Bill Analysis

Peter A. Cooper *Legislative Service Commission*

Sub. H.B. 407

125th General Assembly
(As Reported by H. Ways and Means)

Reps. Gibbs, Taylor, Husted, Raussen, Otterman, Schaffer, Grendell, Fessler, Aslanides, Martin, Blasdel, Faber, Collier, Flowers, Seaver, Gilb, Carmichael, Brinkman, McGregor, Daniels, D. Evans, Wolpert, Reidelbach, White, Distel, Webster, Wagner, J. Stewart, Latta

BILL SUMMARY

- Creates a new rule designating where a sale occurs for the purpose of applying the appropriate state and county sales tax in those cases where the seller makes relatively few sales in states the seller has no physical presence in.

- Requires the Tax Commissioner to verify a taxpayer's school district of residence by comparing the school district reported by the taxpayer with the taxpayer's street address.

CONTENT AND OPERATION

Change in sales and use tax sourcing rules

(R.C. 5739.033 and 5739.034; Section 8)

The bill proposes further changes to a part of Ohio sales and use tax law that was enacted recently to coordinate Ohio law with the multistate Streamlined Sales and Use Tax Agreement (or "SST Agreement," explained below). The bill's changes affect the "sourcing" rules governing where a sale is deemed to occur. The sourcing rules enable sellers to determine the taxing jurisdiction where a sale is taxable, which in turn determines the appropriate tax rate and the appropriate recipient of the tax revenue.

Current Ohio law, scheduled to take effect July 1, 2005, will substitute the SST Agreement's sourcing rules for the sourcing rules that have been in effect for several years and that remain in effect until July 1, 2005.[1] The rules address the circumstances under which a sale might be made, including whether the purchaser is present at the seller's place of business, or places the order by telephone, mail, or internet; and whether the property or service sold is received at the place of business or delivered to some other location.

Existing sourcing rules (effective July 1, 2005)

The rules currently scheduled to take effect July 1, 2005, are as follows:

> (1) If the purchaser receives the property or service at the seller's place of business, the sale is sourced to the seller's place of business.
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> (2) If the property or service is not received at the seller's place of business, the sale is sourced to the place where the property or service is delivered, so long as the seller knows that place.
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> (3) If (1) or (2) does not apply, the sale is sourced to the purchaser's address as shown in the seller's records if the address is in those records.
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> (4) If neither (1), (2), or (3) applies, the sale is sourced to the purchaser's address as given by the purchaser, including an address on a check or other payment instrument.
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> (5) In all other cases, the sale is sourced to the place the purchased property is shipped from, or the place from where the purchased service is provided.

New sourcing rule for qualified small businesses

The bill creates a new rule for sales made by "qualified small businesses." The new rule requires all sales by a qualified small business to be sourced to the business's place of business, regardless of the circumstances of the sale. Thus, the applicable tax rate will be the rate in effect in the state and county where the place of business is located, and the revenue from the tax will be received by that state or county. Circumstances such as whether the purchaser is present at the place of business when making the purchase, or whether the purchased item is cash-and-

[1] *Although the sourcing rules do not become mandatory until July 1, 2005, sellers may choose to apply them as early as January 1, 2005.*

carry, delivered, or picked up at a remote location will not affect where the sale is sourced so long as the sale is made by a qualified small business.

The bill defines "qualified small business" as a vendor having gross nationwide "remote" sales averaging less than $5 million over the vendor's three fiscal years ending in the preceding calendar year. (If a vendor has been in business for fewer than three fiscal years, the bill states that the vendor must average its sales over the number of years it has been in business, either one or two, to determine whether its per-year sales are less than $1.67 million, which is one-third of $5 million.) All remote sales by the seller's subsidiaries, parents, and other affiliates under common control count toward the threshold. The $5 million threshold must be adjusted by the Tax Commissioner each year there is an increase in the Consumer Price Index (CPI). The threshold must be increased by the same percentage that the CPI increases, rounded to the nearest multiple of $10,000.

A "remote" sale is defined as a sale sourced to a state where the seller does not have "substantial nexus" when the sale is made. The bill defines "substantial nexus" as meaning that a seller has sufficient contact with a state to allow that state to require the seller to collect that state's sales and use tax when a person makes a purchase in that state. Whether a seller has sufficient contact is to be based on the Commerce Clause of the United States Constitution and how that clause is construed by the courts. Currently, the clause is construed to mean the seller has physical presence in the taxing state. (A fuller explanation of the constitutional constraints on a state requiring sellers to collect state sales taxes is presented below.)

The bill's proposed change in the sourcing rules would take effect July 1, 2005.

The bill's new sourcing rule for qualified small businesses appears to be inconsistent with the SST Agreement's sourcing rules. Accordingly, the bill implicitly places a condition on Ohio's full implementation of the Agreement: before Ohio can become a member of the Agreement, the Agreement must be modified to allow member states to have sourcing rules such as those proposed by the bill. The bill includes a provision urging the Tax Commissioner to present to the other implementing SST states the burdens of the Agreement on small businesses and the "potentially harmful effects" of the Agreement's sourcing rules on some Ohio counties, and urging the Tax Commissioner to advocate amending the Agreement in order to lessen those burdens and to alleviate those harmful effects.

Streamlined Sales and Use Tax Agreement--background

Ohio is a participant in the Streamlined Sales Tax Project and is in the process of codifying the provisions of the Streamlined Sales and Use Tax Agreement in state law. Once Ohio's sales tax laws, rules, regulations, and policies substantially comply with the Agreement's provisions, Ohio may petition the Streamlined Sales and Use Tax Governing Board for membership in the Agreement.

The Agreement implements a voluntary, multistate system intended to facilitate and simplify sellers' collection and payment of sales and use taxes. Among other things, the Agreement requires its member states to codify in their respective tax codes uniform standards for attributing the source of transactions to taxing jurisdictions (i.e., designating where a sale occurs). The designation of the location of a sale determines the tax rate applied to the sale and also determines which local taxing jurisdiction will receive the tax revenue from the sale.

States apply for membership under the Agreement by submitting a petition and a certificate of compliance documenting the state's compliance with the provisions of the Agreement and citing applicable laws evidencing the state's compliance. Ohio will not have achieved substantial compliance with the terms of the Agreement until it implements the Agreement's uniform standards for attributing the source of transactions to taxing jurisdictions.

Collection of sales and use taxes from out-of-state sellers: constitutional limitations

The United States Constitution's Commerce Clause, Art. I, § 8, cl. 3, bars states from collecting sales and use taxes from sellers located in other states unless those sellers have "substantial nexus" with the taxing state. In *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), the United States Supreme Court held that an out-of-state seller does not have substantial nexus with a taxing state unless the seller maintains a physical presence in the state.[2]

The Agreement will remain a voluntary collection system with respect to sellers without physical presence nexus unless and until Congress dispenses with the physical presence nexus required under the United States Supreme Court's decision in *Quill*. Legislation authorizing states that are parties to the Agreement

[2] *Because the United States Congress has plenary authority over interstate commerce, Congress can effectively overrule the* Quill *holding by enacting legislation permitting states to require out-of-state sellers without physical presence nexus in the taxing state to collect sales and use taxes.* Quill*, 504 U.S. at 318; Prudential Ins. Co. v. Benjamin, 328 U.S. 408, 423 (1946).*

to compel remote sellers to collect and remit sales and use taxes for the state has been introduced in both chambers of Congress (H.R. 3184 and S. 1736). Both bills, which are currently in committee, propose a small business exception specifying that some remote sellers cannot be compelled to collect a state's sales and use tax under any circumstances. To qualify for this exception, a seller must have less than $5 million in sales annually to states where the seller does not have sufficient physical presence to be required, under the existing Commerce Clause construction, to collect those states' sales and use taxes.

Verifying a taxpayer's school district of residence

(R.C. 5747.04; Section 4)

Currently, every person filing an Ohio income tax return must report on the return the school district where the person resides. The school district is coded by a four-digit number. The information can be used to check whether persons residing in a school district levying an income tax pay the tax, and it affects how state school aid is distributed (the amount of aid can depend in part on the relative average income levels in each school district). The information also is used to help ensure that 50% of the income taxes arising from a particular county is returned to that county, as required by Article XII, Section 9, of the Ohio Constitution; state school aid paid to school districts in a county count toward that constitutional requirement.

The bill requires the Tax Commissioner to verify each taxpayer's school district of residence by comparing the school district reported by the taxpayer with the taxpayer's street address. If a taxpayer's reported school district is not consistent with the taxpayer's address, the Tax Commissioner must notify the taxpayer and request that the taxpayer verify the school district and address. If a taxpayer does not reply to the Commissioner's request, the taxpayer must be considered to have filed an incorrect tax return. Under current law, filing an incorrect return subjects a taxpayer to an assessment by the Tax Commissioner for any unpaid taxes, and may result in penalties or interest, or both, being charged.

The bill's verification requirement takes effect January 1, 2006.

HISTORY

ACTION	DATE	JOURNAL ENTRY
Introduced	02-12-04	p. 1643
Reported, H. Ways & Means	09-16-04	pp. 2159-2160

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