An "Original" Solution to Taxation of Online Sales

BY ANDREW MOYLAN

All across the country, legislators and businesses are under increasing pressure to confront issues arising from differences in sales tax collection obligations between traditional "brick-and-mortar" and "remote" retailers. A sales tax authority can only require a business to collect and remit its tax if that business has a legitimate physical presence in the state. The result is that online sellers, who have fewer physical locations across the country, only collect sales taxes under limited circumstances and the "use tax" that consumers technically owe in lieu of sales tax is virtually impossible to uniformly enforce.

Unfortunately, much of the response to this pressure has manifested itself in federal and state efforts to dismantle the important and long-established "physical presence standard," which protects businesses and taxpayers from aggressive, overzealous revenue collectors. This vital safeguard is something that ALEC supports in the realm of sales and income taxes because it prevents other states from harassing your citizens and businesses. The good news is that there is a solution to help address perceived challenges with remote sales, while maintaining the strong taxpayer protection of the physical presence standard: Shift to an "origin-based" sourcing rule for sales taxes.

A destination-based sourcing rule requires businesses to collect sales tax defined by the physical location of the buyer, whereas an origin-based sourcing rule would require sales tax collection defined by the physical location of the seller. This subtle difference seems like little more than an obscure, boring technocratic change, but it would have the effect of dramatically altering the current debate while helping us tackle some of the most vexing issues in sales tax collection with a fiscally conservative approach.

The destination-based sourcing rule that many "tax fairness" advocates support for online sales require Internet companies to quiz their customers about their residence, look up in which of the nearly 10,000 separate taxing jurisdictions they reside, and then collect and remit taxes to that distant authority based on its own complex and ever-changing dictates. An origin-based sourcing rule, on the other hand, would require those companies to levy only one tax based on the laws of the jurisdiction in which their business is located.

This change would fairly address the "level playing field" concerns raised by brick-and-mortar retailers without imposing excessive compliance burdens, all while protecting taxpayers and long-standing ALEC principles. Online companies would have to begin collecting taxes on every sale, but instead of thousands of different rules, they would simply comply with those of the single jurisdiction in which they are sited. That's a dramatically less complicated system than an onerous destination-based rule, and it bears a strong resemblance to the one under which brick-and-mortar retailers already operate.

While many states technically have destination-based sourcing in place today, they operate just like an origin-based system as it applies to traditional retail sales. That's because the rules are constructed in such a way as to simply assume that a good is consumed in the same place it is sold, thus preventing traditional retailers from having to suffer the burden of determining their customer's residence and the associated rates and rules of thousands of different taxing authorities. This bit of maneuvering to mimic origin-based sourcing in destination-based states protects brick-and-mortar businesses from crushing tax compliance obligations and the associated harm to commerce.

Perhaps the most important advantage of origin sourcing, however, would be the infusion of tax competition it could engender. Under such a system, businesses would have an incentive to invest in lower-tax jurisdictions so as to attract price-conscious customers. Sales taxes in Missouri for example, are more than two percentage points lower than in Kansas. An origin-based system would encourage a business to locate on the Missouri side of that border in order to benefit from the lower tax collection obligations.

Origin-based sourcing is not a "silver bullet" solution. It would still require additional action to keep taxpayers from bearing heavier loads. Switching to origin sourcing would effectively expand the tax base, so state legislators must act to reduce rates commensurately at the same time to ensure that net burdens do not increase. It would also require careful contemplation on the proper role of Congress, as federal guidance might prove necessary to encourage a smooth transition without impeding interstate commerce.

Taxation of remote sales is a thorny issue, but origin-based sourcing can help policymakers arrive at an equitable resolution that respects the rights of businesses and taxpayers while upholding limited government.

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