A Potential Game Changer in E-Commerce Taxation

David Gamage  
*Indiana University Maurer School of Law, dgamage@indiana.edu*

Andrew J. Haile  
*Elon University*

Darien Shanske  
*University of California, Davis*

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A Potential Game Changer
In E-Commerce Taxation

by Andrew J. Haile, David Gamage, and Darien Shanske

Since the U.S. Supreme Court’s Quill decision in 1992, numerous commentators have been exhorting Congress to resolve the problem of state taxation of electronic commerce through federal legislation. Despite some recent optimism that remote seller legislation might be included as part of a “grand bargain” in the fiscal cliff negotiations, that did not happen. As a result, states still lack clear authority to require remote sellers to collect sales or use taxes, and consequently, states continue to lose tax revenue through the ever-increasing volume of Internet commerce. With the start of the 113th Congress, legislation to stem those revenue losses has been reintroduced.

In this essay, we first briefly describe the primary bills that have been under consideration for Congress to authorize state taxation of e-commerce transactions with remote sellers. We then make a series of analytic observations about those bills that we hope will be helpful as the bills are reconsidered. To foreshadow: two of those bills contain an important — and we think game-changing — innovation. That innovation is the requirement that states provide remote sellers with “adequate software” to calculate use tax due within that state. That sensible and achievable requirement dramatically simplifies the burdens placed on remote sellers and creates an incentive for states to simplify their sales and use tax statutes (because the states would ultimately bear much of the burden of complexity as a result of their being required to provide remote sellers with software capable of calculating sales taxes).

1“Remote seller legislation” is used here to mean legislation intended to modify Quill’s requirement that a seller have an in-state physical presence before the state may require the seller to collect sales or use tax.


4For purposes of this article, the term “remote seller” means a person that sells goods or services sourced for sales and use tax purposes to a state regarding which the seller does not have adequate physical presence to establish nexus under Quill v. North Dakota, 504 U.S. 298 (1992). That definition is consistent with the term as used in the legislation discussed in the article. See, e.g., Fairness Act, section 6(i); Equity Act, section 5(6); Main Street Act, section 9(6).

5But note that one of us has previously argued that states do in fact have authority to subject remote vendors to sales and use taxation, as long as the states adequately compensate for all compliance costs. See David Gamage and Devin Heckman, “A Better Way Forward for State Taxation of E-Commerce,” 92 B.U. Law Rev. 483 (2012). Moreover, numerous states have been using a variety of “Amazon” tax strategies for circumventing Quill’s physical presence requirement so as to levy sales or use taxes on transactions with remote e-commerce vendors. For discussion, see, e.g., Andrew J. Haile, “Affiliate Nexus in E-Commerce,” 33 Cardozo L. Rev. 1803 (2012); David Gamage and Darien Shanske, “The Saga of State ‘Amazon’ Laws: Reflections on the Colorado Decision,” State Tax Notes, July 16, 2012, p. 197, Doc 2012-13634, or 2012 STT 136-4; Andrew J. Haile, “Defending Colorado’s Use Tax Reporting Requirement,” State Tax Notes, Sept. 20, 2010, p. 761, Doc 2010-16462, or 2010 STT 181-1.

6The Marketplace Fairness Act of 2013 has been reintroduced. This column was written before the act was reintroduced, so we do not analyze it here. We observe, however, that section 2(b)(2)(D)(ii) of the act requires that states seeking to impose use tax collection outside the Streamlined Sales and Use Tax Agreement framework must “provide software free of charge for remote sellers that calculates sales and use taxes due on each transaction.” Our column in effect argues that this is a very positive change and one that should be celebrated and refined.

(Footnote continued in next column.)
and use taxes owed). Moreover, because that requirement of adequate software is so important, we think it wise that more time be spent by the legislation’s drafters on its contours. For example, will federal courts be left to decide “adequacy” with no further guidance? Providing some indication of what is meant by “adequate software” may help to stem unnecessary and wasteful future litigation.

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We also believe that remote-seller legislation is properly included in the ambit of negotiations over a so-called grand bargain. Enabling states to reach remote sales is manifestly a good idea as a matter of tax policy, because it reduces horizontal inequity and effectively broadens the consumption tax base. Therefore, this legislation would have the effect of aiding states in raising revenue in a sensible way. That could be an important ingredient of federal tax reform given that the federal income tax is full of subsidies to the states that arguably do not make much sense and should be pared down. Federal reform to curtail state subsidies will have less bite if the states are able to offset some of the resulting lost revenue with increased use tax collections.

Previously Introduced Legislation

Three primary versions of remote-seller legislation have been introduced in Congress in recent years. Those bills have confusingly similar names — the Main Street Fairness Act (the Main Street Act, S. 1452 and H.R. 2701); the Marketplace Equity Act (the Equity Act, H.R. 3179); and the Marketplace Fairness Act (the Fairness Act, S. 1832). Of the three, the Fairness Act has drawn the most recent attention and support, probably because it is simpler than the Equity Act and imposes significantly fewer burdens on the states than does the Main Street Act.8 The other bills have faded from consideration, particularly the Main Street Act, which requires that states join the Streamlined Sales and Use Tax Agreement before they may require remote sellers to collect sales and use tax. Even so, a quick comparison of these legislative proposals remains useful if for no other purpose than to assess what Congress is electing not to do if it enacts a new version of the Fairness Act.

The Fairness Act

U.S. Sen. Michael B. Enzi, R-Wyo., introduced the Fairness Act in November 2011. According to the Fairness Act, “States should have [(i)] the ability to enforce their existing sales and use tax laws and to treat similar sales transactions equally, without regard to the manner in which the sale is transacted, and [(ii)] the right to collect — or decide not to collect — taxes that are already owed under State law.”9 The Fairness Act would assist states in accomplishing these goals if the states meet either of two requirements. First, a state could require remote retailers to collect and remit use tax conditioned on the state being a member state under the SSUTA.10 Alternatively, even if a state is not an SSUTA member state, the state could still require remote retailers to collect and remit use tax if the state “adopts and implements minimum simplification requirements.”11 The minimum simplification requirements set forth in the Fairness Act include:12

- select a single state-level agency to administer all sales and use tax laws;
- provide a single audit for all state and local taxing jurisdictions within the state;
- create a single sales and use tax return to be filed with the state-level agency selected to administer the sales and use tax laws;
- establish a uniform sales and use tax base for the state and local taxing jurisdictions in the state;
- provide “adequate software and services to remote sellers . . . that identifies the applicable destination rate, including the State and local sales tax rate (if any), to be applied on sales sourced to the State.”13
• hold remote sellers harmless for errors or omissions based on the rate information provided by the state; and
• provide adequate (30 days) notice of rate changes by any locality in the state.

The Fairness Act contains a small seller exception. Under that exception, a state may only require use tax collection by remote sellers with “gross annual receipts in total remote sales in the United States in the preceding calendar year exceeding $500,000.” Formulated differently, those sellers with less than $500,000 in U.S. remote sales will not be required to collect any use tax in a state in which it lacks a physical presence.

**The Equity Act**

Like the Fairness Act, the Equity Act would allow states to require remote sellers to collect use tax if they implement specific minimum requirements. Many of the minimum requirements called for by the Equity Act overlap with the minimum simplification requirements of the Fairness Act, among them:

• identification of a single revenue authority within the state for purposes of filing a sales and use tax return;
• creation of a unitary sales and use tax return for filing with that revenue authority;
• establishment of a uniform tax base applicable at both the state and local level;
• provision of “adequate software to remote sellers that substantially eases the burden of collecting at multiple rates within the State”16; and
• relief from liability for any remote seller as a result of the seller’s reliance on information provided by the state.

Perhaps the most significant difference between the Equity Act and the Fairness Act is the option allowed under the Equity Act for the state to impose sales and use taxes on remote sellers at one of three possible rates:

• a single statewide blended rate that includes both the state rate and applicable rates of local jurisdictions, as determined by the state;
• the maximum state rate, which is the highest rate at which sellers are required by the state to collect tax, exclusive of tax imposed by or for the benefit of local jurisdictions; or
• the applicable destination rate, which is the sum of the state rate and any applicable rate for the local jurisdiction into which the sale was made.

The Fairness Act allows only the applicable destination rate, but that — like the Equity Act — seeks to simplify the determination of the proper tax rate by requiring that the state provide remote sellers with software that specifies the applicable rate for sales sourced to the state. Another difference between the Fairness Act and the Equity Act is that the Equity Act contains no requirement for a unitary audit process for all state and local jurisdictions within the state.

Finally, the Equity Act differs from the Fairness Act in its small seller exception. Recall that the Fairness Act exempts sellers that have less than $500,000 in U.S. remote sales during the previous year. The Equity Act exempts sellers if their total remote sales in the United States are less than $1 million or their sales in the state are less than $100,000. To illustrate the difference between the small seller exception in the Equity Act and the Fairness Act, a remote seller with sales of $550,000 in a state that has enacted the applicable simplification requirements and that has no other sales in the United States would be exempt from use tax collection in that state under the Equity Act (because total U.S. remote sales are less than $1 million) but not under the Fairness Act (since total U.S. remote sales exceed $500,000).

**The Main Street Act**

The Main Street Act differs from the Fairness Act and the Equity Act in that it requires states to join the SSUTA as member states, with all that entails, before they may impose use tax collection obligations on remote sellers.17 There is no alternative approach allowing for the imposition of a use tax collection obligation on remote sellers, as there is with the Fairness Act and the Equity Act.18

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16Should the state elect to use a single tax rate for remote sales (either a statewide blended rate or the maximum state rate, as discussed below), that adequate software requirement does not apply. The requirement is included to assist sellers in determining the proper tax rate when a state uses the more complex and variable applicable destination rate.

17Main Street Act, section 4(a).

18The Main Street Act does set forth 18 minimum simplification requirements that the SSUTA must satisfy for the authority to require remote sellers to collect sales and use tax to apply. Those requirements are already met under the terms of the SSUTA.
An overview of the SSUTA is beyond the scope of this article, but one aspect of it merits some attention — the provisions intended to assist sellers in calculating the amount of taxes owed. Under section 305 of the SSUTA, member states must maintain various databases of information. In particular, section 305 requires that member states maintain a database that provides “all sales and use tax rates for all of the jurisdictions levying taxes within the state” and another that “assigns each five digit and nine digit ZIP code within a member state to the proper tax rates and jurisdictions.”

Also, section 328 requires that member states “complete a taxability matrix adopted by the governing board.” Those taxability matrices, available online, provide useful information about calculating the state’s sales tax and the taxability of a variety of goods. Even so, the SSUTA still places the burden for actually calculating the amount of taxes owed on the seller and, except in certain circumstances, the seller retains potential liability for errors. The requirement in the Fairness Act and the Equity Act that states provide adequate software for the calculation of use taxes owed may — depending on how the term is ultimately construed — radically shift that burden from sellers to states.

**Simplify, Simplify**

Going in reverse order, from the Main Street Act to the Equity Act to the Fairness Act, we perceive a sensible paring down of the legislation. Why require SSUTA membership if the states are required to provide adequate software? And we agree that that software should be sufficient. If a state maintains a baroque and complicated system, its software expenses — and possible disputes with sellers — will reflect that. After all, the deep concern of *Quill* was that states would export the cost of their complicated state and local tax systems onto remote sellers many times over. If each state is forced to internalize its own costs so that the aggregate burden is manageable, it is unclear what interjurisdictional problem the dormant commerce clause is meant to prevent, considering the costs that *Quill* imposes on horizontal equity, state sovereignty, and flexibility. Indeed, the difficulty in arriving at consensus solutions to many thorny state use tax questions is presumably the reason that so many states that levy sales taxes — 24, including California and New York — are not now full members of the SSUTA.

**Why require SSUTA membership if the states are required to provide adequate software?**

If one became fully convinced that software can provide a complete solution to the *Quill* problem, one might ask why should the federal legislation have anything to say about the rates being imposed by a state, as in the Equity Act. Again, if a state is willing to bear the burden of complexity, perhaps to encourage local initiative, it should be allowed to do so. Indeed, we wonder whether the next step could be to eliminate the small seller exception altogether. If the states are required to maintain accurate software — ideally available online — why not require any remote seller to log in to a destination state’s database, enter the item and price, and then be sent a bill monthly or quarterly or perhaps even to sign up for a direct withdrawal from a business credit card on file with the state?

Of course, all that would place significant pressures on the adequacy of those state systems. Our impression based on anecdotal evidence is that the creation of those systems, which large multistate firms already maintain (or contract for), will not pose too onerous a technological challenge — assuming that states budget sufficient resources and that political obstacles do not arise. Indeed, many private providers of software have already been certified by the Streamlined Sales Tax Governing Board, consistent with sections 501 and 502 of the SSUTA. The states will also have to ensure that the right information is getting inputted into any system, however technically advanced; for example, that a local sales tax rate has been increased. We believe that states will have the incentive to get those programs right,

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20 SSUTA section 305(E), (F).
22 Under SSUTA section 306, remote sellers are relieved from liability if they erroneously calculate taxes owed based on information provided by the state.
25 To be workable, this approach might need to require the states to register their software with a central clearinghouse so that small businesses can easily find and access the software for any states they sell into. However, a full discussion of whether it might make sense to eliminate the small seller exception is beyond the scope of this essay. We merely mean to raise the possibility here.
but that nevertheless thought should still be given to how the law of software adequacy will be developed.

There are many possible options to be considered; we will list only a few. Most simply, federal legislation can seek to consolidate where cases about adequacy are to be heard, say in the Court of Federal Claims, as in section 5 of the Main Street Act. We hope that consolidation would lead to the quicker development of a more unified jurisprudence. Congress might also consider giving more statutory detail to the adequacy requirement, perhaps similar to SSUTA section 501(C). Given the complexity of that area, Congress could consider giving a federal agency power to issue regulations or, since there is not an obvious choice, Congress could create a special interstate taxation governing board. Of course, once Congress is inclined to go in that direction, considering some way of piggybacking on the work already done by the Streamlined Sales Tax Governing Board makes a great deal of sense.

**There remains an important role for the SSUTA to play — though not the role originally envisioned.**

That brings us squarely back to the matter of the SSUTA, which was itself supposed to be the answer to *Quill*. In general, we believe that technology now has the potential to largely solve the *Quill* problem — a problem that was made much more severe by technology to begin with. There is little need to simplify ex ante as long as states are required to internalize the costs they create ex post through maintaining adequate software. As just indicated, however, adequacy will not be self-defining or enforcing. We think that federal courts could do a good job if given a bit more direction, but we can also envision a role for a state software adequacy initiative, perhaps under the auspices of the SSUTA (perhaps a new category of membership just regarding software?). It is important to think through the possible role for the SSUTA sooner rather than later because we can foresee some of the states in the SSUTA possibly withdrawing after the passage of federal remote seller legislation if states prefer the adequate software alternative. It would be a shame for the SSUTA to fall apart just when national streamlining of sales and use taxes finally becomes practical, and when there remains an important role for the SSUTA to play — though not, of course, the role originally envisioned.

**A Big Deal**

Today’s fiscal politics is governed by discussions of “grand bargains.” Many of those reform proposals, particularly those targeting so-called tax expenditures, may affect state and local finances. We do think that at least some of those reform proposals might be worth adopting, despite the negative effect they would have on state and local government revenue. Take the state and local tax deduction. Suppose the federal government saved (say) $20 billion a year through capping the value of that deduction for higher-income taxpayers. That could result in the states losing significant revenue, at least in the short and medium run. Allowing states to collect sales and use tax from remote sellers might thus be an opportunity for the federal government to give states a compensating revenue source that is consistent with sound tax policy even as the federal government tightens its belt.

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**27**In this sense, the requirement that states maintain adequate software functions similarly to the argument that one of us has made previously that states should be permitted to subject remote vendors to their sale and use tax regimes conditional on the states fully compensating remote vendors for all compliance costs. See Gamage and Heckman, *supra* note 23. A discussion of the relative merits of the adequate software requirement as opposed to an adequate vendor compensation requirement is beyond the scope of this essay. For present purposes, it suffices to note that the adequate software requirement seems more politically feasible at the moment, in terms of potential federal legislation. All of us agree that the adequate software requirement offers a sufficiently promising path forward such that, even to the extent that an adequate vendor compensation requirement might arguably be preferable, we would strongly support federal remote seller legislation containing a well-developed adequate software requirement.

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**28**IRC section 164.

**29**Alternatively, one of us has argued that were the SALT deduction to be capped only for state and local income taxes, that might make sense for both the federal government and the states, by benefiting the federal government’s bottom line and also potentially aiding the states in the long run by nudging them to adopt revenue systems less reliant on particularly volatile income taxes. See Darien Shanske, “How Less Can Be More: Using the Federal Income Tax to Stabilize State and Local Finance,” *31 Virginia Tax Review* 413 (2012).