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TO: Members of the Electronic Commerce Study Committee

FROM: Michael Mertens

RE: Collection of Iowa Sales and Use Tax From Local and Internet-based Retailers

I. Introduction. The purpose of this background memorandum is to introduce one of the primary legal issues involved in the collection of Iowa sales and use tax from local retailers and Internet-based retailers. The memorandum will first introduce the legal concept of “substantial nexus,” which affects collection of sales and use tax. The memorandum will then provide a very brief overview of Iowa sales and use taxes and their collection in Iowa. Finally, it will discuss state and federal developments relating to the collection of sales and use tax.

II. “Substantial Nexus” — the Legal Issue Surrounding Collection of Sales and Use Tax. A state’s ability to require retailers to collect sales and use tax has been shaped significantly by the United States Supreme Court, especially by a series of cases beginning in the 1960s and culminating with the 1992 case of *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992). Arguably, the most relevant part of these cases dealt with the Commerce Clause of the United States Constitution, which grants Congress the power to “regulate Commerce...among the several States.”¹ The United States Supreme Court has interpreted the Commerce Clause to be not only an affirmative grant of power to Congress, but also a prohibition on states from taxing in ways that unduly burden interstate commerce.

In the *Quill* case, *Quill* was a mail-order retailer with no property or employees in North Dakota. *Quill* solicited sales from North Dakota residents via the mail and telephone. North Dakota attempted to require *Quill* to collect use tax from customers on sales made outside the state of North Dakota to residents of, or for use in, North Dakota. The United States Supreme Court ruled against North Dakota and held it is an impermissible burden on interstate commerce to require an out-of-state mail-order retailer to collect a state’s sales or use tax unless the retailer has a “substantial nexus” with the state, which requires some level of “physical presence” by the retailer within the state. The *Quill* case affirmed a bright-line rule that to date has not been reexamined by the United States Supreme Court or addressed legislatively by Congress.

III. Brief Overview of Iowa Sales and Use Tax. Iowa imposes a statewide retail sales tax and use tax.² The sales tax is imposed on the sales price of all sales of tangible personal property and enumerated services sold at retail in this state.³ The use tax, which is meant to

¹ See U.S. Const. Art. I, sec. 8, cl. 3.

² Iowa Code Chapter 423.

³ Iowa Code § 423.2.

complement the sales tax, is imposed on the purchase price of all tangible personal property or enumerated services purchased outside Iowa and used in this state.⁴ The general rule is that when a transaction would be subject to Iowa sales tax if consummated in Iowa, such transaction, although consummated outside the state of Iowa but involving tangible personal property or enumerated services sold for use in Iowa and used in Iowa, is subject to Iowa use tax.⁵

A transaction involving the sale of goods is generally considered a retail sale in Iowa, and therefore subject to Iowa sales tax, when the retailer transfers physical possession of the goods to the buyer in Iowa.⁶ A transaction involving the sale of goods is generally considered a taxable use, and therefore subject to Iowa use tax, when a retailer transfers physical possession of the goods to a buyer outside Iowa and the buyer subsequently brings the goods into Iowa for use. Determining whether a transaction is subject to the sales or use tax can be complicated when an out-of-state retailer uses a common carrier to deliver goods to a buyer in Iowa, as is frequently done with Internet sales. In these situations, the terms of delivery relating to the point at which title and risk of loss of the goods pass from the retailer to the buyer will usually govern whether the transaction is subject to sales or use tax.⁷ Because of the way many sales contracts are structured, it is commonplace for these transactions to be considered sales outside Iowa and therefore subject to use tax when the buyer receives the goods in Iowa from the common carrier.

IV. Sales and Use Tax Collection in Iowa. Regardless of whether sales tax or use tax is due, Iowa can and does require a retailer to collect the appropriate tax on sales sourced⁸ to Iowa if the retailer has substantial nexus with the state. Iowa law requires that every retailer who is making a taxable retail sale in Iowa shall, at the time of selling the property, collect the sales tax.⁹ Also, every retailer maintaining a place of business in this state and selling property subject to the use tax shall, at the time of making the sale, collect the use tax.¹⁰ A "retailer maintaining a place of business in this state" includes any retailer having or maintaining within this state, directly or by a subsidiary, an office, distribution house, sales house, warehouse, or other place of business, or any representative operating within this state under the authority of the retailer or its subsidiary, irrespective of whether that place of business or representative is located here permanently or temporarily, or whether the retailer or subsidiary is admitted to do business within this state under the Business Corporation Act in Iowa Code chapter 490.¹¹ "Representative" includes but is not limited to agent, employee, and an independent contractor.¹² Use tax that is not collected by a retailer maintaining a place of business in this state shall be paid directly by the consumer.¹³

⁴ Iowa Code § 423.5.

⁵ Iowa Code § 423.5; Iowa Admin. Code 701-31.1.

⁶ See Iowa Code § 423.15; Iowa Admin. Code 701-16.14. See also *Sturtz v. Iowa Dept. of Revenue*, 373 N.W.2d 131, 134 (Iowa 1985).

⁷ Iowa Admin. Code 701-14.3(2).

⁸ A sale of tangible personal property is usually "sourced" to Iowa when the tangible personal property is received by the buyer at a retailer's location in Iowa, or when the retailer ships the tangible personal property to a buyer located in Iowa. Iowa Code § 423.15.

⁹ Iowa Code §§ 423.14(1), 423.29.

¹⁰ Iowa Code §§ 423.14(2), 423.29.

¹¹ Iowa Code § 423.1(48).

¹² Iowa Admin. Code 701-30.1.

¹³ Iowa Code § 423.14.

The Department of Revenue maintains a nonexhaustive list of situations that it believes will create substantial nexus with an out-of-state retailer and, therefore, permit Iowa to require collection of the use tax.¹⁴ Those situations include:

1. An out-of-state retailer owns or maintains within Iowa, either directly or by a subsidiary, an office, distribution house, warehouse, or other place of business.
2. An out-of-state retailer has a representative located in Iowa permanently or temporarily.
 - a. A representative solicits sales in Iowa as an employee of the retailer.
 - b. A representative solicits sales in Iowa as an independent broker, or jobber who is under contract with the vendor.
 - c. A representative acts as a consultant on behalf of a vendor and, while not taking orders, provides regular and significant services to a customer or customers in Iowa.
3. An out-of-state retailer installs in Iowa property it sells.
4. An out-of-state retailer is a construction contractor performing a contract, in whole or in part, in Iowa.
5. An out-of-state retailer performs service work in Iowa.
6. An out-of-state retailer regularly engages in delivery of its products by its own trucks in the state of Iowa.

The General Assembly has taken steps in recent years to increase sales and use tax collection from out-of-state retailers and has considered, but not passed, legislation to theoretically expand the types of activity that create substantial nexus for sales and use tax purposes. Iowa became a member of the Streamlined Sales and Use Tax Agreement (SSUTA) in 2005 after conforming its sales and use tax laws to the agreement's requirements. The objectives of the SSUTA are to simplify and modernize sales and use tax collection and administration across state and local jurisdictions, to reduce the burden of compliance, and to induce Congress to lower *Quill's* physical presence requirement through legislation, thereby allowing states to require out-of-state sellers to collect sales and use tax. The SSUTA allows any retailer to register under the SSUTA using the central registration system, which obliges the retailer to collect sales and use taxes for all its Iowa-sourced taxable sales, as well as those for other SSUTA member states.

The General Assembly considered two similar bills during the 2012 Legislative Session (SSB 3178, HSB 669) related to sales and use tax collection. SSB 3178 is attached for reference. SSB 3178 was later amended and passed by the Committee on Economic Growth/Rebuild Iowa (SF 2309), then amended and passed by the Committee on Ways and Means (SF 2330). These bills would have expanded the definition of "retailer maintaining a place of business in this state" to add activities that may or may not already establish substantial nexus under current Iowa law. These changes would theoretically increase the number of retailers that are required to collect Iowa sales and use taxes. Similar versions of these bills have been proposed and enacted in other states.

IV. Federal and State Developments Relating to the Collection of Sales and Use Tax.

1. Federal Legislation. Because Congress has the power to regulate interstate commerce, it has the power to modify the holding of *Quill* through legislation. Since the *Quill* decision,

¹⁴ Iowa Admin. Code 701-30.1.

several federal bills have been proposed to deal with the legal issue of substantial nexus, but to date nothing has been enacted. One recent example is the 2011 Main Street Fairness Act (S. 1452, H.R. 2701). This bill would grant Congressional consent to the SSUTA (of which Iowa is a member) and allow member states to require all retailers to collect sales and use tax for all sales sourced into the state, regardless of whether the retailer has a physical presence in the state. The bill provides for a small business exemption, the size of which is to be set by the governing board of the SSUTA.¹⁵

Other examples are the 2011 Main Street Equity Act (S. 1832) and the 2011 Marketplace Fairness Act (H.R. 3179). Both are similar to the Main Street Fairness Act, except that they allow states that are not members of the SSUTA to require collection if they enact certain simplification requirements. Also, the Main Street Equity Act sets the small business exemption at \$500,000 in annual U.S. sales, and the Marketplace Fairness Act sets the small business exemption at \$1,000,000 in annual U.S. sales or \$100,000 of in-state sales.

2. State Legislation. In 2008, New York enacted so-called “click-through” nexus legislation requiring out-of-state Internet retailers to collect and remit state sales tax on tangible personal property or services sold through links on Internet sites operated by state residents or in-state businesses. The law establishes a rebuttable presumption that a retailer must collect sales tax if that retailer is making sales of tangible personal property or services to New York customers through an agreement with a New York resident for a commission or other consideration, by which the resident directly or indirectly refers potential customers, by a link on an Internet site, to the retailer, if the cumulative gross receipts from such sales exceed \$10,000 per year. After passage, Amazon filed suit alleging that the law was unconstitutional. The law was upheld by a trial court and the Supreme Court of New York County. It is currently on appeal before the New York Court of Appeals, the highest court in the state of New York.

Since then, several states have enacted legislation similar to the New York “click-through” nexus law, including Arkansas, California, Connecticut, Georgia, Illinois, North Carolina, Rhode Island, and Vermont. The Illinois “click-through” nexus law was held to be unconstitutional in May of 2012 by the Circuit Court for Cook County. The case is on appeal with the Illinois Supreme Court. In December of 2011, Pennsylvania’s Department of Revenue issued an opinion that the state’s existing law already provided for “click-through” nexus.

Several states have also expanded or clarified sales and use tax collection requirements to include retailers that are part of a controlled group that have members in the state or that have a related party or affiliate in the state. Often, these related entities must share a similar name, trade name, trademark, goodwill, similar line of products, or activity. Many are drafted to establish a rebuttable presumption similar to that of the “click-through” nexus laws.

Finally, several states have enacted legislation that requires out-of-state retailers that do not collect sales or use tax to provide various forms of notice or collection information to the customer or the state. For example, Colorado passed legislation in 2010 that required every out-of-state retailer not required to collect Colorado sales tax to provide customers with year-end purchase summaries and notice of use tax liability. Out-of-state retailers with annual gross sales into Colorado of \$100,000 or more were also required to provide customer information to the Colorado Department of Revenue. Monetary penalties were imposed on retailers that failed to comply. In April of 2012, a U.S. District Court in Colorado declared the law unconstitutional because it violated the Commerce Clause of the United States Constitution. Other states’

¹⁵ Iowa has four representatives on the SSUTA governing board who represent Iowa before the board as one vote. The designated representatives include two members of the General Assembly and two members of the executive branch. Iowa Code § 423.9.

notice laws do not include the requirement that information be disclosed to tax authorities nor do they provide for monetary penalties.

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Senate Study Bill 3178 - Introduced

SENATE FILE _____
BY (PROPOSED COMMITTEE ON
ECONOMIC GROWTH/REBUILD
IOWA BILL BY CHAIRPERSON
SODDERS)

A BILL FOR

1 An Act relating to retailers maintaining a place of business
2 in this state for purposes of the collection of sales and
3 use taxes, agreements relating to the collection of sales
4 and use taxes in the state, and sales of tangible personal
5 property and services to the state.
6 BE IT ENACTED BY THE GENERAL ASSEMBLY OF THE STATE OF IOWA:

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1 Section 1. Section 423.1, subsection 48, Code Supplement
2 2011, is amended to read as follows:

3 48. a. "Retailer maintaining a place of business in this
4 state" or any like term includes any retailer having or
5 maintaining within this state, directly or by a subsidiary,
6 an office, distribution house, sales house, warehouse, or
7 other place of business, or any representative operating
8 within this state under the authority of the retailer or its
9 subsidiary, irrespective of whether that place of business or
10 representative is located here permanently or temporarily, or
11 whether the retailer or subsidiary is admitted to do business
12 within this state pursuant to chapter 490.

13 b. (1) A retailer shall be presumed to be maintaining a
14 place of business in this state, as defined in paragraph "a", if
15 any person that has substantial nexus in this state, other than
16 a person acting in its capacity as a common carrier, does any
17 of the following:

18 (a) Sells a similar line of products as the retailer and
19 does so under the same or similar business name.

20 (b) Maintains an office, distribution facility, warehouse,
21 storage place, or similar place of business in this state to
22 facilitate the delivery of property or services sold by the
23 retailer to the retailer's customers.

24 (c) Uses trademarks, service marks, or trade names in this
25 state that are the same or substantially similar to those used
26 by the retailer.

27 (d) Delivers, installs, assembles, or performs maintenance
28 services for the retailer's customers.

29 (e) Facilitates the retailer's delivery of property to
30 customers in this state by allowing the retailer's customers to
31 take delivery of property sold by the retailer at an office,
32 distribution facility, warehouse, storage place, or similar
33 place of business maintained by the person in this state.

34 (f) Conducts any other activities in this state that
35 are significantly associated with the retailer's ability

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1 to establish and maintain a market in this state for the
2 retailer's sales.

3 (2) The presumption established in this paragraph may be
4 rebutted by a showing of proof that the person's activities in
5 this state are not significantly associated with the retailer's
6 ability to establish or maintain a market in this state for the
7 retailer's sales.

8 c. (1) At any time on or after October 1, 2012, a retailer
9 shall be presumed to be maintaining a place of business in
10 this state, as defined in paragraph "a", if a retailer has an
11 agreement with one or more residents of this state under which
12 the resident, for a commission or other consideration, directly
13 or indirectly refers potential customers, whether by a link on
14 an internet site, telemarketing, in-person presentation, or
15 otherwise, to the retailer, if the cumulative gross receipts
16 from sales by the retailer attributable to those agreements is
17 in excess of ten thousand dollars for the twelve-month period
18 ending on the last day of the most recent calendar quarter.

19 (2) The presumption established in this paragraph may be
20 rebutted by a showing of proof that the resident with whom
21 the retailer has an agreement did not engage in any activity
22 within this state that was significantly associated with the
23 retailer's ability to establish or maintain the retailer's
24 market in this state during the preceding twelve-month period
25 ending on the last day of the most recent calendar quarter.
26 Such proof may consist of sworn written statements from all
27 the residents with whom the retailer has an agreement stating
28 that the resident did not engage in any solicitation in this
29 state on behalf of the retailer during the period in question,
30 provided that such statement is provided and obtained in good
31 faith.

32 **Sec. 2. NEW SECTION. 423.13A Administration —**
33 **effectiveness of agreements with retailers.**

34 1. Notwithstanding any provision of this chapter to the
35 contrary, any ruling, agreement, or contract, whether written

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1 or oral, express or implied, entered into after the effective
2 date of this Act between a retailer and a state agency which
3 provides that a retailer is not required to collect sales and
4 use tax in this state despite the presence in this state of
5 a warehouse, distribution center, or fulfillment center that
6 is owned and operated by the retailer or an affiliate of the
7 retailer shall be null and void unless such ruling, agreement,
8 or contract is approved by a majority vote of both houses of
9 the general assembly.

10 2. For purposes of this section, "state agency" means
11 the executive branch, including any executive department,
12 commission, board, institution, division, bureau, office,
13 agency, or other entity of state government. "State agency"
14 does not mean the general assembly, or the judicial branch as
15 provided in section 602.1102.

16 Sec. 3. Section 423.36, Code 2011, is amended by adding the
17 following new subsection:

18 NEW SUBSECTION. 1A. a. Notwithstanding subsection 1,
19 if any person will make taxable sales of tangible personal
20 property or furnish services to any state agency, that person
21 and any affiliate shall, prior to the sale, apply for and
22 receive a permit to collect sales or use tax pursuant to this
23 section. A state agency shall not purchase tangible personal
24 property or services from any person unless that person and any
25 affiliate of that person has a valid, unexpired permit issued
26 pursuant to this section and is in compliance with all other
27 requirements in this chapter imposed upon retailers, including
28 but not limited to the requirement to collect and remit sales
29 and use tax and file sales tax returns.

30 b. For purposes of this subsection, "state agency" means
31 any executive, judicial, or legislative department, commission,
32 board, institution, division, bureau, office, agency, or other
33 entity of state government.

34 EXPLANATION

35 This bill relates to the collection of sales and use taxes

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1 by retailers maintaining a place of business in this state,
2 agreements relating to the collection of sales and use taxes,
3 and sales of tangible personal property and services to state
4 agencies.

5 A retailer located in this state, or maintaining a place of
6 business in this state, must collect and remit sales and use
7 taxes to the department of revenue. Currently, as defined in
8 Code section 423.1, the term "retailer maintaining a place of
9 business in this state" includes certain places of business,
10 and representatives operating under the authority of the
11 retailer.

12 The bill provides that a retailer will be presumed to be
13 maintaining a place of business in this state if any person
14 that has substantial nexus in this state, other than a common
15 carrier, engages in any of six activities specified in the
16 bill. The presumption may be rebutted by a showing of proof
17 that the person's activities are not significantly associated
18 with the retailer's ability to establish or maintain a market
19 in this state for the retailer's sales.

20 The bill also provides that, on or after October 1, 2012, a
21 retailer will be presumed to be maintaining a place of business
22 in this state if the retailer has an agreement with one or
23 more residents of this state whereby the residents receive
24 consideration for referring potential customers to the retailer
25 through the internet, telephone, or in person, and those
26 agreements yield in excess of \$10,000 of gross receipts per
27 year. The presumption may be rebutted by a showing of proof
28 that the residents with whom the retailer has an agreement did
29 not engage in any activity within this state during the year
30 that was significantly associated with the retailer's ability
31 to establish or maintain the retailer's market in the state,
32 which proof may consist of sworn written statements stating
33 that the resident did not engage in any solicitation in this
34 state on behalf of the retailer during the year, so long as the
35 statement is provided and obtained in good faith.

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1 The bill provides that any ruling, agreement, or contract
2 entered into after the effective date of the bill between a
3 retailer and a state agency which provides that a retailer is
4 not required to collect sales and use tax in this state despite
5 the presence in this state of a warehouse, distribution center,
6 or fulfillment center owned and operated by the retailer or
7 an affiliate shall be null and void unless it is specifically
8 approved by a majority vote of both houses of the general
9 assembly. For purposes of this provision of the bill, "state
10 agency" does not include the general assembly or the judicial
11 branch.

12 The bill provides that no person shall make taxable sales
13 or furnish taxable services to a state agency unless that
14 person and their affiliates obtain a sales tax permit. Also,
15 the state is prohibited from purchasing taxable property
16 or services from any person unless that person and their
17 affiliates have a valid, unexpired sales tax permit and are
18 in compliance with all other sales tax laws imposed upon
19 retailers. For purposes of this provision of the bill, "state
20 agency" includes the executive branch, the general assembly,
21 and the judicial branch.