The Case for Consumer-Based Use Tax Enforcement

David Gamage  
*Indiana University Maurer School of Law, dgamage@indiana.edu*

Adam Thimmesch  
*University of Nebraska College of Law*

Darien Shanske  
*University of California, Davis*

Follow this and additional works at: [https://www.repository.law.indiana.edu/facpub](https://www.repository.law.indiana.edu/facpub)

Part of the Taxation-State and Local Commons, and the Tax Law Commons

**Recommended Citation**
Gamage, David; Thimmesch, Adam; and Shanske, Darien, "The Case for Consumer-Based Use Tax Enforcement" (2017). *Articles by Maurer Faculty*. 2640.  
[https://www.repository.law.indiana.edu/facpub/2640](https://www.repository.law.indiana.edu/facpub/2640)
The Case for Consumer-Based Use Tax Enforcement

by Adam Thimmesch, David Gamage, and Darien Shanske

The debates regarding use tax enforcement and the collection of “online sales tax” can sometimes seem stale. The revenue problems created by Quill\(^1\) and the failure of Congress to respond are well known. Notwithstanding these realities, though, there is still significant ground to be covered on the use tax question. The problems related to the collection and enforcement of consumption taxes in the modern world are not going away, and these problems will continue to raise difficulties for our tax systems and their enforcement.

This essay provides a fresh look at the use tax issue by taking a somewhat different approach. Most analyses of the use tax focus on the relationship between states and remote vendors, but that approach ignores a very significant party — the in-state consumer.\(^2\) Consumer compliance has been largely ignored in the literature because it has generally been assumed that consumers will never meaningfully self-report their use tax liabilities.\(^3\) But it is our view that this assumption may be partially in error and should not end the inquiry. Attention to in-state consumers’ use tax compliance is not only warranted, but may be critical for the future of consumption tax enforcement.

This essay is the first in a planned series that introduces several considerations supporting the view articulated above. Two sets of considerations will be discussed in this essay:

(1) economic and (2) rule of law considerations. Planned future essays will consider consumer-focused approaches from a psychological and compliance angle and will also provide specific reform suggestions that states can take to improve their use taxes.

The Use Tax Issue

The state use tax is relatively obscure among the general public but is likely known by readers of this publication, so its details will not be fully explored here. Nonetheless, some brief comments are helpful as we begin to think more broadly about the tax and its enforcement. To begin, discussions of the use tax often equate it to the tax owed on online purchases, but that is too narrow a characterization. The use tax is an integral part of the state system of consumption taxation, and the tax applies in a wide variety of situations.

In general, use tax is owed on any in-state consumption, and states allow credits against that tax for sales tax previously paid on the purchase of the consumed item. This system seeks to ensure that all in-state consumption (of taxable items) is subject to consumption tax regardless of where the purchase is made or whether tax is collected at the point of sale. In the days of National Bellas Hess\(^4\) and Quill, the tax often applied when consumers purchased items though catalogs. Today, online shopping often triggers the use tax, but the tax also applies in a number of other situations. The most common examples include the consumption of items purchased in a state with a lower sales-tax rate than the state of consumption and the consumption of items originally purchased tax free as business inputs or as inventory.\(^5\)

Reminding ourselves that use taxes are about more than collecting revenue on internet sales is important because it helps to counteract attempts to marginalize their importanc\(e\) in the design of states’ tax systems. Use taxes are absolutely critical to the functioning of a broad-based consumption tax, at least for any such tax that is structured similar to the subnational retail sales taxes we have now. Opponents of sales and use tax reform sometimes use terms like “internet sales tax” to create the impression that there is a revenue grab at play in efforts to increase sales and use tax compliance.\(^6\) But the use tax has always been about shoring up a leaky consumption tax, and that has become more critical in recent years with sales tax avoidance becoming much easier and states relying more heavily on consumption taxes.\(^7\)

What Is Being Done Today?

The traditional approach to use tax compliance has been to focus on getting vendors to collect taxes at the point of sale, and states have attempted a wide range of approaches in that vein. Some states have adopted statutes that attempt to fight entity isolation by attributing physical presences between related entities. Other states have adopted click-through nexus statutes that apply a Tyler Pipe-like\(^8\) attributional nexus regime to the digital world. A more recent approach is for states to impose information reporting obligations on noncollecting vendors, potentially making it more practical

---


\(5\) For more robust discussions of the use tax and its applications, see Jerome R. Hellerstein and Walter Hellerstein, State Taxation, ch. 16 (3d ed.); and Thimmesch, “Taxing Honesty,” supra note 2, at 155-60.

\(6\) Americans for Tax Reform, for example, has labeled the MFA a “huge internet sales tax.” See “The Marketplace Fairness Act: A Huge Internet Sales Tax,” Americans for Tax Reform (May 23, 2017). More generally, some third-party organizations funded by and acting on behalf of some e-commerce retailers have campaigned against efforts to improve sales and use tax compliance and in doing so have promoted and exacerbated the misconception that some purchases are tax-exempt solely because those purchases were made on the internet.


for those vendors to just collect the tax. States have also pushed for federal legislation like the Marketplace Fairness Act (MFA). 9

Notwithstanding this focus on vendor-centric approaches, states have not completely ignored consumers’ individual reporting obligations. Many states have included a line to report use tax on their income tax returns. 10 Some states make it even simpler for taxpayers to report use tax by providing tables that taxpayers can use to estimate their liabilities. 11 Other states have engaged in public education efforts. 12 Together, those approaches have had some effect, but none have generated substantial levels of compliance. For instance, one study showed that the percentage of consumers who self-report use tax is less than 2 percent. 13 Based on that figure, it is clear why states have focused their attention on vendors.

The difficulties and inefficiencies of getting consumers to pay use tax of their own accord are not lost on us. Nevertheless, there are compelling reasons for states to try. These reasons include economic efficiency, concerns regarding the rule of law, and the impact of states’ efforts on tax compliance more generally. The first two of these reasons are discussed below, with a discussion of compliance saved for a follow-up essay.

The Economic Case for Consumer-Focused Use Tax Enforcement

It is clear why states have focused their use tax enforcement efforts on vendors — simple administrative efficiency. Collecting tax from vendors is much easier than doing so from their customers, one by one. Vendor-based collection approaches are not perfect, though, and they will leave significant uncollected revenue even if they are successful. Quite simply, states will never have completely unfettered power to require remote vendors to collect their taxes. Whether under their own statutes, the U.S. Constitution, or a federal statutory de minimis rule like that in the MFA, 14 states will always rely to some extent on voluntary compliance by those who purchase goods from “smaller” online retailers or other retailers that the state cannot reach.

It might seem like few retailers would fall into those categories, but that is not necessarily the case. To begin, “small” retailers do a significant amount of commerce in the aggregate. One study estimated that online commerce by retailers that fall within the MFA’s small seller exception represents over 40 percent of total annual online sales. 15 Further, many of the large vendors that make the remaining sales already collect sales tax in many states. The study’s authors thus estimated that if passed, the MFA, with its small seller exception, would reduce the use tax gap by less than 50 percent. 16 If those numbers are accurate, states will have to go further if they want to collect the taxes that are due. 17

One other significant impediment to achieving a high level of tax compliance through vendor-centric approaches is the simplicity of retailer substitution by consumers. To the extent that consumers can shift their consumption to protected vendors, states’ revenue gains from expansions of their enforcement power will be reduced. Unfortunately for states, research suggests this

---

9 That legislation would expand state authority, but not completely. The current bill contains a de minimis rule that would protect vendors with revenues of $1 million or less from remote sales in the preceding calendar year. Marketplace Fairness Act, S. 976, section 2(c) (2017). For prior discussion of federal legislative approaches to the e-commerce sales and use tax problem, see Andrew J. Haile, Gamage, and Shanske, “A Potential Game Changer in E-Commerce Taxation,” State Tax Notes, Mar. 11, 2013, p. 747.
10 Id.
12 Id. at 1113-1114.
14 See supra note 6.
16 Id. at 40.
17 Consider, too, the impact of increasing the small seller exception, something that might be a natural bargaining chip by members of Congress looking to obtain additional votes on a bill. Using the additional authority granted under federal legislation would also require that states conform to any required simplification provisions. See Thimmesch, “Taxing Honesty,” supra note 2, at 164 (discussing the MFA’s simplification requirements). States unwilling to do so will be required to pursue other avenues.
is already occurring. People who want to avoid paying tax on their online purchases are still shopping on Amazon.com; they are just buying from the small vendors that use the platform instead of from Amazon itself. Avoiding use tax often requires only one mouse click.

At the end of the day, the reality is that states should not be optimistic that the MFA, or similar legislation, will completely close the current use tax gap. Any legislative approach that contains a small seller exception will likely leave significant revenue beyond states’ reach, and consumer demand will flow to those protected zones. States will therefore always have an economic interest in taking consumer-centric enforcement activities if they want to rely on consumption taxation to a substantial degree.

Moreover, the challenge posed by consumer compliance extends beyond state-level sales and use taxes. Even structurally superior consumption taxes, namely credit-invoice VATs, have increasing problems with compliance in connection with e-commerce. In that context, the OECD tells a familiar tale, noting that “private consumers have little incentive to declare and pay the tax due, at least in the absence of meaningful sanctions for failure to comply with such an obligation.” The OECD’s approach to that problem has been to focus on vendor collection and to promote changes that would make VAT registration and compliance simpler. Nevertheless, it recognizes the need for proportionality and that smaller vendors may need protection from burdensome compliance costs. Thus, the OECD approach would also benefit from a complementary strategy to improve consumer compliance.

Furthermore, individual-level compliance is not just an issue for consumption taxes. It is commonly noted that compliance with the personal income tax is also tied to third-party solutions, particularly withholding, but also information reporting regimes. If it is true that we are entering the “gig economy,” then reliance on these types of mechanisms might ultimately be undermined in much the same way that the online economy undermined vendor collection. One response to this threat would be to put more obligations on even very small businesses, just as we might require such businesses to collect the use tax. Therefore, even as to the income tax, it seems that we should at least explore how we might get the individual taxpayers themselves to take a more meaningful role in compliance.

The Rule of Law Case for Use Tax Enforcement

The economic case for use tax enforcement is relatively tangible — states need revenue, and creating an online tax-free zone creates unwelcome economic distortions. The rule of law case is perhaps less apparent, but also compelling. The classic modern analysis of the components of the rule of the law comes from Lon Fuller. He claims that legal rules must

---

20 OECD, supra note 19, at para 3.130.
21 Hellerstein, supra note 19, at 262–264; and OECD, supra note 19, at paras 3.135-151.
22 OECD, supra note 19, at paras 3.150–151.
23 See generally Leandra Lederman, “Reducing Information Gaps to Reduce the Tax Gap: When Is Information Reporting Warranted?” 78 Fordham L. Rev. 1733 (2010). It is worth noting here that problems with use tax enforcement are in many ways similar to the problems of enforcing income and payroll taxes in various sectors of the cash economy, with these problems giving rise to labels like “nanny taxes.” Just as labeling specific sales and use tax enforcement measures as “internet taxes” exacerbates the misconception that some purchases would otherwise be legally free of tax because they were made on the internet, labels like “nanny taxes” reflect confusion and misunderstanding about how income and payroll taxes apply in the context of payments for home care services. Like use taxes on e-commerce purchases, the payroll and income tax liabilities owed on payments for home care services have been notoriously difficult for tax agencies to enforce and collect due in part to ignorance and confusion about taxpayers’ legal obligations in this context.
24 To be clear, we are talking about the status of the use tax as a law that should be respected in the first instance rather than potential arguments about the distribution of the use tax burden or of the inclusion of specific items in the tax base (e.g., the application of consumption tax to food or medication). Lon L. Fuller, The Morality of Law, 81–91 Yale University Press 2d ed. (1969). See also John Rawls, A Theory of Justice, 238–239 Belknap Press (1971); and Joseph Raz, “The Rule of Law and Its Virtue,” The Authority of Law 210, 218 Oxford University Press (1979).
meet eight conditions before they can be respected as law: They must be (1) generally applicable, (2) publicly available, (3) generally prospective in application, (4) understandable, (5) free of contradictions, (6) structured so that compliance is possible, (7) stable, and (8) administered consistent with their wording.\footnote{25}{Fuller, The Morality of Law, Yale University Press 1st ed. (1964).}

Running through these eight features is the theme that there must be a reciprocal relationship between the governing and the governed.\footnote{26}{We will focus on the psychology of taxpayer compliance in our next piece, though clearly there is a relationship between a reciprocal relationship and whether there is compliance. In other words, our argument is not reliant on whether the positive law here is consistent with some higher law. (Our position on whether there is a higher law is complicated.)\footnote{27}{Fuller, supra note 25, at 81.}} Acting in a manner that advances these eight features of a legal regime constitutes, for Fuller, the inner morality of law. Fuller is at pains to argue — and so are we — that this inner morality is not to be understood as a set of independent commandments as to what one should or should not do.\footnote{27}{Id.}\footnote{28}{See Leigh Osofsky, “Concentrated Enforcement,” 16 Fla. Tax Rev. 325, 333–338 (2014) (discussing the use of worst-first enforcement strategies).} Rather, these eight features indicate whether a legal regime is functioning well on its own terms. The current misfirings of the use tax illustrate Fuller’s point nicely.

To understand why, consider Fuller’s eighth requirement of a legal system: that there be congruence “between the law as declared and as actually administered.”\footnote{28}{Id.} State use tax laws are necessarily broad so that the use tax can serve as an effective backstop to the sales tax, but these laws are not regularly enforced against individual taxpayers. That creates an incongruity between the law as written and as enforced.

Of course, governments cannot perfectly enforce every law. Governments often have resource constraints that require them to focus on the biggest offenders or offenses.\footnote{29}{Fuller, supra note 25, at 81.} For example, the police are better served by dedicating efforts to prevent an assault than an incident of jaywalking. The nonpayment of use tax could easily be likened to the latter, and we have sometimes heard it discussed in that way. That account is understandable, but incomplete.

Unlike jaywalking or minor speeding, many states proclaim that enforcing use taxes is expected, and they signal that use taxes are every bit as important to them as income taxes. For example, many states have added use tax lines to their income tax returns,\footnote{30}{Id. at 170-171.} and their tax return instructions, websites, and other communications often discuss the necessity of reporting the tax.\footnote{31}{Id. at 171 n.117.} Some states’ voluntary disclosure programs also specifically reference use tax enforcement actions and individuals’ potential liabilities for taxes due in past years.\footnote{32}{See Fuller, supra note 24; and Michael Neumann, The Rule of Law: Politicizing Ethics, 56-57 Ashgate (2002).}

These state communications are certainly warranted, but they create rule of law concerns because they urge compliance even though states take relatively few use tax enforcement actions against individual taxpayers. That incongruity is troubling partially because it means the burden of the use tax is borne primarily by the uninformed and the honest. This is a clear violation of our reciprocal obligations to one another. Yet this incongruity is also troubling because it is reinforcing a mixed message at a very inopportune time. As already explained, it is becoming ever more, not less, important that online commerce not be perceived as a rule-free zone.

Fuller also argues that proper laws require only actions that can be done. There can hardly be a reciprocal relationship between the government and the governed if the government continues to request impossible actions.\footnote{33}{One important thing to keep in mind is that tax returns generally include a jurat that requires taxpayers to attest to the accuracy of the return under penalties of perjury. Perjury is, of course, a serious crime and often a felony. See Thimmesch, “Taxing Honesty,” supra note 2, at 172-173.}\footnote{33}{Id.} This is another issue for use tax compliance. How many people could accurately report their use taxes even if they wanted to?
Of course, compliance is technically possible for taxpayers who carefully track, examine, and recall every transaction. But the level of effort required to be able to attest that one is reporting correctly under penalties of perjury is unreasonably high, given the dollars at stake for many individual consumers. If states want to generate a climate where taxpayers take their tax obligations more seriously, the current situation is untenable.

Fuller maintains that when a government’s actions constitute a significant enough deviation from his eight criteria, then that action is hardly a law at all. State use tax laws have not fallen quite so far, but they clearly represent a troubling deviation from the ideal. This is easy to see if one simply imagines the state of affairs if all laws had the congruence and compliance issues of state use tax laws.

Where to Go From Here?

The economic and rule of law considerations discussed above suggest that states’ current focus on getting vendors to collect their use taxes is insufficient. That isn’t to say those efforts are in error, just that they are not enough. If states want a use tax that serves as an effective, lawful backstop to their sales taxes, then states must also focus on the consumer side of the equation and on how they administer their use taxes. We will explain what states might do to improve this situation in a future essay on this topic.

For now, though, it is worth emphasizing that our argument that states should focus more on consumer-level compliance efforts in no way implies that states should abandon vendor-level compliance efforts. Indeed, it is our view that consumer-level and vendor-level compliance efforts can mutually reinforce one another and that these two levels of effort work best in tandem.\textsuperscript{34}

\textsuperscript{34}This is partly because the current ignorance and confusion about use tax responsibilities on the part of many consumers creates a chicken-and-egg problem for state enforcement efforts. Greater consumer-level enforcement is a necessary part of getting consumers to understand their use tax obligations and to take these obligations more seriously. But state tax enforcement agencies are understandably reluctant to take more than limited enforcement actions against consumers within the current environment in which so many consumers commit use tax evasion out of confusion and ignorance rather than doing so purposefully. Consequently, enforcement measures aimed at improving the communications about sales and use tax responsibilities that consumers see from vendors at the time of purchase must be a key component of consumer-level enforcement efforts. Some e-commerce vendors have acted in ways that exacerbate consumers’ misconceptions about sales and use tax responsibilities. At a minimum, increased state-level regulation and enforcement actions are needed to combat these unhelpful actions by vendors.