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What Small Businesses Need to Know About Internet Sales Tax

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When the Supreme Court decided in 2018 that states could collect sales tax on goods their residents purchased from out-of-state companies, many assumed the ruling applied mainly to large online retailers, like Amazon and eBay. In reality, the decision affects businesses of all sizes that sell tangible goods, digital products and even some services to customers in other states.

Small businesses that are noncompliant run the risk of paying hefty penalties and back taxes. Even worse, as a small-business owner, you could be personally liable for unpaid tax amounts.

So how did we get here? And what does the current legal environment mean for small businesses that sell online or across state borders?

A Brief Legal History Of Internet Sales Tax

Attitudes toward internet sales tax have changed as online business has increased. This shift can be seen in the outcomes of two major court cases.

In 1992, online sellers won an advantage when the Supreme Court decided in Quill Corp. v. North Dakota that a business needed to pay sales tax only in states where it had a physical presence, such as an office or an employee. This meant that an online business in Illinois would not charge sales tax to customers in Ohio or Michigan — provided the company did not have a physical presence in either state.

For years, Quill Corp. v. North Dakota set the precedent for online sellers. Then, came the South Dakota v. Wayfair, Inc. decision in 2018. In this case, the Supreme Court rejected the physical presence rule from the Quill decision and ushered in a new era of state sales tax regulation for internet businesses. On the basis of the Wayfair decision, online sellers are now required to collect sales tax in any state where they do business — regardless of their physical location.

State Sales Tax After South Dakota V. Wayfair, Inc.

With sales tax as a significant source of revenue, many states seized the opportunity to enforce or revise tax laws for out-of-state businesses. While some standards exist, the aftershock of the Wayfair case primarily left it up to states to set requirements. The resulting complex legal environment is particularly challenging for small-business owners who have to keep up with the laws in each state where they have customers.

The good news is that the Supreme Court did hint at its preference for laws that prevent discrimination against interstate commerce. In the Wayfair decision, it noted that South Dakota's law had protections for small businesses and did not apply the law retroactively. The state was also a member of the Streamlined Sales Tax Governing Board, an organization dedicated to creating tax standards. While the future is uncertain, small businesses should remain optimistic that forthcoming standards will include provisions to protect their interests and control compliance costs.

Online Retail Giants Are Ahead Of The Game

Marketplace facilitators like Amazon and eBay have built sophisticated processes to collect and remit state sales taxes. For instance, as Amazon expanded its fulfillment operations, the company was forced to remit sales taxes in more states. Sensing the shifting legal environment, most large internet businesses adjusted their tax strategy early, investing in the necessary technology and expertise to comply with state laws.

How does this help small businesses? Companies that sell on these platforms can benefit from the existing infrastructure, leveraging the larger company's technology and best practices to assist with compliance.

How Small Businesses Can Comply With State Sales Tax Laws

What should small-business owners do to make sure they aren't faced with an audit or hit with penalties for failing to remit state sales taxes? Follow these steps:

1. Know the rules. The first step to compliance is understanding which state tax laws apply to your business and how to meet the requirements. Review out-of-state transactions to determine which state laws apply to you.

Some businesses may need to determine if what they are selling is subject to sales tax. Some states tax certain services, and given that many products are sold in digital formats, you may be required to collect taxes on virtual goods as well.

Keep in mind that some states exempt small businesses. For instance, in South Dakota, businesses with less than $100,000 in annual sales or fewer than 200 transactions in the state are not required to collect sales tax. Business owners can review the threshold for each state in the Remote Seller Guidelines provided by the Streamlined Sales Tax Governing Board.

2. Use technology to simplify reporting. In case of an audit, pristine records of sales tax transactions are a must. Unfortunately, because states have different tax rates and requirements for exemptions, keeping track of the taxes your small business needs to collect can quickly become a complex job. Consider if your business can utilize the system provided by a marketplace partner or if you need to invest in sales tax software.

3. When in doubt, consult a professional. Do you or your employees have the know-how to make sure you understand state laws and have adequate processes for reporting and documentation? If you're unsure, seek an accounting service or CPA with experience helping small businesses become compliant.

4. Stay alert. The future of internet sales tax is unclear. Small-business owners should expect change, particularly as individual states update their laws and new standards are proposed.

One thing is certain: The best way for small businesses to survive the new environment is to familiarize themselves with state laws and to invest early in ways to remain compliant while keeping costs down.

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