internet sales?

Yes and no. If a company has physical presence in a state, then it must collect sales/use tax for that state on all sales. However, separating the online operations into another distinct "dot-com" company could enable this company to avoid collection of the sales/use tax for its online sales.

5) How many taxing jurisdictions are there?

There are currently over 7,500 state and local jurisdictions of a potential 30,000 jurisdictions that have the authority to levy a sales tax.

6) Do states tax the same items?

No, each state has its own set of laws that determines what items are taxable. To add further complexity, each state has its own set of definitions. For example, marshmallows may be food in one state and not taxable yet could be considered candy in another state and taxable.

7) Does a company file one return to the state?

Some states have one return, which incorporate the local sales and use taxes, but in other states, localities require their own separate filing.

8) Can technology be used to administer the current sales and use tax system?

Technology will evolve to address this complex problem. Currently, however, the failure of states/local governments to agree on a common harmonized rate per state, common definitions and exemptions makes collection for multiple jurisdictions unduly burdensome and complex. One harmonized rate per state and the development of common definitions will facilitate a technological solution to this complex taxing problem.

9) If an Internet company attends trade shows in a state will that cause them to have nexus in that state?

Maybe. Some states have "safe-harbors" that allow a company to attend trade shows for a specific number of days (for example, 10 days) in their state without causing nexus. Some states have case law, but the decisions are not consistent between the states. Other states are silent on the matter and have no case law.

International Perspective

While this document focuses on the United States sales and use tax issues, there are also significant international issues with regard to applying traditional taxing systems to e-commerce. The Internet by its very nature knows no geographical boundaries and the United States must focus on solving not only the national issues but also partnering with other countries to solve the international issues.

Harborside Financial Center
201 Plaza Three
Jersey City, NJ 07311

5633-020

Examples

1) Mary Smith, an Illinois resident, purchased a living room set from an online furniture company located in North Carolina. The price of the furniture was $10,000. The online store did not charge Mary sales tax since it had no physical presence in Illinois and was therefore not required to administer Illinois sales/use taxes. Mary should file a use tax return with Illinois reporting this purchase and remitting the use tax which is due.

2) Mary Smith, an Illinois resident, purchased furniture from Main-Street Furniture in her hometown. The price of the furniture, including sales tax, was $10,625 since the vendor was required to charge her Illinois sales tax.

3) ABC Company, a multi-state retailer of tools, decides to sell its products over the Internet in addition to its retail stores. The company set up a new division (not a separate legal entity) for this purpose. The company must collect sales/use taxes in each state in which it currently has a physical presence since the structure of its Internet sales engine is a division and not a separate legal entity.

4) DEF Company, a multi-state retailer of books, decides to sell its products over the Internet in addition to its retail stores. The company set up a new legal entity for this purpose ("def.com"). The company will generally be required to collect sales/use taxes only in those states in which def.com has a physical presence and not all of the states in which DEF Company has retail stores.

Questions & Answers

1) Under the current law, is the Internet a "tax free zone"?

   No, taxable purchases made over the Internet are subject to a use tax if sales tax is not collected by the vendor.

2) Are states losing revenue due to purchases of taxable items on the Internet?

   Yes, to the extent that these purchases would have otherwise been made in a local store, and individuals are not paying the use tax that is due, the states are losing revenue. Local stores would collect sales tax and remit it. Remote sellers like "dot-com" companies without physical presence in the state are not required to collect and remit use tax. The state must rely upon the citizen to properly declare, report, and pay the use tax due on an annual return. Few citizens understand the use tax and consequently, may not report and remit the tax due.