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ADD TO CART: HOW ARKANSAS CAN SUPPORT VITAL SERVICES BY FULLY TAXING INTERNET PURCHASES

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Executive Summary

Arkansas will lose an estimated \$113 million in sales tax revenue this year on Internet purchases and lose more from untaxed catalog, phone and other “remote sales.” This lost revenue makes it harder for Arkansas to invest in public services that draw employers and build a strong economy.

Although Arkansas consumers owe sales tax on all “remote” purchases under state law, much of the potential revenue is lost because out-of-state sellers are not required to collect the tax. Buyers don’t know or ignore their obligation to report it on their income tax returns.

Untaxed remote sales cause two distinct problems other than lost revenue. First, they put local merchants at a price disadvantage compared to online competitors who don’t charge sales tax. Second, avoiding sales taxes disproportionately benefits more affluent customers who have greater access to credit cards and computers.

During the 2011 legislative session, Arkansas adopted the “Amazon law” to begin addressing uncollected tax revenue on Internet purchases and improve economic competitiveness of local retailers. Arkansas should consider other ways to collect this lost revenue, including:

- Requiring remote sellers to charge Arkansas sales tax when other businesses perform market-enhancing activities here on their behalf.
- Requiring remote sellers to remind consumers about their sales tax obligations.
- Requiring that firms getting government contracts to collect sales tax.
- Encouraging taxpayers to self-remit sales and use tax.
- Taxing downloads of software, music and other digital products.



Introduction: Millions Lost Through Online Purchases

Like all states, Arkansas has struggled since the onset of the recession to maintain support for the shared systems we all rely on for economic opportunity. We all know that employers are drawn to communities that invest in education, health and safety. At the same time, families who've lost jobs and homes have turned to support systems. High unemployment and wavering consumer confidence have caused a dramatic decline in the revenue it takes to meet those needs. Trying to respond to this income problem with significant spending cuts will threaten the state's economic recovery and destabilize the economic security of Arkansas families.

The challenge is to find a balanced approach. We know some cuts will be needed, but we'll also need to find new revenue. One option is to address the significant erosion of revenue from the growing number of sales that take place over the Internet—and other “remote” venues such as catalogs—from out-of-state sellers who aren't collecting sales taxes as they should.

Our state's inability to collect these sales taxes is a major problem. And it's growing rapidly. A recent study estimated that the loss of revenue in Arkansas will be \$113 million in 2011. That's the state's share of \$11 billion lost nationwide through Internet sales that are not taxed at the time of purchase, nor reported when taxpayers file with their state.¹

The “Internet Tax Freedom Act” Does Not Bar Sales Taxation of Internet Purchases

The 1998 federal Internet Tax Freedom Act (ITFA) placed a moratorium on taxing access to the Internet. It has been extended until 2014 and also bars taxation of such Internet services as e-mail and data storage. However, ITFA does not bar taxing items purchased over the Internet as long as they are taxed the same way they would be if purchased in a store. There is no law in place (at either the state or federal levels) that says Internet sales cannot be taxed.

Internet sales and other “remote” purchases are a problem in two other ways. First, they put local merchants at a price disadvantage compared to out-of-state online competitors who don't charge the state and local sales tax. In Arkansas, that ranges from 6 percent to 10 percent. In today's competitive—yet stagnant—economy, operating at such a disadvantage can seriously harm the ability of local “mom and pop” businesses to create jobs. Second, because consumers need computers and credit cards to shop on the Internet, low-income residents without those luxuries have to shop in stores end up paying sales taxes that more affluent households can avoid.

How does the problem of untaxed remote sales play out? Consider the following example. Mr. Adams and Mr. Brown are neighbors and have been discussing the release of “The Gadget,” the newest high-tech toy to hit the market. Mr. Adams orders it online from MegaSuperStore.com, an out-of-state, online retailer that does not collect sales tax. He pays \$250 for it.

Mr. Brown goes to the only local store that carries “The Gadget” and pays \$268.75—the price of the item plus \$18.75 in state and local sales tax. It may appear that Mr. Adams got the better deal, but there's a hiccup here. Though Mr. Adams was not charged the sales tax by MegaSuperStore.com (who is not required to collect the tax), legally he still owes the same \$18.75 that Mr. Brown paid at the local retailer. But doesn't Mr. Adam owe sales tax on something he bought online? When he buys online and the retailer doesn't collect sales and use tax, does he still owe it? Therein lies part of the problem.



Amazon's Arguments Don't Hold Up

Amazon.com, the largest and perhaps best known remote seller, is also one of the most vocal in claiming it should not be legally required to collect sales and use taxes.

Amazon says collecting sales and use tax in every state will be too big of a burden. However, that argument would seem to be negated by the fact that Amazon already does collect these taxes in almost every state for retailers—like Target—that sell on Amazon's website. So the company has the capacity to collect the required taxes but still fights against doing so and losing its price advantage.

Amazon claims it does not directly benefit from public services in states in which it doesn't collect tax. In fact, Amazon receives direct public service benefits in the 17 states where it clearly has a physical presence, yet it collects sales tax in only four. In the other 13, Amazon claims it doesn't have to collect taxes because its facilities and employees belong to a subsidiary company.

Amazon says it does not gain a competitive advantage over local retailers by not charging this tax. However, top managers of Amazon have made public statements that it does gain a competitive advantage over in-state sellers because it does not charge its customers sales tax.

Source: Mazerov, Michael “Amazon's Arguments Against Collecting Sales Taxes Do Not Withstand Scrutiny” <http://www.cbpp.org/cms/index.cfm?fa=views&cid=2990>

Under the state's sales tax law, Arkansas consumers are required to pay this tax on every purchase made over the Internet. Technically speaking, it's a “use” tax, levied at the same rate as sales tax on items purchased out of state to be used in Arkansas. In our example, Mr. Adams owes a use tax on his purchase of “The Gadget” from MegaSuperStore.com regardless of whether the retailer collects it or not. The problem is that most consumers either don't know they owe the tax or fail to report their Internet and other remote purchases. Unless remote sellers are required to collect and remit the sales taxes owed on these purchases—or at least report these purchases to states—there is no cost-effective way for the state to collect all of this lost revenue from Internet shoppers.

Even though consumers owe sales tax, out-of-state retailers who sell products remotely are not required to collect state and local sales taxes unless they have a physical presence in that state.² That means they have property, employees or other representatives in the consumer's state. This precedent has been in place since 1967 because of a U.S. Supreme Court decision that was reaffirmed in 1992. In the case of Quill Corp. vs. North Dakota, the court said requiring an out-of-state seller, specifically one that does not have a physical presence in a state, to collect state and local sales and use taxes would

be an unacceptable burden to interstate commerce because each state and locality has different rules and rates.

It should be noted that some large remote sellers, such as Wal-Mart and Barnes & Noble, already collect and remit the sales taxes from online purchases because they also have stores in the state. Arkansas already has legislation on the books requiring online companies with a physical presence within the state to collect taxes on remote sales to state residents.

How Arkansas Can Collect Sales Tax on Remote Purchases

The Quill decision that outlined the physical presence requirement for sales and use taxation also clarified that Congress could pass a law authorizing states to require use tax collection by remote sellers that do not have a physical presence in their state.

Though such a law has yet to be passed, many states have signed on to the Streamlined Sales and Use Tax Agreement (SSUTA) to try to make enacting such legislation easier.³ Today 23 states are full members of the agreement; Arkansas became a full member in 2008.

During the 2011 legislative session, Act 291 was passed to make sure that the Arkansas sales tax law remained in line with SSUTA.⁴

The agreement is designed to simplify sales and use tax collection and administration for both retailers and states in a number of ways. Its major features include:

- Member states must use uniform definitions for key taxable and tax-exempt items.
- States and localities are limited in the number of different tax rates they can impose.
- States must administer all local sales taxes.
- States must have uniform rules for identifying the jurisdiction of the consumer who makes the purchase.
- States provide some compensation to sellers to offset the cost of sales tax collection.⁵

The most comprehensive solution to the problem of uncollected tax due on Internet sales would be for Congress to enact federal legislation along the lines of the Main Street Fairness Act. Introduced in July 2011, it would empower sales tax collection for remote sales by states that are part of SSUTA. But the measure is not given a good chance of passing, in part because a number of large states including California, Florida, Illinois, New York, Pennsylvania and Texas have not joined the agreement. That gives Congress an additional excuse not to act. Many politicians are fearful of supporting such a law because it would be viewed as introducing a new tax. In fact, the measure does not impose new taxes but makes it easier for states and localities to more efficiently and effectively collect taxes already owed at the state and local level.

Without a comprehensive law passed by Congress, a large chunk of the sales tax revenue from remote sales owed to states will continue to be lost. However, that doesn't mean states don't have any tools at their disposal. As detailed in extensive research by Michael Mazerov of the Washington D.C.-based Center on Budget Policy Priorities, there are ways for Arkansas and other states to address this growing problem.

Several of these strategies center on the physical state presence that a seller must have under the U.S. Supreme Court ruling in order to be required to collect sales taxes. Two U.S. Supreme Court cases predating Quill make clear that the physical presence requirement can be satisfied in more ways than an overly rigid



definition might suggest. For example, an in-state physical presence can come in the form of a third party working on behalf of the out-of-state retailer.⁶ In 2008, New York State enacted what is referred to as the “Amazon Law,” which requires the Internet retailer Amazon.com to collect sales tax in New York. While the company has no facilities in New York, it does have a presence by means of “affiliates.” These are typically a business or nonprofit organization that promotes Amazon online in return for a commission a percentage of the cost of sales made through the links.

Arkansas took a major step toward collecting sales tax owed by residents by enacting its own “Amazon Law,” Act 1001 (2011). Now, sellers with in-state “affiliate” members must collect state and local sales

tax from their Arkansas customers. Six other states in addition to New York and Arkansas have adopted these laws: California, Connecticut, Illinois, North Carolina, Rhode Island, and Vermont. Although Amazon has challenged the New York law in court and terminated its affiliate programs in Arkansas and the other states, its ability to continue resisting sales tax collection will diminish as more states adopt these laws.

There are five more things Arkansas can do to recover some additional—and much-needed revenue—from sales made online and by catalogs.

Apply Physical Presence Standards Based on Specific Activities Conducted in Arkansas: Some remote online sellers contract with local businesses to serve customers in the state. These include warranty repairs, installation, troubleshooting, maintenance or assembly of items sold by the remote

seller.⁷ Arkansas can change its law to require remote sellers using independent third parties in Arkansas to conduct these types of activities to collect sales tax for the initial purchases. Act 1001 contains a provision requiring remote sellers to collect sales tax when their sister or parent companies conduct these kinds of activities in Arkansas on their behalf. The requirement should be extended to unrelated companies as well.

Require Remote Sellers to Remind Consumers about Their Use Tax Obligations: In 2010 Colorado passed a law requiring out-of-state sellers that did not collect sales tax to report to the state Tax Department once a year the total purchases made by Colorado residents. In addition, at the time of purchase, the seller must inform customers that they may owe sales and use taxes on that purchase. Also, customers receive an annual statement of all their purchases that clearly explains that they may owe taxes on them. Oklahoma and South Dakota have also passed laws requiring remote sellers to remind customers at the time of each purchase that they probably owe tax on it.

The Colorado law includes exemptions to reduce sellers' compliance costs, including a provision requiring an annual statement only for customers that spend more than \$500 in a year. Since most consumers spend less than that amount with a single seller, that exception limits the impact the law could have had on educating people about their obligations to pay the tax. Also, any seller with less than \$100,000 total sales in Colorado is exempted.⁸ To protect the privacy of consumers, the law requires sellers to report to the state only the customer's total purchase amount rather than specific items bought.

The privacy issue has led a federal judge to temporarily prohibit implementation of the Colorado law until the legal questions can be thoroughly reviewed. To avoid this, Arkansas might consider initially enacting only the provisions that require the seller to report to the purchaser (both with each transaction and annually) his or her obligation to pay sales tax directly to the state, since the seller already is aware of its customer's purchases. (This is what Oklahoma and South Dakota have done, although in both cases the reminder is limited to the time of sale.) Given the widespread lack of understanding among consumers that they owe taxes on their Internet purchases, such a notification requirement could generate additional revenue over time.

Require Firms Getting Government Contracts to Collect Tax: A state can write into its state procurement laws a provision requiring that state contracts (and state-funded local government contracts) with private companies can be awarded only if the contractor (and all of its affiliated companies) agrees to charge applicable sales taxes on all sales to consumers in the state. Fourteen states have enacted such laws.⁹

Encourage Taxpayers to Self-Remit Sales and Use Tax: Of the 38 states with both sales and income taxes, 23 have some sort of mechanism to allow individual taxpayers to pay sales tax on their remote purchases annually along with their income tax return. Arkansas and seven other states include information about tax requirements in the state's income tax booklet. But a stronger step would be to also include a line on the actual income tax form. Though this would not

guarantee that everyone pays sales tax owed, more people would likely do so. Also, research has shown that taxpayers are even more likely to pay their sales tax if the state offers an option to determine the amount of tax owed by looking it up on a table based on household income rather than making consumers add up all of their Internet purchase receipts.¹⁰

Tax Digital Downloads: Digital downloads, such as music purchased from online services, are not subject to sales and use tax in Arkansas though comparable items—like a compact disc—are taxed if purchased at a local store. As a member of the Streamlined Sales and Use Tax Agreement, Arkansas defines digital downloads and products in the same way as defined in the agreement. Using these definitions, Arkansas could tax digital downloads if it chose to do so under the agreement. Given the extent to which such products are now being purchased online and the potential tax revenue loss

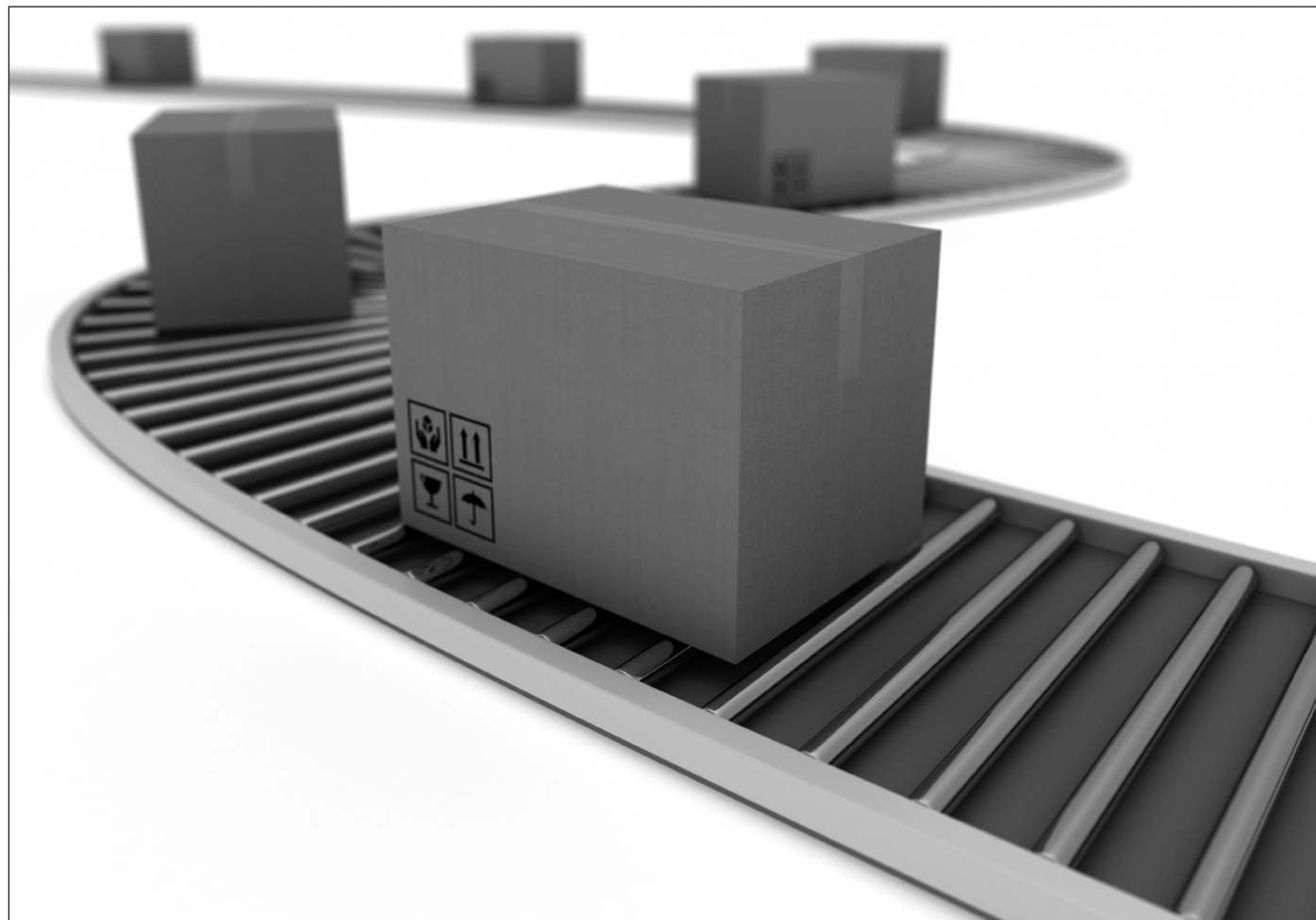
these purchases represent, Arkansas law can and should be amended to require tax on electronically transferred sales of such items as computer programs as well as downloaded music, videos, games and books.¹¹

Conclusion

Every year, uncollected taxes from online purchases and from other “remote” sellers costs Arkansas vital revenue that could be used for schools, transportation, public safety and the other building blocks of job creation and a strong economy. This situation also threatens jobs by putting in-state businesses at a competitive price disadvantage against sellers whose prices are artificially lowered by not including sales tax. It also hurts low-income Arkansans who end up paying more because they are less likely to have access to computers or credit cards, both needed to buy online.

Arkansas has taken two steps toward collecting these lost taxes by joining the national Streamlined Sales and Use Tax Agreement and by passing an “Amazon Law” (Act 1001). But more needs to be done to collect as much of this lost revenue as possible and level the playing field for Arkansas businesses and consumers. Substantial erosion of the state's sales tax base will continue until Congress passes a law authorizing states to require most remote sellers to collect sales tax. In the meantime, though, the five tax law changes outlined in this report would make a meaningful dent in the problem of untaxed Internet sales. These proposals are not panaceas, and are not without potential drawbacks of their own; some of them may draw legal challenges, for example. Nonetheless, at this time of fiscal uncertainty for the state, Arkansas needs to step up to the plate and attempt to preserve its ability to support important public services with all the tools at its disposal.

In this time of fiscal uncertainty, Arkansas needs to preserve its ability to support public systems with every tool at its disposal.



Endnotes

- 1: Donald Bruce, William F. Fox, and LeAnn Luna, “State and Local Government Sales Tax Revenue Losses from Electronic Commerce,” University of Tennessee, 2009. Technically, the tax that is due on an interstate sale is a “use tax,” not a sales tax, regardless of whether it is collected by the seller or self-remitted by the purchaser. Use taxes are generally imposed on the same products and at the same rate as sales taxes. Consistent with the common practice, this report will refer to “sales taxes” on Internet sales rather than use taxes.
- 2: Remotes sales include internet sales from websites such as Amazon or eBay, catalogs like LLBean, TV home shopping like QVC and digital downloads like those from iTunes.
- 3: Mazerov, Michael. “Chipping Away at the Problem of Untaxed Internet Sales: 10 Things States Can Do” State Fiscal Policy Conferences, November 9, 2010.
- 4: Act 291 “An act to amend the sales and use tax laws to be consistent with the streamlined sales and use tax agreement, and for other purposes.” <http://www.arkleg.state.ar.us/assembly/2011/2011R/Acts/Act291.pdf>
- 5: Hazlett, Kathryn. “Capturing Internet Revenue: The Streamlined Sales and Use Tax Agreement.” Arkansas Advocates for Children and Families, March 2006.
- 6: Mazerov. In 1960, *Scripto v Florida* held that remote sellers with in-state, independent, door-to-door salesmen who, while not employees, solicit sales of the remote seller's products are required to charge their customers use tax. Twenty-seven years later (in 1987), the *Tyler Pipe v Washington* case held that remote sellers with an in-state, independent “manufacturer's representative” who solicits orders for a remote seller were required to pay gross receipts tax to the state.
- 7: Ibid.
- 8: Ibid.
- 9: Mazerov.
- 10: Ibid.
- 11: Ibid.



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