Sales Tax Nexus and the Cost of E-commerce

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The Internet can be a wonderful tool for both personal and business endeavors, but it also presents a host of dangers, including anything from viruses and spyware to inappropriate content. We install virus detection software, firewalls and other devices to help combat these risks, but there is one danger that can pose an even greater threat to business owners, and there may be no protection against it – state taxing authorities.

Many Internet retailers can attest to the fact that some aggressive, revenue-hungry states are pushing the proverbial envelope as far as they can to create sales tax nexus in their states. Let's be realistic – it's much easier for a taxing authority to go after a big retailer than to follow up with each consumer to make sure they are paying the appropriate use tax. To be fair, the states may be missing out on a significant revenue source, but businesses can be adversely affected by the additional collection and compliance responsibilities, in addition to competitive disadvantages. In some recent studies, legislation and court cases have posed some very interesting questions about Internet sales.

How much revenue is being lost by the state and local governments?

A report issued by the General Accounting Office (GAO) estimated state and local sales and use tax losses for all Internet sales for the year 2000 at $0.3 billion to $3.8 billion. For 2003 the GAO estimated between $1.0 billion and $12.4 billion. Another report issued by The University of Tennessee's Center for Business and Economic Research estimated lost revenue in 2003 at $15.5 billion and predicts that the revenue loss in 2008 will be between $21.5 billion and $33.7 billion. According to this study, New Jersey alone stands to lose between $566.2 million and $885.5 million dollars in sales and use tax revenue this year due to E-commerce. This is a good chunk of change, but relatively small compared to the revenue California, Florida, New York and Texas will lose.

Are nexus standards changing to accommodate the information age?

Interstate commerce is primarily governed by the U.S. Constitution. However, over time state tax court cases have helped to translate the Commerce Clause and the Due Process Clause into real life definitions. Landmark cases, such as *Quill Corp.* and *National Bellas Hess* may have established the original standards, but new court cases continue to refine these standards.

In a recent tax court case, a retailer with operations in NJ was found to be responsible for collecting NJ sales tax on sales made through its website, which is operated from Washington State. While this outcome seems reasonable under current guidelines, other states have been more aggressive.

The State of New York has passed legislation that it calls the "Amazon Tax," which presumes physical solicitation of sales through an independent contractor if the seller enters into an agreement for consideration with a NY resident to directly or indirectly refer customers to the out-of-state seller's website by virtue of an Internet link. Overstock.com has severed its relationships with NY affiliates due to this piece of legislation, and Amazon has filed suit against the state, challenging the yet untested law's constitutionality. The outcome of this case will set a precedent of paramount importance.

Texas and California have stated that they do not agree with the "Amazon Tax," and would require a greater degree of physical presence than an Internet link before making a determination that nexus exists.

What does this all mean to Internet retailers?

For now, any business owner considering making sales through the Internet should give careful consideration to any possible tax consequences. Research the nexus guidelines of states in which there may be any business connection. In the future, who knows? The Streamlined Sales and Use Tax Agreement has been adopted by nearly half of the states in the U.S. to date. Under this program, member states adopt uniform definitions for sales tax purposes, and taxes are remitted to several states through one cumulative collection process. Registration in this program is voluntary thanks to the protection of interstate commerce afforded by the Constitution, but the growing loss of revenue caused by E-commerce is sure to spur change in the landscape of state taxation.

Dawn Greenberg, CPA, Tax Principal with Cowan, Gunteski & Co. specializes in providing strategic tax planning and consulting services. She has been influential in saving clients money by initiating proactive tax planning strategies such as cost segregation studies, domestic production activities deductions, and 1031 tax deferred exchanges. Ms. Greenberg works with small closely-held businesses, partnerships, multi-million dollar consolidated corporations, as well as high net worth individuals.

With more than 10 years of experience in public accounting she is a recognized expert in sales and use tax, multi-state tax issues (nexus studies), tax accounting for investments, U.S. taxation of foreign entities, "green taxes," and worker classification audits. Dawn has represented numerous clients in state sales tax audits, which have resulted in substantial reductions of taxes and penalties. She can be contacted at 732-349-6880 ext. 118 or *dgreenberg@cowangunteski.com*.

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