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An Analysis of Internet Sales Taxation and the Small Seller Exemption

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Knoxville, Tennessee. 46 pages. Under contract no. SBAHQ-12 M-0183.

Purpose

As the popularity of online shopping has grown, states have seen their sales tax revenues drop. The Supreme Court has ruled that states cannot require a company to collect sales tax on transactions with their residents when the company has no physical presence in the state. Federal legislation has been introduced over the past several years to authorize online sales tax collection. With small business owners on both sides of the issue, the Office of Advocacy recognized the need for objective research for small businesses and policymakers. This report analyzes the number of firms that will be affected by the small seller exemption (SSE) if current legislation passes and how much e-commerce is likely to be affected.

Background

Sales taxes are a critical component of state and local government revenue systems in the United States, contributing nearly one-third of all state taxes and nearly one-quarter of all state and local taxes. All but five states (Alaska, Delaware, Montana, New Hampshire, and Oregon) currently impose a sales tax (Figure 1). In 2012, state sales taxes brought in $243 billion, or approximately 1.6 percent of gross state product. (This was a slightly smaller share than in 2011.)

According to the U.S. Census Bureau, online sales accounted for approximately 5.3 percent of total retail sales in the second quarter of 2013. While online sales still represent a small share of total sales, they are expected to grow significantly in the future.

Sales tax systems are facing significant pressure for a number of reasons, including the growth in online and other remote transactions between in-state buyers and out-of-state sellers. The Courts have ruled that businesses must have nexus—typically physical presence—in a state before they can be taxed by a state or required to collect and remit the state's taxes.[1] The Courts have also determined that only Congress has the authority to redefine nexus (i.e., what constitutes a vendor's presence in a state).

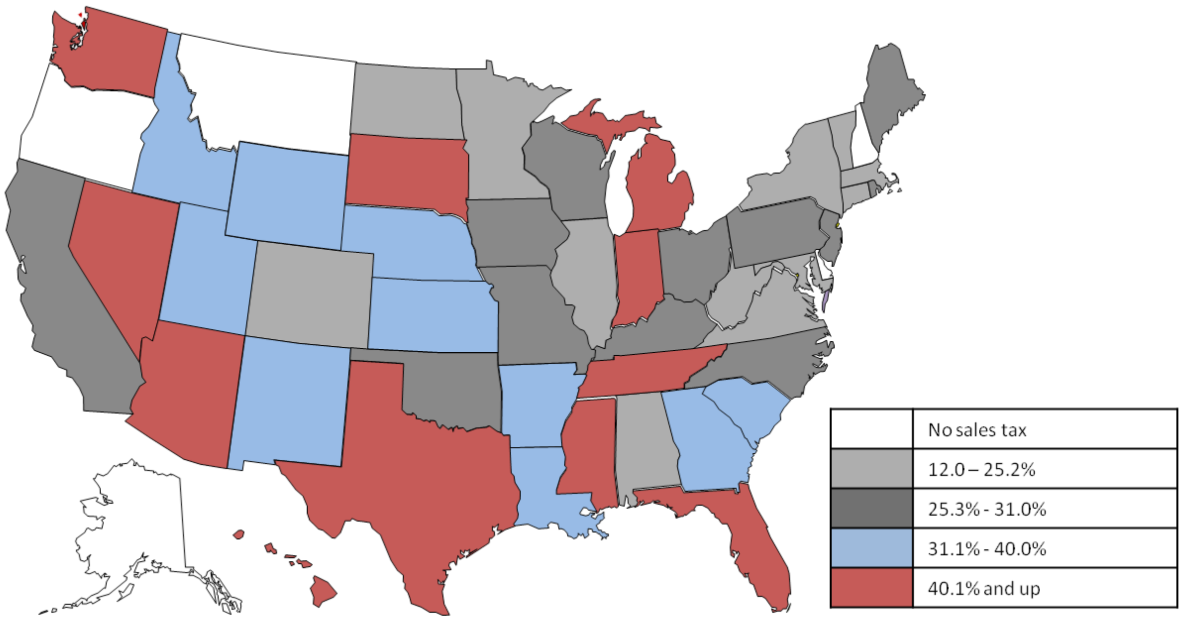
More recently, some cash-strapped states have tried to redefine what it means to have physical presence (i.e., what constitutes nexus) for out-of-state vendors. This has created complex and often inconsistent taxation rules of online commerce among the states.

At the same time, brick-and-mortar retailers, who have always been obliged to charge taxes for sales transactions, began voicing concern that online retailers did not share the same responsibility. These brick-and-mortar retailers suggested that it was unfair that online retailers could charge lower prices as a result of not being forced to remit taxes on sales transactions.

As a result of these developments, some policy groups and legislators have tried to develop a tax policy framework for states and online retailers that is consistent, fair for all retailers, and not overly burdensome for small business. In the 113th Congress, both chambers introduced bills to address some of these issues. The Marketplace Fairness Act of 2013

1. *National Bellas Hess v. Illinois Department of Revenue* (386 U.S. 753, 1967), U.S. Supreme Court in *Quill v. North Dakota* (504 U.S. 298, 1992).

Figure 1: State Sales Tax Collections as a Share of Total State Tax Revenues



Source: *An Analysis of Internet Sales Taxation and the Small Seller Exemption* by Donald Bruce and William Fox, U.S. Small Business Administration Office of Advocacy, November 2013. Authors' calculations using data from the U.S. Bureau of Census as tabulated by the Federation of Tax Administrators (**www.taxadmin.org/fta/rate/11taxdis.html**).

(S.743) offers states two methods of simplification: states can join the Streamlined Sales and Use Tax Agreement or they can adopt a set of simplification guidelines in the bill. The legislation would also provide for a $1 million small seller exemption.[2]

Overall Findings

The most commonly discussed small seller exemption (SSE) in the proposed bills has been $1 million. This report calculates that 974 of the *Internet Retailer* Top 1,000 companies have sales exceeding $1 million. The study's authors use established statistical techniques to account for the possibility that some larger firms are not included in the *Internet Retailer* data. This generates a more realistic estimate of 1,817 online retailers that could be subject to the requirements of the Marketplace Fairness Act. In either case, the number of included retailers is a very small fraction of all online sellers.

An SSE of $1 million would subject only a small share of business to the internet sales tax: less than 4.5 percent of electronic shopping and mail order houses and less than 2 percent of all non-store retailers. However, the volume of sales transactions subject to the tax would represent 57 percent of total U.S. online retail sales. A higher SSE of $5 million would affect an even smaller share of online retailers, but the share of online sales affected would remain near 57 percent (see Table 1).

Determining the impact of sales tax legislation on actual collections is complicated by the fact that many of these firms are already collecting sales taxes for a large number of states in which they currently have nexus. The study examined a sample of online retailers representing 231 of the *Internet Retailer* Top 1,000 companies. As shown in Figure 2, 38 of the surveyed companies (16 percent of the total) collected sales taxes for all 45 sales-taxing states. Only 8 of the surveyed companies (3 percent of the total) do not collect any sales tax, and 57 (25 percent

2. The Streamlined Sales and Use Tax Agreement is a cooperative effort of 44 states, the District of Columbia, local governments, and the business community to simplify sales and use tax collection and administration.

of the total) collect in only one state. The average online retailer among the 231 in the sample collects sales taxes in about 18 states, representing about 47 percent of the total national state and local sales tax collections.

Policy Implications

To summarize, an SSE provision would reduce administration and compliance costs for small online merchants. It would also reduce the potential revenue gains to state and local governments by exempting a portion of online sales from taxation. The uneven sales tax collection playing field in the current policy environment has helped many small online retailers at the expense of many small "Main Street" vendors. However, Main Street vendors—small and large alike—would continue to be disadvantaged relative to many online and mail-order vendors that would be protected by an SSE.

Scope and Methodology

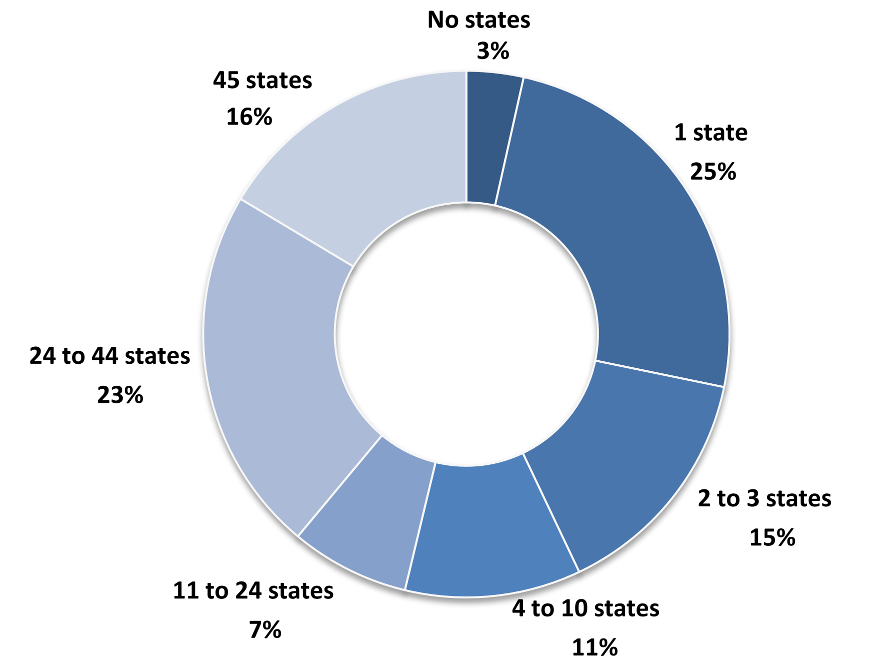
The researchers acquired the Top 500 and Second 500 databases compiled by *Internet Retailer* magazine and evaluated the proportion of firms that would fall above and below the SSE proposed in the Marketplace Fairness Act of 2013. Upon arriving at the figure of 974 firms with annual online American

Table 1: Share of Total Estimated U.S. Online Retail Sales among the Top Retailers

Annual Online Sales Threshold	Companies Above the Threshold	Annual Online Sales Volume	Percent of National Online Retail Sales
$1 million	974	$139 billion	57.3
$5 million	750	$138 billion	57.0
$13.3 million	500	$136 billion	56.1
$49.9 million	250	$129 billion	53.3
$189 million	100	$115 billion	47.5
$440 million	50	$101 billion	41.6
$1.2 billion	25	$84 billion	34.9
$2.7 billion	10	$58 billion	24.1

Source: *An Analysis of Internet Sales Taxation and the Small Seller Exemption* by Donald Bruce and William Fox, U.S. Small Business Administration Office of Advocacy, November 2013. Author's calculations based on 2012 *Internet Retailer* Top 1,000; U.S. Census Bureau; and Bailey, et al. *The Long Tail is Longer Than You Think: The Surprisingly Large Extent of Online Sales by Small Volume Sellers*, http://papers.ssrn.com/so13/papers.cfm?abstract_id=1132723.

Figure 2: Share of Online Retailers Collecting Sales Tax in Multiple States (Sample Size = 231)



- **3% of online retailers did not collect sales tax.**
- **25% collected in only one state.**
- **16% collected in all 45 sales taxing states.**

Source: *An Analysis of Internet Sales Taxation and the Small Seller Exemption* by Donald Bruce and William Fox, U.S. Small Business Administration Office of Advocacy, November 2013. Author's calculations.

retail sales over $1 million, they supplemented their analysis using the Census Bureau's 2010 County Business Patterns and 2013 Annual Retail Trade Survey, plus Dunn & Bradstreet's Million Dollar Database.

This report was peer reviewed consistent with Advocacy's data quality guidelines. More information on this process can be obtained by contacting the director of economic research at **advocacy@sba.gov** or (202) 205-6533.

Additional Information

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