G.O.C. STAFF RULE ABSTRACT

AGENCY:	Department of Revenue
SUBJECT:	State Sales and Use Tax Rules
STATUTORY AUTHORITY:	Tenn. Code Ann., Section 67-6-402
EFFECTIVE DATES:	January 1, 2017 through June 30, 2017
FISCAL IMPACT:	Estimated increase in state and local revenue of at least $200 million per year when full compliance is reached.
STAFF RULE ABSTRACT:	The rulemaking hearing rule sets out sales and use tax registration and collection requirements for out-of-state dealers who regularly and systematically solicit business in Tennessee and who made more than $500,000 in sales in Tennessee during the previous 12-month period. These dealers must register for sales and use tax by March 1, 2017, and begin to collect and remit tax by July 1, 2017, or a later date set by the Department. An out-of-state dealer who meets the $500,000 threshold after March 1, 2017, must register and begin to collect tax by the first day of the third calendar month following the month in which the dealer met the threshold.

Public Hearing Comments

One copy of a document containing responses to comments made at the public hearing must accompany the filing pursuant to T.C.A. § 4-5-222. Agencies shall include only their responses to public hearing comments, which can be summarized. No letters of inquiry from parties questioning the rule will be accepted. When no comments are received at the public hearing, the agency need only draft a memorandum stating such and include it with the Rulemaking Hearing Rule filing. Minutes of the meeting will not be accepted. Transcripts are not acceptable.

Summary of the Department of Revenue's Responses to Public Comments

The State of Tennessee is heavily dependent on the sales tax for revenues. Internet sales continue to expand each year, resulting in ever increasing losses of sales tax revenue to Tennessee. Additionally, both Tennessee and out-of-state businesses that collect the sales tax are put at a competitive disadvantage with respect to businesses that do not. Out-of-state businesses that do not collect the sales tax have a nearly 10% price advantage over businesses that collect the tax, in addition to the benefit that many derive from in-state stores effectively functioning as show rooms for the products that out-of-state businesses sell.

This rule protects the State of Tennessee's tax base and fiscal health as remote sales continue to increase each year. This rule also ensures that the State's economy remains strong and that all businesses selling to Tennessee consumers compete on a level playing field.

The Department of Revenue received several comments in support of the rule filing and several comments opposing the rule filing. It also received comments that did not express support or opposition, but instead made specific inquiries or suggestions about the rule filing.

Almost all participants in the Rulemaking Hearing process provided comments on similar topics, which the Department has grouped into the following categories: 1) The question of the rule's constitutionality in light of the U.S. Supreme Court's decision in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992); 2) The balancing of in-state and out-of-state business interests; 3) The impact of the rule on Tennessee businesses and on small businesses; 4) The cost of compliance with the rule; 5) Whether the rule enacts a new tax; 6) The mechanics of the rule; 7) Potential litigation challenging the rule; and 8) The economic effect of the rule.

1. Constitutionality of the rule

A number of commenters addressed the constitutionality of the rule under the U.S. Supreme Court's decision in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992). In *Quill*, the Court held that North Dakota had violated the dormant Commerce Clause by requiring an out-of-state catalogue business with no physical presence in North Dakota to collect a use tax from its North Dakota customers, because that business lacked a "substantial nexus" with North Dakota.

Some commenters took the position that the rule is unconstitutional under *Quill*. These commenters asserted that the considerations motivating the Court's decision in *Quill* are still relevant; in particular, that the cost of complying with sales tax collection and remittance obligations in other jurisdictions remains burdensome and that Congressional action is still the preferred solution. Commenters thought it unlikely that the U.S. Supreme Court will overrule *Quill*. One commenter asked whether the rule impermissibly exceeds the scope of the Retailers' Sales Tax Act, given that the sales tax laws provide for the collection of sales tax within the bounds of the Constitution.

Other commenters asserted that the Court's reasoning in *Quill* is no longer applicable because, among other things, the cost of complying with collection and remittance obligations in other jurisdictions continues to decline, and, despite twenty-four years of effort, Congress has been unable to pass legislation authorizing states to require out-of-state sellers to collect and remit sales and use taxes. Commenters noted that, in a concurring opinion in *Direct Marketing Association v. Brohl*, 135 S. Ct. 1124 (2015), Justice Kennedy expressed doubt about the continued validity of the bright-line rule adopted in *Quill* given the significant technological and economic changes that have occurred in the decades following that decision.

Response:

The Department believes the proposed rule is permissible under the Commerce Clause. In *Quill*, the U.S.

Supreme Court held that North Dakota had created an unconstitutional burden on interstate commerce, in violation of the dormant Commerce Clause, by requiring an out-of-state catalogue business with no physical presence in North Dakota to collect a use tax from its North Dakota customers, because that business lacked a "substantial nexus" with North Dakota. In doing so, the Court adhered to its previous decision in *National Bellas Hess v. Department of Revenue*, 386 U.S. 753 (1967), while acknowledging that the physical-presence rule *Bellas Hess* adopted was "artificial" and inconsistent with the Court's "contemporary Commerce Clause jurisprudence." *Quill*, 504 U.S. at 311, 315. The Court reasoned that the physical-presence rule would relieve out-of-state vendors of the burden of complying with other jurisdictions' tax collection duties, *id.* at 315 & n.8, and that Congress had "the ultimate power" to determine "whether, when, and to what extent the States may burden interstate mail-order" companies with that duty. *Id.* at 318.

In the twenty-four years since the U.S. Supreme Court decided *Quill*, there have been a number of significant developments that cast serious doubt on the continued validity of *Quill*'s physical-presence rule. First, as Justice Kennedy recognized in his concurring opinion in *Brohl*, the "Internet has caused far-reaching systemic and structural changes in the economy" in the years since *Quill* was decided, and there is a strong case to be made that "a business may [now] be present in a State in a meaningful way without that presence being physical in the traditional sense of the term." 135 S. Ct. at 1135 (Kennedy, J., concurring). When *Quill* was decided, "mail-order sales in the United States totaled $180 billion," and "the Internet was in its infancy." *Id.* As of 2008, "e-commerce sales alone totaled $3.16 trillion per year in the United States." *Id.* As Internet sales have increased, it has become increasingly evident that the physical-presence rule gives out-of-state businesses an unfair competitive advantage over in-state retailers and deprives States—particularly Tennessee, given its heavy reliance on sales tax—of a significant source of revenue.

Second, the cost and burden of complying with collection and remittance obligations in other jurisdictions has decreased due to an increasing array of affordable software options, among other developments. Tennessee, in particular, has greatly simplified sales tax collection by offering retailers without a traditional physical location in the state the option of collecting sales tax at a single uniform rate and filing a single return.

Third, although the Administration has encouraged Congress for several years to enact fair and reasonable legislation that requires sales tax collection by out-of-state sellers, and would welcome such a solution, Congress has not enacted any of the various proposals put forward in the twenty-four years since *Quill* was decided.

Given these developments, the Department believes there is a strong possibility that the U.S. Supreme Court will distinguish or reconsider *Quill*, as evidenced by Justice Kennedy's express invitation for the "legal system [to] find an appropriate case for [the U.S. Supreme] Court to reexamine *Quill* and *Bellas Hess*." *Brohl*, 135 S. Ct. at 1135 (Kennedy, J., concurring). The Department believes that the out-of-state businesses to whom the proposed rule would apply plainly have a "substantial nexus" with the State of Tennessee and therefore may be required to collect and remit sales tax from their Tennessee customers. The rule applies only to out-of-state businesses that have more than $500,000 of sales in Tennessee; a business that conducts such a substantial amount of sales activity in the State clearly benefits from the State's market and customers and will not be unduly burdened by having to collect and remit sales tax to the State.

A summary of the Department's response to related comments on compliance burdens is provided below.

2. Balancing in-state business interests with out-of-state business interests

Commenters stated that there is an unfair competitive advantage that out-of-state retailers enjoy by being perceived as making sales to Tennessee customers "tax free." The commenters pointed out that the State is predominantly dependent on sales tax revenue and that this rule is necessary to protect the tax base.

Commenters also asserted that Tennessee retailers bear higher compliance costs as a percentage of their sales tax collected because in-state retailers handle transactions made via cash, check, and credit card, whereas out-of-state online retailers generally process transactions made only via credit card or via a centralized payment service.

Some in-state businesses commented that they would be harmed by the rule because it would lead to other states enacting similar rules that would require them to collect sales tax in those states.

Response:

The Department believes that this rule will put all retailers on a level playing field in collecting and remitting the sales and use tax.

The issue is ultimately not one of in-state business vs. out-of-state business. Numerous businesses with no physical presence in Tennessee have chosen to register with the Department and collect Tennessee sales tax. These businesses are also placed at a price disadvantage when compared to retailers who do not collect the tax. This rule levels the playing field for these out-of-state businesses as well.

With respect to the comments that in-state businesses would be harmed by the rule because it would lead to their having to comply with other states' laws, the Department has addressed the concern over other states' actions below. The Department respectfully suggests that it is not good public policy for a state to decline to enforce its own sales tax laws because some members of the public do not wish to comply with possible future requirements imposed on them by other states seeking to enforce their own laws.

3. Impact specifically on Tennessee businesses and on small businesses in general

Commenters stated that the rule is burdensome on Tennessee businesses and on small businesses in general because it will force them to incur significant costs to comply with varying laws in over 10,000 taxing jurisdictions.

Commenters stated that promulgation of the rule encourages other states to enact similar laws that might require Tennessee businesses to collect sales tax on their sales into those states, which would be burdensome. Additionally, commenters stated other states might enact similar laws with lower thresholds for economic nexus, which might impose a compliance burden on Tennessee small businesses.

Commenters stated that the rule will expose Tennessee sellers to audit by other state taxing agencies, and force Tennessee businesses to defend themselves in other states' courts against other states' audits.

Response:

This rule does not impact Tennessee businesses. Likewise, this rule does not impact small businesses, regardless of location.

First, this rule by its express terms applies only to out-of-state retailers selling into Tennessee. Retailers with a physical presence in Tennessee are already required to collect and remit the sales tax, and are thus not subject to any new requirements as a result of this rule. Importantly, this rule does not require Tennessee businesses to comply with the laws of even a single other jurisdiction – let alone the laws of over 10,000 other jurisdictions. Tennessee businesses will not incur a single dollar of cost to comply with this rule. This rule simply requires remote sellers to comply with the same laws that Tennessee retailers already comply with.

Second, this rule does not apply to small businesses with no physical presence in Tennessee. To be subject to the rule's registration and tax collection requirements, a seller must make more than $500,000 in sales into Tennessee in a twelve-month period. Given that it is very unlikely that a seller without a physical presence in Tennessee will make sales solely into Tennessee, out-of-state businesses who meet the $500,000 Tennessee threshold are likely to have total sales that far exceed that amount.

Third, this rule will not expose Tennessee sellers to audit by other states' taxing agencies. The rule contains no provision allowing another state to audit Tennessee sellers. Similarly, the rule contains no provision requiring Tennessee sellers to comply with the sales tax laws of other states. Because Tennessee sellers are not exposed to other states' audits by this rule, it follows that Tennessee sellers will not be forced to defend themselves in other states' courts as a result of audits.

Fourth, the Department is unaware of any other states that are actively planning to follow suit if Tennessee promulgates the rule. If other states are considering taking similar action, it is extremely doubtful that they would abandon their efforts in the absence of a similar rule in Tennessee. Other states will proceed with any intended plans regardless of whether Tennessee promulgates a rule or not.

Finally, it is simply not good public policy to decline to enforce Tennessee's tax laws based on conjecture that other states might later choose to enforce their own tax laws, and might choose to enforce them in a manner that

might be burdensome to Tennessee businesses.

4. Cost of Compliance

Commenters stated that affordable tax management software options are readily available from multiple vendors. They point out that online retailers have dedicated "shopping carts" for ease of application in calculating tax before the purchase. They believe that many retailers already have some form of software to address this issue in states in which they already have physical presence.

One commenter provided evidence stating that 24 studies were completed between 1956 and 1983. Those studies found that the median cost of collection during that period was 4.4% of sales tax collected. A 1993 survey found the average compliance cost in all states had declined to 3.18% of sales tax collected. A 1990 PriceWaterhouseCoopers study found a national average cost of compliance to be 3.48% of tax collected. This is a decrease of almost 25% from the prior studies and largely due to technological changes and advances in web-based solutions. The Joint Cost of Collection Study found that from 2004-2005, average gross compliance costs had decreased again to 3.09% of sales tax collected.

One commenter made reference to a study entitled Retail Sales Tax Compliance Costs: A National Estimate, Volume One: Main Report, prepared for Joint Cost of Collection Study, conducted by PricewaterhouseCoopers, April 7, 2006. At page 18, the study concludes that the cost of compliance for remote dealers operating under multiple states' laws is not greater than the cost of compliance of dealers operating in only one state. This study found that the weighted average costs for retailers collecting tax in only one state is 6.17%, compared with 1.94% for retailers filing in more than ten states.

One commenter stated that the cost of compliance would cost small and medium sized businesses "hundreds of thousands of dollars." Commenters stated that small and medium sized businesses will spend $80,000 to $290,000 in setup and integration costs, and $60,000 to $260,000 each year on maintenance costs.

One commenter stated that requiring out-of-state sellers to collect the sales tax imposes a disproportionate collection burden on out-of-state sellers.

Response:

Generally speaking, the Department believes that the evidence presented in the studies cited above indicates that the overall cost of complying with sales and use tax collection and remittance is not burdensome and continues to decrease because of technological advances, software availability, and sales tax simplification. The Department notes that thousands of Tennessee businesses already comply with state sales tax laws, and the Department has not received any information indicating that their cost of complying with Tennessee's laws is prohibitive.

Importantly, this rule does not require any seller – in Tennessee or outside Tennessee – to comply with over 10,000 taxing jurisdictions' laws. It requires only that sellers comply with Tennessee law. For remote sellers, Tennessee effectively has one single taxing jurisdiction with a single return. Under TENN. CODE ANN. § 67-6-702(f), remote sellers currently can opt to collect a single local tax rate of 2.25% in addition to the 7% state tax rate on all sales made in to the state in lieu of the local option rate applicable to the location of the purchaser. Remote sellers, whether they opt to use the single rate or not, will file a single sales tax return for all sales into Tennessee.

The Department respectfully does not find it credible that remote sellers will incur costs of $60,000 to $260,000 each year to comply with Tennessee's single jurisdiction approach. Likewise, the Department does not believe that remote sellers will incur compliance costs that are higher than the costs borne by in-state sellers, especially given that remote sellers (unlike in-state sellers) have the option of electing to collect the sales tax at a single rate and to remit it to a single jurisdiction.

5. Assertion that the rule creates a new tax

Commenters stated that this rule would be seen as, or is in fact, a new tax. Some of these commenters cited a recent poll of Utah residents as evidence of this assertion. One commenter noted that Tennessee's non-collection of the sales tax from remote sellers makes purchasers think that the sale is tax-free.

Commenters asserted that promulgation of the rule constitutes taxation without representation, because out-of-state sellers have no political power in the State of Tennessee.

Commenters also stated that the rule does not create a new tax, because the sales and use tax is already due on the sales covered by the rule.

Response:

The rule does not create a new tax. Since 1947, the sales and use tax has been due on all retail sales of tangible personal property or taxable items in Tennessee, unless exempt. This rule does not change current law. Instead, the rule simply ensures that all out-of-state retailers who make sales in Tennessee, above the $500,000 threshold, properly collect and remit the tax due under current law.

The Department strongly disagrees that promulgation of the rule constitutes taxation without representation. No state is limited to taxing only individual residents who are entitled to vote in the state. Rather, each state may tax individuals and entities that have sufficient nexus with the state, regardless of whether they are entitled to vote there.

The Department respectfully suggests that any perception among the public that enforcement of sales tax laws is the equivalent of imposing a new tax – whether in Tennessee, Utah, or elsewhere – is an issue of public education and not a reason to decline to enforce the law.

6. Mechanics of Rule 129

One group of commenters provided suggestions relating to the mechanics of Rule 129. These suggestions were related to concerns regarding the calendar year period during which the retailer determines that the $500,000 threshold is met (note that the rule was originally drafted to reference meeting the threshold during a calendar year, instead of during the previous twelve-month period).

These concerns included: whether the rule will pose compliance challenges to sellers who did not anticipate meeting the threshold during the calendar year, but did; whether such sellers will be required to retroactively collect the sales tax on all sales that calendar year; and, whether safeguards were in place against double remittance of sales tax and use tax on the same sale, if there is a retroactive collection requirement. Additionally, the commenter suggested lowering the threshold for registration from $500,000 to $100,000 if there is a retroactive collection requirement. One commenter expressed concerns that there may be a duplication of sales tax collected and use tax remitted if the seller had to retroactively collect and remit the sales tax due.

One commenter asked whether the Department would impose any type of penalty on retailers who do not comply with the rule.

One commenter suggested that the Department delay the registration requirement until July 1, 2017, in case the legislature does not approve the rule filing. One commenter asked if the Department would delay implementation of the rule if a request is submitted for an Attorney General Opinion on the issue of whether the rule is constitutional.

Response:

The Department thoroughly considered the comments regarding the calendar year period during which the retailer determines that the $500,000 threshold is met. The Department appreciates the points commenters made about compliance challenges that might be faced by sellers who did not anticipate meeting the threshold during the calendar year, but in fact did. In response to these comments, the Department revised the period for determining whether a seller has met the $500,000 threshold from the current calendar year to the preceding twelve-month period. As revised, the rule will require a seller who meets the threshold during that twelve-month period, unless otherwise exempt, to register with the Department and begin collecting the applicable sales tax prospectively. The Department notes that, with respect to any possibility of duplication of sales and use tax remittance, promulgating the rule as revised eliminates the possibility of double remittance due to a seller retroactively remitting the tax due.

The rule does not contain any special penalty provisions for failure to comply with the rule. Rather, retailers who fail to comply with the rule would be subject to any applicable penalties already in existence under current law.

The Department does not believe that it is necessary to delay the rule's registration requirement until July 1, 2017, in case the rule does not receive legislative approval. First, registration will be a very easy, quick process; the Department has developed a simple online registration form that will be available on its website for sellers to use. Second, no remote seller who complies with the rule is required to collect and remit Tennessee sales tax until July 1, 2017. If the rule does not receive legislative approval, remote sellers will have ample notice of that fact before July 1, 2017, and will be able to plan accordingly. Finally, agencies routinely promulgate rules that contain due dates and other requirements that come into effect before final legislative approval. Given that legislative approval is never a certainty with any rule, the Department does not believe that the circumstances surrounding this particular rule warrant a delay in the registration deadline.

The Department does not believe that it would be necessary to delay implementation of the rule if a request were submitted for an Attorney General's opinion on the issue of whether the rule is constitutional. The Department must obtain approval of the rule from the Attorney General before filing the rule with the Tennessee Secretary of State. Therefore, the Attorney General will have already reviewed and approved the rule by the time it is filed.

7. Potential Litigation

Commenters suggested that rather than promulgating a rule, the Department should wait for the outcome of litigation over remote seller requirements pending in other states (litigation cases are currently pending in South Dakota and Alabama).

One commenter asserted that the State has estimated the cost of litigating the constitutionality of the rule to be in the hundreds of millions of dollars. Additionally, the commenter said that if the state loses a legal challenge to the rule, the state will lose its options and the door will be closed to an important source of revenue. Similarly, the commenter asserted that if the state litigates the rule, it will lose hundreds of millions of dollars in needed tax revenues.

In general, commenters concerned about potential litigation suggested that the State should not use its resources to defend a lawsuit challenging this rule.

Response:

Because the sales tax is not currently collected by many out-of-state retailers, the loss of millions of dollars in revenue is already occurring each year. The Department has concluded that requiring collection, litigating, and losing a challenge would not leave the State in any different a position than it is in already. The Department does not believe that a legal challenge to the rule would foreclose any other options the State might have in the future for collection of sales taxes or that an adverse legal decision regarding this rule would prevent the State from pursuing other options in the future. On the contrary, if the rule is not upheld by the courts, the State will be in exactly the same position that it is in right now to pursue alternative means.

The Department strongly disagrees that this rule filing should be delayed because litigation is pending in other states. State tax law is unique and individual to each taxing jurisdiction; Tennessee's proposed rule differs from the rules and statutes that are being challenged in South Dakota and Alabama. The courts may issue decisions in the Alabama and South Dakota cases that might not apply to Tennessee's rule, in which case Tennessee would have lost years in resolving the issue. It is possible that the parties in the South Dakota and Alabama cases will settle out of court or dismiss their lawsuits, again resulting in time lost for Tennessee. The Administration also does not believe that Tennessee should entrust the viability of its primary revenue source to the lawyers and courts of other states, however competent they may be.

The Department notes that no evidence was presented in support of the assertion that defense of a possible litigation case will cost the state hundreds of millions of dollars, either in litigation costs or in lost revenues. The State of Tennessee currently loses millions of dollars in revenue each year due to its inability to require out-of-state sellers to collect the tax on their sales in Tennessee. The Department is not aware of any study that suggests that promulgating a rule that is challenged in court will lead to an increase in lost tax revenue during the challenge. As noted above, an adverse decision would put the state in no worse a position than it is in already.

The Administration also believes that the use of State resources is warranted in this case. Tennessee is heavily dependent on the sales tax for revenues, and lost revenues far exceed the State's costs to defend any possible litigation. The Department is not aware of any estimate by the State that the cost of litigating the rule will be in the

hundreds of millions of dollars, or even anywhere remotely near that amount. Additionally, the State is well equipped to defend a legal challenge to the rule. At any given time, the State is the defendant in numerous lawsuits involving state taxes, many of which are highly complex and involve very high dollar amounts. Given the amounts of revenue at issue, the Administration believes that the use of State resources is more than justified to ensure Tennessee's fiscal health.

8. Economic Effect

Commenters stated that the rule will not actually increase Tennessee's revenues. One commenter specifically said that no additional revenue would be gained because the rule filing simply moves money from Tennessee residents' pockets to state coffers.

Other commenters expressed concern that out-of-state businesses will cease selling products into Tennessee so as to avoid complying with the requirements of this rule. One commenter provided information indicating that imposing an "internet sales tax" will not significantly increase state tax revenues nationwide.

One commenter stated that most catalogue sellers are not competing with "Main Street" retailers because they sell specialty products that cannot be found in brick-and-mortar stores.

One commenter stated that the rule would likely force Tennessee to transfer its tax dollars to private companies running federally mandated software. Another commenter suggested that the State would incur hundreds of thousands of dollars in costs to implement compliance programs.

Other commenters stated that the rule filing strengthens Tennessee's economy by putting Tennessee retailers on a level playing field with out-of-state retailers. These commenters also stated that the rule will reduce the unfair advantage enjoyed by out-of-state retailers who have a price advantage due to not charging sales tax and by effectively using their in-state competitors as show rooms. Commenters stated that the sustainability of Tennessee businesses depends on fair competition and a level playing field.

Response:

The Department believes that the economic effect of the rule will be to strengthen Tennessee's economy by putting retailers who are already collecting the sales tax on a level playing field with those who are not. The State of Tennessee continues to lose an ever-increasing amount of sales tax revenues due to sales in which tax is not collected. The increased compliance with Tennessee's sales tax laws as a result of the rule will ensure that those revenues are no longer lost.

The Department does not find credible the assertion that no additional revenue would be gained because the rule simply moves money from Tennessee residents' pockets to state coffers. Following that logic, the State should act to repeal the sales tax in its entirety. Moreover, the purpose of the rule is not to fill a "coffer," but instead to pay for important services, such as public schools and public safety, that are provided to residents.

Similarly, the Department does not find credible the assertion that out-of-state retailers will cease making sales to Tennessee residents because of the rule. First, only sellers with more than $500,000 in sales into Tennessee are subject to the rule; it is inconceivable that sellers would en masse abandon over a half million dollars a year in sales to avoid complying with the rule. Second, no evidence was presented indicating that South Dakota and Alabama (the two states that have imposed collection requirements on remote sellers) have experienced any refusal by out-of-state companies to make sales to their residents.

With respect to the comment indicating that increased enforcement by states of their sales tax laws would not significantly increase state tax revenues nationwide, the Department notes that Tennessee is far more dependent on sales tax revenues than the typical state. Most states rely heavily on income taxes for revenue, and therefore experience a smaller overall percentage of lost revenues due to uncollected sales taxes. The Department believes that Tennessee will experience much higher than average increases in revenue due to promulgation of the rule, compared to typical states or on a nationwide scale.

The Department does not agree with the assertion that most catalogue retailers do not compete with "Main Street" businesses. While some catalogue retailers may in fact sell products that are not typically found in brick-and-mortar stores, a large number of catalogue retailers do in fact sell the same types of items. The Department

believes that the large majority of out-of-state sellers offer the same products as in-state sellers, and that there is in fact direct and unbalanced competition between the two groups.

The Department disagrees that the rule would likely force Tennessee to transfer its tax dollars to private companies running federally mandated software. The rule contains no requirement that would require the State of Tennessee to pay private companies for software, federally mandated or otherwise.

The Department also disagrees with the assertion that the State would incur hundreds of thousands of dollars in costs to implement compliance programs. The Department has not asked for any increase in its budget related to the rule. The Department is well equipped to handle any increase in registrations, return filings, and audits that might result from implementation of the rule. Additionally, the Department's recently acquired state-of-the-art integrated tax software system has all of the functionality needed to administer the rule.

The Department believes that the rule strengthens Tennessee's economy by putting Tennessee retailers on a level playing field with out-of-state retailers. The Department finds credible the assertion that out-of-state retailers currently have a price advantage due to not charging sales tax and by effectively using their in-state competitors as show rooms. Additionally, out-of-state sellers would be unable to deliver their products into Tennessee without its infrastructure, which is supported by the State's tax revenues. Out-of-state sellers who send products into Tennessee without contributing to the maintenance of the State's infrastructure enjoy an advantage over those sellers who do contribute.

Regulatory Flexibility Addendum

Pursuant to T.C.A. §§ 4-5-401 through 4-5-404, prior to initiating the rule making process, all agencies shall conduct a review of whether a proposed rule or rule affects small business.

(1) **Types of small businesses directly affected:**
The amendment of Rule 1320-05-01-.63 has no impact on small business. New Rule 1320-05-01-.129 does not apply to small businesses. To be subject to the rule's registration and tax collection requirements, a seller without a physical presence in Tennessee must make more than $500,000 in sales into Tennessee in a twelve-month period. Given that it is very unlikely that a seller without a physical presence in Tennessee will make sales solely into Tennessee, out-of-state businesses who meet the $500,000 Tennessee threshold are likely to have total sales that far exceed that amount.

(2) **Projected reporting, recordkeeping, and other administrative costs:**
The amendment of Rule 1320-05-01-.63 creates no added reporting, recordkeeping, and other administrative costs. New Rule 1320-05-01-.129 requires certain out-of-state dealers who currently do not collect Tennessee sales and use tax to register with the Department of Revenue and begin to collect and remit the tax. Additional reporting and recordkeeping costs for these dealers will depend on various factors such as whether the dealer files its own returns or uses a vendor, and whether the dealer already remits sales and use tax in multiple states. Compliance with Tennessee's sales and use tax is simpler than in many other states because these dealers would collect the uniform state rate and could opt to collect a uniform local rate, eliminating any administrative complexity of collecting multiple jurisdictional rates.

(3) **Probable effect on small businesses:**
These rules do not have a negative effect on small businesses. New Rule 1320-05-01-.129 has a positive impact on small businesses in Tennessee that directly compete with out-of-state dealers.

(4) **Less burdensome, intrusive, or costly alternative methods:**
There is no less burdensome, intrusive, or costly alternative method available outside of these rules.

(5) **Comparison with federal and state counterparts:**
Alabama and South Dakota have promulgated similar provisions. Alabama promulgated Sales and Use Tax Rule 810-6-2-.90.03, effective January 1, 2016, which imposes a collection obligation on out-of-state sellers who had $250,000 or more in retail sales sold into Alabama in the previous year and engage in one or more of the activities listed in Ala. Code § 40-23-68. South Dakota imposed similar requirements effective May 1, 2016, through South Dakota SB 106, whereby an out-of-state seller with no physical location within the state must remit sales tax if it has gross revenues from sales of tangible property, any products transferred electronically, or services delivered into South Dakota exceeding $100,000 or it has 200 or more separate transactions of tangible property, products transferred electronically, or services delivered into South Dakota.

(6) **Effect of possible exemption of small businesses:**
Small businesses are effectively exempted from New Rule 1320-05-01-.129, through application of the $500,000 threshold spelled out in the rule.

Impact on Local Governments

Pursuant to T.C.A. §§ 4-5-220 and 4-5-228 "any rule proposed to be promulgated shall state in a simple declarative sentence, without additional comments on the merits of the policy of the rules or regulation, whether the rule or regulation may have a projected impact on local governments." (See Public Chapter Number 1070 (http://state.tn.us/sos/acts/106/pub/pc1070.pdf) of the 2010 Session of the General Assembly)

As a result of increased compliance with local tax laws by out-of-state dealers, New Rule 1320-05-01-.129 will increase local revenue without any additional local expenditures or administrative burdens.

Additional Information Required by Joint Government Operations Committee

All agencies, upon filing a rule, must also submit the following pursuant to T.C.A. § 4-5-226(i)(1).

(A) A brief summary of the rule and a description of all relevant changes in previous regulations effectuated by such rule;

New Rule 1320-05-01-.129 sets out sales and use tax registration and collection requirements for out-of-state dealers who regularly and systematically solicit business in Tennessee and who made more than $500,000 in sales in Tennessee during the previous twelve-month period. These dealers must register for sales and use tax by March 1, 2017, and begin to collect and remit tax by July 1, 2017, or a later date set by the Department. An out-of-state dealer who meets the $500,000 threshold after March 1, 2017, must register and begin to collect tax by the first day of the third calendar month following the month in which the dealer met the threshold.

Rule 1320-05-01-.63 is amended by moving the content of subsection (2) to New Rule 1320-05-01-.129 for clarity and taxpayer convenience.

(B) A citation to and brief description of any federal law or regulation or any state law or regulation mandating promulgation of such rule or establishing guidelines relevant thereto;

No state or federal law or regulation requires the promulgation of New Rule 1320-05-01-.129 or the amendment of Rule 1320-05-01-.63. Tenn. Code Ann. §§ 67-1-102 and 67-6-402 give the Commissioner of the Department of Revenue the power to prescribe rules.

(C) Identification of persons, organizations, corporations or governmental entities most directly affected by this rule, and whether those persons, organizations, corporations or governmental entities urge adoption or rejection of this rule;

Out-of-state dealers making sales of more than $500,000 in Tennessee in any twelve-month period are subject to these rules and therefore directly affected by them. Local governments are also directly affected by these rules, because compliance with the sales tax laws has a direct effect on local tax revenues.

A number of out-of-state dealers that do not currently collect Tennessee sales tax have urged rejection of the rule. A number of in-state dealers who sell online into other states have urged rejection of the rule, expressing concern that other states might impose similar compliance requirements on them in the future.

A number of in-state dealers have urged adoption of the rule because of the unfair competitive advantage out-of-state dealers maintain by not having to collect and remit Tennessee's sales and use tax. Several local Chambers of Commerce have urged adoption of the rule. Certain retail associations have urged adoption of the rule. Every local government that has contacted the Department urges adoption of the rule because of increased local revenue projections.

(D) Identification of any opinions of the attorney general and reporter or any judicial ruling that directly relates to the rule or the necessity to promulgate the rule;

Judicial decisions that directly relate to the substance of the rule include the U.S. Supreme Court opinions in *Quill v. North Dakota*, 504 U.S. 298 (1992), and *National Bellas Hess v. Department of Revenue*, 386 U.S. 753 (1967). Judicial decisions that relate to the promulgation of the rule include *Direct Marketing Association v. Brohl*, 135 S. Ct. 1124 (2015).

The Attorney General and Reporter has not issued an opinion that directly relates to the rule.

In 1992, the U.S. Supreme Court in *Quill* held that North Dakota had created an unconstitutional burden on interstate commerce, in violation of the dormant Commerce Clause, by requiring an out-of-state catalogue business with no physical presence in North Dakota to collect a use tax from its North Dakota customers, because that business lacked a "substantial nexus" with North Dakota. In doing so, the Court adhered to its 1967 decision in *National Bellas Hess,* while acknowledging that the physical-presence rule *Bellas Hess* adopted was "artificial" and inconsistent with the Court's "contemporary Commerce Clause jurisprudence."

Justice Kennedy in his concurring opinion in the 2015 case *Direct Marketing Association v. Brohl* stated that the

"Internet has caused far-reaching systemic and structural changes in the economy" in the years since *Quill* was decided, and there is a strong case to be made that "a business may [now] be present in a State in a meaningful way without that presence being physical in the traditional sense of the term." Justice Kennedy expressly invited the legal system to find an appropriate case for the U.S. Supreme Court to reexamine *Quill* and *Bellas Hess*.

Given these developments, the Department believes that the out-of-state businesses to whom the proposed rule would apply have a "substantial nexus" with the State of Tennessee and therefore may be required to collect and remit sales tax from their Tennessee customers.

(E) An estimate of the probable increase or decrease in state and local government revenues and expenditures, if any, resulting from the promulgation of this rule, and assumptions and reasoning upon which the estimate is based. An agency shall not state that the fiscal impact is minimal if the fiscal impact is more than two percent (2%) of the agency's annual budget or five hundred thousand dollars ($500,000), whichever is less;

The Department estimates that the promulgation of the rule will increase state and local revenue by at least $200 million per year when full compliance is reached, with no additional state or local expenditures. Due to pending litigation in other states and potential litigation in Tennessee on this issue, it is unknown how many dealers will choose not to register and collect tax pending the outcome of the litigation.

(F) Identification of the appropriate agency representative or representatives, possessing substantial knowledge and understanding of the rule;

David Gerregano, Deputy Commissioner
Kristin Husat, Assistant Commissioner and General Counsel
Barbara Sampson, Assistant Commissioner

(G) Identification of the appropriate agency representative or representatives who will explain the rule at a scheduled meeting of the committees;

David Gerregano, Deputy Commissioner
Kristin Husat, Assistant Commissioner and General Counsel
Barbara Sampson, Assistant Commissioner

(H) Office address, telephone number, and email address of the agency representative or representatives who will explain the rule at a scheduled meeting of the committees; and

Office Address (all three representatives): Tennessee Department of Revenue, Andrew Jackson Building, 500 Deaderick Street, 11th Floor, Nashville, TN 37242

David Gerregano: (615) 532-8967; David.Gerregano@tn.gov
Kristin Husat: (615) 741-2348; Kristin.Husat@tn.gov
Barbara Sampson: (615) 532-6015; Barbara.Sampson@tn.gov

(I) Any additional information relevant to the rule proposed for continuation that the committee requests.

The Department of Revenue is not aware of any request for additional relevant information.