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Capturing Internet Revenue: The Streamlined Sales and Use Tax Agreement

by Kathryn Hazelett

Internet Purchases

Widgets, Inc. has the hottest New Gadget to hit the market in an age. Widgets has stores in Louisiana, Illinois, New York, and Georgia, but has not yet opened a “bricks and mortar” store in Arkansas. Mr. Hitech lives in Jonesboro and the New Gadget is at the top of his wish list. He doesn’t want to hop into his new hybrid car and trek to Louisiana, so he logs on the Internet and discovers Widgets.com where he can purchase the New Gadget and have it shipped to his solar-powered Jonesboro home. Using his identity-protected credit card, Mr. Hitech purchases his New Gadget and it arrives at his home in 48 hours.

Mr. Hitech did what many Arkansans do on a daily basis – they make purchases over the Internet from stores with no “bricks and mortar” (or physical presence) in Arkansas without thinking twice about paying sales or use tax. Mr. Hitech thought about shipping costs, but not the tax due on his purchase.

The state tax loss from purchases like Mr. Hitech’s quickly adds up. It is estimated that Internet sales increased 27 percent from the third quarter of 2004 to the third quarter of 2005.¹ In 2003, this vast increase resulted in an estimated revenue loss to states from uncollected use taxes at \$8 Billion.² Arkansas’ share of the \$8 Billion loss is estimated to be \$165.8 Million.³

Can Arkansas Tax These Transactions?

Arkansas can tax these transactions. Arkansas has in place a “gross receipts tax” comprised of a sales tax and a use tax. The sales tax impacts all purchases made from retailers with a physical presence in Arkansas. Mr. Hitech heads to the Jonesboro location of Gadgets Are Us, Gadgets charges him the sales tax, Mr. Hitech pays it with his purchase, and Gadgets remits, or gives the amount of the tax, to the state and local taxing authorities. If a retailer does not have a physical presence in the state and Mr. Hitech makes a purchase (such as the purchase of the New Gadget over the Internet), Widgets, Inc. is not legally compelled to collect the tax from Mr. Hitech nor to remit it to the taxing authority (see Text Box, page 2). Rather, Mr. Hitech is supposed to pay the tax under the use tax portion of the sales and use tax. Arkansas can not legally compel an out-of-state seller, such as Widgets, Inc., to remit the tax, but can (and does) require in-state purchasers of products to be USED in Arkansas (thus, the “use tax”) to pay the tax. This is true even of Internet purchases.

So, if Arkansas can compel consumers to pay the tax, why don’t more people pay it?

The administrative burden of compelling ALL individual purchasers to pay the use tax outweighs the benefit of collecting it. In other words, it costs more to do the collecting than the collecting raises.



The Supreme Court and Taxation of Out-of-State Sellers

Contrary to the popular belief that the passage of the Internet Tax Freedom Act (ITFA) by the United States Congress created a tax-free zone for Internet purchases, the ITFA only prohibited taxes on Internet access and not on Internet purchases. The prohibition on taxation of out-of-state sellers comes from a line of United States Supreme Court cases starting in 1967 with *National Bellas Hess v. Illinois Department of Revenue*⁴ and ending in 1992 with *Quill Corp. v. North Dakota*⁵. The common thread of these cases is that the United States Constitution's Commerce Clause⁶ prevents states from impeding commerce between the states. The Supreme Court held, in *Quill*, that a state can not compel an out-of-state seller with no physical presence in that state to collect and remit the state's sales/use tax. That requirement would constitute an undue burden on interstate commerce and is therefore prohibited by the Commerce Clause. A purpose of the SSUTA is to streamline collection and remittance procedures so that requiring out-of-state sellers to collect and remit the tax would no longer be an undue burden.

What Can Arkansas do to Recoup the Revenue?

In 2000, a group of states came together to solve this problem and to prevent the revenue loss from untaxed Internet sales. Because of the United States Supreme Court decisions *Bellas Hess* and *Quill* (see Text Box), states are reliant on the United States Congress to use its power under the Commerce Clause of the United States Constitution to allow states to require collection of sales and use tax by out-of-state sellers.⁷ The states' project was called the Streamlined Sales Tax Project (SSTP) and the result of the project is the Streamlined Sales and Use Tax Agreement (SSUTA). The goal of the SSUTA is to create a simplified sales tax system⁸ so that all retailers from traditional "bricks and mortar" storefronts (like Gadgets Are Us) to online sellers (like Widgets, Inc.) can EASILY collect and remit sales and use taxes.⁹ In other words, the SSUTA is a blueprint for a "simplified sales and use tax collection system that removes the burdens and costs from sellers."¹⁰ Recouping the lost revenue is one of the driving forces of the SSUTA.

State Actions

Currently 44 states and the District of Columbia are participating in the project (the remaining six states do not

levy a state-wide sales tax). Of the 44, 13 states are full members and six (including Arkansas) are associate members. Full-member states have changed their state laws to conform with the SSUTA while associate members have begun implementing the requirements and anticipate full membership by January 1, 2008.¹¹ The 25 remaining states and the District of Columbia are participating states, but are not yet close to compliance with all of the requirements to be associate members. Regionally, Oklahoma and Kentucky are full member states while Missouri, Louisiana, Texas and Mississippi are at various stages of implementation. Tennessee joins Arkansas as an associate member state. The SSUTA became active in October of 2005 when states representing more than 20 percent of the population of states with sales taxes were fully compliant. The 13 states that are full members represent 20.2 percent of that population. In those 13 states, sellers may voluntarily comply with the SSUTA and collect sales and use taxes. These states may not yet compel the sellers to so collect (that will happen only if Congress passes legislation giving states the authority to compel collection).

How does the SSUTA work?

Full-member states' tax laws now reflect the SSUTA requirements.¹² These include:

- 1) Uniform Definitions for all Taxable Items – At first glance this does not seem to be overly complicated, but as an example of how complicated this actually is, we can look to varying states' definitions for juice. In some states a beverage with 10 percent real fruit juice is categorized as juice and therefore taxed as a food product and not as a "cola" (in some states, like Arkansas, if a beverage is classified as a cola, it is currently taxed at a different rate). In other states, a much higher percentage of real fruit juice is required to categorize a beverage as juice. The SSUTA solved this particular issue by settling on 50 percent real fruit juice as a requirement to being termed a juice. It is important to note that the SSUTA does NOT tell a state to tax or not to tax juice, rather the SSUTA clarifies what IS juice and leaves it up to the states as to whether they want to tax it.
- 2) Rate Simplification – Each state will be allowed one state sales and use tax rate and one rate for food and drugs. Also, each local jurisdiction will be allowed one rate.

- 3) State-Level Administration – Rather than businesses filing with each city and county tax authority, businesses will file tax returns at the state level and the state will disburse the money to the localities.
- 4) Uniform Sourcing Rules – In order to determine which state/locality’s sales/use tax rates to apply, uniform and simple sourcing rules will be used: transactions will be sourced to the state/local government that is the destination or delivery point. As with the uniform definitions, this seems simple on the surface, but is considerably more complex for sellers or service providers that did not previously source to the destination or delivery point. For example, Dell manufactures and ships computers from its Round Rock, TX location. Dell has sourced its sales to Round Rock, TX meaning that sales tax was paid at the Round Rock and Texas rates. Under the SSUTA, the tax rate used to calculate the sales tax will be the rate at the location of the buyer and the tax will be remitted to that state’s taxing authority.
- 5) Technology, Audit, and Amnesty – One of the primary concerns of sellers when faced with collecting sales and use taxes is the variety and complexity of state definitions and administrative and compliance hurdles. The SSUTA streamlines the former and state-certified streamlined sales tax system technologies aid the latter. Using such technology will ease the seller’s compliance burden - the technology calculates the sales/use tax at the time of the transaction. Another benefit of using the state-certified technology is that the seller either will not be audited or will face a more limited audit (dependent upon which technology is chosen). Lastly, sellers that sign up and use the state-certified technology will be granted amnesty for all past uncollected taxes.

These important simplifications serve to streamline member states’ sales and use taxes and pave the way for congressional action. The changes implemented through the SSUTA should ease the Supreme Court’s concerns about onerous compliance burdens on interstate commerce and should clear Congress to act. There are currently two bills in the United States Congress, S.2152 by Senator Enzi and S.2153 by Senator Dorgan, that would grant members in the SSUTA the authority to compel out-of-state sellers to

collect sales and use taxes.¹³ The only difference in the two bills is in the definition of a “small seller.”

Retailers

State and local taxing authorities as well as the National Governor’s Association are all proponents of the SSUTA, but what do retailers think? Many “bricks and mortar” retailers believe that the current system of “non-collection” favors Internet retailers and support the SSUTA as a way to level the playing field. Importantly, some large bricks and mortar retailers that also have a strong presence on the Internet support AND voluntarily comply with the SSUTA guidelines. These retailers include the Arkansas retail giant, Wal-Mart, as well as Toys ‘R Us. Many other businesses and business groups support the SSUTA including the National Retailers Association, the Gap, Radio Shack, and PetsMart.

As with most proposals, there is some opposition to the SSUTA as well. Opposition is mainly made up of those who believe that the SSUTA represents a new tax rather than a streamlined process to collect taxes that are actually already in place and those who benefit from the current system including consumers who reap the benefit of not paying the sales tax and those merchants that have a slight price advantage by not charging the sales tax.¹⁴

Arkansas’ Status

As mentioned above, Arkansas is an associate member of the SSUTA. As a state with a heavy reliance on sales tax revenue (40.9 percent of FY05 gross general revenue came from Arkansas’ sales and use taxes¹⁵) to fund everything from education to health care, Arkansas needs to ensure that this revenue source does not erode. While Arkansas’ heavy reliance on the sales tax contributes in large part to the regressivity of the state’s tax system¹⁶, allowing Internet sales to go untaxed actually makes this problem worse. It is a safe assumption that Internet users and purchasers of products over the Internet more often come from higher income households.¹⁷ By not enforcing the use tax on out-of-state purchases, the state provides an “evasion” tool to those with more income. It requires Arkansas to tax other items, such as food, that place a higher tax burden on low income working families.

Besides increasing the tax burden on these families, non-enforcement of the use tax also hurts the competitiveness of in-state retailers. In the current system, the state is

encouraging out-of-state purchases by effectively lowering the price on these purchases by not enforcing the sales tax¹⁸.

From both an equity and an efficiency perspective, the SSUTA will shore up Arkansas' sales and use tax system. It will help to prevent the erosion of much-needed revenue and will lead to more efficiency and equity in our tax system.

What does Arkansas need to do to become a full member?

In 2003, the Arkansas legislature passed Act 1273 making the necessary changes in Arkansas' law to allow Arkansas to enter the SSUTA with other states. In 2005, Acts 2008 and 2163 were passed changing the effective date of the agreement to July 1, 2007 and adopting the Agreement's administrative provisions, respectively.

For Arkansas to be in substantial compliance with the SSUTA and become a full member of the agreement, the legislature still needs to take several steps. These steps were introduced as Senate Bills 1170 and 1171 in the 2005 session and have since been referred to the Interim Committee on Revenue and Tax for consideration. Some of the necessary changes that these bills sought to make are: changing sales and use tax definitions so that they are consistent with the SSUTA, repealing the sourcing rules for florists, and making consistent some rebate and extension requirements.

In so doing, Arkansas will be ready for the day when the U.S. Congress passes legislation necessary to implement the SSUTA.

Another important development for Arkansas taxpayers is the potential removal of the state sales tax on food and food ingredients. Act 647 of 2005 provides that upon adoption of the SSUTA and federal legislation authorizing the states to collect sales and use tax from out-of-state sellers, the state sales tax on food will be removed. Removal will occur when the revenue from such collection equals 150 percent of the value of the state sales tax on food.

When the U.S. Congress acts and states can compel out-of-state sellers to collect sales and use taxes, Arkansas' revenue stream will be more secure. Arkansas' tax system will be more fair and Arkansans will face the possibility of no state sales tax on food.

(Endnotes)

¹ U.S. Census Bureau, Quarterly Retail E-Commerce Sales, www.census.gov/mrts/www/data/pdf/05Q3.pdf

² Donald Bruce and William F. Fox, State and Local Sales Tax Revenue Loss from E-Commerce: Estimates as of July 2004, Center for Business and Economic

Research, College of Business Administration, University of Tennessee, July, 2004, pg. 7.

³ Ibid.

⁴ 386 U.S. 753 (1967)

⁵ 504 U.S. 298 (1992)

⁶ U.S. Const., Art. 1 § 8, cl. 3

⁷ Steven Maguire, The Streamlined Sales and Use Tax Agreement: A Brief Description, Congressional Research Service, February 22, 2006, pg. 2.

⁸ "Sales Tax System" includes both the sales and use taxes.

⁹ Maguire, pg. 2-3.

¹⁰ National Conference of State Legislatures, <http://www.ncsl.org/programs/fiscal/tctelcom.htm>

¹¹ Maguire, pg. 4.

¹² See Streamlined Sales Tax Project Executive Summary, January, 2005, pg. 2, <http://www.ncsl.org/programs/fiscal/stslide1.htm>

¹³ Maguire, pg. 5.

¹⁴ Ibid.

¹⁵ Calculations by the Arkansas Department of Finance and Administration, Division of Economic and Tax Research. Calculations do not include Special Revenue contributions from the sales and use taxes.

¹⁶ A regressive tax system is one in which those with less income pay more in taxes as a percentage of income than those with more income do. In Arkansas, the bottom 20% of income earners pays 12% of their income in state and local taxes while the top 1% pay just 6%. See The Impact of 2003-4 Tax Changes on Arkansas Families, Paycheck and Politics, Issue 25, Arkansas Advocates for Children & Families, pg.2.

¹⁷ Jennifer Cheeseman Day et al., Computer and Internet Use in the United States- 2003, Table A, Current Population Reports, United States Census Bureau, October 2005. <http://www.census.gov/prod/2005pubs/p23-208.pdf>

¹⁸ Arkansas has the added efficiency challenge of having a high sales tax rate. A high rate further encourages those with means to seek to evade the tax. For the most recent list of state sales taxes compiled by the Federal Tax Administrators, see http://www.taxadmin.org/fta/rate/sl_sales.html.

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The mission of Arkansas Advocates is to ensure that all children and families have the resources and opportunities to lead healthy and productive lives and to realize their full potential. The goal of our SFAI project is to improve the economic well-being of the state's families with children by providing timely and credible analysis to policymakers, the media, and the public and promoting a more informed public debate about state tax and budget issues. The views of this report are those of the author and does not reflect that of the funders.

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