

MEMORANDUM

TO: The Finance Department of the City of Champaign

FROM: Xuezhu Zhao (Gillian), Undergraduate student in Urban Planning

DATE: November 8, 2018

SUBJECT: Issuing an Internet Sales Tax at a City Level

To promote fair business activities and recover tax revenue loss from online retailers, a number of states have adopted the Internet Sales Tax on online purchases including those from out-of-state retailers. Illinois is one of them. It is the supreme court's recent decision on South Dakota v. Wayfair case that customers are required to pay sales tax remitting through businesses, whether the businesses are physically present in the taxing boundaries or not. However, looking at the city level, the sales tax on traditional brick and mortar retailers and online retailers are not equalized. This unequal taxing policy hinders the neutrality and equity of sales tax as well as decreases tax revenues for the city. Therefore, the City of Champaign should issue an Internet Sales Tax for businesses whose nexus (physical presence) cannot be traced to a given location in the city.

Brick and Mortar Retail is Challenged by Online Shopping

The current sales tax on stores whose nexus are in Champaign is 9% which is a combination of 6.25% to the State of Illinois, 1.25% to the Champaign County, and 1.5% to the city of Champaign. The Use Tax imposed on the customer's privilege of using the goods within the border of Illinois regardless of where the purchase occurred was recently replaced by a stricter Internet Sales Tax. This tax requires the company to collect and remit the use tax in budgeting bills. As a result, since Oct. 1, 2018, online retailers conducting business activities in any municipalities of Illinois have to collect 6.25% of the sales price as sales tax to the state. Yet the total taxes on goods purchased online is still lower than those on goods purchased in physical stores. This unintentionally favors online retailers over brick and mortar businesses, especially at this time when brick and mortar businesses are vulnerable to the more convenient e-commerce. With a lower tax burden, online retailers have advantages on setting 4-11% lower prices than brick and mortar retailers.¹

Existing studies and newspapers are predicting the future of brick and mortar retail, emphasizing on the fact that major retailers have closed down more than 5,000 of their stores in 2017 due to the popularity of e-commerce.² More than 4,000 were added to this list in 2018. Looking closely at the city, major retailers are indeed leaving or have the possibilities of leaving Champaign, indicating a recessionary situation for North Prospect Regional Commercial Center (NPRCC) and a growth of the online retailing industry.

¹ Davis, C. (n.d.). Many Localities Are Unprepared to Collect Taxes on Online Purchases: Amazon.com and other E-Retailers Receive Tax Advantage Over Local Businesses – ITEP. Retrieved November 7, 2018, from <https://itep.org/many-localities-are-unprepared-to-collect-taxes-on-online-purchases-amazon-com-and-other-e-retailers-receive-tax-advantage-over-local-businesses/>

² Timmermann, M. (2018, August 29). These major retailers are closing stores in 2018. Retrieved September 11, 2018, from <https://clark.com/shopping-retail/major-retailers-closing-2018/>

- Toys R Us and Bergner's were the first big box retailers that closed their doors in 2018. Hurt by online shopping, their parent companies filed for bankruptcy and thus the stores had left NPRCC.
- Another two anchor stores remaining in the Market Place Shopping Center (the mall) in NPRCC, Macy's and J.C. Penny, have avoided their chains' chopping block this year. But whether they will stay or not in the near future is unpredictable, since their chains have continued to shrink.³
- Another major retail company, Sears, had already left the mall in 2013, but the company is aiming to shut down more stores.
- Smaller retailers like the Limited and Eddie Bauer had closed in 2017 as well.^{Error!}
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Aimed at maintaining the community's quality of life and regional destination for commerce according to Champaign Tomorrow Comprehensive Plan, Champaign should encourage physical stores for local businesses and residents. The sales tax policies of Champaign should at least not favor online businesses as it is right now.

The City has been Losing Tax Revenues to Fund its Services

The downturn of physical retail is bad news for the city, which decreases not only business activities but also tax generation. As tangible businesses are replaced by intangible e-commerce, both sales tax and property tax revenues are depressed. Employment opportunities also move away from the city, indirectly lowering income tax revenues. A Property Tax increase that was proposed in November 2018 for Champaign indicates a need for additional revenue to provide services.

The city has been losing sales tax revenue from e-commerce compared to physical businesses. The loss will continue if no action is taken because e-commerce shares a growing part of sales in the United States, according to FOXbusiness.com.⁴ E-commerce sales is 9.6% of total retail sales during the second quarter in 2018, reached \$127.3 billion and up 15.2% compared to the same period in 2017. Citing multiple estimates, Anthony Kennedy, a former Supreme Court Justice, noted his opinion in the South Dakota v. Wayfair case that it will cost states between \$8 billion and \$33 billion per year in tax revenue if sales taxes are not collected from e-commerce businesses.

For Champaign, sales tax revenues take up 35% of all revenues for governmental activities according to the Comprehensive Annual Financial Report 2016-2017 for the Year Ended June 30, 2017. It is the largest revenue source, followed by Property Tax and Income Tax. Champaign's noteworthy dependence on a single sales tax, especially one subject to cyclical economic changes, results in greater revenue volatility than more diversified revenue sources. Although the impact on Champaign is mitigated by the relatively stable local economy due to the

³ Peterson, H. (n.d.). JCPenney is closing 138 stores — see if your store is one of them. Retrieved September 11, 2018, from <https://www.businessinsider.com/jcpenney-stores-closing-2017-3>

⁴ Rocco, M. (2018, October 1). Online sales taxes take effect in these states [Text.Article]. Retrieved November 7, 2018, from <https://www.foxbusiness.com/retail/online-sales-taxes-take-effect-in-these-states>

presence of the main campus of the University of Illinois in Champaign, the city should be more alerted by the market changes and issue city-level internet sales tax in advance.

Champaign is also losing property tax from out-of-city businesses orders since they do not have a physical property in the city to be taxed on. Although the city need not provide services to the properties anymore, it could have collected these revenues if the property were physically present to fund public education, which property taxes are the major revenue source of.

Municipalities Do Not Benefit Directly from State-Level Internet Sales Tax

Not many cities have announced their progress in adopting a city-level Internet Sales Tax, but Mississippi Today reported their analysis on the impact of the state-level Internet Sales Tax / Use Tax on the municipal governments: “While Mississippi’s sales tax collections have remained static for the current fiscal year, use-tax revenue has skyrocketed.⁵” While this increase in the use-tax revenue, which has the same purpose as the recommended Internet Sales Tax, has helped the state with raising revenues, the 18.5% reimbursement back to the municipality where the transactions happened is not helpful for municipal governments with their budget needs. A larger diverted portion of the use-tax revenue to local governments for infrastructure needs is desired in this case. For the case of Illinois, the state keeps most for itself too, diverting only 20% to municipal governments.⁶ Municipalities lose out on home rule or business district sales taxes more than they get from the reimbursement from the State-Level Internet Sales Tax.

City-Level Internet Sales Tax Can Solve the Problems

In order to promote a vibrant community and make up for the loss of funding revenues, the city needs to take action. City-Level Internet Sales Tax collected directly by the city in addition to the 6.25% sales tax imposed by the state will help the city to overcome the challenges. It also makes sales tax a more equitable and neutral tax.

How Does It Work

Generally, sales taxes are the taxes collected by the businesses from the customers at the time of purchase and is used to pay the city that mandates the Sales Tax. On the city level right now, the sales taxes at a brick and mortar store is collected to the state of Illinois, the Champaign County, and the City of Champaign. The sales taxes on items purchased online is collected only to the state of Illinois. The proposed city-level internet sales tax is an additional tax on goods purchased from online retailers whose physical presence may or may not be located in the boundary of Champaign. Champaign will collect 1.25% of the sales price as the Internet Sales Tax for all transactions online from the businesses in addition to the 6.25% sales tax for the state. Additional special taxes for certain goods will apply to them as well.

⁵ Harrison, B. (2018, May 23). Cities see no benefit from rising Internet sales tax. Retrieved November 7, 2018, from <https://mississippitoday.org/2018/05/23/cities-see-no-benefit-from-rising-internet-sales-tax/>

⁶ Griffin, J. (n.d.). Your suburb’s take from new online sales tax? \$1.76 a person. Retrieved November 7, 2018, from <https://www.dailyherald.com/news/20180711/your-suburbs-take-from-new-online-sales-tax-176-a-person->

Making Sales Tax More of a Good Tax

City-Level Internet Sales Tax is an amendment to the existing sales tax that makes sales tax in general more equitable and neutral. Neutrality, or efficiency, in taxation requires that taxes minimize unintended influences on private economic decisions.⁷ What is to be avoided, or minimized, is a tax that causes taxpayers to adjust their behaviors in ways that shift the ultimate burden of tax to others or to avoid the tax entirely. If the proposed tax is not adopted, residents of Champaign will rather buy goods online than visit a physical store. Businesses are more likely to shift from offline to online operation given the gap in city and county sales tax. The current base of city-level sales tax is not neutral that the exclusion of e-commerce will result in unintended effects on economic decisions. This ultimately will discourage the activities of brick and mortar stores and encourage the popularity of e-commerce. A tax rate same as purchases in physical stores will offset the unintended effects. To further the principles of the Comprehensive Plan if needed, the city could use this tax as a tool to influence the private market by imposing a higher internet sales tax than normal sales tax. Yet this will shift the sales tax away from neutrality but will help the city guide economic developments.

Speaking of equity, the current sales tax which excludes internet goods largely favors towards people with smart devices and access to the internet. It makes a regressive tax even more regressive. They pay less in taxes on online purchases while receiving the same amount of services offered by the city compared to those who do not shop online. People in similar financial conditions also do not pay equitably towards this tax. The proposed tax will help make sales tax more equitable that the platform the purchase is performed on will not result in different rates of sales tax at a city level.

Anticipated Oppositions

Lack of Precedent Instances

Although a number of states have recently issued state-level Internet Sales Tax, there is not yet a city found that has implemented a city-level Internet Sales Tax. Even for the states, most of the implementation are too new to generate any useful insights from.⁸ Critiques may argue that it will be too risky for Champaign to initiate the movement. They might agree with a less aggressive Use Tax but it is not as efficient as a Sales Tax.

Disfavoring Small E-Commerce Businesses

Online retailers will not favor this tax as it creates more work and fewer benefits. Big retailers like Amazon.com might be able to establish a system that is sophisticated enough to account for taxes for, starting with Champaign and more cities later on. However, smaller e-commerce businesses will not be able to overcome this challenge easily by themselves.⁹ As a matter of fact, a lot of the high-tech industries are operated online, creating benefits for the country and a large

⁷ Bell, Michael E. 2012. Real Property Tax, in The Oxford Handbook of State and Local Government Finance, Robert D. Ebel and John E. Peterson (eds). Oxford University Press: New York.

⁸ Rocco, M. (2018, October 1). Online sales taxes take effect in these states [Text.Article]. Retrieved November 7, 2018, from <https://www.foxbusiness.com/retail/online-sales-taxes-take-effect-in-these-states>

⁹ Peccarelli, B. (n.d.). Tech Companies About To Feel Full Weight Of Supreme Court Internet Sales Tax Decision. Retrieved November 8, 2018, from

amount of revenue that is beneficial to other kinds of taxes. Charging internet sales tax will discourage those beneficial businesses, yet tax exemptions could always be an option available.

Not Meeting Benefits-Received Principle of Taxation

People argue that Internet Sales Tax do not fit the benefit-received principle of taxation because the businesses whose presence is not in the government boundaries do not require services from the government. However, the businesses always shift the tax burden to the customers that the cities are providing the services for the customers rather than the businesses themselves. In this way, the physical location of businesses should not matter for the taxing purposes. As customers are the ones paying for the sales tax on businesses for the most cases, the school, police, and other services are serving the residents which are the customers. Therefore, they are receiving the benefits they paid for.

Recommendation

Based on research on the problems with current sales tax and benefits of a City-Level Internet Sales Tax, the implementation of this proposed tax with a rate consistent with the city sales tax rate will promote fair business activities and recover revenue loss. Right now is a good opportunity to establish this policy because a lot of states have just issued the State-Level Internet Sales Tax.