

# To Tax or Not to Tax?

## *States Ponder New Ways to Collect Taxes on Online Sales*

BY BETTY JOYCE NASH

Online transactions are still only a fraction of total retail sales — about 1.3 percent in 2002. But they are nevertheless at the center of a growing controversy: to tax or not to tax?

In February, several major retailers who sell online agreed to begin voluntary sales tax collections. The stores in question prefer to remain anonymous. The move likely started with stores that have ties to retailers with brick-and-mortar locations. The Supreme Court ruled, in 1967 and again in 1992, that out-of-state sellers without a physical presence in the state, or “nexus,” as the Court called it, cannot be required to collect. But several large firms apparently began to suffer “nexus nerves” and agreed to pay the sales taxes. The firms will be forgiven any back taxes.

“I think it’s certainly a good step forward,” says Sabra Faires of the North Carolina Department of Revenue. “But make no mistake about it — they owe the money in those states, and they don’t want to pay the back taxes.”

The announcement comes at a time when retailers, legislators, and state officials are re-examining the idea of Internet taxation as a federal moratorium nears expiration in November of this year.

State officials and traditional retailers like the idea of the taxes — sales taxes, after all, make up a good chunk of states’ general fund revenues, about 28 percent in North Carolina, for example. And times are tough right now. Most states need cash to close perilously large revenue shortfalls. There’s also the idea of evening out the retail playing field for traditional brick-and-mortar merchants. But many on Capitol Hill say that electronic commerce should remain unfettered by the burden of collecting taxes, which can vary widely from state to state, county to county, city to city. There have been bills introduced in both chambers of the U.S. Congress that would extend indefinitely the current ban on taxes on Internet sales. The backer of one bill, Sen. Ron Wyden (D-Ore.), holds that taxing Internet sales could weaken the growing Internet economy.

While that idea has held sway thus far, the states, eyeing potential revenue sources, have come up with plans of their own, which they hope will ultimately serve as a blueprint when and if they get the OK to capture taxes on



goods sold in cyberspace. And, in fact, the effort did receive a symbolic boost in February when the retailers announced plans to collect.

Using simplification as a mantra, the “Streamlined Sales Tax Project” approved a multistate agreement in November, the culmination of more than a year’s work by representatives from more than 40 states. Under the agreement, state legislatures will consider laws to help simplify collection of sales taxes. Fifth District states, including the District of Columbia, are considering proposals or forming study committees in support of the effort during this legislative session. Sabra Faires says the North Carolina State Legislature has additional work to do in the upcoming session to simplify sales tax rules even further.

“When the retailers sat in on the streamlined sales tax meetings, they said the differences in bases and caps and thresholds is what made it hard for them to pay up,” she explains. “We’ve got quite a few differences.” For example, the state does not tax food, but some localities tax food. “We do not have a uniform, local base.” The state also has certain tax caps, for example an \$80 cap on farm machinery. “[We need to] either tax it at the state rate or exempt it,” she says.

“The hope is that taxes get simpler, and if [they] get simpler, retailers will collect,” she says. What’s more, the simplification could make a difference should the issue be challenged in court again or could inspire Congress to change the law, forcing retailers to collect.

“I think the fact that these large corporations are on board strengthens their [states] case,” says Larry Walters, professor of public policy at George Mason University. But Walters says it isn’t clear whether there is the political will to push simplification through the state legislatures.

In West Virginia, legislation has been introduced to end the aggressive bracketing system and adopt a rounding rule for the state’s 6 percent sales tax, according to Dale Steager, general counsel for the West Virginia Department of Tax and Revenue. For example, a \$1 purchase is taxed 6 cents, while a \$1.01 purchase is taxed 7 cents, Steager says.

Under the new rule, it would be rounded down to \$1 and taxed accordingly.

The Mountain State is facing a \$30 million deficit this year and a projected shortfall of \$200 million next year. Policymakers would love to find a way to help put the state’s books in the black, and some see taxing online sales as an attractive option. A study by Donald Bruce and William Fox of the University of Tennessee estimated West Virginia’s lost e-commerce revenues at \$70 million in 2001. “Our people think that is a high number,” Steager notes. “But we don’t really have the ability to come up with a more precise number.”

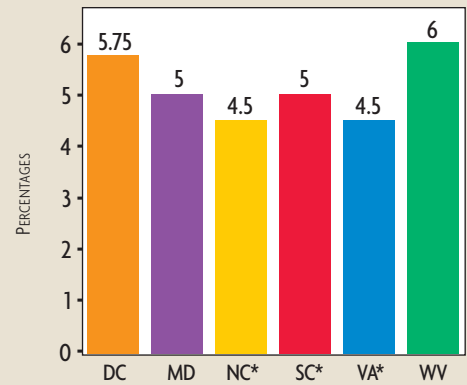
Bruce says that, ultimately, Congress should redefine the concept of nexus. “You don’t need a physical presence to conduct business,” he says. “I think the states would like an economic definition.”

Austan Goolsbee, an economist at the University of Chicago, has written a paper suggesting that people living in locales with high sales taxes are much more likely to buy goods online. Applying existing taxes could reduce the number of online buyers somewhere in the neighborhood of 15 percent, a number he revised downward in 2000 from 24 percent in 1999.

“Using an extensive data source of approximately 25,000 people with online access, the results suggest that local taxation plays an influential role in online commerce,” he wrote in 1999. “Controlling for individual characteristics, people living in places with higher tax rates are significantly more likely to buy things over the Internet. ... In total, the results give empirical support to the idea that taxes (and other price differences) will play an important role for individuals living in a ‘world without borders,’ and they motivate further empirical work on demand in an open economy such as the Internet.”

While the magnitude of the tax effect seems large, Bruce believes that the “infant industry argument” is dead — Internet sellers now have a strong presence in the market — and that local businesses are not being subsidized in the same way that the Internet industry’s major players are. “Is

## State Sales Tax Rates in the Fifth District



\*Allow localities to impose additional sales taxes

SOURCES: Federation of Tax Administrators, Sales Tax Clearinghouse, Inc.

there a public benefit to giving these companies a benefit that’s not earned?”

Technically, consumers already owe taxes on goods they buy over the Internet. Typically a line on state income tax forms asks for a list of such purchases. But few pay this “use tax.”

“The compliance level is virtually zero,” says Bruce. “My sense is the revenue department would probably have a nice laugh if they got a check from somebody.”

But it’s important to note that consumer purchases represent only a small portion of electronic commerce. “In our study and in the real world, it’s not just a retail question,” Bruce says. “It’s all transactions between businesses. More than nine of 10 dollars spent online is [through] business-to-business transactions. While we like to think business purchases are tax exempt, they aren’t always.” And states would love to cash in on that business. **RF**

### READINGS

Bruce, Donald, and William F. Fox. “State and Local Sales Tax Revenue Losses from E-Commerce: Updated Estimates.” *State Tax Notes*, October 15, 2001, vol. 22, no. 3, pp. 203-214.

Goolsbee, Austan. “In a World Without Borders: The Impact of Taxes on Internet Commerce.” *Quarterly Journal of Economics*, May 2000, vol. 115, no. 2, pp. 561-576.

Visit [www.rich.frb.org/pubs/regionfocus](http://www.rich.frb.org/pubs/regionfocus) for links to relevant Web sites.