NATIONAL CENTER FOR POLICY ANALYSIS

The Marketplace Fairness Act: Tilting the Playing Field

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Last year, the U.S. Senate passed the Marketplace Fairness Act (MFA), allowing states to require online retailers to collect and remit sales taxes for each buyer's state. Though the House of Representatives is unlikely to pass the bill anytime soon, the issue will likely come up again. Under the Senate bill, online retailers could collect an estimated $22 billion to $24 billion in sales tax that now goes uncollected.[1]

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The MFA is in response to the Supreme Court's 1992 *Quill vs. North Dakota* decision, in which the Court ruled that a business could not be forced to collect and remit a state's sales tax unless it had a physical presence (nexus) in the state.

The Marketplace Fairness Act should be unnecessary, because 45 states already have laws requiring purchasers of online or out-of-state products to pay a "use" tax on these purchases if the seller does not charge them sales taxes. The individual taxpayer is responsible for reporting purchases and paying the tax, but states rarely, if ever, enforce payment. The MFA would make sellers responsible for collecting any taxes due on sales, but there is little evidence the states would collect the additional billions of dollars in revenue they claim.

The Marketplace Fairness Act of 2013. States that choose to enact the MFA would have to meet five simplification mandates, including establishing a uniform sales tax base for use throughout the state, notifying retailers 90 days in advance of any rate changes, and designating a single state organization to handle sales tax registrations, filings and audits.[2]

However, states that are already part of the Streamlined Sales and Use Tax Agreement (SSUTA) need only adhere to the requirements outlined in the SSUTA agreement. The SSUTA is a voluntary compact of which 24 states are members.[3] It is designed to simplify sales and use tax collection from vendors in cross-border states by requiring participating states to adhere to streamlined rules. These rules include but are not limited to:

- Making tax rates more uniform by requiring local governments to tax and exempt the same products under local sales taxes as under state sales taxes.
- Requiring centralized administration of all sales and use taxes in each state.
- Providing online vendors with software that matches zip codes to state and local tax rates.
- Simplifying tax returns and tax remittances.

Under the SSUTA, sellers voluntarily remit taxes to member states. But unlike the Marketplace Fairness Act, states cannot force sellers to do so.

The Use Tax. Currently, 45 states require purchasers of online or out-of-state products to report their purchases on their tax forms and pay a "use" tax.

Compliance rates are low for many reasons. First, many residents are not even aware that a use tax exists in their state for out-of-state or online purchases. Second, the use tax is not a reporting requirement on a federal tax return, therefore not subject to IRS penalties. Third, much like a sales tax, the use tax is subject to bizarre exemptions that further complicate compliance. For example:[4]

- Connecticut exempts a hodge-podge of goods, including bicycle helmets, fluorescent bulbs, state flags, rare coins and personal property used for burial or cremation (up to $2,500).
- Arkansas exempts Christmas trees, twine used in tomato production, and new or used aircraft.
- Mississippi exempts Girl Scout cookies.
- New York exempts products used for weaving.

Many other states exempt a variety of goods used in agricultural production or health care. Under current law, economist Arthur Laffer estimates $13 billion is currently lost from noncompliance, and that this number will grow to between $27 billion and $33 billion by 2022.[5]

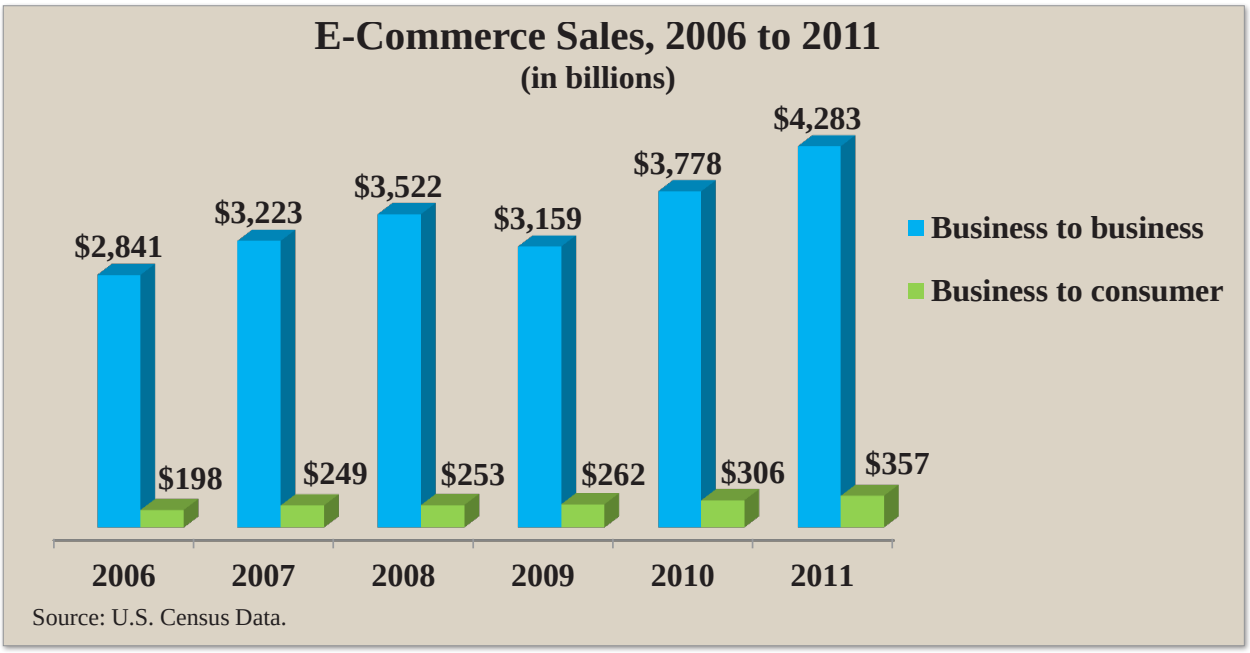
Tax Revenue Resulting From the MFA May Be Overstated. Will the MFA really generate all of the revenue the states claim they are losing?

The National Conference of State Legislatures (NCSL) estimated the loss of tax revenue at $23 billion in 2012.[6] In a 2009 study, Donald Bruce and his colleagues at the University of Tennessee estimated tax revenue losses associated with e-commerce at about $12.65 billion — nowhere near the NCSL's estimate.[7] But how accurate are these estimates?

Bruce's study examined Census data that shows e-commerce grew from $995 billion in 1999 to $2.3 trillion in 2006. He projected e-commerce would grow to $4 trillion by 2012, including purchases by consumers from businesses, and by businesses from other businesses.[8] The vast majority, about $3.7 trillion, are business-to-business purchases.[9] The study estimated that from 2007 to 2012 total uncollected revenue would be around $52 billion, the equivalent of what states would receive if they achieved 100 percent compliance.

But the most recent Census data show that actual business-to-business e-commerce sales were slightly higher than the study projects [see the figure].[10] While 2012 figures are not yet available, total e-commerce sales for 2011 (excluding services) were already $4.6 trillion, surpassing the projected $4 trillion for 2012. Indeed, as Bruce's study notes, the vast majority of e-commerce sales were business to business.

However, the Tennessee study does not provide a reliable estimate for the amount of uncollected sales taxes. Many wholesale goods are tax-exempt. Furthermore, the study does not break out the amount of sales by businesses with gross revenues of less than $1 million, which would be exempt from the MFA. Additionally, the estimate assumes 100 percent compliance with any applicable sales taxes, but analyses show that businesses that pay sales or use taxes are more likely to comply than consumers. Thus, if the study assumes purchasers are at 0 percent compliance and go to 100 percent, it overstates the amount of potential tax revenue.



According to the Government Accountability Office, business compliance ranges from 50 percent to as high as 95 percent, depending on the state. But consumer compliance is much lower, from 0 percent to 5 percent.[11]

The MFA Would Burden Sellers. Proponents of the Marketplace Fairness Act say it will make sales tax collection easy for vendors. After all, states must provide up-to-date software (free of charge) to online sellers so they can efficiently collect for 9,600 taxing jurisdictions. But the Act itself implies that there is a significant compliance burden, simply because it exempts small businesses with revenues under $1 million. Moreover, the MFA does not provide all the protections for vendors that apply under the Streamlined Sales and Use Tax Agreement. For instance, the SSUTA:

- Protects sellers from state requirements to pay fees or other charges for the seller to register in each state.
- Protects sellers by mandating that if a member state fails to provide notice to sellers at least 30 days between the enactment of a rate change and when it is implemented, the seller is relieved of liability for failing to collect tax at the new rate.[12]
- Includes the "rebuttable presumption" that sellers or Certified Service Providers have exercised due diligence.[13]
- Requires states to relieve a seller of the tax if the seller obtains a fully completed exemption certificate within 90 days subsequent to the date of sale, and it also allows states to increase the period of time for the seller to obtain the necessary information.
- Addresses blanket exemptions based on long-term business relations, and claims that the seller is relieved of payment liabilities to a state if proper documentation is supplied.[14]

The Marketplace Fairness Act contains a handful of seller protections, including relieving remote sellers from collection liability if either a state or a company providing the tax software gives incorrect information. This does not mean that the MFA would exclude any of the seller protections the SSUTA provides, but the agreement does not spell out any of these protections, meaning it could be subject to vague interpretations. Because there are several protections that must be addressed, as well as the exemption of small businesses, the question becomes: how easy is compliance?

Experiments in Use Tax Compliance. A few studies have examined how effectively states enforce use tax compliance. Govind Iyer and his colleagues examined different programs to enforce Washington State use tax compliance, which is estimated at only 2.2 percent.[15] The authors created an inexpensive mail-based program that emphasized the probability of getting caught and the penalties of noncompliance. Some of the letters mailed to respondents included wording that emphasized the likelihood of detection and potential penalties for noncompliance.[16] They found that compliance increased significantly.

A 2013 study from the University of Wisconsin-Oshkosh examined use tax compliance rates in Illinois and Florida by allowing participants to pay the use tax through two mechanisms:

- The "effort remedy" gave the purchaser the option to pay the use tax at the time of their online purchase.[17] The vendor who collected the tax remitted it back to the purchaser's state.
- The "information remedy" explained what the use tax is and how to comply with it.

The alternatives were tested on a sample of 122 public university students in Florida and 110 university students and faculty in Illinois. Researchers found:

- With no remedies, the likelihood of compliance was 21 percent in Florida and 41 percent in Illinois.
- The effort remedy alone increased the likelihood of compliance to 48 percent in Florida and to 76 percent in Illinois.
- The information remedy alone increased the likelihood of compliance to 25 percent in Florida and 28 percent in Illinois.
- However, the combined remedies increased the likelihood of compliance to 61 percent in Florida and 87 percent in Illinois.

Conclusion. States may have legitimate concerns in collecting sales tax from online vendors and leveling the playing field between them and brick-and-mortar stores, but the Marketplace Fairness Act is not the way to accomplish those goals. The MFA essentially punishes vendors by requiring them to collect taxes, which is government's job. States with use tax laws on the books should use their own taxing authorities to enforce compliance rather than burden the private sector with the task.

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Endnotes

[1.] Jonathan Weisman, "Internet Sales Tax Bill Gains Ground in Senate," *New York Times*, April 22, 2013.

[2.] S.336, "The Marketplace Fairness Act." Available at http://www.gpo.gov/fdsys/pkg/BILLS-113s336is/pdf/BILLS-113s336is.pdf.

[3.] "Streamlined Sales and Use Tax Agreement," adopted November 12, 2000, and amended through October 30, 2013. Available at http://www.streamlinedsalestax.org/uploads/downloads/Archive/SSUTA/SSUTA_As_Amended_10-30-13.pdf.

[4.] "State Sales Tax Rates," Sales Tax Institute. Available at http://www.salestaxinstitute.com/resources/rates.

[5.] Arthur B. Laffer and Donna Arduin, "Pro-Growth Tax Reform and E-Fairness," Laffer Associates, July 2013.

[6.] Press Release, "NCSL Thanks Senators for Passing Marketplace Fairness Act," National Conference of State Legislators, May 6, 2013. Available at http://www.ncsl.org/press-room/ncsl-thanks-senators-for-passing-marketplace-fairn.aspx.

[7.] Donald Bruce et al., "State and Local Government Sales Tax Revenue Losses from Electronic Commerce," University of Tennessee, April 13, 2009.

[8.] Ibid.

[9.] From 2003 to 2005, business-to-business transactions represented about 93 percent of total annual e-commerce.

[10.] Figure based on U.S. Census Data Tables: Table 2.0/Historical, "U.S. Merchant Wholesale Trade Sales, Including Manufacturers' Sales Branches and Offices - Total and E-commerce: 2011-1998"; Table 3/Historical, "U.S. Selected Services Revenue - Total and E-commerce: 2011-1998"; Table 4/Historical, "U.S. Retail Trade Sales - Total and E-commerce: 2011-1998;" Table 5/Historical, "U.S. Electronic Shopping and Mail-Order Houses (NAICS 45411) - Total and E-commerce Sales by Merchandise Line: 2011-1999."

[11.] "Sales Taxes: Electronic Commerce Growth Presents Challenges: Revenue Losses are Uncertain," Government Accountability Office, Report No. GAO/GGD/OCE-00-165, June 2000.

[12.] Based on whether or not the seller collected tax at the immediately preceding effective rate; and the seller's failure to collect at the newly effective rate does not extend beyond 30 days after the date of enactment of the new rate.

[13.] Due diligence is defined as: If the seller in question has attempted to determine the nine-digit zip code by using software approved by the governing board that makes the designation of the tax rate based on street address and the five-digit zip code applicable to a purchase.

[14.] S.336, "The Marketplace Fairness Act."

[15.] Govind S. Iyer et al., "Increasing Tax Compliance in Washington State: A Field Experiment," *National Tax Journal*, March 2010, Vol. 63, No. 1, pages 7-32.

[16.] The detection manipulation paragraph stated that the Department of Revenue was examining tax returns to "assess use tax underpayments," and that their reports should match Federal tax form 4562. The penalty manipulation paragraph listed the penalties for late filing, negligence and evasion, ranging from a fine to criminal prosecution.

[17.] Christopher R. Jones and Yuyun Sejati, "Improving Use-Tax Compliance by Decreasing Effort and Increasing Knowledge," *ATA Journal of Legal Tax Research*, Vol. 11, No. 1, 2013, pages 1-18.

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