100 Congress Building
100 Congress Avenue
Suite 1900
Austin, TX 78701
Tel.: 512.476.0022
Fax: 512.476.0033

ryan.com

VIA ELECTRONIC MAIL: Paige.Higerd_HC@house.texas.gov

September 14, 2020

Honorable Dustin Burrows
Chair
Committee on Ways & Means
Texas House of Representatives
Extension - Room E2.116
1100 Congress Avenue
Austin, Texas 78701

Re: Request for Information; Interim Charge 3 – Local Option Sales Taxes

Dear Chair Burrows:

We hereby submit the following information relating to Interim Charge 3, which provides:

> Study the role of the local option sales and use tax, including: an analysis of the available uses for those taxes, specifically economic development agreements; the statewide distribution of local tax rates; the proportion of the local government budget supported by sales and use taxes; the application of consistent sales sourcing rules; and the impact of shifting from origin to destination sourcing.

Headquartered in Dallas, Ryan is the world's largest firm focused primarily on corporate tax services. Among other services, we provide sales and use tax consulting and audit defense to hundreds of taxpayers in virtually every sector, including oil and gas, retail, manufacturing, healthcare, telecommunications, transportation, technology and utilities. Local sales and use taxes represent a substantial expense and/or compliance burden for these taxpayers.

The Texas Comptroller of Public Accounts ("Comptroller") recently adopted amendments to 34 Tex. Admin. Code § 3.334 (Local Sales and Use Taxes). We provided written comments and testified at a public hearing on February 4, 2020, expressing our concerns about the myriad changes the Comptroller proposed regarding local tax administration, most of which would result in a shift from origin- to destination-based sourcing. The Comptroller adopted the rule, with some changes, effective May 31, 2020. The adopted rule phases out most of the benefits of certain pre-existing economic development agreements by shifting from origin- to destination-based sourcing by

September 1, 2024.[1] Otherwise, major shifts from origin- to destination-based sourcing take effect on October 1, 2021.[2] For the reasons we provided to the Comptroller, we believe several provisions of Rule 3.334 are unsupported by law and possibly violate the Internet Tax Freedom Act.

Because Interim Committee Charge 3 portends changes in the law regarding sourcing of local sales taxes, we wish to advise the Committee of the history of origin-based sourcing, the effect of the Internet Tax Freedom Act, the cost of compliance with a new system of sourcing, and the impact such a change would have on economic development in Texas.

Origin-Based Sourcing is the Rule in Texas

Sourcing local sales tax based on the seller's place of business, as opposed to the place of delivery of goods or services to the customer, has long been the standard rule in Texas. Current Tex. Tax Code § 321.203 (Consummation of Sale) sets forth general rules for sourcing local sales tax to the place of business of the seller where the order for a taxable item is received, with certain exceptions. Tex. Tax Code § 323.203 applies the same guidelines for county sales taxes.

In the past, transit sales taxes were the exception, and were administered on a destination basis (*i.e.*, they were due only if the purchaser took delivery of a taxable item inside the boundaries of a transit authority). However, the Legislature converted transit tax to an origin-based tax in 2007. See House Bill 142 (80th Leg.), which made the transit tax consistent with city and county taxes. The House Research Organization's analysis of the bill directly addresses the underlying principles of origin-based sourcing:

> HB 142 would conform sales-and-use tax law governing small retailers[3] in transit districts with laws governing retailers in other taxing jurisdictions. ***Typically, when a retailer sells and ships a product to a purchaser living outside that jurisdiction, sales-and-use taxes are assessed on a "point of origin", or point of sales, basis. This presumption is reasonable, given that the originating jurisdiction most likely is the one providing the services that support the retailer's business.***

As set forth above, origin-based sourcing is designed and intended to compensate local taxing jurisdictions for the government services they provide in support of the retailer's business. Obviously, these include emergency medical, fire and police services as well as infrastructure. Advocates for destination-based sourcing assert that local taxes should support government services provided to the purchaser of a taxable item, as opposed to the business of the seller. Determining whose local jurisdictions (the seller's or the purchaser's) should benefit from local

[1] Rule 3.334((c)(3) (which grandfathers economic development agreements entered into before January 1, 2009).
[2] Rule 3.334(b)(5).
[3] The original version of the bill carved out small retailers for origin-based sourcing. Before its eventual adoption, the bill was revised to apply to all retailers in Texas.

taxes is a policy decision for the Legislature; however, we note that a shift to destination-based sourcing would represent a major change in policy rather than a continuation of prior policy.

It is also worth noting that Texas previously experimented with destination-based sourcing when it changed the law to provide that the sale of a taxable service was consummated in the local jurisdiction where the service was performed, regardless of the location of the seller's place of business. See House Bill 2425 (78th Leg.). These changes proved so difficult to administer and disruptive of established practices that members of the Legislature asked the Comptroller not to enforce them. See Comptroller's 2007 Legislative Update (STARS Accession No. 200707003L). The Legislature repealed these changes four years later. See House Bill 3319 (80th Leg.).

Internet Tax Freedom Act

The Internet Tax Freedom Act (47 U.S.C. § 151, n.1 § 1101 (a)(2)), prohibits discriminatory taxes on "electronic commerce." Section 1105(3) of the ITFA defines "electronic commerce" as:

> The term 'electronic commerce' means any transaction conducted over the Internet or through Internet access, comprising the sale, lease, license, offer, or delivery of property, goods, services, or information, whether or not for consideration, and includes the provision of Internet access.

Section 1105(2) of the ITFA defines a "discriminatory tax," as:

> (A) any tax imposed by a State or political subdivision thereof on electronic commerce that—
> ***
> (ii) is not generally imposed and legally collectible **at the same rate** by such State or such political subdivision on transactions involving similar property, goods, services, or information accomplished through other means…."

(Emphasis added.) To the extent the Legislature revises the law to convert to destination-based sourcing, the changes must avoid violating the anti-discrimination provisions of the ITFA. Specifically, no change can result in a different tax rate being imposed on a transaction in electronic commerce.

More broadly, regardless of the form of the discrimination, if a state or political subdivision creates a tax scheme under which Internet commerce bears a burden that is materially greater than that borne by another comparable form of commerce, it will be struck down under ITFA. See, *e.g.*, *Performance Marketing Ass'n, Inc. v. Hamer*, 998 N.E.2d 54 (Ill. 2013), in which the Illinois Supreme Court struck down a state statute that created Internet "click-through" nexus while excluding similar links established via print or over-the-air media. To the extent any change in law creates additional burdens on a seller engaged in electronic commerce, such as requiring the seller

to reprogram software to identify and track orders received electronically and distinguish them from other orders for local tax allocation purposes, it may violate ITFA even if the combined state and local tax rates on such orders were equal.

Administrative Burden and Cost to Sellers

We have surveyed several stakeholders and determined that current sales tax tracking software does not capture the data necessary to convert to destination-based sourcing based on the standards dictated by the Comptroller in Rule 3.334. Such software does not record whether an order was received via the Internet, versus the telephone, United States mail, or in person. Accordingly, businesses would have to reprogram their software, at considerable expense, to add this capability.

In addition, Texas does not provide taxpayers with an electronic data file that would enable them to calculate destination-based local taxes based on customer addresses. Address-specific local tax determinations may be entered manually, only one at a time, on the Comptroller's website. One of our clients received a bid of between $2,000 and $10,000 per month to integrate customer address/local tax data into the taxpayer's tax collection systems. The service would have to be updated every month to capture new addresses and changes in local tax rates. In the current economic climate, this is an unreasonable additional expense to impose on sellers.

Chapter 380 and 381 Agreements

We have heard from both local government entities and businesses with current agreements in place under Chapter 380 and 381, Tex. Local Gov't Code. Changing the local tax sourcing rules could have a far-reaching economic impact on such existing agreements, even taking into account the grandfather clause in Rule 3.334 and any similar provision in prospective legislation. The affected governments and businesses are scrambling to estimate the impact.

We appreciate the opportunity to provide information relating to the interim charge. Please feel free to call me at 512.476.0022, or send me an email at john.christian@ryan.com, if you have any questions.

Regards,

John Christian
Director, Controversy Resolution
Ryan, LLC