REPORT #525

TAX SECTION

New York State Bar Association

May 13, 1986

The Honorable Roderick G. W. Chu
New York State Commissioner of
Taxation and Finance
Building 9, State Campus
Albany, NY 12227

Dear Commissioner Chu:

Enclosed is a report of the Tax Section of the New York State Bar Association commenting on the proposed Interstate Sales and Use Taxation Act (herein the "Bill").

The Tax Section supports the basic premises underlying the Bill: that interstate sales should not remain immune from effective collection of state sales and use taxes and that federal legislation on the subject is appropriate. The enclosed report also addresses those points as to which the Tax Section feels improvements may be made in the Bill's approach to the problem.

I hope the report proves useful to you.

Sincerely,

Richard G. Cohen

Enclosures

REPORT #525

TAX SECTION

New York State Bar Association

May 14, 1986

The Honorable David H. Brockway
Chief of Staff
Joint Committee on Taxation
1015 Longworth Building
Washington, D.C. 20515

Dear Dave:

Enclosed is a report of the Tax Section of the New York State Bar Association commenting on the proposed Interstate Sales and Use Taxation Act (herein the "Bill"). The Bill, together with other proposals on the same topic, was the subject of Joint Committee on Taxation: Summary Description of S.1510 Relating to State Taxation of Interstate Sales (JCX-26-85), November 14, 1985.

The Tax Section supports the basic premises underlying the Bill: that interstate sales should not remain immune from effective collection of state sales and use taxes and that federal legislation on the subject is appropriate. The enclosed report also addresses those points as to which the Tax Section feels improvements may be made in the Bill's approach to the problem.

I hope the report proves useful to you.

Sincerely,

Dick

Richard G. Cohen

Enclosures

NYSBA

TAX SECTION

New York State Bar Association

May 14, 1986

The Honorable Peter W. Rodino, Jr.
Chairman
House Committee on the Judiciary
2462 Rayburn House
Office Building
Washington, D.C. 20515

Dear Congressman Rodino:

Enclosed is a report of the Tax Section of the New York State Bar Association commenting on the proposed Interstate Sales and Use Taxation Act (herein the "Bill"). The Bill deals, in somewhat greater detail, with the same topic as H.R.3549 which has been referred to your committee.

The Tax Section supports the basic premises underlying the Bill: that interstate sales should not remain immune from effective collection of state sales and use taxes and that federal legislation on the subject is appropriate. The enclosed report also addresses those points as to which the Tax Section feels improvements may be made in the Bill's approach to the problem.

I hope the report proves useful to you.

Sincerely,

Richard G. Cohen

Richard G. Cohen

Enclosures
cc: The Honorable Hamilton Fish, Jr.
M. Elaine Mielke, Esq.

REPORT #525

TAX SECTION

New York State Bar Association

May 14, 1986

The Honorable Bob Packwood
Chairman
Senate Finance Committee
259 Russell Office Building
Washington, D.C. 20510

Dear Senator Packwood:

Enclosed is a report of the Tax Section of the New York State Bar Association commenting on the proposed Interstate Sales and Use Taxation Act (herein the "Bill"). The Bill deals, in somewhat greater detail, with the same topic as S.1510 on which the Subcommittee on Taxation and Debt Management of the Senate Committee on Finance held a hearing November 15, 1985.

The Tax Section supports the basic premises underlying the Bill: that interstate sales should not remain immune from effective collection of state sales and use taxes and that federal legislation on the subject is appropriate. The enclosed report also addresses those points as to which the Tax Section feels improvements may be made in the Bill's approach to the problem.

I hope the report proves useful to you.

Sincerely,

Richard G. Cohen

Enclosures
cc: The Honorable Russell B. Long
John Colvin, Esq.

NYSBA

TAX SECTION

New York State Bar Association

May 14, 1986

The Honorable John H. Chaffee
Chairman
Subcommittee on Taxation and
Debt Management
Senate Finance Committee
SD-219 Dirksen Senate
Office Building
Washington, D.C. 20510

Dear Senator Chaffee:

Enclosed is a report of the Tax Section of the New York State Bar Association commenting on the proposed Interstate Sales and Use Taxation Act (herein the "Bill"). The Bill deals, in somewhat greater detail, with the same topic as S.1510 on which the Subcommittee on Taxation and Debt Management of the Senate Committee on Finance held a hearing November 15, 1985.

The Tax Section supports the basic premises underlying the Bill: that interstate sales should not remain immune from effective collection of state sales and use taxes and that federal legislation on the subject is appropriate. The enclosed report also addresses those points as to which the Tax Section feels improvements may be made in the Bill's approach to the problem.

I hope the report proves useful to you.

Sincerely,

Richard G. Cohen

Enclosures
cc: The Honorable Spark M. Matsunaga

NEW YORK STATE BAR ASSOCIATION
TAX SECTION

Comments on Proposed Interstate Sales and Use Taxation Act of 1986

May 13, 1986

This report was written by Edward H. Hein, Co-chair of the Committee on Sales, Property and Miscellaneous Taxes. Helpful comments were received from E. Parker Brown, II, William L. Burke, Herbert L. Camp, Richard G. Cohen, Dale S. Collinson, Peter Miller and James H. Peters.

Introduction

The Interstate Sales and Use Taxation Act of 1986 is proposed federal legislation developed and endorsed by the Advisory Commission on Intergovernmental Relations and the National Association of Tax Administrators. The proposal as modified in January 1986 is herein referred to as the "Bill". The Bill would expand the authority of a state to require vendors outside the state to collect and remit its use taxes. A primary, but by no means exclusive, target of the proposal is the type of mail order firm held immune from use tax collection responsibilities in National Bellas Hess v. Dept of Revenue, 386 U.S. 753 (1967).

The Committee agrees that there exists a serious problem in sales escaping all sales and use taxes solely due to the current jurisdictional limitations on when an out-of-state seller may be required to collect tax for the destination state. We agree that the problem can best be addressed by federal legislation pursuant to the Commerce Clause. Moreover, we believe that it may be particularly appropriate to consider legislation in this area along with federal legislation regulating the use of unitary tax systems for franchise and income taxes.* We are concerned at the

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*See Report on S.1974 and H.R. 3980 (Prohibiting State Taxation on a Worldwide Unitary Basis) by Committee on (footnote continued) possible multiplication of state-vendor relationships with differing states' rules applied separately to each fragment, by geographic destination, of each vendor's sales. One solution is to adopt implementing provisions for multistate audits and controversy resolution. We also discuss below the possibility of a somewhat different approach than proposed in the Bill.

Basic Policy Factors

Sales taxes are a major source of revenue for most states. Compensating use taxes are essential to diminish the incentive, otherwise created by a sales tax, to purchase outside the taxing state.

There is little practical difference between a sales tax and a use tax where the vendor is required to collect and remit the tax. In such instances, as well as in the case of business purchases for which records are regularly maintained and items required to be registered (e.g. motor vehicles), the use tax is currently enforceable. However, use tax laws are, as a practical matter, largely unenforceable directly against individuals purchasing for personal consumption. As New York Commissioner of Taxation and Finance Roderick G.W. Chu has said, "How can I as a tax administrator determine that John Doe purchased a shirt by

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(footnote continued from previous page)
Interstate Commerce, New York State Bar Association, Tax Section (April 1986).

mail order from L.L. Bean?" Without vendors' assistance in the collection of the tax, the revenue is lost to the states.

In the absence of federal legislation, the United States Supreme Court has required some minimum presence of a vendor within the taxing state before permitting the state to require the vendor to collect and remit the state's use tax. National Bellas Hess, supra. There, National Bellas Hess was a mail order house incorporated in Delaware with its principal place of business in Missouri. Its only contacts with Illinois were by mail or common carrier; catalogs and advertising flyers were mailed to past and potential Illinois customers who mailed their orders to National in Missouri where the orders were accepted and from which the goods were sent by mail or common carrier. The Court, 6 to 3, reversed a judgment of the Illinois Supreme Court that National was required to collect and pay to Illinois the Illinois use tax.

Justice Stewart's opinion for the Court stressed the potential administrative burden on interstate commerce of compliance with multiple jurisdictions' tax laws:

> "And if the power of Illinois to impose use tax burdens upon National were upheld, the resulting impediments upon the free conduct of its interstate business would be neither imaginary nor remote ... The many variations in rates of tax, in allowable exemptions, and in administrative and record-keeping requirements could entangle National's interstate business in a virtual welter of complicated obligations to local jurisdictions with no legitimate claim to impose 'a fair share of the cost of the local government.' The very purpose of the Commerce Clause was to ensure a national economy

free from such unjustifiable local entanglements." [footnotes omitted]. 386 U.S. at 759-60.

Perhaps overshadowing in significance both states' loss of use tax revenue and vendors' compliance burdens is the factor of competition between local merchants and out-of-state vendors. In this context it is well to note states' exemptions, significantly in excess of constitutional necessity, of transactions where goods are exported from the taxing state. These exemptions, while generally justified as necessary to allow local merchants access on a tax-neutral basis to markets in other states, in fact give them a possible competitive advantage (where they are not required to collect the destination state's use tax and it is not enforced against the buyer). Considering only sales and use taxes, an out-of-state vendor not required to collect such taxes, unenforced against his customer, has a competitive advantage over both the local merchant and interstate competitors required to collect tax.

To the extent that trade is diverted to out-of-state merchants, a state's sales tax revenues, and indirectly other tax revenues dependent on local business activity, are diminished and other state objectives such as employment may be impaired. The national economy also suffers to the extent that trade is diverted by tax considerations from its most efficient and natural conduct, e.g., curtailing establishment of branch offices or local service facilities or justifying otherwise uneconomic logistics.

On the other hand, the lack of uniformity among states' sales and use tax laws multiplies the compliance burden for interstate commerce required to collect several states' taxes as compared to the burden on purely intrastate business. A purely local vendor need comply with the statutes and regulations of only the one state from which it derives all government benefits and to which it has political recourse. An otherwise comparable business selling in interstate commerce to customers in multiple states in which it has no regular presence is clearly at a disadvantage if required to ascertain for each state and subdivision thereof the applicable rates, the exemptions peculiar to each and the requisite certificates therefor, to file returns with each and to retain and submit for audit records complying with rules prescribed by each. Particularly burdensome is the need to contest alleged deficiencies in multiple forums with each having its own procedural peculiarities.

DETAILED ANALYSIS OF THE BILL

Extension of State Jurisdiction

The operative section of the Bill is section 103, which in subsection (a) states:

> "A state shall have the power to require a person to collect a state sales or use tax with respect to

> sales and uses of tangible personal property and services if (a) the destination of the sale is in that state and (b)(1) that person engages in regular or systematic solicitation and exploitation of a consumer market in that state and (2) [small business limitation discussed separately below]." [emphasis added].

Each of the terms underscored above is defined in section 106 of the Bill. Note, however, the absence of definition of several key terms which are used in many states' sales and use tax statutes as terms of art: "sales", "uses", "tangible personal property" and "services".

The nexus standard in Bill § 103(b)(1) is defined in Bill § 106(h) as follows:

> "The term 'engages in regular or systematic solicitation and exploitation of a consumer market in a state' shall mean and include but not be limited to the periodic solicitation of business in that state by (1) the distribution of catalogues, periodicals or other advertising flyers or other advertising by means of print, radio or television media or (2) otherwise soliciting sales by mail, telegraphy, telephony, computer data base or other communication systems whether by cable, telegraphic, telephonic, radio, optic or micro wave, electronic or other means."

The main departure from current law is in the absence of any requirement of physical presence. No office, inventory or even traveling salesmen need be in the taxing state - only the message to the potential customer need penetrate the state's boundaries. Indeed, curiously omitted is any specific reference to the traveling salesman or missionary.

Note that the definition broadens considerably the ordinary meaning of the word "solicitation". What solicitation will be deemed "periodic" (the original proposal used the word "regular") is not defined.

Consideration should be given to the possible impact of the Bill on advertising practices, particularly of border merchants. Will an ad in The New York Times or The Wall Street Journal create nexus between the advertiser and every state? Would an advertisement in The Village Voice have a different effect? How far will a radio commercial be deemed to extend?

The "person", who by engaging in such solicitation may be required to collect the tax, is defined in Bill § 106(c) as follows:

> "The term 'person' includes but is not limited to an individual, partnership, society, association, joint stock company, corporation, estate, receiver, trustee, assignee, referee, any other group or combination (including related corporate entities) acting as a unit, and any other person or agent acting in a fiduciary or representative capacity, whether appointed by a court or otherwise, and any combination of the foregoing."

The Bill does not indicate what is meant by the phrase "acting as a unit", nor what the criteria are for aggregation as a "group" or "combination", nor what the type of relationship is between the corporations referred to. Possible interpretations range from the dissociation test of Norton Co. v. Dept. of Revenue of Illinois, 340 U.S. 534 (1951), to almost unlimited freedom to aggregate. Will a manufacturer's advertising subject independent retailers carrying the manufacturer's product to collection responsibilities? Will trade association advertising, such as commercials extolling the virtues of drinking milk or Florida orange juice, affect the entire industry's status? What about cooperative advertising programs?

Even within groups of affiliated corporations, the exclusive focus on "solicitation" and aggregation to require collection of tax without a direct association between the soliciting and sales could produce incongruous effects. If Corporation A does not engage in any form of solicitation with respect to the taxing state, A need not collect tax although an affiliate maintains a substantial research or mining facility therein. Yet if A's affiliate had no presence in the taxing state but advertised a totally dissimilar product therein, A might be required under the Bill to collect tax.

Where the term "person" is applied to use one entity's activities to subject another entity to collection responsibilities, will transactions between the two entities be recognized or eliminated? For example, in computing whether the limitations in Bill § 103(b)(2) on applicability to small business (discussed below) apply, will a parent corporation's direct shipment to its subsidiary's customer in the taxing state be included twice in gross sales?

The other prerequisite in Bill § 103(a) to imposition of collection responsibility is defined in Bill § 106(g) as follows:

> "The term 'destination of the sale in a state' shall mean that the seller delivers or causes to be delivered tangible personal property or services to the purchaser or its agent or designee at a location in that state whether such delivery be made by means of the United States Postal Service, common or contract carrier, or otherwise, regardless of (1) whether the purchaser is separately charged the costs of such delivery by the seller and (2) the F.O.B. point or other conditions of the sale."

Delivery of services is an awkward concept. It may be intended to refer to delivery of tangible property upon which services have been performed (e.g., a repaired machine) and/or communication of information or other result of services with little or no tangible property involved (a legal opinion, processed data transmission, private detective report, advertising).

Limitation of Applicability to Small Business

Collection of a state's use tax is required under the Bill for a calendar year only if during the fiscal year ended September 30 of the prior calendar year such person either:

> "[1] has annual gross sales nationwide of tangible personal property and services of greater than twelve million five hundred thousand dollars or [2] has annual gross sales in that state of tangible

> personal property and services of greater than five hundred thousand dollars." Sec. 103(b)(2) as currently proposed.

For purposes of the latter test, presumably the place of sale is to be determined under the delivery test in Bill § 106(g) discussed above.

Consideration might be given to limiting gross sales taken into account to sales of merchandise in the ordinary course of business, i.e., exclude isolated transactions such as the disposition of a corporate aircraft.

Bill § 108 provides that a "person" who is a "successor in interest" by various methods of acquisition including merger or purchase in bulk "shall be deemed to be subject to such provisions of this act as apply or would apply to its predecessor." In the case of a midyear acquisition no advance time to establish collection systems and procedures would be allowed.

Compliance Requirements

Bill § 105 limits a state to requiring, in the case of a person whose collection responsibility arises solely under Bill § 103, a single return and remittance not more frequently than quarterly. For these purposes use of the term "person", as defined to include groups, and combination of entities, appears inappropriate. It is not clear which entity will be responsible for compliance and to what extent.

Applicable Procedures

Bill § 107(c) makes every person subject to the Bill's collection requirements:

> "subject to all applicable provisions of the sales and use tax laws, rules, regulations and related civil and criminal statutory and regulatory provisions with respect thereto of such state... ."

Compliance burdens arise not only from lack of uniformity in tax rate and multiplicity of local returns (alleviated in Bill §§ 104 and 105) but from the maze of exemption certificates, registration requirements and other paperwork.

Dispute resolution is a particularly troublesome aspect of this section of the Bill. Presumably § 107(c) requires the use of the exclusive remedy and exhaustion of administrative procedures in the taxing state. Contest procedures vary so widely from state to state that local counsel is a practical necessity and the expense thereof may cause many meritorious claims to be abandoned. Under what if any circumstances will United States District Courts be open to taxpayers or states to determine or enforce their rights and obligations under the Bill?

Query as to due process (under both federal and states' constitutions), especially as to criminal proceedings and as to long arm jurisdiction under a unitary theory.

Since "person" is not limited to United States persons, will problems arise in foreign as well as interstate commerce?

Stated Findings and Purpose

Two aspects of Bill § 102 have potential policy implications beyond the sales and use tax area. Subdivision (a)(2) states as a Congressional finding that "interstate sellers who systematically exploit a jurisdiction's market benefit from the governmental services provided by such jurisdiction." Subdivision (b)(2) speaks of the Bill "[e]stablishing a uniform standard for determining when it is fair to require interstate sellers who systematically exploit a state or local jurisdiction's market to contribute to the support of that market by collecting sales and use taxes..." It is not difficult to foresee the use of these statements in argument by analogy as to the validity under the Commerce and Due Process clauses of other state taxes. They could, for example, be deemed relevant in the imposition of income or franchise taxes to service industries not protected by Public Law 86-272. To improve the chances of Congressional enactment of a solution to the sales and use tax problem, we suggest deletion of such unnecessary and controversial material.

POSSIBLE EFFECTS OF THE BILL

Dual taxation of a single transaction by both the state of origin and the state of destination is currently not a problem for two reasons. First, states exempt from their sales taxes transactions in which goods are exported to other states. Such exemption, if it ever was, is no longer required under the prevailing judicial interpretations of the Commerce Clause; its continuance is due to each state's concern for the competitive position of its exporting vendors. Second, states generally allow credit against use tax for other jurisdictions' sales taxes on the same transaction as well as their own. Whether or not this credit is constitutionally required is an open question. See Williams v. Vermont, 105 S. Ct. 2465 (6/4/85).

Both of these factors could be undercut by the Bill's expansion of destination states' power to require collection of their use tax. If an exporting vendor must collect and remit tax, apart from significant rate differentials, his political support for exempting exports should vanish. Indeed, so long as an effective credit mechanism exists to preclude duplication of tax, one must assume that vendors will prefer consolidation of their responsibilities with the state of origin. Thus a likely ultimate result of the Bill might well be to cause the sales currently untaxed by any state to be taxed in the state of origin and to shift the tax on purchases currently taxed by the state of destination to the state of origin. However, if states end their exemption of exports, the increased cost of the credit may bring about its curtailment and create a problem of multiple taxation of interstate commerce.

In addition to the potential shift of revenues described above, the objectives of the Bill are not likely to be effectively realized unless appropriate procedural and administrative steps are taken among the states to implement its provisions. The cost of a vendor complying with the various states' use tax laws would be very substantial. If there is not at least suitable provision for multistate audits and controversy resolutions, the resulting burden on interstate commerce would almost certainly be, as Justice Stewart suggested in National Bellas Hess, supra, inconsistent with the purpose of the Commerce Clause.

To deal with these problems, we believe that for the proposed legislation to be viable, consideration also has to be given to the establishment of a system under which:

(1) a single multi-state use tax report could be filed by a vendor in each destination state, with tax paid to it and

(2) audit of the report and controversy resolution would be required to be on a multi-state basis so that there would be only a single audit (and controversy resolution mechanism) that would result in a consistent result binding all states and the vendor.

Such audit and dispute resolution procedures have obvious implications for the independent sovereignty of each state. These implications should be acceptable as a part of the legislation.

AN ALTERNATIVE APPROACH

As an alternative approach, Congress could a) eliminate any nexus requirement under the Commerce Clause to a state requiring vendors to collect and remit its use tax on shipments into the state, but b) allow any vendor whose contacts with a state do not exceed a minimum level to elect to pay tax on deliveries into such state, other than for resale, at the rate prevailing in such state of destination, but to pay such tax to the state of origin and in all respects as if the transaction were consummated entirely within the state of origin, and c) require states to allow purchasers credit for tax collected by electing vendors as if such tax were sales tax of the destination state. As the minimum level of contact below which an election could be made, we suggest the solicitation standard of the Interstate Income Tax Act (Public Law 86-272).

An election would become effective with respect to any destination state on the first of the month at least thirty days after being filed with every state from which the vendor sells or ships goods and could be revoked by the vendor only upon similar notice plus registration with the destination state. For an electing vendor the state of origin's exemptions would apply provided such state imposed a generally applicable sales tax. For all sales affected by an election an invoice might be required to contain specified federally prescribed information such as the vendor's name, address and taxpayer identification number, places from and to which shipped and tax collected pursuant to the election.

This alternative proposal could be expected to result in greater revenues to the states in the aggregate with greater certainty and be easier to comply with and enforce than the Bill. Subject only to due process considerations (present in any event), in the absence of an election every vendor would be required to collect the use tax, if any, on all shipments into a state pursuant to the laws of the destination. Vendors whose activities in a state do not exceed solicitation (an issue which each state having a tax on or measured by net income and vendor shipping thereto must already be concerned with) could avoid any undue burden by making the election with respect to the state.

The election would not cause the vendor's sales to escape tax at the destination state's prevailing rate; no competitive advantage would be perpetuated. (The sole exception would be the instance where the state of origin provided an exemption not provided by the destination state. Since the revenue loss would be that of the state of origin, and for the sake of simplicity, this exception seems justified). The vendor with respect to all electing states would be subject to audit in the states from which it ships and would only have to defend itself in those states.

Conclusion

The problem addressed by the Bill is one which can and should be cured by federal legislation. The Bill provides a useful solution, especially if amended as we suggest herein. We also recommend serious consideration of the alternative outlined herein.