



How U.S. E-Commerce is Currently Taxed – And What Might Happen in the Future

LeAnn Luna, University of Tennessee

On April 17, 2018, the U.S. Supreme Court heard arguments in *South Dakota v. Wayfair*, a case about “nexus” and “sales and use taxes” and a case with the potential to affect what millions of Americans who shop online will have to pay for their purchases. Although most people understand sales tax basics, few beyond policymakers, business groups, and tax preparers know much about “use” taxes, and fewer understand the tax concept of “nexus” and the role it plays in the collection of taxes. This brief offers an overview of the basics.

The Current (Non)-Taxation of E-Commerce

E-commerce grew from \$995 billion in 1995 to \$5.7 trillion by 2015, and the online share of total sales continues to grow. Yet as this massive growth occurred, a Supreme Court decision from 1992 still regulates taxation in this burgeoning sector. Under the current system, a firm selling online is only required to collect sales tax on a transaction when the firm has offices, warehouses, employees or other indications of physical presence (or “nexus” in technical terms) in a state that levies the sales tax, which are the 45 states excluding Alaska, Delaware, Montana, New Hampshire, and Oregon. For example, assume a small coffee shop, that I’ll call Music City Café, roasts specialty coffee and sells to local customers in Nashville, Tennessee. Music City Café also sells packaged coffee by the pound to customers all across the country, using United Parcel Service and the U.S. postal service to ship the coffee. Music City Café must collect approximately a 9% sales tax on all sales in its Nashville coffee shop. It will also collect sales tax on online coffee sales shipped to customers who live in Tennessee. But when it sells and ships roasted coffee beans to a customer in Georgia, or to customers in any sales-taxing states outside of Tennessee, Music City Café does not have to charge and collect their sales taxes.

There is an important twist. Although out-of-state vendors are not required to collect the sales tax, the tax is still due. Every state with a sales tax has a companion “use tax” with the same base and rate as its sales tax. Consumers who purchase and consume items in the state but failed to pay sales tax still owe this use tax. The problem is not the letter of the law, but compliance. Businesses in the 45 states comply with sales tax collections about 75% of the time, but tax compliance by individuals is extremely low. Some states require taxpayers to report online purchases on their individual tax returns, but only about 1.9% of taxpayers did so in 2012. Because it is hard for state revenue departments to audit online purchases, the use tax is so rarely enforced that most consumers do not know they owe it.

Effects of the Quill System

In 2018 – more than twenty-five years and trillions of dollars in online sales after the 1992 *Quill* decision – online sellers are not required to levy a sales tax on transactions unless they have a physical presence in the consumers’ states. Such tax evasion is nice for consumers, but the tax losses are significant and have several harmful effects.

- State and local governments continue to lose tax revenue. According to a University of Tennessee study, an estimated \$11.5 billion in e-commerce use taxes went uncollected in 2012. Governments deal with these revenue losses either by foregoing expenditures on priorities like roads, bridges, and police or by charging residents higher rates on sales, income and/or property taxes.
- Brick and mortar vendors face a competitive disadvantage to online retailers. Music City Café’s products effectively cost 9% more for a Tennessee purchaser than for those who live out of state. By choosing not to enforce use tax laws, states provide a tax subsidy to out of state online sellers, even as

indigenous firms face a sales and use tax penalty for choosing to open a business or operate a warehouse in a given state. The effects are significant. Research on consumer activity shows that every 1% increase in the sales tax rate raises residents' out of state e-commerce purchases by almost 2%. And online purchases from in-state retailers fall 3-4% with a 1% tax rate increase. This situation might have made some sense in the early years of the Internet when the tax subsidy helped jump-start the online revolution, but such a tax subsidy for non-resident online sellers is no longer defensible.

- The whole U.S. economy is harmed as firms tailor modify practices and locations to avoid collecting taxes. Music City Café, for example, might want to open up a store in downtown Atlanta, but if it did it would be forced to collect taxes on its sales to millions of online shoppers from Georgia. Ideally, the sales and use tax system should be neutral with respect to such business decisions.

Toward a Level Playing Field for All Retailers

In both the U.S. House and Senate, a number of bills have been introduced to overturn the *Quill* decision, but none have passed both chambers. Given Congressional inaction and the evolution of technologies that would make it easier for online sellers to collect sales and use taxes, states are moving to bring down *Quill's* physical presence rule. South Dakota has passed a law that requires remote sellers selling more than \$100,000 of tangible personal property into the state to collect and remit South Dakota sales taxes *as if* the seller had a physical presence. As the U.S. Supreme Court considers its ruling in the *Wayfair* case, it will have to re-visit the 1992 holding. Importantly, overturning *Quill* would not create a new tax for consumers – it would straightforwardly shift the responsibility for collecting taxes currently owed for online sales from individual shoppers to the online retailer.

Hopefully, the Supreme Court will overturn *Quill* and send the question of taxing online sales back to state legislatures. The same technological revolution that encourages online sales has dramatically reduced the burden online sellers would bear to collect taxes for the states. Because online retailers would no longer be unduly burdened by collections, it is time for online and brick-and-mortar stores to compete on a level tax playing field. Let consumers decide where to allocate their shopping dollars based not on an outmoded, skewed competition among sellers, but on price, convenience, service, and selection.

Read more in Donald Bruce, William F. Fox, and LeAnn Luna, *E-Tailer Sales Tax Nexus and State Tax Policies*, *National Tax Journal* 68, no. 3S (2015): 735-766.