

SALES AND USE TAX COLLECTION ON INTERNET SALES



AN ISSUE BRIEF FROM LEGISLATIVE BUDGET BOARD STAFF

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OBJECTIVE

Sales and use tax is assessed on all purchases of taxable items (tangible personal property and taxable services) shipped or delivered to Texas destinations, including Internet purchases.

KEY FACTS

- ◆ Forty-five states and approximately 10,000 jurisdictions impose sales and use taxes. As many as 1,500 of these taxing units are in Texas.
- ◆ Texas imposes a use tax upon a buyer when an item is purchased from an online merchant that has no physical presence in the state, equal to the sales tax that would be collected for the item if purchased at a store in the state.
- ◆ Compliance with use tax is low, except for purchases by businesses, because consumers self-remit.

BUDGETARY IMPACT

Estimated Texas sales and use tax collections for the 2016–17 biennium total \$59.9 billion, or 58.8 percent of all projected state tax collections. The Comptroller of Public Accounts reports that less than 1.0 percent of sales tax collections is due to online sales, but also suggests that taxpayer data might significantly understate online sales. For example, chain store retailers that accept orders and payment online but fulfill the orders from local stores might report those as store rather than online sales.

STATUTORY REFERENCES

The Texas Tax Code, Chapter 151

Federal law prohibits state governments from requiring online merchants to collect sales and use taxes unless the merchant has a physical presence or nexus in the state. In Texas, nexus occurs when the merchant has a place of business or an office, distribution center, warehouse, inventory, or an employee in the state.

TAXATION OF INTERSTATE COMMERCE

In 1992, the U.S. Supreme Court ruled in *Quill Corporation v. North Dakota* that out-of-state businesses (e.g., mail order and online merchants) are not required to collect sales tax on purchases if they do not have a physical presence (nexus) in the purchaser's state. The ruling remains the controlling law on interstate taxation. The ruling predates the growth of the Internet and the rise of online shopping, which reached an estimated \$341.7 billion, or 7.3 percent of U.S. retail sales, in calendar year 2015. Online merchants that do not have nexus in a state or local government taxing unit have an economic advantage compared to local merchants, because consumers may browse locally but purchase online to avoid sales tax. Texas, like other states that assess state sales tax, also assesses a use tax. The use tax applies when a seller has no physical presence in the state, but a taxable good is shipped into the state. Unless the merchant voluntarily collects the tax on behalf of the taxing unit, the purchaser is liable for payment of the use tax. The use tax requires self-reporting and payment by the consumer instead of collection at point of sale by the retailer; therefore, use tax compliance is low except for large consumer purchases or business purchases susceptible to audit.

The Marketplace Fairness Act is a recent federal legislative effort to address the *Quill v. North Dakota* ruling. The legislation passed the U.S. Senate in 2013, but it did not pass in the U.S. House of Representatives. The law would have allowed a state to require use tax collection by remote sellers if the state adopts certain modifications to its sales tax system. An alternative would have been for states to join the Streamlined Sales Tax and Use Agreement (SSUTA), which requires similar modifications to the tax systems of member states. A similar version of the Marketplace Fairness Act was introduced in the U.S. Senate in March 2015. In October 2014, the Comptroller of Public Accounts (CPA) estimated that Texas state and local governments could gain \$1.0 billion annually if similar federal legislation were enacted.

STATE POLICY RESPONSES

States have enacted laws increasing their authority to require remote sellers to collect tax on sales into the state. In general, these statutes fall into three categories: the SSUTA, click-through nexus, and notification laws. Click-through nexus statutes require remote sellers to collect tax on sales into states where firms affiliated with the remote seller are located. Notification laws require remote sellers to notify consumers that they owe use tax on their purchases.

Click-through nexus laws. Twenty states have enacted click-through nexus laws, which are sometimes called Amazon laws in reference to the nation's largest Internet retailer. These laws require remote sellers with affiliates located in the state to collect tax on all taxable sales into the state if annual sales due to affiliate referrals exceed minimum thresholds. Typically, an affiliate is a firm that posts on its website a link to an out-of-state business and then receives a

share of revenues from the out-of-state business. Many of the enacted click-through nexus statutes include a provision for remote sellers to prove that an affiliated individual or business did not solicit business or do business on behalf of the seller during the preceding year. This provision is known as a rebuttable presumption of nexus or safe harbor.

Notification laws. Five states have enacted notification laws. Oklahoma and South Dakota require remote sellers to provide notice of use tax due at time of sale. Colorado requires remote sellers to notify state customers of tax due at time of sale, and also to send an annual report to customers and to the state, in a prescribed format, detailing each customer's purchases in the preceding year and the tax owed. Kentucky and South Carolina also have notification laws.

Streamlined Sales and Use Tax Agreement (SSUTA). The other significant state response to the *Quill v. North Dakota* ruling is the SSUTA, which took effect in 2005. The purpose of the SSUTA is to simplify state and local sales tax collections and provide uniformity in the application of sales tax statutes and rules among participating states. As of January 2016, the SSUTA has 24 full-member states; however, none of the five most populous states, including Texas, are members. According to the CPA, Texas did not join the SSUTA for various reasons, including the agreement's destination-based sourcing rule. This rule would likely cause a redistribution of local tax revenue from intrastate sales among Texas' taxing jurisdictions, resulting in some localities benefitting while others would lose revenue. Typically, local sales taxes in Texas are sourced to the location of the seller. To become a full member, states must enact SSUTA simplification and uniformity statutes and rules. The Legislature has passed laws authorizing the CPA to enter the state into the SSUTA if the Governor, Lieutenant Governor, and Speaker of the Texas House agree to it. These laws amended the Texas Tax Code to partially comply with SSUTA requirements. However, all changes necessary for Texas to comply with SSUTA have not been fully implemented.

TEXAS RESPONSE

Texas has taken steps to ensure compliance with applicable sales tax requirements. One factor affecting Texas' response to growth in Internet sales is that Amazon has a physical presence in the state, operating warehouses or distribution centers in Irving, Schertz, and Houston. In April 2012, Amazon and CPA reached an agreement to begin collecting sales and use tax on purchases by Texas customers effective July 1, 2012. Before the agreement, Amazon had been assessed \$269.0 million in sales and use tax that CPA claimed should have been remitted due to Amazon's warehouse operation in Irving. The state and local sales tax due from Amazon for fiscal years 2013 to 2015 substantially exceeds this amount. During the three complete fiscal years since the agreement took effect, Amazon's taxable sales in Texas have grown by an average of 31.0 percent each year. Amazon also collects tax in 23 other states.

Nationally, sales by third-party vendors represent a growing proportion (an estimated 40.0 percent) of Amazon's total sales. Amazon does not automatically collect tax on purchases by Texas customers from third-party vendors, including those with a physical presence in Texas. CPA expects noncompliant vendors to be detected through audits of Amazon to address tax avoidance by third-party vendors with state nexus. Certain third-party vendors participate in the Fulfillment by Amazon (FBA) program, through which Amazon stores, ships, and provides customer service (e.g., merchandise returns) for the merchant's products. For out-of-state FBA merchants making sales into Texas, state nexus would be conferred in certain circumstances, such as fulfillment services including maintaining inventory at one of Amazon's in-state centers or Amazon serving as an agent on behalf of the merchant.

Recent legislative efforts to avoid tax base erosion due to remote sales include a statutory change made by the Eighty-second Legislature, First Called Session, 2011, which prevents remote sellers with a physical presence in the state from organizing their businesses into online subsidiaries to avoid sales tax obligations on Internet sales into the state. At the time, a few retailers with stores in the state claimed that their online subsidiaries lacked nexus. The provision provides that state nexus applies to a retailer that: (1) holds a substantial (at least 50.0 percent) ownership interest in, or is owned (at least 50.0 percent) by a business located in the state, if the retailer sells the same or similar product and "under a business name that is the same as or substantially similar" as the state business, or if the facilities or employees of the state business are used in activities (e.g., advertising, facilitating sales, merchandise exchanges) to establish or maintain a marketplace in this state for the retailer; or (2) holds a substantial ownership in, or is owned by a person that maintains a distribution center, warehouse, or similar location in this state that delivers property sold by the retailer. Other states include similar language in their sales tax nexus statutes.

USEFUL REFERENCES

Legislative Budget Board, *Texas State Government Effectiveness and Efficiency Report*, 2011 Update on the Streamlined Sales Tax, January 2011.

Texas Comptroller of Public Accounts, Fiscal Notes, Taxing Internet Sales, August 2015.

National Conference of State Legislatures, Model Legislative Proposals for States Considering Expanding Sales/Use Tax Collection Requirements, January 2016.

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