Retail Tax and E-Commerce

What You Need to Know

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One of the unique requirements of the American system is that businesses are expected to collect almost all of the taxes required by federal, state, and local governments. For example, property tax is collected by banks, income tax is collected by employers, and sales tax is collected by businesses. And it's an awful lot of burden.

For many U.S. retailers, collecting sales tax is about to get more complex. Despite the well-established precedent of physical presence required for tax collection (based on two Supreme Court cases: the 1967 Bellas Hess case and the 1992 Quill decision) – cash-strapped states are pursuing, some quite aggressively, sales tax based on internet transactions where there is *no physical presence* in an effort to replace a revenue stream that was tangible when retail was primarily a brick and mortar market.

Online and Mobile Sales Continue to Grow

The amount of revenue available via sales tax collection has become so significant because online and mobile sales have continued to gain traction, even while the larger economy has struggled.

Recent studies on consumer shopping trends and habits show:

- "Online retail sales reached a record $43.4 billion," in the fourth quarter of 2010, "an increase of 11 percent versus a year ago," according to comScore, a leader in measuring the digital world.
- In 2011, "Cyber Monday reached $1.25 billion in online spending, up 22 percent versus year ago, representing the heaviest online spending day in history and the second day on record to surpass the billion-dollar threshold," according to comScore.
- Black Friday, considered one of the most significant brick and mortar retail days of the year, "saw $816 million in online sales," in 2011, "making it the heaviest online spending day to date in 2011 and representing a 26-percent increase versus Black Friday 2010."
- In 2011, "roughly half of all smartphone owners use their devices while shopping in bricks-and-mortar stores, a 21 percentage point increase from a year ago," according to a study by marketing consultants WSL/ Strategic Retail.
- comScore has reported that, "the number of people visiting an online retail site from a mobile device increased 90 percent from March 2010 to March 2011."
- Some 12 percent of internet users say they buy groceries online, according to comScore. A trend that has long been thought to lack traction with consumers.

State, county and municipal governments are looking at these same statistics and reach a logical conclusion: more sales are moving to the internet and mobile devices, representing the potential to have a significant impact the traditional tax revenue base. As these same governments face difficult financial challenges and look for much needed revenue to fund programs, they also seeking new ways to track and collect tax on these sales.

The groundbreaking growth in internet and mobile retail sales, combined with the need for governments to track and collect associated sales taxes, has led to the introduction of federal legislation to address online sales tax collection. As Boston Globe reporter Michael Farrell explains in a January 2012 story:

"*On the heels of a record holiday season for Internet sales, congressional lawmakers are expected to take up two bills early next year to force Web retailers to begin collecting state sales taxes, essentially overturning a 1992 Supreme Court ruling that protects Internet megastores…from having to charge tax in states where they aren't physically located.*"

Keeping Up with a Moving Target

What does all of this mean to you? Without a doubt, major changes to internet tax laws are heading your way. The states and the businesses in the U.S. have spent nearly 70 years trying to define physical presence as the general requirement for collecting sales tax. Now – to capture revenue from internet sales, legislatures have to find new ways to define business presence requiring sales tax collection – *nexus*. To capture these revenues, they are attempting to redefine the rules. Besides the

Congressional legislation discussed earlier, other examples include:

- New legislation targets using the volume of business, gross sales into their state, to determine taxability; so that even if you don't have physical presence, if you sell over a certain amount, you are obligated to start collecting sales tax.
- Some states, such as South Dakota, Oklahoma, Colorado, and North Carolina, asking internet retailers that don't collect the sales tax to report sales information so state tax authorities can collect use tax from customers.
- Collection efforts on affiliates. For example, some states are creating tax laws governing instances when out-of-state retailers with a contractual relationship with an in-state entity obligate tax collection. If the retailer requires that the in-state entity have a link to the retailer's website on their website –and commissions are paid to the in-state entity for sales that come through that link – then the state mandate sales tax collection on those sales.

Preparing to Collect Sales Tax on Internet Sales

Based on two related trends – the growth in mobile and internet retail spending, and the effort to track and collect the associated sales tax on these purchases – how should retailers start preparing today in order to ensure accurate collection and compliance? Even while regulations might remain a moving target?

Here are some key steps to begin with for retailers of all sizes:

Step 1: Research and Fully Understand What You Are Obligated To Do

As a retailer, there are several factors that may cause you to have nexus in various tax jurisdictions. Having store locations, distribution centers, or even having an affiliation to an entity that has this presence can constitute Nexus. Keeping track of the Situs laws can be time consuming and difficult. You should consult with a third party expert for guidance concerning if you have Nexus implications.

Step 2: Register in States Where You Will Take Online Orders

Once you have done your research, and if it is identified that you have nexus you should take the appropriate steps outlined by the jurisdictions to go through the registration process. You should consult with your tax advisor for guidance on developing a registration plan.

Step 3: Tax-sensitize your Merchandise for a Multi-state Environment

Invest the time to fully understand situs – the important 'tax where's' for any given retail transaction – and create a product and merchandizing tree that tax-sensitizes your merchandise so you can accurately collect sales tax across all states. These 'where's' include places you legally recognize the transaction, where products originate from, and the destinations of the products and/or services involved in a transaction.

Note that some goods and services are defined and treated uniformly by all states, but others are not, which creates a bit of a challenge. For example, "clothing" is a uniformly defined product category in all states. But that definition isn't granular enough to properly tax given the nuances of different states rules. You may need to break this category into children's clothing and footwear, costumes, formal wear, items with fur, and more. By categorizing your merchandise into these types of buckets – in other words, by tax sensitizing and merchandizing in terms of sales tax – you can better comply with tax codes across the country and even globally.

Step 4: Automate Sales Tax Calculations

With internet sales, you need to understand the rules around tax place. You are shipping in an unlimited fashion to any doorstep, which puts you square into 77,000 combinations of state and local tax places in the U.S. But you're getting a physical address from a buyer on your website – someone who's probably not going to know their 9-digit zip code, or all of the local tax jurisdictions for where they reside, or where they are having their product shipped. Consumers expect you to know how to associate their address to tax jurisdictions. They don't want to even have to think about it.

To increase tax department efficiency – and to mitigate the risk of errors – Vertex recommends that you leverage tax automation software tools. Typically, the consumer tells a retailer where they want the product shipped, and a tax automation tool uses this information – along with tax-sensitized merchandizing and product hierarchy – to accurately determine sales tax for the order. Ideally, the software can also recognize if the customer is tax exempt, such as a resident of an Indian reservation. The right tax automation tool automatically validates the exemption before the transaction is completed – at the point of sale; because legally, you are responsible for ensuring the customer is entitled to that tax break. Both purchase and fulfillment dates should be sent to the tax software so that its rules can decide which date is relevant given a particular state's rules.

Tax automation tools can also ensure you apply tax holidays consistently and accurately. Some states want you to manage the difference between the time you take an order and the time you fulfill it; if you don't fulfill that product before the holiday ends, then the order is no longer exempt.

When Buying Sales Tax Automation Software, Plan for Growth

When evaluating tax automation software for your business, keep in mind that your company can grow quickly and unexpectedly. So you need a tool that supports growth in two ways: growth into new regions of the U.S. or new regions of the world and growth in terms of higher sales volume. If you invest in a tool that can grow with your business, you will have fewer headaches down the road.

Tax Issues Specific to Services

Taxability of services provided to customers can be determined a number of ways. For example, it can be based on:

- Where the service was performed
- Where the benefit is received
- If services were provided via the web
- If tender for the services were received and accepted over the web

Many states are moving toward destination sourcing of services as well – for example, for repair services covered by warranties. Most state tax warranty rules are based upon where a customer took possession of the item (for example, a computer purchased online) that went along with the warranty. But there are still a few states where tax is based upon where a customer has the item serviced, which may be in a different state than where the customer took possession of the item.

Benefits of Automating Sales Tax Collection

Using an automated tool to correctly calculate and collect sales tax offers several key benefits. It keeps customers happy because tax calculations happen seamlessly in the background with no involvement on their part. But even more importantly, the right tool provides transparency so you can demonstrate to auditors that you handled every sales transaction correctly from a tax perspective, complete with links to transaction data and legislation to back up your approach. This frees you from having to spend time defending and debating your sales tax approach with auditors.

And because all historical transaction and tax data is centrally stored in the tax automation software, you have direct, easy access to the data from any year. This is an important feature of any sales tax automation tool, as today's auditors presume that you have those records electronically and can provide them quickly – and in the format required by most states; once they have your electronic records, they can quickly slice and dice your records in the comfort of their office. Most companies find that audits are completed much faster and require less effort when they provide electronic records and a summary of what they sell, how they sell it, and the rules they have in place to collect sales tax.

Take the Next Step

As you can see, state sales tax laws for internet sales are a moving target – and they will continue to be for some time to come. If you are already collecting sales tax on internet transactions, it's imperative that you do it correctly, even as tax laws **change**, so your business is protected during an audit. And if you are not yet obligated to collect e-Commerce, it's vital that you monitor **changes** in legislation as they occur and be prepared to start collecting sales tax in a timely manner – preferably using an automated tool.

When evaluating different vendor products, it's important to assess how they can help you:

- Stay abreast of tax law changes, as well as implement these changes without causing a major disruption to your business
- Maintain compliance as your business scales or you enter unexpected geographies; in most cases, all the back-end management of global transaction taxes are handled by corporate, so you need a global, scalable solution that will be able to process all sales transactions in a timely manner regardless of where you do business or how large your business becomes.

It's also important to take the right approach when you plug a sales tax automation tool into your infrastructure.

For more information visit the Vertex® Indirect Tax for Retail product page at http://www.vertexinc.com/solutions/industry/retail.asp

Additional Resources

Additional resources are available to learn more about retail specific concerns of e-commerce taxation and sales & use tax overall:

Going Global: Expanding Your Business Internationally

Vertex experts offer insight on the important elements to consider when developing a global expansion strategy.

Watch the webcast

Understand how retail tax impacts your business' bottom line

Vertex and experts from the Streamlined Sales Tax Governing Board offer valuable insights on the complexities of taxation within e-commerce environments.

Watch the webcast

About Vertex

Founded in 1978, Vertex Inc. is the leading provider of corporate tax software and services to automate, integrate, streamline or outsource tax processes for companies of all sizes, from small to medium-sized businesses to global multinationals. Vertex provides solutions for all tax types with industry-specific solutions for retail, communications, hospitality and leasing industries.

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