

March 15, 2018

No. 42

Online Sales Taxes Make Government Bigger and Undermine Federalism A Primer on Leading Internet Sales Tax Proposals and their Political Prospects

By Jessica Melugin*

The rapid growth of online retailing has prompted state and local government officials to seek greater authority to capture more sales tax revenue, and from brick-and-mortar retailers to allow states to “level the playing field” by collecting sales tax from retailers in other states who sell to their residents. A leading congressional proposal to grant them this power would harm consumers, hurt small online businesses, and hinder the free flow of interstate commerce. While it would not technically impose a new tax, consumers will experience the legislation as a net tax hike.

A 1992 Supreme Court decision, *Quill v. North Dakota*, mandates that a seller must have a physical presence, or “nexus,” in the buyer’s state to be subject to the latter state’s sales tax. Far from a tax loophole, this is the principle of “no taxation without representation” in action. The seller, not the buyer, calculates and remits sales tax. While this arrangement can lead to different sales tax treatment among different retailers, it benefits consumers by preserving healthy tax competition among states.

Policy Recommendation. Attempts to empower states to tax outside their borders are unpopular with voters and undermine both fiscal conservative principles and state sovereignty under America’s federal system.

By contrast, an [origin-based sales tax](#) system provides a more equitable and efficient approach to Internet sales that preserves healthy tax competition among states. It would address the inequities of the current regime without the negative consequences from allowing states to tax non-residents.

Under an origin-based system, tax is assessed at the point of purchase, as in a brick-and-mortar store. For example, if a Virginia resident buys socks online from a California seller, that purchase is taxed according to California’s tax rate and remitted to the Golden state. It is no different than if that Virginian flew to California to buy socks in person.

* Jessica Melugin is an adjunct fellow at the Competitive Enterprise Institute.

Leading Proposals

The Remote Transactions Parity Act ([RTPA, H.R.2193](#)), sponsored by Rep. Kristi Noem (R-S.D.), gives states unprecedented new powers to reach outside their borders to tax online sales. It creates an option for sellers to use tax compliance software known as Certified Solution Providers (CSPs), but does not compensate sellers for the costs of implementing and testing it. The bill gives lip service to protecting small sellers from cross-border audits, even though all states are already allowed to audit small sellers—those with under \$5 million in sales—if the state has a “reasonable suspicion” of misrepresentation. It also contains a small seller exemption that provides some relief from compliance costs, but phases out completely in only four years—by which time all online businesses will be forced to act as tax-collection agents for every state with a sales tax.

Another proposal is a hybrid origin sourcing option, which was suggested by House Judiciary Committee Chairman Bob Goodlatte (R-Va.) in the 114th Congress. This would require sales to be taxed in accordance with the tax base of the seller’s state—what is and is not subject to taxation—at the buyer’s state’s tax rate for remote purchases. In practice, this means an Etsy seller in California who sells a pair of socks to a buyer in Virginia would have to determine a) if the socks are taxable under California’s tax law and b) Virginia’s tax rate for that item. The sock seller would then remit the tax to California authorities, who would forward those funds to a multistate clearinghouse. The clearinghouse would then calculate an amount to send back to Virginia using a given formula.

The issue has reached the courts. While Congress debated the issue, many states sought to expand the definition of nexus in order to trigger sales tax collection. These attempts, most notably by California, New York, and Colorado, worked their way through the courts with varying results. This culminated in the South Dakota legislature passing an intentionally unconstitutional remote state sales tax bill that helped launch a challenge to *Quill* that has now reached the United States Supreme Court, [South Dakota v. Wayfair](#). Oral arguments in this case are set for April. A ruling is expected before summer of 2018.

State of Play

Polls show that efforts to expand sales taxes on the Internet remain unpopular. A March 2018 National Taxpayers Union [poll](#) found strong majorities across party lines opposed new Internet sales taxes, with 65 percent of likely 2018 voters opposed to expanding online sales taxes. This is consistent with the opposition measured in other polls on the subject.

Proponents of empowering states to tax out-of-state sellers include state and local governments and the associations that represent them. Expanded sales tax collection would provide a windfall to their coffers and allow them to kick politically unpopular budget cuts down the road. Other supporters include big box retailers, whose brick-and-mortar stores pay sales taxes in every state. Their calls for “fairness” notwithstanding, large retailers stand to gain a competitive advantage from the disproportionate compliance cost burdens RTPA imposes on smaller retailers. Amazon is also advocating for online sales tax legislation. The

online retailer now operates warehouses across the country to facilitate fast delivery—a physical presence that has made them subject to sales taxes in several states.

Opponents of RTPA-style legislation include officials of states with no sales tax, who object to subjecting retailers to calculating, collecting, and remitting sales tax to other states. They view this as a states’ rights issue. The Direct Marketing Association and eBay have been vocal in opposition, worried that compliance costs would prove detrimental to their members—and even force some to cease operations. Taxpayer watchdog groups, free-market think tanks, and fiscally conservative columnists have objected on principle.

For Further Reading:

Jessica Melugin, “Don’t Let an Online Sales Tax Hike Creep into Omnibus Spending Bill,” Competitive Enterprise Institute Blog, March 2, 2018,

<https://cei.org/blog/dont-let-online-sales-tax-hike-creep-omnibus-spending-bill>

Jessica Melugin, “States Are Secretly Trying to Tax Your Online Purchases,” Fortune.com, June 22, 2017,

<http://fortune.com/2017/06/22/digital-online-internet-sales-tax-no-regulation-without-representation-act/>

Hans Bader and Ryan Radia, “From Overstock to Overtaxed: The Dubious Legality of State Click-Through Nexus Taxes,” working paper, Competitive Enterprise Institute, November 2014,

<https://cei.org/content/overstock-overtaxed>