

Small Online Sellers Face Specter of New State Income Taxes

By Michael J. Bologna and Tripp Baltz 2021-08-30T04:45:21000-04:00

- States consider tax guidance for 2.1 million internet sellers
- Tax commission expands rationale for taxing e-commerce

Online merchants face paying income taxes in dozens of additional states if revenue agencies adopt a new interpretation of a federal law that has protected out-of-state sellers for 60 years.

Revenue officials in Colorado, Illinois, Oregon, and Utah are studying how to implement some or all of a [statement on Public Law 86-272](#), recently revised by the influential Multistate Tax Commission to reflect the impact of e-commerce on the broader economy. Other states could take similar action, based on their previous adoptions of the the commission's principles through guidance and tax positions taken during audits.

The shift in state policies could have a major impact on the income tax duties of an [estimated 2.1 million](#) online merchants operating in the U.S., according to tax practitioners. The approaching wave of regulation and legislation could also spur litigation if e-commerce sellers conclude the states are illegally and unfairly denying them protections intended by Congress when it enacted the federal law decades back.

Many large sellers won't see much impact from the tax commission's interpretation, but the burdens will be difficult for hundreds of thousands of small sellers, practitioners said.

Case in point: Illinois-based K-Log Inc. The internet- and catalog-based company sells furniture to school systems in all 50 states, but currently pays income taxes in only three states.

"I'm not a tax lawyer, but it looks to me that the way the section on internet sales is written pretty much means K-Log will not have P.L. 86-272 protections in any state," said John Lester, K-Log's director of business development and tax.

Tax consulting services are advising clients to buckle down for a period of adjustment as new regulations are implemented.

“For businesses that are selling goods over the internet, this is certainly something they want to pay attention to,” said Sarah McGahan, managing director of the state and local tax group at KPMG LLP. Businesses should keep an eye out for any states that formally incorporate the revised statement into their own guidance or regulations, she said.

The 1959 federal law prohibits states and localities from imposing income taxes on out-of-state businesses if their only activity within the state is soliciting sales of tangible personal property. The new commission policy, however, removes a portion of this protection for sellers that weave online support services into their e-commerce models. The commission, a quasi-governmental agency, took on the interpretation project as part of its broader mission to make state tax codes more uniform.

‘Business Activity’

The commission ultimately broadened the definition of “business activity,” endorsing a general rule holding that businesses interacting with customers via a website or an app engage in a business activity within the customer’s state. The commission determined, however, that static website sales presentations don’t constitute business activity in the customer’s state and preserve the immunity from taxation under the federal law.

The commission presented 11 scenarios that may or may not qualify for the income tax protections afforded under the federal law. For instance, businesses providing post-sale assistance through a list of frequently asked questions would still qualify for federal protections. But electronic chat functions aimed at helping customers trouble shoot problems wouldn’t qualify.

Possible Triggers for E-Seller State Income Tax

The MTC describes 11 scenarios in which a seller's customer engagement would either preserve or defeat the protections in P.L. 86-272. Here are six.



Protected



Protection Lost



Sells products from a static website and offers no ancillary services



Offers remote repair and product upgrades



Offers post-sale assistance through a list of frequently asked questions



Offers post-sale assistance through electronic chat



Places cookies on customers' computers for solicitation of sales



Places cookies on customers' computers to gather customer search data

Source: Multistate Tax Commission

Bloomberg Tax & Accounting

Nineteen states and the District of Columbia supported the new legal interpretation of the federal law during the commission's annual meeting on Aug. 4. But those states still have to take steps to incorporate it into their tax codes. As a practical matter, "every state will have to decide how to proceed, and they have a variety of options," said Brian Hamer, MTC counsel and a former director of the Illinois Department of Revenue.

Rules and Regulations

States don't have to adopt the new legal interpretation. However, the 24 MTC member states and many others will likely examine the package, said Kimberly Lewis, president of the Federation of Tax Administrators and secretary of the Louisiana Department of Revenue. "That affirmative act would require legislation, regulation or some other administrative action," Lewis said.

The Colorado Department of Revenue "intends to interpret P.L. 86-272 consistent with the revised statement," a spokesman said. Revenue officials in Illinois, Oregon, and Utah said they wouldn't immediately commit to the interpretation, but are examining options for adopting some or all of it.

Other states to watch include Hawaii, Massachusetts, and Ohio, said Jamie Yesnowitz, a state and local tax practice and national tax office leader at Grant Thornton LLP.

In 2019 Hawaii became the first state to enact an economic nexus [standard](#) for income tax purposes, bringing some new remote companies into the state tax code. Massachusetts and Ohio are noteworthy for applying "cookie nexus." Cookie nexus states say remote sellers establish a physical presence in a state for sales tax purposes when they place web cookies on customers' computers to track their browsing activity.

"Runaway Wagon"

States adopting aggressive tax positions targeting remote sellers during audits could face court challenges from business groups and individual taxpayers. The American Catalog Mailers Association, the Direct Marketing Association and the Council on State Taxation all claim the commission has handed the states a legal interpretation that exceeds the authorities intended by Congress.

The commission's action is "a direct assault on the language, substance, and intent" of the federal law, said DMA counsel George Isaacson, a partner with Brann & Isaacson in Lewiston, Maine. "I hope that state governments will refrain from jumping on to the MTC's runaway wagon."

Large businesses with physical presence and service affiliates in multiple states have likely been filing corporate returns in several states for many years, said Christopher Lutz, chair of state and local tax with the Chicago law firm HMB Legal Counsel.

Still, Lutz said e-commerce businesses — large and small — need to monitor the guidance and enforcement initiatives coming out of state revenue agencies to avoid potential penalties for failing to file income tax returns in a particular state.

“This is an interesting issue for us lawyers to talk about in the abstract,” he said. “It will be much more interesting when these cases eventually roll around.”

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