PwC Tax

salt trends

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An ongoing series

- Recently, many states have enacted laws that expand their nexus provisions to address out-of-state retailers.
- Consequently, taxpayers should be aware of these changes to understand their potential new tax exposures and collection responsibilities.
- Based on many states' current fiscal positions and their reluctance to enact new taxes, taxpayers should expect to see more states enact measures targeting the collection responsibilities of out-of-state retailers.
- In addition to many states and the MTC becoming involved in nexus expansion efforts, the federal government has also become much more involved with several proposed bills addressing this issue.

The death of the internet sales tax differential?

As states continue to face severe budget shortfalls with little anticipation of future support from the federal government, state legislatures and revenue departments are seeking new revenue streams, often through sales and use tax impositions. Corporate taxpayers are seeing these efforts manifested through greater audit activity than in prior years, the use of aggressive third party auditors by states, and the expansion of tax bases and sin taxes. In addition to these measures, states are expanding their interpretation of “doing business” within their jurisdictions. Application of agency principles has been aimed at stretching the nexus parameters set by the US Constitution and case law. Most of the effort has been focused on subjecting out of state remote sellers to sales tax collection responsibilities. In a 2009 study, the University of Tennessee estimated that by 2012, sales tax losses nationwide as a result of internet and remote sales will be $11.4 billion, hence the motivation for adopting these changes.

Though these expansion efforts are currently being challenged through courts and other administrative forums, it is undeniable how popular they have become when looking at the various 2011 state legislative sessions. As more and more states join this trend, taxpayers providing goods and services using the out of state remote seller model must be aware of the changing climate so that they may understand their possible tax exposures and collection responsibilities. Consumers, who in the past believed that they were getting a tax advantage when buying online rather than at a brick and mortar store, will begin to see sales tax collected on their purchases or be required to file state use tax returns. As a result, we may be approaching the death of the Internet sales tax differential many online retailers have been enjoying.

Center stage: Expansion of agency nexus

Supreme Court case law provides that in order for a state to impose a sales tax collection responsibility on a seller, the seller must have a physical presence, or substantial nexus, in the state. This presence could be established either by the seller itself having a presence or by having agents or representatives within the jurisdiction acting on behalf of the seller. Because an actual physical presence of a seller in a state is hard to dispute (other than from a de minimis perspective), a majority of the cases and disputes have centered on whether an agent, representative or other third party is creating a physical presence in the state for an out of state seller. Therefore, if a state asserts a collection responsibility on an out of state seller, the state has to prove that the seller has some form of "agency nexus" with the state. In 2008, New York State enacted a new method for doing just that.

Effective June 1, 2008, New York enacted legislation requiring out-of-state Internet retailers to collect and remit state sales tax on all sales of tangible personal property or services sold to New York residents if the retailer had a minimum amount of sales generated through links on websites owned by New York residents. The legislation appeared to target popular Internet retailers. New York's "click-through" nexus law, the first of its kind, requires out-of-state sellers operating "affiliate programs" in the state to register to collect and remit sales tax. New York law provides that a "vendor" includes a person making sales of tangible personal property or services to New York customers through an agreement with a New York resident for a commission or other consideration, who directly or indirectly refers potential customers, by a link on an Internet website to the seller if the cumulative gross receipts from such sales exceeds $10,000 per year. In other words, potential customers reach the out-of-state retailer's website by clicking on a link on the in-state affiliate's website (thereby creating "click-through" nexus). The presumption of nexus may be rebutted by proof that the resident with whom the seller has an agreement did not engage in any solicitation in the state on behalf of the seller that would satisfy the nexus requirement of the Constitution.

Two days after the signing of the bill, Amazon.com filed suit in New York State court alleging, among other challenges, that the law violates the Commerce Clause and the Due Process Clause of the Constitution, both on its face and as applied to Amazon.com, because it imposes tax collection obligations on out-of-state retailers who have no substantial nexus with New York.[1]

The trial court ruled against Amazon.com, upholding the constitutionality of the statute, both on its face and as applied. Amazon.com appealed the trial court's decision. In November 2010, the appellate court found the statute constitutional on its face.[2] The court remanded the case for further fact-finding to determine whether the statute may be unconstitutionally applied to Amazon.com. To date, the status of New York's Amazon law, as applied, is still unknown.

Despite Amazon's challenge, North Carolina and Rhode Island enacted similar measures in 2009. As a result, several large Internet retailers cancelled their affiliate programs in those two states. It has been the subject of debate whether the enactment of such laws actually reduced the tax revenue collected as in-state affiliates lost large portions of their income base. Nevertheless, 2011 saw the adoption of click-through nexus laws in five additional states, Arkansas, California, Connecticut, Illinois, and Vermont. As with North Carolina and Rhode Island, large Internet retailers cancelled their affiliate programs within those states.

Enter: Controlled group and/or substantial ownership nexus

Differing from New York's click-through nexus approach, Colorado decided to capture out of state sellers by focusing on collections from in-state consumers. Effective March 2010, Colorado enacted a two-part statute in an effort to increase the collection of sales and use taxes. (The second part will be discussed later in this article.) In the first part, out-of-state sellers must collect Colorado use tax if they are a part of a controlled group as defined in IRC Sec. 1563(b) that has a "component member" who is a retailer with physical presence in the state. However, this presumption may be rebutted by showing that the component

[1] Amazon.com, LLC, et. al., v. New York State Department of Taxation and Finance, et. al., 877 N.Y.S. 2d 842 (2009).

[2] Amazon.com, LLC, et. al., v. New York State Department of Taxation and Finance, et. al., 913 N.Y.S. 2d 129 (2010).

member did not engage in any constitutionally sufficient solicitation in the state on behalf of the out-of-state seller during the calendar year in question. Prior to this law, sales and use tax nexus had been based solely on each individual entity's actions and physical presence. In Colorado's law, we see for the first time a state asserting that the establishment of nexus by one member of a controlled group may create a presumed nexus for other members of that group. This legislation, like New York's, has had its challenges in court as discussed below in relation to part two of this legislation.

During the same year, Oklahoma enacted a multi-part statute that includes a deemed imposition of nexus and a rebuttable presumption of nexus. An out-of-state retailer is generally deemed to be engaged in the business of selling tangible personal property for use in the state if it holds a substantial ownership interest in, or is substantially owned by, a retailer maintaining a place of business within the state and the out-of-state retailer sells the same or similar line of products as the Oklahoma retailer under the same or similar business name, or the out-of-state retailer holds substantial ownership interest in, or is substantially owned by, a business that maintains a distribution house, sales house or warehouse in Oklahoma, and delivers property sold by the retailer to consumers. There are no provisions to rebut these deemed nexus provisions. Further, an out-of-state seller is presumed to be a retailer engaged in business in Oklahoma if it is part of a controlled group of corporations that has a component member as defined by IRC Sec. 1563(b) that is an in-state retailer engaged in business as described above. This presumption may be rebutted by showing that the component member did not engage in any constitutionally sufficient solicitation in the state on behalf of the out-of-state seller during the calendar year in question.

To date, eight states have enacted similar attributional nexus statutes, Arkansas, California, Illinois, New York, South Dakota, Texas, Utah and Virginia with many others having proposed legislation.

Additionally, in a very bold move, the Pennsylvania Department of Revenue recently released a bulletin stating that they were going to begin enforcing click-through and attributional nexus rules under current statutes. The department's position is that the Commonwealth's doing business statute is broad enough to include such activities. It should be noted that a bill proposing to amend Pennsylvania's code to include such provisions failed to move past its introduction during the Commonwealth's 2011 session.

Rising action: Retailer notification requirements

In addition to seeing a variety of nexus expansion legislation (or a bulletin in the case of Pennsylvania), Colorado introduced a new tactic to promote the remittances of use tax by in-state residents. Along with the enactment of its attributional nexus provision, the legislation provided a second requirement. This requirement applies to out-of-state retailers that are not required to and do not collect Colorado sales tax and that have total annual gross sales worldwide of $100,000 or more. In general, out-of-state retailers that do not collect Colorado sales tax are required to give their customers notice with each purchase that Colorado sales or use tax is due on purchases that are not exempt from sales tax. This notice may be made on the Internet website of the retailer or on an invoice provided to the customer. Further, the statute requires an out-of-state retailer that does not collect Colorado sales tax to annually notify Colorado customers by first class mail of their total amount of purchases during the year, the dates of such purchases, and the category of each purchase. The notification must state that Colorado requires a sales or use tax return to be filed and tax paid on certain purchases made by the customer from the retailer. Finally, the out-of-state retailer must file an annual statement for each Colorado customer with the Department of Revenue showing the total amount of Colorado purchases made during the preceding calendar year. Steep penalties apply for failure to comply with these requirements.

Soon after enactment, the Direct Marketing Association (DMA) filed a motion for a preliminary injunction in the Colorado US District Court. DMA asked the court to enjoin the Colorado Department of Revenue from enforcing the notice and reporting obligations imposed on out-of-state sellers because the requirements violate the rights of many DMA members under the Commerce Clause.[3] The court granted the injunction, finding that the DMA

[3] Direct Marketing Association v. Huber, Civil Case No. 10-cv-01546OREB-CBS (January 26, 2011).

demonstrated substantial likelihood of success on its constitutional claims.[4] On March 30, 2012, the Colorado Federal District Court ruled that the notice and reporting requirements were unconstitutional because they discriminated against interstate commerce and because they impose an undue burden interstate commerce.[5] It is unclear how this ruling will affect similar legislation.

Legislators in Oklahoma enacted a similar statute. However, in adopting its retailer notification statute, Oklahoma differed substantially from the approach taken by Colorado. In Oklahoma, every out-of-state noncollecting retailer not required to collect sales and use tax must give notice to Oklahoma purchasers that use tax is due on nonexempt purchases and should be paid by the Oklahoma purchaser. The notice may be placed on the retailer's Internet website or its retail catalogue and invoices provided to customers. However, out-of-state sellers with total gross sales in Oklahoma in the prior year of less than $100,000 and reasonable expectations of less than $100,000 of Oklahoma sales in the current year are exempt from the notice requirements. Unlike Colorado, the out-of-state retailer is not required to provide end of year purchase reports to its customers or notify the state of its customers' purchases.

To date, four states have enacted similar statutes, South Carolina, South Dakota, Tennessee and Vermont. However, the South Carolina and Tennessee approach is unique. In June 2011, following negotiations with an online retailer, South Carolina enacted a notification requirement law that applies only to out-of-state noncollecting retailers that use a nexus exemption for an in-state distribution facility that meets certain requirements. South Carolina requires out-of-state retailers taking advantage of this "distribution facility nexus exemption" to inform customers of their use tax obligations similar to Oklahoma's notification requirement. The law creates a "distribution facility nexus exemption" and provides that owning, leasing, or utilizing a distribution facility, including a distribution facility of a third party or affiliate, within South Carolina is not considered in determining whether the person has a physical presence in South Carolina sufficient to establish sales and use tax nexus if certain qualifications are met. The law is set to sunset on the earlier of January 1, 2016, when the person fails to meet the requirements set out in the law, or on the effective date of a law enacted by the US Congress that allows a state to require that its sales tax be collected and remitted even if the taxpayer lacks substantial nexus.[6] In April 2012, Tennessee enacted similar legislation.

Enter stage left: Multistate Tax Commission's effort

In 2011, soon after the enactment of Colorado's retailer notice requirement, the Multistate Tax Commission (MTC) began working on draft model language patterned after Colorado's laws. The MTC's Sales and Use Tax Uniformity Subcommittee has had multiple discussions refining language that would require out-of-state retailers to notify customers of their use tax responsibilities as well as require retailers to provide detailed lists of their customers and purchases to the adopting states' revenue departments on an annual basis. In response to questions about states' authority to require out-of-state retailers to meet these informational requirements, the subcommittee felt that such notifications are similar to requiring a public service announcement and are not subject to the standards set by the Supreme Court. The draft model language has progressed through the MTC's uniformity process as far as a Bylaw 7 survey, which failed to get enough votes. (A Bylaw 7 survey occurs when the MTC's Executive Committee authorizes a polling of the affected Commission states to ensure that a majority of the affected states would consider adopting a draft legislative proposal before continuing with the uniformity process. The survey does not determine if the affected states will adopt the proposal, only whether the affected states will consider adopting the proposal.) Prior to the court's recent decision in Colorado, the MTC was in the process of deciding whether to submit the draft rules for another Bylaw 7 survey, accept late votes for the original survey, send the draft rules back to the subcommittee for revisions, or wait for the court's decision in the DMA case. With the case now decided, the MTC may chose to discard its efforts on the draft rules. However, in the meantime, the subcommittee has begun work drafting model legislation patterned after New York's click-through nexus law.

[4] Id.

[5] Direct Marketing Association v. Huber, No. 10-CV-01546oREB-CBS (March 30, 2012).

[6] See S.C. Code Ann. Sec. 12-36-2691.

Denouement: Proposed federal bills

In addition to many states and the MTC becoming involved in nexus expansion efforts, the federal government has also become much more involved. On November 30, 2011, the US House Judiciary Committee held an oversight hearing on the constitutional limitations on states' authority to collect sales taxes in e-commerce. The hearing was set as Congress considers three remote sales tax proposals: the Main Street Fairness Act (S. 1452 and H.R. 2701), the Marketplace Equity Act (H.R. 3179), and the Marketplace Fairness Act (S. 1832). The standing-room-only hearing, which lasted nearly three hours, reflected increased interest in these proposals and hopes that a breakthrough could be reached after years of effort.

In his opening statement, Judiciary Committee Chairman Lamar Smith (R-TX) stated that the purpose of the hearing was to explore two issues — whether Congress should exercise its Commerce Clause power to enact sales tax reform legislation and, if so, how Congress can act in a manner so as to "not increase administrative and compliance burdens on America's small businesses." After hearing testimony from the witnesses, Chairman Smith commented that it likely was appropriate for Congress to aid in sales tax collection reform; however, whether Congress should act depends on the costs to small businesses and the potential undue burden to interstate commerce.

A wide range of viewpoints was expressed among the witnesses, reflective of their varying interests in the remote sales tax collection issue. However, there was general agreement among both witnesses and committee members that there should be a level playing field among retailers operating brick-and-mortar, brick-and-click, and online-only businesses. Much of the disagreement involved how small sellers should be treated, who qualifies as a small seller and whether a carve-out for small sellers perpetuates an unlevel playing field or relieves such sellers from a disproportionate compliance burden.

In addition to avoiding picking winners and losers in the marketplace, another major theme in the hearing was the desire to protect states' rights, as expressed by two Republican witnesses: Representative John Otto, member of the Texas House of Representatives, and Indiana State Senator Luke Kenley, President of the Streamlined Sales Tax Governing Board. Increasingly, the desire to protect the rights of the states by "respecting federalism" has provided the basis for Republican participation on this issue in Congress.

Curtain call: The end of the sales tax differential

Based on many states' current fiscal positions and their reluctance to enact new taxes, taxpayers should expect to see more states enact measures targeting the collection responsibilities of out-of-state retailers. Already, several states have reached agreements with a prominent online retailer in which the online retailer will begin to collect and remit sales taxes on purchases within those states by a certain date if federal legislation is not enacted earlier. Further, though Colorado's notification requirements have been ruled unconstitutional, the other states' notification requirements are still in force. Consequently, retailers selling over the Internet or using mail-order catalogues should decide if applicable wording changes to their websites, catalogues, and/or invoices are needed. Such retailers should review their systems and staff capacities to see if they have the ability to collect and remit taxes if this trend continues and receives traction in the courts and federal legislative branch. With the expanding number of states imposing reporting and collecting requirements on out of state sellers, Congress' increased interest in the issue, and states continual quest to find ways to enhance revenue without tax increases, it appears that the sales tax differential between online and main street sales may be coming to a dramatic end.

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