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MARCH 2018

STATE FACTOR

A PUBLICATION OF THE AMERICAN LEGISLATIVE EXCHANGE COUNCIL

Online Sales Tax Collection, Constitutional Precedent, and Interstate Commerce: What You Need to Know

By Jonathan Williams and Joel Griffith

In an effort to enhance tax collections and force the United States Supreme Court to revisit its landmark *Quill Corp v North Dakota* decision of 1992,¹ many states are aggressively targeting out-of-state businesses. Some state policymakers are looking to force businesses that simply sell products to their residents over the internet to collect sales taxes from the purchaser and remit these taxes to the jurisdictions where the customer is located. In order to prevent the unduly burdening of interstate commerce, the Supreme Court held in the *Quill* decision that businesses lacking a “substantial nexus” or link to a state through a “physical presence,” cannot be forced to adhere to that state’s sales tax collection and remittance requirements. This physical presence requirement may be met if a business maintains facilities, plants, distribution centers, data centers, offices, property, or employees in the taxing state. In short, a taxing state may not require remote sellers lacking a physical presence in the state to act as tax collection agents.

In a direct challenge to *Quill*, South Dakota recently passed aggressive legislation to force tax collection and remittance burdens on out of state companies without physical pres-

ence in the state.² Upon review, the South Dakota Supreme Court sided with online retailers, citing *Quill*’s protections; but, nearly immediately, many states then urged the U.S. Supreme Court to hear the South Dakota case in an attempt to overturn *Quill*. On January 12th, the U.S. Supreme Court agreed to hear the South Dakota case this year—known as *South Dakota v. Wayfair, Inc.*³

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If the Court overturns *Quill*, it would upend decades of precedent safeguarding Congress’s constitutional prerogative to protect interstate commerce from overly-aggressive state and local governments who seek to levy tax collection burdens on businesses with no physical connection to their states. This would be especially damaging to the five states that choose to avoid statewide sales taxes (New Hampshire, Delaware, Montana, Oregon and Alaska), as well as the businesses within their states. More concerning yet, economic growth—particularly from entrepreneurs and start-up businesses—would be stunted as tax compliance costs abound.

Federalism Properly Understood

Hardworking individual and business taxpayers deserve protection from out-of-state tax collectors and regulators. The United States Constitution, as well as subsequent rulings from the United States Supreme Court, such as the landmark *Quill* decision, outlines the proper balance between the federal government, the states and the American taxpayer.

In recent years, states have struggled to control their spending and have been harmed during the era of weak

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economic recovery following the Great Recession of 2008. State policymakers have also realized tax increases on their residents cause significant economic harm—in large part because their policy actions are not enacted in a vacuum. The annual *Rich States, Poor States: ALEC-Laffer State Economic Competitiveness Index* presents this case of tax competition in full detail and shows how Americans “vote with their feet” across state lines to pursue economic opportunity.⁴ This healthy economic competition in a free market, between the

50 “laboratories of democracy,” is at the heart of the American experiment with federalism.

The repeated failures of state tax increases have caused some state policymakers to look aggressively beyond their own state lines for tax revenue. This ill-advised strategy chases short-term revenue promises and fails to consider the enormous harm to the economy that is caused by this policy approach. The Commerce Clause in Article 1 of the United States Constitution⁵ was written to prevent protectionism by states, as well as this sort of aggressive regulation aimed at out-of-state taxpayers and out-of-state voters.

Many supporters of overturning the *Quill* decision have wrapped themselves in the language of federalism. However, a proper understanding of federalism involves a balance between federal and state governments. In the case of protecting interstate commerce, Article 1 of the United States Constitution clearly allocates to the federal government the role of protecting the American people.

Onerous Compliance Costs Related to Sales Tax Remittance Will Stunt Economic Dynamism

The ALEC Principles of Taxation supports the idea that taxes should be simple and transparent.⁶ A complex network of taxes and reporting regulations stretching beyond the purview of residents and into other states is inherently a viola-

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tion of these principles. In addition, many of the entities subjected to these compliance costs have the inability to vote, even indirectly, on these sales taxes. Being deprived of a voice on this matter is akin to taxation without representation. The Court in *Quill* expressed concern that collection duties could possibly “be imposed by the Nation’s 6,000 plus taxing jurisdictions.”⁷ In fact, there are now more than

12,000 tax jurisdictions across the states⁸—roughly twice as many as when the U.S. Supreme Court decided the landmark *Quill* case in 1992.⁹

Requiring online retailers to potentially collect and remit sales taxes for roughly 12,000 different state and local sales tax jurisdictions would unduly burden businesses engaging in

interstate commerce. Each of these jurisdictions might have different rates, exemptions, rules, tax holidays, or other differences that online retailers would either be forced to track or else face the risk of costly audits and fines. Dealing with federal taxes, state and local taxes and regulations is already an incredibly burdensome task for start-ups and small businesses. Expanding this compliance cost burden would fall particularly hard on specialty businesses and small sellers that are dependent on the internet to reach their customers.

Unfair Discrimination Against Online Retailers

Some claim that requiring online retailers to collect sales taxes from out-of-state consumers merely treats online retailers the same as traditional “brick-and-mortar” retailers; This claim is false. These online businesses would be forced to keep track of the thousands of taxing jurisdictions across the country, many with their own rates, bases, rules and regulations. Contrast that with the treatment of sales in similar brick-and-mortar businesses, which are only required to collect and remit taxes for the jurisdiction in which they are physically located.

Forcing online retailers to make the choice between overly onerous sales tax compliance rules or foregoing the potential customer base that the internet allows access to is fundamentally unfair. This could be the most destructive impediment to retailers and small businesses hoping to use the online marketplace to grow and succeed.

When Patrick Byrne, the founder of online retailer Overstock.com, testified before Congress to oppose the threat of new online tax collection burdens, he put it this way:

“In 1999, we had 18 employees, carried 100 products and had \$1.8 million in revenue. If we had been

required to administer and collect sales tax on behalf of remote state governments without meaningful simplification, indemnity and compensation, our chances of becoming an employer of 1,500 American workers that we are today would have been small.”¹⁰

Overturing Precedent Erodes Protection of State Borders

Overturing the *Quill* precedent will erode the protection of state borders as effective limits on state tax power. This will encourage poorly-governed, tax-heavy states like California, New York, and Illinois to unleash their aggressive tax collectors on businesses located in better-managed locations. These businesses could be subject to audit and enforcement actions in states across the country in which they have no physical presence and, thus, little political influence.

The U.S. Constitution was written to replace the Articles of Confederation, in no small part due to the latter’s failure to prevent a spiraling interior “war” of states who could assert tax and regulatory authority outside their borders and thereby create “fiefdoms” for themselves. The U.S. Constitution’s Commerce Clause and subsequent jurisprudence make clear that taxing power must be limited. Yet, if the Supreme Court overturns *Quill*, state tax collectors would be empowered to reach across their boundaries to collect taxes remitted from online retailers located outside of their jurisdictions. These retailers could face fines or legal challenges from taxing jurisdictions based on rules in which the online retailers have no voice.

Elimination of these constitutional safeguards would open the floodgates for revenue-hungry state governments to reach across their borders to tax and audit interstate commerce. Throughout the ongoing transformation of the infor-

mation era, the physical nexus requirements articulated by the Supreme Court have sheltered technological innovation, start-up businesses, and consumers from state and local governments overly eager to collect additional revenue.

The Public Overwhelmingly Opposes Enabling Out-of-State Efforts to Force Remittance by Retailers

It is no surprise that most Americans do not like the idea of burdensome online tax collection requirements. A September 2017 poll by Rasmussen found that Americans oppose internet sales tax collection legislation by a 45-point margin,¹¹ and a March 2018 poll of likely voters by National Taxpayers Union found Republicans oppose such laws by a 42-point margin, Democrats by a 38-point margin, and independents by a 46-point margin.¹²

In Summary

Our founding document—the Constitution—wisely delegated to Congress the authority to protect interstate commerce. For nearly 20 years, ALEC members have steadfastly supported the physical presence standard reaffirmed in *Quill* through model policies such as the Sales and Use Tax Collection Protection Act¹³ as well as the 21st Century Commercial Nexus Act.¹⁴

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Technology and business practices have advanced immensely the past two centuries since our founding, largely because we learned from our mistakes in the Articles of Confederation and allowed commerce to flow unfettered between the states. If the U.S. Supreme Court changes the status quo and strikes down the *Quill* physical presence standard, this very innovation could be choked out by tax and regulatory burdens from revenue-hungry state and local governments. That would be horrible news for economic growth and innovation. Even more concerning, it would be a blow to our Constitution and the proper understanding of federalism.

Jonathan Williams is chief economist at the American Legislative Exchange Council and vice president of its Center for State Fiscal Reform. Joel Griffith is director of the ALEC Center for State Fiscal Reform.

[End Notes]

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