MFA Perspective

On E-Commerce Sales Tax

Four Questions Online Sellers Need to Ask About E-Commerce Sales Tax

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Over the course of two decades, online sales went from fad to fortune to bust, and have now settled in as part of everyday business for a wide variety of small to medium sized companies. In fact, if you're selling something then you most likely have an online component – and if you don't, you're thinking about it. The wide net that can be cast brings in more buyers from more places, giving sellers the ability to leapfrog to a new level of success.

But just as online sales yield higher income for companies, the states in which they do business expect to be compensated through both sales and income tax. The Internet allows for any combination of cross-border transactions, and as a result states are struggling to collect what is theirs by law.

Enter the sales tax dilemma: State And Local Tax (SALT) codes differ from jurisdiction to jurisdiction, making for a confusing e-commerce tax landscape. Each local jurisdiction has authority over how electronic sales are taxed, and little coordination exists between states.

To be sure your company is properly withholding and remitting the required sales tax and – from a tax perspective – being as efficient as possible with your cross-border sales operations, there are four questions you should be asking of your CPA and your business leader.

Question 1: How does my state apply sales tax to online transactions?

The challenge with e-commerce sales tax is that each state prescribes its own laws, definitions and formulas in determining taxation. Generally, states may impose sales tax collection obligations on vendors if companies have "nexus" with a state, whereas companies without a substantial presence in a state may not be required to collect sales tax. Complicating issues even further, individual states have great flexibility in determining what defines nexus and what gets taxed if nexus does in fact exist. For example:

In California, sales tax does not apply to the sale or lease of prewritten programs if the product is transferred for download by remote telecommunications from the seller's place of business to the purchaser's computer and the purchaser does not obtain tangible personal property (i.e., a CD on which the software program is written).

In Connecticut, canned, or prewritten software is considered tangible personal property and its sale, leasing or licensing (including upgrades) is taxable at 6%. Here's where it gets tricky, though: if software is downloaded but no tangible property is transferred, the charge assessed is for computer and data processing services. That means a Connecticut retailer of downloaded software is actually a retailer of computer and data processing services and must register, collect, and remit sales tax of 1%.

In Massachusetts, whether delivered through tangible or electronic means, a sale of prewritten (canned) software is a taxable sale and is subject to sales tax.

These are just a few examples; there are more variations across the country. Be sure to identify the states in which you transact business and ask your CPA about the definition of nexus and how taxes are applied to online sales.

Question 2: If I am making a purchase and a vendor does not withhold sales tax, do I still have to pay tax on the transaction?

The short answer is generally "yes;" when sales tax does not apply, often "use" tax comes into play. Let's take, for example, a software package that is sold by a vendor in Oregon and shipped to a buyer in Massachusetts. The buyer may be charged tax if the vendor has nexus in Massachusetts, however if the vendor does not have nexus in Massachusetts and is not required to collect sales tax, then the burden of paying use tax lies on the Massachusetts purchaser.

Collecting use tax, however, can be difficult for states to track. That makes it easy for it to fall through the cracks and go unpaid today, but as states come together in a unified taxation system there could be a backlash and penalties for noncompliant purchasers.

Question 3: What will a change in e-commerce sales tax mean for my business?

Only time will tell for certain, but creating consistency across all states will have an impact on online purchasing, especially in states which currently have a complex sales tax system. In the late 1990s, when e-commerce was at its peak and Internet "pure play" retailers were enjoying heightened success, studies showed that more aggressive online sales tax would inspire marginal shoppers to abandon online purchasing and head back to their local brick-and-mortar stores.[1]

However, a recent study found that the market's adjustment to "click and mortar" has lowered sensitivity to tax rates. Businesses with an online transaction element and a physical store are in the safest position: "Negative effects would be limited to high-tax jurisdictions…online companies would see an overall decrease in sales, but it would be far less than what was previously expected. "Pure play" companies would be the most harmed, especially if they are currently only able to stay in business as a result of demand for their tax-free goods."[2]

States, therefore, are being hurt the most by the current system and should be mobilized to achieve uniformity. After all, retail e-commerce sales in Q407 alone totaled $36.2 billion,[3] a drastic leap since Q402, when the same sales were at $14.3 billion.[4] States have the most to gain by collecting taxes in such a powerful marketplace, and they are motivated to get a more enforceable system in place.

Question 4: How will I know what changes are coming?

Easy enough: keep in touch with your CPA. But there are also organizations that are proactively pursuing uniformity. To keep abreast of developments, check in with:

- Streamlined Sales Tax Project (SSTP), which follows a mission of radically simplifying sales and use taxes. SSTP has 17 full member states, and nearly all 50 states are involved on some level. In addition to the uniform definitions for taxable goods and services, simplification of tax rates and reducing the compliance burdens for businesses, the SSTP promotes an Amnesty program for unpaid sales and use tax, which can be applied to sellers in states that agree to conform to uniform standards going forward. You can find more information at www.streamlinedsalestax.org.

- The Multistate Tax Commission (MTC) is an intergovernmental state tax agency which works on behalf of states and taxpayers to administer tax laws that apply to multistate and multinational enterprises. Nearly all states support the MTC on some level, and the website provides ongoing updates on activities around nexus uniformity, court cases, and legislation. More on the MTC is at www.mtc.gov.

Download speeds are getting faster, mobile phone transactions are a reality, and soon buyers will be able to make purchases with a click of their television remote. All these advances – and the sheer size of the e-commerce market – mean that at some point a uniform approach to sales tax may take a front seat at the national level. Stay informed of developments, arm yourself and your business with the knowledge to conduct transactions which are compliant with state laws and regulations across state borders, and take small comfort that a simpler system may lay ahead.

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1 Marc A Scanlan, "Tax sensitivity in electronic commerce," Fiscal Studies, December 2007

2 Ibid

3 US Census Bureau, "Quarterly retail e-commerce sales, 4th Quarter 2007," Press release, February 2008

4 US Census Bureau, "Retail e-commerce sales in fourth quarter 2002 were $14.3 billion, up 28.2 percent From fourth quarter 2001, Census Bureau reports," Press release, February 2008

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