

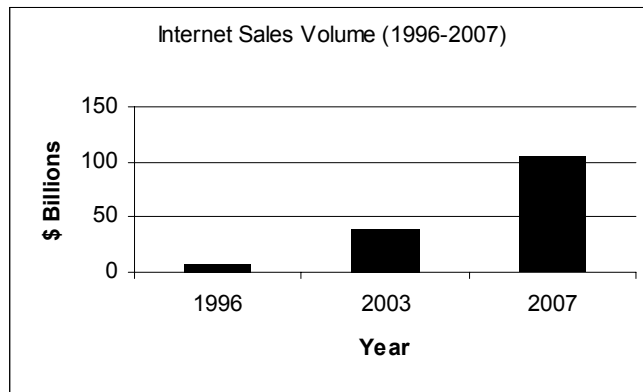
E-Commerce: Choosing the Appropriate Tax Model

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ABSTRACT. The Internet's economic role has increased dramatically over the past decade. Along with many benefits, e-commerce has brought with it some important policy questions. One question relates to tax policy, and whether Internet transactions should be subject to sales or use taxes. This paper examines that question, considering factors such as feasibility, efficiency, fairness (virtual v. "brick-and-mortar" retailers), and legality. The relationship between e-commerce tax policy and state and local government revenues will also be addressed. Based on these factors, the evidence suggests that taxing Internet sales would be feasible, efficient, and provide revenue for important public services.

I. Introduction

The Internet has a substantial impact on the United States and its economy. Over the past half-decade, e-commerce revenues have increased six-fold, from about \$8 billion in 1996 to more than \$40 billion in 2003 [Goolsbee, 1999, 413 and *Newsday*, 2002, A48]. Forecasts vary with respect to future online revenues. Some suggest that online revenues will grow to \$105 billion by 2007 [*Newsday*, 2002, A48], while others project \$269 billion in sales as early as 2005 [Bakos, 2001, 69]. The chart below illustrates the rapid growth pattern:



Source: *Newsday*, 2002, A48.

The Internet boom has caused several public policy debates that are relevant for all economic actors. How should Internet content be monitored to avoid, among other things, the transmission of child pornography? How can society protect personal information when so much of it is exchanged electronically with few safeguards? Should e-commerce be subject to taxation, and if so, how? The final question is the one this paper will attempt to answer.

Various economic actors have competing interests. Consumers are concerned about having to pay tax on Internet purchases, and about the possibility that the mechanics of doing so would make e-shopping less convenient. In that sense there is overlap with corporate interests; in a 2001 survey of Chief Financial Officers by KPMG, 40 percent of respondents said that a consistent, simple structure was their foremost concern with any potential e-commerce tax policy [Marshall, 2000, 11]. The same CFOs were more worried about tax issues than about addressing cultural differences in global online commerce.

Fairness is another concern of the business community. Because Internet sales are seldom subject to the same sales taxes that “brick-and-mortar” retailers are legally obligated to collect, many argue that e-commerce has an unfair advantage in the marketplace. When e-commerce was in its infancy, policy-makers believed that the risk of halting its evolution by taxing Internet sales outweighed the benefits of modest tax revenue, so the issue was overlooked. As the Internet enters adolescence and its sales continue to grow as a proportion of overall commerce, the issue has resurfaced. Opponents of Internet taxes counter that there is little direct competition between “Main Street” businesses and Amazon.com, for example [Powell, 2000, 39]. Still, the question of fairness persists and is noteworthy in the larger public policy debate.

The primary concern of governments in this debate is the potential loss of billions of tax dollars if Internet commerce continues to be largely tax-free. Goolsbee [2001, 15] notes that “sales taxes account for about 33 percent of state revenues” across the United States. A study by the University of Tennessee estimated that in 2001 “states, cities, and counties lost \$13.3 billion in revenue from uncollected e-commerce sales taxes” [Newsday, 2002, A48]. For states like California, New York, and Texas, the moratorium on Internet taxes that existed in 2001 cost them more than \$1 billion in lost tax collections. Even for Iowa the loss approached \$90 million, according to Donald Bruce in a *National Tax Journal* article [2000, 1373]. Bruce’s estimate of revenue loss in 2003 tops \$24 billion

nationally. In the midst of an economic downturn and with dozens of states slashing budgets and services, the loss of potential revenue has not gone unnoticed.

After reconciling these and other issues, this paper will show that taxing e-commerce is necessary to strike a fair balance among competitors in the marketplace and to compensate state and local governments for the erosion of their traditional tax bases.

II. Political and Legal Background

The debate over Internet taxation began in earnest following the United States Supreme Court's 1992 decision in *Quill v. North Dakota*. In that case, issues of federalism and state autonomy in determining tax policy were weighed against the possibility of impeding interstate commerce, which would be a violation of the Constitution's Commerce Clause. The Court's resolution of the case applied a "nexus" standard to determine whether mail order (or by extrapolation e-commerce) taxes could be assessed on transactions. This standard, which is discussed elsewhere in this paper, requires that an Internet retailer have a physical presence in a state before that state can collect taxes on any of its sales [Powell, 2000, 39].

Congress approved the Internet Tax Freedom Act (ITFA) in 1998, which imposed a three-year moratorium on new e-commerce taxes through late 2001. A focus of the legislation was preventing taxes on Internet access itself, which some say could impede the growth of its use and slow the process of bridging the "Digital Divide" [Houghton, 2000, 1351].

ITFA also created the Advisory Commission on Electronic Commerce (ACEC), a body charged with the task of investigating the potential effects of Internet taxation and making policy recommendations based on that research [Curatola, 2000, 18]. The ACEC consisted of 19 members, including representatives of state and local governments [Powell, 2000, 39]. Although a desired 13-member supermajority was not reached, the group's general recommendations were three-fold: no taxes should be imposed on Internet access; the telecommunications excise tax of 3 percent should be repealed; and the existing sales tax system needs to be simplified [Curatola, 2000, 19].

Another important political element relates to the stance of state and local governments. Groups such as the National Governor's Association

(NGA) have been instrumental in keeping the door ajar for the eventual taxation of e-commerce transactions, and have developed specific proposals for doing so [Powell, 2000, 39]. Some of their ideas will be discussed later in this paper when various options for implementing a tax system are examined. A complication arises, however, when one considers the reality that even the NGA has been unable to definitively state its own position on the issue of Internet taxation. Virginia Gov. James Gilmore, who chaired the ACEC, has been publicly opposed to taxing e-commerce sales for fear of inhibiting Internet growth. Michael Leavitt, Governor of Utah, has on the other hand led a faction of state leaders aimed at implementing a “tax with limitations” plan [Powell, 2000, 39].

III. The Question of “Nexus”

Internet transactions are by definition “remote” because they do not involve direct contact between the seller and buyer. The Supreme Court’s *Quill v. North Dakota* “nexus” standard has therefore been applied to determine whether or not they can be subjected to tax liability. The same standard is applied to mail-order sales and other remote transactions. “Simply put, nexus implies a minimum contact with a state to trigger a tax collection responsibility on behalf of the merchant selling the goods in State A to the purchaser in State B.” [Crosby, 2000, 28].

The concept of nexus is constantly evolving. For example, “creeping nexus” occurs when a company expands across state borders and takes on more of a national presence in the marketplace [*Journal of Accountancy*, 2001, 24]. In a preemptive move, several major retailers recently announced that they would voluntarily collect sales taxes on their Internet commerce sites. Because “there is wide disagreement about what qualifies as a nexus” and to avoid ultimately being forced to pay back-taxes to some states, companies like Wal-Mart and Target began expanding their online sales tax collections in early 2003 [Wingfield, 2003, B5].

The American Institute of Certified Public Accountants, in an effort to help its members determine their clients’ online tax liability, formulated the follow criteria to test for the nexus standard [*Journal of Accountancy*, 2001, 24]:

1. Is the company’s Internet Service Provider (ISP) physically

- present in the state?
2. Does the company have a server located in the state?
 3. What telecommunication services does the company use, and where are the providers located?
 4. What tangible property (e.g. computer servers) does the company have, and where is it located? Does the company have customers in the state? How important are they *in relation to the rest of the business*?
 5. Does the company have a brick-and-mortar affiliate in the state?
 6. Does the company advertise itself as a business in the state?
 7. What provision, if any, is made for product repair services within the state? (For example, the company may sell cars, television sets, or appliances.)
 8. What are the state tax ramifications for transactions involving barter—for example, with an Internet provider – and for contractual obligations? Barter transactions are likely to be taxable, as they often are an exchange of goods or services.

Under these criteria, meeting the nexus standard is relatively easy. Firms that are primarily or entirely virtual in their service delivery, however, still maintain that the standard cannot be easily applied to their operations. This becomes the crux of the “Virtual v. Main Street” debate, which will be discussed later.

IV. Adam Smith’s Canons of Taxation

A definition of “efficiency” is important before additional analyses can be reviewed. Pauline Downer wrote an interesting article in 2001’s *Journal of Financial Management and Analysis* that discusses efficiency in the context of Adam Smith’s canons of taxation: equality; certainty; convenience of payment; and economy in collection [52]. Neutrality was also one of Smith’s concerns that Downer discussed.

Downer writes, “The objective of any tax system is to transfer resources from the private sector to the public sector, influence behavior and redistribute the wealth of a nation...The goal has been to maintain neutrality, fairness and simplicity as this serves to advance desirable economic activity” [2001, 52].

Equity in the case of e-commerce relates to the Main Street v. e-

commerce debate, and suggests that differential tax treatment of e-commerce sales should be ended. It also applies to minimizing the regressive nature of sales taxes, which will be discussed later. Finally, “a tax is neutral or efficient when it does not induce tax payers to change their behavior in response to the tax. Market forces alone should determine the success or failure of a method of conducting commercial activities” [Downer, 2001, 52]. This is an argument for equal tax treatment of e-commerce and traditional sales.

Certainty, convenience of payment, and economy in collection are sticking points in the debate, since they are presumably more difficult to achieve in an online environment. Studies suggest that these difficulties will subside with time, and the issue will be discussed later in the paper. With respect to neutrality, Downer goes on to say, “The concept of neutrality assumes that tax law will not impact economic decisions” [2001, 52]. Here again, the implication is that e-commerce should not be tax-exempt because it artificially changes economic behavior. Also, the concept of neutrality will be important later in considering various ways of collecting Internet sales taxes. For example, an ideal system would not induce retailers to relocate or make other economic decisions solely on the basis of tax laws unique to particular states.

Other issues related to more traditional definitions of efficiency will also be discussed, but Smith’s canons form a solid foundation.

V. Issues of Equity and Efficiency

Several equity issues color the debate over whether Internet commerce should be taxed. Among these, the widely held belief that exempting e-commerce from sales taxes is unfair to traditional retailers stands out. In a *Publius* article, David C. Powell summarizes the argument:

Advocates of state and local taxation of e-commerce fear that creating a ‘tax-free’ Internet would place traditional retailers at an unfair disadvantage. Internet e-tailers already have the advantages of convenience to offer consumers. Coupling this with the prospect of tax-free transactions discriminates against traditional bricks-and-mortar retailers. As more expensive items become the subject of e-commerce, the savings to consumers could be extensive, thus further eroding traditional commerce. [2000, 39].

Powell's forecast has become more realistic in the past few years. Concerns about transaction and/or personal identity security have diminished as mainstream Internet users have become more acclimated to the purchasing process. And while in its infancy the Internet was only used to purchase small, easy-to-ship items (e.g. books, music CDs, novelties, etc.), corporate partnerships between sellers and shippers now enable a consumer to buy virtually anything online.

Intuitively, the claim that differential tax treatment of traditional and Internet retailers gives the latter an unfair advantage is reasonable. This is supported by empirical evidence that e-commerce sales continue to grow at double-digit rates which far exceed the sales growth of "Main Street" retailers, or even large volume discounters [Aaron, 2000, 24]. Goolsbee suggests that, "There is clearly an economic distortion created from diverting commerce from retail stores to on-line ventures simply for the purpose of avoiding taxes" [2001, 19]. His statement goes to the heart of the efficiency question raised earlier.

Henry Aaron provides an illustrative analogy in *Spectrum: The Journal of State Government* which adds weight to this argument:

Suppose someone proposed the following retail sales tax: Customers who buy from a store with more than 10,000 square feet of floor space will pay a 5 percent tax, but customers who buy from a store with fewer than 10,000 square feet of floor space will pay no tax. Yes, I know it's a silly idea. But just to carry this absurdity a bit farther, assume that some state actually adopted the proposal. Then, sales in stores with fewer than 10,000 square feet grew more rapidly than did sales in larger stores. The organization representing small stores pointed to this fact and argued that they should remain tax-free because low taxes promote sales growth. No one would take them seriously, would he? Well, it appears that Virginia Gov. James Gilmore and U.S. House Budget Committee Chairman John Kasich of Ohio would—at least if you replaced "stores with fewer than 10,000 square feet" with "Internet commerce" and "stores with more than 10,000 square feet" with "ordinary retailers. [Aaron, 2000, 24].

Still, opponents of Internet taxation argue adamantly that the enhanced growth in e-commerce sales, which is partially due to its tax

exemption, promotes innovation and further development of the Internet itself. One could postulate further that the Internet enables consumers to be better-informed, even if eventual purchases are made at “brick-and-mortar” retailers. That question raises the issue of overall economic efficiency.

Some opponents of Internet taxation maintain that e-commerce growth will expand the broader economy, in part by boosting productivity. Donald Bruce in the *National Tax Journal* questions, however, whether tax exemptions are needed in the long run to achieve these efficiency gains. “One possible argument for subsidization involves the presence of a network or information externality that requires a subsidy to achieve efficiency...It seems hard to imagine that externalities would remain in the near future, given the expected magnitude of e-commerce transactions over the next several years” [2000, 1373].

Bruce and co-author William F. Fox go on to say that efficiency losses are “probable” in the event that tax exemptions continue in the absence of externalities to warrant them. Specifically, if tax rates on production inputs obtained traditionally are increased to compensate for tax-exempt e-commerce, the economy could be harmed. This is an argument in favor of tax parity between traditional and e-commerce [Bruce, 2000, 1373].

The relationship between personal income levels and Internet usage represents an additional equity consideration in the debate. Sales taxes are notoriously regressive. In Washington State, the House of Representatives’ Office of Program Research estimated the following relationship between income level and sales tax burden:

Income Level	% of Income Paid in Sales Tax
\$20,000-30,000	4.4
\$60,000-70,000	3.5
\$130,000+	2.2

Source: DeSilver, 2002, A1.

Similar relationships have been observed nationally. Some say that exempting online purchases from sales taxes only exacerbates the

regressive nature of sales taxes. This is based on data that clearly shows a direct relationship between personal income and Internet usage.

The Wall Street Journal recently performed a study that showed this relationship. According to the report, 80 percent of households earning more than \$100,000 annually have a computer and elective access to the Internet. Meanwhile, a mere 25 percent of households earning \$30,000 or less have personal computers at home. “Web Week Magazine found that the average income for persons making purchases over the Internet exceeds \$60,000” [Grayson, 1998, 1].

Why is this significant? If Internet transactions are not subject to sales tax, and if richer consumers are significantly more likely to use the Internet to make such purchases, then those consumers who were already bearing a lighter sales tax burden will be able to avoid the tax entirely in some cases. This makes the tax system even less equitable. “If Internet purchases are not subject to sales taxes, a person with sufficient means to have a credit card, a computer, and an Internet access account will be able to avoid taxation on the purchase of a good or service that would be taxed if a person without such resources purchased the same or similar good or service from a neighborhood store” [Grayson, 1998, 1].

In addition to placing a disproportionate tax burden on lower-income consumers, the Internet’s tax exemption may also reduce government services. Lost sales tax revenues force state and local governments, which are largely responsible for subsidizing education and welfare-related services, to reduce expenditures on those services. “Recent history suggests that when declining revenues lead states to reduce services, programs serving low- and moderate-income families and individuals tend to be hit disproportionately” [Grayson, 1998, 1].

The equity argument is by definition normative. Some retort that comparing Internet and traditional commerce is like “comparing apples and oranges.” Often, e-commerce involves selling services as opposed to tangible goods, which would make sales tax exemptions appear more legitimate. But serious questions remain as to the efficiency implications of tax disparities between e-commerce and the traditional retail sector.

VI. Revenue Implications for State and Local Governments

Perhaps the most quantifiable element of this debate is the revenue various taxing entities are currently losing because of electronic commerce. Notwithstanding arguments about the validity of sales taxes in general, or

about the need for Internet retail growth, the data indicate that some states are losing billions of dollars per year because online sales are exempt from taxes. Further, the forgone revenue has come in tandem with lost tax policy autonomy. Federalism has thus been raised as an issue, and subsequently balanced against the national government's right to oversee interstate commerce per the Constitution's Commerce Clause.

"The precipitous rise in the magnitude of e-commerce could mean that, although the amount of revenue generated by Internet taxation is quite minimal, the future potential is unlimited. Preempting state and local government tax authority in this area could be very detrimental to state and local coffers in the future." Powell's [2000, 39] statement summarizes the concern held by many states and localities regarding their long-term revenue stability and their subsequent ability to provide necessary social services.

The problem of eroding state sales tax bases is not new, nor does it originate solely with the advent of Internet commerce. Rather, "state sales tax bases have been declining relative to state personal income for many years" [Bruce, 2000, 1373]. Bruce claims that in 1979, the average sales-taxing state had a tax base of 51.4 percent of its personal income. Less than 20 years later, in 1998, that base had fallen to an average of 42.8 percent of personal income. In his *National Tax Journal* article, Bruce identifies three primary reasons for this erosion: 1) growth in remote sales (e.g. mail-order, e-commerce, etc.); 2) a shift in consumption from goods to services; and 3) increasing amounts of legislated exemptions in sales tax codes nationwide. In many cases he says states have raised tax rates to compensate for this reduced base. In Iowa for example, sales tax rates would have to be increased 0.5 percentage points to make up for lost revenues which approached \$100 million [Bruce, 2000, 1373].

Some observers say that the growth of the Internet is accelerating the loss of state revenues. Because many states are in the middle of financial crises, the acceleration is occurring at the worst possible time. Estimates of lost revenue run all over the board because it is a difficult variable to calculate. In 2000, Powell forecast an annual loss of \$10 billion by 2003 [39]. Schafer suggested in 2001 that the 2000 tax loss was somewhere in the \$500 million to \$4 billion range. Bruce in 2000 agreed with Powell's estimate, and pegged expected tax losses at approximately \$10.8 billion for the year 2003 [1373]. In each case, the number is significant.

As already discussed, the lost revenue disproportionately harms lower income groups. On the other hand, in absolute terms, the losses will affect

all socio-economic groups. To continue with the Iowa example, the \$90 million in estimated lost revenues for 2003 would fund approximately half of the real budget deficit faced by the state. In places like California and New York, the losses top \$1 billion.

The magnitude of the lost revenue has led many states to call for Internet taxation. To the extent that the data represent the true fiscal picture, the call seems legitimate. If citizens continue to demand education, health care, welfare, and other services, funds must be raised to pay for them. A related question becomes how a tax model can most efficiently and effectively be implemented which both responds to state and local revenue needs and fosters growth in Internet commerce.

VII. Alternative Ways to Tax E-Commerce

Many opponents of Internet taxation believe that opening the “flood gate” would result in certain transactions being taxed by multiple jurisdictions. This concern is magnified by the reality that there are more than 7,500 jurisdictions in the U.S. that currently impose some type of sales tax [Schafer, 2001, 415].

Opponents of taxing e-commerce also believe that in order to cope with these duplicative tax jurisdictions, businesses would have to purchase sophisticated, expensive software to trace purchases and accurately assign tax liability. The burden of tax compliance would create deadweight loss, they maintain [Schafer, 2001, 415]. In addition, the burden would be more harmful for small e-commerce retailers. According to Bruce, “There is only limited evidence on the compliance costs of the sales tax. One conclusion is that compliance costs are disproportionately higher for smaller establishments...A number of states provide vendor compensation to help offset compliance costs [for smaller firms], typically in the range of 2% of the volume of taxes collected” [2003, 25].

Goolsbee acknowledges the compliance concerns, but suggests they will diminish over time. In 1999 he wrote, “states have a strong incentive to take up simplifying recommendations to make collection easy...state governments would have incentives to invest in a low-cost or even free system fully linked to popular electronic commerce platforms” [421]. Goolsbee also notes:

Calculation of taxes for each particular jurisdiction may be tedious, but such a task is well-suited to an electronic

environment. Companies such as Vertex or Taxware International have produced databases that can calculate the amount of tax to be collected if given the address of the purchaser and the amount of the purchase, data known to the merchant for transactions involving the shipment of physical goods. [1999, 421].

Goolsbee himself suggested that compliance would become easier over time, and nearly four years have passed since his paper was published. Nevertheless, any viable proposal to levy sales taxes on e-commerce must strive for simplicity. One such model is a “seller-based system,” which would call for Internet sellers to levy taxes on purchases at the rate charged in their own state. This mirrors European systems in a variety of ways, and reverses the current U.S. focus on the “destination” of a good or service. It would provide for some funding recovery and autonomy at the state level [Lee, 1999, 33]. An incentive would be created, however, for e-commerce retailers to locate in states with lower or no sales taxes. Moreover, a seller-based system would not address the equity issue of *Main Street v. Internet commerce*, because different sales tax rates would still be possible for a consumer within a given market. A seller-based system would therefore not address many of the problems with the status quo.

Another option involves a “buyer-based system” in which current sales tax laws would be extended to e-commerce transactions. In other words, if a consumer in Iowa was to purchase online a copy of *Atlas Shrugged* by Ayn Rand, that individual would pay sales tax on the book equivalent to what s/he would pay at a local bookstore in Iowa. Again this option addresses the revenue issue and provides for autonomy, but it would be less simple than a seller-based system.

A buyer-based system would require retailers to use zip codes and/or other means to determine tax liability on sales, and to forward tax proceeds to the appropriate governments. Since a large proportion of e-commerce transactions occur at a relatively small number of websites, the process would be more complex than a seller-based system. But consumers under a buyer-based system would be faced with equal tax rates on traditional and e-commerce purchases, which would completely address the equity issue. Furthermore, no incentives for relocation would be provided under this system to e-commerce retailers.

Still other alternatives propose a nationwide e-commerce sales tax that would be divided up on the basis of some formula to each of the states.

Sandi Owen in a *Federal Communications Law Journal* article stated that, “Internet transactions have virtually eliminated the geographic boundaries between states and localities that formerly provided the framework for sales and use taxation. As a result, a national tax policy must be developed either through uniform state laws or federal legislation” [1998, 245].

Other concerns relate to compliance and the feasibility of collecting Internet sales taxes. “While tax compliance has depended historically on identifying key taxing points, electronic commerce creates a challenge for the identification of such points, and such transactions may be prime candidates for tax evasion” [Owen, 1998, 245]. To be sure, a compliance and collection strategy would have to be developed simultaneous to any proposed sales taxes on e-commerce. This too could be costly for the economy, and would have to be weighed against the expected benefit of actually collecting e-commerce taxes. Bruce suggests the benefits outweigh the costs:

There is no question that application of the sales tax to e-commerce poses many challenges and will give rise to additional administration and compliance costs. But other taxes, including the corporate income tax and the personal income tax also entail substantial enforcement and compliance costs. Optimal tax theory requires an assessment of the relative costs of generating revenue from alternative tax instruments. There is simply no evidence that the changes in excess burden plus administration and compliance costs of taxing e-commerce are sufficiently high to warrant a blanket exemption of all transactions, or indeed, are higher than alternative ways of generating funds. [2003, 40].

VIII. Discussion of Limitations

Goolsbee and others were skeptical about taxing Internet transactions when the first body of research was published on this topic in the late 1990s. Their claims were that e-commerce sales taxes would provide insignificant revenue for governments, stifle Internet sales growth, and be expensive to collect. Goolsbee also disputed many of the calculations of lost government revenues. But even he predicted that those claims would reverse themselves over time, and a few years later, his criticisms actually reinforce the idea that e-commerce should be taxed.

In 1999, Goolsbee conducted a behavioral study of Internet consumers and suggested, “Evidence... does not seem to point to intense competition between retail and online commerce at present – consistent with the notion of the Internet as a trade creator.” That is to say, his findings were that e-commerce was not cannibalizing traditional retail sales. Goolsbee went on to predict, however, that “as time progresses...and the Internet becomes a larger fraction of total retail, the competition may become more intense” [1999, 420]. The latter claim is reflected in e-commerce sales volume data.

With regard to compliance costs and problems, Goolsbee said, “The goal is to make compliance easy and evasion difficult so that the problem is limited. In this sense, in the short run, there may be some problems with trying to enforce sales taxes online, but looking forward, these problems are likely to lessen in importance” [1999, 422]. Discussions elsewhere in the paper on the topic of compliance support the final portion of his statement.

Finally, Goolsbee argued in 1999 that the positive externalities of the Internet (e.g. information networks) were significant enough to warrant a sales tax exemption. But in one of his subsequent papers, Goolsbee summarizes:

As a final thought regarding the domestic taxation of the Internet, the losses of tax revenue due to e-commerce are likely to be small in the short run and rise over time. Conversely, any positive externalities for the economy as a whole arising from electronic commerce and the spread of Internet access are likely to be largest in the short run and diminish as the Internet becomes an established retail channel. In such circumstances, choosing not to enforce online sales taxes aggressively for a few years, followed by equal treatment once the Internet is established, may be a desirable outcome as well as being a plausible political compromise. [Goolsbee, 2001, 21].

The data suggest e-commerce has become “an established retail channel.” Thus, Goolsbee’s last sentence seems instructive. Overall, his predictions have materialized, and suggest that e-commerce sales should be taxed. Nevertheless, other limitations to this analysis remain. First and foremost, e-commerce is still relatively “new.” More time needs to pass before the true impact of online sales on the larger economy is known.

Time-series studies of consumers need to be conducted to detect changing behaviors. Payment mechanisms for e-commerce transactions are evolving. As the Internet continues to grow and mature, many of these questions will be answered more clearly. For now, the question of whether to tax Internet sales remains, and must be answered in the context of what we already know—which is that e-commerce is already a “big deal.”

IX. Conclusion

The legal debate about e-commerce taxation likely will be resolved only with additional federal legislation. Although online sales still account for a small proportion of overall commercial activity, their share is growing at a rate that will bring the issue to the forefront of tax policy debate. By 2005, Bakos predicts that e-commerce transactions will account for almost 8 percent of all retail sales – up from 1.5 percent in 2000 [2001, 69]. In addition, his forecast is that about 18.5 percent of all sales will be “affected” by e-commerce via online research. Clearly, e-commerce’s slice of the overall retail pie is growing rapidly.

Although some argue that the nature of Internet sales inherently is different from that of traditional retail sales, and that the difference justifies the existing tax rate disparity, the reality is that issues of equity and efficiency justify an online sales tax. Doing so would mitigate increases in the regressive nature of traditional sales taxes, and also promote broader economic efficiency. The argument that we should implement an e-commerce sales tax to protect “brick-and-mortar” retailers is also noteworthy.

Most importantly, decisions should take into account the long-term impact of exempting Internet transactions from sales tax on governments that provide core services to society at-large. There is a growing problem with revenue shortages, in no small part due to the growth of online and other remote sales that are difficult to tax. If policy-makers allow this trend to continue, the result could be increases in other taxes that would damage economic activity even more than taxing Internet sales (e.g. income tax rate increases, traditional sales tax increases, etc.).

Finally, a tax model must be chosen. The need for simplicity and “fairness” in a model requires that we do not double-tax single transactions. And since legal issues related to state and local autonomy in determining tax policy suggest that a national Internet sales tax would

be ill advised, one must support the adoption of a buyer-based system. Such a system would minimize artificial incentives (e.g. relocation) for retailers, provide maximum autonomy to local taxing authorities, and fully address the equity issues that have been raised.

As has been discussed, a buyer-based sales tax would also reduce the impact of the “nexus” debate on the applicability and collection of Internet taxes, and it would offer states sufficient revenue for sales originating within their borders. It would be foolish to believe this issue will ever be “resolved” given the evolutionary nature of the Internet itself. But for efficiency’s sake, for equity’s, and for the sake of quality government services—the evidence strongly supports the need for implementing a universal Internet tax policy.

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