

# Preparing for the Internet Sales Tax

Better online business practices

WHITE PAPER:

BUSINESS GEOGRAPHICS

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## ABSTRACT

FOR OVER TWENTY YEARS, THE INTERNET LARGELY HAS ENJOYED A UNIQUE FREEDOM FROM THAT MOST TRADITIONAL OF U.S. INSTITUTIONS, THE STATE SALES TAX. WITH MULTIPLE VERSIONS OF NATIONAL LEGISLATION BEFORE CONGRESS THE PASSAGE OF AN NATIONAL INTERNET SALES TAX IS INEVITABLE. RETAILERS WHO RECOGNIZE ITS EFFECTS EARLY WILL GAIN A COMPETITIVE ADVANTAGE BY UNDERSTANDING THE IMPLICATIONS TO PROFITS, INFRASTRUCTURE AND COMPLIANCE.

# ONE OF THE MAJOR CHALLENGES FOR RETAILERS IS THE MASTERY OF THE PROCESS OF ASSESSING AND COLLECTING TAXES FROM CUSTOMERS

## The era of the tax-free Internet and the pressure for change.

As U.S. online shopping evolved into a \$100 billion industry,<sup>1</sup> its historically robust, double-digit annual growth had been fueled not only by ease of doing business and the convenience of armchair shopping, but also by the unique advantages it enjoyed as a tax-free haven.

The central argument for online sales tax exemption was based on a 1992 Supreme Court ruling that mail-order businesses and online retailers did not need to collect taxes for sales in states where they did not have nexus—a store, shipping center or some other physical presence. The high court reasoned at the time that subjecting out-of-state merchants to the disparate tax laws of the various states would place an undue burden on interstate commerce.<sup>2</sup> Perhaps in recognition of the potential of an evolving technology, the Supreme Court also noted in the ruling that Congress had the ability to change the situation.<sup>3</sup> This in turn caused a series of chess moves and counter-moves by Congress, state governments, consumer advocates and private businesses resulting in multiple versions of Internet tax legislation being sent to congress for debate.

This has large implications for online business accounting – state taxes are a complicated business. Jurisdictions were not aligned with the U.S. census or any overarching government body. They do not conform to uniform regulations state by state, or often even from neighborhood to neighborhood. Beyond geography, they also include special districts, including school, police, fire, transit, and a variety of others. These complexities have critical implications for business infrastructures, processes and profits. By understanding the issues, savvy retailers can apply best practices solutions that make their lives easier and businesses more profitable.

## The argument for Internet sales taxes.

### State and Local Governments

46 states collect sales taxes, with as much as 33% of state revenues coming from them.<sup>4</sup> These states have a heavy stake in an alternative to the 1992 ruling that upheld *Quill v. North Dakota*, which cost them well over \$20 billion a year in lost revenue. Moreover, the largest losses to occurred in states with the largest population and the greatest reliance on sales taxes for revenue (California alone estimates losses over a \$1 billion per year).<sup>5</sup> These numbers pointed to online tax exemptions as responsible for a substantial loss in their ability to fund civic programs, establish schools and protect their communities.<sup>6</sup>

### Consumer Advocates

Consumer advocacy groups were also at odds with the system, calling the lack of taxation “regressive” by pointing out that only those people with credit cards and Internet access were able to take advantage of the tax break. They also argued that online retailers often appeared to be hiding behind their status by establishing separate legal subsidiaries to handle Internet business (for example, the Barnes & Noble website didn’t have a physical presence in a certain state, such as business offices or a warehouse, so no sales tax was charged for online purchases to customers in that state). This perceived loophole was felt to subsidize the growth of distant companies that contribute little to a community’s civic and economic vitality.<sup>7</sup>

### Local Businesses

The practice of establishing a separate legal entity principally to avoid sales taxes was also opposed by the thousands of brick-and-mortar retailers across the country whose customers must still pay tax because they shopped or accepted shipment intrastate. Depending on the state tax rate, online shoppers were automatically given a 6 to 8 percent price advantage over local stores, making competition daunting.<sup>8</sup>

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### The changing landscape.

In 2002, 40 state governments and the District of Columbia banded together to simplify their sales tax codes in order to ease the way toward Internet sales tax collection.\*<sup>9</sup> Together, they led an initiative dubbed the Streamlined Sales & Use Tax Agreement (SSUTA), a system by which Internet e-commerce companies can voluntarily collect state taxes on behalf of the states in which their customers reside.

Some states had already gone farther in trying to encourage e-commerce companies to pay state sales taxes. North Carolina and South Dakota, for instance, purchased goods and services only from companies that collect state sales taxes. Thus, if a company wanted to do business with those state governments, it must collect their sales taxes.<sup>10</sup>

Perhaps most significantly, SSUTA supporters endorsed the increasingly popular approach to Internet sales taxes – taxation based on customer's address and primary point of use (PPU).<sup>11</sup> By fixing taxes on the usage side, the interstate inequities cited by the Supreme Court largely disappeared.

*\* The full members of the SSUTA at that time included Indiana, Iowa, Kansas, Kentucky, Michigan, Minnesota, Nebraska, New Jersey, North Carolina, North Dakota, Oklahoma, Rhode Island, South Dakota, Vermont and West Virginia. The associate-member states were Arkansas, Nevada, Ohio, Tennessee, Utah and Wyoming.<sup>12</sup>*

### The challenge of address-based tax assignments.

From all the signs, it seemed inevitable that people would be “throwing a few more dollars into their shopping cart for state sales taxes.”<sup>13</sup>

At the same time, retailers were encouraged that some experts believed Internet sales taxation would not appreciably slow online sales. Just nine percent of consumers surveyed by Jupiter Research, for example, said

they would buy less or stop buying from an online store if it charged sales tax. In fact, says Patti Freeman Evans, an analyst for Jupiter, “It’s not that big a deal to customers.”<sup>14</sup>

What may not be a big deal to customers, however, is most certainly a very big deal to retailers as they surveyed the challenge of accurately and efficiently tracking all the tax jurisdictions throughout the U.S., with their accompanying infrastructure burden and potential for crippling litigation should mistakes be made.

“For a small business to have to track all the taxing jurisdictions is enough of a burden as to possibly risk putting them out of business,” says Hani Durzy, an eBay spokesman.<sup>15</sup>

### The current state of tax assignments.

Assigning state taxes represents a challenge for online retailers because of its sheer scope, complexity and, in many cases, contradictions. Determining correct Sales Tax jurisdictions for scores of states and thousands of municipalities places burdens on even the most sophisticated accounting practices. Constantly changing boundaries, an increasing number of tax districts, new government mandates and the legacy of old tax assignment methodologies breed inaccuracies and impact revenue.

For example, location accuracy is critical for tax jurisdiction assignment, yet between 6% to over 25% of all current sales tax territory assignments are incorrect.<sup>16</sup>

One of the major reasons for jurisdiction assignment errors is the traditional reliance by tax directors, comptrollers and accounting services on ZIP Code™ addresses to determine locations. Seemingly simple to use, ZIP Codes have inherent characteristics and limitations that consistently cause ongoing and expensive problems for tax jurisdiction assignments.

First of all, Zip Codes don't always correspond to jurisdiction boundaries. In addition, ZIP Code coverage changes

## AN INCREASINGLY POPULAR APPROACH TO INTERNET SALES TAX IS TAXATION BASED ON THE CUSTOMER'S ADDRESS AND PRIMARY POINT OF USE

frequently (see Figure 1a and 1b) and ZIP+4 Codes™ experience additions, deletions and other changes at a rate of 600,000 each month. In fact, about 7% of municipalities nationwide do not have postal ZIP+4 assigned as mail is collected at a post office and not delivered to a street address. Further complicating the landscape, some states require that jurisdictions correspond not just to ZIP Code requirements, but to political or census boundaries as well, which ebb and flow along with local populations. They may even be based on police or fire districts (as in states like Florida) resulting in still higher tax assignment errors.

### ZIP Codes Change Frequently

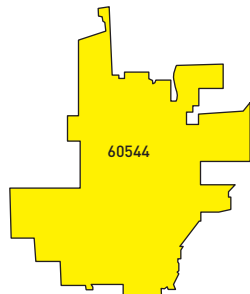


FIGURE 1A – ZIP CODE 60544 IN 2005

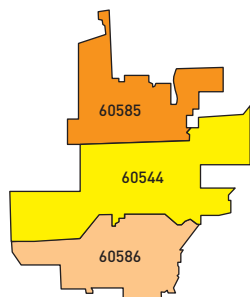


FIGURE 1B – ZIP CODE 60544 SPLITS INTO 3 ZIP CODES IN 2006

Note that the three new ZIP Codes do not align evenly with the original ZIP Code boundary. Portions of neighboring ZIP Codes have either been included or removed from the area that constituted what used to be ZIP Code 60544.

Of the approximately 20,000 municipalities across the U.S., in fact, as many as 30% of ZIP Codes are in conflict with municipal, county and even state boundaries,<sup>17</sup> resulting in taxes being charged where, in fact, none are due. This picture is a challenge to the most experienced tax directors and comptrollers – it's no wonder it inspires trepidation in online retailers.<sup>18</sup>

There is good news for large and even smaller online retailers, however, as they prepare for Internet sales tax realities: there are proven methodologies applied to the Internet retail arena that can help support and protect their investment.

### Business geographics: the solution to jurisdiction assignments.

#### A Street Level Assignment Provides the Correct Jurisdiction

Many companies and agencies are already taking advantage of segmentation strategies and innovative technology to correct ZIP Code deficiencies and confidently assign sales and use tax jurisdictions, most notably in the area known as “Business Geographics”.

Business Geographics is a methodology that is bringing street address-level precision to county, municipality and subjurisdiction tax assignments. It can also help citizens determine their congressional districts, representatives, voting precincts and polling locations or school districts. For retailers, it can help improve their accounting, business and bottom line.

Business Geographics go far beyond Zip Codes to correct, clean and standardize information so that it reflects accurate physical addresses and locations. Utilizing technology-based Geographic Information Systems (GIS) that combine multiple layers of geographic data, Business Geographics provide a better scope of understanding of a physical location. It combines geocoding, the assignment

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of latitude and longitude to address locations, and spatial analysis, the assignment of territories, to map rich sets of data for use in such far-ranging activities as census gathering, disaster preparedness, fire services, health services, sanitation, transportation, economic development, housing, land use and assessments.<sup>19</sup>

Government agencies and major corporations were early adopters of Business Geographics, with great success. Pitney Bowes Software, a leader in enterprise-wide tax jurisdiction assignment solutions, launched GeoTAX.com ([www.geotax.com](http://www.geotax.com)), a free, online service that enabled consumers and small businesses to instantly determine and accurately calculate local sales and use tax rates for U.S. addresses.

According to Tony Burton, GeoTAX Product Manager for Pitney Bowes Software, “The movement by states to tax sales at the point of use, rather than the point of sale, consumers and small businesses needed to have instant access to accurate, nationwide sales and use tax jurisdiction information. GeoTAX.com will help ensure that consumers and businesses have a resource to help make the complex assignment of sales taxes reliable and a lot easier.

“With GeoTAX.com, consumers and smaller businesses—who don’t have the sales volume to justify an enterprise-level solution—could leverage the same technology that large companies were using to instantly and very accurately determine and calculate sales and use taxes based on actual U.S. street addresses.”

By entering street address and city/state or ZIP Code information on the GeoTAX.com website, consumers and businesses receive an instant Tax Rate Report. The report validates and corrects address information, and identifies the applicable state, county, municipal, and other tax jurisdictions and associated tax rates. If the user chooses to enter an item value, the service also calculates the dollar amount of tax due on that item. Users can process up to 50 requests per 24-hour period at no cost.

As this technology evolves, as in the partnership between GeoTAX and ADP Taxware, Business Geographics is being embedded directly into retail tax rate and filing products, making accounting even easier.

In addition, Pitney Bowes Software offers its GeoTAX Enterprise Tax Management solution, which extends the GeoTAX platform functionality to also support payroll, business personal property, and insurance premium taxes.

### Conclusion.

After twenty years of exemptions, sales taxes on products sold via the Internet are becoming a reality. One of the major challenges this poses to online retailers is the mastery of the process of assessing and collecting taxes from customers in the 46 states and the thousands of municipalities that imposed these taxes. Fortunately, the Business Geographics approach demonstrated the accuracy of street-level assignments for tax jurisdiction in a variety of applications. Now it serves the Internet as well.

# A BUSINESS GEOGRAPHICS APPROACH HAS DEMONSTRATED THE ACCURACY OF STREET-LEVEL ASSIGNMENTS FOR TAX JURISDICTION IN A VARIETY OF APPLICATIONS

## GeoTAX

GeoTAX.com is based on Pitney Bowes Software's GeoTAX® software technology platform currently used by many large organizations. In combination with Pitney Bowes Software's industry-leading data quality tools and tax jurisdiction files, the GeoTAX Enterprise Tax Management solution and GeoTAX.com online service provide a comprehensive suite of tax jurisdiction assignment solutions serving consumers and businesses of all sizes.

## About Pitney Bowes Software

Pitney Bowes Software ([www.pb.com/software](http://www.pb.com/software)) turns data into results, providing innovative software solutions that enable clients to better understand and connect with their millions of

customers, prospects, and partners. Pitney Bowes Software helps over 3,000 organizations maximize the value of customer data to improve profitability, increase effectiveness, and strengthen customer relationships, through consolidating, cleansing and enriching corporate data, and generating personalized business documents for multi-channel delivery, customer care and efficient business processing. Customer Communications Management (CCM) solutions span from database to delivery, adding value to every aspect of communication and allowing clients to integrate intelligence throughout their mailstream. Pitney Bowes Software solutions are utilized by leaders in the insurance, financial services/banking, GIS/mapping, government, mail services, retail, telecommunications, utility, and other industries, including Entergy, ING, L.L. Bean, MapQuest, Microsoft, Safeco Insurance, Wal-Mart and Wells Fargo.

## FOOTNOTES

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