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UPDATE: Massachusetts Department of Revenue Releases Proposed Regulation Requiring Large Out-of-State Internet Vendors to Collect Massachusetts Sales Tax

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Our previous QuickStudy published on July 14, 2017, discussed the swift revocation of Directive 17-1 by the Massachusetts Department of Revenue ("DOR") following a ruling from the Massachusetts Superior Court that Directive 17-1 was invalid on procedural grounds because in substance it was a regulation that the DOR had issued without following the notice and comment procedures applicable to agency regulations under the Massachusetts Administrative Procedure Act, M.G.L. c. 30A ("APA"). Directive 17-1 would have imposed a bright-line sales tax nexus standard requiring all out-of-state internet vendors that in the prior taxable year had greater than $500,000 in Massachusetts sales and had 100 or more sales transactions with delivery in Massachusetts to collect and remit sales and use tax on their Massachusetts sales beginning on July 1, 2017. It was revoked by Directive 17-2 on June 28, 2017, only several days before its effective date.

The DOR indicated in Directive 17-2 that while it was revoking Directive 17-1, it expected to issue proposed regulations that, if adopted, would require large out-of-state internet vendors to collect Massachusetts sales and use taxes under similar standards, and relying on a similar legal rationale, as those present in Directive 17-1.

On July 28, the DOR made good on its promise and released proposed regulation 830 CMR 64H.1.7, generally requiring all out-of-state internet vendors that in the prior taxable year had greater than $500,000 in Massachusetts sales and had 100 or more sales transactions with delivery in Massachusetts to collect and remit sales and use tax on their Massachusetts sales beginning on October 1, 2017. The proposed regulation reiterates the legal rationale originally contained in Directive 17-1 (and discussed in our previous QuickStudy "Massachusetts Department of Revenue Adopts a Novel Administrative Position Requiring Large Out-of-State Internet Vendors To Collect Massachusetts Sales Tax – Will Other States Adopt the Same Position?") but provides persons and businesses affected by the new regulation with the opportunity to comment. The DOR has scheduled a public hearing on the proposed regulation for August 24 in Boston, and it has encouraged the submission of written comments prior to the scheduled hearing, in order to comply with the requirements of the APA.

The proposed regulation imposes its bright-line sales tax collection obligation based on a stated presumption that "invariably" out-of-state internet vendors who exceed the sales thresholds have an in-state physical presence through (i) the use of in-state software and ancillary data (e.g., "cookies") which are distributed to or stored on the computers or other devices of a vendor's in-state customers, (ii) contracts or other relationships with content distribution networks resulting in the use of in-state servers or the receipt of other related in-state services, and/or (iii) contracts or other relationships with online marketplace facilitators resulting in in-state services such as payment processing or order fulfillment. However, unlike Directive 17-1, the proposed regulation does not make this a binding presumption because the tax collection obligation "does not apply" to internet vendors that do not actually have any of the three specified types of contacts. As an example, the proposed regulation cites an internet vendor whose only contact with the state is that Massachusetts customers may access a site on the internet vendor's out-of-state computer server.

Also unlike Directive 17-1, the proposed regulation specifically addresses non-internet vendors. The regulation states that if a non-internet vendor has the types of Massachusetts contacts presumed to exist for internet vendors, then that non-internet vendor will generally be required to collect and remit sales and use tax on its Massachusetts sales. However, "[t]he jurisdictional analysis in these cases is a facts and circumstances test," which is a far different standard than the presumption applied to internet vendors.

The proposed regulation preemptively asserts several counterarguments to potential challenges. As we discussed in our previous QuickStudies, one potential challenge is that the regulation's approach violates the Internet Tax Freedom Act ("ITFA"), which is designed to prevent state governments from discriminatorily taxing e-commerce by imposing a higher tax burden on internet sales when compared to sales made by other means. Directive 17-1 did not address ITFA, but the proposed regulation recites that it is non-discriminatory because it asserts jurisdiction over all vendors (internet or non-internet) that have the specific contacts identified in the regulation, and applies the same jurisdictional standards to all vendors that are otherwise subject to tax. While this may be true on its face, it remains unclear how a mail-order retailer would ever have an in-state physical presence via the use of "cookies" or software, the linchpin of the new regulation's nexus presumption. Moreover, the regulation presumes that all internet vendors who exceed the bright-line standard have nexus but the regulation does not apply the same presumption to non-internet vendors. That differing treatment arguably is facially discriminatory.

The proposed regulation also preemptively responds to an attack on constitutional grounds by stating that the regulation's provisions are enforced to the extent allowed by the "physical presence" dormant Commerce Clause standard as set forth in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992). *Quill* held that under the dormant Commerce Clause of the United States Constitution, a state could not require an out-of-state vendor making sales delivered via common carrier to collect its sales tax unless the vendor also had an in-state physical presence. The proposed regulation states that unlike the mail order vendor at issue in *Quill*, internet vendors with a large volume of in-state sales invariably have one or more contacts with the state that constitute the requisite physical presence by the use of software and "cookies" that are downloaded onto computers or other devices by consumers located within the state in order to buy products online. The DOR charts new tax law territory in claiming such computer based items are a substantial physical presence as required by the Supreme Court in *Quill*.

While the DOR's proposed regulation may satisfy the APA procedural requirements, it seems highly likely that large out-of-state internet vendors will again bring suit to challenge the legal rationale of the regulation, which the Massachusetts Superior Court did not address in its previous ruling. The DOR is likely prepared for and expecting future lawsuits from affected vendors, as the proposed regulation contains substantive refinements and legal justifications seemingly added as defensive measures.

For more information on the matters discussed in this *Locke Lord QuickStudy*, please contact the authors.

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