

Texas among states seeking to collect taxes on Internet sales

As states seek to bolster revenue, many are considering ways to increase collections on taxes and fees they say already are owed. One focus is on collecting sales and use taxes on sales that take place outside the state for goods or services consumed within it. These remote sales, primarily those that take place over the Internet, are a major source of potential revenue.

Many states are enacting legislation to compel the collection of sales taxes on out-of-state sales or are negotiating agreements with major Internet-based retailers to collect them. In April, Texas and Nevada became the most recent of several states to negotiate agreements with Amazon.com. Those agreements will require the company to start collecting and remitting sales taxes in Texas this July and in Nevada in 2014. In the same month, a federal court struck down an Internet sales tax law in Colorado and a state court struck down one in Illinois. Both courts found the laws to be violations of the Constitution's commerce clause, which grants the federal government exclusive authority to regulate interstate commerce.

In addition, Texas recently enacted legislation that would expand the number of retailers required to collect and remit sales taxes, while still not capturing all remote sellers. Before the deal with Amazon was reached, the comptroller had estimated that Texas loses \$600 million a year in uncollected Internet-based sales taxes. The taxes go uncollected because, under current law, states cannot compel remote, out-of-state sellers either to collect and remit the taxes or to disclose information on those sales. The National Conference of State Legislatures projected, before recent state agreements

with Amazon and other major retailers, that states across the country would lose \$23.3 billion in uncollected sales taxes on Internet-based sales in 2012. Along with the federal government, states have been exploring whether and how to increase collection of these taxes.

Current law

In 1992, the U.S. Supreme Court found that states could not require sellers to collect sales tax on interstate shipments unless the seller had a physical presence, or "nexus," in the state where delivery occurred. In *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), the court found that the myriad rules and rates charged by different state and local jurisdictions would make it too difficult for a business lacking a physical presence to comply and thus was an unconstitutional burden on interstate commerce. *Quill* stemmed from a case concerning mail-order catalogs. The *Quill* decision left room for Congress, acting under its constitutional authority to regulate interstate commerce, to pass legislation that would allow states to require sellers to collect sales taxes on interstate sales.

Many states that impose sales taxes, including Texas, also impose use taxes. A use tax requires the buyer of a taxable item that came from outside the taxing jurisdiction to pay a tax on the use of goods that will be consumed within the state. Use tax liability is incurred when someone buys an item from outside the state for consumption within it. The sale of goods and the use of goods usually are taxed at the same rate. However, consumers often do not pay use taxes because states cannot compel out-of-state retailers to provide

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information on the sale of taxable goods and services. The difficulties inherent in enforcing sales and use taxes on remote sales have contributed to the popularity of both catalog and online shopping.

Collecting sales taxes on remote sales

Because states, under *Quill*, cannot require out-of-state retailers to collect sales taxes and are having little success requiring consumers to pay use taxes, states are trying novel ways to increase tax revenue on remote sales. According to *Forbes Magazine*, 10 states passed legislation affecting remote sellers in 2011: Arkansas, California, Connecticut, Illinois, New York, North Carolina, Rhode Island, Tennessee, Texas, and Vermont.

Congress also is considering several bills to grant states explicit authority to require remote sellers to collect sales taxes.

Uniformity in state taxation. Some states are trying to coordinate their sales tax policies and rates to reduce compliance costs and increase voluntary collection of sales taxes on remote sales. The Multistate Tax Commission, the National Conference of Commissioners on Uniform State Laws (NCCUSL), and the Streamlined Sales and Use Tax Agreement (SSUTA) seek to streamline rates and definitions of taxable goods and services with a goal of improving sales tax compliance and reporting. These groups hope uniformity will promote the flow of goods and commerce by diminishing the administrative burden of collecting

Amazon and state reach agreement on sales taxes

Large Internet-based retailer Amazon.com will start collecting sales taxes on online purchases by Texas customers this July. The state of Texas and Amazon announced the agreement in April. The agreement also resolves an outstanding lawsuit by the Texas state comptroller against Amazon. In the lawsuit, filed in October of 2010, the comptroller sought \$269 million in outstanding sales taxes. The comptroller argued that Amazon had a duty to collect and remit sales taxes on sales made to Texas residents between 2005 and 2009. Under the agreement, the state no longer will pursue its claim against Amazon for the payment of back taxes.

The comptroller claimed that Amazon had a duty to collect and remit these taxes because Amazon's distribution warehouse in Irving constituted a physical presence, or nexus, in Texas. Under the U.S. Supreme Court decision in *Quill Corp. v. North Dakota* and related cases, this nexus triggers Amazon's responsibility to collect and remit Texas sales taxes, the comptroller said (*see Current law, page 1*). Amazon said that because it did not maintain a storefront or a sales force in Texas, it was not required to collect sales taxes. In a letter to the Legislature in February of 2011, the comptroller wrote that Tax Code, sec. 151.107 required any entity engaged in business in Texas to collect applicable sales taxes. The statute defines "engaged in business" to include maintaining, either directly or through a subsidiary, an office, sales or sample room or place, warehouse, storage space, or any other place of business.

During the regular session of the 82nd Legislature in 2011, Amazon offered to invest \$300 million in additional distribution warehouses and to create 6,000 jobs in Texas. As part of the deal, Amazon sought a four-and-a-half-year moratorium on any obligation to collect Texas sales taxes. The Legislature did not enact the moratorium. In its first called session in 2011, the Legislature enacted SB 1, which, among other changes, expands the definition of a retailer doing business in Texas to include businesses, like Amazon, whose controlled subsidiaries operate in Texas.

and reporting sales taxes with common definitions and notice of tax changes.

Many states and some members of Congress have determined that voluntary uniformity is probably not achievable. According to the Council on State Taxation, these agreements conflict with other basic tenets of the federal system, including state sovereignty and state tax competition and innovation. Outside of federal legislation, critics say, states are likely to continue to find advantage through differing rates and definitions of taxable goods and services.

Proposed federal legislation. Several bills on uniform national sales tax collection on remote sales have been filed in Congress, including the Marketplace Equity Act (Rep. Womack (R-AR) and Rep. Speier (D-CA)) and the Marketplace Fairness Act (Sen. Enzi (R-WY) and Sen. Durbin (D-IL)). Both bills would allow states to require sellers to collect and remit sales taxes on remote sales into their states as long as the state had adopted certain simplified sales tax collection rules under the Streamlined Sales and Use Tax agreement (SSUTA). Both bills would define a “remote sale” as a sale that took place outside of a state where the product or service was consumed and where the seller did not have the physical presence necessary to establish a taxable nexus.

Under the proposed Marketplace Equity Act, which is before the U.S. House Judiciary Subcommittee on Courts, Commercial, and Administrative Law, states would have to create:

- an exception for remote sellers with gross annual receipts in the previous year of \$1 million or less in the United States and \$100,000 or less in the state;
- a single sales and use tax return to be used by remote sellers and a single designated revenue collection authority with which remote sellers would file state and local tax returns; and
- a uniform tax base in the state in which the goods and services subject to the tax were identical throughout the state and any exemptions applied statewide.

Under the proposed Marketplace Fairness Act, which is before the U.S. Senate Committee on Finance, states that were full members of the SSUTA could require remote sellers to collect sales taxes if the seller did not qualify for a small business exemption of \$500,000 or less in total U.S. remote sales. A state that was not a member of SSUTA could require remote sellers to collect sales taxes if the state enacted certain sales tax simplification requirements, including:

- providing a single state agency to administer all sales taxes;
- establishing a uniform sales tax base;
- relieving remote sellers from liability to the state or locality for incorrect collections if the seller relied on information provided by the state; and
- providing remote sellers 30 days notice of a tax rate change in any locality in the state.

Debate on the bills in Congress has centered on how difficult they would be to implement. Sales tax administrators note that jurisdictions have varying rules for “sourcing,” which is the process of assigning the location of a taxable event. For example, many say services should be taxed where they are provided, rather than where the consumer resides.

Others say states would need to develop a reliable database that both correctly listed and updated sales tax rates and definitions in a timely manner. Many states, including Texas, allow for local sales taxes, which means state administrators also would have to track local rate changes. Legislation would need to consider responsibility for faulty reporting of rates and may need to include indemnity provisions.

Federal legislation may also need to take into account whether and when states could drop out of requiring remote sellers to collect sales taxes or if they could deviate from the SSUTA to create exemptions or change definitions.

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Alternatives to out-of-state sales tax

Because of perceived drawbacks in requiring out-of-state sellers to collect sales taxes, some have looked for other methods to either increase fairness in the market or increase tax revenue.

Origin-based sourcing rules. Some say that Congress should impose an “origins-based” sourcing rule for those states that seek to place sales tax collection obligations on interstate vendors. Under such a rule, all sales would be “sourced” to the retailer’s principal place of business and taxed by that locale. Supporters of this model say it is the traditional method of taxing sales and that millions of cross-border sales are conducted this way every day at brick-and-mortar stores when consumers cross state lines to shop. They say origin-based sourcing would be constitutional under *Quill* because it would avoid imposing tax duties on out-of-state businesses.

Beyond ease of determining where to remit taxes, the real benefit of this model, supporters say, is that it would create vigorous tax competition. Companies would be encouraged to move to locations with low tax burdens to make their goods and services more affordable. Opponents of origin sourcing say it could lead to a “race to the bottom” in which states trying to compete on sales tax rates undercut their sales tax revenue.

National Internet sales tax. Still others have proposed establishing one national Internet sales tax on remote sales, with a method for distributing the revenue among states and localities to be determined. Supporters say it would avoid the complexity of conflicting state tax policies and rates by providing a single rate and set of definitions and would improve fairness in the marketplace between remote sellers and traditional brick-and-mortar stores. Opponents say a national Internet sales tax may prove to be too tempting to federal budget writers, who might decide to appropriate new tax revenue to federal programs, diverting revenue from needy states. Other opponents say it would create a new federal tax when American consumers and businesses already pay too much in federal taxes.

Recent legislation in Texas

A bill enacted by the 82nd Legislature in its first called session in 2011, SB 1 by Duncan, expands the definition of a retailer doing business in Texas. The purpose of this change is to increase the number of companies that must collect sales taxes. Under the new law, retailers responsible for collecting sales tax now include those with a substantial ownership interest in or owned by an entity with a location in Texas where business is conducted if:

- the retailer sells a line of products that is the same as or substantially similar to that of the entity with the Texas location and also sells these products under a business name that is the same as or similar to that of the entity with the Texas location; or
- the facilities or employees of the entity with the Texas location are used to advertise, promote, or facilitate sales by the retailer to consumers or to perform any other activity on behalf of the retailer intended to establish or maintain a marketplace for the retailer in Texas, including receiving or exchanging merchandise.

Under the new law, the definition of a retailer doing business in Texas also includes an entity with a substantial ownership interest in another entity with a distribution center, warehouse, or similar location in Texas and that delivers property sold by the retailer to consumers.

The definition also includes a person or business who, under an agreement with another person:

- is entrusted with possession of tangible personal property in which the other person has title or another ownership interest, such as in consignment sales; and
- is authorized to sell, lease, or rent the property without additional action by the person with the title to or ownership interest in the property.

“Ownership” is defined as direct, common, or indirect ownership through a parent entity, subsidiary, or affiliate. “Substantial” means an ownership interest of at least 50 percent.

HB 2403 by Otto, enacted during the regular session in 2011 but vetoed by the governor, had provisions identical to some of those in SB 1, the omnibus fiscal matters bill that was enacted during the first called session. Gov. Perry, in his veto of HB 2403, stated that there was not yet widespread consensus on whether and how sales taxes on remote sales should be collected and that Texas should wait until there was agreement “that balances the competing interests, respects federalism, and is fair and equitable.”

Supporters of SB 1 say the new definitions clarify existing law requiring businesses that are physically present in Texas to collect sales taxes on their sales to Texas customers. They say some businesses selling to Texas customers were attempting to avoid the statutory definition of doing business in Texas through creative corporate and ownership structures, in which certain business aspects were fulfilled by companies present in Texas, while the taxable sales were performed by related out-of-state companies.

Supporters say the bill was narrowly drafted and defines retailers as being physically present in Texas only if they control more than 50 percent of a business entity in the state where the retailer sells substantially the same product line as the subsidiary and does so under substantially the same business name. They point out that it also covers out-of-state retailers that are more than 50 percent controlled by a Texas business. Supporters say it provides a narrow definition of nexus that fits within the *Quill* ruling, unlike broader definitions of taxable nexus, such as those enacted by Colorado and Illinois that recently were struck down in court.

Broader definitions of nexus, such as the affiliate (“click-through”) nexus used by Colorado and Illinois, risk running afoul of the *Quill* decision and being struck down by courts as a violation of the commerce clause of the U.S. Constitution. Using affiliate nexus would require out-of-state retailers to collect sales taxes on online purchases made by customers who had clicked through an in-state website linked to the retailer if the retailer and the affiliated website had a contractual agreement for these referrals.

Opponents of SB 1 say it regulates Internet companies that more appropriately should be regulated by Congress. They say the U.S. Constitution assigns the regulation of interstate and international commerce to the federal government. Piecemeal state statutes like SB 1, they say, complicate an already byzantine system of sales taxes and regulations with which retailers must comply when doing business in multiple jurisdictions.

Opponents say that in the *Quill* decision the U.S. Supreme Court determined that businesses should not have to collect sales taxes under the differing tax rules and rates imposed by the states, cities, counties, and other taxing jurisdictions unless the businesses are physically present there. Requiring otherwise is onerous to business and can stifle interstate commerce. Opponents of SB 1 say that even under the bill’s definition of control, the out-of-state business is not physically present in the state and that, absent congressional regulation, should not be required to collect sales taxes.

Other opponents of SB 1 say its definition of nexus is too narrow and that the bill does not adequately tax out-of-state Internet sales. They say the bill should use affiliate (“click-through”) nexus. This would require out-of-state retailers to collect sales taxes on online purchases made by customers who clicked through an affiliated in-state website that had a contractual agreement with the retailer for referrals. Affiliate nexus would help capture millions more of the sales taxes lost to Internet sales, thus enabling the state to collect taxes that already are due to it and better level the playing field between online and brick-and mortar retailers.

— by Tom Howe

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