



MULTISTATE TAX COMMISSION

Analysis of Online Sales Simplification Act of 2016

Based on Discussion Draft Released August 25, 2016

This analysis was prepared by the Multistate Tax Commission with input from member states and others. The Commission previously stated a position opposing the origin or hybrid-origin sourcing approach used in the Online Sales Simplification Act. This paper provides overview of the provisions of the draft and identifies potential constitutional, legal, and other administrative issues with those provisions.



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Background

Limitation on Collection of State Sales and Use Tax

Sales and use taxes, like income taxes on wages, rely almost entirely on tax collection and reporting by third parties. In the case of sales and use taxes, that third party is usually the seller who keeps the necessary records and can collect the tax along with the sales price. But in 1992, the U.S. Supreme Court in the *Quill* case held that the dormant Commerce Clause prevented states from imposing a use tax collection duty on mail-order sellers that lacked some physical presence in the state.¹ At the time the case was decided, Internet retail was a novelty. And although charging and collecting the sales or use tax does not impose the same difficulty on Internet sellers, states have generally considered the *Quill* limitation to apply them as well.² With the growth of e-commerce, the *Quill* limitation has reduced sales and use tax revenues and placed brick-and-mortar (locally based) businesses at a competitive disadvantage since purchasers can get the same goods from Internet sellers without the tax being collected.

Since 1992, states have worked with industry groups and software and service providers to streamline and automate sales and use tax compliance functions. Today, there are a number of efficient options for Internet sellers who want to comply with tax collection requirements. But the *Quill* limitation is still in place and Internet retailers can structure their businesses to avoid having to collect taxes. States have tried alternative approaches to collecting use taxes directly from taxpayer-purchasers, but no method has resulted in more than minimum levels of compliance.

¹ *Quill Corp. v. North Dakota*, 504 U.S. 298.

² Catalogue sellers who receive orders and payment by mail face the difficult task of charging for the tax due only after receipt of the order. Internet sellers, in contrast, can calculate and charge the tax during the ordering and payment process online.

The Multistate Tax Commission



The Commission was created in 1967 by the states in response to federal proposals to regulate state taxation and to create a federal administrative agency to oversee that proposed regulatory scheme. (See the Report of the Special Subcommittee on State Taxation of Interstate Commerce of the Committee on the Judiciary, September 2, 1965.) The purposes of the Commission are to facilitate proper determination of tax liabilities of multistate taxpayers, promote uniformity or compatibility in significant components of state tax systems, facilitate taxpayer convenience and compliance, and avoid duplicative taxation.



State Legislation and Litigation

Since 1992, states have made inroads in establishing that Internet sellers often have some kind of physical presence in states where they make sales. That presence may include commissioned sales people or representatives, other contract agents or representatives providing essential services to customers, warehousing or fulfillment services, marketplace providers performing seller functions, etc. By enacting statutes clarifying that such presence creates an obligation to collect sales and use taxes, and by pursuing successful litigation on the issues, states have reduced the extent to which the *Quill* limitation might otherwise apply to modern e-commerce. Most recently, states have required Internet sellers to provide information to in-state purchasers and to the state tax agency to create more effective mechanisms for purchaser-reporting of use tax.³

Federal Legislation

The states and some retail groups have sought legislation from Congress to remove the *Quill* limitation. Over the years, different proposals have been put forward with limited success. In May 2013, the Senate, along with support of the states and retailers, passed the Marketplace Fairness Act (S. 743). That act would have required states to simplify their sales and use tax collection and reporting systems if they wished to impose a collection obligation on sellers over a certain size. The House did not take up the bill.

Note on the OSSA's Hybrid-Origin-Based System

Under the long-established sales and use tax system used by states, tax is imposed on interstate sales on a destination basis. That is, it is the purchaser's state that determines which goods and services are taxable, or exempt, and the tax rate. This destination-based system ensures that it is the lawmakers representing the purchaser who are accountable for the imposition of taxes. OSSA departs from this long-standing system. Instead, it uses a hybrid-origin-based system for taxing "remote sales," broadly defined. Under this system, it would not be the lawmakers in the state of the purchaser who determine which sales are taxable. Rather, it would be lawmakers in some other state (that is, the state defined as the "origin state" under the draft, which will not necessarily be where the transaction originated). This radically different approach poses constitutional questions and significant administrative problems.

³ See *Direct Marketing Ass'n v. Brohl*, 814 F.3d 1129 (10th Cir., 2016)(cert. pending) where the Tenth Circuit held that sellers who could not be required to collect the tax could be required to provide information for enforcement of the tax on purchaser.



Overview – Principles and Summary of Provisions

The Principles that Guide Our Analysis

The principles which guide this analysis are:⁴

1. The chief problems to which OSSA is ostensibly addressed, and by which it must be evaluated, are –
 - The need for states to be able to enforce the collection of their sales and use tax
 - The need for tax parity so that sellers of all types compete on a level playing field with respect to purchasers in a given market
2. Disruptions of the existing state tax system must be balanced against any benefits that federal legislation might provide.
3. Unless federal legislation specifically delegates regulatory authority to the states or some state agency, any federal measure must be carefully drafted so as to be self-executing, addressing all probable scenarios, otherwise it will generate controversies and inconsistencies in application that can only be resolved through litigation.
4. As a federal preemption statute, courts may interpret OSSA to preempt not only the state laws that are explicitly preempted, but also laws that may be in conflict with the purposes of the act.⁵
5. When proposed federal legislation is unprecedented and the effects of that legislation have not been thoroughly studied, we assume that unintended consequences are likely to follow.

⁴ It should be noted that the drafters of OSSA have asserted that the bill should meet the following principles:

1. Tax Relief – Using the Internet should not create new or discriminatory taxes not faced in the offline world. Nor should any fresh precedent be created for other areas of interstate taxation by States.
2. Tech Neutrality – Brick & Mortar, Exclusively Online, and Brick & Click businesses should all be on equal footing. The sales tax compliance burden on online Internet sellers should not be less, but neither should it be greater than that on similarly situated offline businesses.
3. No Regulation Without Representation – Those who would bear state taxation, regulation and compliance burdens should have direct recourse to protest unfair, unwise or discriminatory rates and enforcement.
4. Simplicity – Governments should not stifle businesses by shifting onerous compliance requirements onto them; laws should be so simple and compliance so inexpensive and reliable as to render a small business exemption unnecessary.
5. Tax Competition – Governments should be encouraged to compete with one another to keep tax rates low and American businesses should not be disadvantaged vis-a-vis their foreign competitors.
6. States’ Rights – States should be sovereign within their physical boundaries. In addition, the federal government should not mandate that States impose any sales tax compliance burdens.
7. Privacy Rights – Sensitive customer data must be protected.

See <https://judiciary.house.gov/press-release/house-judiciary-committee-releases-principles-on-internet-sales-tax/>

⁵ *AT&T Mobility v. Concepcion*, 563 U.S. 333 (2011)(holding that even if a federal statute does not explicitly preempt a state law, that law will be preempted if “stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress”).



Summary of OSSA's Provisions

This section contains a summary of how OSSA's provisions appear to work based on the draft reviewed. But there are a number of areas in which the draft contains provisions that are incomplete or ambiguous. This is due both to the structure of the draft and the imprecise use of defined terms and other language. In terms of structure, there is no one section that sets out clearly how a seller must treat a remote sale depending on whether the "origin state" has or doesn't have a sales and use tax, or does or doesn't participate in the draft's clearinghouse, and whether the destination state has or doesn't have a sales and use tax, or does or doesn't participate in the clearinghouse. Because there is no one section that addresses all these scenarios, the results must be determined by piecing together different provisions.

The imprecise use of language makes this determination more difficult. As an example, sometimes the draft refers to the "origin state" (a defined term) and sometimes to the state the seller is "in" (which might very well imply a different state). Similarly, the draft sometimes refers to the destination state (a precise term based on the draft's sourcing rules) and sometimes to the state that the purchaser is "in" (which might very well not be the destination state). When it is not possible to determine how the draft would treat a particular situation, this summary attempts a "best guess," but notes the uncertainty.

Summary:

1. The draft applies to "sales, use or similar tax." The draft does not define a sales or use tax but it does define "similar tax" as one "measured by gross receipts or selling price, imposed with respect to the sale or use of a product or service, regardless of whether the tax is imposed on the seller or the purchaser, with the right or obligation of the seller to obtain reimbursement for the amount of the tax from the purchaser at the time of the transaction."
2. The draft preempts states from requiring sellers to collect tax on "remote sales" except as provided under the draft. Sec. 2(a). It does not preempt collection of tax directly from purchasers. Sec. 2(e). It does, however, preempt states from requiring that "remote sellers" report information that may be essential to collection of tax from purchasers. Sec. 2(c).
3. Definitions of "remote seller" and "remote sale" (and the related definition of "physical presence") create a much larger class of sellers not subject to the regular state sales and use tax collection requirements than would currently be included under the interpretation of *Quill's* limitation in most states. See Sec. 6(8),(10) and (11). Further, while there are attributional rules when determining a seller's origin state (attributing employees of affiliates for that purpose), but there are no attributional rules with respect to physical presence—so that property or activities of an affiliate will not be attributed to the seller.



4. In general, the draft attempts to simplify sales and use tax reporting for sellers making “remote sales” by subjecting those sales to a single tax base, that of the “origin state,” and requiring the “origin state” to collect and distribute the tax to the destination states through a clearinghouse. An exception is made for “compliant purchasers” (business purchasers) who may be taxed on a destination basis rather than an origin basis in certain circumstances. See Sec. 3(a)(6)(A).
5. The state where a seller has the largest number of employees will be designated the “origin state” for that seller and the seller will collect tax on any “remote sales” based on what that state taxes or doesn’t tax. Sec. 6(6), and Sec. 2(a)(2). But, assuming the destination state (the state to which the sale is sourced) participates in the clearinghouse, the tax will be imposed at the destination rate (the rate applicable in the purchaser’s state). Sec. 2(b).
6. Assuming the “origin state” participates in the clearinghouse, the tax collected on remote sales will be collected and distributed by the “origin state” to the destination state (with exceptions, see below) through the clearinghouse to be set up by the states.
7. The draft attempts to address the reality that some states do not impose a general sales and use tax (or “similar tax” defined by the draft) and some states may choose not to participate in the clearinghouse. While the draft does not clearly address every situation, it appears that its provisions would lead to the following results:
 - a. If a seller’s “origin state” has a sales and use tax and participates in the clearinghouse, then:
 - i. If the sale is a “remote sale” to a purchaser sourced to a destination state that has a sales tax and participates in the clearinghouse, the seller will determine if the sale is taxable under the “origin state’s” law, applying the destination state rate (as determined under the draft) and the tax will be collected from the purchaser, reported to the origin state, and then distributed to the destination state. Sec. 2(a) and (b), Sec. 3(a)(1),(2) and (3).
 - ii. If the sale is a “remote sale” to a purchaser sourced to a destination state that has a sales and use tax but doesn’t participate in the clearinghouse, the seller will determine whether the sale is taxable under the origin state’s law, applying the origin state’s normal tax rate for the seller’s in-state location, and the tax will be collected from the purchaser, reported to the origin state, and retained by the origin state. Sec. 2(b), Sec. 3(a)(4) and (b).
 - iii. If the sale is a “remote sale” to a purchaser sourced to a destination state that does not have a sales and use tax, then the treatment of that sale is unclear. It appears under the provisions of the draft (See Sec. 2(a) and (b); Sec. 3(a)(4)



and (b)) that if the destination state does not participate in the clearinghouse (despite not having a sales and use tax) the origin state would be able to collect and retain a tax on the sale. If, however, the destination state does participate in the clearinghouse, it appears that under Sec. 2(a) and Sec. 4(b), the seller would not have to collect tax on the sale.

- b. If the seller's "origin state" has a sales and use tax but that state doesn't participate in the clearinghouse, then the seller must provide an information report on remote sales including purchaser name and amount to the clearinghouse, but there is no requirement to collect tax even under the so-called "alternative base" as defined. See Sec. 3(a)(5) and Sec. 5(a).
 - c. If the seller's "origin state" does not impose a sales and use tax AND does not participate in the clearinghouse, the seller must generally collect and report tax at the destination rate on the so-called "alternative base" (the tax base of the state into which the seller "had the most gross receipts the preceding calendar year") directly to the clearinghouse. Sec. 4(a) and Sec. 6 (1).
 - d. The question of what happens if the seller's "origin state" does not impose a sales and use tax but does participate in the clearinghouse is not directly answered by the draft. On the one hand, it does not appear that a state that does not impose a sales and use tax can participate in the clearinghouse since Sec. 3(a)(1) requires that "each state participating in the clearinghouse establish a single state-wide destination rate to apply to sales by a remote seller to purchasers in such State." On the other hand, states cannot require a remote seller to pay or collect tax if the purchaser is "in" a state that does not impose a sales and use tax and is also a participant in the clearinghouse. See Sec. 4(b). If it is allowable for a state to impose a rate of 0%, these seeming contradictions can be resolved. Assuming that a state can participate in the clearinghouse without a sales tax, then it is not clear how the seller that must report to that state as its "origin state" would treat a remote sale made to a destination state that had a sales tax but did not participate.
8. Sec. 2(c) of the draft preempts states other than the "origin state" from requiring a seller to report sale-specific information, and also precludes the "origin state" from disclosing that information.
 9. Only the "origin state," or in limited cases, the clearinghouse, may audit a seller with respect to "remote sales." Sec. 2(d) and Sec. 3(a)(7).
 10. The draft removes the protection of the Tax Injunction Act for actions arising under the act, except for the assessment, levy, or collection of tax by an "origin state." Sec. 7.



Analysis

This analysis covers only the most significant issues. It is not limited to the text of the draft but looks at likely impacts.

OSSA does not fully address the problems that it ostensibly seeks to address.

As noted in the Principles section above, OSSA has been put forward as a potential fix for the two main problems in this area:

- The need for states to be able to enforce the collection of their sales tax; and
- The need for tax parity so that sellers of all types compete on a level playing field.

To address the first problem, OSSA should enable the collection of tax in instances in which the destination state imposes such a tax and participates in the clearinghouse. However, this will not always be the case. In particular, as noted in the summary above, if the seller's "origin state" has a sales and use tax but doesn't participate in the clearinghouse, then the seller must provide an information report on remote sales including purchaser name and amount to the clearinghouse, but there is no requirement to collect tax even under the so-called "alternative base" as defined. See Sec. 3(a)(5) and Sec. 5(a). This would leave the destination state to have to collect the tax directly from the purchaser.

As for tax parity, if a purchaser in a destination state that taxes a good or service can purchase that good or service from a seller with an "origin state" that doesn't tax it, then the purchaser can buy that good or service tax free. The destination state could try to collect the use tax in that case, but would be constrained by Sec. 2(c) which prevents the destination state from obtaining sale-specific information from the seller.

OSSA elevates interests of sellers over those of purchasers, creating constitutional questions.

Under OSSA's provisions, whether a purchaser must pay tax on a particular product or service purchased from a "remote seller" will not be determined by lawmakers in the purchaser's state of residence, but instead by lawmakers in the state where the seller has a plurality of employees (the "origin state"). That state may have no connection with the purchaser or even the transaction being taxed. Indeed, because of the employee attribution rules for determining the "origin state," the employees may belong to an affiliated entity, and be entirely unrelated to the transaction or activities of the entity that is the seller. (These employee attribution rules do not carry over to the determination of "physical presence." See further discussion below.)



For example, assume Seller X is located in New York and California, with most of its employees in California. If a purchaser in Illinois (where X is a remote seller) buys a product from X's New York operations, it will be California lawmakers, not those in either Illinois or New York, that will determine whether that product is taxable. California, as the "origin state," will also have certain administrative duties with respect to the tax (even if it is distributed to Illinois), thus requiring that the purchaser seek any relief or remedy not from Illinois, but from California. If Illinois does not participate in the clearinghouse, California would be able to retain the tax collected by the seller from the purchaser. Note that under OSSA, states must either permit or require sellers to seek reimbursement of the tax from purchasers. See Sec. 3(c) and Sec. 6(12).

Under due process principles, California normally has no jurisdiction to impose tax on a resident of another state unless that resident reaches out to California somehow. Whether the fact that the seller's "origin state" happens to be California creates a sufficient connection with a purchaser who deals with the seller's New York office is highly doubtful. Further, Congress has no power to change the due process limits of state jurisdiction.⁶ Therefore, even if Congress has power under the Commerce Clause to preempt state taxing authority, it does not have the power to give a state due process jurisdiction over a taxpayer that the state otherwise lacks.

Even if it were constitutional to do so, there appears to be no reason to favor the interests of the seller, providing the seller with access to the political process but denying that access by the ultimate payer of the tax, the purchaser, as this draft would do.

The definitions of "remote seller," "remote sale," and "physical presence" would cause a number of sellers currently collecting tax to fall under this alternative system.

The definition of "physical presence" in Sec. 6(8) would create a larger class of "remote sellers" than exists under interpretation and application of the *Quill* limitation. The chief issue involves the degree to which sellers will be able to engineer their business structures, setting up affiliated entities to isolate their presence-creating activities. Currently, most states will attribute property or activity in the state to a seller for purposes of the *Quill* limitation if the property is held by an affiliate and promotes the seller's business. But while the employees of an affiliate may be attributed to the seller when determining the "origin state" in some circumstances (See Sec. 6(7)), there is no similar provision for attributing employees or physical presence from one

⁶ Ironically, the case that stands for this proposition is *Quill*, 504 U.S. at 305.



affiliate to another for determining “physical presence.”⁷ The lack of a clear attribution rule makes it easy for Internet sellers and even traditional sellers to engineer their structures to meet the definition of “remote seller.”

For example, assume that the seller has most of its employees and operations in Florida but also has employees in California who provide on-site design, installation, and repair services supporting the seller’s market there. If the seller drops those employees into a separate affiliated entity, then under the explicit provisions of Sec. 6(8)(A)(iv), they would no longer be employees of the seller and their activities would not provide physical presence for the seller. Similarly, if the seller has inventory in a state that exceeds the amount or time-limit under the draft’s provisions, it would be a simple matter to drop that inventory into a separate legal entity and isolate this presence-creating property. (See Sec. 6(8)(A)(ii)).

OSSA creates a greater likelihood of unproductive state competition.

Not all competition on taxes among states is negative, but it appears that the hybrid-origin-based approach used by OSSA would lead to competition by states that would not be productive and would harm the sales and use tax system. Most economists and policy analysts agree that the best consumption-based tax is one with a broad base and low rate. Currently, states have minimal incentive to exempt goods and services except for policy reasons that tend to apply across the states and that are focused on the purchaser’s burden. So, for example, lawmakers in all states have chosen to exempt certain business inputs, because doing so avoids “cascading” the tax. And most states exempt food (or tax it at a lower rate) to mitigate regressivity of the tax.

But under the draft, a state would have an incentive to exempt the goods or services sold by sellers who claim the state as their “origin state,” even though such exemptions would have no general policy rationale apart from favoring those sellers for maintaining a plurality of their attributed employees in the state. The sellers, in turn, would get tax exemptions for certain goods or services which would make them more competitive in all their markets. The impact of those exemptions on the “origin state” might be very small in comparison to the value to the sellers from being able to better compete in the multistate market. Sellers might be willing to pay other taxes and fees to the “origin state” (making it whole for the loss in its own revenue)

⁷ For example, in 2011, Texas determined that an affiliate of Amazon.com had real and tangible property in the state and asserted a tax filing and collecting obligation against the Internet seller which was eventually settled by Amazon agreeing to collect tax in the state. See <https://www.texastribune.org/2012/04/24/amazon-comptroller-negotiating-sales-tax-deal/>. And although the draft is silent on this type of attribution, the fact that attribution of employees in determining the “origin state” is explicitly allowed makes it more likely that courts would decline to apply any implicit attribution for some other purpose.



in order to obtain tax exemptions that apply in its other markets. Alternatively, the “origin state” might simply raise taxes in other areas to make up the loss in its own revenue from the exemptions. For these reasons, granting targeted exemptions will not necessarily create positive competition, but may only make the sales and use tax system less uniform and less fair.

The draft is likely to create significant administrative problems because it lacks sufficiently specific, unambiguous provisions, and fails to delegate regulatory authority to the clearinghouse.

As noted under the principles above, to avoid unintended consequences or the risks of significant disruption of the current state sales and use tax system, it is necessary that the provisions of any federal legislation be clear, specific, and not subject to interpretation. Because there will be multiple states involved, it is possible that states’ interpretations of the law will differ. Moreover, taxpayers may also interpret the provisions differently. This affects whether the draft can be implemented without significant controversy.

One important example of a provision that is subject to multiple interpretations is Sec. 2(c). That provision states, in part, “. . . a seller who makes a remote sale shall not be required to report information pertaining to that sale to a State other than the origin State. The information reported by the origin State to any entity other than a destination State and related to a compliance certificate in the course of an audit of a remote seller shall be limited to the amount of sales, use or similar tax paid and the destination State.” This provision expresses a broad preemption against state authority to require information reporting for general regulatory purposes. It is possible that the drafters intended this preemption to apply only for tax purposes, although it is not so limited. But whether it is intended to apply broadly or narrowly, this will no doubt be the subject of controversy since there are numerous areas in which states would currently assert general regulatory authority over sellers who might be considered “remote sellers” under the draft’s definition of “physical presence.”

Another example of a provision in the draft that will likely need further regulatory interpretation is the term “destination state” which is defined by way of general sourcing rules. These rules may be fine for tangible goods. They will be less useful for services and for digital products. If there is a controversy over where a service or digital product is received, there will need to be some way of resolving this other than through ongoing litigation (which litigation may involve multiple states).

One way to address these types of problems is by delegating regulatory authority to the clearinghouse. The draft does not do this. The draft provides that the states must create a clearinghouse and requires the states to perform certain functions through that body, but it does not



specifically delegate regulatory authority to the clearinghouse. The clearinghouse will therefore not be able to adopt general interpretive or implementing regulations other than through the individual states. Those state regulations will not necessarily have to be the same, nor will they necessarily have binding effect, since they interpret federal law (also without any specific congressional delegation).

Assuming that OSSA would require a state without a sales and use tax to fully participate in the clearinghouse (taking taxes from instate remote sellers and distributing them) in order to avoid having tax imposed on citizens' remote purchases (by the "origin state" of the seller of those items), this may constitute unconstitutional commandeering.

To make this hybrid-origin system workable, there needs to be some basis for expecting states that have no sales and use taxes to nevertheless participate in the clearinghouse—setting up a new system to take in reports and to collect and distribute taxes. Further, it appears that the draft uses a kind of penalty to achieve this—unless a state participates, remote sales to its own citizens will be subject to tax (see the Summary of OSSA's Provisions, number 7 above). This may constitute coercion or commandeering of state resources that has been held to violate states' rights under the Constitution. Most recently, the Supreme Court in *National Federation of Independent Business v. Sebelius*⁸ reiterated its long-held principle that the federal government may not "conscript state agencies into a national bureaucratic army." There, the Court held that "Congress is not free to penalize States that choose not to participate in that new [Medicaid] program by taking away their existing Medicaid funding."

Conclusion

Given the issues identified in this analysis, it appears that the potential costs and difficulties in implementing the draft exceed any benefits to the states. Moreover, the draft creates political and constitutional issues that are as great as those it seeks to resolve. The draft's hybrid-origin-based approach is unworkable even if its drafting problems are fixed. There are alternatives. Although the Multistate Tax Commission does not endorse any federal preemption of state tax law, it is important to note that the Marketplace Fairness Act (MFA) uses a workable destination-sourcing system and lacks the numerous drafting and constitutional challenges of this draft.

⁸ 567 U.S. ____ (2012), 183 L. Ed. 2d 450, 132 S.Ct. 2566.

