

## Comparison of Destination-based Sales Tax versus Origin-based Sales Tax

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### Key Findings

1. Washington's change in sales tax collection is rooted in the growing battle over whether remote sellers should collect and remit states' sales taxes.
2. The decision to make local sales tax collection destination based was one step in the national effort to harmonize states' sales tax and to lobby for passage of a federal law requiring online and mail-order sellers to collect and remit state and local sales taxes.
3. The small business community in Washington is divided over the issue of origin- versus destination-based taxing.
4. While some small business owners say the change to destination-based sales tax is burdensome and unfair, advocates say the benefits will be realized when Congress passes a federal law for all online retailers to collect and remit state sales tax.

In 2008, Washington state changed how most businesses must collect local retail sales tax for products sold to customers through the mail or delivered to your home or business. SSB 5089, passed by the legislature in 2007, required a switch from origin-based to destination-based collection of sales tax for some of the state's retail businesses.

Under the pre-2008 origin-based system, all Washington state retailers collected local sales tax based on the point-of-sale jurisdiction — the location from which a product was purchased. The local sales tax collected by retailers was the same for goods purchased by walk-in customers as for goods shipped to another locale within the state. The new destination-based tax structure requires retailers shipping their goods within the state to collect the tax based on the delivery location of the customer; that is, the destination of a product.

Only retailers shipping or delivering their goods within the state are affected by the change. Retailers who deliver products outside the state, or sell their product over-the-counter at a “brick and mortar” location, are not impacted.

The change does not affect wholesale sales, services, sales of vehicles, aircraft, mobile homes, boats, towing companies or florists.

The small business community in Washington is divided over the issue of origin-based versus destination-based taxing.

The Washington Retail Association, representing 2,800 retail storefronts, believes the tax rule change to destination-based taxing was necessary to bring state tax law “in line with the new economy ... when our sales-tax based structure was put into place, there wasn't an Internet, there wasn't a lot in catalog sales. We need to keep up with the times.”<sup>1</sup> These retailers believe the change will help small businesses by keeping sales tax revenue stable and making them more competitive with online retailers.<sup>2</sup> They also worry state governments that rely heavily on sales tax revenue, like Washington, will increase other business taxes and fees to make up for sales tax shortfalls.

Many small businesses, however, find the change to be burdensome, forcing those who ship their goods within the state to track the sales tax rates of all destinations where they deliver within Washington. There are currently 364 local taxing districts in the state.<sup>3</sup> “It's not streamlined [the destination-based sales

<sup>1</sup> “Buying online? State sales tax now awaits,” *The Seattle P-I*, June 30, 2008, available at <http://www.seattlepi.com/business/article/Buying-online-State-sales-tax-now-awaits-1278065.php>

<sup>2</sup> “New consideration for Washington sales tax,” *Tri-City Herald*, April 27, 2008

<sup>3</sup> “Streamlined Sales Tax Mitigation, Proposed Final Report,” State of Washington Joint Legislative Audit & Review Committee (JLARC), January 5, 2011, available at <http://www.leg.wa.gov/JLARC/AuditAndStudyReports/2011/Documents/StreamlinedSalesTaxProposedFinal.pdf>

tax], it's not simple. It's incredibly expensive for small businesses," said one small business owner.<sup>4</sup> Returning the state's tax law to origin-based was one of the top seven recommendations from the small business owners who attended Washington Policy Center's Statewide Small Business Conference last year.<sup>5</sup>

## Background

Washington's change from origin-based to destination-based sales tax collection is rooted in the growing battle over whether remote sellers — businesses that sell products to customers using the Internet, mail order, or telephone, without having a physical presence in the customer's state — should collect and remit states' sales taxes.

In 1992, the U.S. Supreme Court ruled in *North Dakota v. Quill* that remote sellers who do not have a physical presence in a state cannot be required to collect and remit sales tax for that state. The Court held the burden of collection for remote sellers was unreasonably high given the number of taxing districts in the country and variations among states as to what products are taxable and at what rate. When the *Quill* case was decided, there were 6,000 sales tax jurisdictions in the U.S. — today there are 9,600.<sup>6</sup> Given the complexity of taxing conditions, the Court ruled that requiring remote sellers to collect sales tax would place an unconstitutional burden on interstate commerce.

The Court's decision in *Quill*, however, did not dismiss the possibility of mandating sales tax collection in interstate commerce: "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." The Court left the door open for Congress to require the collection of sales tax in interstate commerce.

The ensuing boom in tax-free Internet sales convinced states to take action. A University of Tennessee study estimates states have forgone more than \$52 billion over the past six years in untaxed Internet sales. Washington state's share of that estimated uncollected tax is \$1.2 billion, including \$282 million in estimated untaxed sales from out-of-state retailers in 2012.<sup>7</sup>

A movement was organized among some states to simplify state sales tax systems in order to lobby Congress to overturn the *Quill* decision.

Washington's 2008 implementation of the destination-based tax was part of a multi-state tax uniformity effort asking Congress to change the federal law that allows remote retailers to avoid collecting sales tax from their customers.

The Streamlined Sales and Use Tax Agreement (SSUTA) is a 44-state nationwide effort that simplifies sales tax collection and administration by retailers and states in order to reduce the burden of tax compliance. One of the requirements of the agreement is that participating states use a destination-based

<sup>4</sup> "Buying online? State sales tax now awaits," *The Seattle P-I*, June 30, 2008, available at <http://www.seattlepi.com/business/article/Buying-online-State-sales-tax-now-awaits-1278065.php>

<sup>5</sup> Washington Policy Center, "7 Steps on the Road to Economic Recovery," January 2012, available at <http://www.washingtonpolicy.org/sites/default/files/Small-Business-PB-compiled.pdf>

<sup>6</sup> Tax Foundation, "Assessing Federal Action on State Efforts to Collect Sales and Use Taxes on Internet Commerce (Testimony Before the U.S. House of Representatives)," November 30, 2011, available at <http://www.taxfoundation.org/news/show/27803.html>

<sup>7</sup> Donald Bruce, William F. Fox & LeAnn Luna, "State and Local Government Sales Tax Revenue Losses from Electronic Commerce," University of Tennessee, April 13, 2009, available at <http://cber.bus.utk.edu/ecommm/ecom0409.pdf>

system for collection of local sales tax. Currently 24 states have passed legislation conforming to the simplification measures called for by the Agreement.<sup>8</sup>

Upon passage of SSB 5089, Washington State became a member of the SSUTA, which includes a seat on the governing board of the agreement and the ability to vote on amendments to and interpretations of the SSUTA.<sup>9</sup>

Membership as a Streamlined Sales Tax state also allows Washington to receive the sales taxes voluntarily collected from Washington residents by 1,200 retailers (online and mail order) who have agreed to collect the tax from customers living in SSUTA states, even if the retailer does not have a physical presence in that state. The state collected \$5.6 million in new sales tax revenue from out-of-state SSUTA-registered retailers in 2009 and \$7.1 million in 2010.<sup>10</sup>

This revenue is significantly lower than expected. The state predicted it would collect new sales tax revenue of \$49.1 million in 2009 and \$59 million in 2010 from this voluntary compliance by SSUTA-member retailers.

The theory behind SSUTA is if enough states pass legislation conforming with the agreement, thus simplifying the sales tax process and reducing the burden on remote sellers, Congress will be encouraged to pass a federal law requiring all remote sellers to collect sales tax.

Washington's decision to shift the local sales tax collection from origin-based to destination-based was one step in the national effort to harmonize states' sales tax and to lobby Congress for passage of a federal law requiring all online and mail order sellers to collect and remit state and local sales taxes.

Washington State Department of Revenue spokesman Mike Gowrylow confirmed the motivation for changing the state's tax rule: "This is a necessary evil."<sup>11</sup> "If enough states are able to pass the streamlined sales tax legislation, it may prompt Congress to require all remote sellers to collect sales tax. The long-term goal is to get Congress to say that the states have done a good job of streamlining the sales tax process, reducing the burden on remote sellers, so that these businesses should pay tax in the state that's the point of sale."<sup>12</sup>

### **Why Some Businesses Support the Destination-based Sales Tax**

As online sales increasingly capture a greater share of the retail market, many of the state's brick-and-mortar stores say they are at a competitive disadvantage with remote sellers. As a result of the Quill decision, remote sellers are not required to collect and remit sales tax for any state in which they do not have a physical presence. This often enables remote sellers to offer products to consumers at a lower price than their brick-and-mortar counterparts.

<sup>8</sup> Streamlined Sales Tax Governing Board, Inc., "Frequently Asked Questions," available at <http://www.streamlinedsalestax.org/index.php?page=faqs>

<sup>9</sup> Washington State Department of Revenue, "Streamlined Sales and Use Tax Agreement," available at <http://dor.wa.gov/Content/FindTaxesAndRates/RetailSalesTax/DestinationBased/DepartmentStreamLineFAQ.aspx>

<sup>10</sup> State of Washington Joint Legislative Audit & Review Committee (JLARC), "Streamlined Sales Tax Mitigation, Proposed Final Report," January 5, 2011, available at <http://www.leg.wa.gov/JLARC/AuditAndStudyReports/2011/Documents/StreamlinedSalesTaxProposedFinal.pdf>

<sup>11</sup> "Buying online? State sales tax now awaits," *The Seattle P-I*, June 30, 2008, available at <http://www.seattlepi.com/business/article/Buying-online-State-sales-tax-now-awaits-1278065.php>

<sup>12</sup> Association of Washington Business, "Streamlined Sales Tax: Big changes coming for Washington's retailers," May/June 2008, available at [http://www.awb.org/articles/magazine-mayjun2008/taxation\\_streamlined\\_sales\\_tax\\_big\\_changes\\_coming\\_for\\_washington\\_s\\_retailers.htm](http://www.awb.org/articles/magazine-mayjun2008/taxation_streamlined_sales_tax_big_changes_coming_for_washington_s_retailers.htm)

The competitive disadvantage extends to online and mail order retailers with a physical presence in a state, which means they must collect Washington sales tax while remote sellers — those with no presence in the state — do not.

While the change to a destination-based sales tax does not itself directly benefit the state's retailers, the change allowed Washington to join the organized group of SSUTA states pushing Congress to pass federal legislation requiring remote sellers to collect and remit sales tax to the jurisdiction of the buyer. Supporters argue every state that joins SSUTA adds pressure for Congress to adopt a national law they say is desperately needed to level the playing field for all retailers. The change also has the benefit of setting up the tax collection system that would be used should Congress pass a law requiring all online retailers to collect sales taxes on consumer purchases.

### **Why Some Businesses Oppose the Destination-based Sales Tax**

According to some small businesses, the state's change from origin-based to destination-based tax collection currently does little to level the playing field for brick-and-mortar stores versus online retailers. Until Congress changes the law, remote sellers are still under no obligation to collect sales tax in states in which they do not have a physical presence.

Some out-of-state retailers who are members of the SSUTA have voluntarily agreed to collect the tax in SSUTA states, but the number of participating retailers is a fraction of the tens of thousands of online retailers selling products via the Internet. The tax revenue generated so far has been relatively insignificant.

Many of the state's small business owners argue the playing field has been made less level by the change in tax structure, because over-the-counter customers are charged an origin-based sales tax while customers taking remote delivery are charged a destination-based sales tax. This means brick-and-mortar stores that do not ship their goods are only required to keep track of and charge one sales tax rate — the tax rate of the jurisdiction in which their business is located. But stores that ship their goods are required to keep track of the 364 taxing districts and charge the appropriate sales tax.

Another complaint from some small businesses is the exemption for florists. Qualified florists — those whose flower sales comprise at least 50 percent of sales — enjoy the simplicity of a single, origin-based sales tax, while businesses that don't qualify as florists but still deliver, such as grocery stores, must calculate a destination-based sales tax based on the delivery address. Other high-volume delivery retailers, such as pizza sellers, must also calculate sales tax based on the delivery address.<sup>13</sup>

### **Conclusion**

While some small business owners say the change from origin-based to destination-based sales tax is burdensome and unfair, advocates of the destination-based tax say the benefits will be reaped when Congress passes a federal law giving states the authority to require all online retailers to collect and remit state sales tax.

That effort appears to be gaining momentum. There are several bipartisan bills under consideration in Congress that would give states the authority to require

<sup>13</sup> Washington State Department of Revenue, "Retail Sales Tax," available at [http://dor.wa.gov/docs/pubs/excisetax/retailsales\\_usetax/retailsales.pdf](http://dor.wa.gov/docs/pubs/excisetax/retailsales_usetax/retailsales.pdf)

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all online retailers to collect sales tax. H.R. 3179, the Marketplace Equity Act, would allow all states to collect sales tax from remote sellers, with an exemption for online sellers with less than \$1 million in remote sales annually, or less than \$100,000 in remote sales in a specific state. S. 1832, the Marketplace Fairness Act, would exempt online sellers with less than \$500,000 in annual remote sales. S. 1452/H.R. 2701, the Main Street Fairness Act, would provide sales tax collection authorization only for the 24 states that have adopted SSUTA-complying legislation.

In April 2012 Congress held two hearings on these bills, and support for the idea of collecting sales tax on Internet purchases is growing. Numerous state-specific polls show clear support for the collection of online sales taxes, and a national poll conducted by the National Retail Federation in October 2011 revealed strong backing by a majority of voters.<sup>14</sup>

A vote on the issue is all but certain in the near future as in-state retailers demand sales tax equality and cash-strapped states, facing declining retail sales tax collection as shoppers shift to online retail purchases, eye new revenue to plug their deficits.

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<sup>14</sup> National Retail Federation, October 2011, available at [http://www.nrf.com/modules.php?name=Newsletter&op=viewlive&sp\\_id=385](http://www.nrf.com/modules.php?name=Newsletter&op=viewlive&sp_id=385)