No Parity in New Federal Online Sales Tax Bill

by George S. Isaacson


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In this article, Isaacson takes to task federal legislation (H.R. 2775, the Remote Transactions Parity Act of 2015) that would allow states to require tax collection on remote sales, arguing that it would subject states to only minimal simplification requirements, fail to adequately protect consumer data, and allow states to bypass the Streamlined Sales and Use Tax Agreement.

On June 15 U.S. Rep. Jason Chaffetz, R-Utah, introduced H.R. 2775, the Remote Transactions Parity Act of 2015 (RTPA). The bill would grant states the authority to impose sales and use tax collection obligations on catalog companies and electronic merchants that have no physical presence in the tax jurisdiction.

Requiring remote sellers to collect sales taxes has been a long-standing objective of states and large retailers. Moreover, the U.S. Supreme Court in *Quill*[1] recognized that Congress, under its commerce clause power (Art. I, section 8, cl. 3), is "free to decide whether, when, and to what extent the States may burden interstate mail order concerns with a duty to collect use taxes."[2] However, in this regard, the Court in *Quill* emphasized Congress's role in protecting interstate commerce from undue burdens: "Congress has the power to protect interstate commerce from intolerable or even undesirable burdens."[3]

So the question presented is whether the RTPA is a balanced approach to helping states obtain sales tax revenue on remote transactions, while avoiding onerous burdens on catalog or Internet merchants and dampening the vitality of electronic commerce. The answer is an emphatic no. The bill as drafted is:

- complex and confusing;
- biased against small businesses;
- a drag on electronic commerce;
- an expansion of government bureaucracy;
- a retreat from Chaffetz's own prior efforts at tax simplification; and
- an invitation to protracted litigation.

I. Misleading Title

The RTPA has serious shortcomings, starting — not surprisingly — with its title. Contrary to that title, the bill does not create "parity." Rather, the legislation favors point-of-sale retailers who must comply with only one state and local tax jurisdiction (that is, where they are physically located), while forcing catalog companies and online retailers to comply with over 10,000 tax jurisdictions (where their customers are physically located).

It also favors big-box stores and online megaretailers that have the resources to manage complex tax requirements, such as in-house tax personnel, information technology departments, and the retention of major accounting firms to assist them. Meanwhile, small companies would be disproportionately burdened.

II. Problems in Section 2

A. Bypassing the SSUTA

If the Streamlined Sales and Use Tax Agreement, which was negotiated and adopted among the states themselves, is supposed to be the gold standard for sales and use tax simplification, then why does the RTPA permit states to bypass SSUTA altogether and conform their tax systems only to a substantially lesser alternative?

States developed the agreement to simplify and standardize sales and use tax administration, and its relevance is recognized in RTPA section 2(a). But the bill then proceeds to authorize massive new tax collection obligations on remote sellers without requiring states to bring their tax systems into conformity with SSUTA.

If state tax administrators developed SSUTA as the standard for simplification and uniformity in order to justify congressional action for expanded state tax authority, then federal legislation granting that authority should require states to adopt the agreement as a condition of extraterritorial tax jurisdiction.

B. Section 2(b)(1)(A) and (B): Cherry-Picking

States should not be allowed to cherry-pick which portions of their tax laws will be subject to the requirements of

[1] *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).
[2] *Id.* at 318.
[3] *Id.*

federal law. The RTPA provides that a state may enact legislation "specifying the tax or taxes to which such authority and the minimum simplification requirements . . . shall apply and specifying the products and services otherwise subject to the tax or taxes . . . to which the authority of this Act shall not apply."

In other words, the bill creates a smorgasbord of options for states. They can, at their unfettered discretion, include state taxes within the scope of the bill (expanding the reach of those tax laws but subjecting them to the bill's minimum simplification requirements), or exclude taxes altogether from the operation of the federal law and pursue out-of-state companies based on their own theories of nexus and tax liability.

It gets worse. Not only can states exclude taxes, but they may also exclude products and services from the operation of the proposed federal law. This is an invitation to manipulation, bias, and harassment. A state seeking the benefit of expanded tax authority under federal legislation should be subject to an "all in or all out" rule when it comes to the application of its sales and use tax to remote sellers.

C. Section 2(b)(2)(A): Minimum Simplification Requirements

The emphasis here is on the word "minimum." The Chaffetz bill makes:

- no effort at greater uniformity in tax administration (forms, filings, and audits) among the 46 states with sales and use taxes;
- no effort at greater uniformity in the tax base, or in requiring common definitions of products and services, among the 46 states with sales and use taxes;
- no effort at reducing the number of varying tax rates for over 10,000 different sales and use tax jurisdictions in the United States;
- no reference to the problem of remote sellers being forced to appeal tax assessments through foreign states' administrative agencies and courts — usually located hundreds (even thousands) of miles away; in most cases, an out-of-state retailer, especially a small business, would effectively be coerced into paying a disputed assessment because a small retailer simply cannot afford the cost of retaining a lawyer and protesting a tax bill far from its place of business; and
- no effort to correct the unjust rule in many states that a seller must pay the disputed tax before being allowed to challenge a tax assessment in court (so-called pay-to-play provisions) — this requirement is especially oppressive to small out-of-state businesses.

D. Section 2(b)(2)(D)(iii): False Reliance on Certified Software Providers

The bill creates the false impression that a certified software provider (CSP) is the silver key to tax compliance and insulates the retailer from liability for errors in the reporting of taxes due. The real compliance challenge is "mapping" a retailer's products to myriad state laws, regulations, bulletins, administrative rulings, and court decisions defining what is taxable and what is not. This is where the real audit risk lies, and the CSPs assume no responsibility for that function — so remote sellers have no protection from audit exposure (including penalties and interest) for good-faith errors caused by the complexity and inconsistency of state tax laws.

E. Section 2(b)(2)(D)(iii)(VI): No Protection of Consumer Data

The bill broadly refers to "safeguards and protection of consumer privacy" without (1) incorporating any established standard for protection of that information; (2) requiring periodic data security audits of CSPs by independent third parties; or (3) imposing penalties (or other consequences) for data breaches.

Under RTPA, confidential customer transaction information in the possession of CSPs could be at risk, without any recourse available to consumers. Congress should adopt strong data protection standards for CSPs to minimize the vulnerability of customer information to hacking and unauthorized distribution.

F. Section 2(b)(2)(D)(iii): Cost of Installation and Integration of Certified Software

The bill provides that "free access [to certified software] shall include installation, setup, and maintenance of the automated system into the remote seller's system."

But what does this provision really mean? Would the states individually or collectively reimburse remote sellers for the hundreds of thousands of dollars that it would cost to integrate the tax software into their systems and maintain that integration? The vagueness of this provision is a sure predictor of future disputes.

G. Section 2(c): The Small Seller Phase-In Farce

Aside from the inadequacy of the stepped-down, three-year, dollar-volume-of-sales, small-seller exemption, this modest safe harbor is unavailable to any remote seller that "utilizes an electronic marketplace for the purpose of making products or services available for sale to the public."

In other words, if a small seller offers its products on eBay and permits payment by PayPal, there is no small business exception or phase-in. This provision alone is a death knell for small entrepreneurs seeking to sell goods to a national market via such websites as Etsy, eBay, and the like.

III. The Missing Federal Preemption Provision

If enacted, the RTPA would fulfill state tax officials' dream to expand their jurisdictions beyond their borders without having to accept in return any meaningful limitation on the scope of their cross-border authority.

States are currently subject to constitutional limitations on the extraterritorial reach of their tax jurisdiction (*Quill*). They now want Congress to replace *Quill* with federal legislation. In prior legislative proposals, the explicit understanding was that federal law regarding use tax collection by

remote sellers would "preempt" any state laws addressing the same subject — that is, federal law would control. Even the Chaffetz bill's previous draft included a preemption provision. Now, however, Chaffetz has yielded to states' overreaching desire to have their cake and eat it too, by removing the federal law preemption provision from the RTPA.

What would be the effect of dropping the preemption provision? States could elect not to exercise authority under the RTPA (or parts of it) and instead pursue exotic nexus theories (such as click-through nexus laws), then impose onerous obligations on remote sellers different from the federal legislation, which would not preempt state law dealing with the same subject. Similarly, a state would be able to impose additional burdens on remote sellers beyond those authorized by the Chaffetz bill, so long as those requirements were not in direct conflict with federal law. Absent a preemption provision, the RTPA constitutes an unconstrained license for expanded state taxation of interstate commerce.

IV. Abandonment of Federal Court Jurisdiction

Even a cursory reading of the RTPA reveals that its terms are complex and confusing. It is the kind of ambiguous law that will certainly wind up in court, where judges will be asked to resolve controversies over its meaning.

An earlier version of Chaffetz's bill recognized the inevitability of judicial challenges and provided for federal court jurisdiction over those disputes. Why federal court jurisdiction? Because federal courts would work toward achieving a uniform and consistent interpretation of the federal law and be vigilant in ensuring that states adhere to its requirements.

By dropping the provision for federal court jurisdiction, the RTPA leaves exclusive jurisdiction to state courts — so each state's judicial system would be free to interpret the federal statute. The result would be a federal law with increasingly different applications depending on the state exercising authority under it. Moreover, state courts (many with elected judges) are likely to favor their own revenue departments and be disinclined to protect the rights of out-of-state companies that have no presence or political voice in the state.

V. Disregard for U.S. House Judiciary Committee Principles

In September 2013 the U.S. House Judiciary Committee released seven Internet sales tax principles. The central theme is the need for greater simplicity in the administration of sales and use tax collection:

> 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.

As noted, the RTPA fails to meet these basic principles by a wide margin.

There are alternative legislative proposals under consideration, including the Online Sales Simplification Act (OSSA) being circulated for comments by House Judiciary Committee Chair Bob Goodlatte, R-Va. OSSA would satisfy all the Judiciary Committee's principles in a straightforward — and even elegant — manner. OSSA would treat an Internet purchaser as a virtual visitor to the remote seller's store, similar to a consumer traveling to a store in a neighboring state. The seller would collect sales tax at one rate: the retailer's home jurisdiction rate. For online sales, however, the taxes collected would be forwarded by the retailer's home state revenue department to the customer's state of residence. The bottom line is that the remote seller collects tax at one rate, with one tax base, and is subject to only one audit. The customer's home state, however, receives all tax revenue from sales to its residents. A default arrangement applies to sales originating from states that do not have a sales tax.

Put simply, the RTPA is neither fair nor practical. The Internet sales tax issue can be addressed by Congress in a manner that will increase state sales and use tax revenues while avoiding the complexity and burdens associated with Chaffetz's proposal. In exercising its commerce clause power, Congress should abide by the House Judiciary Committee principles and ensure that simplicity is the hallmark of federal legislation. ☆