Legal Alert:
Federal Streamlined Sales Tax Legislation Introduced in Senate

December 22, 2005

Senators Michael Enzi (R-WY) and Byron Dorgan (D-ND) introduced alternative versions of federal streamlined sales tax legislation (S. 2152 and S. 2153, respectively) on December 20, 2005. Both bills implement a streamlined sales tax by endorsing many of the simplification provisions contained in the Streamlined Sales and Use Tax Agreement (the “Agreement” or “SSUTA”). The difference between Senator Enzi’s Sales Tax Fairness and Simplification Act (S. 2152) and Senator Dorgan’s legislation (S. 2153) relates to a small business exception that is discussed in more detail below. Subject to certain requirements and limitations, the bills authorize “Member States” to impose a sales tax collection obligation on remote sellers. If either bill is enacted, the legislation would negate, in some respects, the physical presence nexus standard articulated in National Bellas Hess v. Department of Revenue of Illinois and Quill v. North Dakota.

I. Overview of the Proposed Federal Legislation.

The proposed federal legislation partially incorporates the provisions of the Agreement adopted November 12, 2002 by the Streamlined Sales Tax Project. The Agreement is a model state sales tax law that contains substantive and administrative simplification rules intended to reduce the burden of sales and use tax collection. Currently, 19 states have enacted legislation that substantially conforms to the terms of the Agreement. Additional states are expected to adopt the Agreement.

1 Because the bills are substantively identical except for the “small business exception” provision, this article cites only to the Sales Tax Fairness and Simplification Act (S. 2152).
2 Section 9(3) of the proposed federal legislation defines “Member State” as that term is used in the Streamlined Sales and Use Tax Agreement (the “Agreement” or “SSUTA”), except “Member State” does not include the Agreement’s “associate members.” See SSUTA §§ 704 and 805. Therefore, a state is only a “Member State” under the proposed federal legislation if it is a “full member state” in the Agreement.
3 386 US 753 (1967).
5 The Streamlined Sales Tax Project was organized in March 2000 to simplify and modernize state and local sales tax systems. Dissolved on the Agreement’s effective date of October 1, 2005 and replaced by the State and Local Advisory Council at that time, the Streamlined Sales Tax Project was a collaborative simplification effort between state and local governments with input from the business community.
The proposed federal legislation and the Agreement are intertwined. For instance (and as discussed in greater detail below), the proposed federal legislation requires that the states adopt the Agreement as a pre-requisite to granting the states the right to enforce tax collection on remote sellers.

SUTHERLAND OBSERVATION: The proposed federal legislation applies to “Member States”, meaning only those states qualifying as “full member states” under the Agreement will be permitted to require sales tax collection on non-physically present sellers. A “full member state” is a state whose laws, rules, regulations and policies are “substantially compliant” with each of the Agreement’s provisions. Currently, the full member states include: Indiana, Iowa, Kansas, Kentucky, Michigan, Minnesota, Nebraska, New Jersey, North Carolina, North Dakota, Oklahoma, South Dakota and West Virginia. In addition, six states currently qualify as “associate member states” by virtue of their partial – but not “substantial” – compliance with the Agreement as a whole, as well as each of its provisions. However, the proposed federal legislation by its terms does not apply to associate member states.

Specifically, the proposed federal legislation would:

- Permit Member States to require collection of sales and use taxes on “remote sales” subject to three authorization requirements;\(^6\)

- Require Member States to maintain 19 minimum simplification standards to retain the authority to collect sales tax on remote sales;\(^7\)

- Limit the Member States’ collection authority to sales/use taxes and taxes imposed on telecommunications services, \(i.e.,\) Member States cannot use the federal legislation’s principles to impose franchise taxes, income taxes or licensing requirements;\(^8\) and

- Provide for administrative and federal judicial review of disputes available to any person affected by the federal legislation, including expedited judicial review for certain constitutional challenges.\(^9\)

\(^8\) Sen. 2152, 109\(^{th}\) Cong. § 7 (2005).
\(^9\) Sen. 2152, 109\(^{th}\) Cong. §§ 5, 8 (2005).
II. AUTHORIZATION TO IMPOSE SALES TAX ON REMOTE SALES.

**Sutherland Observation:** In interpreting the dormant Commerce Clause’s substantial nexus requirement, the U.S. Supreme Court in *National Bellas Hess* and *Quill* applied a physical presence nexus test. The Court also made clear in *Quill* that Congress has broad authority to enact laws that may deviate from or replace this nexus standard.

The federal legislation’s fundamental goal is to “level the playing field” and make *Quill’s* physical presence nexus standard inapplicable to Member States in the context of sales, use and telecommunication taxes. Subject to specified requirements, the proposed federal legislation authorizes Member States to require sellers “to collect and remit sales and use taxes with respect to remote sales sourced to that Member State under the Agreement.”10 The proposed federal legislation defines a “remote sale” as:

[A] sale of goods or services attributed to a particular Member State with respect to which a seller does not have adequate physical presence to establish nexus under the law existing on the day before the date of enactment of this Act so as to allow such Member State to require, without regard to the authority granted by this Act, the seller to collect and remit sales or use taxes with respect to such sale.11

**A. Small Business Exception.**

In one of its more unique and hotly debated provisions – evidenced by the alternative bills introduced in the Senate – the proposed federal legislation provides a “small business exception” to Member States’ authorization to collect sales or use tax on remote sales (i.e., a “small business” will not be subject to the sales tax collection rules applicable to remote sellers).12 The two bills differ in defining “small business.” Under S. 2152, a seller qualifies as a small business (and therefore does not have to collect sales or use tax on remote sales) if:

- The seller and its affiliates collectively had gross remote taxable sales nationwide of less than $5 million in the calendar year preceding the date of such sale; or
- The seller and its affiliates collectively meet the $5 million threshold of this subsection but the seller has less than $100,000 in gross remote taxable sales nationwide.

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In contrast to S. 2152’s bright line small business exception described above, S. 2153 provides an alternative small business exception requiring the Small Business Administration (with input from government entities, the Governing Board and small business representatives) to submit a definition of “small business” for congressional approval at a specific point after the federal legislation’s passage. The Small Business Administration was created by Congress in 1953. It provides financial and other types of assistance to small businesses. The Small Business Act, which created the Small Business Administration, states that the definition of a small business will vary from industry to industry.\(^\text{13}\) S. 2153’s small business exception, though more amorphous than S. 2152’s version, does provide additional time for interested parties to reach a compromise to this contentious issue.

\section*{B. Authorization Requirements.}

In addition to the federal legislation’s minimum simplification requirements\(^\text{14}\) discussed below, each Member State must meet specific requirements to maintain federal authorization to collect sales or use tax on remote sales (the “authorization requirements”). Member States must satisfy these authorization requirements to receive the authority granted by the federal legislation:

- 10 states comprising at least 20 percent of the total population of all States imposing a sales tax become Member States under the Agreement (the “10/20 requirements”);\(^\text{15}\)

- The Agreement’s Governing Board\(^\text{16}\) implements eight requirements regarding the operation of the Agreement (the “operational requirements”);\(^\text{17}\) and

- Each Member State satisfies the Governing Board’s requirements relating to the availability and maintenance of a rate and boundary database and taxability matrix.\(^\text{18}\)

\(^{13}\) See www.sba.gov/size.


\(^{15}\) The 10/20 requirement is based on Section 701 of the Agreement, which requires the Member States to meet the same “10/20” thresholds for the Agreement to become effective. The Agreement’s Member States met these thresholds in July, 2005 and the Agreement became effective October 1, 2005.

\(^{16}\) Representatives from the Agreement’s Member States make up the Governing Board, which generally administers the Agreement. SSUTA § 806.

\(^{17}\) See Appendix A.

\(^{18}\) See SSUTA §§ 305, 307 and 328.
SUTHERLAND OBSERVATION: The Agreement’s Member States have not satisfied all of the operational requirements. Therefore, the proposed federal legislation – if passed by Congress and signed into law – would not presently authorize the Agreement’s Member States to collect sales or use tax on remote sales.

C. Termination of Authority.

A Member State may subsequently lose its authority to tax remote sales. First, the proposed federal legislation terminates all Member States’ authority to tax remote sales if the Member States fail to satisfy the above threshold requirements or the Governing Board amends the Agreement to cover taxes other than sales, use and telecommunications taxes. Additionally, a Member State may separately lose its authorization if it falls out of compliance with the terms of the Agreement.

III. Minimum Simplification Requirements.

As mentioned above, the proposed federal legislation requires the Agreement to maintain 19 minimum sales and use tax simplification requirements in order for the Member States to tax remote sales. These minimum simplification requirements generally cover the basic provisions of the SSTP’s Agreement, with the exception of a new “single audit” requirement. The single audit provision requires Member States to adopt procedures for sellers to elect to be subject to one sales and use tax audit on behalf of all Member States. Notably, the proposed federal legislation requires Governing Board approval prior to giving effect to a single audit election by a seller. Because the Agreement does not currently provide for a single audit procedure as described in the federal legislation, the Governing Board would have to amend the Agreement to satisfy the minimum simplification requirements if the proposed federal legislation becomes law.

IV. Limitations on Member States’ Authority to Tax Remote Sales.

The proposed federal legislation limits the Member States’ collection authority to sales and use taxes and telecommunications service taxes, and the legislation does not authorize the imposition of income, franchise and many other state and local taxes.

19 See Appendix B.
Further, a Member State cannot use seller registration under the Agreement “for the purpose of, or as a factor in determining, whether a seller has nexus with that Member State for any tax at any time.”\(^{21}\) The registration/nexus prohibition is important because, although the Agreement precludes Member States from using registration as a “factor” in non-sales and use tax nexus determinations,\(^{22}\) some have expressed concern that some states will interpret the Agreement’s registration/nexus prohibition as permitting Member States to use centralized registration as an audit lead. Also, some business representatives have expressed concern that sales and use tax reporting could be used to substantiate an economic nexus determination for income/franchise tax purposes (i.e., nexus premised on an entity’s market contacts with a state, as opposed to its physical presence). The proposed federal legislation not only precludes use of centralized registration for use as a “factor” in making a nexus determination, but also for the “purpose” of making any nexus determination. This “purpose” language may put an end to the audit-lead interpretation of the Agreement, but it is unclear if the seller’s sales/use tax information would also be unavailable for income and franchise tax nexus determinations.

V. ADMINISTRATIVE AND JUDICIAL REVIEW.

The proposed federal legislation sets forth subject matter jurisdiction requirements whereby a person may petition the Governing Board, Court of Federal Claims, Federal District Courts or the U.S. Supreme Court to address disputes relating to the Agreement or the federal legislation.\(^{23}\)

A. Administrative Review.

The proposed federal legislation would permit any person (including non-Member State governments) to petition the Governing Board and seek relief on any issue relating to the implementation of the Agreement.\(^{24}\) Such permission expands the ability to petition the Governing Board for issue resolution over and above the current provision in the Agreement (which limits petitions for resolution by the Governing Board to matters including state membership, state compliance, possibility of state sanctions for noncompliance, interpretations of the Agreement, or other matters at the discretion of the Governing Board).\(^{25}\)

\(^{22}\) SSUTA § 401(D).
\(^{23}\) Sen. 2152, 109\(^{th}\) Cong. §§ 5, 8 (2005).
\(^{24}\) Sen. 2152, 109\(^{th}\) Cong. § 5(a) (2005); see also Sen. 2152, 109\(^{th}\) Cong. § 9(6) (2005) (defining “person” as any “individual, trust, estate, fiduciary, partnership, corporation, or any other legal entity, and includes a State or local government”.
\(^{25}\) See SSUTA § 1002.
B. Judicial Review by the Court of Federal Claims.

If the Governing Board denies a petition or fails to act on a petition, the proposed federal legislation provides that the petitioner may seek judicial review in the Court of Federal Claims if the dispute involves an issue related to the proposed federal legislation or the Agreement. The Court of Federal Claims will review Governing Board determinations using an “arbitrary and capricious standard.” Because the “arbitrary and capricious standard” is difficult to meet and the Court of Federal Claims has limited equitable powers, petitioners may find that they have a limited opportunity to challenge a Governing Board decision.

**Sutherland Observation:** The Court of Federal Claims provides a forum to hear refund claims related to federal income taxes (and other suits for money damages against the U.S. Government). As such, it has never heard a state sales tax case and has never addressed a Commerce Clause issue during its entire existence.

C. Constitutional Challenges to the Federal Legislation.

Finally, a person may petition a three-member federal district court regarding constitutional questions related to the federal legislation. On a finding of unconstitutionality by the district court, the matter will be reviewable as a matter of right with direct appeal to the U.S. Supreme Court.

VI. OTHER SIGNIFICANT PROVISIONS.

A. Telecommunications Services.

The proposed federal legislation defines “tax on telecommunications service” and “telecommunications service.” The former adopts by reference those taxes included within 4 USC § 116, the federal statute that encompasses the Internet Tax Freedom Act federal legislation

26 Sen. 2152, 109th Cong. § 5(b) (2005) (permitting judicial review for issues dealing with a state’s Member State status in the Agreement, the Governing Board’s performance of certain non-discretionary duties, the Agreement’s continued satisfaction of the minimum simplification requirements, or satisfaction of any authorization requirement).
29 Sen. 2152, 109th Cong. § 8(b) (2005).
30 Sen. 2152, 109th Cong. § 9(11) – (12) (2005). The proposed federal legislation incorporates these definitions in Section 6(a)(17) (requiring Member States to apply the Agreement’s simplification requirements relating to telecommunications services taxes) and Section 4(b) (terminating Member State authorization to tax remote sales if the Agreement exceeds the scope of sales or use taxes and telecommunications services taxes).
and Internet Tax Nondiscrimination Act. It is interesting to note that the definition of “telecommunications service” in the proposed federal legislation is different and broader than the definition currently in the Agreement.

B. Digital Goods.

The proposed federal legislation mentions “digital goods,” but does not provide much in the way of helpful guidance or language.\textsuperscript{31} Instead, the proposed federal legislation says it is the “sense of Congress” that states should work with one another to prevent double taxation of digital goods where foreign countries tax such goods or services. The Governing Board has not approved a “digital goods” definition.

VII. What’s Next?

The future of the federal legislation is difficult to predict given the competing business concerns and state and local government sovereignty issues. Previous federal streamlined bills have failed.\textsuperscript{32} Even if the proposed federal legislation passes Congress and is signed into law, the legislation’s effective date will be indefinitely delayed until the Governing Board and/or Member States meet the various unfulfilled requirements – most importantly certification of service providers/systems and seller/vendor compensation levels.

For additional information on what this means for your business, or our state and local tax practice, please contact:

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\textsuperscript{31} Sen. 2152, 109\textsuperscript{th} Cong. § 10 (2005).
\textsuperscript{32} See Sen. 1736, 108\textsuperscript{th} Cong. (2003).
APPENDIX A

The following summarizes the federal legislation’s operational requirements and the status of each requirement among the Agreement’s Member States:

<table>
<thead>
<tr>
<th>Operational Requirement</th>
<th>Implemented by Governing Board/Member States?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Provider and System Certification</td>
<td>No</td>
</tr>
<tr>
<td>Setting of Monetary Allowance by Contract with Service Providers</td>
<td>No</td>
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<tr>
<td>Implementation of an On-line Multistate Registration System</td>
<td>Yes</td>
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<tr>
<td>Adoption of a Standard Form for Claiming Exemptions Electronically</td>
<td>Yes</td>
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<tr>
<td>Establishment of Advisory Councils</td>
<td>Yes</td>
</tr>
<tr>
<td>Promulgation of Rules and Procedures for Dispute Resolution</td>
<td>Yes</td>
</tr>
<tr>
<td>Promulgation of Rules and Procedures for Audits</td>
<td>No(^{33})</td>
</tr>
<tr>
<td>Provisions for Funding and Staffing the Governing Board</td>
<td>Yes</td>
</tr>
</tbody>
</table>

\(^{33}\) The Agreement does not specifically provide for audit administration. Rather, it merely provides for state level administration, which prevents local governments from conducting separate audits. SSUTA § 301.
APPENDIX B

The following summarizes the federal legislation’s minimum simplification requirements, lists corresponding sections in the Agreement (if any), and provides the current status of Member States’ compliance with these requirements:

<table>
<thead>
<tr>
<th>Federal Legislation’s Minimum Simplification Requirements</th>
<th>Corresponding SSUTA Section(s)</th>
<th>Implemented by Governing Board/Member States?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Centralized Registration</td>
<td>§§ 303, 401</td>
<td>Yes</td>
</tr>
<tr>
<td>Product Definitions, Common State and Local Tax Bases, Enactment of Product-Based Exemptions, Relaxed Good-Faith Requirement for Acceptance of Exemption Certificates</td>
<td>§§ 327, 302, 316, 317(C) and Appendix C Part II (Product Definitions)</td>
<td>Yes</td>
</tr>
<tr>
<td>Sourcing Rules</td>
<td>§§ 309, 310, 311</td>
<td>Yes</td>
</tr>
<tr>
<td>Certification of Service Providers and Software</td>
<td>§ 501</td>
<td>No</td>
</tr>
<tr>
<td>Bad Debts and Rounding</td>
<td>§§ 320, 324</td>
<td>Yes</td>
</tr>
<tr>
<td>Returns and Remittances</td>
<td>§§ 318, 319</td>
<td>Yes</td>
</tr>
<tr>
<td>Electronic Filing and Remittance Methods</td>
<td>§§ 318(F), 319(B)</td>
<td>Yes</td>
</tr>
<tr>
<td>State-Level Administration and Filing</td>
<td>§§ 301, 318(A)</td>
<td>Yes</td>
</tr>
<tr>
<td>Single Sales and Use Tax Rate</td>
<td>§ 308</td>
<td>Yes</td>
</tr>
<tr>
<td>Elimination of Caps and Thresholds</td>
<td>§ 323</td>
<td>Yes</td>
</tr>
<tr>
<td>Taxability Matrices</td>
<td>§ 328(A)</td>
<td>Yes</td>
</tr>
<tr>
<td>Hold Harmless Provisions</td>
<td>§§ 306, 328(B)</td>
<td>Yes</td>
</tr>
<tr>
<td>Single Audit Provision</td>
<td>N/A</td>
<td>No</td>
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<tr>
<td>Seller/Vendor Compensation</td>
<td>§§ 601, 602, 603</td>
<td>No</td>
</tr>
<tr>
<td>Consumer Privacy</td>
<td>§ 102(J)</td>
<td>Yes</td>
</tr>
<tr>
<td>Agreement Governance Procedures</td>
<td>§§ 804, 806, 901, 902, 903, 1001,1002, 1003</td>
<td>Yes</td>
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<tr>
<td>Telecommunications Services Simplification</td>
<td>§§ 314, 315, Appendix C Part II (Telecommunications Product Definitions)</td>
<td>Yes ³⁴</td>
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<tr>
<td>Sales Tax Holidays</td>
<td>§ 322</td>
<td>Yes</td>
</tr>
<tr>
<td>Refund and Credit Procedures</td>
<td>§ 325</td>
<td>Yes</td>
</tr>
</tbody>
</table>

³⁴The Agreement’s telecommunications-related provisions (including sourcing rules, sourcing definitions and uniform product definition) do not become effective until January 1, 2008. Therefore, Member States do not have to enact substantially compliant laws until that time.