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## Tax Legislation

Rimon P.C.'s David Fruchtman urges that any federal legislation to require state sales tax collections by remote vendors should exclude sales of services. "The elimination of nexus barriers to tax collection responsibility combined with broad-based taxation of services risks unpredictable, material, adverse effects on businesses, consumers and the national economy," Fruchtman writes.

### Congress Should Exclude Sales of Services From Any Remote Vendor Tax Collection Legislation

By DAVID A. FRUCHTMAN

**N**o topic in the state tax world is more controversial than the potential imposition of sales and use tax collection responsibilities on remote vendors (i.e., retailers lacking substantial nexus with the state at issue).<sup>1</sup> The dispute is loud and public, with battle lines that seem to offer no real hope for compromise.

The states estimate that there will be an enormous increase in tax revenue if remote vendors are required to

<sup>1</sup> This article presumes reader familiarity with the issue's history (including familiarity with *Nat'l Bellas Hess, Inc. v. Ill. Dep't of Revenue*, 386 U.S. 753 (1967), *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), and cases decided by state courts). Readers are also presumed to be familiar with the positions of leading advocates (for example, the Multistate Tax Commission, the Streamlined Sales Tax Governing Board and the Direct Marketing Association). Those desiring more on that history or those positions should please refer to any of the many informative articles published in the state tax press.

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collect taxes on their sales; on the other hand, industry officials predict substantial adverse effects on remote vendors' sales, coupled with unreasonable compliance costs.

### Where We Are

The U.S. Senate in May 2013 passed the Marketplace Fairness Act (MFA), which, if enacted, will impose destination-based collection responsibilities on remote vendors having sales exceeding a threshold amount.<sup>2</sup>

The MFA then moved to the House where, over the next 18 months, the House Judiciary Committee studied the matter. The Judiciary Committee in September 2013 issued a set of principles on Internet sales tax. And in January, Rep. Robert W. Goodlatte (R-Va.), the chairman of the Judiciary Committee, released a draft proposal differing from the MFA, including by abandoning traditional destination-based tax collection responsibilities for origin-based sourcing.

Rep. Jason Chaffetz (R-Utah) in June introduced a new bill in the House, the Remote Transactions Parity Act (RTPA), which has bipartisan support as well as support of sponsors of the Senate bill (MFA).

Both the MFA and the RTPA, as well as the draft proposal, include sellers of services within the definition of a "remote seller."

<sup>2</sup> S. 743, passed by the Senate on May 6, 2013, and reintroduced in 2015 as S. 698 (currently in the Senate Committee on Finance).

As the fall session of Congress approaches, two points about this legislation are clear:

- If the legislation is going to pass in the next 18 months, it will have to pass during 2015. Once the calendar turns to 2016, an election year, the chances for passage of tax legislation drop markedly.<sup>3</sup>

- The U.S. Supreme Court appears to be losing patience with the lack of movement on this tax collection issue. In *Direct Mktg. Ass'n v. Brohl*, 135 S.Ct. 1124, 2015 BL 55913 (3/3/15), Justice Anthony M. Kennedy wrote a concurring opinion casting doubt on the court's continued adherence to the physical presence requirement established in *Nat'l Bellas Hess, Inc. v. Ill. Dep't of Revenue*, 386 U.S. 753 (1967), and reaffirmed in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992). Justice Kennedy stated that the growth in the dollar amount of Internet commerce nationwide "has caused far-reaching systemic and structural changes to the economy," and that principles of stare decisis might no longer require the preservation of the physical presence requirement. He advised that "The legal system should find an appropriate case for this Court to reexamine *Quill* and *Bellas Hess*."<sup>4</sup>

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In short, there are significant hazards here: Perpetuating the stalemate is increasingly likely to result in a total loss for industry in the courts.<sup>5</sup> However, as is discussed below, the elimination of nexus barriers to tax collection responsibility combined with broad-based taxation of services risks unpredictable, material, adverse effects on businesses, consumers and the national economy.

Fortunately, there is path open to Congress that avoids both hazards.

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<sup>3</sup> Tax practitioners will correctly observe that this proposed law doesn't impose a new tax but, instead, allows for a new collection mechanism. Nevertheless, that nuanced understanding is going to be lost on consumers (i.e., voters) who have to pay tax on purchases for which no tax was paid before the legislation passed.

<sup>4</sup> The states have received the message and are hoping to have the Supreme Court revisit this issue. See, e.g., Alabama Gov. Robert Bentley's (R) July 31 comments in defense of the state's new economic nexus standard for requiring remote vendors to collect sales taxes, daring Amazon.com to "sue us." "Alabama Governor to Amazon: 'Sue Us,'" *State Tax Today*, Aug. 5, 2015.

<sup>5</sup> The industry is aware of this. See, e.g., a Jan. 22 letter of the American Catalog Mailers Association, stating that "Unfortunately, our assessment is that *Quill* won't hold up for much longer. Furthermore, in the absence of clarifying federal legislation, states are becoming increasingly creative and aggressive, ushering in the potential for a patchwork of contradictory state laws with the need to fight a multi-front war." Available at [http://www.nemoa.org/news\\_manager.php?page=15202](http://www.nemoa.org/news_manager.php?page=15202).

## **Next Steps**

### **Any Legislation Should Be Limited To Sales of Tangible Personal Property**

As indicated above, the U.S. Senate and House are working on a new version of the legislation. However, circumstances have changed since the MFA was passed in 2013. Under current circumstances, any remote seller legislation should apply to sales of tangible personal property only.

That is, the physical presence requirement set forth in *National Bellas Hess* and *Quill* should continue to be controlling law for determining whether retailers of services are required to collect tax.

### **Physical Presence Should Continue to Be Prerequisite to Imposition of Tax Collection Responsibility on Sales of Services**

Almost every state that imposes a sales tax does so on all sales of tangible personal property (each state has a few exceptions). States and vendors know how to tax these sales, and imposition of collection responsibility on remote sellers shouldn't affect the fundamental business operations of the industries that make such sales.

In contrast, under current law in states across the U.S., sales of services aren't subject to sales and use taxes unless they are expressly made taxable.<sup>6</sup> Thus, in almost all states most services aren't subject to sales tax. As a consequence, a very large portion of the U.S.'s economy has no familiarity with sales tax laws, regulations or principles, and no familiarity with sales tax collection and remittance procedures. Moreover, the states themselves haven't yet had to resolve many thorny issues raised by the sale of services, including basic considerations such as definitions,<sup>7</sup> the sourcing/apportioning of sales and the avoidance of pyramiding of taxes.<sup>8</sup>

There is no doubt that sales taxation of services is difficult—as the legislatures of both Florida and Massachusetts can attest based on their failed attempts to tax a broad range of services.<sup>9</sup> Nevertheless, difficult as the

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<sup>6</sup> Only Hawaii, New Mexico and South Dakota impose sales taxes on a broad range of services.

<sup>7</sup> For example, what are "legal services"? Do legal services include assistance with a real estate filing? Assistance obtaining a business license? Assistance obtaining a sales tax license? Assistance obtaining a marriage license? What about an unregulated service, such as interior design services—which activities come under the umbrella of that phrase? Which don't?

<sup>8</sup> A bedrock principle of sales taxation is that the tax should be imposed on the end consumer only. Knowing on whom to impose the tax is usually easy when there is a sale of tangible personal property. But doing so with services is more difficult. As a result, it could occur that purchasers of services pay tax on those services, even though the service will be resold (and taxed again) or will be a component of another service (and taxed again). For example, hotels often offer a service of overnight dry cleaning. The hotel pays the dry cleaner to do the work. The hotel then marks up the cost of the dry cleaning and charges the guest the higher amount. Here, no tax should be due on the hotel's purchase of the dry cleaning service, with tax instead being charged on the guest's payment for the service. But whether that result can be achieved will depend on the contours of the state's resale exemption.

<sup>9</sup> Florida's 5 percent tax on services was enacted effective July 1987 and repealed effective January 1988. Massachu-

taxation of services may be, the growth of the amounts involved eventually will provide state legislatures and revenue departments with the justification they need to pursue this revenue source. That day might well be upon us.

When the Senate passed the MFA in 2013, and when the House Judiciary Committee took up the issue that same year, it is very likely that their focus was on the sale of tangible personal property. Moreover, they undoubtedly believed that they were working with a reasonably stable taxing environment. They can be excused for both beliefs, as that was the general state of affairs in 2013.

However, beginning in December 2014, notice has been served in California, Pennsylvania and Illinois of potential fundamental changes to the taxation of services.

**California.** S.B. 8, introduced Dec. 1, 2014, would figuratively and literally add a new chapter to California law by taxing all services sold to consumers:

CHAPTER 3.8. Services.

■ Section 6305. In addition to the taxes imposed by this part, for the privilege of selling services at retail a tax is hereby imposed upon all retailers at the rate of \_\_\_ percent of the gross receipts of any retailer from the sale of all services sold at retail in this state on or after January 1, \_\_\_.

■ Section 6306. In addition to the taxes imposed by this part an excise tax is hereby imposed on the receipt of the benefit of the service in this state of services on or after January 1, \_\_\_, at the rate specified in Section 6305 of the sales price of the services.

The California State Board of Equalization estimates that the new tax would generate \$122 billion in new tax revenue for the state and its sub-state units of government during fiscal year 2016.<sup>10</sup> To put that figure in perspective, consider that the U.S. Census Bureau reports that during fiscal 2014 all states collected \$866 billion from all taxes.<sup>11</sup> Allowing for uncertainty as to whether the Census Bureau treated California municipalities as fiscal bodies independent of the state,<sup>12</sup> California's new tax on services would generate 7 percent to 14.1 percent of the total amount of all taxes collected by all states during 2014. Or, considering only sales taxes, California's new tax on services would be 14.8 percent

sets's attempt to tax services was effective beginning March 6, 1991, and repealed March 8, 1991, retroactive to March 6. See "State Sales Tax on Services: Massachusetts as a Case Study," S. Bruskin and K. Parker, 45 Tax Law. 49 (1991). This article provides an excellent, concise analysis of some of the problems of taxing services performed in one jurisdiction but received or enjoyed in multiple jurisdictions.

<sup>10</sup> "Estimate of Potential Revenue to Be Derived From Taxation of Currently Non-Taxable Services," California State Board of Equalization (April 14, 2015). The state of California would receive approximately half of the revenue and sub-state units of government would receive the other half.

<sup>11</sup> "State Government Tax Collections Summary Report: 2014," U.S. Census Bureau (released April 16, 2015).

<sup>12</sup> The Census Bureau report cautions that "The state government tax data presented by the U.S. Census Bureau may differ from data published by state governments because the Census Bureau may be using a different definition of which organizations are covered under the term, 'state government.'" See [http://www.census.gov/govs/statetax/population\\_of\\_interest.html](http://www.census.gov/govs/statetax/population_of_interest.html).

to 29.6 percent of the total amount of sales taxes collected by all states during 2014.

This is in addition to the sales taxes California already collects on the retail sale of tangible personal property. Certainly, other states will watch and some can be expected to follow California's approach to taxing services. As a result, there will be a tremendous amount of new tax revenue and, inevitably, undesirable consequences for service providers far removed from California.

**Pennsylvania.** Gov. Tom Wolf's (D) 2015-2016 budget proposal included a recommendation to expand the commonwealth's sales tax to include many services not currently taxable. These include accounting services, investment advisory services, consulting services, advertising services, architectural services, legal services, graphic design services, computer programming services, computer design services and dozens of other services.<sup>13</sup>

In June, the governor's budget proposal was defeated in toto, and in July he vetoed an alternative budget proposal. As of this writing, Pennsylvania lacks a budget and the expansion of the types of services subject to sales tax remains a possibility.

**Illinois.** The Taxpayers' Federation of Illinois and the Center for Tax and Budget Accountability on May 20 jointly published a report, "Issue Brief: Expanding the Base of Illinois' Sales Tax to Consumer Services Will Both Modernize State Tax Policy and Help Stabilize Revenue."<sup>14</sup> The report hasn't yet resulted in legislation but, given its sponsors and the state's need for funds, must be taken seriously.

No one knows how long it will take to arrive at a mature approach to the taxation of multistate services, but it is certain to be a contentious and messy process. Likewise, no study has yet estimated how disruptive such taxation will be to the national economy. Until the states know what they are doing when taxing multistate services, the imposition of remote vendor tax collection responsibility on sales of services isn't only unwarranted, it is unwise because the service economy will be burdened by trial and error experimentation by the states.<sup>15</sup>

A resulting drag on the economy is easy to foresee. The Senate and House shouldn't incorporate that uncertainty into federal law requiring remote sellers to collect sales taxes.

<sup>13</sup> "Memorandum: Governor Wolf's Sales Tax Proposal," Pennsylvania Department of Revenue (March 18, 2015).

<sup>14</sup> "Issue Brief: Expanding the Base of Illinois' Sales Tax to Consumer Services Will Both Modernize State Tax Policy and Help Stabilize Revenue," available at [http://www.ctbaonline.org/sites/default/files/reports/ctbaonline.org/node/add/repository-report/1432134924/IB\\_05.20.2015\\_Expanding%20the%20Base%20of%20Illinois%E2%80%99%20Sales%20Tax%20to%20Consumer%20Services\\_FINAL.pdf](http://www.ctbaonline.org/sites/default/files/reports/ctbaonline.org/node/add/repository-report/1432134924/IB_05.20.2015_Expanding%20the%20Base%20of%20Illinois%E2%80%99%20Sales%20Tax%20to%20Consumer%20Services_FINAL.pdf).

<sup>15</sup> To be clear, the states surely have the right to experiment with differing approaches to taxation, and that right is one of the benefits of federalism. But difficulty with federal government involvement arises when such experimentation is performed in an uncontained environment, directly affecting taxpayers and economic forces far and wide. Remote seller legislation should protect against that possibility by applying only to the stable environment of sales of tangible personal property.

## State Revenue Departments, Tax Practitioners Know How to Distinguish Tangible Personal Property From Services

Imposing remote seller tax collection responsibility on sales of tangible personal property, while not imposing that responsibility on sales of services, requires distinguishing between such sales. But that isn't the additional burden that it might seem. This analysis must be done anyway under the MFA, RTPA and Goodlatte proposal to determine the taxability of sales.

Therefore, the question of whether a transaction is taxable must be determined—in every case—by the business alone or by the business and a revenue department together. Removing sales of services from remote tax collection responsibilities means that the result of the analysis of whether a sale is of tangible personal property or a service now applies to both taxability and collection responsibility.

For sales involving both a service and a transfer of tangible personal property, the task of categorizing a sale can become quite difficult. Nevertheless, it is a common practice in the state tax area. The standard test is known as the “true object” test,<sup>16</sup> and is sometimes called the “essence of the transaction” test or “dominant purpose” test.

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<sup>16</sup> See, e.g., Cal. Code Regs. 1501 (“The basic distinction in determining whether a particular transaction involves a sale of tangible personal property or the transfer of tangible personal property incidental to the performance of a service is one of the true objects of the contract; that is, is the real object sought by the buyer the service per se or the property produced by the service. If the true object of the contract is the service per se, the transaction is not subject to tax even though some tangible personal property is transferred.”).

Whatever the name, the concept is essentially the same: One evaluates whether the purchaser wanted to acquire personal property or a service. For example, the retail sale of prepaid telephone cards has been held to be a nontaxable sale of a service, as the “true object” in purchasing a calling card is the long distance service. The card serves only as a medium for securing the telephone service.<sup>17</sup>

The difference in characterization is significant where one characterization results in a taxable transaction (e.g., the taxable sale of tangible personal property) but the other characterization doesn't result in a taxable transaction (e.g., the sale of a nontaxable service). Similarly with any remote vendor legislation: The difference in characterization is significant where one characterization is subject to a remote tax collection responsibility (the sale of tangible personal property) but the other characterization isn't subject to remote tax collection responsibility (the sale of a service).

## Conclusion

Any new federal law requiring remote sellers to collect sales taxes should be limited to sales of tangible personal property. Sales of services shouldn't be included in such a law because of the change and uncertainty in the taxation of such sales. For tax collection on sales of services, Congress shouldn't alter the requirement that the physical presence test of *National Bellas Hess* and *Quill* applies to vendors of services for sales and use tax purposes.

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<sup>17</sup> See, e.g., Va. Dept. of Tax'n, P.D. 94-325 (Oct. 24, 1994).