Tapping Into Online

States have a \$23 billion sales tax loophole and Congress is considering a bill to close it.

BY JON KUHL

ith states still struggling from the 2008 financial crisis that ripped through budgets and stunted revenues, an effort to improve the revenue outlook is gaining widespread support. The Marketplace Fairness Act would allow

states to enforce tax laws currently being ignored. It needs the support of Congress, but would cost the federal government nothing.

Backers say the law would generate billions for state budgets—without raising tax rates—to help build roads, improve schools, support small businesses and fight crime.

"This is a chance for the federal government to really help out the states," says Illinois Senator Pamela Althoff (R). "And it's not chump change. We're talking billions of dollars in extra revenue. During good times we may have been able to get by without the revenue, but the recession has changed everything, and states can no longer afford to forgo any sources of revenue."

In 2008, states lost an estimated \$18 billion in uncollected



Senator Pamela Althoff (R) Illinois

taxes from out-of-state sales, \$7.7 billion of which were from online sales. That figure is expected to climb to \$23 billion this year, with almost half of that coming from Internet transac-

Opponents argue the Marketplace Fairness Act is merely a tax hike in disguise and will hit consumers with taxes that, while already owed, are often not collected. Others who oppose the law come from states without sales taxes who feel

it will unfairly burden local companies who do business on the Internet.

What the Act Would Do

The bill will allow states to enforce tax laws currently being circumvented. When a company does business with customers

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in states where it has no physical presence, the customers' states have the right to impose sales and use taxes on those transactions.

But, as the Supreme Court ruled in two landmark decisions, the states do not have the authority under the Constitution to compel out-of-state merchants to collect the taxes

This is where Congress comes in: If Congress explicitly grants states the authority to enforce their current tax laws, the loophole would be closed.

This tax-enforcement problem dates back to a 1967 Supreme Court case, National Bellas Hess v. Illinois, in which a mailorder company located in Missouri mailed flyers and catalogs to customers in various states, including Illinois. After clashing with the Illinois Department of Revenue over sales taxes, the catalog company took the state to court. The Illinois Supreme Court ordered National Bellas Hess to collect sales and use taxes from customers who intended to use their products in Illinois.

Appealing to the Supreme Court, Bellas Hess argued that since the company owns no tangible property in Illinois, the state had no right to force it to pay Illinois sales taxes. The Supreme Court agreed, ruling that compelling a merchant to collect sales taxes for a state in which it does not have a physical presence is a violation of the interstate commerce clause, and therefore unconstitutional. In its decision, the Supreme Court established a firm precedent that can only be remedied by an act of Congress.

Twenty-five years after Bellas Hess, North Dakota put the Court's legal reasoning to the test. The state ordered Quill Corporation, an out-of-state merchant with no offices in North Dakota, to collect sales and use taxes on products sold to North Dakota residents. In Quill v. North Dakota, the Supreme Court



Simplified and Streamlined

But the act is only part of the equation. Knowing it would be difficult to recoup their taxes in full without an effective enforcement mechanism, several states created a program that would comply with the Court's decisions and convince Congress to act. To this end, the National Conference of State Legislatures helped develop the Streamlined Sales and Use Tax Agreement, a multi-state effort to simplify and modernize the states' sales and use tax collection systems. To date, 24 states have passed it.

When the agreement went into effect in 2005, it opened an amnesty program in which states would forgive sales taxes owed by companies if the businesses voluntarily registered to collect sales taxes. Although the agreement can't force companies to collect sales taxes on out-of-state transactions, a company that complies with it does not have to pay the sales taxes owed to states before the company's registration date. Companies that don't register run the risk of being compelled to pay back sales taxes when and if Congress passes the Marketplace Fairness Act.

At the start of this year, 1,737 businesses had volunteered to collect and remit previously uncollected sales taxes. That's a little more than \$916 million, not counting the holiday season, from 2011.

Taking on Amazon

Although the Marketplace Fairness Act would provide a comprehensive solution to the challenge of collecting sales tax on out-of-state sales, some states have passed their own so-called Amazon.com laws.

Eight states—Arkansas, California, Connecticut, Illinois, New York, North Carolina, Rhode Island and Vermont—have enacted a version of the law, also referred to as affiliate nexus legislation.

These bills require out-of-state retailers that have contracts with "affiliates"—independent entities within the state who link to an out-of-state business on their website and get a share of revenues from the business—to collect the state's sales and use tax. Typically, the website in-state owner is not an employee or agent of the vendor and has no information about what purchases, if any, were made.

In all of these states, except for New York, little sales taxes have been collected because online vendors, including Amazon.com and Overstock.com, have canceled their in-state affiliate arrangements. Cancellation of such contracts not only means the affiliate nexus law won't apply, but also that state revenues may drop because of the reduced income of the affiliates. In New York, Amazon.com challenged the constitutionality of the legislation and has been collecting the use tax for the state while in litigation.

Even if successful, the affiliate nexus laws reached only remote vendors with affiliate arrangements, leaving states unable to collect the full amount of sales taxes they are owed.

—Max Behlke

Bipartisan Support

The Marketplace Fairness Act was introduced in the U.S. Senate last November with bipartisan support. It includes an exception for small businesses with gross revenues under \$500,000, over concerns that they might be unfairly burdened by the law. States, not businesses, will be responsible for the cost of any tax-collecting software needed for online businesses to comply.

Not all online retailers support the effort, however. "Overturning the Supreme Court ruling helps big-box retailers with websites, since they already have to collect in nearly all states," Steve DelBianco, executive director of NetChoice, a trade association representing online businesses, wrote in an op-ed piece in the Wall Street Journal. "It will raise costs for small firms that compete via their online and catalog sales."

DelBianco explains that big-box retailers already have the advantage of allowing customers to buy products online, then pick them up in stores to avoid shipping costs. He argues that requiring online retailers without stores to collect sales taxes removes one of their primary competitive advantages.

Opposition aside, prospects for the new federal bill are high. "We've had legislation introduced in Congress before," says Neal Osten, director of NCSL State-Federal Relations. "But this time, I think all the stars have aligned. We have always had a strong and bipartisan group of state legislators and governors pushing for this from the state level, but now we have a strong and bipartisan group of senators and representatives in Washington who are working to pass this. And with the cuts in federal dollars about to hit the states, people at the federal level know this is something they can do to help states offset the cuts."