

The Project approved sending this paper to the Implementing States in the July 11, 2002 meeting.

STATE AND LOCAL TAX COLLECTION LIABILITY CUSTOMER REMEDY PROCEDURES

Issues:

Vendors collecting state and local sales and use taxes face two main liability risks. First, if vendors fail to collect sufficient tax, they face liability risks attributable to audit assessments. Second, if vendors over-collect or collect for the wrong jurisdiction, they face potential actions and lawsuits filed on behalf of customers or pursuant to consumer protection statutes. These lawsuits can name state and local governments as codefendants.

The Streamlined Sales Tax Agreement as amended on January 24, 2001 addresses the first liability risk. Section 308(c) provides that:

The member states must relieve sellers and Certified Service Providers from liability to the State or local jurisdictions for having charged and collected the incorrect amount of sales or use tax resulting from the seller or Certified Service Provider relying on erroneous data provided by a State on tax rates, boundaries, or taxing jurisdiction assignments...

The agreement does not address actions and lawsuits filed on behalf of customers or pursuant to consumer protection statutes. Vendors may not volunteer to collect state and local taxes if they face these risks as a result of relying on sate-state provided data. Also, expanding the number of jurisdictions to which the vendor complies increases the vendor's potential liability risk. It is in the interest of both State and Local Governments and Vendors to address the liability risks resulting from complying with state and local tax provisions. This is particularly true because some Streamlined Sales Tax Project provisions may provide a “roadmap” to those seeking to bring actions on behalf of a class.

This paper reviews the factors causing these risks, current state and local provisions to address these risks, and a recommended solution for consideration by the project.

Background:

Customer liability actions relating to collection and administration of state and local sales taxes fall under three main categories: jurisdictional rate assignments, sourcing conventions and product/service taxability.

Jurisdictional Assignments

Vendor^s utilizing nine digit zip code databases, and exercising due diligence to maintain such databases, are held harmless from additional audit liability. However, these databases, even with the best information, may not accurately assign all addresses to the proper jurisdiction. For example, new real estate developments, new municipal incorporations and boundary annexations create situations where the databases may not have information on addresses to determine the proper taxing jurisdiction. Knowledge of these shortcomings will give a roadmap to those filing actions on behalf of customers against both the vendor and the tax jurisdictions. For example, actions can focus on potential over-collections in tax when new addresses are placed in

jurisdictions based on postal zip codes that do not match the actual taxing jurisdiction boundaries.

Sourcing Conventions

Vendors of transactions that cross multiple jurisdictions often must source the transaction to only one taxing jurisdiction. Allegations in customer actions have asserted that the vendor incorrectly assigned the transaction to a tax jurisdiction. For example, the vendor may have sourced the transaction on a destination basis and the action asserts that the vendor should have used the origination basis. Uniform rules for sourcing transactions under the model agreement should minimize the assertions. However, they will still exist to the extent that non-participating states maintain differing rules.

Product/Service Taxability

Traditional “Brick & Mortar”, multi-state retailers, and more recently “dot.com” companies are facing lawsuits due to alleged incorrect application of tax to certain products and services. For example, a retailer’s system may apply sales taxes to shampoo products, some of which treat dandruff. In some jurisdictions the statute could be interpreted to exempt this product as a medicine, while other jurisdictions treat the same shampoo as taxable. The risk of lawsuits could increase when a vendor uses certified taxability software by providing documentation to those filing lawsuits of perceived errors in interpretations.

Another fact pattern results from the bundling of two or more services or products for one aggregate charge. Due to variances in the tax base across states, the taxability of the various components of the bundle can vary. Some states require the vendor to apply tax to the whole charge on the theory that the inclusion of a taxable service or product makes the entire charge taxable. Actions filed on behalf of customers assert that the vendor should not have collected tax on the non-taxable components.

Impact on Vendors and Taxing Jurisdictions

Vendors often successfully defend against these actions because they used due diligence and remitted the funds to the taxing jurisdictions. Vendors do not benefit from any over collection because they remitted the taxes collected to the taxing jurisdictions. However, the successful defense is not without costs to the vendor. These costs can add up to significant amounts for large vendors, often the prime target due to their sales volumes and size of their customer base. For example, one vendor reported spending in excess of \$1.5 million for outside legal counsel and thousands of hours of internal staff time to successfully defend against an action arising over a \$5.00 tax overpayment that was refunded to the customer.

Exposure to lawsuits will increase the cost of collection and will discourage some vendors from voluntarily collecting state and local sales and use taxes. Some vendors have seen actions from customers arising from assertions that they improperly collected tax on a transaction in a jurisdiction where they supposedly had no nexus. State and local jurisdictions can also face class action lawsuits. In *Arizona Department of Revenue v. Bernard J. Dougherty* (29 P.3d 862), one question before the court was whether, as a prerequisite to participating in a class action asserting a claim for refund, each taxpayer must file an individual claim with the Department. The Arizona Supreme Court held that class action lawsuits against the State were permitted in Tax Court and that class action lawsuits are a suitable vehicle for taxpayers to exhaust administrative remedies.

Recommendation:

The Streamlined Sales Tax Project recommends that the purchasers be required to file a claim with a seller in an attempt to resolve an overpayment of tax before proceeding with a lawsuit against the seller. This recommendation would not deprive the purchaser of recourse against an adverse determination of the vendor. This recommendation attempts to balance the rights of purchasers, vendors, and state and local governments. See Attachment A for proposed Agreement language.

Current State, Local and Federal Protections:

Discussion:

Current federal, state and local statutes provide a range of methods for addressing the risk that vendors face in collecting and remitting transaction taxes. They range from outright prohibitions of using class action lawsuits for refunds of tax to procedures that customers must follow to claim a refund before they take any other action. The following section briefly reviews some of the existing provisions.

California – Public Utilities Code §799(a)

The statute was enacted to clarify the duties and responsibilities of public utilities and other service suppliers to collect taxes imposed on their customers by local jurisdictions and to remit those taxes to the local jurisdictions. In relevant part the statute provides that:

(a) ~~With respect to all taxes enacted by any local jurisdiction ... which taxes have been collected by the public utilities and other service suppliers and remitted to the local jurisdiction all of the following shall apply: ...~~

(2) ~~In connection with any actions or claims relating to or arising from the invalidity of the tax ordinance, in whole or in part, the public utility or other service supplier shall not be liable to any customer as a consequence of collecting the tax.~~

...

(4) ~~In any action seeking to enjoin collection of taxes imposed on customers of utilities or other service suppliers and collected by the utilities or other service suppliers, in any action seeking declaratory relief concerning the taxes, in any action ... seeking a refund of the taxes, or in any action seeking otherwise to invalidate the taxes, the sole necessary party defendant in the action shall be the local jurisdiction on whose behalf the taxes are collected and ... the public utility or other service supplier collecting the taxes shall not be named as a party in the action.~~

Florida – (§202.23)

The Florida communications tax contains an exclusive remedy provision for purchasers to follow in seeking a refund of tax. Similar language providing a first course of remedy has been enacted in several states, for wireless telecommunications providers, that conforms to the Mobile Telecommunications Sourcing Act. The states include: Alabama, Arizona, Arkansas, Colorado, Connecticut, Delaware, Illinois, Indiana, Kentucky, Louisiana, Nevada, North Dakota, Oklahoma, and Texas, Virginia, Washington, and Wyoming. Eight additional states have legislation pending with a similar provision. Common features include a time frame within which sellers have to refund any over

collected tax to customers or notify them of a denial of the claim. Customers must follow the remedy procedures before they can pursue a cause of action against the seller.

Maryland – Hooks v Comptroller, 265 Md380, 289A.2d 332

In Hooks v Comptroller the court held the class action lawsuits are prohibited for refunds of sales tax.

New Jersey – §54:49-14(c)

Section 54:49-14 sets forth procedures for refund claims under the state sales and use tax. This section prohibits refund claims on behalf of a class.

§54:49-14(c) Each taxpayer shall file a separate refund claim. A refund claim on behalf of a class is not permitted.

Federal – IRC

§6332(e)

This section provides that a person who honors a levy is discharged from any obligation to the taxpayer or any other party arising from honoring the levy.

§3403:

This section provides that *"The employer shall be liable for the payment of the tax required to be deducted and withheld under this chapter, and shall not be liable to any person for the amount of any such payment."*

Customer Refund Procedures

- (1) These customer refund procedures apply only when a state allows a purchaser to seek a return of over-collected sales or use taxes from the seller.
- (2) Nothing in this section shall either require a state to provide, or prevent a state from providing, a procedure by which a purchaser may seek a refund directly from the state arising out of sales or use taxes collected in error by a seller from the purchaser. Nothing in this section shall operate to extend any person's time to seek a refund of sales or use taxes collected or remitted in error.
- (3) These customer refund procedures provide the first course of remedy available to purchasers seeking a return of over-collected sales or use taxes from the seller. A cause of action against a seller for the over-collected sales or use taxes does not accrue until a purchaser has provided written notice to a seller and the seller has had sixty days to respond. Such notice to the seller must contain the information necessary to determine the validity of the request.

NOTE: In connection with a purchaser's request for a return from a seller of over-collected sales or use taxes, a seller shall be presumed to have a reasonable business practice, if in the collection of such sales or use taxes, the seller: i) uses either a provider or a system, including a proprietary system, that is certified by the state; and ii) has remitted to the state all taxes collected less any deductions, credits, or collection allowances.