NetChoice Promoting Convenience, Choice, and Commerce on The Net

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Nicolas Maduros, Director
California Department of Tax and Fee Administration (CDTFA)
450 N Street, Room 2322
Sacramento, CA 95814

RE: Comments after your October 24 discussion of *Wayfair*

Dear Director Maduros:

We offer these comments following your October 24 discussion of *Wayfair*.

As a threshold matter, CDTFA should defer enforcement of the state's long-arm statute against out-of-state businesses. Instead, the Department should allow the legislature to deliberate and design legislation that addresses the way forward as described in *Wayfair*. If CDTFA were to issue regulations this year, remote businesses would face changing rules and small business thresholds several months later when the legislature adopts its preferred post-*Wayfair* law.

Moreover, if your department were to impose sales tax collection on remote businesses under the current long-arm statute, it would be a misreading of the *Wayfair* decision[1] and would likely violate the commerce clause of the US Constitution and the Internet Tax Freedom Act.[2] These legal risks are explained below.

Also, the *Wayfair* decision only addressed the question of physical presence. The *Wayfair* decision did not create law when it cited the South Dakota threshold of $100,000 for sales into the state. This was dicta that neither creates law nor binds lower courts. So any required small seller threshold chosen by the CDTFA is not based on "good law" and would therefore require a formal rule-making process.

Failure of the CDTFA to engage in proper rule-making will likely result in a lawsuit. NetChoice and ACMA obtained an injunction against Massachusetts for its failure to follow proper rule-making when creating their online tax rule.[3]

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[1] *South Dakota v. Wayfair, Inc.*, 585 U.S. ___ (2018).

[2] 47 U.S.C. § 151.

[3] *See. Am. Catalog Mailers Ass'n & NetChoice v. Heffernan*, No. 2017-1772 BLS1 (Mass Supp. Ct. June 28, 2017).

Instead of issuing regulations now, we offer four suggestions for how the Department can help the state navigate the post-*Wayfair* legal landscape:

1. CDTFA can help lawmakers most by doing the white paper requested at the 15-Oct joint hearing, to compare California law with Streamlined Sales & Use Tax Act (SSUTA) and with the "*Wayfair* standards." California is not a Streamlined member state, so this analysis will be helpful to the legislature and would be essential in responding to any litigation.

   In addition, the Department could analyze establishing *a statewide e-commerce sales tax rate*, which would simplify compliance while maintaining or even increasing revenue realized. This statewide e-commerce sales tax rate would also provide a useful precedent for other states.

2. CDTFA should ask the legislature to grant the Department authority to adjust the compliance effective date. This way CDTFA can directly respond if remote businesses need additional clarity or time to comply.

3. Establish a small-seller threshold, as outlined in *Wayfair*, that is appropriate for a state the size of California. When pro-rated for Gross Domestic Product (GDP), the South Dakota thresholds in *Wayfair* suggest California thresholds of $5 million in sales into the state.

4. The Department can draft legislative language to make it clear that California will not seek retroactive application of *Wayfair*. One point of Justice Kennedy's dicta in *Wayfair* was the importance of eliminating retroactivity to achieve constitutionality under *Complete Auto*.

Below we add further explanation for our claim that the state could face legal challenges if it attempted to enforce remote seller tax obligations under the current long-arm statute.

Failure to provide a reasonable time for sellers to implement constitutes an undue and unreasonable burden on interstate commerce

Some tax service providers who are certified by the Streamlined Sales Tax Project are now informing sellers that custom software implementation could take as much as a year. Many of these Certified Service Providers (CSPs) are working against a significant backlog due to a surge in demand. This results in a very low likelihood that all sellers can begin to collect sales taxes for California by early 2019.

In addition, the cost of implementing tax collection solutions can run into hundreds of thousands of dollars – even for small businesses. The True Simplification of Taxation (TruST) coalition commissioned a study to measure the upfront and ongoing costs, examining both catalog and online retailers in the mid-market bracket ($5 - $50 million in annual sales).[4] The study found that mid-market online retailers would spend $80,000 to $290,000 in setup and integration costs in order to use the so-called "free" software promised by the Streamlined Sales Tax Project.

Moreover, California lacks any vender compensation for remote sellers having to comply with these new obligations.

[4] Larry Kavanagh and Al Bessin, *The Real-World Challenges in Collecting Multi-State Sales Tax*, September 2013.

Taken together, these factors could be an undue burden on interstate commerce and a likely violation of the commerce clause of the US Constitution.

The new tax would violate Interstate Commerce Protections in the US Constitution.

It is a misreading of the court's decision to suggest that the Supreme Court's decision in *South Dakota v Wayfair* makes constitutional an automatic new tax on remote sellers without significant changes in California.

First, the Supreme Court decision in *South Dakota v Wayfair* did not find that the South Dakota law was constitutional. The court merely found that the physical presence rule of *Quill* is no longer good law. This means that South Dakota's law might still be held as unconstitutional under the three other prongs of the *Complete Auto*[5] test.

Nor did the court rule on whether South Dakota's law could survive a challenge of violating the Federal Internet Tax Freedom Act (ITFA) as discussed below.

So, to assert that imposition of California tax on remote sellers is permitted by *Wayfair* is a misreading of the decision and of dicta in *Wayfai*r.

Moreover, California currently fails to achieve any of the factors suggested by the Supreme Court in *Wayfair.* Unlike South Dakota, California has not adopted the Streamlined Sales and Use Tax Agreement (SSUTA), has inadequate small seller protections,[6] and allows retroactive taxation.

Discrimination against online sellers would be unconstitutional, as a violation of the federal Internet Tax Freedom Act

As noted above, the *Wayfair* decision did not declare South Dakota's law constitutional. Nor did it address constitutional challenges based on the Internet Tax Freedom Act (ITFA).

In 2016, a Republican-controlled congress and a Democratic president made ITFA permanent. The ITFA prohibits states from imposing "any tax . . . on electronic commerce that is not generally imposed and legally collectible by such State."[7] The legislative purpose of the ITFA was to prevent the kind of e-commerce discrimination that would likely result from the Department's enforcement of the long-arm statute.

In our court filing in Massachusetts, former Congressman Chris Cox,[8] an author of ITFA said,

> There can be no question the ITFA is meant to apply to taxes on the e-commerce transactions that are the subject of Massachusetts Directive 17-1.
> …
> Directive 17-l plainly violates the ITFA's prohibition on discriminatory taxes. Under Directive 17-1, out-of-state catalog and mail order vendors will not be required to

[5] *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977)

[6] Adjusted for GDP, California's small seller threshold should be $5.4million or 10,848 transactions.

[7] 47 U.S.C. § 151.

[8] *See. Am. Catalog Mailers Ass'n & NetChoice v. Heffernan*, No. 2017-1772 BLS1 (Mass Supp. Ct. June 28, 2017).

> collect Massachusetts sales or use taxes - but out-of-state Internet vendors will. This is the quintessence of the discrimination against Internet commerce that ITFA was written to prevent.
> …
> By specifying uniquely Internet-related factors as the very criteria upon which the Massachusetts sales and use tax collection and reporting obligations are based, Directive 17-1 has made itself a prime example of what the ITFA was meant to prohibit. Its enunciation of aspects unique to Internet commerce such as cookies, apps, CDNs, and online marketplaces offends the plain terms of the ITFA.

Soon after Massachusetts issued its "cookie nexus" directive targeting only online businesses,[9] NetChoice and the ACMA sued for injunction and the Massachusetts Superior Court quickly invalidated the regulation.[10]

A rule that discriminates against online sales would be a clear violation of the ITFA, resulting in a likely legal challenge and injunction.

A better way for CDTFA to support the California State Legislature

Wait for the legislature to act

At this point, we suggest that CDTFA not issue regulations based on the present long-arm statute. The legislature has already announced plans to act on the remote sales tax issue in 2019. If CDTFA were to issue regulations now, businesses would be required to adjust their systems and compliance twice in 2019 -- once for CDTFA regulations, and then again after legislative enactment.

Moreover, since the *Wayfair* decision did not make South Dakota's law "good law" (the decision only addressed the question of physical presence), any new rules created by CDTFA would need to be the result of a formal rule-making process.

Help the legislature pass a law to comply with Wayfair standards

As discussed above, California currently does not meet any of the factors set forth in *Wayfair*.

Whether California joins SSUTA or not, the CDTFA can help simplify taxes to bring the state closer to the *Wayfair* standards. The Department can also assist in identification and certification of certified service providers (CSPs) and establish a regime to compensate sellers for other tax compliance costs incurred.

The CDTFA can also ensure that the legislature enacts an appropriately robust small seller threshold that is adjusted for California's size and share of GDP.

Seek authority from the legislature to adjust the effective date of compliance

If implementation challenges and changing circumstances reveal the need to adjust compliance rules, the legislature cannot respond as effectively as CDTFA. As noted above, some CSPs are backlogged and

[9] Mass. Dept. of Rev. Directive 17-1

[10] *See. Am. Catalog Mailers Ass'n & NetChoice v. Heffernan*, No. 2017-1772 BLS1 (Mass Supp. Ct. June 28, 2017).

unable to assist businesses to implement collection software and map inventory for 46 states. This is but one of the obstacles remote sellers across the country are facing.

Rather than drawing a line in the sand for compliance, the state legislature should entrust CDTFA to adjust the compliance effective date. In doing so, CDTFA can directly address situations where remote businesses need additional clarity or time to comply.

Establish an adequately robust small seller threshold

The *Wayfair* court did not hold that the South Dakota level of $100,000 was adequate for South Dakota. Nor did the court hold that this was adequate for larger states.

What the *Wayfair* court called for is a robust protection for small sellers. For California to best achieve this, California must substantially increase the threshold used by South Dakota since California has over 40 times the Gross Domestic Product (GDP) of South Dakota.

A relative GDP adjustment suggests California thresholds of $5 million in sales to the state. Without this adequate adjustment, California risks a legal challenge for failing to implement the *Wayfair* standard of a robust small seller exemption adequate for a state the size of California.

Avoid allowing or empowering each tax district to set its own rules

During the October 24th meeting there was discussion about allowing each California tax district to set its own rules and thresholds. But this would clearly run-afoul of the simplicity requirements of *Complete Auto* and *Wayfair* dicta.

Once again pointing back to the dicta in *Wayfair*, there must be a "single, state level tax administration."[11]

Make clear that no retroactive taxes are owed

One of the *Wayfair* factors includes a preclusion against retroactive tax collection based on vacating *Quill*. However, California law allows the Board of Equalization to seek taxes prior to an enactment date. This creates not only a constitutional challenge but a policy challenge to tax collection.

We applaud CDTFA for stating at the October 24th meeting that it will not pursue retroactivity. The CDTFA can also help the legislature address this problem by drafting legislative language indicating that retroactive taxes are not owed by remote sellers prior to the effective date of the legislation.

Nonetheless, businesses must also be given enough time to bring themselves into compliance with the new tax requirements before being held liable.

Analysis of SSUTA and Single Rate for California

The Department should research and provide analysis to support establishing a statewide e-commerce sales tax rate for remote sellers. This would simplify compliance to the extent that it might actually increase tax revenue for California. The easier it is to comply; the more businesses *will* comply. The

[11] *Wayfair* at 23.

Texas Comptroller has the statutory authority to create a statewide e-commerce tax rate, and the Department should explore the same concept for California.

A statewide e-commerce sales tax rate for remote sellers could also create a positive precedent for other states to follow, which would benefit California-based businesses selling into those other states.

We appreciate your consideration of our views, and please let us know if we can provide further information.

Sincerely,

Steve DelBianco
President
NetChoice