The Sky Is Not Falling: GAO Report Hobbles Attack on *Quill*

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In this edition of Eyes on E-Commerce, the authors argue that a new report issued by the Government Accountability Office puts the "problem" of *Quill* in perspective, showing that, if *Quill* is abrogated, the "lost revenue" to states is much smaller and the costs to retailers much greater than often asserted. The GAO report shows that the economic case against the *Quill* rule has been greatly overstated.

As H.L. Mencken said, "For every complex problem there is an answer that is clear, simple, and wrong." So, it is with the efforts by the states, now before the U.S. Supreme Court, to discard 50 years of precedent and, in the process, remove *all* limits on the power of 12,000 state and local jurisdictions to impose sales and use tax registration, collection, and remittance obligations on every retailer — small, medium, and large — across the United States.[1]

It turns out, in fact, that the states went Mencken one better by getting both the problem and the solution wrong. A new study from the Government Accountability Office[2] confirms that the internet did not upend the sales and use tax world, as the states vociferously argue. Among its findings, the report shows that the states have wildly *overstated* the revenue losses they are experiencing as a result of *Quill Corp. v. North Dakota*.[3] It also shows that they have dramatically *understated* the costs to businesses of undoing *Quill*. The report reveals that the states' anti-*Quill* posture is built on phantom "lost" revenue and a deliberate oversimplification of the costs and complexity to retailers of nationwide sales and use tax compliance. Once the facts are laid out, it becomes evident that the abrogation of *Quill* proposed by the states is a cannon aimed at a mouse.

The States' Simplistic View

State revenue officials and their allies have consistently opposed the "substantial nexus" rule of *Quill* on two purported grounds: first, that states are annually losing untold sums — by their count, more than $30 billion — of uncollected sales and use taxes; and second, that remote

[1] *See South Dakota v. Wayfair Inc.*, U.S. Supreme Court No. 17–494 (petition for a writ of certiorari granted) (Jan. 12, 2018). In *Wayfair*, the *only* connection to South Dakota on which the state relies is that respondents have customers located in the state. *See South Dakota v. Wayfair Inc.*, 901 N.W.2d 754 (S.D. 2017). Just 200 transactions a year, no matter how small, put remote sellers in the grip of the law.

[2] "Sales Taxes, States Could Gain Revenue From Expanded Authority, but Businesses Are Likely to Experience Compliance Costs," U.S. Government Accountability Office, Nov. 2017 (released Dec. 18, 2017) (GAO report).

[3] 504 U.S. 298 (1992).

sellers can easily collect state and local sales taxes at little or no cost.

The difference between the states' claims and the reality laid bare in the GAO report is striking. In contrast with the states' projection of nearly $34 billion of uncollected sales tax because of *Quill* projected for 2018, the GAO found that states and localities might lose as little as $8.5 billion in 2017,[4] that is, one-quarter of the states' estimates. While $8.5 billion is no small sum, other evidence shows that the amount of losses sustained by the states is likely shrinking each year as e-commerce becomes increasingly dominated by large "clicks and mortar" sellers who have already registered to collect and remit sales taxes in every state and local jurisdiction because they have stores and/or distribution facilities located throughout the United States. As a result, collecting the claimed "lost" revenue would fall squarely on the shoulders of smaller companies that have limited physical presence and would be most harmed by an elimination of *Quill*'s substantial nexus rule.

Against this backdrop of disproportionate impact on smaller internet and catalog retailers, the GAO report also undercuts dramatically the states' claim that tax compliance in the 12,000 state and local jurisdictions is quick and easy to start up. In sharp contrast with the states' contention that the cost of collection is negligible, the GAO report found that the costs of sales and use tax compliance are manifold and significant: software installation, implementation, and integration; per-transaction software licensing fees; internal administrative costs; legal fees incurred in distant jurisdictions in connection with assessments and audits; legal and other professional fees incurred in keeping up-to-date on changes in the laws of thousands of taxing jurisdictions; and so forth. Those expenses would be particularly burdensome for smaller and medium-sized retailers that do not already have internal systems for multistate tax collection.[5] Now that the U.S. Supreme Court is scheduled to hear arguments regarding the continuing viability of the *Quill* standard in today's marketplace,[6] the evidence set out in the GAO report showing the actual consequences of overruling *Quill* must be clearly understood.

In revealing the faulty premise beneath the states' demand for the abrogation of *Quill*, the GAO report further reinforces what the Supreme Court recognized in *Quill:* any grand compromise in the remote sales tax debate should come through Congress, which is better equipped to make the careful policy judgments required to produce a law that balances the competing interests of all parties in light of the facts of the matter. Any comprehensive solution would need to make compliance simpler, cost-effective, and standardized across the thousands of state and local jurisdictions.

The GAO Report

The GAO report was issued in response to a request from U.S. Sens. Ron Wyden, D-Ore., ranking minority member of the Finance Committee; and Jeanne Shaheen, D-N.H., ranking minority member of the Small Business and Entrepreneurship Committee. The senators "asked [the GAO] to review the effects on businesses and state revenue agencies of legislation that would grant states the authority to require businesses to collect and remit taxes on all remote sales."[7] Put differently, they posed the question, what would the state and local tax world look like without *Quill*. The GAO's mission was fact-finding, not policymaking.[8] In particular, the GAO made estimates of (1) revenue gains to taxing jurisdictions from being able to collect taxes on sales from all remote sellers and (2) compliance costs and challenges to remote sellers if states were given the authority to require collection and remittance of sales and use taxes.[9]

[4] GAO report at 11-12 (estimating between $8.5 billion to $13.4 billion in "lost" revenue depending on whether one adopts a more or less conservative approach to the factors affecting collection and remittance rates for sales and use taxes).

[5] *Id.* at 15-24.

[6] *South Dakota v. Wayfair Inc.*, U.S. Supreme Court No. 17-494. Brann & Isaacson partners George Isaacson, Martin Eisenstein, and Matthew Schaefer represent the respondents before the Supreme Court.

[7] GAO report at 1 (brackets added).

[8] *See id.* at Highlights (report contains no recommendations to Congress).

[9] *Id.* at 2-3.

State Revenue Gains Significantly Less Than Previously Estimated

In arguing that the Supreme Court should take its case, South Dakota relied heavily on estimates of so-called "lost revenue" from a study performed by Professor William Fox of the University of Tennessee in 2009, later updated in 2012. Those studies purported to show that state and local governments were owed an estimated $23 billion in sales tax revenue in 2012 that could not be collected because of *Quill*.[10] The state contended that an updated study projected losses of $33.9 billion in 2018, and a projected total of $211 billion in losses between 2018 and 2022.[11] What the state did not disclose is that the 2009 Fox study was funded by the Streamlined Sales Tax Governing Board.[12] The unpublished 2012 update was funded by the Retail Industry Leaders Association.[13] It goes without saying that these organizations oppose the *Quill* rule and have advocated its abandonment. Furthermore, the study is based solely on data from 29 state revenue officials, dating to 2009.[14] Those flaws by themselves suggest that any extrapolation forward from these data to 2018 and beyond would be speculative at best.

It is little wonder, then, that the GAO report, conducted by a nonpartisan federal governmental body using much more recent and reliable data, reached quite a different, and more modest, set of conclusions. They included the following: (1) between 87 and 96 percent of sales and use taxes that could be collected without *Quill* are already being collected by the top 100 internet retailers; (2) the overall business compliance rate is between 70 and 90 percent; (3) between 75 and 80 percent of all taxes that would be owed without *Quill* are already subject to collection under existing law, across internet sellers of every size; (4) of these, 80 percent of taxes on internet sales are already subject to collection; (5) for taxable business-to-business sales, 85 to 94 percent of taxes on sales are already collectible; and (6) the total gain in sales revenue from inclusion of remote sales for which collection is not allowed would be only between $8 billion and $13 billion — a small fraction of the $377 billion in total state and local government revenue from sales and gross receipts taxes in 2016.[15]

Put differently, the GAO estimates that uncollectible sales tax revenue amounts to between 24 and 39 percent of the estimate South Dakota submitted to the Supreme Court based on the Fox study. Virtually all the largest internet retailers are already collecting sales and use taxes. Amazon, the largest internet retailer, already collects sales or use taxes in all 45 states (plus the District of Columbia) that impose such taxes, as do a substantial number of the top 100 internet retailers.[16] As noted, the overall collection rate for these retailers, which make up the majority of online sales in the United States, is between 87 and 96 percent.[17] And the overall collection rate for the top 1,000 online retailers is between 78 and 86 percent.[18] Whatever one's views on whether *Quill* creates a problem for state sales and use tax revenue collection, the conclusions of the GAO report show that the scale of the problem has been vastly overstated by the states seeking *Quill*'s undoing. Any proposed "solution" to such a "problem" must be proportional to the problem and attuned to its nuances. Even adding in smaller retailers, who will suffer the most from the burdens of collection if *Quill* is abandoned, states still already realize 75 to 80 percent of the purported "lost revenue" not collected because of *Quill*. Rather than burdening small business with inordinate tax collection obligations (advantaging the larger retailers that already dominate the market), states might be better served by increasing compliance efforts on the use tax side. Alternatively, if a global solution is desired, Congress is the branch of government best suited to the kind of nuanced policymaking that could balance the competing interests of the states, large

[10] *See* Petition for Writ of Certiorari, *South Dakota v. Wayfair Inc.*, No. 17-494, at 13 (Oct. 2, 2017).

[11] *Id.*

[12] *See* Respondents' Brief in Opposition to Petition for Writ of Certiorari, *South Dakota v. Wayfair Inc.*, No. 17-494 (South Dakota Petition), at 29 (Dec. 7, 2017).

[13] *See id.*

[14] *See id.* at 29-30.

[15] *See* GAO report at 8-15 and 41.

[16] *Id.* at 41.

[17] *Id.*

[18] *Id.* at 42.

businesses that are already collecting and remitting, and small businesses that would bear the brunt of *Quill*'s abrogation.

Compliance Is Complicated and Costly

In seeking Supreme Court review of *Quill*, South Dakota also made the argument that compliance with the requirements of the individual state and local tax jurisdictions throughout the United States — which the GAO report notes number between 10,000 and 12,000[19] — is easy in the internet age because of the existence of "[r]eadily available accounting software."[20] "Today," South Dakota suggests, "this kind of algorithmic, data-driven task is rightly treated as marginal."[21] South Dakota's argument is both breathtakingly simplistic and breathtakingly wrong.

The GAO report makes plain that the costs of compliance to retailers required to collect and remit tax to a host of new jurisdictions would not be "akin to flipping a switch."[22] Rather, when viewed in the proper context, compliance would be cumbersome and expensive, and not just about finding, installing, and paying for software capable of keeping up with thousands of different and unpredictably changing tax requirements governed by statutes, regulations, and ordinances across the United States. First, the initial costs of software setup would be high, especially for businesses not already using software for multistate tax collection.[23] Software is a necessity because the number of potential jurisdictions with authority to impose collection and remittance obligations is in excess of 10,000 at a minimum.[24] In setting up the software system, retailers would need to engage in expensive mapping and system integration work, which requires coding *all* of a retailer's products for applicable taxation categories.[25] The GAO report cites the differential treatment of apparel by different states: Pennsylvania exempts most, but not all, clothing from taxation; and New York exempts clothing sold for less than $110.[26] Thus, product mapping is labor-intensive and generally offered to customers by tax software service providers only at premium prices.[27] Furthermore, the tax software must be integrated with existing business software.[28] The costs of integration can vary widely depending on how much customization is required.[29] Additionally, software licensing costs can be significant, as they are generally set as a function of the volume of information requests sent to the tax database.[30] And this list does not even take into account associated administrative costs.[31]

Second, there are substantial costs not regarding software implementation, integration, and licensing. Each taxing jurisdiction that has the authority to require a remote seller to collect and remit sales or use taxes also gains the right to audit that business for compliance. The costs of responding to audits and assessments can be substantial. Companies with a sales tax collection obligation in a large number of states may have to contend with numerous audits at a time, or audits that last multiple years.[32] Responding to these audits requires significant internal resources to comply with document requests, auditor visits, and other related matters. Audits can require a business to travel to and retain counsel in a distant jurisdiction.[33] Businesses interested in challenging assessments will have to litigate in distant forums, an expensive proposition that can lead businesses to settle claims on unfavorable terms.[34] Remote sellers will also be required to keep up-to-date with changes in the tax laws of the dozens or hundreds or thousands of jurisdictions to which they send goods sold. Remote sellers without an extensive in-house legal team will be required to

[19] *See* GAO report at 17.
[20] South Dakota Petition at 29 (brackets added).
[21] *Id.* at 30.
[22] *Id.*
[23] *See* GAO report at 17.
[24] *See id.*
[25] *See id.*
[26] *See id.*
[27] *See id.*
[28] *See id.* at 18.
[29] *See id.*
[30] *See id.* at 18-19.
[31] *See id.* at 19-20.
[32] *See id.* at 21.
[33] *See id.*
[34] *See id.* at 21-22.

retain outside counsel to advise them in these areas.[35]

Third, there is a set of additional financial risks that attend the expansion of state and local taxing authority over remote sellers. Such retailers may be liable retroactively for tax due under state or local laws or regulations that impose requirements on them but for *Quill*, as in Alabama, which has already promulgated a rule authorizing the imposition of collection and remittance obligations without regard to any physical presence requirement.[36] That means that if *Quill* were abrogated, state and local tax authorities would be able to issue assessments for the failure of retailers to collect taxes in the past (while *Quill* was good law). State tax laws and regulations that remain on the books but unenforced in light of *Quill* can once again become legal grounds for audits, assessments, and litigation over taxes that businesses believed they did not have to collect because of the certainty afforded to them by the bright-line rule of *Quill*. Concerns about the expense or exposure of litigation may lead businesses to agree to pay claims of dubious legal merit.[37] The removal of *Quill*'s physical presence nexus text would open up a new host of legal issues for remote sellers to navigate regarding what types of activities performed by business partners might constitute substantial nexus with a particular jurisdiction.[38] Moreover, as we have written elsewhere, private businesses deputized to serve as public revenue agents by states throughout the country are exposed to class action lawsuits for overcollection of tax and private-plaintiff-driven *qui tam* actions for undercollection.[39] In other words, one consequence of the abrogation of *Quill* is that it would allow states to impose significant costs of collection on remote sellers *and* expose those businesses to the downside risk of undercollection or overcollection, while keeping revenue departments largely insulated from them.

Viewed against this backdrop, it is clear that the states are only telling one side of the story using exaggerated claims of lost revenue. The other side — the costs of compliance to small- and medium-size business — is wrongfully trivialized to the point of nonexistence. Common sense exposes the reality that tax compliance isn't just a matter of buying expensive, difficult-to-implement software. If it were, the states would have no need for auditors, attorneys, and administrative staff. There would be no need for tax dispute procedures to resolve disagreements on the numerous gray areas that exist in the application of their individual tax statutes, regulations, ordinances, bulletins, and enforcement policies against businesses large and small. The GAO report shows that whatever the lost revenue might be to the states, it is likely at least to be offset by the costs to be borne by millions of smaller companies in the form of accounting services, legal representation, software and equipment requirements and integration, and staff time, among other things.

Conclusion

In sum, the logic states and localities rely on to argue for abrogating *Quill* does not hold up to dispassionate scrutiny. The GAO report shows that the undercollection problem is grossly overstated. Compliance levels are already high, and the revenue that would be added were *Quill* eliminated is not nearly as substantial as suggested. Indeed, the amount at issue is between 25 and 40 percent of the estimate previously treated as the "gold standard," according to the University of Tennessee study from 2009. On top of that, the compliance costs to businesses have been significantly understated. It is not a question of installing plug-and-play software and then flipping a switch from "don't collect" to "collect." Businesses would face difficult and expensive decisions about software licensing and integration; compliance review; managing audits and assessments; keeping abreast of changes in the laws of thousands of taxing jurisdictions; and controlling for the threats of overcollection and undercollection.

[35] *See id.* at 22-23.

[36] *See id.* at 23.

[37] *See id.*

[38] *See id.* at 23-24.

[39] *See* David W. Bertoni and David Swetnam-Burland, "Barbarians at the Gates: Private State Tax Enforcement," *State Tax Notes*, Nov. 21, 2016, p. 585.

These are the conclusions not of a partisan, but a federal agency with no vested interest in the outcome either way. They reveal a fundamental truth that parties that *do* have a vested interest in the outcome must wrestle with, whatever side of the dispute they fall on. Even if you are inclined to see *Quill* as a problem to be solved, the solution to that problem is not simple. Whatever the path forward from the present legal rule — whether that is the status quo or a dramatic shift — there are a host of devilish details that will need to be considered in crafting a rule for handling the question of which remote sellers should be required to collect sales and use taxes in what jurisdictions. If the virtue of *Quill*'s physical presence test lies in the relative simplicity of a black-letter rule, any change to the current regime will require managing a host of complications, many of which the GAO report highlights. That is the kind of spadework Congress is more suited to undertake. Subtracting *Quill* does not provide an affirmative solution to the problems inherent in any effort to bring order to sales and use tax collection by remote sellers. Only a legislative solution can ensure standardization of collection obligations across many thousands of state and local jurisdictions; cost efficiency for businesses of all sizes; protection for small businesses facing a brave new world of multistate tax collection; and legal certainty for all stakeholders. ■