DEPARTMENT OF TAXATION
2012 Fiscal Impact Statement

1. Patron Frank W. Wagner

2. Bill Number SB 597
House of Origin:
_____ **Introduced**
_____ **Substitute**
_____ **Engrossed**

Second House:
__X__ **In Committee**
_____ **Substitute**
_____ **Enrolled**

3. Committee House Finance

4. Title Retail Sales and Use Tax; Presumption of Nexus for Out-of-State Dealers Belonging to a Commonly Controlled Group

5. Summary/Purpose:

This bill would create a rebuttable presumption that an out-of-state dealer has sufficient activity in Virginia to require the dealer to register if a "commonly controlled person" maintains a distribution center, warehouse, fulfillment center, office, or similar location in Virginia that facilitates the delivery of tangible personal property that is sold by the out-of-state dealer. Out-of-state dealers could rebut this presumption by demonstrating that the activities conducted by the commonly controlled person in Virginia are not significantly associated with the dealer's ability to establish or maintain a market in the Commonwealth for the dealer's sales. The bill would also impose reporting and notification requirements on those retailers that are able to rebut the presumption. The bill also contains a severability clause that would protect the remaining provisions of the statute if any portion of the statute were invalidated by a court.

Under current law, only certain vendors who meet the definition of "dealer" and who have sufficient contact with the Commonwealth are required to register and collect the Retail Sales and Use Tax.

The effective date of this bill is not specified.

6. Budget amendment necessary: Yes.
Page 1, <u>Revenue Estimates</u>

7. Fiscal Impact Estimates are: Preliminary. (See Line 8.)
7a. Expenditure Impact:

Fiscal Year	***Dollars***	***Positions***	***Fund***
2011-12	$0	0	GF
2012-13	$310,000	6	GF
2013-14	$709,000	6	GF
2014-15	$731,000	6	GF
2015-16	$748,000	6	GF
2016-17	$766,000	6	GF
2017-18	$784,000	6	GF

8. Fiscal implications:

Administrative Costs

Rebuttable Presumption Component

In order to implement this component of the bill, the Department would need to hire two additional Virginia-based field auditors to identify and bring into compliance non-registered businesses.

Use Tax Reporting and Notification Component

The Department would incur additional administrative costs due to the additional notification and reporting requirements imposed on certain companies of $310,000 in Fiscal Year 2013, $709,000 in Fiscal Year 2014, $731,000 in Fiscal Year 2015, $748,000 in Fiscal Year 2016, $766,000 in Fiscal Year 2017, and $784,000 in Fiscal Year 2018 in implementing this bill.

The Department may be presented with significant challenges in implementing this bill. Because the retailers will not have the individual social security numbers and federal employment identification numbers for each purchaser, the Department would need to try to match the billing addressees with the social security numbers or federal identification numbers. This match-up process may be difficult, and the Department may need to design an automated system to issue automated letters to the billing addresses in order to verify that the individual is liable for the tax and has not already remitted the tax to the Department. The Department anticipates incurring postage and printing costs to mail approximately 200,000 letters, and costs to hire three additional customer service representatives to respond to taxpayer questions concerning these letters

Using the billing address to determine taxpayer liability presents additional challenges where taxpayers order items from an affected retailer and directs that the order be shipped to an individual or business out-of-state. In such a case, use tax liability would not attach and the Department would need to know whether the tax applies before auditing individuals. Thus, the Department would need to hire an additional part-time employee to review the annual statements to determine whether use tax liability attaches, in addition to whether it is cost-effective to pursue taxpayers who have not remitted consumer use taxes, particularly where they have made less than $100 in purchases in the calendar year.

Revenue Impact

The revenue impact of this bill would depend largely on the response to its enactment by affected online retailers. Some online retailers and their affiliates have threatened to cease operations in those states that have enacted similar legislation. If the bill were enacted and affected retailers elected to cease operations in Virginia in lieu of paying the tax, there would be no revenue gain associated with the enactment of this bill.

The bill would likely be a significant issue for affected companies currently operating in Virginia or those that may wish to locate in Virginia.

The notification and reporting requirements contained in this bill may expose the Commonwealth to litigation costs. The Direct Marketing Association is in litigation with Colorado over extensive use tax notification and reporting requirements and has threatened to sue in other states that have enacted similar legislation. The United States District Court has issued a preliminary injunction against the state of Colorado. Similar litigation costs in Virginia to defend such a suit would offset any potential revenue anticipated from this bill.

While the issue of whether statutes, like this bill, that confer nexus based upon the relationship between the out-of-state retailer and the in-state entity has not been litigated, once states begin making assessments based on these statutes, legal challenges are likely to follow, and the courts may rely on precedent established well before these statutes were enacted. For example, both the Pennsylvania and Connecticut Supreme Courts have ruled that attempts to require tax collection by mail-order sellers that were part of a corporate structure that included retail stores in the state violated the commerce clause of the U.S. Constitution because the mail-order companies did not have sufficient nexus with the taxing state. If these statutes are held unconstitutional, this bill would have no revenue impact.

Assuming, however, that the provisions of the bill are deemed constitutional and affected retailers comply with the bill and begin to collect the Retail Sales and Use Tax, this bill would result in an unknown revenue increase for Virginia. Based on a survey of the total revenue generated by the retailers that would be affected by this bill, adjusted to reflect Virginia's share of such sales, Virginia could realize as much as an additional $24 million in state and local sales tax revenue. The notification and reporting provisions could reduce this number significantly. First, some purchasers already pay the use tax on their purchases from some of the affected companies. Individuals and businesses paid a total of $43.8 million of consumer use tax in calendar year 2011. Second, customers may feel compelled to purchase from other online retailers that are not required to report their customers' purchases to the Department.

9. Specific agency or political subdivisions affected:

Department of Taxation

10. Technical amendment necessary: No.

11. Other comments:

<u>Constitutional Nexus</u>

The Commerce Clause of the U.S. Constitution reserves to Congress the power to regulate commerce among the states and with foreign nations. The U.S. Supreme Court has established a four-prong test to be used in determining whether a state tax on an out-of-state corporation's activities in interstate commerce violates the Commerce Clause. A state may require an entity engaged in interstate commerce to collect taxes on its behalf provided the tax is 1) applied to an activity with a substantial nexus with the taxing State; 2) is fairly apportioned; 3) does not discriminate against interstate commerce; and 4) is fairly related to the services provided by the state. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977). The U.S. Supreme Court has also determined, in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992) that the Commerce Clause barred a state from requiring an out-of-state mail-order company to collect use tax on goods sold to customers located within the state when the company had no outlets, sales representatives, or significant property in the state. In this case, the Court determined that only Congress has the authority to require out-of-state vendors, without a physical presence in a state, to register and collect that state's tax.

Virginia law specifically sets out the standards for requiring out-of-state dealers to collect the Virginia Retail Sales and Use Tax on sales into the Commonwealth. The law provides that a dealer is deemed to have sufficient activity within the Commonwealth to require that dealer to register to collect the Virginia Retail Sales and Use Tax if the dealer:

- Maintains an office, warehouse, or place of business in the Commonwealth;
- Solicits business in the Commonwealth, by employees, independent contractors, agents or other representatives;
- Advertises in Commonwealth publications, on billboards or posters located in the Commonwealth, or through materials distributed in the Commonwealth;
- Regularly makes deliveries into the Commonwealth by means other than common carrier;
- Continuously, regularly, seasonally, or systematically solicits business in the Commonwealth through broadcast advertising;
- Solicits business in the Commonwealth by mail, provided the solicitations are continuous, regular, seasonal, or systematic and the dealer benefits from any banking, financing, debt collection, or marketing activities occurring in the Commonwealth;
- Is owned or controlled by the same interests which own or control a business located within this Commonwealth;
- Has a franchisee or licensee operating under the same trade name in the Commonwealth, if the franchisee or licensee is required to obtain a certificate of registration; or
- Owns tangible personal property that is rented or leased to a consumer in the Commonwealth, or offers tangible personal property, on approval, to consumers in the Commonwealth.

Restricted by the United States Constitution and the Supreme Court's decision in *Quill*, many states have similar nexus statutes that restrict their ability to require remote sellers to collect taxes on sales made into the state. With growing retail sales on the Internet and declining tax receipts, some state tax collectors have turned their attention to the revenue being lost from sales by out-of-state retailers to the residents of their states. Although individuals who purchase goods from out-of-state firms via the Internet or mail order owe their states of residence use tax on their purchases in lieu of sales tax, states find it difficult to enforce this obligation. As a result, many states lose out on substantial revenue.

Several proposals have developed as a result of the difficulty among states in collecting sales and use taxes on remote purchases. Some states have become involved with the

Streamlined Sales Tax Project, which is an effort among states to simplify and unify state and local sales taxes in order to encourage Congress to overturn *Quill*. Other states have enacted "Amazon statutes," aimed directly at Amazon.com and similar Internet retailers.

Streamlined Sales Tax Agreement

The Streamlined Sales Tax Project ("SSTP") was founded in March, 2000, with the purpose of developing measures to simplify and unify state and local sales taxes. Streamlining is primarily an effort by states to enhance sales tax collection on mail order, catalog, Internet, and other remote sales. In reaction to the *Quill* decision and in an attempt to create a level playing field, whereby out-of-state vendors and in-state vendors are both operating under the same tax rules, 40 states and the District of Columbia came together through the SSTP and endorsed the concepts embodied in the Streamlined Sales and Use Tax Agreement ("SSUTA"). States expect that out-of-state businesses without a requirement to collect sales tax will voluntarily collect tax when the states adequately streamline their sales tax.

The SSUTA seeks to improve the sales and use tax administration systems used by the states through:

- State level administration of sales and use tax collections.
- Uniformity in the state and local tax bases.
- Uniformity of major tax base definitions.
- Central, electronic registration system for all member states.
- Simplification of state and local tax rates.
- Uniform sourcing rules for all taxable transactions.
- Simplified administration of exemptions.
- Simplified tax returns.
- Simplification of tax remittances.
- Protection of consumer privacy.

Currently, there are 21 full member states and 3 associate member states that make up the Streamlined Sales Tax Governing Board. Since 2002, Virginia has been an active member of the Streamlined Project, but is not a member of the Governing Board.

Legislation which would allow those member states that have implemented the SSUTA provisions to require large Internet and mail order retailers to collect state and local sales taxes, known as the "Main Street Fairness Act," was introduced in Congress in July, 2011.

Two other federal legislative proposals, the "Marketplace Fairness Act" and the "Marketplace Equity Act" do not remove the SSUTA option, but also allow states to collect remote sales taxes without signing the SSUTA, provided the states adopt and implement minimum simplification requirements.

Other States' Efforts

Click-Through Affiliate Nexus Statutes

These statutes generally create a rebuttable presumption that an Internet retailer has nexus with the applicable state if the seller enters into an agreement with an in-state resident or person to refer potential customers, directly or indirectly, through a link on a website or otherwise, to the seller, in exchange for a commission or other consideration. Generally, the presumption applies only if the seller's cumulative gross receipts do not exceed a certain amount for sales to in-state customers resulting from these agreements. New York was the first state to adopt a "click-through" nexus statute. In response to this statute, Amazon.com filed suit against the state of New York, asserting that the law violated the Commerce Clause, the Due Process Clause, and the Equal Protection Clause of the United States Constitution. Opining that none of the challenges had merit, the trial court fully dismissed Amazon's suit. Amazon has appealed and the case is still pending in the appellate court.

Facility, Employees to Facilitate Sales, Warehouse, Distribution Center

Several states have enacted statutes conferring nexus to an out-of-state retailer when the retailer holds a substantial ownership interest in or is owned partially or fully by a business that maintains a distribution house, warehouse, or similar place of business that delivers property sold by the retailer. Similarly, several states confer nexus to an out-of-state retailer that uses in-state employees to advertise, promote, or facilitate the seller's sale. has a facility or employees in the state that assists or facilitates the retailer in making sales to customers. Similarly, some states presume nexus for out-of-state retailers when an affiliate owns a distribution center or warehouse in the state, even if the distribution center was in a separate corporate entity.

Component Member Retailer

In some states, there is a presumption of nexus for an out-of-state retailer that is part of a controlled group of corporations with a component member that is a retailer engaged in business in the state. The presumption may be rebutted by demonstrating that during the calendar year at issue, the component member did not engage in specified activities on behalf of the seller.

Statutes to Increase Consumer Use Tax Compliance

A few states have focused their efforts on statutes to increase consumer use tax compliance. The statutes generally require the remote retailer to notify the purchaser of the potential use tax obligation in the destination state and to comply with various other information reporting requirements on sales to in-state residents. For example, in 2010, the Colorado legislature enacted HB 10-1193, which imposed notification and reporting requirements on "retailers that do not collect Colorado sales tax" similar to the ones set forth in this bill. The legislation does not apply to retailers making sales solely by means of download of digital goods and retailers who made less than $100,000 in total gross sales in Colorado in the previous calendar year. In response to this legislation, the Direct Marketing Association, which consists of businesses and organizations that market products directly to consumers via catalogs and Internet, sought an injunction from the United States District Court to enjoin the Colorado Department of Revenue from enforcing the statute. The District Court issued a preliminary injunction against the state of Colorado on January 26, 2011, agreeing with the Direct Marketing Association's contention that the legislation is likely to place an undue burden on businesses in violation of the Commerce Clause of the U.S. Constitution. Colorado has appealed this decision to the Tenth Circuit Court of Appeals and the case is still in litigation.

Summary of State Legislation

The table below summarizes the statutes that have been enacted to reach out-of-state Internet retailers.

State	Click-through	Corp. Group	Warehouse/ Distribution Center	Similar Trade Name/ Trademarks	Use Tax Compliance Statute	Special Agreements or other Responses
AL	N	N	N	Y (2003)	N	
AR	Y ($10,000 min.)	N	Y	Y	N	Terminated affiliate relationships
CA	Y ($10,000 annual, total cumulative $1 million)	Y (if in-state member performs services for seller)	N	N	N	Click-through and corp. group statutes effective if fed'l law enacted on or before 7/31/12 authorizing remote collection and state does not elect to implement law by 9/12, effective 1/13.
CO	N	N	N	N	Y	Online retailers terminated affiliates; Direct Mkt'ing Association filed lawsuit challenging the law.
CT	Y ($2,000 quarterly minimum)	N	N	N	N	Online retailers terminated affiliates.
IL	Y	N	N	Y (commission required)	N	Online retailers terminated affiliates; Performance Marketing Association filed lawsuit.
IN	N	N	N	N	N	Governor announced on January 9 that online retailer will begin collecting taxes on sales into the state beginning January 1, 2014.
NY	Y	N	N	Y	M	Amazon.com and Overstock.com filed law suit in 2008. Amazon maintains affiliates in NY and collects sales tax while case pending.
NC	Y	N	N	N	N	Online retailers terminated affiliates.
OK	N	Y	Y	Y	Y	Online retailers post notice on invoice/website notifying customers of use tax obligation.
PA	Y (admin. ruling)	N	Y (admin ruling)	N	N	Department of Revenue has announced that it will delay enforcement from February 1, 2012 until September 1, 2012.
RI	Y (More than $5,000 in previous four quarters)	N	N	N	N	Online retailers terminated affiliates.
SC	N	N	Y (special agreement)	N	Y—As part of special deal, must notify customers of responsibility to pay tax and provide link to DOR website.	Special agreement with Amazon if: 1) place distribution facility in service; 2) makes capital investment of at least $125 million; 3) creates at least 2,000 full time jobs; and 4) maintains at least 1,500 full-time jobs for those employees until 1/1/2016. Expires when: 1) entity ineligible; 2) 1/1/2016, or 3) Congressional action.
SD	Y	Y	Y	Y	Y	Online retailers post a notice on their invoice and/or website notifying customers of their use tax obligation.

TN	N	N	N	N	N	Amazon relieved of tax collecting burdens until 1/1/14 in exchange for new distribution center and promise to provide 3,500 full time jobs and $350 million in capital improvements. Bill to ratify will be filed in 1/2012.
TX	N	N	Y	Y	N	Amazon has said it will terminate operations at its TX distribution center.
VT	Y	N	N	N	Y	Click-through provision will only become effective when 15 or more other states have adopted same or substantially similar requirements.

Proposal

Rebuttable Presumption Component

This bill would create a rebuttable presumption that an out-of-state dealer has sufficient activity in Virginia to require the dealer to register if a "commonly controlled person" maintains a distribution center, warehouse, fulfillment center, office, or similar location in Virginia that facilitates the delivery of tangible personal property that is sold by the out-of-state dealer. Out-of-state dealers could rebut this presumption by demonstrating that the activities conducted by the commonly controlled person in Virginia are not significantly associated with the dealer's ability to establish or maintain a market in the Commonwealth for the dealer's sales.

Under the terms of this bill, "commonly controlled person" would be defined as any person that is a member of the same "controlled group of corporations," as defined in § 1563(a) of the Internal Revenue Code, as the dealer or any other entity that, notwithstanding its form of organization, bears the same ownership relationship to the dealer as a corporation that is a member of the same "controlled group of corporations.

Use Tax Notification and Reporting Requirements for Certain Dealers

Any dealer that is able to rebut the presumption of sufficient activity and is not required to collect the state and local use tax for sales it makes into Virginia, this bill would mandate that the dealer notify purchasers with an address in Virginia of their potential use tax liability and potential requirement to file a use tax return. Dealers that failed to comply would be subject to a $5 penalty for each failure unless the dealer showed reasonable cause for the failure.

Dealers would also need to provide these purchasers written notice by first class mail by January 31 of each year reporting the total amount the purchaser paid for purchases from the dealer in the immediately preceding calendar year, and to include on such notice, if available, the dates, amount, category, and Virginia sales and use tax implications for each purchase. Dealers failing to send the notice would be subject to a $10 penalty for each such failure unless the dealer showed reasonable cause for the failure.

The bill would also require that these dealers file an annual statement with the Department by March 1st of each year for each purchaser with an address in Virginia who made purchases from the dealer during the preceding calendar year, reporting the total amount of purchases the purchaser made from the dealer. The Department would be authorized to require dealers that made more than an aggregate of $100,000 in sales during the preceding calendar year to purchasers with a Virginia billing address to file the annual statement by magnetic media or another machine-readable form. Dealers that failed to comply would be subject to a $10 penalty for each such failure unless the dealer showed reasonable cause for the failure.

Severability Clause

The bill also contains a severability clause. When a severability clause is attached to legislation, if a portion or several portions of the law are deemed unconstitutional or are otherwise invalidated by a court of competent jurisdiction, the remaining provisions of the law continue in force as law.

The effective date of this bill is not specified.

cc : Secretary of Finance

Date: 2/21/2012 KP
DLAS File Name: SB597FE161