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Representative Ben Toma
Chair, Ways & Means Committee
Arizona House of Representatives
1700 W. Washington Street
Phoenix, AZ 85007

Re: Without first simplifying Arizona's tax system, H.B. 2702's economic nexus provisions probably would not survive a Constitutional challenge

Dear Chairman Toma,

Rather than address the myriad of minor concerns we have identified with H.B. 2702,¹ today we² write to express our grave concern that, unless Arizona simplifies its tax system first, H.B. 2702's economic nexus provisions probably would not survive a Constitutional challenge.

As you know, in the *Wayfair*³ case, the U.S. Supreme Court held that, unless something else about South Dakota's tax system discriminates against or imposes an undue burden on interstate commerce,⁴ South Dakota's economic nexus law that requires out-of-state sellers to collect and remit sales tax as long as they annually sell more than \$100,000 worth of goods or services or engage in 200 or more separate transactions with customers in the state is Constitutional.

¹ Thank you for your commitment to work through the concerns various stakeholders have raised concerning this important bill.

² Peter C. Guild is a Senior Member at The Cavanagh Law Firm with over 37 years of experience in tax matters. Otto S. Shill, III is a Member at Jennings, Strouss & Salmon, P.L.C. with nearly 34 years of experience in tax matters. James G. Busby, Jr. is a Senior Member at The Cavanagh Law Firm with nearly 23 years of experience in Arizona state and local tax matters.

³ *South Dakota v. Wayfair*, 138 S. Ct. 2080 (2018).

⁴ Although the U.S. Supreme Court determined that South Dakota's economic nexus law satisfied the first prong of the four-part *Complete Auto* test, namely (1) the substantial nexus prong, it remanded the case to the South Dakota Supreme Court determine whether it (2) is fairly apportioned, (3) does not discriminate against interstate commerce, and (4) is fairly related to the services provided by the state.

Features of South Dakota's Tax System Designed to Make it Constitutional

Writing for the majority of the court, Justice Kennedy identified three features of South Dakota's tax system that "appear designed to prevent discrimination," including [1] a safe harbor for those who transact only limited business in the state, [2] the lack of a retroactivity provision, and [3] South Dakota dramatically simplified its tax system by adopting the Streamlined Sales and Use Tax Agreement ("SSUTA").

Critical Differences Between South Dakota's and Arizona's Tax Systems

Like South Dakota's law, H.B. 2702 is [1] limited to those who annually sell more than \$100,000 worth of goods or services or engage in 200 or more separate transactions with customers in the state, and H.B. 2702 is [2] not retroactive. But, as explained below, unlike South Dakota, [3] Arizona has not done enough to simplify its tax system before imposing an economic nexus standard.

While the *Wayfair* Court did not hold that states must adopt the SSUTA in order to implement an economic nexus standard, Justice Kennedy explained that the SSUTA is important because it:

1. "standardizes taxes to reduce administrative and compliance costs;"
2. "requires a single, state level tax administration;"
3. "requires ... uniform definitions of products and services;"
4. "requires ... simplified tax rate structures;"
5. "requires ... other uniform rules;" and
6. "provides sellers access to sales tax administration software paid for by the State" and that "[s]ellers who choose to use such software are immune from audit liability."⁵

Unlike South Dakota, which adopted the SSUTA in order to simplify its sales tax system in these six key ways, Arizona has only simplified its tax system in one of these ways, namely the state now administers all city taxes (consistent with principle #2 above).

Because the *Wayfair* case was just decided in June and the various economic nexus statutes enacted in other states have not been challenged yet (or at least any pending challenges have not been adjudicated yet), nobody knows whether a state that has not adopted the SSUTA or otherwise simplified its tax system in all six of the ways the Court identified will be able to successfully defend its economic nexus statute. But, it is safe to say that the most important thing Arizona could do to simplify its tax system enough for H.B. 2702's economic nexus

⁵ See page 23 of the *Wayfair* opinion.

provision to be more likely to survive a Constitutional challenge is to adopt a single state-wide retail tax base. By adopting a single state-wide retail tax base, even if it did not adopt the SSUTA, Arizona would dramatically simplify its tax system because remote sellers would only have to comply with one tax code when they sell products to Arizona customers rather than up to 92 unique tax codes (one for the state and one for each of the 91 Arizona municipalities that impose a tax).

But rather than “standardiz[e] [its] taxes” (consistent with principle #1 above), both from state-to-state and within the state at the municipal level as South Dakota and other states that adopted the SSUTA have, **Arizona’s state transaction privilege tax is unique among the forty-five states that impose sales taxes and different in each of its 91 municipalities that impose a privilege tax because each municipality imposes tax under its own tax code adopted by its own city or town council and because each municipal tax code differs from the other and from the state’s tax code because municipalities get to select from a variety of tax base and tax rate options.**

To illustrate the disparity between South Dakota’s streamlined tax system and Arizona’s burdensome tax system, the Council on State Taxation’s April 2018 Scorecard on State Sales and Use Tax Administration awarded South Dakota an “A” and assigned Arizona a “D” on simplicity and transparency grounds.⁶

By itself, the fact that Arizona allows each municipality to impose taxes under its own tax code may make it impossible for the state to successfully defend H.B. 2702 against challenges that its economic nexus provisions impose an undue burden on interstate commerce because remote sellers would be forced to evaluate the taxability of their products under up to 92 separate tax codes (one for the state and 91 for the municipalities) when they sell their products to Arizona customers. And perhaps worse yet, H.B. 2702 discriminates against interstate commerce because it would require remote sellers to pay tax based on the location of their customers at up to 106 different tax rates (91 different rates for the municipalities and 15 more for sales to customers located in Arizona counties but outside municipal limits) rather than at the single rate local sellers pay based on the location where they receive customer orders.

While adopting a single state-wide retail tax base other than the SSUTA would not standardize Arizona’s taxes with those states that have adopted the SSUTA (part of the allure of principle #1 above) or make Arizona’s definitions uniform with those states that have adopted the SSUTA (part of the allure of principle #3 above) or make Arizona’s tax rules uniform with the rules of those states that have adopted the SSUTA (part of the allure of principle #5 above), at least the state’s municipal tax bases would be standardized with the state’s tax base, the state’s municipal definitions would be uniform with the state’s definitions, and the state’s tax rules would be uniform with the state’s municipal tax rules, which would be a major improvement.

⁶ *The Best and Worst of Sales Tax Administration*, by Karl Frieden and Fred Nicely, April 2018.

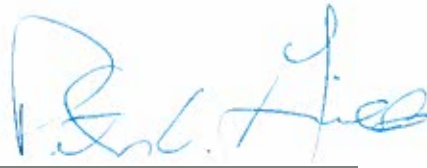
Then, while Arizona may decide to roll the dice and allow its municipalities to maintain their two-tier tax rate structures⁷ rather than require each of them to utilize a single tax rate (consistent with principle #4 above), the state could help taxpayers comply with the various municipal two-tier tax rate structures and thereby reduce the likelihood that taxpayers could successfully challenge the Constitutionality of H.B. 2702 by requiring the Department of Revenue to provide a free tax rate database that allows taxpayers to calculate the tax due by entering the address for their customer and the amount of the transaction.

Finally, even if Arizona does not adopt the SSUTA, it could provide sellers with access to sales tax administration software paid for by the state and grant sellers who choose to use such software immunity from audit liability (consistent with principle #6 above).

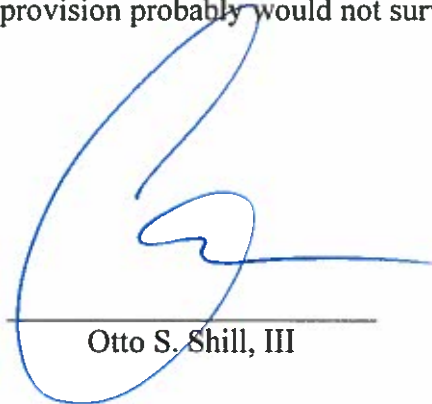
Conclusion

In sum, while nobody knows for sure whether a state that has not adopted the SSUTA or otherwise simplified its tax system in all six of the ways the Court identified will be able to successfully defend an economic nexus statute, we agree, and we believe most neutral tax experts would agree, that if Arizona does not at least simplify its tax system by adopting a single state-wide retail tax base, H.B. 2702's economic nexus provision probably would not survive a Constitutional challenge.

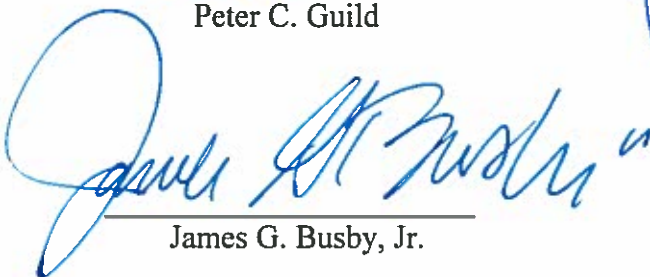
Sincerely,



Peter C. Guild



Otto S. Shill, III



James G. Busby, Jr.

cc: Speaker Rusty Bowers

⁷ Because, in some cases, municipalities entered into long-term bond agreements based on two-tiered tax rate structures.