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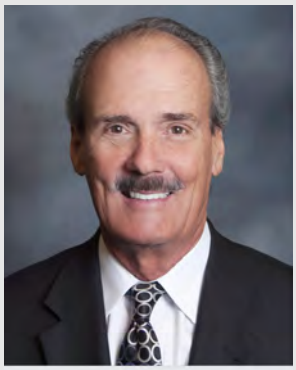

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In this article, the authors discuss Arizona's H.B. 2757, which created nexus standards for remote sales made into the state and will comment of whether Arizona's legislation meets the *Wayfair* guidelines.

Arizona H.B. 2757 created economic nexus standards for internet sales made into Arizona in response to the U.S. Supreme Court's decision in *South Dakota v. Wayfair Inc.*,[1] and took effect October 1. H.B. 2757 also requires marketplace facilitators (Amazon et al.) to collect the sales tax on behalf of sellers using the facilitator's platform. The new law preempts the retail classification for city sales taxes under the Model City Tax Code (MCTC).

Approximately 43 states have economic nexus laws, while 27 states have adopted rules regarding online marketplaces. With H.B. 2757, Arizona is one of the last states to jump on the *Wayfair* bandwagon and adopt economic nexus for both remote sellers and marketplace facilitators.

In *Wayfair*, the U.S. Supreme Court eliminated the decades-old physical presence nexus rule in favor of a more nebulous economic nexus standard to accommodate the age of online retailing.[2] The South Dakota law at issue established economic nexus — and the resultant tax collection obligation — for remote sellers that made $100,000 or more in sales or 200 individual transactions to customers in South Dakota. In overturning the physical presence standard, the U.S. Supreme Court favorably described several key factors of South Dakota's law, including:

- a single, statewide tax base;
- only two municipal tax rates;
- single state-level administration;
- a safe harbor for small sellers (the sales and transactions thresholds);
- prospective-only application; and
- South Dakota's adoption of the Streamlined Sales and Use Tax Agreement.

The SSUTA is a voluntary agreement aimed at standardizing state sales tax laws to ease compliance burdens on sellers. SSUTA member states are required to use single, standardized definitions of products and services, adopt simplified rate structures, and offer sellers access to tax administration software that limits the seller's audit liability.

Possibly hindering Arizona's efforts to adopt economic nexus is its transaction privilege tax (TPT) regime — the Arizona version of a sales tax — which is widely recognized as one of the most complex in the nation. The state uses different tax codes at the state and the municipal levels, and

[1] 138 S. Ct. 2080 (2018).

[2] Although the U.S. Supreme Court eliminated physical presence as a prerequisite for having nexus with a state, physical presence will still establish nexus.

while all cities and towns are required to use the MCTC, they have numerous options on what to tax within that framework. The state, counties, and municipalities can set their own rates, which can further vary depending on what activity is being taxed. Arizona is not a member of the SSUTA, and it only recently moved to centralized reporting and audits, although taxpayers may still be subject to single-jurisdiction audits in some circumstances.

Although the Arizona Legislature attempted to draft an economic nexus law that satisfies the *Wayfair* parameters, questions regarding the law's constitutionality remain. H.B. 2757 establishes safe harbors for small sellers, setting sales thresholds for both remote sellers and marketplace facilitators. The law applies only prospectively, including a phase-in period. And, as noted above, Arizona implemented state-level administration of all sales taxes in 2017. However, while the bill preempts the retail classification in the MCTC for tax base purposes, cities retain the ability to independently assess taxes on several categories of retail sales, and the bill does not address the plethora of tax rates. It also prohibits cities from requiring remote sellers and marketplace facilitators to obtain municipal TPT licenses, which is good but does not address the potential for a city-specific audit.

Finally, while H.B. 2757 adopts economic nexus rules, it does not appear to overrule or otherwise modify the old physical presence rules. Thus, out-of-state sellers should be aware that any in-state activities, such as the presence of salesmen attendance at a conference, could still establish nexus with Arizona, even if the remote seller or marketplace facilitator sales thresholds have not been met. The Department of Revenue needs to clarify its position on this issue.

Arizona's Economic Nexus Thresholds for Remote Sellers

A remote seller is defined as a person selling products for delivery into Arizona that does not have a physical presence in the state. Under H.B. 2757, a remote seller is required to collect and remit Arizona TPT on retail sales to customers in the state if sales exceed thresholds in the table either during the previous or current calendar year.

Arizona Remote Seller Nexus Thresholds by Year

Year	Sales Threshold
2019	$200,000
2020	$150,000
2021 and beyond	$100,000

The economic nexus law requires a remote seller to obtain a TPT license and begin collecting and remitting tax on the first day of the month that starts at least 30 days after the threshold is met. And the law requires the remote seller to continue collecting and remitting tax for the following calendar year, even if the sales threshold is not achieved (a concept known as "trailing nexus"). However, the remote seller would be permitted to cancel its TPT license for the following calendar year.

For example, if a remote seller had $130,000 in Arizona sales in 2019 and reached the threshold of $150,000 in Arizona sales on May 15, 2020, the seller would then be required to begin collecting tax on July 1, 2020. The seller is required by H.B. 2757 to continue to collect and remit TPT for the remainder of 2020 and all of 2021. If, however, the seller has only $90,000 in Arizona sales in 2021, it would be permitted to cancel its TPT license and cease collecting and remitting TPT in 2022. But if the remote seller exceeded the threshold midway in 2022, it would have to start the collection process again.

Several states have taken a more sensible approach. Rather than having an ongoing and rolling threshold that could be met during the tax year, these states make the threshold determination based on sales in the prior year. If the threshold was met in that year, the remote seller then begins collection from day 1 in the next year — that is, if a remote seller surpassed the threshold during 2019, it would begin collecting tax on January 1, 2020.

Economic Nexus for Marketplace Facilitators

H.B. 2757 statutorily adopts nexus rules for marketplace facilitators. Under the new law, a marketplace facilitator is a person that "facilitates a retail sale by a marketplace seller by listing or advertising for sale . . . in a marketplace tangible

personal property . . . regardless of whether the marketplace facilitator receives compensation" for its services. A marketplace is a physical or electronic space where tangible personal property is available for sale. A marketplace seller is a person making retail sales through a marketplace operated by a marketplace facilitator. The definition of marketplace facilitator does not include payment-processing businesses like credit card companies. Finally, the definition of sale is amended to include "transactions facilitated by a marketplace facilitator on behalf of a marketplace seller."

Marketplace facilitators will have economic nexus with Arizona if they have $100,000 or more in annual sales to Arizona customers through at least one marketplace seller. A marketplace facilitator that facilitates no sales for third parties would instead be considered a remote seller, subject to those thresholds. As with individual remote sellers, marketplace facilitators must obtain a TPT license and begin collecting and remitting tax on the first day of the month that starts at least 30 days after the threshold is met, and the one-year trailing nexus provision also applies.

Marketplace facilitators must collect and remit retail TPT on sales made through the marketplace, whether by the marketplace facilitator or by a marketplace seller. Additionally, sales of tangible personal property by marketplace sellers that are facilitated by a marketplace facilitator when the marketplace facilitator is required to collect and remit tax are specifically exempted under the state retail classification. When reporting TPT to the DOR, marketplace facilitators can either report all sales made through the marketplace on one combined tax return or report its sales separately from marketplace sales on two different returns.

Effective Dates

The new nexus rules for remote sellers and marketplace facilitators officially took effect on October 1. However, the law specifies that the sales thresholds are based on sales during the calendar year — not sales made after the new law takes effect. This means that businesses that meet the definition of a remote seller or marketplace facilitator must look back at all their sales to Arizona customers starting January 1, 2019. If the threshold has already been met, these sellers should prepare to collect tax starting October 1.

Audits and Assessments

Marketplace facilitators and remote sellers are eligible for some limitations of liability during 2019 and 2020, as explained below. The DOR will determine how a marketplace facilitator or remote seller can claim the liability relief, and it may waive penalties and interest if it finds reasonable cause exists, but only if the marketplace facilitator or remote seller actually paid tax during the period in question. Additionally, H.B. 2757 states that an audit of a marketplace facilitator cannot automatically trigger the audit of a marketplace seller.

Although Arizona centralized its audit procedures in 2013, eliminating the potential for multiple audits by different cities and a separate state audit, it is possible that remote sellers and marketplace facilitators may still be subject to city-directed audits. Cities are permitted to request from the DOR the authority to audit taxpayers doing business in only that jurisdiction. It is unclear how the department would view such requests regarding remote sellers or marketplace facilitators, but it is our understanding that the DOR has yet to turn down such a request.

Limitations on Liability for Marketplace Facilitators and Remote Sellers

Marketplace Facilitators

A marketplace facilitator will not be liable for a failure to remit the correct amount of TPT on a sale made by a marketplace seller if the failure was a result of incorrect information provided by the marketplace seller or another non-sourcing error. In both cases, the marketplace facilitator and marketplace seller cannot be affiliated persons as defined by the statute (generally, common ownership of 5 percent or more).

The protections for a marketplace facilitator are capped, however. The relief is limited to 5 percent of the total tax due for 2019, 3 percent of the total tax due for 2020, and 0 percent of the total tax due in 2021 and beyond.

Remote Sellers

Remote sellers are not liable for failing to pay the correct amount of TPT if failure to pay was because of an error other than an error in sourcing. As with marketplace facilitators, there are limits on the protection available: 5 percent of the total tax due for 2019, 3 percent of the total tax due for 2020, and 0 percent of the total tax due in 2021 and beyond.

Effect on the MCTC: State Preempts the City Retail Classification

One of the key factors contributing to the *Wayfair* decision was South Dakota's relatively simple sales tax regime: It had one statewide tax base and only two tax rates. South Dakota is also a member of the SSUTA. By contrast, Arizona is not an SSUTA member and its TPT is considered highly complex, due in no small part to the municipal autonomy embodied in the MCTC.

With that in mind, H.B. 2757 adopts several provisions aimed at simplifying the retail sales tax for remote vendors and marketplace facilitators:

- The state-level retail classification (A.R.S. section 42-5061) now supersedes all city or town ordinances, including MCTC section 460 (the municipal retail classification), with exceptions. In other words, the state finally was successful in preempting the MCTC's retail classification.
- A city or town cannot require a person or business to obtain a municipal TPT license merely because that person or business has exceeded the economic nexus thresholds as either a remote seller or a marketplace facilitator.
- The municipal tax rate applicable to marketplace facilitators will be the municipal retail tax rate in effect in that city or town.

Municipalities are still permitted to impose local sales taxes on the following:

- some sales of food at retail;
- selling textbooks required by a state university or community college;
- some sales to agricultural, horticultural, viticultural, floricultural, farming, ranching, livestock feed, and livestock breeding businesses, if the tax was already levied on or before May 1, 2019;
- sales of nonmetalliferous mined materials;
- in-state sales of fine art to nonresidents who ship the art out of state; and
- some sales of motor vehicles to nonresidents and members of Native American tribes.

Cities are permitted to exempt sales of fine art, if the sale is made by the original artist.

Finally, the legislative intent section of the bill states that the state Legislature will not enact legislation to preempt other classifications under the MCTC for five years following the effective date, to provide "stability to adapt to and implement the new regulatory structure created by" H.B. 2757.

Pre-*Wayfair* Economic Nexus: Marketplace Facilitators

H.B. 2757 represents a departure from the online marketplace policy the DOR adopted in 2016. In Arizona Transaction Privilege Tax Ruling TPR 16-3 (Sept. 20, 2016), the department ruled that a retailer subject to Arizona's TPT included a business that operated an online marketplace, if the business provided:

- the e-commerce infrastructure used by individual sellers to make sales into Arizona;
- a primary point of contact for general customer service, including providing customers with information on their orders, order confirmations, shipment notifications, delivery notifications, and refund status;
- payment-processing services, including any refund processing; and
- marketing of the online marketplace under a single brand (that is, the brand itself is marketed, rather than each merchant listed on the marketplace).

Notably, TPR 16-3 did not purport to establish nexus for any online marketplace business that did not already have nexus with the state.

Does Arizona's Economic Nexus Law Satisfy *Wayfair*?

One of the biggest challenges in the post-*Wayfair* world is determining whether an economic nexus law does in fact pass

constitutional muster. Although the U.S. Supreme Court used *Wayfair* to eliminate the physical presence rule, it did not create a new nexus rule. Rather, it favorably described South Dakota's, while laying out some constitutional considerations and explicitly noting that some economic nexus laws may violate the commerce clause.

Whether a state tax on interstate commerce is permissible requires a four-part analysis articulated in *Complete Auto*,[3] under which a tax is constitutional if it:

- applies to activity with a substantial nexus to the state;
- is fairly apportioned;
- does not discriminate against interstate commerce; and
- is fairly related to the services the state provides.

Wayfair addressed only the substantial nexus prong of the *Complete Auto* test, noting that a business may be present in a state in a meaningful way without that presence being "physical in the traditional sense." The Court held that substantial nexus exists when a taxpayer "avails itself of the substantial privileges of carrying on business" in a state, and that such nexus could be established through economic and virtual connections, as well as physical ones.

The Court also took care to point out that not all economic nexus laws will pass the *Complete Auto* test, particularly regarding the third prong, that the tax does not discriminate against interstate commerce. This prong typically demands that a state's tax law not place any undue burdens on interstate commerce. While the Court pointed out aspects of South Dakota's law that indicated that there was no undue burden on interstate commerce, such as the thresholds and SSUTA membership, it did not explicitly address this prong or articulate any sort of rule for economic nexus laws.

Whether Arizona's economic nexus law passes the *Complete Auto* test remains to be seen. Although H.B. 2757 features protections for small sellers, Arizona is not a member of the SSUTA. Preempting the retail classification of the MCTC is a significant step, but H.B. 2757 does not address the plethora of local rates, and the cities' continued authority to tax some sales, and their power to audit.

Finally, the U.S. Supreme Court also favorably cited that South Dakota's law applied prospectively only. By contrast, while Arizona's law nominally took effect on September 30, it defines its sales thresholds based on the calendar year, with no carveout for sales made before the law's effective date. This means that sellers that now meet the definition of a remote seller or marketplace facilitator must look back at all sales to Arizona customers starting January 1, 2019, to determine if they surpass the nexus threshold. While not a true retroactivity provision, this requirement appears to conflict with the spirit of the Supreme Court's "prospective application only" directive.

Caution for Software Providers

Like many states, Arizona considers software to be tangible personal property generally subject to tax regardless of the method of delivery, although custom software applications designed for a customer are exempt. However, whether software is taxable under the retail classification or the personal property rental classification depends on the terms of the software license: A perpetual license is considered a sale subject to tax under the retail classification, while a license for a definitive term (whether or not it can be renewed) is considered a lease subject to tax under the personal property rental classification.

It is possible that out-of-state software providers could establish nexus with Arizona, either as remote sellers under the new economic nexus thresholds or under the traditional physical presence analysis. Because the DOR considers software to be tangible personal property, the download of the software by an Arizona customer onto its computer could establish nexus. As such, software providers might find that the department considers them to have nexus with Arizona even without meeting the remote seller sales thresholds. This is a potential issue that calls for a resolution.

Additionally, out-of-state software providers may find themselves subject to taxation under multiple classifications. As noted above, Arizona

[3] *Complete Auto Transit Inc. v. Brady*, 430 U.S. 274 (1977).

distinguishes between perpetual and renewable software licenses, and taxes them under different classifications, and H.B. 2757 only preempts the MCTC regarding the retail classification — the city-level personal property rental classification is still in effect. Out-of-state software providers may thus find themselves subject to multiple sets of tax rules: the state-level retail laws on their perpetual software licenses (but no local rules, as H.B. 2757 preempts the local retail classification) and both state and municipal taxation on their renewable software licenses. This undermines the Legislature's attempts at simplifying the tax structure for remote businesses. And whether a fix is possible is an open question — the legislative intent section of H.B. 2757 states that it will not act to preempt other classifications under the MCTC for five years. ■