# PERFORMANCE AUDIT REPORT

## Online Sales Tax: Reviewing Issues Related to Online Sales Tax Laws in Kansas

A Report to the Legislative Post Audit Committee
By the Legislative Division of Post Audit
State of Kansas
February 2019

R-19-004

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TO: Members of the Kansas Legislature

The Legislative Post Audit Committee authorized this audit of the state's online sales tax policies at its April 25th, 2018 meeting. The audit addresses questions related to current Kansas online sales tax laws, the laws in other states, and how much revenue the state could potentially generate under a different set of laws.

This audit was requested by Senator Rob Olson.

The audit team was Chris Clarke, manager; Heidi Zimmerman, supervisor; and Daria Milakhina, Tanner Rohrer, and Jonathan Borghetti, auditors.

We conducted this performance audit in accordance with generally accepted government auditing standards with the exception that we were unable to test some data provided by the United States Government Accountability Office. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. Overall, we believe the evidence obtained provides a reasonable basis for our findings and conclusions based on those audit objectives.

Also, audit standards require that we report on any work we did related to internal controls. Because this work was not focused on internal controls, we did not conduct any assessments of the department's controls.

If you are interested in learning more, our office has more details than we could fit into this report. If you would like more information, an individual briefing, or a committee presentation, please call Heidi Zimmerman or me at 785.296.3792.

Justin Stowe
Legislative Post Auditor

# Online Sales Tax: Reviewing Issues Related to Online Sales Tax Laws in Kansas

## Question 1: How do Kansas' online sales tax laws compare to those in a sample of other states?

## Answer: Kansas lacks two laws that many states have that require more retailers to collect and remit sales tax for online purchases.

**In Kansas, all brick and mortar retailers and certain online retailers are required to collect and remit sales or use tax.**

- In Kansas, a consumer must pay sales tax on most items purchased in the state or pay a use tax on items purchased out-of-state that will be used or stored in Kansas.

- For items purchased in brick and mortar stores or through certain online retailers, the retailer must collect the tax and remit it to the state. If an online retailer does not have an obligation to collect and remit the tax the consumer is required to report the purchase on a consumer use tax return or an income tax return and pay the appropriate tax.

- Sales and use taxes apply to most tangible goods and some services with a few exceptions. Certain organizations such as schools, government agencies, and some non-profit organizations are exempt from paying sales tax on the items they purchase. Additionally, certain items such as prescription drugs, farm machinery, and aircraft parts are exempt from sales tax. These exemptions are the same whether you buy the item in a brick and mortar store or through an online retailer.

- The sales or use tax rate the consumer must pay is a combination of the state rate of 6.5% plus a local rate that can range from 0% to 5.0%. The local rate that is applied is based on where the consumer takes possession of an item or benefits from a service. For example, if a person buys a couch in Kansas City but has it delivered to Topeka, the buyer would pay the sales tax rate in Topeka because that is where he took possession of the item. In FY 2018, sales and use taxes generated about $2.7 billion in revenue for Kansas.

**A 2018 Supreme Court case now allows states to collect sales tax from retailers without a physical presence in the state.**

- In 1992, the Supreme Court reinforced a previous ruling that it was unconstitutional to require retailers that did not have a physical presence in the state to collect and remit sales tax. The court ruled that the complexity of collecting and remitting sales tax across states created an undue administrative burden on interstate commerce.

- In 2016, South Dakota passed a law that required out-of-state retailers to collect sales tax if they generated more than $100,000 in revenue from sales into the state or had more than 200 separate sales in the state.  Wayfair, a major online retailer of home goods, had no physical presence in South Dakota.  Consequently, Wayfair argued that the law was unconstitutional in light of the physical presence standard set in 1992.

- In June 2018, the Supreme Court ruled that online retailers engaging in a significant amount of business within a state may be required to collect and remit sales tax even if the retailer lacks a physical presence in that state.

**Currently, Kansas law specifically requires certain online retailers to collect and remit sales tax.**

- In 2013, Kansas passed two laws that specifically defined which out-of-state retailers were considered to be conducting business in the state including:

  - K.S.A. 79-3702 (2)(B) defines a retailer that is affiliated with a business that has an obligation to collect and remit tax (either because they have a physical presence or operate in other statutory defined ways) as a retailer that is considered to be conducting business in the state. For example, some major companies split the operation of their brick and mortar business from their online business.  This statute would define the online business as being an affiliate which would require that company to collect and remit because their brick and mortar company must do so.

  - K.S.A 79-3702 (2)(C) defines a retailer that makes a sale through a link on a Kansas resident's website <u>and</u> has gross sales to Kansas customers of at least $10,000 in the last 12 months as a retailer conducting business in the state (this is often referred to as a click-through nexus).

- As a result, retailers that meet the above definitions are legally required to collect and remit sales tax.

**Kansas lacks two specific laws that would require more online retailers without a physical presence in the state to collect and remit sales tax.**

- Since the Wayfair decision, there appears to be some disagreement among those we spoke to regarding which retailers are obligated to collect and remit sales tax under the state's current statues.  Some have interpreted K.S.A. 79-3702 to require all online retailers to collect and remit although others indicated that an additional statute might be necessary to require this.  We found that many of the states we reviewed had specific statutes that required retailers without a physical presence to collect and remit sales tax.

- We compared Kansas' sales tax laws to six other states that have similarly sized economies, median incomes, and overall tax structures (Alabama, Iowa, Kentucky, Mississippi, Nebraska, and Oklahoma).  We found:

- **Kansas lacks a specific law to require online retailers conducting <u>a minimum amount of business</u> in the state to collect and remit sales tax.** These laws (often referred to as economic nexus laws) typically require online retailers who have sales or revenues of at least $100,000 in the state to collect sales tax, regardless of whether the retailer has a physical presence. In some cases, the state requires the retailer to conduct a certain number of transactions before it has an obligation to collect sales tax. Five of the six other states we reviewed had this type of law, as **Figure 1-1** shows.

- **Kansas lacks a law to require <u>a marketplace facilitator</u> to collect and remit sales tax on behalf of its retailers.** Typically, a marketplace facilitator is defined as a retailer that coordinates the sale of another retailer's product through an infrastructure that brings buyers and sellers together. The three most significant marketplace facilitators currently operating in the United States are Amazon, Ebay, and Etsy. Marketplace facilitator laws place the responsibility for sales tax collection on the facilitator, which removes the burden of collection from individual sellers. The Supreme Court does not address marketplace facilitators in the Wayfair decision; therefore, the constitutionality of these laws is unknown. Three of the six other states we reviewed had this type law.

**Figure 1-1**
**Comparing Kansas' Online Sales Tax Laws With Other States**

| State | Economic Nexus Threshold (a) | Marketplace Facilitator Law? |
|---|---|---|
| **Kansas** | No | No |
| **Alabama** | Yes<br>Retail sales over $250,000 in previous calendar year | Yes |
| **Iowa** | Yes<br>Gross revenue over $100,000 OR over 200 separate sales in the current or previous calendar year | Yes |
| **Kentucky** | Yes<br>Gross receipts over $100,000 OR over 200 separate sales in the current or previous calendar year | No (b) |
| **Mississippi** | Yes<br>Sales over $250,000 in previous 12 months | No |
| **Nebraska** | No (c) | No |
| **Oklahoma** | Yes<br>Sales of at least $10,000 in previous 12 months | Yes |

(a) Differences in terminology in this column (i.e. revenue, sales, and receipts) are intentional. States choose their own terminology and we acknowlege they do not all have the same meaning.
(b) Kentucky defines Marketplace Facilitator in its laws, but does not impose any collection obligations on them.
(c) Nebraska does not currently have an economic nexus threshold in statute. Despite this, officials told us they plan on requiring retailers with more than $100,000 in sales to collect and remit.
Source: LPA interviews with state officials and review of documents and statutes.

- Other reports by the Sales Tax Institute noted that as of November 2018, 35 states had passed economic nexus laws and 12 states had passed marketplace facilitator laws or other regulations. The revenue thresholds above which a retailer must collect sales tax ranged from $10,000 to $500,000, although $100,000 was the most common (25 states).

**Several factors should be considered for laws that specify which retailers must collect and remit sales tax.**

- The Supreme Court and a Tax Foundation report noted several important criteria states should consider for a law to be constitutional, including:

  - **The Supreme Court noted three important components that made the South Dakota law constitutional.** First, the court noted that a minimum threshold (such as yearly sales of $100,000) under which a retailer would be exempt was necessary to not impose excessive administrative burdens on small retailers. Second, the law did not require retroactive collections. Third, South Dakota's membership in the Streamlined Sales Tax and Use Agreement required simpler registration, collection, and remittance processes that reduced administrative burden on retailers.

    The Streamlined Sales Tax and Use Agreement requires member states to modernize sales and use tax administration in order to reduce the burden of tax compliance. States must have laws and regulations to simplify tax returns, have uniform tax definitions, and have central registrations for retailers, among other requirements. Kansas has been a member of the agreement since 2005.

  - **A Tax Foundation report mentioned several other ways states could create laws to reduce administrative burdens.** The Tax Foundation is a non-profit think tank that collects data and publishes research on tax policies at the state and federal level. The report recommended setting the time period that determines a retailer's sales on a calendar period rather than a roving period (e.g. 'calendar year 2018' rather than 'in the preceding 12 months') and setting an enforcement start date that provides retailers enough time to prepare for the new tax responsibility. Further, it noted states should consider methods to simplify collecting local sales taxes as most states have many local sales tax jurisdictions each with different rates. Last, repealing click-through nexus laws can be helpful because they typically encompass fewer retailers and may conflict with broader economic nexus laws.

## Question 2: How much revenue would the state generate under a sample of additional online sales tax laws?

# Answer: We estimate the state could collect an additional $40 million to $70 million in sales tax revenue annually over what the state collected in FY 2018 if it had two additional laws.

**Many large online retailers already collect and remit sales tax under current Kansas law.**

- Many large online retailers, such as Wal-Mart, Lowes, and Amazon (in certain situations) already have a requirement to collect and remit sales taxes from online transactions in Kansas because they have a physical presence in the state. Additionally, many other online retailers collect and remit sales tax because of the state's current click-through nexus and affiliate laws (see page 2 for more information about those laws). Finally, some companies voluntarily collect and remit sales tax (this practice increased following the 2018 Wayfair decision).

- As a result, much of the possible sales tax from online purchases is currently being collected. We estimated that under the current law and with voluntary remittances, the state already collects at least 90% of the sales and use tax that it can collect from all online purchases.

**We estimate the state could collect an additional $40 million to $70 million in sales tax revenue annually over what the state collected in FY 2018 if it had two additional laws.**

- We used additional data provided by the U.S. Government Accountability Office (GAO) and Kansas Department of Revenue to adjust the state online sales tax estimates from a 2017 GAO report. We adjusted the GAO number because it was from 2017 and did not include many retailers that began collecting sales tax in 2018.

- If Kansas adopted an economic nexus law (in place of the current click though nexus) and a marketplace facilitator law, the state likely would generate additional sales tax revenue from retailers currently without a physical presence. An economic nexus law requires online retailers who have sales in the state above a certain threshold to collect and remit sales tax. A marketplace facilitator law requires the facilitator of an online platform that brings together retailers and consumers (e.g., Etsy, Ebay) to collect sales tax on behalf of its retailers.

- We estimate the state general fund could increase $35.0 million to $60.0 million and the state highway fund could increase $5.0 to $10.0 million annually over what the state collected in fiscal year 2018 (for a total increase of $40 million to $70 million). Additionally, local governments could see an increase in sales tax revenues of $10 million to $25 million.

- Our estimate is similar to an estimate the Kansas Department of Revenue created for the November Consensus Revenue Estimating Group. That estimate suggested the state could potentially generate up to an additional $71 million (or about 1% more than our estimate) if it could collect sales tax from all possible retailers but noted some compliance challenges to collect that amount.

- Kansas (and most of the states we talked to) do not collect data in a way that would allow us to make more detailed estimates. Generally, states collect sales tax by business but not by method (online, catalog, etc). As a result, data related specifically to sales tax revenue by online retailers is not available.

**Our estimate of additional sales tax revenue could be slightly overstated for a few reasons.**

- Due to a lack of data and other information, we were not able to account for a few factors that could overstate our results.

    - **Our estimate does not include a threshold exemption for retailers who have less than $100,000 in sales in the state.** The Supreme Court suggests a threshold, such as $100,000, below which retailers would not have to collect and remit sales tax. We lacked the data to know how many retailers nationwide might have sales less than $100,000 in Kansas. However, we think it would have only a negligible effect on our estimate because a GAO report suggests that only 0.3% of online sales are by retailers who would fall under the threshold.

    - **We could not control for sales tax exemptions.** Some portion of the items purchased online will be exempt from sales tax because either the item or purchaser is exempt from paying sales tax. We lacked any information about what products are purchased online or by what entities, so we could not adjust our estimate accordingly.

    - **Potential changes in consumer shopping patterns are difficult to predict.** Our estimate assumes consumer behavior does not change. However, current research indicates that in some situations, consumers change their spending habits when a retailer begins collecting sales tax. Potentially, if online retailers collect sales tax, they will lose their price advantage which could result in less online shopping and less sales tax revenue than estimated. However, if less online shopping simply results in more shopping at brick and mortar stores, the state may not experience a net loss in sales tax revenue.

- There are other potential financial affects related to adopting laws that require additional retailers to collect sales tax. Kansas Department of Revenue officials told us they may need up to two additional staff (a cost of about $125,000 each year) due to the increased number of companies remitting sales taxes. In addition, as a member of the Streamlined Sales and Use Tax Agreement (SSUTA) Kansas pays about $550,000 annually in fees for retailers that <u>voluntarily</u> remit taxes to the state through SSUTA. However, if more retailers are required to remit sales tax to the state, those fees will likely decrease. These factors have only a very negligible effect on the sales tax estimate we noted above.

**Some retailers could incur costs related to collecting and remitting sales tax and indirect costs from changed consumer behavior.**

- We did not quantify how much it might cost retailers to collect and remit sales tax but there are potential cost considerations. Retailers would need to register in every state that has sales tax (currently 45 states and the District of Columbia) and comply with all applicable laws, reporting, and audit requirements in those states. Retailers also may need to make investments in software systems that aid in determining sales tax rates across the country and update them regularly.

- Larger multi-state retailers may be in a better position to absorb the costs of collecting and remitting sales tax than smaller retailers. A 2017 GAO report found that retailers with limited experience in multi-state tax collection and those that currently lack the software systems necessary to collect sales tax across multiple states incur significant costs.

- Consumer shopping patterns could change which could shift business away from some types of retailers. For example, consumers may shop less at larger retailers that must collect and remit sales tax and shop more at smaller retailers who do not have an obligation to collect sales tax. It is likely that potential shifts in shopping patterns may harm some businesses while helping others.

# *CONCLUSION*

Kansas already has several sales tax laws that apply to most online purchases. The U.S. Supreme Court recently made some changes that would allow states to increase sales tax revenues by requiring more retailers to collect and remit tax for online sales. Kansas could change its laws to pursue additional collections. However, doing so will likely generate less revenue than might be expected because the state already collects an estimated 90% of what is possible. In addition, Kansas policymakers will have to weigh the benefit of increased tax revenue against costs to both the state and small businesses.

# *APPENDIX A*

On January 28, 2019 we provided copies of the draft audit report to the Department of Revenue. Its response is included as this appendix. Department officials generally concurred with our findings but provided additional comments in several areas.

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Laura Kelly, Governor

February 4, 2019

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Dear Mr. Stowe:

Thank you for the opportunity to respond to the Legislative Post Audit's Online Sales Tax: Reviewing Issues Related to Online Sales Tax Laws in Kansas.

In general, the Department of Revenue agrees with the Audit. There are, however, a few items the Department would like to address.

With regard to a consumer's obligation to report and remit tax to the Department, if a retailer fails to properly collect from them, K.S.A. 79-3705a, requires consumers to remit the use tax if the retailer fails to collect. Further, K.S.A. 79-3221o requires the Department to include an explanation of an individual's obligation to remit compensating tax in the Kansas individual income tax instructions, and to provide a line on the Kansas individual income tax for said reporting.

In addition to the two compensating (use) tax provisions concerning affiliate and click through nexus noted within the Audit, K.S.A. 79-3702(h)(1)(F) further, and specifically, defines "retailer doing business in this state" to include:

> "any retailer who has any other contact with this state that would allow this state to require the retailer to collect and remit tax under the provisions of the constitution and laws of the United States."

A similar provision is also found at K.S.A. 79-3702(2)(A). In reversing *Quill*, the Court in *Wayfair* held that there is no longer any constitutional prohibition for states to require collection and remittance of sales taxes from out-of-state retailers conducting business on-line. The Department believes that K.S.A. 79-3702(h)(1)(F) and 79-3702(2)(A), as written, meet the *Wayfair* standards, and are sufficient to require an on-line business making sales in Kansas to collect and remit Kansas tax.

The Audit notes at pages 3 and 4 that Kansas law does not have a minimum amount of business threshold (noting several states that have a $100,000 *de minimus* threshold). The Audit references the *Wayfair* decision in which the court noted the features of the South Dakota statutes under review. Department believes that the Court's notation of the South Dakota law was *obiter dicta*, and that the final order did not hold that these features were required or constitutionally mandated.

The Audit notes that the Department is already collecting approximately 90% of what it can collect from all on-line purchases from current law, and through those sellers voluntarily remitting. The Department believes that it is currently collecting tax from about 80% of the top 100 online retailers, and that those 100 retailers comprise about 80% of all online taxable transactions.

Last, the Audit notes that state general and highway funds would increase for a total of $40 million to $70 million over what was collected in 2018, and local sales tax revenues would increase $10 million - $25 million. The Department does not object to these estimates (which are based on a GAO estimate), but would like to note that it may take a period of time before collections will reach that level. The Department would also like to note that it believes the top end of local sales taxes would increase to a level closer to $17 million.

The Department would like to thank the members of the LPA team for their professional and courteous handling of this Audit. We appreciate the constructive dialogue as we move forward.

Sincerely,

Mark Beshears

Mark Beshears,
Interim Secretary,
Kansas Department of Revenue

# *APPENDIX B*

**Cited References**


1. Post-Wayfair Options for States. (August 2018). *Tax Foundation*.

2. States Could Gain Revenue from Expanded Authority, but Businesses Are Likely to Experience Compliance Costs. (November 2017). *United States Government Accountability Office.*

3. Remote Seller Nexus Chart. (August 2018). *Sales Tax Institute.*