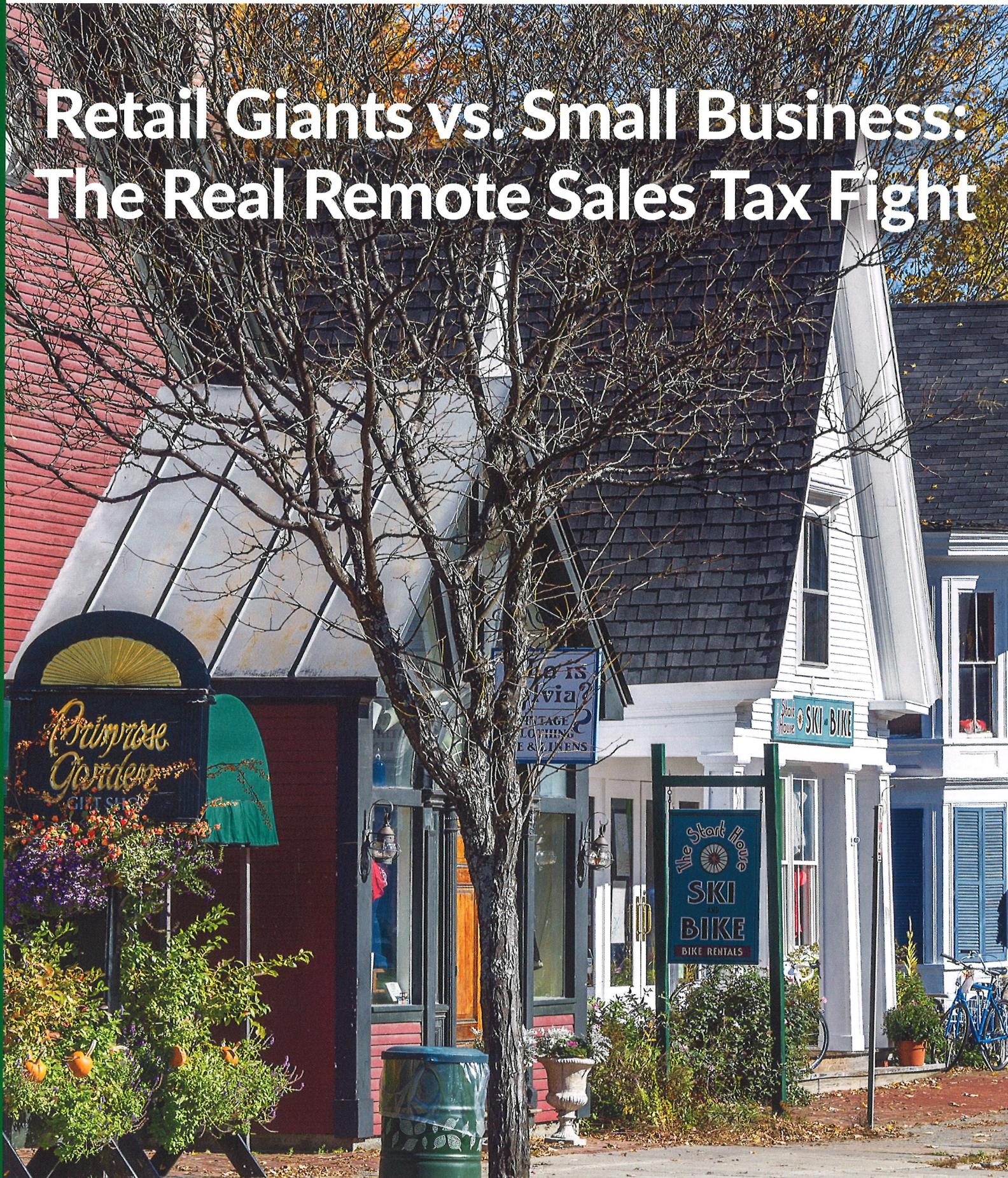


Retail Giants vs. Small Business: The Real Remote Sales Tax Fight



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In this edition of Eyes on E-Commerce, Isaacson and Schaefer examine how efforts to expand state sales tax authority over remote sales transactions benefit major retailers at the expense of small and medium-sized businesses and start-ups, threatening to block access to the digital marketplace for all but the largest companies.

For years now, state governments have taken up arms against catalog companies and electronic merchants to impose use tax collection obligations on remote sellers. Those battle plans have included agency

nexus theories, affiliate nexus regulations, click-through nexus statutes, notice and reporting laws, economic presence statutes, and other exotic approaches to compel tax collection by retailers located beyond state borders. Efforts to expand the territorial reach of state laws and circumvent the constitutional limits on the scope of state taxing authority have been grounded primarily on exaggerated projections of lost use tax revenue resulting from sales made by out-of-state direct marketers. Indeed, state politicians and tax administrators insist on blaming the U.S. Supreme Court for its allegedly erroneous and outdated decisions that shield remote sellers from tax collection obligations because of the physical presence substantial nexus rule of *National Bellas Hess Inc. v. Illinois Department of Revenue*¹ and *Quill Corp. v. North Dakota*.² As part of their campaign for reversal or circumvention of Supreme Court precedent, state officials regularly cloak themselves in a pro-Main Street mantle by maintaining that the existing constitutional limitations on state taxing power are unfair to in-state businesses that must collect sales tax.

Really at issue are two major policy considerations. The first is the competition between, on the one hand, the underlying objectives of the commerce clause³ in creating and protecting a single national marketplace unfettered by commerce-choking state regulations and taxes, and, on the other hand, the interest of state governments in obtaining use tax revenue due from consumers located in their states. The second policy consideration is the actual dimension of the lost revenue purportedly suffered by the states as a result of commerce clause limitations on the scope of their extraterritorial taxing jurisdiction.

Advocates of expanded state taxing authority are understandably focused on local concerns, and consequently they have never taken into proper

¹387 U.S. 753 (1967).

²504 U.S. 298 (1992).

³U.S. Const., Art. 1, section 8, cl.3.

account the paramount national interests that underlie both the *Quill* rule and the commerce clause itself — that is, structural concerns regarding the proper regulation of the national economy.⁴ Significantly, however, in today's online marketplace, a new paradigm has arisen, which renders the states' revenue concerns marginal, at best, while bringing the Constitution's central commercial concerns into sharp relief.

Major retailers that collect sales tax on all (or nearly all) of their remote sales — including Amazon.com and its big-box retail chain competitors, such as Wal-Mart Stores Inc., Target Corp., and Best Buy Co. — dominate the direct marketing landscape, claiming an ever greater share of the digital marketplace. As a result, the states' efforts to expand their taxing authority to require remote sellers with no physical presence within their borders to collect use tax is directed primarily at smaller businesses, especially start-up companies and niche retailers, for whom the internet provides an opportunity to sell their goods and services to a national market. Imposing complicated and burdensome multistate tax collection obligations on small and medium-size businesses, which lack the resources for nationwide sales tax compliance, would effectively block them from participating in the unprecedented opportunities made possible through e-commerce and would only serve to benefit retail giants by eliminating their smaller competitors. The remote sales tax battle has evolved into a direct assault on small business.

Uncollected Use Tax on Remote Sales Is a Self-Correcting Problem

Estimates of uncollected sales tax revenue on remote sales relied on by advocates of expanded state tax authority have always been exaggerated in both gross amount and directional trend. Those figures are now demonstrably incorrect. The states have pointed primarily to a 2009 University of Tennessee study⁵ that has gained wide currency.⁶ However, that study was discredited by competing analyses almost

immediately⁷ and was proven exaggerated by later developments.⁸ Even more significantly, its relevance to the debate has been eroded entirely by the considerable changes that have occurred in the marketplace since 2009, which have rendered the study's excessive projections of lost revenue essentially meaningless.

The most dramatic change has been the decision by internet behemoth Amazon.com Inc. to adopt widespread sales tax collection. In 2009, when the Tennessee study was published, Amazon collected tax in only five states. Beginning March 1, Amazon will collect tax on sales to consumers in 39 states and the District of Columbia, which together comprise over 90 percent of the U.S. population.⁹ Because Amazon's internet sales alone exceed, by some estimates, the total combined sales of the next 18 largest internet retailers (most of which also collect sales tax),¹⁰ its change in tax collection practices reflects a drastic *reduction* in the amount of so-called uncollected sales tax revenue.

Further, large retailers that collect state sales tax nationwide increasingly dominate the online marketplace. Industry analyses of online revenue during the recent 2016 holiday season show that the top 10 internet sellers, which include Amazon.com and nine major multichannel "clicks and mortar" retailers — BestBuy, Target, Wal-Mart, Macy's Inc., Apple Inc., Nordstrom Inc., Kohl's Corp., Home Depot Inc., and J. Crew Group Inc. — alone accounted for 57.9 percent of all online sales.¹¹ There are, of course, many more companies among the largest internet sellers that also engage in widespread sales tax collection.¹² Those

⁷For example, a subsequent study showed that the Tennessee study overstated the uncollected use tax on internet sales by approximately 300 percent. See Jeffrey A. Eisenach and Robert E. Litan, "Uncollected Sales Tax on Electronic Commerce: A Reality Check" (Feb. 2010).

⁸Joseph Henchman, "The Marketplace Fairness Act: A Primer," Tax Foundation (July 14, 2014) ("The Fox study estimates have proven to be overstated by four- or five-fold based on subsequent actual collections experience in states that have been able to tax a large share of Internet purchases (such as those by Amazon.com)").

⁹David Grogan, "E-Fairness Continues to Expand: Amazon Collecting in 39 States and D.C.," updated Jan. 25, 2017.

¹⁰See Arthur Zaczkiewicz, "Amazon, Wal-Mart Lead Top 25 E-Commerce Retail List," WWD, Mar. 7, 2016.

¹¹Marcia Kaplan, "2016 Holiday Ecommerce Wrap-Up," Practical Ecommerce, Jan. 17, 2017.

¹²By the authors' count, 18 of the top 20 internet retailers have widespread physical presence, and dozens more top retailers have stores located nationwide (for example, Office Depot, Sears, Lowe's, J.C. Penney) and collect sales tax in all states that impose transaction taxes. See "Top 500 Guide," Internet Retailer (2016).

⁴*Quill*, 504 U.S. at 312 (the commerce clause is informed by "structural concerns about the effects of state regulation on the national economy").

⁵Donald Bruce, William F. Fox, and LeAnn Luna, "State and Local Government Sales Tax Revenue Losses From Electronic Commerce," University of Tennessee (Apr. 13, 2009).

⁶See, e.g., *Direct Marketing Association v. Brohl*, 135 S. Ct. 1124, 113 (2015) (Kennedy, J., concurring) (citing the Tennessee study for estimate of Colorado's uncollected use tax revenue).

companies have undertaken sales and use tax collection because of the business models they have chosen, including operating retail stores in most states (that is, multichannel retailers) and regional distribution centers (permitting faster overnight delivery to customers). Further, the growth in online sales has been driven primarily by Amazon (which alone accounted for 60 percent of online sales growth in 2015)¹³ and the major clicks-and-mortar retailers that now collect sales tax. The percentage of remote sales on which use tax goes uncollected is dwindling. As a result, the supposed problem of uncollected use tax on online sales is substantially smaller than past projections have claimed and is largely self-correcting.

Expanded State Tax Burdens Hurt Small Business

Thirty-five years after the Supreme Court decided *Quill*, the system of state and local sales taxes in the United States remains highly complex and is getting worse. Forty-five states, the District, and 10,000 local taxing jurisdictions impose a sales or use tax.¹⁴ That results in thousands of different tax rates, taxable and exempt products and services, exempt purchasers, shipping tax treatment, specialized tax rules (such as sales tax holidays and thresholds for different products), statutory definitions, registration and reporting regimes, documentation and record-keeping requirements, and filing systems. In addition to the compliance burdens of such a system, companies are exposed to potential audit by every state and locality with a self-administered sales or use tax. Remote sellers are only shielded from such inordinate burdens by the physical presence substantial nexus requirement for state taxes under *Quill*.¹⁵

The costs of compliance with this complex system are substantial, particularly for small businesses. The most conservative estimates suggest the sales tax compliance costs for small business are more than six

times greater, measured by the amount of sales tax collected, for smaller firms in comparison with their larger competitors.¹⁶ More recent industry analyses put the initial costs alone of implementing nationwide sales tax collection at between \$80,000 and \$270,000 for each retailer, with substantial annual compliance-related costs thereafter, including the ongoing expense of managing potential audits in 46 states and many more local jurisdictions.¹⁷ These costs would dramatically cut, and potentially eliminate, already tight profit margins in the retail marketplace for existing small and medium-size business.¹⁸ Costs of that magnitude are potentially prohibitive for entrepreneurs seeking to launch new businesses.

Because most large online retailers such as Amazon already collect sales tax, the real victims of expanded state taxing authority — should it be approved without requiring meaningful simplification — will be the small and medium-size internet and catalog companies that lack the resources of their larger competitors. Access to a national marketplace, via the internet, is crucial for small entrepreneurs to grow their businesses and succeed in the modern economy. Indeed, those are the innovators and job creators on which our 21st-century economy will rely. The excessive burdens placed on those companies by complex state and local tax regimes will effectively close access to the electronic superhighway for many start-ups and small businesses, stunting their potential for growth. The traditional backbone of the American economy — small and medium-size businesses — will suffer, while the primary economic engine of the “new” economy — the internet — will be the domain of only the largest retailers and service providers.

Debate Should Focus on Commercial Effects

The emerging, and now apparent, dynamic of Big Retail vs. Small Business in the remote sales tax debate highlights the fundamental issue that has always been present (though often masked by distracting claims) at the core of the remote sales tax debate. In deciding

¹³Tonya Garcia, “Amazon Accounted for 60% of U.S. Online Sales Growth in 2015,” MarketWatch, May 3, 2016.

¹⁴See “State Sales Tax Jurisdictions Approach 10,000,” Tax Foundation (Mar. 24, 2014).

¹⁵Instead of simplifying the burdensome sales tax system after *Quill*, the states collectively have made it even more complex. When the Court decided *Quill*, it cited in support of its decision the diverse and potentially conflicting sales tax obligations that would be imposed on remote sellers (in the absence the “physical presence” doctrine) by “the Nation’s 6,000-plus taxing jurisdictions,” explaining that they would unduly burden interstate commerce in violation of the commerce clause. *Quill*, 504 U.S. at 313 n.6. Since 1992, the number of state and local taxing jurisdictions imposing a sales tax has increased by several thousand to 10,000 or more such jurisdictions.

¹⁶PricewaterhouseCoopers, “Retail Sales Tax Compliance Costs: A National Estimate” (Apr. 7, 2006).

¹⁷Larry Kavanagh and Al Bessin, “The Real World Challenges in Collecting Multi-State Sales Tax for Mid-Market Online and Catalog Retailers,” TruST (Sept. 2013).

¹⁸Ben DiPietro, “What Are Compliance Costs for Online Sales Tax?” *The Wall Street Journal*, May 7, 2013 (“I see a situation where a lot of the \$1 million to \$10 million retailers fold up shop or heavily limit where they’re willing to sell. Many would fold up because the small margins don’t justify the compliance costs,” [Brian Kirkell, a retail tax expert at assurance, tax and consulting services firm McGladrey] said. “Where will that business go? To the large online retailers.”).

whether, and under what conditions, states should be authorized to impose sales tax collection obligations on remote sellers, the issue is principally one concerning the proper protection and regulation of interstate commerce and *not* a question of safeguarding local businesses or securing marginal state tax revenue. Indeed, the goal of a single national marketplace is precisely why the Framers reserved for Congress the power to regulate commerce "among the several States."¹⁹

Balancing the competing interests of the free flow of interstate commerce against state demands for increased taxing authority over internet and catalog sales requires a careful and cautious analysis. The myopic and parochial perspective of in-state vs. out-of-state or Main Street vs. online businesses no longer aptly describes the nature of the retail marketplace. The question for policymakers now is whether to deliver a body blow to small and emerging businesses hoping to compete in the increasingly integrated retail marketplace (and a gift to big retail) by imposing an overly complex and antiquated state sales tax system on the digital economy, or whether to demand real simplification in state and local tax regimes as the condition for expanded taxing authority.

The solution to that vital policy question must come from Congress, to which the Constitution properly assigns the responsibility for regulation of interstate commerce under the commerce clause. Congress alone has the expertise and legislative tools to view the issue on a national scale, taking account of the competing interests while ensuring that America's small businesses can continue to thrive and grow. Consideration of the *economic* consequences for the national market, not a continued focus on ever-shrinking "lost"

sales tax revenue, is necessary to protect small businesses and an accessible e-commerce environment from overly complicated state and local tax obligations in the modern digital marketplace. The goal of federal legislation should be true simplification of use tax collection, reporting, and associated audits. It is time for state governments to work with direct marketers, rather than against them, in achieving that result. If they do not, the states will only ensure the dominance of big retailers in the digital era, shutting small businesses out of the 21st-century economy. ■

¹⁹ See *Comptroller of the Treasury v. Wynne*, 135 S. Ct. 1787, 1794 (2015) (quoting *Hughes v. Oklahoma*, 441 U.S. 322, 325-326 (1979) (the underlying concern for adoption of the commerce clause was the "immediate reason for calling the Constitutional Convention: the conviction that in order to succeed, the new Union would have to avoid the tendencies toward economic Balkanization that had plagued relations among the Colonies and later among the States under the Articles of Confederation").