Ross School of Business at the University of Michigan

Independent Study Project Report

TERM : **Winter 2013**

COURSE : **LHC 489**

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TITLE : **E-Commerce and Sales Tax: Necessity for Small-Business Exemption on Internet Sales**

E-Commerce and Sales Tax:

Necessity for Small-Business Exemption on Internet Sales

by

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A thesis submitted in fulfillment of the requirements of LHC 489, February 28, 2013.

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Acknowledgements

Apart from the efforts of myself, the success of any project depends largely on the encouragement and guidelines of many others. I take this opportunity to express my gratitude to the people who have been instrumental in the successful completion of this thesis. First and foremost, I would like to demonstrate my utmost appreciation to Prof. Dana Muir and Prof. George Siedel. I will never be able to thank them enough for their tremendous support and help throughout this strenuous process. I feel motivated and encouraged every time I attend their tutorials. Without their constant encouragement and guidance this project would not have materialized. Deepest gratitude is also due to writing consultant John Morrow without whose knowledge and assistance this thesis would never have received the start it needed. Special thanks also to the Ross School of Business and all of my Undergraduate classmates, especially group members Nathan Torreano, Rebecca Beagan, Vikram Sridhar, Nick Vasdekas, and Ankur Shah. Finally, I am forever indebted to my parents and sister for their understanding, endless patience and encouragement when it was most required.

Abstract

Current tax law makes it near impossible to enforce the collection of sales taxes on the majority of Internet commerce, which has generated considerable controversy among policy makers. This thesis examines the origins, development, legislative reality and rhetoric, and economic policy behind and consequences of a possible small-business exemption in relation to the collection of online sales tax. Hence, this thesis serves a dual purpose: (1.) To make the case that small business Internet retailers should be exempt from e-commerce sales tax collection and (2.) To discuss issues that policymakers should clarify regarding size of small business exemptions to ensure that analysts use appropriate data to evaluate current and proposed tax policy. In an effort to help the reader understand the magnitude of the situation, this thesis begins by examining the growth of e-commerce and consequential erosion of the sales tax base over the past decade. After the background materials have been set forth, the thesis introduces the core concepts surrounding taxation of small business and analyzes the exemption levels set forth by the current legislation proposals. Through this analysis we find that policy makers are setting arbitrary levels with little academic backing while also being pressured by large retailers to limit the coverage of the exemption. The analysis leads to the determination that, considering the increasing dominance of large retailers over the past decade and the pending costs of being forced to collect and remit in over 9,500 tax jurisdictions, a small business exemption is the fairest way to level the playing field. Given the limited knowledge of policy makers with regards to small business and online retail, the optimum solution would be to encourage the Small Business Association (SBA) to research and take responsibility for defining appropriate size distinctions for online small businesses. The SBA is a federal government organization that assists small businesses in providing programs and opportunities to hasten their potential growth and success (Holland). Once properly defined, I would propose setting the exemption levels to these sizes, pending the approval of legislation by policymakers.

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Introduction

The rise of electronic commerce has brought to attention fundamental questions of tax policy. Electronic commerce or "e-commerce" is a term for any type of business, or commercial transaction, that involves the transfer of information across the Internet ("What Is Ecommerce?"). Most fundamentally: Should e-commerce be taxed?

Although many policymakers are now in agreement that e-commerce should be taxed and have begun to formulate federal legislation, additional challenges have arisen specifically regarding the topic of tax exemptions for small businesses. This is the area that this thesis will focus on. If e-commerce is to be taxed, it needs to be done in a fair manner such that all entities can comply regardless of size and resources. Specifically, this entails including a "small-business exemption" in the federal legislation in order to maintain a proper balance between large and small retailers. While the science of calculating an exact exemption size may be difficult, the SBA is uniquely positioned to make an accurate analysis with their vast resources and experience doing similar measures for brick-and-mortar stores. By delegating this responsibility to an entity that works in the trenches of the constantly changing national business environment, we can ensure that these exemption levels are updated appropriately to remain relevant and are limited to the qualifying beneficiaries.

This thesis provides background for these and other issues and discusses the implications for small businesses. The first section takes an in-depth look at the history of taxation on e-commerce and where the United States currently stands in terms of a developing a federal legislative solution. The second section describes in broad terms the current tax bias towards big retailers and explains why a piecemeal approach that does not adequately acknowledge the importance of small businesses cannot produce a satisfactory solution. The third section proposes

a rational solution to the tax problems that avoids unduly burdening small business or providing unfair advantages to large retailers. While this solution is quite unlike what prevails today, it is simple, at least in concept.

Thesis Statement

Any Federal legislation that would upset the free and fair e-commerce marketplace and allow government to impose new, burdensome sales tax-collecting schemes on out-of-state, online small businesses would adversely impact hundreds of thousands of jobs, reduce consumer choice, and impede the development of interstate commerce. Given the prospective enactment of such legislation, it has become crucial that policymakers include a reasonably sizable small business exemption to exempt businesses with small amounts of online sales from being required to collect. Due to their small size and limited resources, these small online retailers would receive a disproportionate impact from a blanket requirement and would experience further difficulties competing on the free market if such exemption is not initiated. Considering the lack of policymaker expertise with the matter, responsibility for defining the size standards should be delegated by Congress to the Small Business Association, an organization with both the unique positioning and adequate resources to develop and maintain an appropriate exemption methodology.

Part I: Overview of Current E-Commerce Tax Situation

Before we examine the current legislation and analyses, we first need to take a look at the history of e-commerce taxation. To begin the conversation, we will look at two Supreme Court rulings that set precedent for the current laws regarding collection of sales tax from remote sellers. Next, we will review the growth of the e-commerce market over the past decade and how this growth is impacting the traditional tax revenue base. To end the section, I will briefly summarize the current proposed solutions by Congress.

Background

Forty-five states and the District of Columbia impose general sales and use tax (SUT) on retail transactions as a compulsory contribution to state revenue (Reuben). SUT applies to all retail sales of tangible personal property, and in some states services, in the state. The use tax is imposed on consumers of tangible personal property that is used, consumed, or stored in this state. The sales tax and the use tax are "mutually exclusive", which means either sales tax or use tax applies to a single transaction, but not both. In 2012 state SUT rates ranged from 2.9 percent in Colorado to 7.5 percent in California and brought in over a third of state revenue (Reuben). State and local governments may impose taxes only on sales that occur in their jurisdiction, but determining the location of certain sales can be difficult. A retailer with sufficient physical presence in a state to be obligated to charge the state's sales tax is said to have "nexus". A nexus is a connection between the vendor and state such that subjecting the vendor to the state's laws is neither unfair to the vendor nor likely to harm interstate commerce — requirements stemming from the due process and commerce clauses of the U.S. Constitution (Nellen). A state or local government may tax sales by a retailer with nexus in the state or locality, but nexus rules are

complicated, and many questions about their application to online transactions remain unresolved. To simplify things, if an online retailer has a physical presence in a particular state, such as a store, business office, or warehouse, it must collect SUT from customers in that state. If a business does not have a physical presence in a state, it is not required to collect SUT for sales into that state (Stim). While technically the end customer is expected to pay a SUT on remote purchases, a majority of these transactions are not collected as evidenced by the estimated $23.3 billion in uncollected SUT from all remote sales in 2012 (Behlke). A breakdown by state can be seen in Appendix Figure #1.

This is made clear by the following example. Jack, who lives in Florida, wants to buy a laptop retailing for $1000. He goes to his local electronics retailer, where the laptop sells for $1000, plus Florida sales tax of 7 percent for a total of $1070. He goes home to find the same laptop online being sold by a business located in Wyoming for $1000. He saves $70 – less the shipping charge — buying the laptop online. Of course, Jack is required by state tax law to declare this purchase on a SUT return and pay the $70 directly to the State of Florida Department of Treasury. However, somehow this manages to slip his mind, or he just fails to do so. It is near impossible for Florida to identify and tax these purchases, so in the aggregate Florida loses substantial tax revenue.

Bellas Hess v. Illinois

The case of National Bellas Hess v. Illinois Department of Revenue is one of the key decisions that framed the Internet sales tax debut. Ironically, the Supreme Court decision did not involve an Internet company and occurred in 1967. The facts are pretty straightforward in the Bellas Hess case. National Bellas Hess was a catalog company incorporated in Delaware, but

with the principle place of business in Kansas City, Missouri. Like many mail order companies, Hess mailed out catalogs to a mailing list twice a year to all parts of the country including Illinois. Even though no orders or customer service were handled within the borders of Illinois, any person or company soliciting business in the state in any manner was considered a retailer under Illinois law. Illinois sought out the payment of SUT per the laws of the state and the Supreme Court of Illinois agreed. Hess appealed to the Supreme Court and argued that such an imposition was a violation of its due process rights and constituted an unconstitutional burden on interstate commerce (Bellas Hess).

The Supreme Court set the stage for the debate on taxing Internet sales by agreeing with Hess when, in a majority (5 to 4) opinion, the Court ruled that, "the many variations in rates of tax, in allowable exemptions, and in administrative and record-keeping requirements could entangle [the company]'s interstate business in a virtual welter of complicated obligations to local jurisdictions" (Bellas Hess). This quote demonstrates the ruling's basis in complexity and burden, which has rippled forward to create today a tidal wave of unanticipated consequences. As a result of the Bellas Hess case, if a company does not have a physical presence in a state, it cannot be forced to pay SUT there. To provide a sense of historical perspective, keep in mind that the year this ruling was issued was the same year the floppy disk was invented at IBM. It was also one year before the first plans were developed at MIT to create ARPANET, which laid the foundation for the Internet we know today. This single decision could very well have been the difference between many small Internet companies staying in business or failing due to excessively burdensome administrative costs.

Quill Corp. v. North Dakota

In 1992, the matter of sales tax on remote sales came before the high Court again in Quill Corp. v. North Dakota, which held that mail-order merchants did not need to collect SUT for sales into states where they did not have a physical presence. This time, the Court reaffirmed the earlier Bellas Hess decision (8 to 1), primarily on the basis of honoring past precedents (Quill Corp.)

For the past 20 years, states have been unable to enforce their own SUT laws on sales by out-of-state, catalog, and online sellers as a result of the Quill Corp. case. In the decision, the Supreme Court explained that a business had to be physically present in a state before that state could require the business to collect SUT on the state's behalf. The Supreme Court's reasoning was at least partially based on the fact that, at the time the case was decided in 1992, there were over 6,000 separate SUT jurisdictions in the United States (states, localities, special tax districts, etc.) and to impose a collection obligation on a remote seller would be too complex and impose a crushing burden that would severely restrict interstate commerce (Quill Corp.).

However, the Court explicitly stated that Congress has the power to overrule through legislation under the Commerce Clause to create a level playing field for local merchants (Atkins). The ruling went on to state, "Our decision is made easier by the fact that 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. No matter how we evaluate the burdens that use taxes impose on interstate commerce, Congress remains free to disagree with our conclusions" (Quill Corp.). Clearly, the Supreme Court felt that Congress would come face-to-face with the issue in the future. The recent emergence of e-commerce over the last decade has started a new movement for change as revenues made by online retailers continue to grow without restrictions forcing

them to collect sales taxes like brick-and-mortar businesses. At a time when State budgets are under increasing pressure, the spotlight on these uncollected taxes is beginning to magnify.

Sizing Up The Modern E-Commerce Market

Online shopping has continued to become more popular as consumers become more familiar with and begin, and in many cases, to prefer the convenience of making purchases on the Internet. Increased Internet connectivity via devices like smartphones, tablets and game consoles has driven growth, as well as new e-commerce models like flash sales (i.e. Gilt Groupe), daily deals (Groupon, LivingSocial) and digital downloads of media (Netflix, iTunes), all of which have enjoyed rapid adoption in recent years. Consequently, these trends have also led to an increasing amount of uncollected SUT (Behlke).

Cumulative state SUT revenues collected in 2012 amounted to about $150 billion annually and made up approximately one-third of all state revenues. These taxes pay for everything from schools and police to roads, parks, and other state services (Stim). According to a NCSL study mentioned previously, states claim they lost over $23.3 billion in uncollected SUT between internet, catalog, and phone mail orders in 2012 (Behlke). This represents a potential 14% increase in revenue on top of the $150 billion that they actually were able to collect. California alone estimates losses of over a billion dollars per year in SUT revenues. States that do not have a personal income tax, like Texas, are even more dependent on SUT revenue. In the current economic climate, states need revenues to balance their budgets more than ever before. As a result, they are now mobilizing to institute laws to require online sellers to collect sales tax on behalf of buyers just like brick-and-mortar stores (See “Current Proposals”).

The amount of revenue available via sales tax collection has also 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 (Cowan):

- Online retail sales reached a record $226 billion in 2012 and are expected to increase 62% by 2016, according to Forrester Research.
- According to the U.S. Online Retail Forecast, 2011 to 2016, by Forrester Research, 15 percent more consumers will be shopping online (192 million vs. 167 million) and spending 44 percent more ($1,738 annually vs. $1,207 annually).
- 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 (Hassett). 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 state and federal legislation to address online sales tax collection.

Current Proposals

While the country has been waiting for Congress to take a national approach, many states have resorted to their own actions to claw back SUT, leading to greater confusion and further distortion in the marketplace. While over 30 states have attempted to remedy this problem on the state level, none have had very much success (Womack). For example, in 2010 Colorado passed a law requiring out-of-State sellers with more than $100,000 of sales to Colorado residents to inform the buyers they owe SUT tax, and levied a $5-per-violation penalty on sellers who did not. Although a federal district court voided this law in March 2012, the State is appealing (Saunders). Additionally, about two-dozen states now pointedly ask taxpayers to estimate and pay remote SUT on state income-tax returns, with some suggesting a figure based on the resident's overall income. But a 2012 study by Minnesota found this does not work well: For tax year 2009, most taxpayers did not admit to owing use taxes. In Alabama, the average use tax reported per return that paid it was $12 (Saunders). Online retailers have responded to attempts

by Texas, California, and South Carolina to pass collection legislation by threatening to remove jobs from the state in order to avoid having to comply with state laws (Brunner).

Perhaps the most effective effort to date has been the Streamlined Sales and Use Tax Agreement (SSUTA). In 2002, when state governments first started organizing to fight back, 44 states and the District of Columbia joined together to simplify their sales tax codes in order to make e-commerce and remote sales tax collection easier. It intended to reduce the cost and administrative burdens on retailers that collect the sales tax, particularly retailers operating in multiple states. It encouraged "remote sellers" selling over the Internet and by mail order to collect tax on sales to Washington customers. The primary goal was to make local "brick-and-mortar" stores and remote sellers all operate under the same rules and in the same competitive environment (Streamlined Sales and Use Tax Agreement). Under SSUTA, the collection of sales tax still remains voluntary and the system is far from perfect. However, the SSUTA was a clear statement by the states that they are tired of losing out on revenue they deserve and that they are willing to work together towards an eventual national solution. Nevertheless, it has become increasingly clear that the most efficient and effective solution to this interstate commerce dilemma is to enact federal legislation.

In response to all of the claims for change, three different federal bills have been introduced in Congress that would grant states the right to collect sales tax from online merchants: the Marketplace Fairness Act, the Marketplace Equity Act, and the Main Street Fairness Act. All three would grant states the authority to require online retailers to collect and remit sales tax on behalf of customers from outside states (Aldrich).

In the Senate, the leading legislation is the Main Street Fairness Act (S. 1452), introduced by Sen. Durbin in July 2011 (“Main Street Fairness Act”). The legislation would allow states that

have signed on to the Streamlined Sales and Use Tax Agreement to require collection of sales taxes on Internet-based sales. But one of the requirements of this bill is that the Streamlined Sales and Use Tax Agreement must include a " … uniform rule to establish a small seller exception." This legislation does not define a "small seller"; it leaves that determination up to the states. Although giving power back to the individual States may be ideal in theory, this leads to more complications and a lot of work left to be done by State legislatures. Instead of tackling the small business exemption with federal resources, this effort would only multiply the problem by granting authority to 50 different small, less capable entities to come up with their own version.

In the House, HR. 3179, the Marketplace Equity Act of 2011, has emerged as the leading bill (Womack). This legislation would allow a state to enforce collection of sales tax on sales made into the state's border from an out of state seller. Unlike the Main Street Fairness Act, the Marketplace Equity Act would not require states to sign on to the Streamlined Sales and Use Tax Agreement (SSUTA) in order to enforce sales tax collection; states would only need to simplify their SUT filing systems. One method of simplification could be to adopt the SSUTA, but other simplification methods also could qualify. With respect to small sellers, this legislation does improve upon the Main Street Fairness Act, because it spells out a specific small business exemption. It would exempt businesses with $1 million or less total annual remote sales or $100,000 or less remote sales into a single state (Womack). While the adequacy and academic soundness of this limitation is debatable, the certainty of a specifically defined small business exemption is an improvement to the undefined exemption contained in the Main Street Fairness Act.

Also in the Senate is the Marketplace Fairness Act, S. 1832, which is essentially a compromise solution between the two previously discussed bills. The Marketplace Fairness Act

provides that SSUTA full member states may require remote sellers that do not qualify for the small seller exception, to collect and remit sales tax on in-state states beginning on first day of the calendar quarter that is at least 90 days after enactment of the Marketplace Fairness Act ("Marketplace Fairness Act Information"). Because the Marketplace Fairness Act looks to the provisions of the SSUTA, the Act does not elaborate on the SSUTA's simplification requirements in the actual bill. For instance, because the small seller exception under the current version of the SSUTA provides that businesses with less than $500,000 in revenue per year are exempt from the remote seller requirements, this threshold would apply to states whose remote seller collection authority under the Marketplace Fairness Act is based on their status as full-member SSUTA states. Thus, the small business exemption would remain the same as the SSUTA's. States that are not SSUTA full-members, but who adopt and implement the Marketplace Fairness Act's alternative simplification requirements would also be authorized to require remote sellers who do not meet the Marketplace Fairness Act's small seller exception to collect taxes on sales sourced to their states in accordance with the sourcing rules detailed in the Marketplace Fairness Act ("Marketplace Fairness Act Information"). According to the bill, to meet the Marketplace Fairness Act's alternative simplification requirements, states must meet five different mandates listed in the bill (Appendix Figure #2). Although this hybrid bill has received significant media attention, it has only combined the previous two congressional efforts without any groundbreaking additions. The bill lacks any additional analysis and relies on the values from the previous two bills as anchors instead of looking at the whole picture. Although it has good intentions, a more appropriate effort would be to start from scratch, employ an organization or team that is capable of tackling size standards for online retail sellers, and really examine what the key drivers should be to setting the small business exemption level.

The current bills fail to do this and lack a true small business exemption. In fact, they replace the small business exemptions in previous proposals with a “small seller exception” that is arbitrary and does not recognize the importance of online small businesses as job creators. Consequently, these bills do not protect small business retailers.

Summaries of all three bills and their current status can be found in Appendix Figure #3.

The Inevitable Result

The evidence of substantial revenue loss, increasing importance of e-commerce, and pending legislation all point to one thing: Online purchases will be taxed in the near future (Langley). The next question to answer now is, “Will there and should there be an exemption included for small businesses?”

Part II: Big Retail Vs. Small Retail

The focus of this section concentrates primarily on the role of small businesses in the United States. First, we will look at why small businesses are so valuable to the economy and how small business exemptions can protect that value. Next, we will analyze the expanding power of large retailers and the crowding out threat that they are having on small business. Finally, we will go over the potential compliance implications of a federal solution that did not include a small business exemption.

Economic Importance of Small Business

Small businesses are vital to the success of the economy. Defined by the U.S. Office of Advocacy as having 500 employees or fewer, small businesses have been meeting local needs (i.e. hairdresser, financial consultant, plumber) and serving the requirements of larger businesses (catering, photography service, routine maintenance) for decades ("What is a Small Business"). Small businesses contribute to local economies by bringing growth and innovation to the community in which the business is established (Longley). Small firms also make important contributions to the economy through innovations and the creation of jobs, enterprises, and entire new industries. In general, small businesses create most of the nation's new jobs, employ about half of the nation's private sector work force, and provide half of the nation's nonfarm, private real gross domestic product (GDP), as well as a significant share of innovations. Consequently, a small business exemption to remote taxation is necessary to protect these contributions.

How important are these small firms to the U.S. economy? Just to expand upon a few facts, small firms (Longley):

- **Represent 99.7 percent of all employer firms.**

In 2009, there were 27.5 million businesses in the United States, according to Office of Advocacy estimates. The latest available Census data show that there were 6.0 million firms with employees in 2007 and 21.4 million without employees in 2008. Small firms with fewer than 500 employees represent 99.9 percent of the total (employers and non-employers), as the most recent data show there were about 18,311 large businesses in 2007.

- **Employ half of all private sector employees.**

Small businesses employ about half of U.S. workers. Of 120.6 million non-farm private sector workers in 2007, small firms employed 59.9 million and large firms employed 60.7 million. About half of small firm employment is in second-stage companies (10-99 employees), and half is in firms that are 15 years or older. Small firms' share of employment in rural areas is slightly higher that in urban areas; their share of part-time workers (22 percent) is similar to large firms' share (19 percent). Small firms' employment share remains steady since some small firms grow into large firms over time.

- **Survive longer than expected; Seven out of 10 new employer firms survive at least 2 years, half at least 5 years, a third at least 10 years, and a quarter stay in business 15 years or more.**

"Four out of five new firms fail within the first five years." This statement has been made so many times that most people believe it is true. But it isn't. Census data report that 69 percent of new employer establishments born to new firms in 2000 survived at least 2 years, and 51 percent survived 5 or more years. Survival rates were similar across states and major industries. Bureau of Labor Statistics data on establishment age show that 49 percent of establishments survive 5 years or more; 34 percent survive 10 years or more; and 26 percent survive 15 years or more.

Over the past two decades, e-commerce has revolutionized small business in the U.S. by allowing a small business anywhere to become a small everywhere. Actually, 60 percent of all small business retailers use the Internet (Whitman). The Internet empowers small businesses to grow beyond traditional boundaries, compete globally and create jobs in their hometowns. Americans everywhere now benefit from wider shopping choices and competing prices online. Small online retail businesses in thousands of U.S. communities are growing and making a positive effect on the local economy (Brown). But small retail businesses can only continue to compete online with larger enterprises if government does not add new tax burdens that increase the advantage of bigger operations.

Policymakers often inquire about the tax code's impact on "small business" and "small business owners." Although many factors motivate their concerns, two factors seem especially relevant. First, many small businesses operate at a cost disadvantage relative to their larger counterparts due to the lack of economies of scale (Kokemuller). For example, small firms might have greater difficulty lowering the price of a good to match a larger competitor because productions costs are higher without economies of scale. They might also realize that it is more difficult and expensive to raise capital for investment or expansion than it is for competitors who have more assets. Second, despite any inherent disadvantages, small businesses generate a disproportionate share of overall economic and employment growth as evidenced by the facts mentioned earlier in this section (Kokemuller). For these reasons, policymakers are concerned that the proposed tax code for e-commerce transactions not excessively burden small businesses or give unfair advantages to large retailers. In particular, this concern should be communicated in the form of a small business exemption from taxation of online transactions.

Expanding Dominance of Large Retailers

Although originally opposed to online sales tax, large retailers have accepted that taxation may be unavoidable and are now trying to use pending legislation to disadvantage small business competitors by requiring them to share the same tax burden (Bartz). At the heart of this issue has been the recent success of large retailers at the expense of small business. Large retail establishments, often termed "big box retail" or "mega-retailers," have become a familiar fixture on the American landscape. Best Buy, Staples, Target, representing different categories of these large-scale establishments, have become household names (Ewoldt). Large chains like these can exploit economies of scale and density to offer lower prices and wider product selection that their small size competitors struggle to match. However, big-box stores are usually located in suburban areas (Pozzi). This leaves smaller retailers a chance of shielding themselves from competition by locating more conveniently. Diminishing the relevance of travel and other costs, the diffusion of e-commerce has reduced the advantage from geographic differentiation and threatens to reduce the main competitive advantage of small businesses (Pozzi). In short, no community is immune from the potential effects these of large-scale retail businesses.

Over the past 30 years, as these large retailers have grown more dominant in retail, small independent retailers have been edged towards the brink of disaster (Pozzi). This rate of decline has intensified over the past two decades since the arrival of e-commerce. As shown in a recent eBay study, large retailers accounted for 42% of total retail sales in 1987. As of July 2010, their market share had jumped to 87% (Cohen). In addition, large retailers make up 18 of the Top 25 retail websites today. Large retailers realize that the collection of remote SUT may make it tougher for their small competitors to compete and are therefore doing everything they can to enable the legislation.

Meanwhile, small business retailers are lobbying policymakers to include a small business exemption, arguing that they do not have the physical presence, resources, distribution, and other benefits that larger retailers enjoy. I agree with the small businesses: We must protect the rights of our small businesses and keep them on a fair playing field with the large retailers. In my opinion, if small businesses cannot receive the same shipping costs and local and/or state tax deals that the large national retailers often receive, then it is not fair to hold small businesses to the same tax collection standard as large retailers.

Amazon.com is one example of a large retailer that has already been trying to navigate government regulation to help generate an advantage (Brunner). Coincidentally, also a past adversarial turned leading proponent for the new legislation, Amazon has made numerous deals over the past several years with individual states in which they have a physical presence to avoid paying sales tax. For example, Amazon has been a retailer with distribution facilities in the State of Tennessee for many years and yet has not been required to collect sales taxes in the state. They were recently able to leverage their size in the state and received a continued exemption from collecting sales taxes for several years in exchange for adding to their in-state facilities (Cohen). When discussing this situation in his letter to the House of Representatives regarding the Marketplace Equity Act, eBay Vice President Tod Cohen wrote:

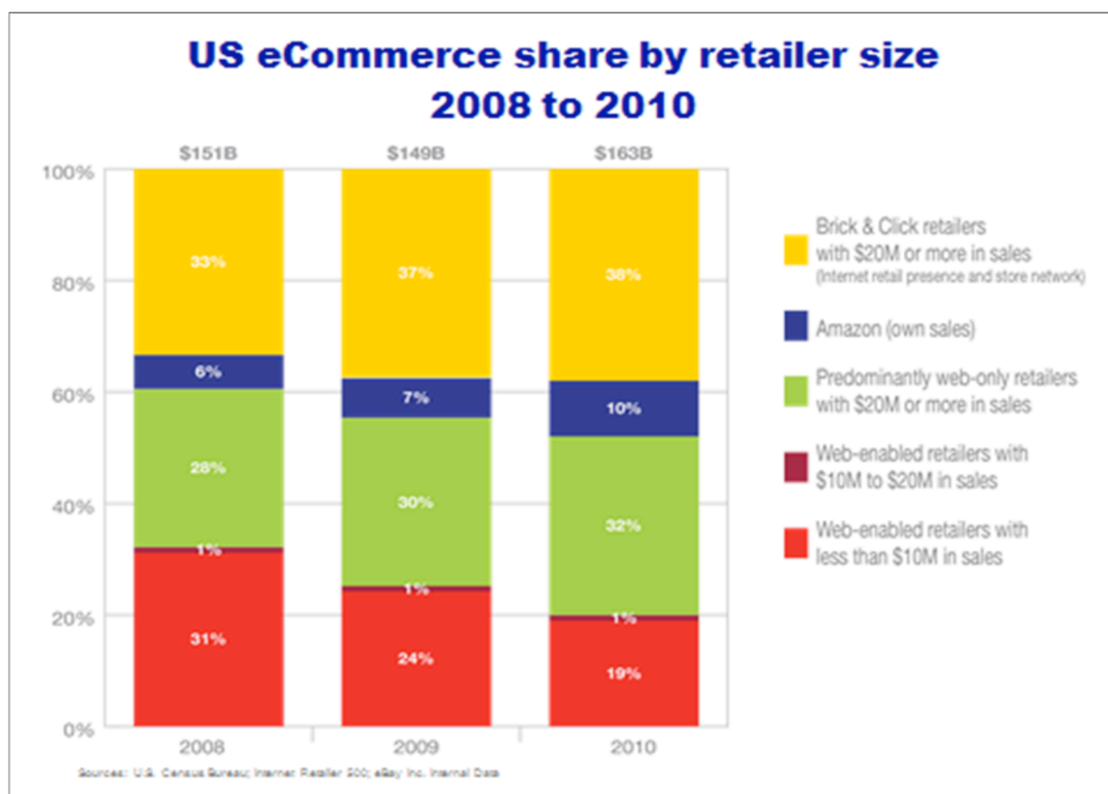
> I am not mentioning this tax policy of the state as a criticism. The state has the right to treat in-state businesses in any legal manner. That is up to the State of Tennessee. However, it is important to note that small business retailers are generally not given the same tax-breaks. Small business retailers in every state, including Tennessee, are using the Internet today to sell to customers across the country. These are great small businesses that are creating jobs and adopting the latest technology. I am confident that every state, including Tennessee wants to

> promote that small business growth. At the same time, when those small business retailers sell to a consumer in their state, they collect sales taxes. They do not get a special break. The small business retailer, when using the Internet to compete for sales with customers who are far away, does not benefit from local facilities. They enter the fray without the benefit of stores, distribution centers and other local facilities that can help serve customers.

Cohen makes a good point because while small independent retailers are active online and doing their best to adapt technology, these tax breaks are putting them at an unfair advantage compared to large competitors who can afford to charge lower prices due to these breaks. In fact, they face competition from large retailers who are also adopting the full range of technologies because these large retailers often have national store or distribution networks as well as key services like in-store pick up, same day delivery, free or significantly lower-cost shipping, and in-store returns of items bought online. Consumers value those features, and as a result, large retailers are commanding more and more market share year over year (Chen). Taking the tax burden that comes with those local services and applying them to a remote small business will only further tip the playing field against the small business retailer.

Even though most large retailers have a bigger sales tax burden due to their physical presence, being big has benefits that have outweighed the tax cost. In fact, in the current landscape, large “Brick and Click” retailers and the largest online retailer Amazon have experienced healthy growth (Cohen). In contrast, Internet sales by retailers with less than $10 million in revenue are decreasing due to this crowding out effect (see chart below next paragraph). And not surprisingly, the large retailers who are now dominating the Internet are united in proposing a change in remote sales tax law that will harm the smaller retailers who do

not have national physical presence. Market share data helps cut through the rhetoric and illustrates that small business retailers face meaningful challenges today without a new tax burden being placed on them by the US Congress. In short, if small business retailers using the Internet were gaining unfair advantages from current remote sales tax laws, one would expect that their share of Internet sales would be growing. As he chart in the figure below illustrates, that is not the case (Cohen).



As the chart clearly displays, the idea that small business retailers on the Internet are a threat to the survival of small business storefronts is simply not true: The true threat is coming from giant multi-billion dollar competitors. To prevent this trend from crushing small business completely, the inclusion of a small business exemption in future Internet sales tax legislation is an absolute necessity.

Potential Impact of Compliance Costs

Although much of the focus of this thesis has been on lost revenues for states, there should be equal consideration given to the added compliance costs on small businesses. Focusing entirely on the “small seller” frames the argument as one of “how much revenue can the state forego.” Instead, the focus should be on “how much compliance costs can small businesses bear before withdrawing from interstate commerce.” Essentially, the enforcement system cannot become so burdensome that it forces small businesses to fail. We need to refocus this debate to balance the needs of states to collect these taxes with the ability of small businesses to cover these new compliance costs. States need to collect sales and use taxes owed, but the costs associated with moving this compliance burden onto small businesses must also be weighed.

Currently, some members of Congress want override that well-thought-out decision and allow states to force online retailers to collect sales taxes for each customer’s home state. A small online retailer in a modest warehouse – even the owner’s home – would have to deal with ever-changing sales tax rates across 9,600 state and local jurisdictions (Rugy).

Under those parameters, "Smaller operators are most likely to be hurt," says Bruce Clark, an associate professor of marketing at Northeastern University's College of Business Administration (Hindman). "Large organizations have the resources to comply with regulatory burdens, even if they don't like them." Yet Campbell stresses that collecting taxes isn't as burdensome as it might sound, even it removes some competitive advantage price-wise. "It's no more complicated than calculating shipping costs," Campbell says. "Sales tax management software is available at every price point, including free. So collecting sales tax can be easy and cheap for anyone, including sole proprietorships" (Hindman).

However, I believe the task may be far more complex than Campbell assumes. Contrary to Campbell's claim that the software would be easy to set up and free of cost, I would estimate significant costs of compliance. Sellers will need to review items sold in order to setup all of the different tax classes. This alone will take plenty of time and money to pay for the IT programmer and get the system just right. I doubt that the states will be willing reimburse the hundreds or thousands of dollars required to setup and maintain tax compliant websites.

Within states that have sales taxes, there are also a plethora of local option taxes, special exemptions for certain products and other rules that are constantly changing. According to a Vertex, Inc. study done in 2010, there were over 500 sales tax rate changes in each of the eight years between 2003 and 2008 (Rugy). That maintenance challenge may be far beyond the capability of many small online retailers and their limited staffing and sales tax management technology. A 2006 PricewaterhouseCoopers study found that sales tax compliance costs for small retailers (with less than $1 million in sales) equaled almost 17 cents of every dollar they collected for states (Rugy). Expanded tax collection obligations could increase that economic burden and discourage marketplace innovation and new entry. To remedy that, states have considered a "small seller" exemption, but exemptions that only cover companies below $1 million will not cover the extent of the problem. In my opinion, the same threats posed to interstate commerce that the Court found in the Quill ruling still exist today. The administrative and financial burdens that would be placed on small online retailers by these proposals would greatly hinder the ability of those businesses to compete against larger "brick & click" retailers and to create prosperity and jobs that benefit their local economies. To combat these burdens, these exemptions must be set higher to more appropriate levels.

Part III: Proposed Recommendations and Analysis

This final part of the thesis will examine various definitions of small business, particularly to help decide how to define an internet-based small business before proposing a rational solution. Although "small business owners" are often the subject of tax policy debate, a consensus does not exist regarding the specific attributes that distinguish small businesses from other firms. Current small business size standards rely on the number of employees, dollar volume of business, net worth, net income, sales turnover, market share, a combination thereof, or other appropriate factors ("What Is A Small Business"). The choice of a size measure for an industry depends on which measure best represents the magnitude of operations of a business. That is, the measure should indicate the level of real business activity generated by firms in an industry. While the 2012 remote SUT legislative proposals took small business owners into account with small business exceptions up to $1 million, those numbers are not nearly high enough, seem to be obtained completely arbitrarily, and are not sensitive to specific industries in my opinion.

Before deciding just how high to make exemptions though, this section examines how the government measures or defines a "small business". If we are trying to prevent real small businesses from being hurt by a change in the legislation regarding online sales tax, then the definition of a small business is an important one. However, the definition is much more complex than one might originally think. The legal definition of "small business" varies by country and industry but the most common definition for a U.S. small business is simply having less than 500 employees (Burke). The U.S. Census follows this method by tracking businesses with less than 500 employees. Meanwhile, the European Union generally defines a small business as one that has fewer than 50 employees and in Australia a small business is defined as

having less than 15 employees. While one might assume that the overlord of tax collection, the IRS, would have a definition for small business, a report published in August 2011 by the U.S. Office of Tax Analysis confirms differently (Burke):

> Although "small business owners" are often the subject of tax policy debate, a consensus does not exist regarding the specific attributes that distinguish small businesses from other firms. Previously, the Office of Tax Analysis had counted a small business owner as any individual who receives flow-through income from a sole proprietorship, partnership, S corporation, farming operation or miscellaneous rental activity. This overly broad definition was used because, for the majority of flow-through business income (partnerships and S corporations), it was not possible to trace income from the business entity to the respective owner(s). Due to newly accessible tax data, this technical constraint has been overcome.

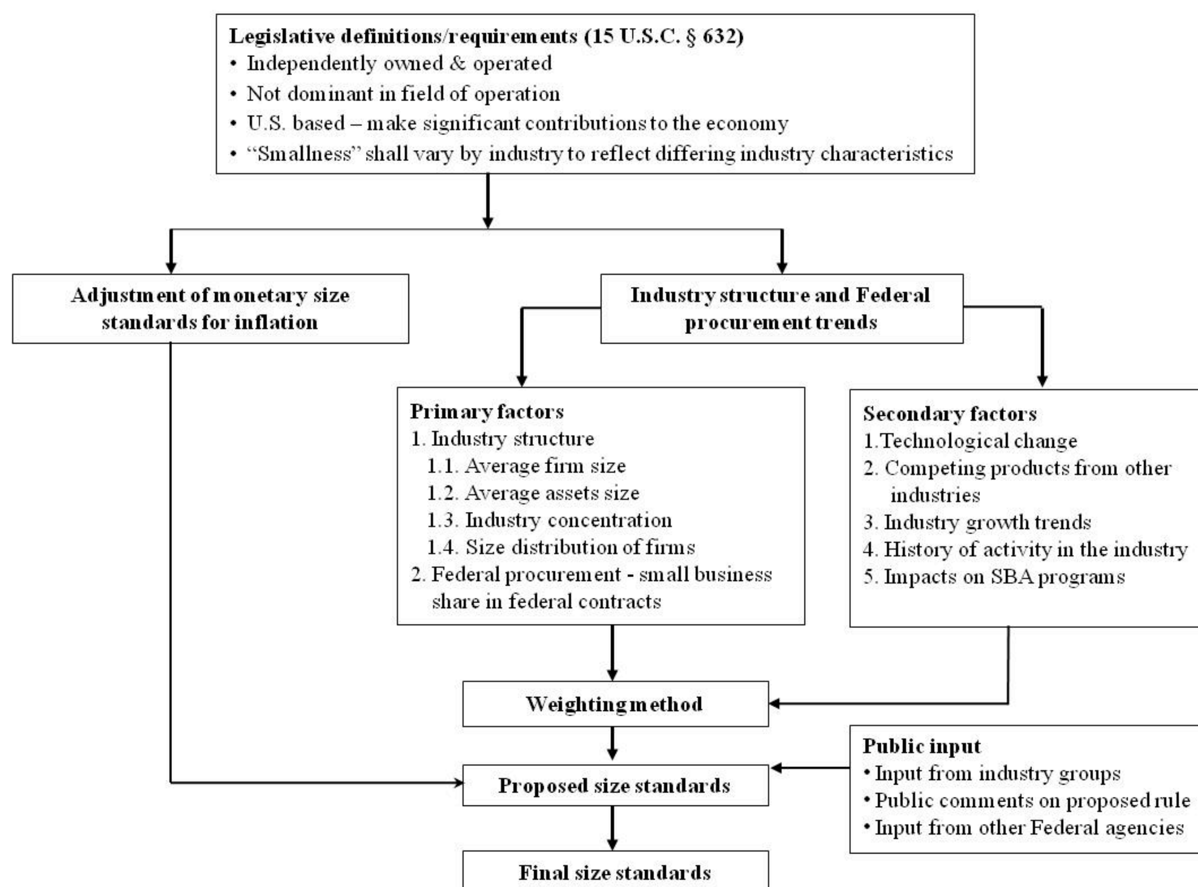
If the IRS does not define small business and most other definitions tend to vary by user, where should we turn to help determine the appropriate size standard for an online small business?

After doing all of my research and thinking critically about a solution, I would propose delegating the authority to create small e-commerce business size standards to the Small Business Administration (SBA). The U.S. Small Business Administration was created in 1953 as an independent agency of the federal government to aid, counsel, assist and protect the interests of small business concerns, to preserve free competitive enterprise and to maintain and strengthen the overall economy of our nation (“What Is A Small Business”). Given their vast resources, close relationship with U.S. Congress, unmatched experience with small business,

office locations in each U.S. state, and unique perspective on the pulse of the U.S. economy, I can think of no better methodology or organization to help define size standards and propose a level for small business exemption. Similar to the widely accepted principles mentioned before, the SBA defines a small business concern as "one that is independently owned and operated, is organized for profit, and is not dominant in its field" ("What is a Small Business").

Perhaps the primary reason I would fully support using the SBA as the backbone for setting an appropriate small business exemption for SUT is because of their rigorous methodology for establishing size standards and vast experience within different industries. In analyzing size standards for other industries, the SBA has highlighted two important considerations (United States, SBA). First, size standards should vary to account for differences among industries. Second, the size standards and policies of the Agency should assist small businesses as a means of encouraging their strength in the economy. SBA size standards methodology examines the structural characteristics of an industry as a way to assess industry differences and the overall degree of competitiveness of an industry and of firms within the industry. Industry structure is typically examined by analyzing five primary factors – average firm size, degree of competition within an industry, start up costs and entry barriers, distribution of firms by size, and small business share in Federal contracts (United States, SBA). The SBA also considers other secondary factors as they are relevant to the industries and the interests of small businesses, including technological change, competition among industries, industry growth trends, and impacts on SBA programs. The full overview of the SBA's Size Standard Methodology can be seen in the chart below:

Figure 1. Overview of SBA's Size Standard Methodology



Furthermore, SBA conducts a statistical analysis of data on the primary factors, and secondary factors as appropriate, to establish a size standard for a specific industry (United States, SBA). Depending on the industry, the SBA's size standards for brick-and-mortar businesses are usually stated either in number of employees over the past 12 months, or average annual receipts over the past three years – whichever is larger (For a breakdown of employee vs. receipt factors, see Appendix Figure #5) The SBA generally prefers receipts as a size measure because it measures the value of output of a business and can be easily verified by business tax returns and financial records (United States, SBA). Additionally, employee thresholds have historically incentivized businesses to hire fewer employees, which is the opposite of what the SBA is trying

to achieve. Nevertheless, these size standards define the maximum size that a firm (including affiliates) can be to qualify as a small business for most SBA programs. Based on those criteria, the SBA has established the following common "anchor value" standards for a small business, depending on the North American Industry Classification System (NAICS) code (United States, SBA):

- 500 employees for most manufacturing and mining industries, and
- $7 million in average annual receipts for most non-manufacturing industries
- 100 employees for Wholesale Trade industries

There are many exceptions, but these are the primary size standards for most industries (for a complete sector breakdown, please see Appendix figure #4). Regardless, every sector listed by the SBA has a size limit much greater than the $500,000 - $1,000,000 mark currently being looked at by policymakers. Given the depth of this factors and the cross-functional analysis, I am confident the SBA could determine an accurate measure for the size of a small business exemption in regards to remote seller taxation.

In order to ensure that the established levels remain relevant, a key factor for legislation like small business exemption levels that are constantly changing, the SBA periodically increases receipts and other monetary based standards for inflation and outside factors (United States, SBA). Under current SBA regulations, an adjustment to size standards for inflation will be made at least once every 5 years. Given the level of the size standards and the rate of inflation, recent inflation adjustments have been made on more frequent intervals.

Although $7 million may seem reasonable given that most e-commerce retailers are non-manufacturing, it would not be sensible to assume this value could be used as a blanket approach for a small business exemption. As seen in the SBA's methodology above, further analysis of external primary and secondary factors need to be completed on an industry-by-industry basis in

order to develop the most reasonable size standards. Any other shortcut method to reach a terminal value for the exemption would simply not be as comprehensive or effective.

The current small seller exemption in the legislation being considered today is not only an arbitrary and blanket approach that is significantly below estimated Small Business Administration levels, but it is also well below the levels of just about every other government entity that attempts to define small business (French). Regardless of how it is precisely defined in the end, small business retailers should be exempt from expanded sales tax burdens in order to give them the best opportunity to grow into large retail businesses. In order to protect the relevance of retail small businesses and emerging online businesses, we need to provide them relief from national-level tax collection and other such measures that may compromise their growth and hurt their economic contribution. The best way to do this is through a small business exemption defined by the size standards set by the SBA.

Conclusion

In this paper, I have examined the role of small business in respect to Internet sales tax, looking specifically at the impact of a potential small business exemption. The results suggest several things. One, because of the rapidly increasing size of e-commerce relative to retail and because of the substantial impact remote sales are having on state budgets, the aggressive enforcement of taxes on e-commerce through federal legislation is all but a certainty within the next few years. Two, large retailers have continued to extend their dominance in e-commerce and the best way to protect the fairness and importance of smaller retailers is through the inclusion of a small-business exemption. Third, although the costs of complying with taxes on e-commerce are unlikely to be exceedingly large for most online transactions, there is still suggestive evidence of spillovers and of information problems that should be considered burdensome costs to smaller retailers. Fourth, the level of small business exemption should be set according to the SBA's definition of a small business (hence, based on gross income) and be reviewed independently as needed. Hopefully, results such those in this paper will encourage advocates and policy makers on both sides to give more empirical thought to the tax issues raised by the Internet.

Appendix

#1

Estimated Uncollected Use tax from all Remote Sales in 2012 (NCSL)

	Non-Electronic Business to Customer	Non-electronic Business to Business	Electronic Business to Business and Business to Customer	Total
Alabama	101,657,313	75,677,086	170,400,000	347,734,399
Alaska	880,149	655,832	1,500,000	3,035,981
Arizona	220,741,594	118,086,660	369,800,000	708,628,254
Arkansas	67,947,572	54,464,358	113,900,000	236,311,930
California	1,136,801,607	1,118,366,340	1,904,500,000	4,159,667,947
Colorado	103,065,552	76,798,022	172,700,000	352,563,574
Connecticut	38,022,475	50,544,930	63,800,000	152,367,405
District of Columbia	21,211,612	15,805,570	35,500,000	72,517,182
Florida	479,769,709	200,120,301	803,800,000	1,483,690,010
Georgia	244,857,701	182,452,688	410,300,000	837,610,389
Hawaii	35,822,100	26,692,395	60,000,000	122,514,495
Idaho	27,636,706	29,083,776	46,400,000	103,120,482
Illinois	302,507,519	249,542,069	506,800,000	1,058,849,588
Indiana	116,619,861	86,897,847	195,300,000	398,817,708
Iowa	52,897,008	39,415,552	88,700,000	181,012,560
Kansas	85,286,525	51,037,503	142,900,000	279,224,028
Kentucky	65,659,182	48,925,127	109,900,000	224,484,309
Louisiana	236,320,247	176,091,110	395,900,000	808,311,357
Maine	19,099,252	14,231,572	32,100,000	65,430,824
Maryland	109,930,722	81,913,518	184,100,000	375,944,240
Massachusetts	78,333,340	58,369,120	131,300,000	268,002,460
Michigan	84,494,390	62,959,949	141,500,000	288,954,339
Minnesota	140,471,923	79,447,327	235,300,000	455,219,250
Mississippi	80,533,715	87,852,645	134,900,000	303,286,360
Missouri	125,773,420	93,718,508	210,700,000	430,191,928
Nebraska	36,614,235	20,137,833	61,300,000	118,052,068

	Non-Electronic Business to Customer	Non-electronic Business to Business	Electronic Business to Business and Business to Customer	Total
Nevada	100,865,178	75,158,440	168,900,000	344,923,618
New Jersey	120,844,580	90,045,845	202,500,000	413,390,425
New Mexico	71,908,246	53,581,540	120,500,000	245,989,786
New York	516,559,974	384,908,277	865,500,000	1,766,968,251
North Carolina	127,621,735	95,095,757	213,800,000	436,517,492
North Dakota	9,153,558	6,820,661	15,300,000	31,274,219
Ohio	183,775,298	136,937,891	307,900,000	628,613,189
Oklahoma	84,054,315	71,494,343	140,800,000	296,348,658
Pennsylvania	206,483,165	153,858,377	345,900,000	706,241,542
Rhode Island	17,338,952	24,097,506	29,000,000	70,436,458
South Carolina	74,372,666	55,417,872	124,500,000	254,290,538
South Dakota	17,779,027	13,247,822	29,800,000	60,826,849
Tennessee	245,209,761	92,471,128	410,800,000	748,480,889
Texas	519,552,484	387,138,109	870,400,000	1,777,090,593
Utah	52,808,993	39,349,968	88,500,000	180,658,961
Vermont	14,962,548	4,696,781	25,100,000	44,759,329
Virginia	123,573,045	92,078,926	207,000,000	422,651,971
Washington	168,284,660	90,784,044	281,900,000	540,968,704
West Virginia	30,189,141	22,495,065	50,600,000	103,284,206
Wisconsin	84,846,450	62,059,664	142,100,000	289,006,114
Wyoming	17,074,908	16,069,797	28,600,000	61,744,705
Total	**6,800,214,113**	**5,067,095,451**	**11,392,700,000**	**23,260,009,564**

#2

States that choose the alternative simplification option under the Marketplace Fairness Act must agree to:

1. Notify retailers in advance of any rate changes within the state
2. Designate a single state organization to handle sales tax registrations, filings, and audits
3. Establish a uniform sales tax base for use throughout the state

4. Use destination sourcing to determine sales tax rates for out-of-state purchases (a purchase made by a consumer in California from a retailer in Ohio is taxed at the California rate, and the sales tax collected is remitted to California to fund projects and services there)
5. Provide software and/or services for managing sales tax compliance, and hold retailers harmless for any errors that result from relying on state-provided systems and data

#3

<u>H.R. 2701/S. 1452, Main Street Fairness Act</u>

Sponsors: Rep. John Conyers (D-MI-14)/Sen. Richard Durbin (D-IL)

- ➢ Grants consent of Congress to the Streamlined Sales & Use Tax Agreement, the multistate agreement on SUT collection and administration adopted on 11/12/02; authorizes each state that is a party to Agreement (member state), after 10 states (comprising at least 20% of the total population of all states imposing a sales tax) have petitioned for and have become member states, to require all remote sellers not qualifying for the small seller exception to collect and remit SUT on remote sales owed to each such member state under the terms of the Agreement. Sets forth minimum requirements for simplifying the administration of multistate sales and use taxation under the Agreement; provides for judicial review of civil action challenging the constitutionality of this Act by a panel of three judges of a U.S. District Court.

Status: H.R. 2701 introduced 7/25/11 and referred on 8/25/11 to the House Committee on the Judiciary Subcommittee on Courts, Commercial and Administrative Law. S. 1452 introduced on 7/29/11 and referred to the Senate Finance Committee.

H.R. 3179, Marketplace Equity Act

Sponsors: Rep. Steve Womack (R-AR-3)

- Authorizes states to require all sellers making remote sales to collect and remit sales and use taxes with respect to such sales into the state, without regard to the location of the seller, if such states implement a simplified system for administration of sales and use tax collection for remote sellers. Requires such a system to include, at a minimum: (1) **an exception for remote sellers with gross annual receipts in the preceding calendar year from remote sales not exceeding $1-M in the U.S. or not exceeding $100,000 in the state**, (2) a single sales and use tax return for use by remote sellers and a single revenue authority within the state with which remote sellers are required to file a tax return, and (3) a uniform tax base throughout the state. Defines "remote sale" as a sale of goods or services attributed to a state with respect to which a seller does not have adequate physical presence to establish a nexus so as to allow such state to require such seller to collect and remit taxes.

Status: H.R. 3179 introduced 10/24/11, referred to the House Committee on the Judiciary Subcommittee on Courts, Commercial and Administrative Law

S. 1832, Marketplace Fairness Act

Sponsors: Sen. Mike Enzi (R-WY)

- Gives states the right to decide to collect (or not) taxes that owed; closes tax loophole and provides states with the clear authority to require all retailers to collect sales taxes; does not create a new tax; releases consumers from tax remittance obligations; **exempts**

businesses with less than $500,000 in online or out-of-state sales from collection – requirements which will protect small merchants and give new businesses time to get started.

Status: Introduced 11/9/11, referred to the Senate Finance Committee.

#4

Size Standards for principal NAICS Sectors

Construction

- General building and heavy construction contractors: $33.5 million
- Special trade construction contractors: $14 million
- Land subdivision: $7 million
- Dredging: $20 million

Manufacturing

- About 75 percent of the manufacturing industries: 500 employees
- A small number of industries: 1,500 employees
- The balance: either 750 or 1,000 employees

Mining

- All mining industries, except mining services: 500 employees

Retail Trade

- Most retail trade industries: $7 million
- A few (such as grocery stores, department stores, motor vehicle dealers and electrical appliance dealers) have higher size standards, but none above $35.5 million (or 200 employees for New Car Dealers only).

- Retail Trade NAICS codes and their size standards do not apply to Federal procurement of supplies. For Federal contracts set aside for small businesses a concern that supplies a product it did not manufacture (which is what a retailer would do) is a "non-manufacturer." To qualify as small for Federal government contracting, a non-manufacturer must: 1) have 500 or fewer employees; 2) be primarily in the wholesale or retail trade and normally sell the type of the item9s) being supplied; 3) take ownership or possession of the item(s) with its personnel, equipment or facilities in a manner consistent with industry practice; and 4) supply the end item of a United States small business manufacturer, processor or producer or obtain a waiver of such requirement pursuant to SBA's regulations. This is called the "non-manufacturer rule." This rule does not apply to supply contracts of $25,000 or less that are processed under Simplified Acquisition Procedures.
- For SBA's financial assistance and other Federal programs the Retail Trade size standards apply.

Services

- Most common: $7 million
- Computer programming, data processing and systems design: $25.5 million
- Engineering and architectural services and a few other industries have different size standards
- The highest annual-receipts size standard in any service industry: $35.5 million

Wholesale Trade

- For loans and all other Federal government programs: 100 employees is the size standard for all wholesale trade industries.

- However, for Federal contracts set aside for small businesses a concern that supplies a product it did not manufacture is a "non-manufacturer." To qualify as small for Federal government contracting, a non-manufacturer must: 1) have 500 or fewer employees; 2) be primarily in the wholesale or retail trade and normally sell the type of item being supplied; 3) take ownership or possession of the item(s) with its personnel, equipment or facilities in a manner consistent with industry practice; and 4) supply the end item of a United States small business manufacturer, processor or producer or obtain a waiver of such requirement pursuant to SBA's regulations. This is called the "non-manufacturer rule." This rule does not apply to supply contracts of $25,000 or less that are processed under Simplified Acquisition Procedures.

Other NAICS Sectors and Industries

- Other NAICS Sectors include Agriculture; Transportation and Warehousing; Information (such as telecommunications); Utilities; and Finance, Insurance and Real Estate.

Because of a wide variation in the structure of industries in these Sectors, there is no common size standard pattern.

#5

Table 1
Industry Factors Supporting Employee vs. Receipts Based Size Measure

Industry factor	No. of employee	Receipts	Comment
Highly capital intensive	X		Employment levels vary with level of production while value of output substantially derived from fixed assets.
Low operational costs relative to receipts	X		Large receipts amounts generated with low labor inputs.
Variation of firms within industry by stage of production or degree of vertical integration	X		Firm's value added contribution to final value varies depending on structure of firm. Employment is more strongly correlated to value added than receipts.
Horizontally structured firms	X		Varying receipts to employee relationships among firms.
Highly labor intensive		X	Value of output varies with employment level and more easily verified.
Ease of factor substitution		X	Same value of output can be achieved by varying levels of labor and capital inputs.
Presence of subcontracting		X	Same value of output is achieved with differing levels of outsourcing.
High proportion of part-time or seasonal employment		X	Same level of output is achieved with differing employment practices.
Operation in multiple industries		X	Receipts is a more homogenous measure than employment.

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