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Ecommerce Sales Tax: Everything You Need to Stay Tax-Compliant



Before you became a business owner, you probably didn't realize how much time you'd spend on administrative minutiae. That includes collecting and remitting sales taxes for purchases made via your online store.

Unfortunately, the United States does not have a federal tax law. Hence, states are free to determine tax rates, payment frequency and the conditions determining whether or not a transaction is taxable.

As you can imagine, this creates an inordinately confusing process for business owners.

Tax rates, if they apply at all, hinge on several factors, including the location of the sale, the end user's location and the product or service sold. Since the first legitimate online transaction ever made — purportedly in August 1994, involving the sale of a Sting CD — legislators have had to play catchup to collect taxes on ecommerce purchases.

After all, sales tax was historically based on a business's physical presence in a tax jurisdiction, such as a warehouse, fulfillment center or physical store. However, the 2018 U.S. Supreme Court case South Dakota v. Wayfair decision determined that ecommerce businesses are required to file sales tax returns for transactions made in every state in which they meet certain thresholds for economic nexus (more on that later!), just like brick-and-mortar retailers.

Consequently, ecommerce businesses must stay up-to-date with sales tax laws in more than 12,000 tax jurisdictions in the U.S.

Here's a comprehensive guide on how sales taxes work, how to determine if you owe taxes and how to stay on top of your tax obligations.

How Does Ecommerce Sales Tax Work?

Sales tax is a small percentage of an item's sale price that the retailer adds on. Since sales tax is a "consumption tax" consumers only pay sales tax on taxable items they buy at retail.

Most tangible personal property (eg: furniture and clothing) is taxable. Forty-five U.S. states and Washington D.C. collect sales tax. In addition to a statewide sales tax, most states allow local jurisdictions such as cities, counties and other "special taxing districts" to collect local sales taxes.

Alaska, Delaware, Montana, New Hampshire and Oregon are the only states that do not charge a sales tax.

Steps to Stay Sales Tax Compliant

Small business owners must know the tax rules for each state where they do business to determine if they are liable for taxes based on economic nexus rules.

Ecommerce platforms have built-in automation to handle the most common sales tax calculations. You can also set up tax overrides to address unique tax laws and situations.

However, the software does not file and remit your taxes for you; you must still register your business with your local tax authority.

Here are some things you can do to ensure you remain tax-compliant while selling online:

Get familiar with economic nexus.

Regarding online sales, most states levy taxes based on the consumer's physical location, not the business's. In other words, if you do business in Pennsylvania, you must charge sales tax based

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on the tax rate in Pennsylvania, even if your business is located elsewhere.

This is known as “destination-based” sales tax sourcing, which most states use. Some states use “origin-based” sourcing, in which the business’s physical location determines the tax rate and other applicable rules.

However, sales taxes only apply when internet sales reach a certain threshold of transactions or economic value. “Economic nexus” defines these thresholds and other conditions that establish nexus, such as hiring a remote employee, hosting a tradeshow or establishing a dropshipping relationship in that state.

Here are types of nexus for online businesses:

Click-through nexus

States can tax a business that receives a significant number of referrals from other businesses in the state, even if they don’t have a substantial physical or economic presence there. Consequently, sales made through referral programs and affiliate links are taxable.

Note that the threshold for click-through nexus is typically much lower than for economic nexus. Most states have thresholds between $10k and $50k.

Affiliate nexus

Businesses establish a physical connection through in-state affiliates, employees, representatives and other entities.

For example, in Arizona, in-state affiliates establish nexus for an out-of-state business by cross-promoting and advertising the business, or by taking orders or accepting returns on behalf of the business.

Some states including Georgia establish affiliate nexus if an in-state entity provides assembly, delivery, or maintenance services for the remote vendor’s customers.

Understand the tax rules for each state.

States typically alter tax rules according to their revenue needs. For example, Virginia exempts gun safes valued at $1,500 or less from sales tax.

Not all states tax digital goods, such as apps, downloadable art and Software-as-a-Service (SaaS) products. Deadlines for filing taxes and registering for a sales tax permit differ by state, so it’s crucial to keep an eye on things.

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Consider investing in sales tax software.

Sales tax software automatically adds sales tax to your transactions. Software companies track taxes for each state and locality and automatically update the software when the rules change.

The software integrates with your ecommerce platform and website, so that product pricing includes applicable taxes.

Register for a sales tax permit.

Most states require businesses to register for a sales tax permit (also known as a seller's permit), which authorizes online sellers to collect sales taxes on purchases within that jurisdiction. Most states consider it illegal to collect sales tax without a permit because merchants may simply pocket the money.

Remember, you must register for a permit in every nexus state. In some states, remote sellers must obtain a sales tax permit when the economic nexus threshold is crossed (i.e. before the next sale). Other states, such as Colorado, allow more time (up to 90 days after economic nexus is established).

To register for a permit, visit your state's Department of Revenue website. Follow the steps to register your business. You'll need to provide your EIN and other business identifying information.

Collect sales tax.

Set up sales tax collection on your website or marketplaces where you do business. While the end user pays consumption taxes, retailers are responsible for collecting taxes.

Most ecommerce platforms, including BigCommerce, allow users to integrate tax software such as TaxJar into their online store, which automatically charges applicable taxes.

If an automatic tax provider cannot be reached, BigCommerce uses a default or "fallback" tax rate of 10%.

Report and file sales tax.

Sales taxes are due on a monthly, quarterly, semi-annual or annual basis. When you receive a sales tax permit, the state assigns you a tax filing frequency.

Bear in mind that every state has its own sales tax deadlines. When the due date arrives, you must report how much sales tax you've collected in each state to the state and local taxing authorities.

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Unfortunately, it's not as simple as adding up the total transactions in each state. States want to know how much sales tax you collected in each taxing jurisdiction, including cities, counties and special tax districts.

If you sell on multiple channels, you must integrate sales figures into one sales tax report for each applicable state.

Some tips for filing and reporting:

- **Set reminders**: Tax deadlines and payment frequency differ by state. Once a state assigns you a tax filing frequency, set calendar reminders to prevent filing late and incurring penalties. Hiring a tax professional or CPA can help to reduce complexity.
- **Separate sales tax from other receivables**: Don't spend sales tax along with company funds. Open a separate bank account to hold the sales tax you've collected so you won't jeopardize your cash flow.
- **Always file "zero returns":** Even if you didn't collect sales tax over the taxable period, always file a return by your due date. Some states levy penalties for failing to file a zero return.
- **Take advantage of discounts:** About half the states with a sales tax compensate retailers for collecting taxes. These states allow you to keep a very small percentage (1-2%) of the sales tax you collect from buyers.

State by State Ecommerce Sales Tax Breakdown

Whether you're in Alaska or California, New York or New Hampshire, each state has a specific tax breakdown and code to follow for your ecommerce store.

Most states have substantial sales thresholds for sales tax nexus. The most common is $100,000 in gross annual sales or 200 transactions in the last four quarters. Massachusetts, California, Texas and New York have a threshold of $500,000, so you may be exempt from collecting taxes in many states.

Meanwhile, states like Idaho, Iowa, North Dakota, and Tennessee require online sellers who make $100,000 in gross annual revenue to pay sales tax, regardless of the number of transactions.

Beware of states with lower or no thresholds: Economic nexus in Oklahoma kicks in at $10,000, while Kansas requires sales tax collection from the first sale.

Here are a few other less common state laws to make note of:

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New York:**To establish economic nexus, a business must make $500,000 per year in gross revenue and at least 100 separate transactions in the last four quarters. This exempts smaller businesses from remitting sales tax to the state. Clothing and footwear under $110 are exempt from New York City and New York State sales tax.

California:**California has the highest state sales tax at 7.25%; additional district taxes may apply. Effective April 26, 2019, California considered retailers who exceed $500,000 in taxable annual sales to have economic nexus. Digital products are tax-exempt in California.

Alabama: The threshold for economic nexus is $250,000. Alabama is a destination state, meaning that Alabama tax rates apply when a state resident purchases an item from an out-of-state seller.

Texas: Texas is an origin-based sales tax state. Consequently, sellers do not need to collect Texas sales tax on items shipped and delivered to out-of-state locations. However, if you sell items to customers in Texas from your place of business, you must collect state and local taxes based on your location.

Mississippi: Vendors who make more than $250,000 in sales in the prior 12 months must pay sales tax. Digital products are taxable.

Ecommerce Sales Tax Requirements by Products

Some states impose lower tax rates on specific commodities or exempt them altogether. For example, Illinois charges sales tax at a reduced rate of 1% on grocery items, while other products are taxed at 6.25% plus any local rates that apply.

States tax some services, but exemptions are common. Commodities like alcohol, motor fuel and tobacco are subject to selective sales tax.

Selective sales tax is a sales tax applied to “demerit goods” such as alcohol, motor fuel and tobacco, the consumption of which is considered unhealthy.

Sales Tax Exemptions

Most states consider survival items such as groceries, clothing and prescription medications non-taxable. States that don’t provide a complete exemption for these items often impose a lower tax rate.

For example, in New York state, clothing and footwear under $110 are considered non-taxable at the state level. Seven states including Alabama, Mississippi and South Dakota tax groceries at the full state sales tax rate.

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In general, tax exemptions are based on:

- The item being sold.
- The identity of the purchaser .
- The use to which the item will be put.

Wholesale exemptions.

Wholesalers can claim an exemption from sales-and-use tax on merchandise purchased for resale. Examples include businesses that sell fresh produce to restaurants or parts to a manufacturer. Each state has slightly different requirements for claiming the reseller exemption and a list of wholesale-exempt products.

The business you sell to must provide a resale certificate at the time of purchase so you can verify that they are a legitimate retailer.

Nonprofit exemptions.

Nonprofits such as charitable groups, or religious and educational organizations are exempt from income tax and sales tax. This includes churches, schools, civic groups, clubs, labor relations groups and agricultural organizations.

To qualify for tax-exempt status, nonprofits must:

- Submit an application for recognition with the IRS.
- File the appropriate paperwork to maintain exemption status.

Sales tax holidays.

Many states hold periodic sales tax holidays during which specific items are tax-free for a limited time. This is often around a theme, such as going Back to School or disaster preparedness.

For example, Alabama laws prevent the collection of sales tax from July 15-17 on clothing items under $100, computers under $750 and school supplies under $50. Hurricane-prone Florida exempts disaster preparedness items from sales from May 28-June 10. In 2022, Florida began exempting diapers and children's clothes from July 1-June 30.

Meanwhile, Massachusetts lifts sales tax requirements for all tangible personal property on August 13-14 each year.

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Ecommerce Sales Tax When Selling Overseas

Some U.S. states provide tax exemptions for overseas sales. Still, some destination countries will charge value-added tax (VAT) or goods and services tax (GST) for items when they enter as imports.

Those with revenue under AUD$75,000 in 12 months don't have to register to collect GST, while the qualifying threshold in New Zealand is $60,000. Sellers catering to customers in the EU must register for EU VAT upon reaching the annual threshold of £35,000 or the local currency equivalent. In Germany, the Netherlands, Luxembourg, and Northern Ireland the threshold is £70,000.

Sales tax rates in Asia range from 5-50%. Singapore levies a 7% GST, scheduled to increase to 9% before 2025. However, the registration threshold is SGD 1 million in annual sales (roughly US$729,000).

China's standard VAT rate is 13% for most goods and services, while some services regarding education, healthcare, travel and other daily lifestyle services are taxed at 6%. Hong Kong does not impose sales taxes.

The Final Word

Sales tax compliance requires business owners to navigate a minefield of rules, regulations and deadlines, which vary widely between jurisdictions.

Luckily, most ecommerce platforms include built-in features that automatically track tax rates and add the correct amount to the sale price.

However, even if you take advantage of this feature, it's still important to understand general tax rules, apply for a permit in applicable nexus states and remit your taxes before the deadlines.

FAQs About Ecommerce Sales Tax

What is the difference between sales tax and use tax?

Sales tax is a tax on the sale of goods and services, collected by the seller at the point of purchase and then remitted to the government. Use tax, on the other hand, applies to purchases made out of state for use within the buyer's state, where sales tax was not collected. It ensures that out-of-state purchases are taxed similarly to in-state purchases, maintaining tax fairness and revenue for the state. Both taxes aim to prevent tax evasion and ensure fair competition among businesses.

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What is origin and destination-based sales tax sourcing?

Origin-based tax sourcing refers to taxes based on the online retailer's home state, even if goods and services are provided to an out-of-state buyer. Conversely, destination-sourced sales are taxed at the location where the buyer takes possession of the item sold.

What are the consequences of not collecting sales tax?

Not collecting sales tax can result in significant legal and financial consequences. Businesses may face audits, penalties, interest on unpaid taxes, and potential back taxes owed to state and local governments. Failure to comply can also damage your reputation and lead to legal action, which can be costly and time-consuming. Additionally, non-compliance can disrupt business operations and result in lost customer trust. Ensuring proper sales tax collection and remittance is crucial to avoid these risks and maintain smooth, lawful operations.

What are the common mistakes businesses make with sales tax?

Common mistakes businesses make with sales tax include not correctly determining nexus, leading to incorrect tax collection across states. They often fail to keep up with changing tax laws and rates, resulting in compliance issues. Misclassifying products or services can also cause incorrect tax calculations. Additionally, many businesses neglect to maintain proper records and documentation, which is crucial for audits. Another frequent error is not applying for or renewing necessary sales tax permits. These mistakes can lead to penalties, fines, and legal complications, impacting a business's financial health and reputation.

What is a sales tax nexus?

"Nexus" establishes that a business has a significant connection to a particular taxing jurisdiction. This connection is established by making a certain amount of sales to customers located within that state, receiving referrals from entities in that state, and/or maintaining a physical presence through a warehouse, office or relationship with a supplier.

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