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Inter-Departmental Memo

To: Hon. Lianne Altmann, Chairperson
All Member of the Budget Review Committee

From: Eric C. Naughton, Director 
Legislative Budget Review

Date: July 31, 2007

Re: Internet Sales Tax

During the First Quarter Budget hearing, Legislator Kevan Abrahams requested that we provide an Internet Sales Tax report. Attached please find an update to our annual report.

The Internet and County Revenues, 2007

This memo seeks to quantify the current revenue loss to the County attributable to untaxed Internet purchases, to detail the status of the Streamlined Sales Tax Project and to report on the status of the federal Sales Tax Fairness and Simplification Act. Online retail sales experienced double digit growth in 2006. According to comScore Networks, a private research firm, online retail sales grew 24% in 2006¹ and eMarketer, a private research firm, opines that US retail e-commerce sales will grow on average 17.5% a year from 2007 through 2011.² Although, the Internet is expected to record positive, albeit slower, growth, OLBR believes that the County's revenue loss as a percentage of total sales is decreasing since more online sales taxes are being paid voluntarily. The County is collecting sales tax on more Internet purchases due the increase in "brick-and-click companies"; increased use tax payments included on personal income tax filings, and diminished online price advantage. OLBR estimates that Nassau County will lose \$6.4 million in 2007 from untaxed online purchases.

I. Estimate of Lost County Revenue

Purchases made out of state, either online or via mail order, continue to be tax exempt if the business selling the item does not have either a nexus, physical presence, in the purchaser's state or does not mix media by allowing Internet buyers to make returns, exchanges and pick-ups at their local store.

To estimate the revenue lost by Nassau County from e-commerce purchases, the Census Bureau 2005 E-Commerce percentages were applied to the dollar value of Nassau County sales made in each sector. The Part County Sales Tax collections were backed out of the dollar value of Nassau County sales since most of that revenue comes from purchases made within Nassau County, but outside of Long Beach, on hotel rooms and alcoholic beverages. Next, we utilized the actual Nassau County taxable sales data by industry percentages compiled by the New York State Department of Taxation and Finance. This data was available for the years 1995 through 2003. This provided us with historical data for both business-to-consumer sales and business-to-business sales. We found that the percentage of sales by industry has not varied greatly from year to year and thus we were able to extrapolate the taxable sales by industry data for years 2004 through 2005. Then, using the percentage of total U.S. retail, wholesale, manufacturing and service sales done via the Internet in the United States calculated by the U.S. Census Bureau, we computed the lost County sales in each industry. To arrive at the County portion of the sales tax collections, OLBR took 4.25% of the total sales.

To account for the fact that many online purchases are already taxed, OLBR subtracted a fixed percentage of online sales each year. OLBR assumed that the percentage of already taxed items was 35% in 1998 and rose 5% a year until reaching the current figure of 75%. According to Forrester research, multi-channel retailers account for more than 75% of online sales.³ The already taxed percentage is estimated to be rising over time as the number of mix media, brick-

¹ Burns, Enid, "E-Commerce Spending Up for 2007 Holiday and Year", Clickz.com, January 5, 2007.

² "US Retail E-Commerce: Entering the Multi-Channel Era", The-Infoshop.com, May 2007.

³ "Streamlining New York's Sales Tax: Examining Requirements for Compliance with the Streamlined Sales and Use Tax Agreement", New York State Dept. of Taxation and Finance, October 2006.

and-click companies, has increased. According to Dan Whaley, the founder of GetThere (an Internet travel business), the click-and-brick model is a powerful phenomenon, and that nearly every big box retailer is using the mixed media strategy.⁴ Mixing media makes the shopping experience easier by allowing one to make returns, exchanges and pick-ups at the local stores, and also to research and compare prices prior to entering a store. According to eBusiness News, more than 50% of consumers, who do research online before making a purchase, make the purchase at a local store. This allows a store to use online coupons and other incentives to lure shoppers into the store and to avoid in-store questions as individuals find answers to most of their questions online. Forrester research estimates that almost \$400 billion of in-store sales, or about 16% of purchases, are directly influenced by the web. They are expecting that figure to surpass \$1 trillion by 2012.⁵

A second subtraction was made to reflect the fact that the County collected use tax payments on some Internet purchases through individual income tax returns. In 2006, Nassau County collected \$1.3 million in use tax payments. The same figure was utilized for 2007 use tax payments. These calculations yielded a Nassau County revenue loss of \$6.4 million for 2007. The results of these analyses are shown in Chart 1 below.

Chart 1

Nassau County Internet Sales Revenue Loss 1998 -2007										
	\$ in Millions									
	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Nassau Taxable Sales Grand Total, actual	\$15,953	\$16,950	\$17,791	\$17,952	\$18,211	\$18,331	\$20,775	\$21,029	\$21,854	\$22,592
Nassau Total Sales Tax Collections	\$678	\$720	\$756	\$763	\$774	\$779	\$883	\$894	\$929	\$960
Percentage of Total US sales done via Internet										
Wholesale Trade	7%	7%	9%	11%	12%	13%	13%	13%	13%	13%
Retail Trade	0%	1%	1%	1%	1%	2%	2%	3%	3%	3%
Manufacturing	18%	18%	18%	18%	19%	21%	23%	27%	27%	27%
Services	1%	1%	1%	1%	1%	1%	2%	2%	2%	2%
Sector sales as a % of Total Nassau Taxable Sales										
Wholesale Trade	6%	7%	6%	6%	7%	7%	7%	7%	7%	7%
Retail Trade	65%	65%	63%	63%	55%	60%	60%	60%	60%	60%
Manufacturing	4%	4%	4%	4%	2%	2%	2%	2%	2%	2%
Services	30%	30%	30%	30%	30%	27%	27%	27%	27%	27%
Nassau County Sales by Sector										
Wholesale Trade	\$991	\$1,128	\$1,114	\$1,124	\$1,326	\$1,242	\$1,407	\$1,424	\$1,480	\$1,530
Retail Trade	\$10,323	\$10,938	\$11,293	\$11,396	\$10,078	\$10,922	\$12,379	\$12,530	\$13,022	\$13,461
Manufacturing	\$587	\$603	\$675	\$681	\$320	\$283	\$321	\$325	\$338	\$349
Services	\$4,798	\$5,098	\$5,351	\$5,399	\$5,477	\$4,954	\$5,615	\$5,684	\$5,907	\$6,106
Total All Sectors	\$16,699	\$17,768	\$18,433	\$18,601	\$17,201	\$17,402	\$19,721	\$19,963	\$20,746	\$21,446
Lost Nassau County Sales by Sector										
Wholesale Trade	\$71	\$81	\$98	\$119	\$162	\$163	\$186	\$188	\$195	\$202
Retail Trade	\$21	\$55	\$102	\$125	\$141	\$186	\$272	\$313	\$326	\$337
Manufacturing	\$106	\$109	\$122	\$124	\$61	\$60	\$74	\$87	\$90	\$93
Services	\$29	\$31	\$43	\$43	\$44	\$50	\$84	\$91	\$95	\$98
Total All Sectors	\$227	\$276	\$364	\$412	\$408	\$458	\$616	\$679	\$706	\$729
4.25% of lost sales	\$10	\$12	\$15	\$17	\$17	\$19	\$26	\$29	\$30	\$31
Less Already Taxed	(\$3)	(\$5)	(\$7)	(\$9)	(\$10)	(\$12)	(\$17)	(\$20)	(\$22)	(\$23)
Less Use Tax Collected on Income Tax							(\$1)	(\$1)	(\$1)	(\$1)
Lost County Revenues	\$6.3	\$7.0	\$8.5	\$8.7	\$7.8	\$7.8	\$8.2	\$7.4	\$6.2	\$6.4

* Percentages are based on the Census Bureau's Multi-Sector report which included percentages through 2005; the 2005 figures were used as proxy values for 2006 and 2007.
Source: New York State Department of Taxation and Finance and the US Census Bureau

⁴ Richtel, Matt, and Bob Tedeschi, "Online Sales Lose Steam", New York Times, June 17, 2007.

⁵ "How Online Shoppers are Driving Offline Retail Sales", ebusinessnews.com, February, 2007.

According to the U.S. Census Bureau's most recent E-commerce Multi-sector Report, e-commerce continues to grow as a percentage of total sales. In 2005, the manufacturing sector continued to be the heaviest user of e-commerce, with 26.7% of all shipments being made through e-commerce. The merchant wholesale sector was second to the manufacturing sector with 13.2% of total sales being made via e-commerce. The retail and service sectors also recorded increases in the usage of e-commerce. In the retail sector 2.5% of all sales were made via e-commerce and in the service sector 1.6% of total sector revenue was generated through e-commerce.⁶ The chart on the prior page details the specific industries which recorded the highest volume of Internet sales as a percentage of total industry sales.

Looking forward, OLBR expects that online sales growth will diminish since online items will no longer enjoy a price advantage relative to those recorded at brick-and-mortar stores. According to Nancy F. Koehn, a professor at Harvard Business School, due to fierce competition, many online sellers have been steadily raising their shipping fees to bolster profits or make up for their low prices.⁷ Not only are online prices/fees rising, but the total cost of an online item increases as the percentage of online tax sales has gone up. A recent MIT working paper found that a 1% increase of sales taxes in one state increases the demand addressed to out-of-state online retailers by about 6%.⁸ Hence, conversely as the price of out-of-state online retailers increases, the demand for the goods sold by local in-state retailers will increase. The net effect would be lower untaxed online sales growth.

II. Streamlined Sales Tax Project

Since many municipalities opine that they are losing revenues due to increasing e-commerce sales, they have elected to join the Streamlined Sales Tax Project that aims at simplifying sales taxes so that collecting sales tax on items brought online or through mail-order can easily be implemented. Appendix A, details the U.S. State membership in the Streamlined Sales Tax Project. Currently, there are 15 full member states. A full member state is in compliance with the Streamlined Sales Tax Projects' laws, rules, regulations and policies. New York State is listed as an advisory state since it has enacted legislation which would allow it to join the project once it simplifies its sales tax system to be in compliance with the projects' laws, rules, regulations and policies. It is not necessarily in Nassau County's or New York State's best interest to join the project. This is because some of the simplification laws, rules, regulations and policies could entail a revenue loss for either the County, the State or both. For example, the project mandates that there be one sales tax rate throughout the entire state. Within New York State there currently are 12 separate sales tax rates. Chart 2 on the following page details the frequencies of these rates. The most frequently used sales tax rate in New York State is 8%. Currently, 45 separate taxing jurisdictions utilize this rate. If this rate was chosen to be the one sales tax rate for New York State, Nassau County would lose sales tax revenue unless it was held harmless. It is unclear if the State would elect to hold the County harmless.

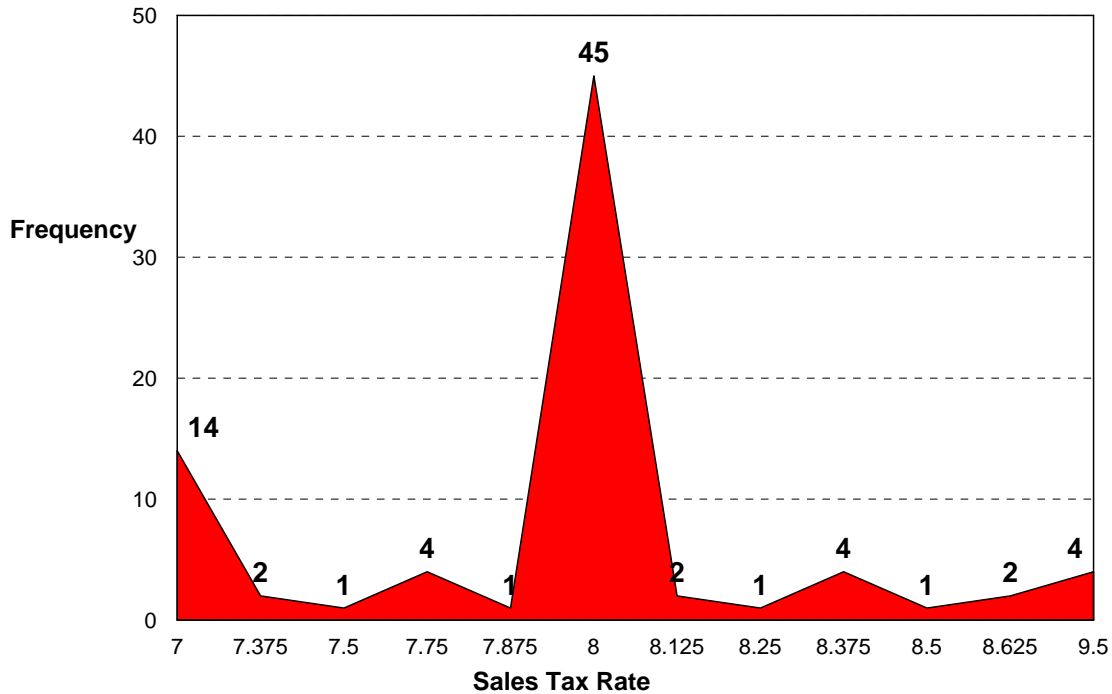
⁶ "2003 E-commerce Multi-sector Report", U.S. Census Bureau, May 11, 2005.

⁷ Richtel, Matt, and Bob Tedeschi, "Online Sales Lose Steam", New York Times, June 17, 2007.

⁸ Ellison, Glenn, and Sara Fisher Ellison, "Internet Retail Demand: Taxes, Geography, and Online-Offline

Competition", smarteconomist.com, Report 175, August 2, 2006.

**Chart 2
New York State County Sales Tax Rates**



Source: NYS Dept. Of Taxation and Finance

In addition to the potential revenue loss, joining the project would significantly increase New York State’s expenses since it would mandate that the State adopt new technologies which require extensive systems programming and processing changes by the State Tax Department. As a result of the previous detailed issues regarding New York State sales tax simplification, the New York State Department of Taxation and Finance stated,

Legislation to modernize and simplify the New York sales tax would be worthwhile, but it is unclear if the proposal developed by the Streamlined project would yield net benefits to New York’s taxpayers and local businesses. There are, however, provisions of the Agreement which State policymakers may determine would provide benefits to New York. The likelihood of the State and its localities generating vast amounts of “new” sales tax revenue from taxing mail order and e-commerce sales is low. As the Streamlined project moves forward, New York’s policymakers may wish to consider a number of options, including the option of adopting some, but not all, of the Agreement’s provisions to realize some benefits of simplification short of full conformity.⁹

⁹ “Streamlining New York’s Sales Tax: Examining Requirements for Compliance with the Streamlined Sales and Use Tax Agreement”, New York State Department of Taxation of Finance, October 2006.

III. Federal Sales Tax Fairness and Simplification Act

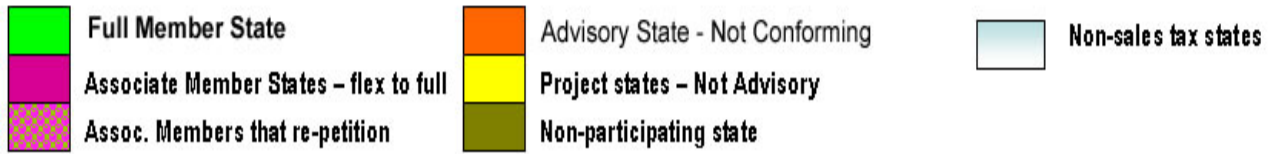
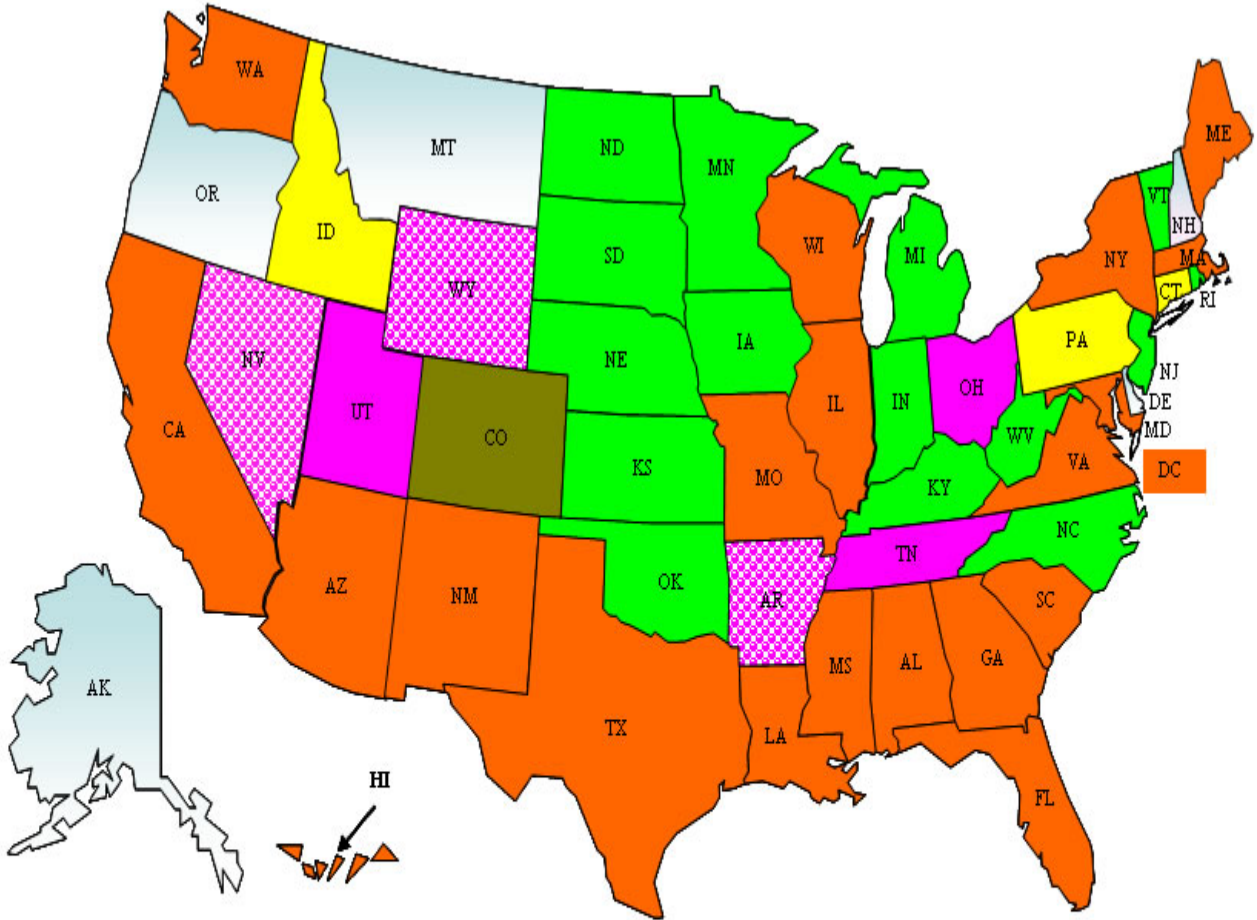
At the federal level, a bill has been introduced to the Senate by Wyoming Senator Michael Enzi entitled the, “Sales Tax Fairness and Simplification Act.” This bill was unsuccessfully introduced to the Senate in 2005. Its goal is to put out-of-state online retailers on the same playing field as in-state online and local brick-and-mortar retailers who collect sales tax. The bill includes an exemption for online businesses whose annual revenues are less than \$5 million.¹⁰

IV. Conclusion

Nassau County is losing sales tax revenue when individuals and businesses make purchases online or via mail order. OLBR estimates that the County sales tax loss from online purchases will decline in the future as more online purchases are taxed voluntarily. It is unclear if the Streamlined Sales Tax Project would benefit Nassau County from a revenue perspective. Moreover, it is unclear if the federal bill will be successful in mandating sales tax collection on all online purchases. However, it seems that competitive market forces have already reduced the County sales tax loss and it is possible if not probable that these forces will level the playing field on their own without any state or federal action.

¹⁰ Weiss, Todd R., “Senate Eyes Sales Taxes for Online Purchases”, Computerworld.com, May 24, 2007.

Appendix A



Source: Streamlined Sales Tax Project