



Arizona State Senate Issue Brief

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TAXATION OF INTERNET SALES

INTRODUCTION

In 1998, Congress passed the Internet Tax Freedom Act (ITFA). The ITFA initially imposed a three-year moratorium, until October 21, 2001, prohibiting state and local governments from imposing multiple and discriminatory taxes on electronic commerce and from levying new taxes on internet access services. It also included a limited grandfather clause for some states that were already taxing internet access at the time the law went into effect. The grandfather clause initially applied to 13 states that had imposed and enforced a tax on internet access before October 1, 1998. However, the number of states collecting tax revenue from internet access had decreased to 7 by 2016. Unless protected by the grandfather clause, states may not impose a sales tax on the monthly payments made by consumers to their internet service providers. The Trade Facilitation and Trade Enforcement Act, passed in 2015, permanently extended the moratorium on taxing internet access while temporarily extending the grandfather clause until June 30, 2020.

The ITFA does not prohibit states from imposing sales and use taxes on internet sales. Rather, the ITFA requires the equal administration of sales or use tax on transactions subject to the tax, regardless of the means through which these transactions are conducted (e.g., in-person, over the internet, etc.). Thus, if a state imposes sales or use tax on electronic commerce transactions, the same tax treatment must apply to “brick-and-mortar” store transactions.

Until recently, a state was prohibited by the U.S. Constitution and by U.S. Supreme Court (SCOTUS) decisions from imposing sales and use taxes on retailers that have no sufficient physical connection (or “nexus”) with that state.² The term *nexus* refers to a retailer’s minimum level of physical presence within a state that permits the taxing authority of that state to require the retailer to register, collect, and remit sales and use tax and comply with the state’s taxing laws and regulations. This has prevented states from requiring mail-order

¹ See CRS Report R43772, *The Internet Tax Freedom Act: In Brief*, by Jeffrey M. Stupak.

² See *National Bellas Hess v. Dep’t. of Rev. of Illinois*, 386 U.S. 753 (1967) and *Quill Corp. v. North Dakota*, 504 U.S. 298, 308 (1992).

retailers to collect taxes on most catalog sales; this logic has also been applied to retailers engaging in electronic commerce. For example, the State of Arizona could not have required an online or mail-order retailer located in another state to collect taxes on sales made to Arizona residents if that retailer did not have a nexus in Arizona. While this prohibition could have been lifted by Congress, to date this has not occurred.

On June 21, 2018, SCOTUS overturned the physical presence standard established under prior rulings. SCOTUS concluded that physical presence is not required for a retailer to establish "substantial nexus" with the taxing state, finding instead that extensive virtual presence in the form of significant targeted advertising and sales activity to consumers is sufficient for nexus purposes.³

THE NEXUS REQUIREMENT

The nexus requirement is established under two provisions of the U.S. Constitution: 1) the Due Process Clause of the 14th Amendment; and 2) the Dormant Commerce Clause (DCC). Each clause serves a different purpose within the context of a state taxing internet sales, including the imposition of tax collection and payment obligations on internet retailers. Due process is concerned with whether the imposition of such obligations is fair, while the focus of the DCC is whether such imposition burdens interstate commerce.⁴

In the 1967 case of *National Bellas Hess, Inc. v. Department of Revenue of Illinois (Bellas Hess)*, SCOTUS held that the Commerce Clause prohibits a state from imposing use tax collection and payment obligations on a retailer who lacks physical presence in that state and whose only connection with customers in that state is by mail or common carrier. SCOTUS concluded that such a requirement violated the Due Process Clause

and created an unconstitutional burden on interstate commerce. However, in the 1992 case of *Quill Corp. v. North Dakota (Quill)*, SCOTUS overruled its holding in *Bellas Hess* that due process precludes the imposition of tax obligations on retailers that do not meet the physical presence requirement. It found that the imposition of tax by a state on such a retailer did not violate the Due Process Clause as the degree to which the retailer has contact with the state's residents and benefits economically from such contact is sufficient for due process purposes. Further, it reasoned that while a tax may be consistent with the requirements of due process, it can still interfere with interstate commerce, thereby making such a tax unconstitutional.

Despite this change in approach, SCOTUS still upheld the use of the physical presence requirement for state sales and use taxes, noting that it established the boundaries for a state's legitimate authority to impose tax obligations. However, as a result of the 2018 case of *South Dakota v. Wayfair, Inc. (Wayfair)*, this requirement was subsequently overturned. Noting changes in the interstate marketplace since the *Quill* ruling, SCOTUS concluded that the physical presence requirement was an incorrect interpretation of the Commerce Clause and not a necessary interpretation of the requirement that a state tax must be "applied to an activity with a substantial nexus with the taxing state." In its assessment, rejection of the physical presence requirement was necessary to ensure: 1) that artificial competitive advantages would not be created for out-of-state (remote) retailers to the detriment of their brick-and-mortar competitors; and 2) that states would not be barred from collecting lawful taxes for commercial activities within their respective jurisdictions.⁵

IMPACT ON STATES

Critics, including many state governments, contend that upholding the nexus requirement in

³ See *South Dakota v. Wayfair, Inc.* 585 U.S. (2018).

⁴ See CRS Report R42629, "Amazon Laws" and Taxation of Internet Sales: Constitutional Analysis, Erika K. Lunder and Carol A. Pettit.

⁵ See *South Dakota v. Wayfair, Inc.* 585 U.S. (2018).

Quill limited the ability of states to collect sales and use tax on internet sales made to state residents remote retailers. Per the 1992 ruling, a retailer must generally have had substantial nexus within a state in order to be required to collect and remit sales and use tax to that state's taxing agency. In absence of nexus, a remote retailer has not been required to collect and pay tax to a state. State residents purchasing products from remote retailers may still have owed sales or use tax on such purchases, but may not have been aware of this tax liability or simply chose not to report it.

State governments generally prefer having retailers collect tax on their behalf, as opposed to collecting it from resident purchasers, as such arrangements make tax revenues easier to track. The inability to do so can potentially hinder the ability of states to realize tax revenues from growth in electronic commerce as revenues from traditional sales decline. Due to the restrictions imposed by *Quill*, historically, a remote retailer must have either agreed to voluntarily collect tax on a state's behalf, or the state must have found a way to establish that the retailer does in fact have nexus and is thus subject to its taxing authority.

AFFILIATE NEXUS LAWS

In the absence of federal action, some states have attempted to extend nexus requirements to remote retailers through alternative means, generally known as “click through” or “affiliate nexus” laws. The basic idea behind such laws is that a relationship between a retailer and a state resident, established through solicitation of sales, is sufficient to create a substantial nexus to incur tax collection and payment obligations. The primary goal for states that enact affiliate or click through nexus laws was generally to improve sales and use tax collection. A 2017 U.S. Government Accountability Office (GAO) report found that states lose between \$8 and \$13 billion annually due to not being able to require sales tax collection from all remote retailers.⁶

In 2008, the State of New York expanded its use tax collection statute to include remote retailers with contractual relationships, or “affiliations,” with New York residents. The state's law targets remote retailers with in-state affiliate marketing programs, whereby New York-based affiliates of the retailer post online links to the retailer's website for compensation based on clicks and successful purchases through such links. The law was challenged by Amazon and Overstock.com (at whom it had been directed). However, the law's constitutionality was upheld by the New York State Court of Appeals – the state's highest court – which reasoned that if a remote retailer is paying the residents of a state to actively solicit business in that state, then there is no reason why that same retailer should not be required to shoulder the appropriate tax burden. SCOTUS declined to take action on the subsequent appeal.⁷

Despite this outcome, similar laws passed in other states have not fared as well. In 2013, for instance, a nexus law passed in Illinois was invalidated by the Illinois Supreme Court (ISC). In striking down the law, the ISC reasoned that the law imposed tax obligations on remote vendors who use online marketing without imposing similar obligations on vendors using traditional print and broadcast marketing – a violation of the ITFA's prohibition on multiple and discriminatory taxes on electronic commerce.⁸

A potential downside to affiliate or click-through nexus laws stems from the fact that they are not a “catch all” mechanism and are generally limited in their application to only those remote retailers with in-state affiliate relationships. A remote retailer is free to terminate such relationships, thus severing its nexus within a state along with its tax collection and payment obligations.

⁶ GAO, Report to Congressional Requesters: Sales Taxes, States Could Gain Revenue from Expanded Authority, but Businesses Are Likely to Experience Compliance Costs (GAO-18-114), November 2017). <https://www.gao.gov/assets/690/688437.pdf>

⁷ See *Overstock.com, Inc. v. New York State Dept. of Taxation & Fin.*, 2013 NY Slip Op 02102.

⁸ See *Performance Marketing Ass'n v. Hamer*, 2013 IL 114496.

ECONOMIC NEXUS LAWS

Given the limitations of affiliate or click-through nexus laws, several states, including Alabama, Indiana and South Dakota, have passed “economic nexus” laws aimed at taxing sales by remote retailers with substantial economic presence in those states, but lacking the previously-requisite physical presence. In his concurring opinion in the case of *Direct Marketing Association v. Brohl* (2015), Justice Anthony Kennedy noted the need to reexamine both *Bellas Hess* and *Quill*, inviting the legal system to provide an appropriate legal case in order to do so.⁹ The subsequent enactment of economic nexus laws by states, including South Dakota, has occurred in response to this request. The South Dakota law requires remote retailers with no physical location in the state to remit sales tax to the state, provided they meet one of the following criteria:

- *the remote retailer’s gross revenue from sale of tangible property, any products transferred electronically, or services delivered in the state exceeds \$100,000; or*
- *the remote retailer has sold tangible property, any product transferred electronically, or services for delivery into the state in 200 or more separate transactions.*¹⁰

More recently, Connecticut passed a similar economic nexus law requiring remote retailers to remit sales tax if they realize \$250,000 or more in gross receipts, or conduct more than 200 retail sales within a 12-month period. The Connecticut law goes into effect December 1, 2018.¹¹

The South Dakota law was signed by Governor Dennis Daugaard on March 22, 2016, and went into effect May 1, 2016. Afterwards, the South Dakota Department of Revenue began issuing notices to retailers it believed were now subject to the law, advising them to register for

state sales tax licenses and informing them of the possibility of legal action in state circuit court (as authorized in the law) in cases of non-compliance. On April 28, 2016, the State of South Dakota filed a declaratory judgment action against several remote retailers with no physical presence in the state,¹² seeking a judicial declaration that the requirements of the new law were valid and applicable to these retailers. The state circuit court adhered to SCOTUS precedent with respect to the physical presence requirement, prohibiting the state from enforcing the 2016 law. The state then appealed to the South Dakota Supreme Court, which affirmed the lower court’s ruling on September 13, 2017.¹³

SCOTUS granted review of the South Dakota law on January 18, 2018, and subsequently overturned the precedent set in the *Quill* case, thereby allowing South Dakota to continue to enforce compliance with tax remittance on remote retailers. Despite South Dakota’s success, however, the ruling does not provide a state with unrestricted authority to enforce all forms of economic nexus laws, as imposing undue burden on remote retailers still has the potential to violate Commerce Clause protections. When determining whether a taxpayer has established a substantial nexus within a state, the taxpayer must have, “availed itself of the privilege of carrying on business” in that state.¹⁴ In this case, SCOTUS found that the South Dakota law was satisfactorily insulated from violating Commerce Clause protections for the following reasons: 1) the law applies a safe harbor for those with limited business transactions; 2) there is no obligation to retroactively remit sales taxes; and 3) South Dakota is a member of the Streamlined Sales and Use Tax Agreement (SSUTA), which provides a model for a more simplistic sales tax

⁹ See *Direct Marketing Ass’n v. Brohl*, 575 U.S. ____ (2015).

¹⁰ See 2016 Session Laws – Chapter 70 (S.B. 106).

¹¹ Public Act No. 18-152 (S.B. 417).

¹² Initially, the retailers were Wayfair, Overstock.com, Newegg and Systemax. Systemax was dismissed from the state’s lawsuit on May 19, 2016 after voluntarily registering for a sales tax license and immediately initiating tax collection as required under the 2016 law.

¹³ See *State of South Dakota v. Wayfair Inc. et al*, No. 3:2016cv03019 – Document 38 (D.S.D. 2017).

code.¹⁵ Such considerations must be adhered to as more states take advantage of the *Wayfair* ruling.

In lieu of the economic nexus approach, some states, including Colorado, Louisiana, Oklahoma and Vermont, have passed laws to require remote retailers that lack nexus in those states to simply notify purchasers of their sales or use tax liability. Payment of such taxes on purchases from remote retailers is generally required by law in most states. However, enforcement of these laws has been problematic given that purchasers are often unaware of their tax liability while states tend to lack data on how much tax is actually owed.

Colorado's use tax notification law, first enacted in 2010, established notice and reporting requirements for retailers with at least \$100,000 in annual in-state sales who do not collect state sales tax. Such retailers are required to collect and report certain information to the Colorado Department of Revenue (CDOR), including purchaser names, billing and shipping addresses, and the total annual dollar amount of the purchases made. The constitutionality of the Colorado law was initially challenged, delaying implementation for several years. On February 22, 2016, the Tenth Circuit Court of Appeals ruled that the law does not violate the DCC as it does not discriminate against interstate commerce nor unduly burden such commerce.¹⁶ On December 12, 2016, SCOTUS declined to review the lower court's ruling. CDOR began enforcing the law on July 1, 2017.

ARIZONA TAX IMPLICATIONS

Internet access charges are not subject to transaction privilege tax (TPT) – Arizona's version of a sales tax – nor are they subject to tax

as a telecommunications service.^{17,18} Additionally, a business that operates an online marketplace and makes internet sales on behalf of third-party merchants is considered a retailer conducting taxable sales. The gross receipts the business derives from sales of tangible personal property to Arizona purchasers are subject to TPT and use tax, provided that the business has a nexus in Arizona.¹⁹ Gross receipts derived from the sale of computer software are also taxable, regardless of the method that a retailer uses to transfer the software to its customers. However, custom software designed or modified specifically for an individual customer's use is tax exempt. If a retailer has a nexus, then the retailer is required to collect and remit tax to the state. If the seller does not have nexus, the purchaser by law should self-assess and remit the tax directly to the state.

In 2008, Arizona enacted legislation to exempt internet application services that are designed to assess or test student learning or to promote curriculum design or enhancement, which are purchased by or for any school district, charter school, community college or state university from the retail and telecommunications classifications of TPT and use tax. In 2018, legislation aimed at creating a statutory framework for determining the taxable status of specified digital goods and services at the state and local levels was considered, but ultimately did not pass due to fiscal impact considerations. The 2017 GAO report estimated between \$190 and \$293 million in potential state and local revenue gains if Arizona were to obtain expanded

¹⁶ See *Direct Marketing Ass'n v. Brohl*, No. 12-1175 (10th Cir. Feb. 22, 2016).

¹⁷ See *Publication 618 – Utilities & Telecommunications*, Arizona Department of Revenue (DOR), January 1, 2017.

¹⁸ A.R.S. § 42-5064

¹⁹ See *Arizona Transaction Privilege Tax Ruling (TPR) 16-3*

²⁰ A.A.C. § R15-5-154

²¹ A.R.S. § 42-5155 and A.R.S. § 42-5160

²² Laws 2008, Chapter 194

²³ A.R.S. § 42-5061, A.R.S. § 42-5064 and A.R.S. § 42-5159

²⁴ See S.B. 1392/H.B. 2479 (53rd Legislature, 2nd Regular Session 2018)

²⁵ See <https://www.gao.gov/assets/690/688437.pdf>.

tax collection authority on remote sales. It remains to be seen what, if any, legislative action is taken by the state in light of the *Wayfair* ruling.

ADDITIONAL RESOURCES

- Arizona Department of Revenue
<https://azdor.gov/>
- Federation of American Scientists– Congressional Research Service Reports
<https://fas.org/sgp/crs/>
- National Conference of State Legislatures
www.ncsl.org