Supreme Court Justice Anthony Kennedy invited a legal challenge over whether states can require out-of-state and online retailers to collect sales taxes. Kennedy’s opinion was issued as part of the Supreme Court’s unanimous ruling in the case of Direct Marketing Association v. Brohl, which examined what types of cases are allowed to file suit under the Tax Injunction Act (TIA). The TIA prohibits federal courts from blocking state tax collections, assessments and policies. The Supreme Court’s ruling will be viewed as undoing the Colorado law requiring remote sellers to report Colorado consumers’ remote purchases for the purpose of collecting sales and use taxes, and could narrow the scope of the online sales taxes in other states, as well as open a door for legal challenges in other jurisdictions.

However, Kennedy’s comments reveal the court’s awareness of the need for federal intervention to enable states to collect e-commerce taxes. In his opinion, Kennedy added that he believes that the Quill and National Bellas Hess decisions establishing the physical presence rule for sales tax are “now inflicting extreme harm and unfairness on the states.” Kennedy cited the growth of Internet commerce, the reality of business presence even in the absence of physical presence, and his view that “it is unwise to delay any longer a reconsideration of the court’s holding in Quill…. The legal system should find an appropriate case for this court to reexamine Quill and Bellas Hess.”

QUILL AND BELLAS HESS

Two U.S. Supreme Court decisions of the previous century (before the Internet was popular) established federal law with respect to remote sales tax collection as we know it today — the 1967 National Bellas Hess v. Department of Revenue of Illinois case and the 1992 Quill Corp. v. North Dakota. In the first case, the Illinois Department of Revenue attempted to force catalog retailer Bellas Hess, which was based in Kansas City, to collect Illinois sales tax. Bellas Hess refused. In its ruling on the case, the Supreme Court said that only businesses with nexus in a state have to collect sales tax for that state. Nexus is created by a physical presence. The Bellas Hess decision was reaffirmed in 1992 when North Dakota tried to require Quill Corporation, a mail-order office supply company incorporated in Delaware, to collect tax on its sales into the state. Quill refused on the grounds that it had no physical operations or employees in North Dakota. However, in the Quill ruling, the Supreme Court specifically invited Congress to exercise its authority to overrule the
Supreme Court by enacting legislation: “Our decision is made easier by the fact that the underlying issue is not only one that Congress may be better qualified to resolve, but also one that Congress has the ultimate power to resolve ... In this situation, it may be that the better part of both wisdom and valor is to respect the judgment of the other branches of the government.”

However, as Kennedy’s comments recognize, remote sales have changed dramatically since 1992 through the advent of e-commerce, and federal law has not kept pace. The absence of an update has left brick and mortar retailers at a 6 to 10 percent price disadvantage, compared with online retailers. According to the U.S. Department of Commerce, e-commerce sales in 2005 were $87 billion, and grew by nearly 40 percent to $225.5 billion in 2012. Online sales continued to explode during the 2014 holiday season, with Black Friday sales netting $2.4 billion, a 24 percent increase over Black Friday 2013, according to Adobe. 2014 Cyber Monday sales reached $2.04 billion, according to analytics firm comScore, rising 17 percent over sales for the popular online shopping day in 2013. And as online sales continue to increase, the amount of taxes on these sales that are not being paid to state and local governments to provide critical community services is likely to grow considerably. The National Conference of State Legislatures revealed in 2013 that online sales produced approximately $23 billion in unpaid sales and use taxes in 2012. In the absence of congressional action to respond to the Supreme Court’s 1992 invitation to modernize our tax laws, states have begun taking the law into their own hands and organizing their own collection systems. Kennedy’s concurrence in Direct Marketing Association v. Brohl, although it is the voice of just one justice, strongly signals a desire by the court to see Congress act on this issue, as well as the court’s willingness to permit states to collect taxes on Internet purchases even if Congress does not.

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OUTLOOK ON CONGRESSIONAL ACTION

Kennedy’s opinion comes as federal lawmakers face a stalemate on legislation that would allow states to enforce sales taxes on remote online vendors. While a bipartisan group of senators has reintroduced legislation that would enable state collection of e-commerce taxes, the bill faces significant hurdles from Senate majority leadership and a dubious path toward consideration. The new measure, the Marketplace Fairness Act, is virtually identical to legislation of the same name that Senate approved by a 69-27 vote in 2013. The bill would allow states that are interested in collecting taxes from online retailers to either (1) join the Streamlined Sales and Use Tax Agreement (a compact between 24 states to use simplified state-level administration of sales and use taxes and uniformity in state and local tax bases and definitions); or (2) agree to implement minimum tax simplification requirements as outlined in the bill.

Senate leadership now rests with a new majority, however, and chamber leader Mitch McConnell (R-KY) has not been supportive of the Marketplace Fairness Act. Senate Finance Committee Chairman Orrin Hatch (R-UT) is similarly unenthusiastic. The finance committee holds jurisdiction over the bill, and has indicated that it will first address much larger and more politically challenging legislation that includes the repeal or reform of the Patient Protection and Affordable Care Act of 2010, the Senate’s efforts to develop a comprehensive federal tax reform package, and a financing scheme to fund federal surface transportation programs for the next six years as part of the reauthorization of MAP-21.

Obstacles to advancing online sales tax collection legislation in the House are even more daunting. In January, House Judiciary Committee Chairman Bob Goodlatte (R-VA), who has been adamantly opposed to considering the Senate’s 2013 Marketplace Fairness Act, circulated draft legislation designed to enable state and local governments to collect taxes from Internet sales. The legislation, dubbed the Online Sales Simplification Act, offers an alternative approach to the Marketplace Fairness Act by proposing an origin-based sourcing sales tax collection and remittance structure, as opposed to the destination-based sourcing structure of the Marketplace Fairness Act.
Rather than compelling retailers to collect taxes on online purchases based on the address of the purchaser (destination-based sourcing), the Online Sales Simplification Act would compel retailers to collect the tax based on the address of the retailer. In another departure from the Marketplace Fairness Act, Goodlatte’s draft bill would not require the online retailer to remit the tax on the purchase back to a state or local government of the consumer who purchased the item online; instead, it would steer the tax to a collection clearinghouse, which would redistribute the tax at an agreed-upon rate. This proposal is alarming for two fundamental reasons:

1. The bill could inspire businesses with an online presence to relocate to states with very low sales tax rates (or one of the five non-sales tax states), which would impose economic harm on those states and jurisdictions left behind.

2. All purchasers in states with a sales tax rate that is less than the rate of the seller’s home jurisdiction would pay at the higher sales tax rate. In other words, the clearinghouse wouldn’t deliver taxes on a remote sale back to the purchaser’s state or local government of residence at the same rate imposed by the seller’s state or local government.

Goodlatte’s explanation for this approach is that it is designed to protect small businesses from endless out-of-state audits, which he and many other House Republicans worry numerous small businesses could be subject to; they are concerned that these audits could ultimately harm these businesses or cause them to fail. The GFOA is working with its state and local government coalition association partners at the National League of Cities, U.S. Conference of Mayors, National Association of Counties, and National Governors Association, along with our partners in the retail community, to urge Goodlatte to consider moving forward with a destination-based sourcing bill instead of an origin-based sourcing bill. In discussions with the chairman’s office, the coalition has relayed to them that Internet tax software providers (such as TaxCloud) have agreed to handle out-of-state audits for small businesses, and that these providers are comfortable with language that could be included in the Marketplace Fairness Act that would squarely place the burden of out-of-state audits and related liability on the software providers instead of small businesses. So far, however, the chairman’s office has indicated that they are very unlikely to support a destination-based sourcing bill like the Marketplace Fairness Act.

The coalition’s efforts to seek a House alternative to Goodlatte’s draft have led to discussions with the office of Congressman Jason Chaffetz (R-UT) on developing a destination-based sourcing bill. Chaffetz organized legislation of this nature in 2014 that also included language addressing the concerns of many House Republicans about the legislation’s impact on small businesses. Senators Mike Enzi (R-WY), Lamar Alexander (R-TN), Dick Durbin (D-IL) and Heidi Heitkamp (D-ND) are holding similar meetings with Chaffetz’ office to discuss collaboratively organizing House Marketplace Fairness Act-like legislation that, while similar, would also include provisions capable of attracting enough votes to pass the House. It is worth noting, however, that even if such legislation were introduced, it would ultimately need to pass through House Judiciary Committee Chairman Goodlatte’s committee in order to eventually receive House floor consideration.

CONCLUSIONS

Along the way, the bill would also need to overcome the myths promoted by opponents of online sales tax legislation such as NetChoice, whose members include AOL, eBay, Facebook, Overstock.com, and Yahoo. Such myths include the notion that legislation like the Marketplace Fairness Act would impose a new tax on consumers, and that collecting remote sales taxes is too complex. While untrue, these shallow arguments have convinced a fair number of lawmakers that they would be better off if the House opted not to hold a floor vote on such a measure. Despite these obstacles, the GFOA and its state and local association partners continue its work to meet with congressional offices to build support for enacting online sales tax legislation this year. As this campaign continues, we will continue to keep GFOA members informed as to the status of these discussions and, where appropriate, engage our members to weigh in directly with their federal elected leaders.

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