TAXATION OF E-COMMERCE

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TAXATION OF E-COMMERCE

A Project

by

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6-11-2008
Abstract
of
TAXATION OF E-COMMERCE
by
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Statement of Problem
Should electronic commerce be required to collect and remit sales taxes on interstate sales to consumers when there is no nexus between the seller and the taxing jurisdiction of the purchaser?

Conclusions Reached
Electronic commerce should keep developing and expanding without subjection to sales tax collection requirements for thousands of differing tax jurisdictions.

Dr. Stephen Crow, Committee Chair

June 11, 2008
Date
# TABLE OF CONTENTS

**Chapter**

1. **INTRODUCTION** ........................................................................................ 1  
   - Background of Sales and Use Tax ................................................................. 2  
2. **NEXUS** ........................................................................................................ 5  
   - Internet Tax Freedom Act ............................................................................. 7  
   - Streamlined Sales and Use Tax Agreement .................................................. 9  
3. **SUCCESSES IN E-COMMERCE** ................................................................ 14  
4. **FINDINGS AND INTERPRETATIONS** ............................................................ 15  

**Appendix**

- Appendix A. Estimated Quarterly U.S. Retail Sales: Total and E-commerce .......... 17  
- Appendix B. Retail E-commerce Sales as a Percent of Total Quarterly Retail Sales: .... 18  

**References** ........................................................................................................ 19
Chapter 1

INTRODUCTION

Electronic commerce is becoming an increasingly hot topic among state and local governments. The debate centers over whether on-line retailers have the right to continue selling goods and services to out of state customers without collecting sale or use taxes. As the law currently stands, sellers are only required to collect sales tax from purchasers located in the same state as the seller’s presence. If the seller is located in a different state it is up to the purchaser to report the use tax to their state authority and pay the appropriate tax on the item. For consumer purchases this self-assessed tax is rarely paid. Fortunately for state and local governments who rely on sales tax revenue, the majority of e-commerce sales are business to business purchases. These business-to-business transactions are more likely to comply with tax regulations and the buyer will pay the use tax on any goods subject to the tax. This is due to the audit process that a business is subject to and the need for financial compliance to accounting standards. The Board of Equalization assumes an 80 percent use tax compliance rate for businesses.¹ Consumer purchases where the sales tax is not collected by the seller are the least likely to voluntarily pay the use tax on the goods. Individuals usually only pay use taxes when they purchase items such as automobiles, boats or other recreational vehicles that require registration in their state of residence. States who collect and depend on sales and use taxes as a source of income feel they are losing revenue. These potential monies would otherwise be going to public funds, but the regulations do not require sales tax collections.
by interstate sellers who conduct business with their residents. States and local
governments vary vastly in what goods they impose sales and use taxes upon, but
typically, it applies to retail sales of tangible personal property, which includes material
goods. Generally, sales and use taxes exclude most services and intangible products
unless the law specifically states the service as taxable. Example of services that are not
taxable would be financial and legal services, medical treatment and education services.

Background of Sales and Use Tax

State governments have little trouble ensuring that sellers located within their
boundaries collect and remit the appropriate tax. Situations involving remote sellers, who
are not located in the state government's jurisdiction, selling to buyers within the
destination state's jurisdiction who should be paying the tax, are becoming a greater
problem. The Supreme Court has set the precedent in the taxing of interstate commerce.
In 1942 there were two major cases which made it before the Supreme Court in regards to
mail order sales. The cases involved Sears, Montgomery Wards and the state of Iowa.²
Both retailers operated brick and mortar stores in Iowa but they also sold merchandise to
Iowa residents via their mail order divisions, who operated completely outside of the
state. The companies had not been collecting sales tax on transactions between the mail
order division and Iowa residents, since the merchandise was being shipped to Iowa from
an out of state location. Iowa contended that since it had jurisdiction over the
corporation, who operated stores in state and the residents who made the purchases, the
state had the legal right to require those entities to collect and remit appropriate sales and use taxes on all their sales in the state, including those made by mail order. The Supreme Court agreed with the state of Iowa, since the two entities (mail order division and physical stores) were operated by the same parent corporation.

The next major case to appear before the Supreme Court regarding this topic was *National Bellas Hess, Inc v. Illinois Department of Revenue.* In this case, National Bellas Hess was purely a mail order seller who had no physical presence in Illinois. Due to their lack of physical presence in the state of Illinois the Supreme Court struck down the state’s attempt to require the remote seller to collect and remit the state’s sales tax.

The most influential case heard before the Supreme Court was *Quill Corp v. North Dakota.* In this case, the Supreme Court set forth two constitutional nexus tests which have to be met in order for a state to have tax jurisdiction over an out of state person or entity. The Court held that a remote seller could be required to collect sales taxes only if the seller had the requisite nexus with the buyer’s state. The Quill Corporation sold office furniture products through a catalogue. They had no physical presence in North Dakota nor did they have any sales agents in the state, but the North Dakota Supreme Court held that by selling its products to North Dakota residents, Quill established an economic presence that created nexus for sales tax purposes. However, the US Supreme Court held differently and ruled that a state could not require a company to collect and remit sales taxes unless the company had substantial connections with the state. Under the Commerce Clause, a mail-order company without a physical location, employees or sales agents in North Dakota cannot be compelled to collect sales tax on its
sales to North Dakota customers. Through these above cases the precedent of physical presence became necessary for a state to require an entity to collect and remit sales taxes on sales to their residents.

In recent decisions, the California State Board of Equalization sought to require Borders Online to collect and remit the California sales and use taxes on its sales of merchandise shipped into California. Borders Online sells books and other items to California residents but has no employees or property in the state. However, Borders Online did have an affiliation with Borders Stores who operate out of physical locations in California. Online customers who purchased items and then wanted a refund had the option of returning the item to one of the brick and mortar Borders Stores to receive a full refund. Even returns not accompanied with a proof of purchase, could still receive a credit usable for future purchases at Borders Stores. The Board found the option of a return for a refund at California stores was a significant selling advantage, and that substantial physical presence test was met since Borders Stores physical buildings and personnel could be connected with Borders Online.⁵

Nexus can be a difficult concept to define in an increasingly electronic and global environment. In some states, they have found that just having a server located within the state will not create nexus for use tax purposes. The Virginia Department of Taxation came to the conclusion that nexus was not created for an out-of-state seller whose only presence was the use of a computer server to create and maintain a site on the world wide web.⁶ Sales and use taxes are still due to the state by their residents, but it would not be the responsibility of the out of state seller to collect and remit these taxes.
Chapter 2

NEXUS

Whether an e-commerce business is required to collect and remit sales and use taxes depends on the seller's nexus to the purchaser's state of residence. Nexus is defined through the Supreme Court's interpretation of the Constitution. The Commerce Clause of the U.S. Constitution prevents states from imposing taxes that would interfere with the free flow of interstate commerce. Congress has the sole authorization to regulate commerce with foreign nations and among states. This is expressed in Article I, section 8, cl. 3 of the constitution. Current laws regarding interstate commerce could change, but it would require an act of Congress. The concept of nexus is prohibiting most e-commerce purchases and sale transactions from taxation by state authorities. Nexus is a contact or link, which forms the legal basis for the imposition of taxes. A sufficient link between the seller and the state must exist in order for the transaction to be subject to state sales taxes. The question with e-commerce is where is the nexus? Is it between the seller and their home state, the seller and the state of the consumer, the consumer and the state of the seller, or the consumer and their state of residence? Most tax regulations were established well before e-commerce entered the arena and the current tax laws are deeply rooted in concepts of physical location or presence. Since current sales and use taxes are destination based, it is the purchaser's responsibility to pay their state's appropriate tax.
Attempting to pinpoint the location of an e-commerce transaction can be very difficult. There are 15 possible locations where activities could possibly occur in a complex transaction:

1. Buyer’s physical location
2. Buyer’s Internet service provider
3. Electronic commerce mall Web site
4. Seller’s Internet service provider
5. Sales authorization center
6. Credit authorization
7. Shipping warehouse
8. Common carrier to deliver product
9. Buyer’s temporary storage warehouse
10. Buyer’s accounts payable
11. Buyer’s operating facility
12. Seller’s technical support
13. Third-party customization
14. Resale to final consumer
15. Delivery to final consumer

While most e-commerce transactions involve much fewer locations, it would not be rare for the transaction to involve at least four different locations. The more locations involved, the more potential there is for different tax laws and sales tax rates to come into effect. Some e-commerce sellers do not require a buyer to supply their physical location.

For example, a customer downloading music or software may only need to provide a valid credit card number and the credit card billing address, which some sellers have validated, but this address might not be the location where the product is delivered. Even if a seller does require the shipping or billing address, determining the appropriate tax rate is still not an easy process. Boundaries of many local tax jurisdictions are not the same as city or county boundaries. In many large urban areas, the sales tax rate includes
components for the state, city and other local taxing authorities. Therefore, just using standard five digit postal zip code is not adequate in determining the appropriate tax jurisdiction. To date, on-line sellers are protected from having to assume the burden of collecting interstate sales taxes due to a moratorium known as the Internet Tax and Freedom Act.

Internet Tax Freedom Act

When the internet was in its early stages of formation, people began expressing concern that internet taxation would stifle its growth and innovation. In response to these concerns, Congress enacted the Internet Tax Freedom Act, in 1998. This Act provided a three year moratorium on state and local governments from enacting any new taxes specifically on Internet access and prevented them from imposing multiple and discriminatory taxes on electronic commerce. This Act was renewed in 2004, President Bush recently signed H.R. 3678, the “Internet Tax Freedom Act Amendment Acts of 2007,” which continued the prohibiting of multiple, and discriminatory taxes on electronic commerce until November 1, 2014. These Acts do not exempt all on-line retailers from collecting and remitting sales taxes. An on-line merchant, who has a brick and mortar presence in a state, is still subject to sales tax collection on any sales to consumers located in that respective state. This type of legislation from the government is a step in the right direction. Letting the Internet takes its own course and not restricting it in the formative years has demonstrated growth at a pace that dwarfs any prior
technological advancement. The telephone took 38 years to penetrate 30 percent of US households, television took 17 years to reach that milestone and personal computers took 13 years. Once the World Wide Web made access to the Internet available to all households, it took less than seven years to reach the 30 percent penetration level. The Internet has not only provided access to information for people who would otherwise not have it, but is providing infinite opportunities for small businesses. These businesses now have the prospect to offer their goods and services to potential customers outside of their immediate market and it has increased the demand for high-tech workers. This rapid growth of the Internet with its developments in e-commerce and new business models have allowed business to evolve from a classic business model into a complex model. Traditional tax laws do not necessarily contain the legal language to cover the scope of possible transactions within an e-commerce transaction compared to traditional retail transactions.

Since taxes first came into existence in the United States, people and businesses have been trying to find ways to reduce their tax liabilities and collection responsibilities to their lowest possible level. States such as Oregon, New Hampshire or Montana, which do not have any sales or use tax, are becoming a popular locations for e-commerce companies to locate their sales centers. Oregon has become a particularly popular tax haven for software transactions. Larger companies who purchase software will have it downloaded on a server located in Oregon and then transmit numerous copies to locations in other states. Oregon does not collect any sales or use tax and users in California are exempt when they download software from the Oregon server. In an
attempt to prevent this type of sales tax avoidance, a coalition of over 40 state
governments and some private sector businesses have joined together to create the
Streamlined Sales and Use Tax Agreement.

Streamlined Sales and Use Tax Agreement

The U.S. Streamlined Sales Tax Project began in early 2000 as an initiative by state
governments, with input from both local governments and the private sector, in an
attempt to simplify and modernize sales and use tax administration for all types of
commerce. The primary focus of this project is to improve sales and use tax collection
and administration systems for the Main Street brick and mortar retailers, remote sellers
and for states. The project’s main goal is to provide a sale and use tax system, which has
the following characteristics:10

- Neutrality – Taxability should be independent of the method of commerce used in
  a transaction.
- Efficiency – Administrative costs should be minimized for both business and
government.
- Certainty and Simplicity – Tax rules should be clear and simple.
- Effectiveness and Fairness – Taxation systems should minimize the possibility of
evasion.
- Flexibility – Taxation systems should keep pace with changes in the economy.

While the concept of simplifying the current tax system throughout the country is
an appealing one, states already have the ability to simplify the tax systems within their
own borders. The laws regarding interstate commerce are set at the federal level; states
concerns of loss revenue would require a federal law to change the existing sales tax regulations. This policy role is the federal government's only part in the Internet sales tax debate; the issue has no direct federal budgetary implications. Internet commerce and the growth seen within it for the past nine years is just an example of rational economic behavior. E-commerce has seen double digit growth for the past five quarters when compared to the respective quarter of the prior year (Appendix A). If a consumer lives in a high tax jurisdiction, they are going to purchase the item where it costs them less, and on-line might be a very viable option. While brick and mortar stores might claim this is taking sales away from their operation through an unfair advantage, it also could be a way for these storefronts to increase their exposure and customer database. Many have asserted that consumers deliberately shop on-line as a means to avoid sales tax. According to a survey by Jupiter Research, more than 25 percent of users said sales tax never figures into their decision on where to shop, while 54 percent were not even aware they could avoid sales tax by shopping at different web sites. The amount of wealth in the US economy is not fixed. When there is growth in the economy, a gain in one sector does not necessarily correlate to a loss in another. While the percentage of e-commerce sales as a percentage of total retail sales is steadily increasing, it does not automatically mean a decrease to traditional retail sales.

State governments supporting this Agreement say it is designed to deal with the concerns of cash-strapped states and localities who are concerned about the growth of remote sales, especially those transacted via the Internet. These state governments argue if laws are not changed to make it easier to collect taxes on such sales, which by their
nature are difficult to tax, funding for key public services will be lost. This type of agreement would require an increase in the size of state governments and would eliminate a tax advantage which has been helping the Internet grow to a desirable size. From a business’s perspective, efforts to comply with state sales and use taxes would be further complicated by administrative burdens due to the lack of uniformity among the states regarding the definition of taxable items, determination of the sale location, and many other administrative requirements. Additional complexities arise from the administration of sales and use taxes by numerous local governments. There are currently more than 7,500 sales tax jurisdictions across the United States. The Agreement does recommend the creation of a Certified Automated System (CAS) or a Certified Service Provider (CSP) to handle the determination of tax due and/or serve as the collecting agent. These systems would serve as a tax clearinghouse where sales taxes are both collected and remitted based on the purchaser’s tax jurisdiction. Hypothetically, how the process would work is that when an online order is placed, the seller would either have had to purchase their own CAS software to calculate the correct tax rates or subscribe to a CSP who would handle the tax collecting responsibilities for the seller. Typically, the purchaser’s credit card company would be contacted to determine the individual’s tax jurisdiction. The CAS would then notify the seller of the appropriate tax dollars, and the credit card company would collect the funds and remit them either to the seller or to a CSP. If the seller wanted to maintain all their own records, they would then be responsible for remitting the collected tax to the correct tax jurisdiction being able to retain a small percentage of the taxes collected as a processing fee. If the seller opted for
a CSP, they would distribute the funds to the states and localities and be paid a small percentage of the taxes collected. The CASs and CSPs would need to be licensed by each state and all costs associated with approving these systems would be the responsibility of state and local governments.\textsuperscript{14}

All tax systems require administrative and compliance costs. Tax systems require administration, tax laws must be enforced and taxpayers, both individuals and businesses must spend both time and money to comply with those laws. States trying to make it the responsibility of the remote sellers to collect the sales and use taxes from their residents saves them administrative costs but these costs would just be passed down as an increase in costs to remote retailers. These costs could ultimately be higher than local retailer’s compliance costs, since remote retailers would be collecting sales and use taxes for up to thousands of differing tax jurisdictions. Since local retailers are only responsible for collecting and remitting their local taxes and not those of differing jurisdictions, the administrative cost and time involved is much less. The US economy is not solely comprised of giant corporations, in fact, 99 percent of all independent enterprises in the US employ fewer than 500 employees and these small enterprises account for 52 percent of all US workers.\textsuperscript{15} These small enterprises are the backbone of the US economy and subjecting them to increased tax regulations and compliance costs would only be detrimental. Despite the rapid growth of the Internet, not all competitive advantages are held by e-commerce. Any product ordered over the Internet involves a delay between order and delivery, in contrast to shoppers of a traditional brick and mortar store who make a purchase and leave the store with possession of their goods. In addition, many
people do not feel comfortable ordering certain items or providing their credit card
information over the Internet. Traditional retailers also have the advantage of personal
service and the opportunity for a consumer to physically handle and examine the actual
product they are intending to purchase. E-Commerce sales typically involve shipping
and handling costs, which can add as much or more to the cost of a product as would
sales taxes.
Chapter 3

SUCCESSES IN E-COMMERCE

When looking at all the different types of operations conducted via the Internet, many operations are drawing the attention of taxing authorities in regards to the tax revenue, which they might be missing out. E-Bay is a prime example of a startup company, which has produced large profits for itself, and created an avenue for the average citizen to make extra money if not a living. Income received from this type of online auction is taxable. The question is would a site like E-Bay be responsible for policing their users and collecting taxpayer identification numbers from clients and then reporting these sales to the Internal Revenue Service? This type of policy would put E-Bay at a competitive disadvantage since sellers who would rather not report their auction income could move to other sites, such as Craigslist, and continue their status quo. As an E-Bay representative told The Financial Times, “Forcing E-Bay, but not Craigslist, to report sales to the government would be like requiring indoor shopping malls, but not strip malls, to report on their tenants...Business owners would relocate to the strip mall.” Since E-Bay never takes possession of the items sold from its site; it cannot be considered a broker. E-Bay is never informed if a sale is completed, they only provide a platform for individuals and businesses to sell and shop for goods.
Chapter 4
FINDINGS AND INTERPRETATIONS

Electronic commerce is on the rise and at a period in time when the rest of the economy is facing possible turmoil, e-commerce should be allowed to keep growing at a steady pace. In a recent release from the U.S. Census Bureau, the total retail sales for 2007 increased 4 percent from 2006. E-commerce sales increased 19 percent from 2006 sales, and in 2006 e-commerce sales only accounted for 2.9 percent of total retail sales and for 2007 they accounted for 3.4 percent of the total. Granting power to states to levy taxes and tax collecting responsibilities on companies not physically located in the taxing state is similar to taxation without representation. Taxation should be strictly limited to functions performed within the governing jurisdiction. Taxes should not be levied on or collected from people who have no say in how the revenue is spent and who receive no direct benefit from the public services they would be funding. The concept of granting power to politicians from one state to tax the people of a different state contradicts the Constitution of the United States. The people and businesses being subject to this tax would not have any recourse through the voting process. In addition, requiring remote sellers to collect sales and use taxes could possibly cause a decrease in national income due to tax-motivated decisions about consumption while increasing compliance costs on these sellers who would have to collect and remit the taxes. This could force these on-line retailers to pass along their compliance costs to the consumer, making their goods even more costly. When you factor in shipping and handling fees
that most often accompany an on-line purchase, it could ultimately make e-commerce goods more than those offered by traditional retailers. Former US Supreme Court, Chief Justice John Marshall correctly noted that, “The power to tax is the power to destroy.”

Every tax rate has a point where it will no longer bring in incremental revenue, because people will cease to engage in the taxed activity. President Calvin Coolidge stated it precisely, “Collecting more taxes than is absolutely necessary is legalized robbery.”

State governments have only been relying on sales and use taxes since the mid-1930s. If the state governments would do a better job managing their expenditures and revenue, they would not need to harass a growing sector of the economy. Mandatory collection of sales or use taxes will primarily affect e-commerce sites including eBay and Amazon. However, smaller e-commerce providers may also suffer and shut down, which in turn would reduce revenues to Web hosting services, bandwidth providers, and interfere with state and federal income tax revenue as these companies could have to shutdown or see a decrease in profits. As both a bulwark against heavy-handed government and an engine to advance economic growth, a broad moratorium on Internet taxation continues to make sense. In some distant future of heavy Internet commerce, the country may need to reassess. For now, the Internet is still more like a frontier than a settled land and it should be treated accordingly.
APPENDIX A

Estimated Quarterly U.S. Retail Sales: Total and E-commerce

(Estimates are based on data from the Monthly Retail Trade Survey and administrative records.)

<table>
<thead>
<tr>
<th>Quarter</th>
<th>Retail Sales (millions of dollars)</th>
<th>E-commerce as a Percent of Total</th>
<th>Percent Change From Prior Quarter</th>
<th>Percent Change From Same Quarter A Year Ago</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total</td>
<td>E-commerce</td>
<td>Total</td>
<td>E-commerce</td>
</tr>
<tr>
<td>Adjusted</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4th quarter 2007(p)</td>
<td>1,030,715</td>
<td>36,247</td>
<td>3.5</td>
<td>0.9</td>
</tr>
<tr>
<td>3rd quarter 2007(r)</td>
<td>1,021,042</td>
<td>34,667</td>
<td>3.4</td>
<td>0.9</td>
</tr>
<tr>
<td>2nd quarter 2007</td>
<td>1,012,375</td>
<td>33,477</td>
<td>3.3</td>
<td>1.1</td>
</tr>
<tr>
<td>1st quarter 2007</td>
<td>1,000,919</td>
<td>31,613</td>
<td>3.2</td>
<td>1.6</td>
</tr>
<tr>
<td>4th quarter 2006</td>
<td>984,910</td>
<td>30,712</td>
<td>3.1</td>
<td>0.2</td>
</tr>
<tr>
<td>Not Adjusted</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4th quarter 2007(p)</td>
<td>1,078,555</td>
<td>41,758</td>
<td>3.9</td>
<td>6.1</td>
</tr>
<tr>
<td>3rd quarter 2007(r)</td>
<td>1,016,550</td>
<td>32,234</td>
<td>3.2</td>
<td>-1.4</td>
</tr>
<tr>
<td>2nd quarter 2007</td>
<td>1,030,508</td>
<td>31,828</td>
<td>3.1</td>
<td>10.3</td>
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<td>30,624</td>
<td>3.3</td>
<td>-9.0</td>
</tr>
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<td>4th quarter 2006</td>
<td>1,027,047</td>
<td>35,322</td>
<td>3.4</td>
<td>4.3</td>
</tr>
</tbody>
</table>

(p) Preliminary estimate. (r) Revised.

E-commerce sales are sales of goods and services where an order is placed by the buyer or price and terms of sale are negotiated over an Internet, extranet, Electronic Data Interchange (EDI) network, electronic mail, or other online system. Payment may or may not be made online.
APPENDIX B

Retail E-commerce Sales as a Percent of Total Quarterly Retail Sales

4th Quarter 1999–1st Quarter 2008
REFERENCES


3 *National Bellas Hess, Inc v. Illinois Department of Revenue*, 386 US 753, 18 L Ed 2d 505

4 *Quill Corp v. North Dakota*, 504 US 298, 119 L Ed 2d 91


8 Retrieved on 5/1/08 from: www.informationweek.com/story/showArticle.jhtml?articleID=202801131


14 *Streamlined Sales and Use Tax Agreement*. Amended April 2, 2008, Pg. 55


