Alternative Approaches to Remote Sales Taxation : 10 Things States Can Do

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The Current Context

- We have just passed the 18th anniversary of the *Quill* decision : May 26, 1992
- We have recently passed the 10th anniversary of the Streamlined Sales Tax Project: March 2000
- With just 6 months left in the 111th Congress, a new version of the “Main Street Fairness Act”, H.R. 5660, has just been introduced.
- *Quill*'s “physical presence” threshold for use tax nexus remains the law of the land — despite the subsequent explosion of remote sales and vast improvements in technology that facilitate sales/use tax collection

The Status Quo Is Intolerable

- At a time when they are being forced to lay-off teachers, increase class sizes, cut critical health care services, eliminate summer school, close libraries, and sharply increase tuition, S/L govts are losing at least $8 billion in legally-due revenues annually

- Local merchants continue to start out with an unfair price disadvantage of 6%-10% vis-à-vis online competitors

- The sales tax is rendered even more regressive, since people with computers and credit cards buying online tax-free are disproportionately affluent

- De facto exemption encourages aggressive tax planning based on "entity isolation" strategies

Prospects for Federal Legislation

- Ultimately, federal legislation along lines of HR 5660 — empowering use tax collection by states in the Streamlined Agreement — would be the best, most comprehensive solution to the problem of untaxed remote sales
- Most segments of business community (except remote sellers) strongly support this legislation
- But the politics is inherently difficult; members of Congress know they will be (falsely) attacked for imposing a "new tax", and they can't even claim credit for reducing deficit or preserving services. Rise of "Tea Party" anti-tax sentiment makes politics even harder.

Status of Streamlined Agreement Is Further Obstacle to Federal Legislation

- Streamlined Agreement has been adopted in full by only 20 of 45 states with sales taxes; such large states as CA, FL, IL, NY, PA, TX not members. Gives Congress an additional excuse not to act.

- Some states not in because they disagree with commitment of Streamlined Agreement and federal legislation to provide some vendor compensation to all retailers, even those with physical presence nexus

- Some states fear legislation would become vehicle for new preemptions, e.g., BATSA, permanent ITFA

- Opposition of local government organizations to tying use tax collection authority to telecom tax simplification

Streamlined vs. Self-Help

- Do states continue to put all their eggs in the SSTP/federal legislation basket, or do they explore available avenues for chipping away at the problem of untaxed remote sales while awaiting the day when Congress decides to act?

- Some states have struck out on the latter course, and those efforts are justified.

- Some have argued that these actions give Congress an additional excuse not to act, but Congress has plenty of reasons already.

- Proponents could just as easily use these actions to light a fire under Congress and point out that the benefits of harmonization could be lost if Congress doesn't act.

Ten Self-Help Approaches to the Problem of Untaxed Remote Sales

- Addressing remaining entity isolation by “bricks & clicks”
- Expanded attributional nexus based on specific activities
- “Amazon law” — attributional nexus based on “affiliates”
- Expanded disclosure/info reporting — CO approach
- Taxing real drop shipments
- Taxing phony drop shipments
- Pursuing unitary approaches to use tax nexus
- Conditioning procurement on use tax compliance
- Facilitating more use tax compliance by households
- Requiring paid preparers to inform clients about use tax

A Key Tool: "Attributional" Nexus

- Two pre-*Quill* Supreme Court decisions make clear that "physical presence" requirement for nexus can be satisfied by in-state physical presence of third party working <u>on behalf</u> of the remote seller

- Both decisions cited in *Quill* as examples of *Quill*'s physical presence holding, with no noting of the fact that the physical presence was actually that of an independent third party

  - i.e., opponents of attributional nexus approach can't claim that *Quill* somehow intended to overrule these earlier decisions

Scripto vs *Florida* (1960)

- Held: in-state presence of independent (non-employee) door-to-door salesmen soliciting orders on behalf of a remote seller obligated the seller to charge use tax

- "True, the 'salesmen' are not regular employees of the [remote seller] devoting full time to its service, but . . . the formal shift in the contractual tagging of the salesman as 'independent' neither results in changing his local function of solicitation nor bears upon its effectiveness in securing a substantial flow of goods into Florida. . .To permit such formal 'contractual shifts' to make a constitutional difference would open the gates to a stampede of tax avoidance."

Tyler Pipe vs *Washington* (1987)

- Held: in-state presence of independent "manufacturer's rep" firm soliciting orders on behalf of a remote seller obligated the seller to pay WA's gross receipts tax
- "The crucial factor governing nexus is whether the activities performed in this state on behalf of the [out-of-state] taxpayer are significantly associated with the [out-of-state] taxpayer's ability to establish and maintain a market in this state for [its] sales."

Two Things These Decisions Don't Require

- Businesses often argue that since both cases involved in-state solicitation of sales, that's the only third-party activity that creates attributional nexus.

- But quote from *Tyler Pipe* suggests that much broader range of activities can be nexus-creating

- Businesses often argue that in-state person must be actual legal "agent" of remote seller (whose activities are specified in detail by seller and who can create binding contract between purchaser and seller)

- But nothing in either decision says that; "formal 'contractual shifts' reference in *Scripto* undermines

States Should Pursue "Attributional Nexus"

- Growing number of remote sellers have begun charging use tax in most or all states because they know they're engaging in more activities that make them vulnerable to the assertion of "attributional nexus."

- States should pursue the hold-outs:
  - Amend the nexus language in their sales/use tax statutes to state explicitly that these types of in-state activities conducted by third-parties create nexus
  - Offer a reasonable period to come into compliance, along with amnesty
  - Enforce these laws through audits and litigation if necessary

State Nexus Statutes: The Lay of the Land (1)

- Most states have some "attributional nexus" language in their definitions of a "retailer engaged in business in this state"
- But often limited to "solicitation" — not including other activities that arguably facilitate "creation and maintenance of market" — too restrictive
- Often limited to in-state "agents" — too restrictive
- States with more expansive language on attributional nexus in their statutes include AL, AR, CT, ID, IN, KS, KY, MN, OH, UT. (AZ and MI have done rulings.)

State Nexus Statutes: The Lay of the Land (2)

- Even in these statutes, some language is less than ideal; best models for attributional and affiliate nexus language are probably IN, ID, and KS
- One other thing to add is a catch-all provision that includes in the definition of "retailer engaged in business in this state" "any retailer who has any other contact with this state that would allow this state to require the retailer to collect and remit tax under the provisions of the Constitution and laws of the United States"
- Only ID, IN, KS, ME, MN, NY, OH, PA, VT, VA, and WA do this. (Again, some statutory language less than ideal.)

#1: Addressing the Hold-Outs Among "Bricks & Clicks" Retailers (1)

- Many retail store chains have commonly-owned Web operations — they're "Bricks & Clicks" retailers
- In past, most B&C's attempted "entity isolation" — separately incorporating physical and Web stores — and claimed former didn't create nexus for latter
- Most large B&C's (e.g., Target, WalMart) abandoned entity isolation because they started using stores in ways they knew likely created attributional nexus for Web site
- But there are still a few hold-outs (e.g., Sports Authority, Ritz Camera)

#1: Addressing the Hold-Outs Among "Bricks & Clicks" Retailers (2)

- State nexus laws should be amended to assert that the following activities are attributional nexus-creating for the Web site if conducted by affiliated physical stores:
  - Selling gift certificates that are redeemable on the Web site
  - Accepting returns of items ordered from the Web site
  - Operating any type of joint frequent-buyer or co-branded credit card program
  - Being able to pick up at store an item bought on Web site
  - Advertising the Web site in any way in the stores (register receipts, shopping bags, in-store posters, etc.)
  - Distributing discount coupons redeemable on the Web site
  - In-store kiosks that can be used to place order at Web site
  - Compiling customer lists that are rented to the Web site

#1: Addressing the Hold-Outs Among "Bricks & Clicks" Retailers (3)

- Rather than assert attributional nexus based on the conduct of specific activities on behalf of the website by the stores, some states (e.g., OK, CO) have amended their laws to assert that any remote seller with a related in-state retailer has nexus. Often limited to retailers selling similar goods under similar trade names

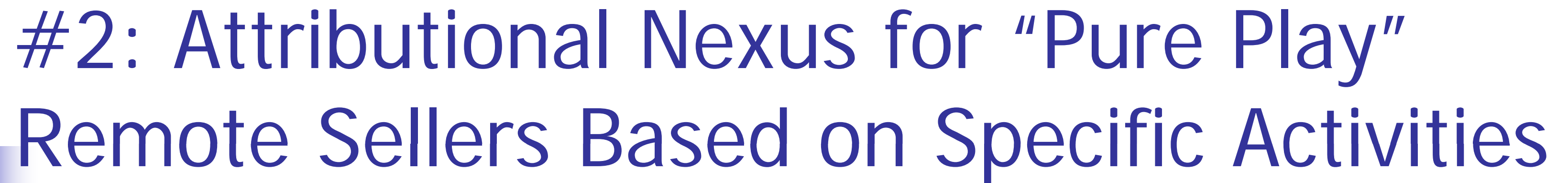
- Arguably on solid legal ground — any remote seller choosing to sell same items under same name is benefiting from all in-state marketing activities engaged in by affiliated stores

- But approach not yet tested in court

#1: Addressing the Hold-Outs Among "Bricks & Clicks" Retailers (4)

- States and localities have often given property tax abatements to many "big box" (e.g. WalMart) and "destination store" (e.g. Bass Pro Shops) retailers

- State laws should be changed to state that no such abatements will be granted to any retailer whose affiliated remote sellers fail to collect use tax on all sales into the state.



#2: Attributional Nexus for "Pure Play" Remote Sellers Based on Specific Activities

Amend nexus language in sales/use tax statute to assert as nexus-creating using independent third parties or related companies to:

- Perform at customer location: warranty repair, installation, assembly, maintenance, troubleshooting, or training employees in use of products sold by remote seller
- Engage in any activities on behalf of remote seller for which compensation is calculated as a percentage of sales

#3:New York's "Amazon Law"

- NY in 2008 enacted a targeted law asserting attributional nexus over remote sellers that operate "affiliate programs" with NY members. (Amazon is largest/most prominent such company, but vast majority of large internet retailers have them.) NC & RI enacted in 2009.

- Under typical program, independent website places on its own site a banner ad and link to product(s) of remote seller. If someone follows link and makes a purchase at remote seller's online store, affiliate is paid commission that is set percentage of purchase amount.

- NY estimates that law will generate $73 million in annual revenue; = 0.6% increase in sales tax collections

New York's "Amazon Law": Nuances

- NY's law is not a flat assertion of nexus based on in-state presence of affiliates; law written as a "rebuttable presumption" that nexus has been established

- Assumption can be rebutted by showing that no in-state affiliates did anything (beyond maintaining the link) to encourage in-state residents to buy from the remote seller

- New York has issued guidance on how assumption can be rebutted; e.g., annual attestation by affiliates that they engage in no in-state solicitation

Amazon's Legal Case

- Amazon began collecting use tax on all New York sales and filed suit challenging law as inherently unconstitutional.
- Amazon arguing that affiliate is just being paid to carry advertising, is not really in-state representative of company as in *Scripto*
- Courts *could* side with Amazon (this is path-breaking case likely to be appealed all the way to US Supreme Court). Trial court upheld law; appeal decision imminent.

Case for Constitutionality of "Amazon Law"

- Commission-based compensation combined with forwarding of customer directly to retailer arguably makes the in-state affiliate the cyberspace equivalent of *Scripto's* in-state independent solicitors

- Amazon's program arguably creates intensely symbiotic co-marketing arrangement; affiliates are known as "Associates," constantly exhorted with email and blog, substantial Amazon proprietary computer code placed on their sites to facilitate direct ordering, sampling of music, etc.

- If computer kiosk in shopping mall linked to Amazon would create nexus, affiliates should, too

Internet Retailers' Response: Terminating Affiliates

- Overstock and some smaller retailers eliminated their affiliate programs in NY, NC, RI; Amazon did so in NC & RI and threatened to do so when HI and CA enacted the law — prompting gubernatorial vetoes

- Generated political backlash; affiliates argued that state was harming in-state small businesses by taking away their commission income. Also claimed this would lead to PIT revenue loss and therefore no net revenue gain. (NY, NC and RI did not repeal their laws.)

- Counterargument: some Main Street sellers likely generating increased sales/sales tax revenue because in-state marketing efforts by remote sellers have stopped

The Future of Amazon Laws

- If NY law is upheld at appeals court level, additional states probably will enact — and every state <u>should</u>.

- If states hang together, likely that Internet retailers will eventually begin collecting; affiliate programs too important form of marketing to eliminate entirely and permanently (e.g., $2B in commissions paid annually).

- State economic development departments should assist affiliates in identifying compatible affiliate programs of Internet sellers that *do* collect tax (e.g., switch from Amazon to Barnes & Noble)

Resources on the “Amazon Law”

- Michael Mazerov: “New York’s ‘Amazon Law’: An Important Tool for Collecting Taxes Owed on Internet Purchases” July 23, 2009
  http://www.cbpp.org/files/7-23-09sfp.pdf

- Michael Mazerov: “Amazon’s Arguments Against Collecting Sales Taxes Do Not Withstand Scrutiny” November 16, 2009
  http://www.cbpp.org/files/11-16-09sfp.pdf

#4: Requiring Remote Sellers to Disclose Sales to State Tax Depts./Purchasers (1)

- In 02/10, Colorado became first state to require remote sellers to either collect and remit sales tax to state or make an annual disclosure to state tax department of total $ purchase amount made by state residents. (HB 10-1193)

- Law also requires seller to disclose to purchaser at time of sale that CO use tax may be due on purchase. (OK recently emulated this provision.)

- Law also requires seller to make annual disclosure to customer of total purchases, broken down into broad categories, along with statement that use taxes may be due

#4: Requiring Remote Sellers to Disclose Sales to State Tax Depts./Purchasers (2)

- To reduce cost to sellers, recently-adopted regulation eliminated obligation to send annual purchases report to any customer buying less than $500 per year. Removes important tool for purchaser education since most people spend less than this. States adopting similar laws in future better-advised to permit mailings to be done at bulk rate rather than 1st class to reduce this cost.

- Reg. appropriately created exemption for sellers with less than $100k annual CO sales

- To reduce privacy concerns, reg. requires sellers to state that *only* total purchase amount will be reported to DoR.

#4: Requiring Remote Sellers to Disclose Sales to State Tax Depts./Purchasers (3)

- Legal challenge filed by Direct Mktg. Assn. primarily on grounds of facial discrimination against interstate commerce and violation of purchaser privacy.

- First argument will turn on court's willingness to treat info rptg. mandate as compensating for actual collection of tax.

- Privacy argument is political; such info already in hands of govts. (e.g., medical conditions of Medicaid recipients, religious affiliation of PIT itemizers) or public (campaign contributions). No info to be made public, in any case. Future state adoptions should include provision that all existing tax confidentiality laws (and penalties for violations) apply to all info supplied to DoR under this law

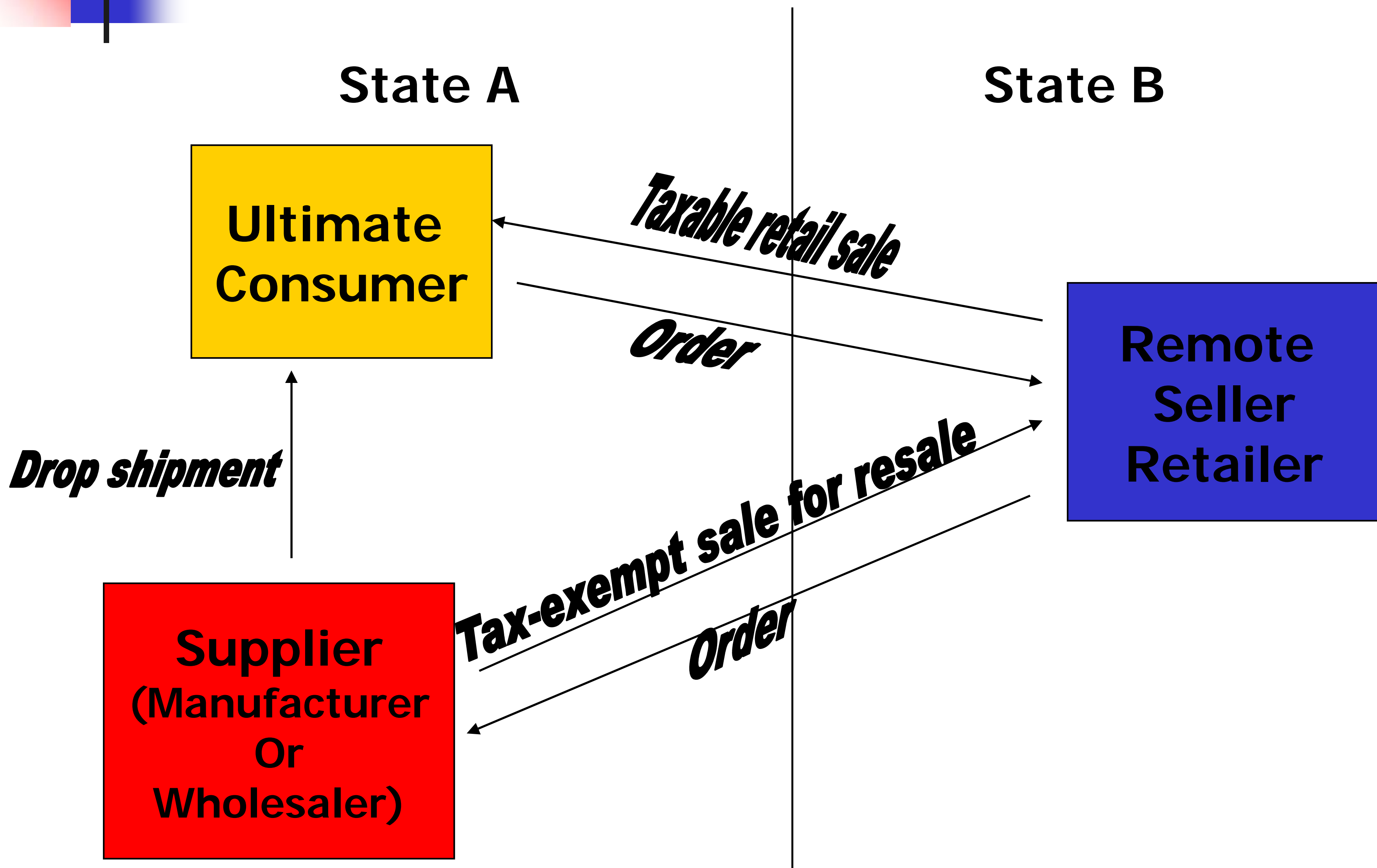
Requiring Remote Sellers to Disclose to In-State Sales to State Tax Departments (4)

- Multistate Tax Cmn developing model reporting/disclosure law

- Colorado approach holds considerable promise for obtaining additional collection of use taxes due:

  - Consumers will be constantly reminded that they likely owe use tax on their purchases; some will comply
  - State DoR will have information about aggregate amount of purchases that will enable it to pursue follow-up enforcement activity if purchases large enough to justify costs
  - Some sellers may choose to collect tax rather than make disclosures

#5: Taxing Drop Shipments (1)



#5: Taxing Drop Shipments (2)

- Drop shipments are very common transaction in business-to-business remote sales
- Not uncommon in household purchases of big-ticket, bulky, or custom-made items
- Likely to grow steadily over time because enables retailers to avoid having to buy/store their own inventories

#5: Taxing Drop Shipments (3)

- Because supplier has nexus in consumer's state, states can effectively tax transaction

- But most states don't! They treat the sale from supplier to retailer as exempt "sale for resale" and must attempt to collect tax directly from ultimate consumer because retailer has no nexus.

- What to do: change law to require in-state supplier to charge tax to the out-of-state retailer. (Some states that have attempted this without clear statutory authority have lost in court.)

#5: Taxing Drop Shipments (4)

- Which states already tax sale between supplier and retailer: CA, HI(?), LA(?), MA(?), MD(?), MS(?), WI (some contradictory info re: states with (?))

- Which states can't because they're in Streamlined Agreement (which prohibits): AR, IN, IA, KS, KY, MI, MN, , NE, NV, NJ, NC, ND, OH, OK, RI, SD, TN, UT, VT, WA, WV

- Which states are free to change their laws to tax drop shipments: AL, AZ, CO, CT, DC, FL, GA, ID, IL, ME, MO, NM, NY, PA, SC, TX, VA

#5: Taxing Drop Shipments (5)

- Two options:
  - CA approach: "When tangible personal property is delivered by a . . . former owner thereof. . . to a consumer [in CA] pursuant to a retail sale made by a retailer not engaged in business in this state, the person making the delivery shall be deemed the retailer of that property." Tax is charged on the price between the supplier and retailer plus an assumed 10% mark-up, unless the retailer provides the actual retail price.
  - Change law to deny sale-for-resale exemption to any purchaser not registered to collect sales tax in state. Treat sale as retail sale, and charge tax based on actual supplier-to-retailer price.

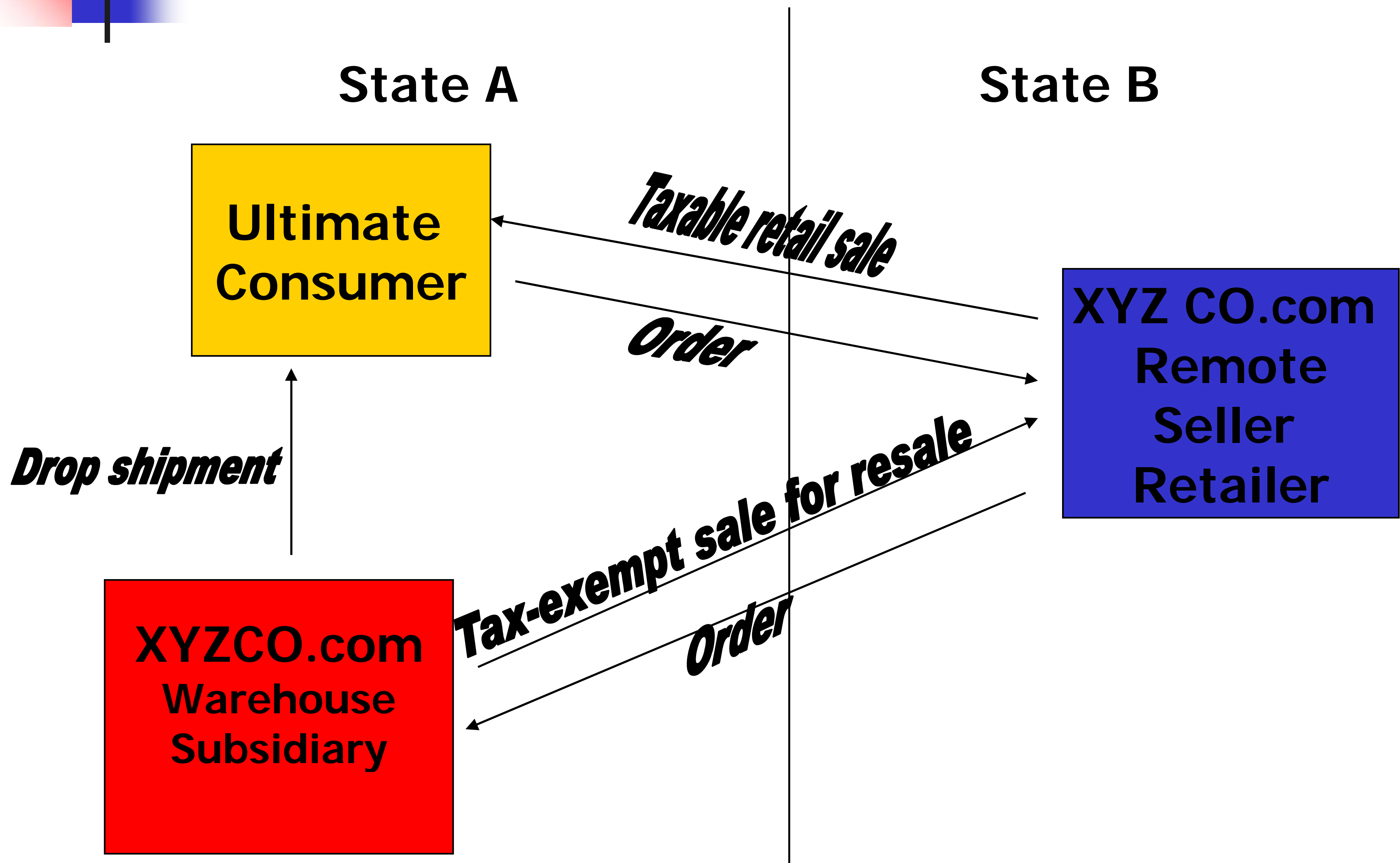
#5: Taxing Drop Shipments (6)

- Option 2 results in less revenue because no tax is charged on the retailer's mark-up over wholesale price

- Nonetheless, it may be more defensible legally because states can determine their own conditions for sale-for-resale exemptions.

- Both options potentially subject to constitutional challenge as discrimination against interstate commerce, but no such challenges have apparently been successful

#6: Taxing Phony Drop Shipments (1)



#6: Taxing Phony Drop Shipments (2)

- VA has given a retailer that could be Amazon a private letter ruling recognizing this as a legitimate tax-exempt drop shipment transaction. Amazon has hinted it has received similar approval from TX.

- NJ caught Drugstore.com doing the same thing and convinced a court that the transaction was taxable. If these 2 companies are doing this, others probably are, too.

- States should add language to their laws stating that a “retailer engaged in business in the state” includes any retailer that has an affiliate shipping or delivering goods from an in-state distribution center to in-state customers. OK recently did this (but language may have loophole).

#7: Pursuing "Unitary" Approaches to Nexus (1)

- One of the worst consequences of *Quill* has been its encouragement of aggressive "entity isolation" to avoid use tax nexus.

- As already discussed, "attributional nexus" approaches may overcome entity isolation by "bricks and clicks" retailers, because stores often engage in activities that arguably facilitate creation of in-state market for affiliated remote seller.

- Likewise, when in-state entity is a warehouse involved in the transaction with no real shifting of inventory risk or economic substance, state should simply treat as sham transaction

#7: Pursuing "Unitary" Approaches to Nexus (2)

- But there are other cases in which remote sellers have a substantial physical presence in a state not directly involved in selling to customers where these legal approaches probably don't apply.

- "Poster child" for this is the presence in CA of the Amazon subsidiary responsible for the ongoing development of the company's Kindle e-book reader. These are sold in CA, but Amazon does not collect use tax in the state. Amazon has physical facilities in at least 13 states in which it does not collect use tax.

#7: Pursuing "Unitary" Approaches to Nexus (3)

- This claimed lack of nexus is especially deplorable; Amazon is clearly substantially benefitting from public services provided by CA and its local governments, and Kindle and e-books are core products of Amazon's retailing business.

- It is time for states to bring test cases in an effort to overcome such entity isolation. States should first amend their laws to state that a "retailer engaged in business in the state" includes any retailer that has a related entity in the state engaged in a unitary business with the retailer.

- If entity isolation is not attacked, there are virtually no limits to what any corporation could do in an age when it is easy to locate the nominal "seller" anywhere

#7: Pursuing "Unitary" Approaches to Nexus (4)

- The legal basis for this approach is well set out in John Swain, "Cybertaxation and the Commerce Clause: Entity Isolation or Affiliate Nexus?" *Southern California Law Review*, January 2002

- Must be acknowledged that this theory is largely untested and the few state courts that have considered it have split on its validity

- Arguably some support for it in Supreme Court's *Ntl. Geographic* decision. Would decision really have gone the other way if Ntl. Geographic had separately incorporated its magazine and its retailing operation?

#8: Ensuring State and Local Government Contractors Collect Use Tax

- States should add language to their state procurement codes requiring all contracts with private companies to include a provision stating that the contractor agrees that it <u>and all its affiliate companies</u> will charge applicable sales and use tax on all sales made to customers in the state.

- At least 14 states have already done this: AL, CA, CT, GA, IL, IN, MN, MO, NJ, NY, NC, SD, VA, WI

- Although possibly subject to legal challenge, none evident so far. Defense in "market participant" exception to C. Cl.

- Unknown how well these laws being enforced or complied with

#9: Encouraging More Use Tax Self-Remittance by Individuals (1)

- 38 states with sales taxes also have income taxes

- Of these, 22 have placed a line on the income tax form for annual, self-remittance of use tax by households

- 8 states — AR, CO, MN, MO, NE, ND, PA, and WV — include form and/or info on use tax obligations in income tax booklet but don't put line on return. (Processing separate form and check is more expensive!)

- 8 states — AZ, GA, HI, IL, IA, MD, MS, NM — do neither

#9 Encouraging More Use Tax Self-Remittance by Individuals (2)

- States should at least take opportunity of annual income tax booklet to inform individuals of use tax obligations

- Research by MN Dept. of Revenue suggests that line on form is more effective than info in booklet (See: www.house.leg.state.mn.us/hrd/pubs/usetax.pdf)

- Same research suggests that states collect more revenue if they have a default option for taxpayers to pay use tax based on lookup table rather than forcing them to go back and compile credit-card receipts.

- Only following 9 states have lookup tables: KS, ME, MA, MI, NJ, NY, NC, OK, VT

#10 Enlisting Paid Preparers

- In recently-enacted HB 2359, Oklahoma added the following to its tax code:

  "When assisting taxpayers in preparing an individual income tax return, tax preparers shall advise their clients of their responsibility to remit use taxes through the use tax remittance line on the individual income tax return or by filing a consumer use tax return."

- All states should enact similar provisions, as well as reasonable penalties for non-compliance. Any "sting" operations aimed at paid preparers should test for compliance with this provision.

- States could amend laws to allow preparation of list of large remote sellers not registered for use tax and require paid preparers to examine credit card bills for purchases