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ADP Lunch & Learn
Course Materials

Sales and Use Tax Collection Requirements: Stop Making Sense

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2. Sales and Use Tax Collection Requirements: Stop Making Sense

Learning Objectives:

Upon successful completion of this segment, you should be able to:

- explain the concept of economic nexus;
- discuss the Ohio "bright-line" nexus standard;
- describe the important considerations that surround "click-through" nexus laws;
- understand the implications of the proposed Main Street Fairness Act and Business Activities Tax Simplification Act (BATSA).

Segment Overview:

Facing increasing budgetary pressures, state governments are – not surprisingly – aggressively searching for new revenue sources. McDermott Will's *Lindsay LaCava* reviews how various jurisdictions are exporting their tax burden to out-of-state businesses by radically redefining the obligation for collecting sales and use taxes.

Field of Study: Taxes

Course Level: Update

Course Prerequisites: Work experience in tax planning or compliance, or an introductory course in taxation

Advance Preparation: None

Recommended Accreditation: 1 hour group study
2 hours self-study

Required Reading (Self-Study):

"Streamlining versus Amazon Laws: The Remote Seller Dilemma"
By Cara Griffith
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For additional information, go to: www.taxanalysts.com
See page 8.

Video Transcript: See page 14.

Running Time: 26 minutes

Outline

I. State and Local Taxes

A. State Tax Initiatives
   1. New broad-based enterprise or gross receipts taxes
   2. Revised allocation formulas for income taxes

B. Expanded Scope of Taxing Authorities
   1. Few clearly defined guidelines or "bright-line" tests

C. State Governments Are Looking for Ways to
   1. Raise revenue
   2. Cut spending

II. Economic Nexus and States' Efforts

A. Economic Nexus: Taxing Companies
   1. Not based on in-state employees or property
   2. Based on in-state customers

B. Ohio Commercial Activity Tax (CAT)
   1. Based on
      a. gross receipts
      b. economic nexus standard
   2. Lindsay LaCava's reminder on gross receipts taxes
      a. even companies with losses pay the tax
   3. Ohio "bright-line" nexus
      a. taxpayer has nexus based on threshold number
      b. amount: $500,000 of Ohio receipts

C. "Bright-Line" Nexus Standard
   1. Very controversial
   2. Being challenged by L.L. Bean
   3. Currently pending before the Ohio Board of Tax Appeals
   4. Upheld by Commissioner in initial review

D. Transactions Traditionally Subject to Sales Tax
   1. Tangible personal property
   2. Certain enumerated services
      a. utility
      b. installation

E. Lindsay LaCava Observes That States Are Increasingly
   1. Subjecting online services to sales taxes
   2. Targeting remote sellers for tax obligations
   3. Basing physical presence on third parties

outline outline outline outline

Outline (continued)

III. Click-Through Nexus Laws

A. The Quill Decision vs. "Amazon Laws"
   1. Quill Decision (1992): states cannot require businesses without a physical presence in a jurisdiction to collect or remit sales and use taxes
   2. "Amazon Laws": states require online vendors to collect sales taxes based on in-state physical presence of "associates"

B. Attributional Nexus: Third Party
   1. Can create sufficient nexus
   2. Must be doing something on behalf of out-of-state retailer to enhance market

C. "Click-Through" Nexus Laws
   1. Based on attributional nexus
   2. In-state person posts link to your web site
   3. Exceeds threshold sales amount from in-state customers
   4. Important Considerations
      a. law should create rebuttable presumption
      b. there should be reasonable way to rebut presumption
      c. Internet Tax Freedom Act prohibits discriminatory taxes

D. Supreme Court Decisions Endorse Attributional Nexus
   1. Tyler Pipe, 483 U.S. 232 (1987)
   2. Scripto, 362 U.S. 207 (1960)

E. Colorado's Version of Amazon Law
   1. Requires out-of-state sellers
      a. to report Colorado sales to revenue department
      b. to inform customers of use tax obligations
   2. Is very controversial
   3. Led to lawsuit by Direct Marketing Association
   4. District court granted preliminary injunction against Colorado

F. Streamlined Sales Tax Agreements
   1. Retailers get simplified definitions, rates, compliance processes
   2. States impose tax on retailers who don't have physical presences

G. Amazon Is Fighting Back
   1. Involved in litigation in New York
   2. Trying to get California law overturned through referendum
   3. Terminating affiliate programs in Connecticut and California

IV. New Legislation and Other Activities

A. Proposed Main Street Fairness Act Would
   1. Sanction Streamlined Sales Tax Agreement
   2. Allow member states to tax retailers who don't have physical presence

B. Proposed Business Activities Tax Simplification Act (BATSA)
   1. Would adopt physical presence standard for
      a. income
      b. other business activity
   2. Approved by House Judiciary Committee

C. States Could Obtain Customer Information Through
   1. Information sharing agreements
   2. Information obtained from another state
   3. IRS or other federal agencies

D. Lindsay LaCava's Takeaway
   1. You must focus on where a business's customers are located for tax purposes

Group Discussion

Instructions for Segment

- As the Discussion Leader, you should introduce this video segment with words similar to the following:

  "In this segment, Lindsay LaCava reviews how jurisdictions are exporting their sales tax burden to out-of-state businesses."
- Show Segment 2. The transcript of this video starts on page 14 of this guide.
- After playing the video, use the questions provided or ones you have developed to generate discussion. The answers to our discussion questions are on page 5. Additional objective questions are on pages 6 and 7.
- After the discussion, complete the evaluation form on page A–1.

Discussion Questions

2. Sales and Use Tax Collection Requirements: Stop Making Sense

You may want to assign these discussion questions to individual participants before viewing the video segment.

1. What does the concept of economic nexus mean? What is your experience with the concept?
2. What are the implications of the Ohio "Bright-Line" nexus rules? How do you feel about the Ohio Commercial Activity Tax approach?
3. What does the concept of attributional nexus mean? Do you agree with the concept? If so, why? If not, why not?
4. What are the key principles involved with "click-through" nexus laws? What are the important considerations?
5. What are the important things to be aware of with regards to Colorado's version of the Amazon law?
6. What is Amazon doing to fight back against the states attempts to tax Internet sales?
7. What are the key components of the proposed Main Street Fairness Act and Business Activities Tax Simplification Act (BATSA)?

Suggested Answers to Discussion Questions

2. Sales and Use Tax Collection Requirements: Stop Making Sense

1. What does the concept of economic nexus mean? What is your experience with the concept?
   - Economic nexus: taxing companies
     - not based on in-state employees or property
     - based on in-state customers
   - Response is based on participant experience
2. What are the implications of the Ohio “Bright-Line” nexus rules? How do you feel about the Ohio Commercial Activity Tax approach?
   - Ohio “bright-line” nexus
     - taxpayer has nexus based on threshold number
     - the amount is $500,000 of Ohio receipts
   - Response is based on participant opinion
3. What does the concept of attributional nexus mean? Do you agree with the concept? If so, why? If not, why not?
   - Attributional nexus: third party
     - can create sufficient nexus
     - must be doing something on behalf of out-of-state retailer to enhance market
   - Response is based on participant opinion
4. What are the key principles involved with “click-through” nexus laws? What are the important considerations?
   - “Click-through” nexus laws
     - based on attributional nexus
     - in-state person posts link to your web site
     - exceeds threshold sales amount from in-state customers
   - Important considerations
     - law should create rebuttable presumption
     - there should be reasonable way to rebut presumption
     - Internet Tax Freedom Act prohibits discriminatory taxes
5. What are the important things to be aware of with regards to Colorado’s version of the Amazon law?
   - Requires out-of-state sellers
     - to report Colorado sales to revenue department
     - to inform customers of use tax obligations
   - Is very controversial
   - Led to lawsuit by Direct Marketing Association
   - District court granted preliminary injunction against Colorado
6. What is Amazon doing to fight back against the states attempts to tax Internet sales?
   - Involved in litigation in New York
   - Trying to get California law overturned through referendum
   - Terminating affiliate programs in Connecticut and California
7. What are the key components of the proposed Main Street Fairness Act and Business Activities Tax Simplification Act (BATSA)?
   - Main Street Fairness Act would
     - sanction Streamlined Sales Tax Agreement
     - allow member states to tax retailers who don’t have physical presence
   - Business Activities Tax Simplification Act
     - would adopt physical presence standard for
       * income
       * other business activity
     - approved by House Judiciary Committee

Objective Questions

2. Sales and Use Tax Collection Requirements: Stop Making Sense

You may want to use these objective questions to test knowledge and/or to generate further discussion; **these questions are only for group discussion purposes.** Most of these questions are based on the video segment, **a few may be based on the required reading for self-study** that starts on page 8.

1. In addition to Ohio, ___________ also has a business and occupations tax that's gross receipts based.
   a) Washington
   b) Texas
   c) New York
   d) California

2. In the case of the Ohio CAT, the "bright-line" for tax nexus is that if a taxpayer has ___________of Ohio receipts, then they are subject to the tax.
   a) more than $10,000
   b) at least $100,000
   c) $500,000 or more
   c) over $1,000,000

3. There are those who believe that physical presence is required before a state may impose an income or business activity tax because:
   a) it is the main gist of click-through nexus.
   b) the Supreme Court has not articulated a standard.
   c) this is in line with the Amazon laws.
   d) of attributional nexus.

4. According to Lindsay LaCava, click through nexus laws:
   a) are unfair.
   b) should be rebuttable.
   c) should not be rebuttable.
   d) should not apply to affiliates.

5. Customers who purchase goods out of state or from an out of state retailer and use them in their home state:
   a) are supposed to remit use tax on that transaction.
   b) pay use taxes only if spending more than $1,000.
   c) do not owe any taxes on that purchase.
   d) owe taxes in both states.

6. The Direct Marketing Association brought a lawsuit in federal court:
   a) that they won based on the Quill physical presence standard.
   b) that prompted the Streamlined Sales Tax Agreement.
   c) that prompted Colorado to enforce gross receipt taxes.
   d) that temporarily stopped Colorado from enforcing the Amazon law.

7. In a recent court case involving Amazon in North Carolina:
   a) Amazon was required to remit customer purchasing activity to the state tax authority.
   b) North Carolina was able to impose use taxes on previously unreported purchases.
   c) the Court held that Amazon did not have to turn over customer purchase information on free speech grounds.
   d) North Carolina was able to get information on customer purchases from the IRS.

8. One of the benefits of a streamlined sales tax effort would be:
   a) a shift in revenues from one jurisdiction to another.
   b) a change in rate and base structures.
   c) the way audits will be handled.
   d) nexus would be the same for all states.

9. In the Scripto and Tyler Pipe cases:
   a) attributional nexus did not apply.
   b) affiliates were considered to have attributional nexus.
   c) affiliates established long-term relationships.
   d) the vendor presumption was used to enforce nexus.

Objective Questions (continued)

10. It has been estimated that sales tax exemptions __________ the cost of compliance for small businesses.
    a) help lower
    b) are less than 25 percent of
    c) account for 60 percent of
    d) do not impact

Self-Study Option

Instructions for Segment

When taking a segment on a self-study basis, an individual earns CPE credit by doing the following:

1. Viewing the video (approximately 25 minutes). The transcript of this video starts on page 14 of this guide.
2. Completing the Required Reading (approximately 20 minutes). The Required Reading for this segment starts below.
3. Completing the online steps (approximately 55 minutes).

Required Reading (Self-Study)

STREAMLINING VERSUS AMAZON LAWS: THE REMOTE SELLER DILEMMA

By Cara Griffith
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State Tax Notes
For additional information, go to:
www.taxanalysts.com

"The present system of State taxation as it affects interstate commerce works badly for both businesses and States." – Willis Commission Report, 1965

There are many reasons that electronic commerce exploded in the past decade. The e-commerce business model enables remote sellers, even very small ones, to operate in one state and have customers in other states or even other countries. For consumers, in addition to having or benefiting from the simple convenience of online shopping, the Internet has enabled them to search many vendors before making a purchase. Nearly any item can be located and prices compared. It's a bargain shopper's delight. And even though the overall growth of online retail sales was down by 0.7 percent in 2009, eMarketer Inc. predicts that online sales will return to growth in 2010 and will grow by double digits in 2011. The company estimated that in 2009, e-retail sales totaled $131.4 billion and that by 2011 that amount will have increased to $157.6 billion.

Despite the benefits of e-commerce, sales by remote sellers via the Internet present a significant problem for state tax officials: If a remote seller has no physical presence in a state, the seller is not obligated to collect and remit that state's sales tax. And although consumers are technically obligated to pay use tax on online purchases, those remittances rarely are paid. The result is that states fail to capture sales tax revenue on many out-of-state sales by remote sellers. States, however, have shown they are unwilling to simply roll over and accept a loss of sales tax revenue. Instead, they continue to explore new methods and arguments for collecting sales tax from remote sellers.

One means of doing so is by joining the Streamlined Sales Tax Project. In joining the Streamlined Sales and Use Tax Agreement, a state agrees to take steps toward simplifying and modernizing its sales and use tax administration in an effort to reduce the burden of sales and use tax compliance. The streamlined effort, through uniform definitions and rules, enables vendors to more easily collect and remit sales and use tax. Though the goals of the SSTP are laudable, it is arguable how successful it has been in practice. The SSTP relies on voluntary compliance or the passage of federal legislation. Also, the SSTP has failed to persuade several large sales tax states to join the agreement.

As a more immediate measure, some states, such as New York, have enacted vendor presumption laws (or “Amazon” laws) that broaden the definition of vendor to include some remote sellers. For example, New York broadened the definition of vendor in N.Y. Tax Law sec. 1101(b)(8) to provide that persons making sales of property or services are “presumed to be soliciting business through an independent contractor or other representatives if the seller enters into an agreement with a resident of that state under which the resident” is paid a commission or other consideration for referring customers to the seller. That definition essentially requires vendors that use an affiliate marketing program to collect sales tax. Affiliate marketing is an Internet-based marketing tool that rewards “affiliates” – individuals who maintain a link on their Web site – for sending customers to the vendor’s Web site.

Although the SSTP and vendor presumption have one thing in common – they both are an attempt to get out-of-state retailers to collect and remit sales tax on remote sales – they are otherwise strikingly different. This article will examine the fundamentals behind both the SSTP and vendor presumption laws and evaluate the benefits and shortcomings of each. It will become clear why the SSTP presents a better solution, with one major problem: Will a streamlined system ever become the rule nationwide, or will we forever be stuck with a patchwork of sales and use tax laws?

Streamlined Sales Tax Project

The Streamlined Sales Tax Governing Board specifies on its Web site that its goal is “to assist states as they administer a simpler and more uniform sales and use tax system” [www.streamlinedsalestax.org]. To accomplish that goal, the streamlined effort has attempted to simplify and modernize sales and use tax administration in order to reduce the burdens of compliance. The effort has focused on such concepts as:

- uniformity in state and local tax bases;
- uniformity of tax base definitions;
- simplification of tax rates;
- uniform sourcing rules;
- simplified administration of exemptions;
- simplified tax returns; and
- a central, electronic registration system.

The SSTP began in 1999 because the National Conference of State Legislatures and the National Governors Association were concerned about the potential revenue loss states were facing because they could not, under the U.S. Constitution’s commerce clause, require remote sellers with no physical presence in the state to collect and remit sales tax. Today, 23 states have adopted the simplification measures in SSUTA. Yet even with nearly half of the states as members, “there is some frustration on the part of member states, and likely the board, that some of the larger sales tax states have not signed on to the agreement,” said Loren Chumley, a principal in the State and Local Tax Practice at KPMG LLP and former Tennessee commissioner of revenue. California, Florida, and New York have declined to join the streamlined effort. Getting larger states such as those as members may be one of the biggest challenges the board faces, said Ferdinand Hogroian, a director with PricewaterhouseCoopers LLP.

The problem with getting the larger states to become members, Chumley said, “is that some states find it difficult, politically, to make the law changes necessary to adopt the agreement." For example, the agreement requires states to adopt uniform definitions, a uniform sourcing rule, and changes to rate and base structures. Sourcing, in particular, has been a sticking point for some states, said Chumley. The agreement uses a destination sourcing rule, which specifies that sales tax is applied at the point where the purchaser takes possession of the goods. A change in sourcing rules can result in a shifting of revenue from one jurisdiction to another. For many states, the loss in revenue from a change to destination sourcing is negligible, but for other states, such as New York, the loss is significant. The board adopted an alternative sourcing rule to make the transition easier for some states, but the changes may still prove to be a significant burden.

Nonetheless, the streamlined effort is a positive step for member states and for vendors. Chumley said that the streamlined project has successfully established a uniform exemption certificate and a simplified electronic return and made other administration efforts that reduce compliance burdens. Also, the SSTP removed the burden of due care on resale certificates for sellers, which is a strong benefit for vendors. Yet another benefit of the streamlined effort is that if a federal streamlined bill were to be enacted, "nexus would be the same for all states, not just a few who want to demand revenue from out-of-state companies," said Melanie Little, owner of The Sales Tax Connection in Harrisburg, Pa.

Federal legislation has been introduced several times to implement a streamlined system. In 2009 U.S. Rep. William D. Delahunt, D-Mass., and U.S. Sen. Michael B. Enzi, R-Wyo., introduced the Sales Tax Fairness and Simplification Act of 2009 (H.R. 3393/S. 34). Although its sponsors say the bill would "provide tens of billions of dollars in funding to many state and local governments at a minimal or no cost to the federal government," its passage is uncertain. Congress has historically been reluctant to address state revenue issues, preferring instead to leave tax administration to the states. As a result, similar bills have gained little to no momentum. Whether this one will suffer the same fate is yet to be seen.

The streamlined effort is, of course, not without its shortcomings. Some practitioners have argued that the SSTP has failed to hold true to its fundamental goals and instead is willing to adjust those goals to accommodate difficult-to-persuade states. Also, the board is still working on how audits will be handled, Chumley said. Finally, the effort has faced, and will continue to face, technical challenges. In particular, Chumley said:

There must be uniform interpretation of the provisions of the streamlined agreement. If states disagree among themselves on how uniform definitions or uniform sourcing rules should be interpreted, the streamlined effort would be undermined.

Vendor Presumption

Vendor presumption laws are an attempt by states to require remote sellers to collect sales tax. However, vendor presumption laws have several major shortcomings, including their questionable constitutionality. Under the U.S. Supreme Court's decision in *Quill Corp. v. North Dakota* [504 U.S. 298 (1992)], an out-of-state retailer must have substantial nexus with the taxing state before the state can require the retailer to collect and remit sales and use tax. Substantial nexus, the Court also held, requires physical presence. Out-of-state remote sellers seem to fall outside the definition of substantial nexus because, by their nature, they have no physical presence in the taxing state.

New York and other states that have enacted or are considering a vendor presumption law argue that if a remote seller has an affiliate marketing or similar program, a seller's in-state affiliates can satisfy *Quill*'s physical presence requirements and thus create sales tax nexus for the seller. That argument is based on the theory of attributional or affiliate nexus and has been analyzed in many articles. For purposes of vendor presumption laws, attributional nexus, as established in *Scripto Inc. v. Carson* [362 U.S. 207 (1960)] and *Tyler*

Pipe v. Washington Dep't of Revenue [483 U.S. 232 (1987), generally holds that if a retailer has in-state agents (though an agency relationship is not required) that sell on behalf of the retailer, the in-state agents may establish nexus on behalf of the out-of-state retailer.

Even though attributional nexus seems to be applicable to an affiliate marketing program, the e-commerce model and an affiliate marketing program were not contemplated when *Scripto* and *Tyler Pipe* were handed down, and they differ significantly from the fact patterns in those cases. Also, the work of an affiliate is a far stretch from the work of a salesperson "actively engaged" on behalf of Scripto Inc. or independent contractors that were calling on customers and maintaining "long-established and valuable relationships" on behalf of Tyler Pipe. Most affiliates that participate in an affiliate marketing program do so only part time. Their work is also passive in nature. That is, affiliates do not call on customers, directly solicit orders, or establish long-term customer relationships.

Although the New York Supreme Court of New York County has upheld the state's vendor presumption law, there is no guarantee that a higher court in New York or a court in another jurisdiction will follow suit [*Amazon.com LLC v. New York State Dep't of Taxation and Finance*, Jan. 12, 2009]. A more thorough commerce clause analysis than that provided by the New York court would dictate a ruling striking down New York's law. Two of the major shortcomings of that type of law are that the constitutionality of vendor presumption is questionable and e-commerce retailers believe the laws are unfair because they capture only some remote sellers. Vendor presumption laws may raise some revenue for states in the short term, but in the long term, they require potentially unconstitutional sales tax collection, present a remedy problem if the laws are struck down, and do nothing to encourage more widespread voluntary compliance from remote sellers.

Streamlined Versus Vendor Presumption

Although the streamlined effort and vendor presumption share a common thread – both are attempts to force remote sellers to collect sales tax – they are fundamentally different. Chumley said:

The SSTP and vendor presumption are going along very different paths. Vendor presumption, by itself, has not yet addressed the issues left after the *Quill* decision. Good tax policy would dictate that a state should make it as easy as possible to comply. Currently, vendor presumption is challenging for companies from a compliance standpoint.

Vendor presumption is a limited yet forceful remedy to a difficult problem. What it fails to do is address why the problem exists in the first place. The *Quill* opinion was issued more than 17 years ago. E-commerce and its potential issues for sales tax collection were not considered by the Supreme Court justices. The justices were concerned with the burden of requiring vendors to collect sales tax in thousands of jurisdictions in which the vendors had no physical presence. The potential burden that sales tax collection places on remote vendors has not diminished, and the concern over that burden should not diminish. Yet drafters of vendor presumption laws chose to ignore it.

By contrast, if states are able to join the SSTP, which could create a more uniform system that could encourage broad-based compliance by remote sellers, it seems beneficial to do so. Hogroian said that "the streamlined effort, if successful, could result in a simplified system and harmonized laws among all states, while vendor presumption provides none of these benefits in addressing nexus on a state-by-state basis." Also, vendor presumption is a piecemeal approach aimed at specific remote sellers, while the ultimate goal of the streamlined effort is to apply a uniform nexus standard to all sellers, Hogroian said.

Dueling Efforts?

For states that are in a revenue crisis, vendor presumption has one significant advantage – the immediate revenue gain that comes from requiring some remote vendors to collect sales tax. SSTP, by contrast, depends on voluntary compliance or federal legislation.

That said, there is little doubt that in enacting vendor presumption laws, states are frustrating the goal of the streamlined effort. "If there is no broad application of the streamlined approach," said Hogroian, "there cannot be a streamlined system."

Little likewise said that vendor presumption laws are "completely ignoring any hope the SSTP presents. Instead of joining the streamlined effort and utilizing volunteer organizations to collect their sales taxes, states that have or are planning to enact vendor presumption laws are trying to strong-arm their way to gain compliance in a bully-like manner."

Besides potentially upsetting efforts to create a simplified, uniform system, vendor presumption could hinder the streamlined effort in other ways. Because some streamlined states, such as North Carolina and Rhode Island, have enacted vendor presumption, those states may believe it is less important to maintain streamlined compliance. Adopting vendor presumption and lessening compliance with SSUTA may give Congress the impression that vendor presumption is a viable remedy for states concerned with collecting sales tax from remote vendors. Any indication that a remedy is available to states, and in particular that some states have already adopted that remedy, will diminish the urgency of streamlined legislation, Hogroian predicted.

Solutions Available

One of the main issues with requiring retailers to collect and remit sales tax nationwide is compliance. There are some 8,000 taxing jurisdictions in the United States. Even if basic rates could be determined and updated regularly, other problems further complicate matters. Determining how to handle tax-exempt sales, sales tax holidays, and product taxability coding can be a daunting task, particularly for small and midsize businesses. It has been estimated that sales tax exemptions account for 60 percent of the cost of compliance for small businesses.

Eliminating some of those exceptions could significantly reduce the compliance burden. However, the challenge of determining what sales tax rate should apply can be addressed, particularly if there is nationwide adoption of the agreement with its uniform definitions and tax bases, which would simplify the system. What is needed is for technology providers to create viable (and affordable) solutions for vendors. Although that is already happening, market forces dictate that if a streamlined solution is adopted and remote vendors are required to collect sales tax, technology providers will create solutions to meet unmet needs. However, any streamlined solution should avoid broadening a small-business exception. Raising such a threshold would neither promote improved technology nor encourage small businesses to grow.

Several businesses already provide technology for sales tax compliance. AccurateTax.com is one such company. Its owner, Pete Petracco, explained that the company evolved from its predecessor, Miva Merchant, to address the issue of destination-based sales tax collection. Vendors needed a ZIP-code-based system with more frequent updates. AccurateTax.com offers that. It is a thin client system in which a vendor's retail software calls the AccurateTax.com servers to verify sales tax information for each purchase. The system will soon account even for sales tax holidays.

There are other technological solutions available to vendors. The governing board has certified several that use various methods. Some systems will impose a flat sales tax rate and reconcile with the vendor quarterly. In any case, technology solutions exist or will exist and should be encouraged. But they will work best with a system that is as simple and uniform as possible. The more exceptions and rates that must be included increase the potential for errors or noncompliance.

Conclusion

It's not news that economic times are tough. States are looking for new and creative ways to generate revenue – and will continue to do so for the foreseeable future. Because of the rise of e-commerce retailers, and the near guarantee that e-commerce will continue to grow, the problem of how to capture sales tax on remote sales will remain. It is important for states to realize that a strong-arm approach such as vendor presumption does nothing to address the larger issues concomitant with sales taxation and e-commerce. And what is worse, vendor presumption may act as an impediment to the streamlined effort at both the state and federal levels, blocking an attempt to offer real solutions to the problems facing states and remote sellers.

Video Transcript

2. Sales and Use Tax Collection Requirements: Stop Making Sense

SURRAN: For several years, we've documented how state and local governments are facing increasing fiscal pressure, due to a combination of a faltering economy, the loss of federal money, and diminishing tax revenues. Not surprisingly, this has led to an increasingly aggressive search for new revenue sources.

For example, dissatisfied with traditional business tax regimes, state legislatures have enacted new, low-rate, broad-based enterprise taxes in a number of states, including Ohio and Texas. In addition, states continue to move away from origin-based tax rules and export their tax burden to out-of-state businesses, through allocation formulas based on where customers or economic markets are located, rather than on where a business is located.

In this context, the concept of nexus is multi-faceted, with the rules varying by type of tax, industry, and state. For example, nexus dictates whether multistate retailers are liable to collect state and local sales taxes outside their home location.

Businesses, legal scholars, taxing authorities, and tax practitioners strongly disagree on the expanded scope of state taxing authorities. As we have come to expect, there are few clearly defined guidelines to help businesses apply these legal standards and so-called "bright-line" tests are rare.

QUINLAN: Viewers may recall that Lindsay LaCava is based in the New York City office of McDermott Will and Emery, where she focuses her legal practice on state and local tax issues. Thanks for joining us again this month, Lindsay.

LACAVA: Mike, it is great to be back.

QUINLAN: As they try to recover from the economic downturn, it seems as if many states are facing budget shortfalls and are attempting to collect more revenue. I assume this means they're doing something other than – or more than – just raising tax rates.

LACAVA: Of course, you know, when states face budget issues they're going to try to raise revenue, but also we're seeing huge pressures to cut spending, so we're seeing two things going on here, and we'll see how this plays out, I think, in the upcoming months.

While states need to increase their revenues there is sort of a general sentiment that people don't want to see tax increases, and so I think the legislatures have to balance the desire for people not to raise taxes with trying to get more revenues in the door.

QUINLAN: It makes sense that voters – particularly in today's political climate – are "turned off" by new taxes and by higher tax rates. I'm curious, Lindsay: is it true that there are ways that states can adjust their tax regimes to "target" out-of-state businesses?

LACAVA: You know, Mike, clients ask us that all the time, and what we're seeing is states adjusting their tax base in such a way that they're trying to pull more taxpayers into the state. The term that this is often referred to as is economic nexus, and what that means is trying to tax companies that don't necessarily have employees or property in the state, but whose only connection is an in-state market, i.e.; customers in the state.

QUINLAN: We've seen a number of states adopt gross receipts taxes. You know, like the commercial activity tax in Ohio. In a way, that's "pushing" economic nexus, isn't it?

LACAVA: Yeah, the Ohio Commercial Activity Tax is somewhat unique in the sense that it is based on gross receipts and not net income, so you don't have the deductions that you might normally have in an income tax system.

The Ohio CAT has an economic nexus standard, making taxpayers who may not have any connection with Ohio other than the presence of customers or sales into the state have to worry about that tax and how that might apply to their business.

I think with the higher commercial activity tax it might be a response to sort of the tough economic times we have been having, and because it's based on gross receipts, companies who maybe in loss positions end up paying the tax.

Ohio certainly is not the only state that has this gross receipts type of tax. Texas has a margins tax that is very similar, although there are some deductions allowed, and Washington also has a business and occupations tax that's gross receipts based.

QUINLAN: Speaking of Ohio, in connection with their CAT tax, they imposed what is called "bright-line" nexus on out-of-state businesses. What does that mean in this context?

LACAVA: Well, you know, we use the term nexus, and just to remind our viewers, when you're talking about nexus you're talking about the amount of activity that a taxpayer has to have in commercial sales in the state before that state can impose a tax collection obligation on that taxpayer. In the context of the Ohio commercial activity tax they have what's known as a bright-line nexus standard.

What that means is that a taxpayer has nexus if they have a certain threshold number of sales, payroll or property in the state.

In the case of the Ohio CAT, for example, if a taxpayer has $500,000 or more of Ohio receipts they are subject to the tax.

QUINLAN: I know the Multistate Tax Commission proposed the concept of "bright-line" nexus. To what extent is it controversial? I mean, is it likely – in Ohio or other places – to be challenged?

LACAVA: First we have to remember that the Multistate Tax Commission is a body of state tax commissioners, so it's the revenue departments that had adopted this model, bright-line presence nexus standard.

As states have started adopting it, we're seeing that it is quite controversial. I mean, in fact, the Ohio standard is being challenged in a case that was brought by L.L. Bean.

As many people know, L.L. Bean typically sells through catalogue and mail order sales. They are challenging the $500,000 bright-line nexus standard and the case is currently pending before the Ohio Board of Tax Appeals.

The initial level of review, the Commissioner, upheld the tax, but I think viewers have to remember he doesn't have the authority to rule on the Constitutionality of the tax, so really I think we have to wait, as the case progresses to see how this pans out.

QUINLAN: Let's make sure I understand what you mean by "economic nexus," Lindsay. Are you saying that companies might be subject to taxation by a state, even if they do not have a physical presence in that jurisdiction?

LACAVA: Mike, that's exactly right. The whole theory behind economic nexus is that merely having customers or sales in a state is enough to create sufficient nexus, however, unfortunately the Supreme Court has never really articulated the proper standard, so there are those who believe that physical presence is required before a state may impose an income or business activity tax.

QUINLAN: In terms of nexus, the one rule that's really "bright-line" is the one you've discussed before, Lindsay. It deals with the obligation to collect and remit sales taxes, right?

LACAVA: Mike, that's right, for sales tax purposes the Supreme Court has issued a decision on this and said very clearly that physical presence is required before a state can impose a sales or use tax collection obligation on a retailer.

QUINLAN: I want to ask you about the Quill decision and about remote sellers, Lindsay. But first, please remind me: what transactions are traditionally subject to a sales tax?

LACAVA: Well, with a few exceptions sales taxes are typically imposed on tangible personal property and then just certain enumerated services, so, for example, utility services or installation services might be subject to tax.

Of course there are few states that impose tax on a number of services or all services, but most states it's just a small number.

QUINLAN: OK, if I buy a book from Amazon or from Barnes & Noble, I know that it is a tangible product. But what if I buy the book for my Kindle or eReader of some kind, is that still considered to be tangible property?

LACAVA: I think we have to remember that, you know, sales tax is imposed on tangible personal property. I don't think anyone would argue that a digital product, an e-book or, you know, an iTunes song, is tangible property, but what we're seeing states have done is amend either their definition of tangible property to include certain digital goods, or have expanded the scope of their sales tax to include digital goods.

It's really a state by state question, and in fact some states do impose sales tax on these types of transactions.

The theory for some states is that if a digital product is taking the place of a tangible product, for example if an e-book is taking the place of a tangible book, they should impose tax on that transaction. Or they would like to find a way to impose tax on that transaction.

QUINLAN: Let me tell you about my teenage daughter. She has a cart – you know, the online equivalent of a gift card – that allows her to download $50, or whatever amount I allow her, of music from iTunes. Is she buying a tangible product?

LACAVA: I think when you look at digitally downloaded music, it's going to raise issues as digital books. Some states may treat it in the same way as if you bought the tangible CD, and some states may not.

You really have to look state by state to see, but I think states that just have your standard definition of tangible personal property, I don't think that people would argue that digital product is tangible personal property without some alteration of the statute.

QUINLAN: Books and music are very visible, but they may also be the tip of the iceberg. There might be a whole group of online services that the states are thinking about taxing, right?

LACAVA: Mike, that's right. We're finding more and more revenue departments are trying to find ways to tax services that are provided online. For example application service providers often allow users to go on their website and, for example, maybe it's a Photoshop program where you can manipulate your photographs, and for example here in New York what we're seeing is that the revenue department is taking the position that when you go online and use that service provider's software, they're treating it as a license to use software, and therefore a license to use tangible personal property. A taxable license as opposed to a service, and I think that position is pretty controversial.

QUINLAN: Whether it's taxing the downloading of music, or the providing of online services, I've got to ask you: is this just an acceleration of a trend that you've seen for a long time? Or is this a result of the states fearing the loss of revenues this year because of the recession?

LACAVA: Well I think certainly we're seeing states are getting, you know, more creative in trying to find revenues without, you know, per se increasing taxes, but I think if you step back you're going to see that this is really a trend that started way back when business models were shifting to catalogues and direct mail models, you saw states as early as the forties, fifties and sixties trying to go after these out of state companies that were selling into the state by mail.

Now I think we're just seeing that shift to e-commerce, and we have these Internet retailers selling over the Internet. They are obviously reaching a much broader audience than they would absent the Internet, and states are trying to get more creative in ways to tax, either both for the services they provide and to have them collect tax on taxable services and goods.

QUINLAN: Thanks, Lindsay. We'll return to your commentary in a minute.

SURRAN: Even as online sales have grown exponentially over the past 15 years, the states have generally been prohibited under the U.S. Constitution from imposing sales or use tax collection requirements on out-of-state vendors.

Under the "physical presence" rule re-affirmed by the U.S. Supreme Court in its 1992 decision in Quill, a vendor must be physically present in a state to become subject to the jurisdiction's sales or use tax collection requirements.

Over the past few years, some states have adopted policies that seek to avoid running afoul of the physical presence requirement. The trend began when New York, North Carolina, and Rhode Island enacted so-called "Amazon laws" or "click-through nexus" statutes which impose collection requirements on online vendors with sales "associates" located in the jurisdiction. As you would expect, opponents of these laws argue that they unconstitutionally impose an obligation to collect sales tax on companies that lack a physical presence in the state.

QUINLAN: A few minutes ago, you reminded me that physical presence is necessary in order for a business to be required to collect and remit sales taxes. But, over the past few years, I've heard about states that have enacted click-through or so-called Amazon laws, haven't I?

LACAVA: Well, Mike, you're right. Physical presence is required as you know, the Supreme Court said that rule in Quill, but there are also a line of cases that the Supreme Court has decided that has basically said it doesn't necessarily have to be your employee or your company that's in the state.

A third party can create physical presence sufficient to create nexus if that third party is enhancing your market in that state, if they are conducting activities that are significantly associated with your ability to establish and maintain an in-state market.

In those cases, what they were was companies sending independent contractors door-to-door to sell products, and the Supreme Court said that is enough to create nexus, even though it's not an employee, that's enough.

QUINLAN: Is this similar to the controversies that Art Rosen and you have described for us before? You know, is "SFA Folio" the same thing as "Saks Fifth Avenue"?

LACAVA: Right, I think those cases also got to the issue of attributional nexus, the idea that the presence of a third party can create sufficient nexus for an out of state entity.

One thing that's important to note in the context of those cases is that merely being affiliated with an in-state entity is not enough.

The entity has to be doing something on behalf of the out of state retailer that enhances that out of state retailer's market in the state.

We we've seen taxpayers who have been successful in these types of cases. There was the SFA Folio case in Ohio, the Current case in California, and recently cases involving in-state affiliates of online retailers.

QUINLAN: OK, but how does the notion of "attributional nexus" relate to the enactment of these "click-through" or "Amazon" laws?

LACAVA: Well, these so called Amazon or click-through nexus laws are really premised on this whole concept of attributional nexus, that the presence of an in-state party can create nexus for the out of state Internet retailer.

What these laws typically say is if you have an in-state person who is soliciting sales on your behalf by, for example, posting a link on their website to your website, that the presence of that person will create sufficient nexus if they generate over a certain threshold amount of sales from in-state customers.

The leading state that everybody talks about is New York, who is one of the first states to adopt this law, but we've seen more and more states heading in this direction, for example Connecticut, California, and Arkansas all recently within the past few months have passed these types of laws.

QUINLAN: Tell me, Lindsay: what type of reaction has there been to the enactment of these laws around the country?

LACAVA: Yeah, these laws have been quite controversial. Obviously a lot of Internet retailers are challenging them. But I think we have to remember a couple of things. These laws are premised on the Supreme Court cases, Tyler Pipe and Scripto where the Court basically said the in-state person created nexus because they were enhancing the market for the out of state person.

When you have these click-through nexus laws, I think there are two things that are important.

First, the law should be rebuttable, and therefore should create a rebuttable presumption, not an irrebuttable presumption, that the presence of an affiliate in the state who is posting links to your website actually does enhance your market.

There should also be a reasonable way to rebut that presumption.

So, for example in New York, there is informal guidance that says if you get a sworn statement, for example, from your in-state affiliate that shows that they're not conducting in-state solicitation on your behalf, it's merely passively posting a link on their website, that will be sufficient to rebut this presumption that the presence of that affiliate created nexus.

I think you will see most of the laws are drafted broadly enough to apply to referrals made by Internet links or otherwise. That's important because the Internet Tax Freedom Act prohibits states from imposing discriminatory taxes on Internet transactions only.

QUINLAN: I understand that states believe that they're losing sales tax revenue because of electronic commerce. Aren't they supposed to collect that revenue – as a use tax – from their own residents?

LACAVA: Mike, you're right. Customers who purchase goods out of state or from an out of state retailer and use them in the state are supposed to self-report and remit use tax on that transaction. The problem here is that the compliance is very low in a lot of states for use tax. Some states don't really have a good system in place for customers to do that.

Some states have a line item on individual income tax returns, but a lot of people just ignore it or don't understand what that line is for.

QUINLAN: OK, they've added a line to the personal income tax return. What else can the states do to enhance their use tax collections?

LACAVA: Well, some states, I think as an alternative to perhaps this Amazon or click-through nexus approach have actually attempted to enact laws aimed at increasing use tax compliance.

For example, Colorado adopted what I guess is their version of an Amazon law, that requires online sellers or retailers who don't collect tax, so typically out of state sellers, who sell to customers in Colorado to report those sales to the revenue department and also to inform the customers of their use tax obligations and liabilities.

You know, the problem with those laws is that they are also controversial because some say that the Quill physical presence standard should apply for reporting purposes as well as collection purposes.

QUINLAN: You mentioned the statute in Colorado, Lindsay. Has there been any pushback there in the same way that companies have opposed the Amazon laws?

LACAVA: Mike, the Colorado statute has actually been just as controversial as some of these Amazon laws, and in fact the Direct Marketing Association brought a lawsuit in federal court challenging the law. That case is currently pending, but what did happen is that the district court granted a preliminary injunction stopping Colorado from enforcing its law pending the outcome of that case on the basis that the Quill physical presence standard should apply for purposes of enforcing this provision.

In other words, it's unconstitutional, or likely to be unconstitutional for Colorado to enforce this law on out of state retailers who do not have a physical presence in the state.

QUINLAN: As you said, state revenue departments are enthusiastic about requiring remote sellers to collect sales taxes for them. Isn't this also related to the so-called Streamlined Sales Tax Agreement?

LACAVA: Well, the ability to impose tax on remote sellers, the sellers who don't have a physical presence in the state, is really one of the huge premises behind the whole Streamlined Sales Tax Agreement.

The trade-off for retailers who get simplified definitions, rates, compliance processes, is that states get to impose tax on retailers who do not have a physical presence in the state.

Subject to exceptions, for example, for small sellers who have under a certain threshold number of receipts, for example.

QUINLAN: OK, I understand the battleground. So, explain to me, Lindsay: what is it that Amazon and the other e-Sellers are doing in the face of all these jurisdictions enacting laws affecting remote sellers?

LACAVA: Yes, for example, Amazon is actually involved in litigation right now in New York challenging the constitutionality of New York's Amazon or click-through nexus provision.

That case made its way through the appellate division, which is New York's middle level court. It upheld the facial constitutionality of the law, but the case has been remanded for determination as to whether the law is constitutional as it's applied to Amazon and Overstock, who's the other business that is involved in the lawsuit.

But that's not the only way that e-tailers or online retailers are fighting back.

For example, California recently passed a click-through nexus or Amazon nexus law and Amazon is actually trying to get that law overturned through a ballot referendum. So they're in the process right now of petitioning for a referendum to be placed on the ballot that would go out to the voters, where the voters would decide whether the law should be overturned.

In addition to fighting these laws in court and through various political measures there are also dropping their affiliates. We've seen in Connecticut, Illinois, and California, that as soon as the law is passed, Amazon has been terminating its affiliate programs, which of course puts pressure on the states to perhaps repeal the law. But again we're seeing a lot of Main Street retailers approaching those affiliates to perhaps maybe work for them instead, so it'll be interesting to see how this all plays out.

QUINLAN: I suppose there is a solution. The Supreme Court suggested it in their Quill decision, didn't they? Why doesn't Congress just pass a federal law to determine the sales tax consequences of goods purchased online?

LACAVA: Mike, because Quill was decided on commerce clause grounds, Congress can reverse that decision, and so Congress can decide to allow states to impose tax on sellers who do not have a physical presence.

A bill has been introduced into Congress in the last couple of weeks, the Main Street Fairness Act that essentially would sanction the streamline sales tax agreement, or the compact as well as the governing board and all of its provisions, and that would also explicitly allow member states to impose tax on retailers who do not have a physical presence. Essentially overturning the decision in Quill.

There is actually a bill pending – the Business Activities Tax Simplification Act – that would adopt a physical presence standard for income and other business activity tax purposes.

That bill has actually had a little bit more traction in that it is already approved by the House Judiciary Committee.

QUINLAN: Our producer asked you to bring your crystal ball with you to today's program, Lindsay. So, tell me: in today's post-debt ceiling environment, how likely is Congress to consider federal legislation on state tax issues?

LACAVA: Well, Mike, I wouldn't want to disappoint your producer, so I'll give you my thoughts. It looks like the BATSA (Business Activities Tax Simplification Act) bill has some traction, as I mentioned, it has already been passed by the House Judiciary Committee, so that's making steps forward.

The streamlined bill on the other hand, it's too hard to tell right now. It doesn't have bipartisan sponsors, and some might view it as not being simplified enough for multi- state businesses. Some view it as a tax increase by imposing tax collection obligations on remote retailers, even though we know that use tax is technically due.

QUINLAN: On one hand, you've told us about the effort to collect sales taxes from remote sellers. But, on the other hand, aren't they also stepping up their efforts to collect use taxes from their own residents?

LACAVA: Certainly states might be enhancing their use tax audits or enhancing their education efforts aimed towards consumers, but also we see states going after retailers who make sales into the state.

For example, we saw a recent case involving Amazon in North Carolina, where North Carolina was requesting copies of Amazon's customer list so that they could then perhaps seek use tax from the individual consumers. Ultimately the Court held that they did not have to turn over the information about the customers and what they purchased on free speech grounds. That information about books and music and other items purchased was protected under the privacy protections of our Constitution.

Of course states could try to get the information by other means, either through information sharing agreements with other states, perhaps information provided to another state, or through, with the IRS or even other federal agencies, for example, Customs, if you declare something when you come back into the country or through personal audits, where they might request your credit card statements or other items that might indicate an online purchase has been made.

QUINLAN: Once again, Lindsay, you've covered the waterfront: from gross receipt taxes to remote sellers. If our viewers could take one thought away from this program, what would you like that to be?

LACAVA: I think the important takeaway here is that businesses that sell into states, other than the state where they are located, really need to pay attention to what's going on in the states where their customers are located.

With economic nexus there is a risk that they could be facing an income or other business activity tax on their operations. With these Amazon type laws and other expanded nexus laws, and this push for federal legislation allowing the taxation of remote retailers, there is a risk you could have a sales and use tax collection obligation. So I think people have to be on alert as to what is going on nationwide to the extent that they are making sales in more than one state.

QUINLAN: McDermott Will's Lindsay LaCava, thanks – as always – for bringing us up-to-date.

LACAVA: Mike, thanks, it was great to be here again.