NARROWING THE GAP: OPTIONS FOR BOOSTING CALIFORNIA'S SALES TAX COLLECTIONS FROM ONLINE RETAILERS

California loses more than $1 billion each year in uncollected taxes on Internet sales because out-of-state online retailers refuse to collect the taxes owed on consumers' purchases.[1] While consumers are legally obligated to pay these taxes, few do, largely because few are aware that they owe any tax. Compelling more businesses to collect taxes that are already legally owed is the most practical means of reducing the significant gap attributable to untaxed Internet sales. California should follow the lead of other states and enact legislation aimed at increasing sales tax collections from out-of-state online retailers. By doing so, California stands to boost sales tax revenues by as much as hundreds of millions of dollars each year. These much-needed dollars could help close California's budget gap and provide funding for the state's core public structures, including schools, health care, and public safety, as well as other priorities that are essential to California's future prosperity. The case has never been stronger for California to address the problem of untaxed Internet sales: With growth in online sales far outpacing that of traditional "brick-and-mortar" stores, failure to act will result in even more severe erosion of state sales tax collections, which are already low as a result of the recent recession. This *Brief* describes several approaches California could take to help boost sales tax collections from online retailers.

What Is California's Sales and Use Tax?

The sales and use tax, which is California's second-largest revenue source, is actually two separate taxes: A tax on the sale of tangible goods occurring in California and a tax on goods purchased outside of the state for use in California. The use tax was established in 1935, less than two years after the creation of the state's sales tax. Individuals and businesses that purchase taxable goods from out-of-state retailers online owe use tax to the state in an amount equal to what they would have paid in sales tax had the purchase been made from retailers in California. As such, the use tax is designed to help level the playing field for in-state businesses by ensuring that goods purchased within and outside of the state are taxed at the same rate.[2]

California Loses More Than $1 Billion Each Year From Untaxed Internet Sales

California loses an estimated $1.1 billion each year in uncollected taxes on purchases of taxable goods made online from out-of-state retailers.[3] This substantial loss of revenues reflects the fact that most out-of-state retailers – unlike their in-state counterparts – do not collect the tax on purchases made by California consumers that are delivered into the state.[4] While consumers are legally obligated to pay the tax, few do, largely because few are aware that they owe any tax. The Board of Equalization estimates that less than 1 percent of Californians who owe tax on out-of-state purchases actually pay it.[5] In fact, just 61,000 taxpayers paid the tax when they filed California personal income tax returns in 2010, representing less than half of 1 percent of all California residents who filed personal income tax returns.[6]

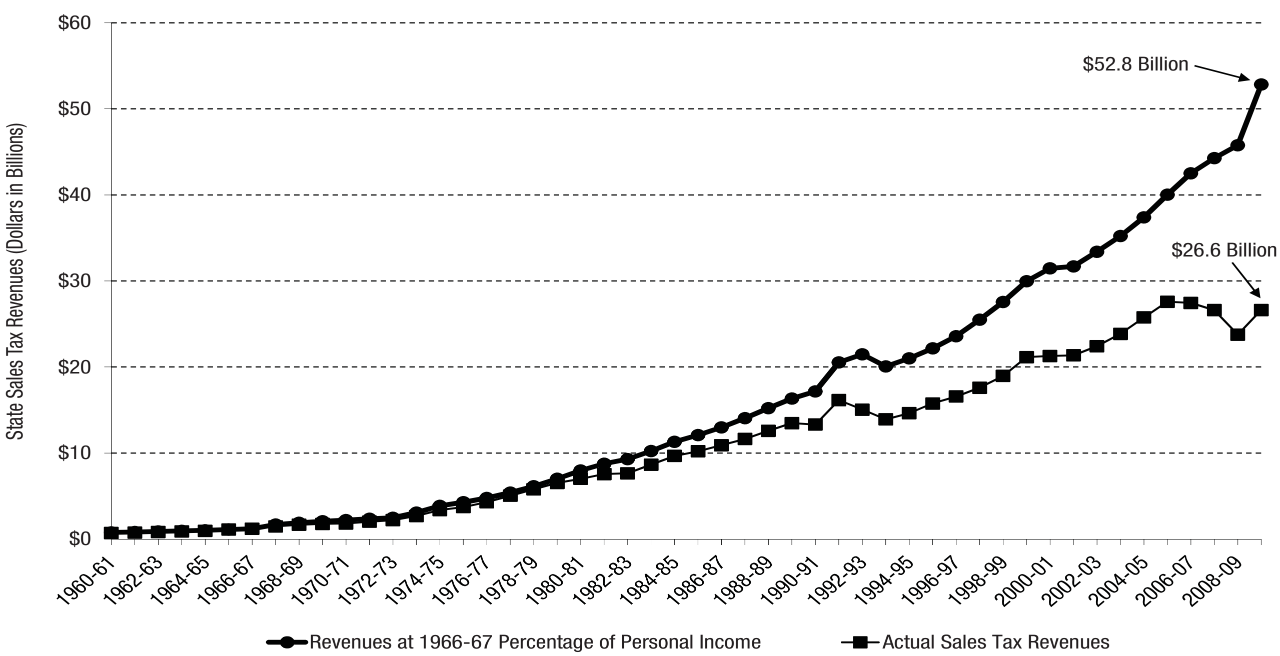
The significant increase in online sales for which the sales tax goes uncollected has contributed to the declining "yield" of California's sales tax. In 2009-10, the revenue raised by a 1 percent state sales tax rate was less than 60 percent of the amount raised in 1966-67.[7] In fact, if taxable purchases accounted for the same share of California personal income in 2009-10 as they did in 1966-67, the state would have collected an additional $26.2 billion in sales tax revenues – nearly twice the amount actually collected (Figure 1).[8]

Tax Preference Undermines California Businesses to the Detriment of Local Economies

Since many online retailers do not collect the sales tax on purchases made by California consumers – tax that is legally owed – these businesses have a significant advantage over traditional retailers, which do collect the tax. Failure to charge state and local sales tax means that the price of goods sold by out-of-state retailers appears to be as much as 10.75 percent less than the after-tax price of the identical goods sold in brick-and-mortar stores.[9] For example, residents of Los Angeles, where the combined state and local sales tax rate is currently 9.75 percent, appear to save $9.75 for every $100 spent on taxable goods purchased through the online retailer Amazon rather than at local retail stores.[10] Numerous studies have confirmed that this perceived price advantage draws customers away from traditional stores, which typically are unable to match the artificially low prices offered by their online competitors that appear to sell goods sales tax free.[11]

Failure to compel online retailers to collect the sales tax gives preferential treatment to businesses that do not employ a single Californian or invest in state, at the expense of local businesses that create jobs for California workers and boost local economies. As discussed below, companies that avoid collecting sales tax are, by definition, businesses with no property or employees in the state, which means that these companies not only fail to collect sales taxes, but also pay no property taxes to local governments or wages to California workers. Consequently, when consumers make purchases from out-of-state retailers, the dollars they spend leave the state, with no direct benefit to California. In contrast, purchases from local stores keep dollars in local communities. They directly support the wages of California workers who, in turn, spend most of their incomes locally, which gives a boost to other local businesses. Moreover, these

Figure 1: State Sales Tax Revenues Would Be $26 Billion Higher if Taxable Sales Had Remained at 1966-67 Levels as a Share of the Economy

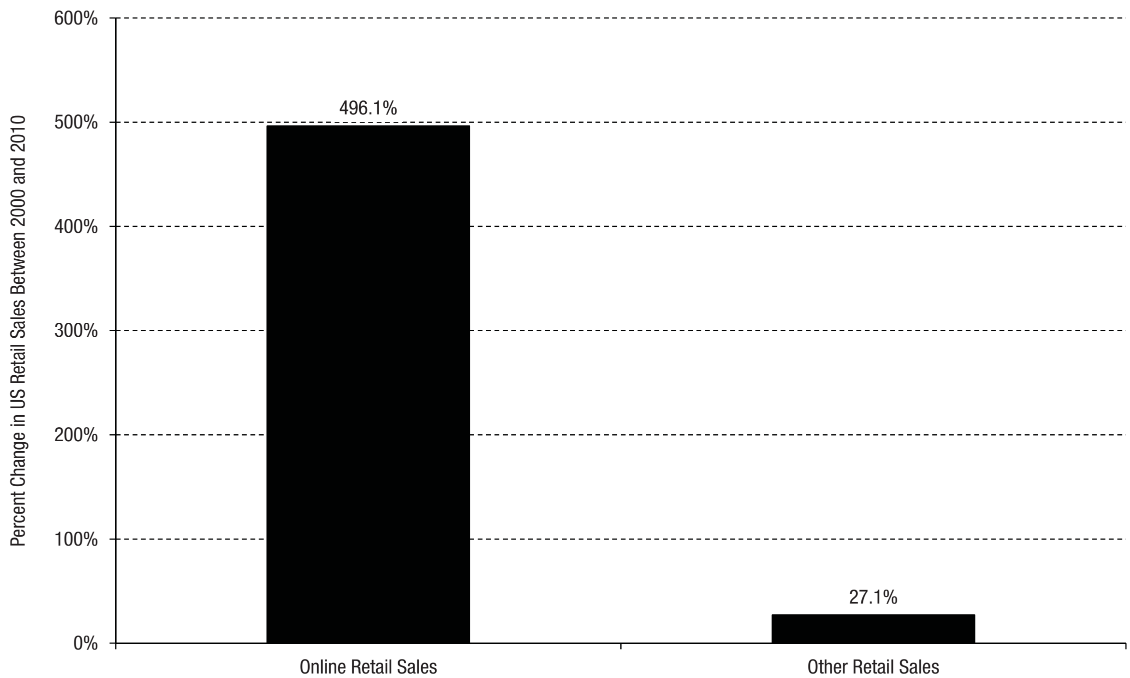


Note: 2009-10 data are estimated.
Source: CBP analysis of Department of Finance, Legislative Analyst's Office, and US Bureau of Economic Analysis data

Online Sales Have Far Outpaced Other Retail Sales Over the Past Decade

Online sales have skyrocketed over the past decade, far outpacing sales at brick-and-mortar stores. Online retail sales nationwide increased sixfold between 2000 and 2010, rising by 496.1 percent – 18 times the increase in other retail sales during the same period.[12] Consequently, Internet purchases as a share of all retail purchases increased nearly fivefold, from 0.9 percent in 2000 to 4.2 percent in 2010.[13] One of the most remarkable trends in recent years is the fact that online sales held up during much of the Great Recession, while sales at brick-and-mortar stores declined throughout most of the downturn. In fact, as of the fourth quarter of 2010 – the most recent period for which data are available – online sales were up by 22.3 percent compared to the fourth quarter of 2007, when the recession began, while all other sales were still down by 1.3 percent.[14] Online retailers may have fared better during the recession than traditional stores as many families, struggling with job loss and reduced incomes, became more cost-conscious and sought out lower prices online.

Online Sales Far Outpaced Other Retail Sales Between 2000 and 2010



Note: Includes taxable and nontaxable goods.
Source: US Census Bureau

businesses and the workers they employ pay state and local taxes, which help support the public structures, such as schools, that enable California's communities to thrive.

As consumers have increasingly gone online to do their shopping, drawn in large part by the low prices they can find there, purchases made at local stores have declined, to the detriment of local communities. California businesses lost an estimated $4.1 billion in sales to online retailers in 2010, costing jobs and pulling dollars out of local communities.[15] The rise of major online book sellers, in particular, has made it difficult for brick-and-mortar bookstores to compete on an uneven playing field, and some have gone out of business.[16] Sales that local businesses lose to online retailers are projected to more than triple this decade, according to one estimate, reaching $14.3 billion by 2020, making it increasingly hard for many more local stores to survive.[17]

How Can States Compel Out-of-State Retailers To Collect the Sales Tax?

A comprehensive solution to increase sales tax collections by out-of-state retailers requires Congressional action. Congress can overturn the "physical presence" requirement established by US Supreme Court decisions (see box) by developing new standards under which states can require out-of-state retailers

Why Don't Out-of-State Online Retailers Collect the Sales Tax?

A series of US Supreme Court rulings has limited states' ability to require out-of-state retailers to collect the sales tax owed on purchases of taxable goods by consumers that in-state retailers are legally obligated to collect. The grounds for these decisions rest on the Court's interpretation of a provision of the US Constitution commonly referred to as the Commerce Clause.[18] This provision explicitly reserves to Congress the power to regulate interstate commerce and has been interpreted by the Court to also prohibit certain state actions that interfere with interstate commerce. Court decisions have determined that states can levy taxes on businesses without violating the Commerce Clause as long as certain conditions are met, including that that the tax applies to businesses with a significant connection to the state – referred to as "substantial nexus."[19]

The Supreme Court has established that companies without a "physical presence" in a given state do not have substantial nexus in that state and cannot be required to collect the sales tax. In its 1967 ruling in *National Bellas Hess, Inc. v. Illinois,* the Court determined that a mail-order company whose *only* contact with Illinois involved mailing catalogues and goods sold to consumers in that state could not be compelled to collect the sales tax.[20] While this ruling did not explicitly define what kind of contact *is* sufficient for a company to have nexus in a state, it made clear that contact via mail *alone* was not sufficient.[21] The *Bellas Hess* ruling was reaffirmed by the Supreme Court 25 years later in *Quill Corporation v. North Dakota,* which also involved an out-of-state mail-order company.[22] In that case, the Court maintained a "bright-line" distinction between companies with a physical presence in a state, which could be required to collect sales taxes in that state, and companies without a physical presence in a state, which could not. While the *Quill* decision specifically pertained to a mail-order businesses, courts have interpreted it to apply to online retailers as well.[23]

The physical presence requirement affirmed by the *Quill* decision continues to be the most significant obstacle preventing states from requiring many online companies to collect sales taxes that are legally owed. In effect, the *Quill* decision means that a state cannot require a business to collect sales taxes if it has no property, workers, or sales representatives in a state. The Supreme Court acknowledged in *Quill* that the strict physical presence requirement it had established "appears artificial" and that no such distinction exists for other types of taxes. However, the Court stated that its decision to uphold the requirement "is made easier by the fact that the underlying issue is not only one that Congress may be better qualified to resolve, but also one that Congress has the ultimate power to resolve."[24]

to collect sales taxes. Efforts to persuade Congress to do this have been under way for nearly two decades. In 1999, the National Governors Association and National Conference of State Legislatures created the Streamlined Sales Tax Project, an effort to simplify and align states' sales tax policies to make it easier for national retailers to collect the tax across multiple states.[25] State officials involved in the project hope that if a sufficient number of states streamline their policies, thereby reducing the supposed burden retailers face in complying with various sales tax laws, they will convince Congress to pass legislation requiring online retailers to collect the sales tax in those states – whether the companies are physically present or not. Legislation to do this has been introduced in Congress for many years, but has never passed.[26]

Actions Taken by Several States Could Help Narrow Their Sales Tax Gaps

Until Congress acts, states' ability to close their sales tax gaps is somewhat limited. However, several states have enacted laws in recent years aimed at boosting sales tax collections by out-of-state retailers. Further state action could spur Congress to implement a comprehensive solution to the problem. New York led the way in 2008 with an innovative law that requires out-of-state retailers to collect the sales tax on all purchases made by the state's consumers if those retailers use "affiliates" in the state to promote their sales.[27] Affiliates are individuals or businesses located in New York, including bloggers, newspapers, and nonprofit organizations, who post on their websites links to the sites of online retailers, such as Amazon. Each time someone follows a link on an affiliate's website and makes a purchase, the affiliate receives a commission from the retailer who made the sale. The law assumes that online retailers' relationship with affiliates constitutes a "physical presence" in New York that entitles the state to require those companies to collect the sales tax. The Appellate Division of the New York Supreme Court has upheld the law.[28] New York officials estimate that approximately 30 retailers began collecting state and local sales tax as a result of the legislation, boosting collections by more than $100 million in two years.[29] Encouraged by the success of New York's approach, several other states, including Arkansas, Illinois, North Carolina, and Rhode Island have enacted legislation modeled after New York's law, and at least 10 additional states, including California, are considering similar measures.[30] A bill currently before California's Legislature, AB 153 (Skinner), is modeled after New York's law.

Colorado tried a different approach to narrowing its sales tax gap. In 2010, the state passed a law requiring any retailer that does not collect the sales tax to notify Colorado consumers of the amount of sales tax they owe each time they make a purchase. The law also requires these retailers to provide annual reports to consumers summarizing the total amount of sales tax they owe as a result of purchases made during the year.[31] In addition, copies of these reports, along with consumers' names and addresses, must be sent to the state's Department of Revenue. This law is currently being challenged in court, and a federal district court recently blocked the Department of Revenue from enforcing the law. After Colorado's law passed, Oklahoma and South Dakota enacted similar legislation requiring certain online retailers to notify consumers of their obligation to pay sales tax on taxable goods.[32]

Avoiding Nexus Is the Name of the Game: The Case of Amazon

Amazon.com is the largest online retailer in the world, accounting for nearly one-fifth of all Internet sales made by the 500 largest online retailers.[33] Amazon's business model is explicitly based on the significant price advantage it gains over brick-and-mortar stores by avoiding collecting state and local sales taxes in most states.[34] In the company's 2008 report to the Securities and Exchange Commission, Amazon made clear that selling goods "sales-tax free" is essential to the company's competitive strategy: Requiring it to collect state and local sales taxes, the company wrote, would diminish its "ability to compete with traditional retailers and otherwise harm our business."[35]

Since avoiding sales tax collection is critical to Amazon's business model, the company has made numerous strategic business decisions to deliberately avoid such obligations in as many states as possible. For example, Amazon's founder, Jeff Bezos, chose to base the company's office in Seattle, Washington – a state with a relatively small customer base – because "in the mail-order business, you have to charge sales tax to customers who live in any state where you have a business presence. It made no sense for us to be in California or New York."[36] Although he considered locating in the San Francisco Bay Area because it is the nation's "single best source for technical talent," doing so would have meant losing the ability to sell products to customers in California – the largest market in the US – "sales-tax free."[37] His decision to base Amazon in Washington demonstrates his expectation that the company would gain a greater competitive advantage by selling products "tax-free" in the most populous state in the US than by having direct access to California's world-renowned high-tech workforce. In fact, Bezos added:

> "I even investigated whether we could set up Amazon.com on an Indian reservation near San Francisco. This way we could have access to talent without all the tax consequences. Unfortunately, the government thought of that first."[38]

Amazon has also avoided collecting the sales tax in many states by engaging in a strategy called "entity isolation." Essentially, Amazon has placed different components of its business, such as warehouses, research and development offices, and customer service facilities, into individually incorporated entities that the company claims are unrelated to its retail business and, as such, do not constitute Amazon's physical presence in the states in which they are located. In fact, Amazon claims that it faces no obligation to collect sales taxes in at least 17 states, including California, where it currently maintains facilities that support its business.[39] For example, when Texas officials recently tried to compel the company to pay the state millions of dollars in sales taxes that Amazon failed to collect – taxes that the state argued Amazon was obligated to collect since it maintains a distribution center in Texas – Amazon refused to pay, claiming that it had no physical presence in Texas because the center was owned by one of the company's subsidiaries.[40]

In recent years, Amazon has become increasingly aggressive in its attempts to avoid collecting state sales tax, particularly in response to states that have tried to compel the company to comply with the law. For example, Amazon sued the state of New York and canceled all contracts with small business partners – known as "affiliates" – that had been promoting the company's sales in return for a commission in five other states after those states enacted legislation aimed at boosting sales tax collections on Internet purchases.[41] Amazon threatened to close its distribution center in Texas after the state tried to bill the company for sales taxes that it claimed the company was obligated to collect. In other states where Amazon currently maintains or wants to establish warehouses, the company has reportedly tried to convince state officials to explicitly exempt the company from collecting the state sales tax.[42] As *The New York Times* has pointed out, these efforts demonstrate just "how far Amazon is willing to go to protect a business model that relies on not collecting sales tax."[43]

California Should Follow the Lead of Other States and Boost Sales Tax Collections From Out-of-State Retailers

Compelling more retailers to collect sales taxes that are *legally owed* by consumers is the most practical means of reducing the significant gap attributable to untaxed online sales.[44] California should follow the lead of other states and enact legislation aimed at increasing sales tax collections by out-of-state retailers. By doing so, California stands to boost sales tax revenues by as much as hundreds of millions of dollars each year. These much-needed dollars could help close California's budget gap and provide funding for the state's core priorities, including schools, health care, and public safety, as well as other public structures that are essential to California's future prosperity. Several complementary approaches that policymakers should consider are described below.

Ensure That California Can Enforce Sales Tax Collection to the Full Extent Allowed Under Federal Law

Policymakers should ensure that California has the authority to enforce out-of-state retailers' collection of the sales tax to the full extent allowed under federal law. Currently, California law defines the conditions under which retailers are "engaged in business" in the state for the purposes of determining whether they are obligated to collect the sales tax.[45] Policymakers could clarify the breadth of the state's reach by including a "catch-all" provision in state law explicitly stating that retailers are obligated to collect the sales tax to the extent permissible by the US Constitution.[46] This provision – commonly referred to as the "long arm" provision – would provide California with an important tool to increase retailers' compliance with current federal law and give the state flexibility over the long-term to respond to a changing federal policy climate and enforce the law as it evolves. Two bills currently before the Legislature, SB 234 (Hancock) and SB 655 (Steinberg), include this provision.

Technology Greatly Facilitates National Retailers' Compliance With Various State Tax Laws

Technological advances should dispel any concerns that requiring national retailers to collect sales taxes presents a significant burden for retailers.[47] Many companies have developed software in recent years that greatly facilitates compliance with various state and local sales tax laws.[48] One such company, for example, advertises that its software "can consider a virtually unlimited number of transaction elements to correctly determine, calculate, and report taxes on all sales and purchase transactions. … Sales and use tax can be quickly and accurately determined for 13,253 tax authorities without any manual intervention."[49] Moreover, online retailers are, by definition, technology savvy companies that should have no difficulty using such software to facilitate sales tax collection across multiple jurisdictions.[50] Amazon, for example, is one of the most technologically sophisticated companies in the world. It employs thousands of software development engineers who design and maintain the company's search engine, which enables consumers to search its website for tens of millions of unique products and provides consumers with recommendations on which products to buy.[51] Complying with various sales tax laws is a relatively easy task compared to the work online retailers like Amazon do every day.[52]

Online Retailers Already Collect Sales Taxes in Many States, Demonstrating That It's Not a Significant Burden

Many large online retailers currently collect the sales tax in most states, which demonstrates that they have the capacity to comply with diverse sales tax laws. Major retailers including Wal-Mart, Barnes and Noble, and Best Buy collect sales taxes for purchases made through their websites in every state in which they have brick-and-mortar stores.[53] Even Amazon, which is one of the most vocal opponents of state efforts to require online retailers to collect sales taxes, currently collects the tax in nearly every state in the nation on behalf of retailers like Target, which sells products through Amazon and charges sales tax for online purchases made in states where it maintains physical stores.[54] In fact, Amazon reportedly collects state sales taxes on behalf of approximately 5,000 independent vendors that sell products through the company's website.[55] Amazon also collects the taxes levied by other countries where the company sells products.[56] If collecting taxes in multiple states and nations did indeed present an excessive burden to the company, it would have terminated agreements with independent vendors in the US and discontinued its foreign sales.

While the "long arm" provision could potentially allow state tax administrators to broadly enforce the law, it would not necessarily compel them to do so. Therefore, policymakers may also wish to provide specific policy direction regarding what constitutes substantial nexus under current federal law, thereby enabling California's tax administrators to immediately begin enforcing sales tax collections by out-of-state retailers to the fullest extent possible. Two policy options that could be adopted on their own or together merit consideration. First, policymakers could specify that out-of-state retailers establish nexus in California "horizontally" through members of their corporate family – called a combined reporting group in tax terminology. Second, policymakers could adopt New York's strategy and specify that out-of-state retailers establish nexus "vertically" through their relationship with in-state business partners. Each of these options is described below.

Specify That Retailers Establish Physical Presence in California Through Members of Their Corporate Family

Policymakers could specify that retailers are engaged in business in the state, and therefore obligated to collect the sales tax, if any member of their corporate family is located in California and performs services related to goods sold by those retailers. A bill currently before the Legislature, AB 155 (Calderon), would make this change to state law and help California counter a strategy called "entity isolation" that certain retailers have employed to avoid collecting the sales tax. Specifically, some corporations have placed different components of their business, such as research and development offices, into individually incorporated entities that they claim do not establish the company's physical presence in the states in which they are located (see box). For example, Amazon refuses to collect the sales tax on purchases made by California consumers even though several of its subsidiaries are based in California. Two in Silicon Valley are of critical importance to Amazon's retail sales: Lab 126 developed the Kindle and A9.com maintains the company's online search engine that enables customers to search for products to buy. California has made progress countering entity isolation in the past and should expand this effort by targeting retailers, like Amazon, that not only share common ownership and an integrated business operation with other companies based in the state, but whose sales are directly supported by the services those companies provide.[57]

Specify That Retailers Establish Physical Presence in California Through Their In-State Affiliates

Policymakers could also adopt legislation modeled after New York's law, which specified that corporations using in-state affiliates to promote their sales have a physical presence that obligates them to collect the sales tax. As mentioned earlier, AB 153 (Skinner), would make this change. While many experts believe this approach to boosting sales tax collections is constitutional and will continue to be upheld in court, one drawback is that it is relatively narrow in scope: Out-of-state retailers with no California affiliates could continue to avoid collecting the sales tax. In addition, the effectiveness of this approach depends on retailers' willingness to maintain their affiliate programs – a questionable prospect given that some retailers terminated their contracts with affiliates in states that have enacted legislation modeled after New York's law. If many retailers were to cancel their contracts with California affiliates to avoid collecting the sales tax, the state may only see a modest increase in sales tax revenues. However, some experts argue that retailers' threats to cancel their affiliate programs should not dissuade California from trying New York's approach because its success requires that more states get on board. Evidence suggests that retailers highly value the service provided by affiliates and would be unlikely to terminate their programs in a large number of states.[58]

Conclusion

California has several options for boosting out-of-state retailers' collection of sales taxes that are legally owed by consumers. The most promising approach over the long-term requires policymakers to broaden state law so that California has the authority to enforce sales tax collections to the fullest extent allowed under federal law as it stands today and evolves in the future. However, this approach alone may not immediately compel broad enforcement of the law unless policymakers provide specific policy direction to the state's tax administrators. Therefore, policymakers should also consider specifying that out-of-state retailers establish nexus in California – and thus are legally obligated to collect sales taxes owed by consumers – both "horizontally" through members of their corporate family and "vertically" through their relationship with in-state business partners. Together, these efforts could make meaningful progress in narrowing California's sales tax gap and provide additional resources to support core public structures that are essential to California's future prosperity. Moreover, action taken in California, the largest market in the US, could pave the way to a solution to a national problem.

Alissa Anderson prepared this Budget Brief *with assistance from Luke Reidenbach. The California Budget Project (CBP) was founded in 1994 to provide Californians with a source of timely, objective, and accessible expertise on state fiscal and economic policy issues. The CBP engages in independent fiscal and policy analysis and public education with the goal of improving public policies affecting the economic and social well-being of low- and middle-income Californians. General operating support for the CBP is provided by foundation grants, subscriptions, and individual contributions. Please visit the CBP's website at www.cbp.org.*

ENDNOTES

1 This loss of revenue also reflects uncollected taxes on purchases made by mail or over the phone that are delivered into California. However, for simplicity, this *Brief* will refer to these as online or Internet purchases.

2 Since sales and use taxes are complementary, they are typically referred to simply as the sales tax and this *Brief* will use the term "sales tax" to refer to both taxes.

3 Board of Equalization, *Revenue Estimate: Electronic Commerce and Mail Order Sales,* downloaded from http://www.boe.ca.gov/legdiv/pdf/e-commerce-11-10.pdf on April 7, 2011, p. 2 and Donald Bruce, William F. Fox, and LeAnn Luna, *State and Local Government Sales Tax Revenue Losses From Electronic Commerce* (University of Tennessee: April 13, 2009). The authors of the latter publication estimate that this lost revenue represents approximately 4 percent of California's annual sales tax collections and that the cumulative revenue loss between 2007 and 2012 will total $8.7 billion.

4 Retailers without a "physical presence" in California, such as Amazon.com and Overstock.com, cannot be compelled to collect sales tax on purchases made by California consumers (see box). Retailers such as Target and Wal-Mart, which sell products online and in brick-and-mortar stores in California, are required to collect the sales tax.

5 About three-quarters of uncollected sales tax from sales by out-of-state sellers reflects purchases by individuals, while the remainder is due to purchases by businesses. Board of Equalization, *Economic Perspective* (February 2011), p. 3.

6 Board of Equalization, *Economic Perspective* (February 2011), p. 3.

7 CBP analysis of Department of Finance, Legislative Analyst's Office, and US Bureau of Economic Analysis data. 2009-10 data are estimated.

8 CBP analysis of Department of Finance, Legislative Analyst's Office, and US Bureau of Economic Analysis data. 2009-10 data are estimated. The decline in California's taxable sales as a share of economic activity also reflects the fact that consumers now spend a larger share of their incomes on services, which are largely untaxed, rather than on goods, which are subject to the sales tax.

9 The combined state and local sales tax rate is 10.75 percent in Pico Rivera and South Gate, the highest level in California.

10 In fact, Amazon explicitly developed its business model around this perceived price advantage (see box). Amazon does not collect sales tax from California consumers unless they make purchases from a third-party retailer with physical stores located in the state.

11 Several studies have found that the ability to "save" money by purchasing goods online from retailers that do not assess the sales tax draws a substantial share of customers away from traditional retailers. For example, one study found that if online retailers charged sales tax, the number of people buying goods online would fall by approximately one-quarter. Austan Goolsbee, "In a World Without Borders: The Impact of Taxes on Internet Commerce" *The Quarterly Journal of Economics* 115(2) (May 2000), pp. 561-576. A study of "highly savvy and price-sensitive consumers" who make purchases from California-based online retailers finds similar results. See Glenn Ellison and Sara Fisher Ellison, *Tax Sensitivity and Home State Preferences in Internet Purchasing* (Massachusetts Institute of Technology: August 2008). For an overview of the literature, see James Alm and Mikhail I. Melnik, "Do eBay Sellers Comply With State Sales Taxes?" *National Tax Journal* 63(2) (June 2010), pp. 215-236. Surveys also suggest that avoiding the sales tax is an important motivation for shopping online. See, for example, International Council of Shopping Centers, "Phase 2 Shopping Habits Report: How the Recession Has Impacted Consumer Shopping Habits" (no date).

12 US Census Bureau. Data include taxable and nontaxable sales.

13 US Census Bureau. Data include taxable and nontaxable sales.

14 US Census Bureau. Data include taxable and nontaxable sales. Online sales dropped for just two quarters during the recession, while other sales declined for five quarters.

15 Richard A. Parker, *Flawed System: Online Sales Tax Collection: Economic Impact Upon California Businesses and Employees* (Rea & Parker Research, prepared for Taxpayers Advocate: August 2010), p. iii.

16 For example, Borders recently filed for bankruptcy, which analysts attribute to the company's inability to compete with Internet-only retailers. Joseph Checkler and Jeffrey A. Trachtenberg, "Bookseller Borders Begins a New Chapter…11" *The Wall Street Journal* (February 17, 2011).

17 Richard A. Parker, *Flawed System: Online Sales Tax Collection: Economic Impact Upon California Businesses and Employees* (Rea & Parker Research, prepared for Taxpayers Advocate: August 2010), p. 11.

18 US Supreme Court, *Quill Corporation v. North Dakota* 504 US 298 (1992). Specifically, the Commerce Clause, in Section 8 of Article I, states that Congress has the power to "regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes."

19 Specifically, "nexus describes whether a taxpayer, property, or activity has sufficient connection with a state to be subject to that state's taxing jurisdiction." See Paul Mines, "Nexus," in Joseph J. Cordes, Robert D. Ebel, and Jane G. Gravelle (Eds.), *The Encyclopedia of Taxation & Tax Policy,* Second Edition (Washington, DC, The Urban Institute Press: 2005).

20 US Supreme Court, *National Bellas Hess, Inc. v. Illinois* 386 US 753 (1967). The Court argued that imposing such a requirement on a mail-order company with limited contact in a state would open the door for all states and municipalities to do the same. This, the Court argued, would create a significant burden on interstate commerce because it would mean that mail-order companies would have to comply with diverse sales tax laws across a multitude of jurisdictions that lacked a legitimate claim to impose such obligations.

21 Michael Mazerov and Iris Lav, *A Federal "Moratorium" on Internet Commerce Taxes Would Erode State and Local Revenues and Shift Burdens to Lower-Income Households* (Center on Budget and Policy Priorities: May 1998), pp. 33-34.

22 US Supreme Court, *Quill Corporation v. North Dakota* 504 US 298 (1992).

23 Michael Mazerov and Iris Lav, *A Federal "Moratorium" on Internet Commerce Taxes Would Erode State and Local Revenues and Shift Burdens to Lower-Income Households* (Center on Budget and Policy Priorities: May 1998), p. 34.

24 US Supreme Court, *Quill Corporation v. North Dakota* 504 US 298 (1992).

[25] To date, 44 states and the District of Columbia have approved the Streamlined Sales and Use Tax Agreement, which outlines the policies states must agree to adopt as part of this effort, and 24 states have enacted legislation conforming to the agreement.

[26] The Main Street Fairness Act (HR 5660), introduced in July 2010, would authorize states that meet the conditions set forth in the Streamlined Sales and Use Tax Agreement to require out-of-state retailers to collect the sales taxes owed for purchases made by the state's consumers. However, the bill would provide an exception for certain "small sellers." The provisions of the Act would go into effect only if at least 10 states comprising at least 20 percent of the US population meet the conditions outlined in the agreement.

[27] Specifically, the law applies to retailers with more than $10,000 in annual sales in New York that are attributable to affiliates. Retailers that can demonstrate that their affiliates do nothing to actively solicit sales, however, can petition for an exemption from the law.

[28] Two US Supreme Court decisions established that out-of-state retailers have a physical presence in a state, and therefore can be required to collect state sales tax, if they use independent contractors in the state to establish and maintain a market for their sales. This suggests that out-of-state retailers' relationship with affiliates could be sufficient for those companies to have nexus with the state. Michael Mazerov, *New York's "Amazon Law": An Important Tool for Collecting Taxes Owed on Internet Purchases* (Center on Budget and Policy Priorities: July 23, 2009), p. 4.

[29] Michael Mazerov, *New York's "Amazon Law": An Important Tool for Collecting Taxes Owed on Internet Purchases* (Center on Budget and Policy Priorities: July 23, 2009), p. 7.

[30] North Carolina and Rhode Island enacted laws modeled after New York's in 2009, followed by Illinois and Arkansas in early 2011. States currently considering measures modeled after New York's law include Arizona, California, Connecticut, Hawaii, Massachusetts, Minnesota, New Mexico, Tennessee, Texas, and Vermont.

[31] Colorado Fiscal Policy Institute, *The Facts Behind Colorado's New Internet Sales Tax Law and the Termination of Affiliates at Amazon.com* (March 18, 2010) and Edward A. Zelinsky, *The Siren Song of 'Amazon' Laws: The Colorado Example* (Tax Analysts: March 7, 2011).

[32] Specifically, Oklahoma's and South Dakota's legislation requires certain out-of-state companies to post notices on their websites, in their catalogues, and on invoices sent to customers.

[33] Internet Retailer, *Top 500 Guide,* downloaded from www.internetretailer.com/top500/list/ on March 18, 2011. In addition, in 2009, Amazon's sales accounted for 9.1 percent of total online sales in the US. See William Blair & Company, *E-Commerce Annual Report* (March 18, 2010), downloaded from www.scribd.com/doc/28642640/2010-03-10-William-Blair-Report-on-E-commerce on March 18, 2011.

[34] Amazon collects sales tax in five states: Washington, where its headquarters are based; New York, where a state law imposed a sales tax collection obligation on the company; and Kansas, Kentucky, and North Dakota. See www.amazon.com/gp/help/customer/display.html?nodeId=46852, downloaded on March 10, 2011.

[35] Amazon.com, Inc. Form 10-K for the year ended December 31, 2008, p. 14.

[36] William C. Taylor, "Who's Writing the Book on Web Business?" *Fast Company* (October 31, 1996).

[37] William C. Taylor, "Who's Writing the Book on Web Business?" *Fast Company* (October 31, 1996).

[38] William C. Taylor, "Who's Writing the Book on Web Business?" *Fast Company* (October 31, 1996).

[39] Michael Mazerov, *Amazon's Arguments Against Collecting Sales Taxes Do Not Withstand Scrutiny* (Center on Budget and Policy Priorities: Revised November 29, 2010), p. 5.

[40] Verne G. Kopytoff, "Amazon Pressured on Sales Tax," *The New York Times* (March 13, 2011) and Sarah Weinman, "Texas Sends Amazon a $269 Million Sales Tax Bill," *Daily Finance* (October 25, 2010).

[41] Amazon canceled affiliate programs in Colorado, Illinois, Rhode Island, and North Carolina.

[42] Personal communication with Center on Budget and Policy Priorities (March 22, 2011); Michael Mazerov, *Amazon's Arguments Against Collecting Sales Taxes Do Not Withstand Scrutiny* (Center on Budget and Policy Priorities: Revised November 29, 2010), p. 13; and Janet Novack, "Are Amazon.com's Days of Tax Free Selling Numbered?" *Forbes* (February 27, 2011).

[43] "Amazon and Sales Tax," editorial, *The New York Times* (May 7, 2010).

[44] According to Board of Equalization member Betty T. Yee, "data show that virtually all sales and use tax compliance occurs when retailers assume their traditional responsibility for collecting sales and use taxes." Betty T. Yee, letter to Senator Lois Wolk, Chairwoman of the Senate Committee on Governance and Finance (March 21, 2011).

[45] Revenue and Taxation Code, Section 6203.

[46] Nearly a dozen states have already adopted this strategy to help boost out-of-state retailers' collection of state sales taxes. Michael Mazerov, *Alternative Approaches to Remote Sales Taxation: 10 Things States Can Do,* presentation to the Southeastern Association of Tax Administrators (Center on Budget and Policy Priorities: July 13, 2010).

[47] The Supreme Court established its "physical presence" standard for determining which businesses must collect sales taxes long before technology to automate the collection of those taxes existed.

[48] These include Vertex, Taxware International, and Sabrix.

[49] Additionally, the company's website states: "Your sales, ordering, accounting, and purchasing personnel do not need to manually specify the sales tax jurisdictions and tax type or spend time researching tax rules and rates for multiple states. … The Sabrix Sales Tax and Use Tax Manager software solutions automatically determine any state, county, city, transit, or special district taxes associated with a given address. Additionally, sales tax rates and special rules such as maximum tax and tiered taxes are correctly applied. Once the tax jurisdictions for a transaction have been determined, Sabrix's sales tax software solution automatically uses customer and product information to determine what tax exemptions, exceptions, or special rates might apply." Sabrix, *US Sales and Use Tax Management,* downloaded from www.sabrix.com/enterprise/appsuite/us-sales-and-use-tax-management/ on March 21, 2011. Amazon reportedly uses this software. See Michael Mazerov, *Amazon's Arguments Against Collecting Sales Taxes Do Not Withstand Scrutiny* (Center on Budget and Policy Priorities: Revised November 29, 2010), p. 11.

[50] Michael Mazerov, *Amazon's Arguments Against Collecting Sales Taxes Do Not Withstand Scrutiny* (Center on Budget and Policy Priorities: Revised November 29, 2010), p. 11.

[51] Michael Mazerov, *Amazon's Arguments Against Collecting Sales Taxes Do Not Withstand Scrutiny* (Center on Budget and Policy Priorities: Revised November 29, 2010), p. 11.

[52] As a *New York Times* technology blogger put it, "When you look at all the things Amazon does every day – such as the recommendations it offers about goods to buy, or the way it optimizes its warehouse operations – figuring out sales tax looks like a job for the summer intern." Saul Hansell, "Amazon Plays Dumb in Internet Sales Tax Debate," *The New York Times* (February 13, 2008).

[53] Michael Mazerov, *Amazon's Arguments Against Collecting Sales Taxes Do Not Withstand Scrutiny* (Center on Budget and Policy Priorities: Revised November 29, 2010), p. 5.

[54] Michael Mazerov, *Amazon's Arguments Against Collecting Sales Taxes Do Not Withstand Scrutiny* (Center on Budget and Policy Priorities: Revised November 29, 2010), p. 4.

[55] Michael Mazerov, *Amazon's Arguments Against Collecting Sales Taxes Do Not Withstand Scrutiny* (Center on Budget and Policy Priorities: Revised November 29, 2010), p. 4.

[56] Amazon.com.uk is required to collect the "valued-added tax" – a tax that is comparable to the sales tax levied by states – on all sales delivered to countries in the European Union. Michael Mazerov, *Amazon's Arguments Against Collecting Sales Taxes Do Not Withstand Scrutiny* (Center on Budget and Policy Priorities: Revised November 29, 2010), p. 5.

[57] In 2001, California was the first state in the nation to make an administrative ruling that an online store, Borders.com, was engaged in business in the state – and therefore obligated to collect the state's sales tax – based on the fact that its affiliated company, Borders Books & Music, sold similar goods in brick-and-mortar stores throughout the state. Specifically, this ruling was based on the fact that the brick-and-mortar Borders stores in California provided return and exchange services for Borders.com, which the Board of Equalization argued meant that Borders.com was a "retailer engaged in business in the state," as defined by California law. See Board of Equalization, *Memorandum Opinion Before the Board of Equalization of the State of California in the Matter of the Petition for Redetermination Under the Sales and Use Tax Law of Borders Online, Inc.* (September 26, 2001). Borders contested the ruling in court, but it was ultimately upheld. Court of Appeal of California, First Appellate District, Division Four, *Borders Online, LLC v. State Board of Equalization* (2005).

[58] Most large online retailers use affiliates to boost their sales, and online retailers as a whole spend billions of dollars each year paying commissions to affiliates who promote their sales. See Michael Mazerov, *New York's "Amazon Law": An Important Tool for Collecting Taxes Owed on Internet Purchases* (Center on Budget and Policy Priorities: July 23, 2009), pp. 7-9.