Onset of the Online Sales Tax and the Impact on Municipalities

Tax-free shopping is under threat for many online shoppers, as states facing widening budget gaps increasingly pressure Amazon.com Inc. and other Internet retailers to start collecting sales taxes from their residents. Last month, Senator Dick Durbin (D-Il) introduced a bill allowing states to require all retailers, including those online, to collect sales taxes.

Billions of dollars are at stake as a growing number of states look for ways to generate more revenue without violating a 1992 U.S. Supreme Court ruling that prohibits a state from forcing businesses to collect sales taxes unless the business has a physical presence, such as a store, in that state. States are trying to get around that restriction by passing laws that broaden the definition of a physical presence.

State and local governments are worried the rising e-commerce trend is gradually eroding their tax base. Nationally, states relied on sales taxes for one-third of their tax revenues in 2010. The proportion of sales tax as a percent of total tax revenue varies from state to state. Five states do not have a state sales tax, while 18 states rely on a combination of state and local sales taxes for at least half of all revenue. To stem the erosion of sales taxes losses, state and local governments have looked to Congress to grant them authority under the Constitution's Commerce Clause to collect sales taxes on out-of-state retailers. Currently, states are legally barred from collecting a sales tax on vendors that have no physical presence, like a store, within the state. States have tried to pass laws on their own that require online retailers like Amazon and eBay to pay taxes when they have a distribution center based in a state. Those efforts face political resistance from Democrats and Republicans over job creation and anti-tax supporters.

Retailers are resisting being deputized as tax collectors. Until recently, the Supreme Court ruling has meant that Wal-Mart Stores Inc., based in Bentonville (AR), would collect taxes from shoppers in all states with sales taxes, whether those shoppers buy items on or off the Web, because it has stores nationwide. But Amazon, based in Seattle (WA), would not collect taxes from Floridians because it does not have a presence there. Although in such cases, shoppers in Florida are supposed to pay the tax directly to their state, few actually do.

With the new laws, those living in Evanston (IL) or Providence (RI) can no longer expect to avoid paying taxes when shopping online even though Amazon and others have no traditional operations there. States backing these laws argue that a retailer has a physical presence when it uses affiliates -- people and businesses that refer customers to the retailer's website and collect a commission on sales. These affiliates range from one-person blogs promoting the latest gadgets to companies that run coupon and deal sites.

Illinois passed a law in March requiring Internet companies with affiliates in that state to collect taxes on sales to Illinois customers. In Vermont and Arkansas, similar bills scored initial legislative victories in recent months. New York, North Carolina, and Rhode Island have already adopted similar laws. In Colorado, a law requires online retailers to either collect the tax or send customers an annual notice letting them know how much they owe their state. Retailers would also have to report that to Colorado officials. Several other states including Arizona and Massachusetts are considering passing their own flavor of online sales tax collection legislation.

It is not known exactly how much in uncollected taxes is due to states from online sales, but a 2009 study from the University of Tennessee estimated that it could total $10.14 billion this year, assuming total e-commerce sales of $3.49 trillion. Only a fraction of this owed tax would result from consumer purchases, however, because most e-commerce sales are from one business to another. The tax revenue would only be one plug in the states' budget holes. The total gap is expected to reach $125 billion in the fiscal year that began in July, according to the Center on Budget and Policy Priorities, a policy-research organization.

The states are getting extra prodding from brick-and-mortar retailers, which have long thought it unfair that online retailers could essentially give customers better deals by not collecting sales taxes. They claim that the choice of the merchant by the customer should not be based on tax policy; it should be based on service, convenience, on the shopping experience and, of course, price -- but not price based on tax policy. Online retailers such as Amazon and Overstock.com Inc. disagree with the states' actions, and they are fighting back. After Illinois passed its law, Amazon and Overstock said they would drop their affiliates in that state -- Amazon on April 15, and Overstock on May 1. Online retailers earlier dropped affiliates in several states that are now requiring them to collect taxes. Rebecca Madigan, executive director of California-based Performance Marketing Association, said those affiliates then saw 25 percent to 30 percent declines in revenue. According to Madigan, there are 200,000 Internet retail affiliates across the country, some of which are fighting the legislation in their own ways.

FatWallet, which runs a coupon and deals website in Rockton (IL), is planning to move to another state – probably neighboring Wisconsin, founder Tim Storm said. Storm believes the new law could cost his business $4 million to $5 million in revenue this year, which would be a 30 percent to 40 percent hit, if it stays in Illinois. Already, the company has received notices from Amazon, Overstock, electronics site Newegg, and musical instrument retailer Musician's Friend on their plans to end affiliate programs in Illinois. Storm believes Illinois' law would backfire as affiliate companies such as his leave.

The strategy of cutting off affiliates might also backfire against Amazon and its competitors online. Bricks-and-mortar retailers such as Walmart and Barnes & Noble Inc. have been recruiting affiliates being abandoned by Amazon and others. That means sales could go to these companies instead. Walmart and Barnes & Noble are also among the businesses large and small that support a Washington, D.C.-based group called the Alliance for Main Street Fairness, which is in favor of the changing of tax laws in various states so that online retailers would have to collect sales taxes.

Amazon does collect sales taxes in North Dakota, Kansas, Kentucky, and its home state of Washington. It collects in New York, too, as it fights the state over a 2008 law that was the first to consider local affiliates enough of an in-state presence to require sales tax collection. Amazon is also tussling with Texas, which contends the company owes it $269 million in uncollected online sales taxes because it operates a distribution center near Dallas. Amazon plans to close that facility, and scrapped plans to expand elsewhere in Texas over the dispute. Paul Misener, Amazon's vice president of public policy, said Amazon is not against the principle of collecting sales taxes. Rather, it wants "a constitutionally permissible system that is applied evenhandedly." Last month, Republican Governor Perry vetoed a bill that would have required Amazon to collect sales taxes. But lawmakers inserted a similar provision into a broad fiscal bill this month. Last week, members of the Texas House voted against stripping the Amazon tax provision from the fiscal bill.

Just this past week, Amazon filed papers to try to get a referendum in the June 2012 California election in an effort to overturn a new online tax-collection law. A bill passed by Democratic lawmakers and signed by Governor Brown as part of the adopted budget requires major online retailers to collect sales taxes. Democrats believe the proposal would raise $200 million the first year. Once the law passed, Amazon cut off its thousands of affiliates to avoid collecting taxes.

South Carolina recently passed a law exempting Amazon from collecting sales taxes if it maintains at least 1,500 jobs at a new distribution center. The exemption drew support from local Democrats who said the job gains outweighed the tax benefits.

Online sales tax bills will continue to pop up across the country, gaining support from some and inciting ire from others as more and more consumers shop online. MTAM believes that other important issues will be sure to arise, such as enforcement of the tax law compliance via affiliates. To put it mildly, there are numerous problems associated with the logistics of states collecting sales tax outside their borders. State tax auditors are unlikely to be heading from Dallas to Seattle to conduct audits of Amazon. And how, exactly, would Illinois determine if a shopper in Miami bought a hubcap from a Chicago-based auto parts retailer? The idea of protecting and nurturing Internet-based sales is not as sensitive as it was 10-15 years ago, when far fewer transactions took place online, but at the same time it appears the impetus for new laws taxing e-commerce transactions is motivated mostly by a desire to increase state tax revenues during this time of budget deficits.

State and local governments will lose at least $10.14 billion this year in tax revenue not collected on Internet transactions — a figure some experts believe is too low. California is projected to lose $1.7 billion this calendar year; Texas and New York could lose $700 million each. MTAM has concerns that while the onset of the online sales tax would most certainly prove to be a mini-boon to U.S. state coffers (and add to bondholder security), the tax could also depress retail sales which would have a negative impact on the already weakening economic recovery.