Understanding Constitutional Limits on State Taxation and the Taxation of Internet Sales

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Frank Crociata, Tax Policy Director

The Big Four

- Supremacy Clause. U.S. Const. art IV, cl. 2;
- Due Process Clause. U.S. Const. amend. V & amend. XIV, § 1;
- Equal Protection Clause. U.S. Const. amend. XIV, § 1;
- Commerce Clause [Dormant]. U.S. Const. art. I, § 8, cl. 3.

Supremacy Clause

- "This Constitution and the Law of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made under the Authority of the United States, shall be the *supreme Law of the Land*; and *the Judges in every State shall be bound thereby, anything in the Constitution or Laws of any State to the Contrary notwithstanding*."

Supremacy Clause Doctrines

- States cannot levy a tax directly on the federal government.
  - *McCullough v. Maryland*, 17 U.S. 316 (1819).
- Validly enacted federal laws may fully or partially prohibit state taxation.
  - Permanent Internet Tax Freedom Act (2015);
  - The Four R Act. 49 USCA § 11501(b);
  - Interstate Commerce Commission Termination Act. 49 USCA § 14505;
  - Public Law 86-272.
- State taxation can be prohibited by federal jurisprudence.

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Due Process Clause of the 14th Amendment

- "[N]or shall any State deprive any person of life, liberty or property, without due process of law."

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Due Process Clause Principles

- Taxes effect property.
- Due Process is concerned with fairness and notice.
- Has the state given anything for which it can ask something in return?
- Does the tax, in practical operation, have a rational relationship to the opportunities, benefits, or protections afforded by the state?
- Must be some minimum connection between the state and the person, property, or transaction subject to the state tax.

Due Process Clause Doctrine

- Due process is generally satisfied if the taxpayer has purposefully availed itself of the state's economic market.
  - Unlike Commerce Clause "Nexus" (for sales/use taxes) due process does not require taxpayer's physical presence in the state.
  - But PACT act cases indicate that states will have to show that taxpayers have sufficient connections with the state in order for the state to impose tax.

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Equal Protection Clause

- [Nor shall any State] deny to any person within its jurisdiction the equal protection of the laws.

Equal Protection Clause Doctrine

- States have broad latitude to create classifications – exemptions, deductions, etc.
- But states cannot make unreasonable classifications – policies that *arbitrarily discriminate* against one group in favor of another.
- Similarly situated taxpayers must be treated the same, unless the disparate treatment is *rationally related* to achieving a legitimate state interest.
    - Plausible policy reason for the classification;
    - Rational consideration by legislature;
    - Logical relationship between policy goal and classification.

Commerce Clause

- Affirmative grant: [The Congress shall have Power] to regulate Commerce with Foreign Nations, and among the several States, and with the Indian Tribes.
- Negative or "Dormant" Commerce Clause – the US Supreme Court has construed the clause to place restraints on state action by its own force and absent Congressional action.
- State action cannot create an undue impediment to the operation of the national economy.

Commerce Clause Doctrine

- A state can impose a tax on activities in interstate commerce as long as:
  - (1) there is substantial nexus between the state and the activity being taxed;
  - (2) the tax is fairly apportioned;
  - (3) the tax does not discriminate against interstate commerce; and
  - (4) the tax is fairly related to the services provided by the state. *Complete Auto Transit, Inc. v. Brady* (1977).

The Four Prongs in Reverse Order

- **(4) Fair relation to services provided by the state.**
  - Fairly low bar;
  - Not widely litigated;
  - Satisfied by things like police and fire protection, availability of courts, roads and common infrastructure.
  - *DH Holmes v. McNamara*, 486 U.S. 24 (1988).

The Four Prongs in Reverse Order

- **(3) The tax cannot discriminate against interstate commerce.**
  - Tax laws, on their face or by application, cannot impose greater burdens on out-of-state goods, activities, or business than on their in-state counterparts.
    - *Halliburton Oil Well Cementing Co. v. Reily*, 373 U.S. 64 (1963);
    - *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996).
  - **Notable exception: compensating (use) taxes because they are designed to equalize burdens.**

The Four Prongs in Reverse Order

- **(2) Fair Apportionment.**
  - A tax laid on activities that occur across multiple states must be fairly apportioned.
  - **Internal consistency** – If every state imposed the same tax, would it result in double/multiple taxation;
  - **External consistency** – does the state's tax reach beyond that portion of value that is fairly attributable to economic activity occurring within that state.

The Four Prongs in Reverse Order

- **(1) Substantial Nexus.**
  - “Nexus” is a Greek word, meaning “connection.”
  - Nexus determinations are made taxpayer-by-taxpayer and are fact-intensive.
  - Similar to the concept of “minimum contacts” for due process, but there are different standards under the Commerce Clause.
  - Nexus standards differ under the Commerce Clause for income taxes and sales/use taxes.

Nexus for Income Taxes

- A taxpayer does not need to have physical presence in a taxing state in order to have nexus for income tax purposes.
- Rather "economic presence" or "intangible presence" are sufficient.
  - Economic presence – regular and systematic exploitation of the state's market;
  - Intangible presence – the ownership of intangible property in the state, especially income-generating intangible property.

Nexus for Sales/Use Taxes

- A remote vendor must have actual physical presence in the taxing state in order to be subject to sales/use tax collection obligations.
  - *National Bellas Hess* (1967); *Quill* (1992). A state cannot impose sales/use tax obligations if the vendor's only contact with the state is delivery of orders via common carrier.

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Taxpayer Nexus

- Independent Nexus:
  - Any kind of office, storehouse, warehouse;
  - Owning or leasing real property;
  - Owning or leasing real/tangible property as lessor or lessee;
  - Permanent employees in the state;
  - Temporary employees in the state.
- For use tax collection, the in state presence does not need to be related to the sales activity being taxed.

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Attributional Nexus (nexus through others)

- A remote vendor (with no independent nexus) can have actual physical presence if related or unrelated third parties conduct activities in the taxing state that help the remote vendor establish and maintain a market for its goods and services in that state.
  - Body of law has been developing steadily, thinning the nexus thread, since 1967.
- Nexus by mere affiliation (common ownership) has, to date, been held insufficient by courts.

Dealing with Nexus in the E-Commerce Landscape

- Simplify state laws to get Congress to act.
  - Streamlines Sales Tax Project/Marketplace Fairness Act;
- The 2008 Legislative Revolution – legislatively thinning the "physical presence" requirement;
  - Rapid adoption of "click-through" nexus, attributional nexus, and affiliate nexus laws.
- The Next Revolution – remote vendor reporting requirements and "economic presence" laws/regulations.
  - Colorado, Alabama, South Dakota

The Colorado Route
Notice and Informational Reporting

- 2010 statute, codified at Colo. Rev. Stat. § 39-21-112(3.5)(c):
- Remote vendors that cannot be constitutionally required to collect must:
  - Provide transactional notice to Colorado purchasers that use tax may be due;
  - Provide an annual statement to each Colorado purchaser by Jan. 31st of each year; and
  - Provide an informational report to CDOR by March 1st of each year.
- Penalties apply to each failure.

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The Colorado Route
The Litigation Road

- Colorado federal district court permanently enjoined enforcement on commerce clause grounds;
- Tenth Circuit held that the District Court could not enjoin because of the federal Tax Injunction Act;
- SCOTUS held: (1) Tax Injunction Act was not applicable because the law involved only notice and information requirements, not tax collection; and (2) Justice Kennedy invited a *Quill* challenge;
- Tenth Circuit Remand – the law does not violate the commerce clause because Colorado is not imposing a tax and it does not place discriminatory burdens on interstate commerce.

The Colorado Route

- Louisiana H 1121 (2016) enacted similar notice and reporting requirements, effective July 1, 2017.

Alabama Economic Nexus

- **Alabama Regulation 810-6-2-.90.03 (effective January 1, 2016).**
- Remote vendors with no physical presence in Alabama must remit use tax on sales to Alabama purchasers if:
  - Sales into Alabama in the previous calendar year exceeded $250,000; AND
  - The remote vendor satisfies one of the following (among others):
    - Maintains or operates an office or facility (physical presence);
    - Registers to do business in Alabama (physical presence not necessary);
    - Employs or retains a sales solicitor (physical presence);
    - Solicits orders by mail if the solicitations are substantial and recurring (economic nexus) and the vendor benefits from any banking, financing, debt collection, telecommunication, or marketing activities in the state (minimum contacts).
- Newegg, Inc. filed suit to challenge on June 8, 2016.

South Dakota Economic Nexus

- **South Dakota Senate Bill 106 (2016) – pure economic nexus.**
- A remote vendor (with no physical presence in South Dakota), who sells tangible personal property, electronically transferred products, or services for delivery into the state must remit sales tax if either:
  - Its gross revenues from sales into South Dakota in the previous calendar year exceeded $100,000; or
  - It conducted more than 200 separate transactions with South Dakota purchasers during the previous calendar year.

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South Dakota Economic Nexus Expedited *Quill* Challenge

- SB 106 was enacted to get a *Quill* challenge before the US Supreme Court as soon as possible.
- The bill authorized the state to bring a declaratory judgment action against any taxpayer it believed met the bill's requirements;
- It enjoined the state from collecting tax while the suit is pending (exception for voluntary compliance or previous nexus decisions);
- It prohibits retroactive application of the bill and the state can only enforce after the injunction is lifted;
- Provided for expedited review to SD Supreme Court.
- Two suits filed on April 28 and 29.
  - State filed DJA against Wayfair, Inc., Systemax, Inc., Overstock.com, and Newegg, Inc.
  - American Catalog Mailers Ass'n and NetChoice filed DJA against the state.

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