Docket: **CIVIL ACTION NO. 2017-1772 BLS1**
Date: **June 28, 2017**
Parties: **AMERICAN CATALOG MAILERS ASSOCIATION and NETCHOICE VS. MICHAEL J. HEFFERNAN, in his capacity as Commissioner of the MASSACHUSETTS DEPARTMENT OF REVENUE**
Judge: **Mitchell H. Kaplan, Justice of the Superior Court**

MEMORANDUM OF DECISION AND ORDER ENTERING DECLARATORY JUDGMENT ON COUNT I OF PLAINTIFFS' VERIFIED COMPLAINT

In this case, the plaintiff trade associations [1] challenge the validity of Directive 17-1 issued by the Commissioner of the Massachusetts Department of Revenue (the Commissioner and the DOR, respectively) on April 3, 2017 (the Directive). The Directive is entitled: "Requirement that Out-of-State Internet Vendors with Significant Massachusetts Sales Must Collect Sales or Use Tax." In effect, it requires that, beginning on July 1, 2017, large internet vendors who do not have places of business in Massachusetts, but have made a minimum number of product sales for delivery into Massachusetts, collect and remit to the DOR Massachusetts sales or use taxes. This is a new policy, as these internet vendors were not previously required to collect sales or use taxes from their online customers who place orders for goods to be delivered in Massachusetts. The plaintiffs' verified complaint (the complaint) is pled in four counts: Count One asserts that the Directive was issued in violation of the

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[1] Plaintiff American Catalog Mailers Association is a trade association representing companies engaged in catalog marketing. Plaintiff NetChoice is a trade association of internet companies engaged in online sales.

Massachusetts Administrative Procedure Act (G.L. c. 30A, the APA); Count Two asserts that the Directive is preempted by the federal Internet Tax Freedom Act (47 U.S.C. § 151, the IFTA); Count Three asserts that the Directive violates the Commerce Clause of the United States Constitution; and Count Four asserts that the Directive violates the Due Process Clause of the United States Constitution. The case came before the court on June 27, 2017, three days before the Directive was to take effect, on the plaintiffs' motion for a preliminary injunction enjoining the Commissioner from enforcing the Directive.

In their moving papers, the plaintiffs relied on Counts One and Two in pressing their request for preliminary injunctive relief. At the hearing, both the plaintiffs and the Commissioner agreed that as to Count One, which alleges that the Directive was invalid because not promulgated as a regulation pursuant to the APA, there were no facts in dispute, the issue had been fully briefed, and that Count could be resolved as a matter of law on the materials submitted. In consideration of the parties' memoranda and oral arguments, the court finds that the Directive established a new policy that substantially altered the rights and interests of the regulated parties and therefore had to be promulgated pursuant to sections 2 or 3 of Chapter 30A. It is undisputed that it was not. The court therefore finds that the Directive is invalid and of no force or effect. The court will not address the Counts Two-Four, but rather dismiss those counts without prejudice. If the Directive is promulgated as a regulation, the plaintiffs' federal preemption and constitutional claims may be reasserted in a new action.

ADDITIONAL BACKGROUND FACTS

In Massachusetts, the sales tax is established by G.L. c. 64H and the use tax by G.L. c. 641. These two taxes are "complementary elements of a unitary taxing program intended to

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reach all transactions except those expressly exempted, in which tangible personal property is sold inside or outside the Commonwealth for storage, use, or consumption within the Commonwealth." Comm'r of Rev. v. J.C. Penney Co., 431 Mass. 684, 687 (2000) (internal citations omitted). Consumers pay the sales tax when they make purchases from a vendor in Massachusetts. G.L. c. 64H, § 2. When a consumer purchases goods outside Massachusetts, but does not pay sales/use tax to the vendor, the consumer has a duty to remit the use tax. G.L. c. 641, § 3. Not surprisingly, consumers who purchase goods outside Massachusetts for use in this state frequently do not comply with their obligation to report the transaction and remit the use tax, which is therefore never collected. However, under G.L. c. 641, § 4, an out-of-state vendor of goods for use in the Commonwealth is required to collect and remit to Massachusetts the use tax when that vendor is "engaged in business in the commonwealth." G.L. c. 64H, § 1 provides the definition of what it means to be engaged in business in the Commonwealth.

In Quill Corp. v. North Dakota, 504 U.S. 298 (1992) (Quill), the United States Supreme Court addressed the limitations that the Due Process Clause and the Commerce Clause of the United States Constitution place on the power of a state "to require an out-of-state mail order house that has neither outlets nor sales representatives in the state to collect and pay a use tax on goods purchased for use within the state." Id. at 301. In Quill, the Supreme Court reaffirmed its prior ruling in National Bellas Hess, Inc. v. Department of Revenue of Ill., 386 U.S. 753 (1967) in which it had held "that a vendor whose only contacts with the taxing State are by mail or common carrier lacks the "substantial nexus" required by the Commerce Clause" to subject it to the taxing authority of that state. In so doing, the Supreme Court commented that: "Like other bright-line tests, the Bellas Hess rule [i.e., that the seller must have a 'physical presence' in the state] appears artificial at its edges: whether or not a State may compel a vendor to collect a sales

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or use tax may turn on the presence in the taxing State of a small sales force, plant, or office. This artificiality, however, is more than offset by the benefits of a clear rule. Such a rule firmly establishes the boundaries of legitimate state authority to impose a duty to collect sales and use taxes and reduces litigation concerning those taxes. . . . Moreover, a bright-line rule in the area of sales and use taxes also encourages settled expectations and, in doing so, fosters investment by businesses and individuals." Id. at 316. The Supreme Court has not modified the "physical presence" test reaffirmed in Quill, notwithstanding the growth in internet merchandising since that 1992 decision.

While this court's decision in the present case does not turn on the federal ITFA, a brief reference to Congress' entry into this out-of-state sales/use tax issue, as it applies to internet sales, provides further context. The IFTA was first enacted in 1998 and codified as 47 U.S.C. § 151. It initially imposed a moratorium which prohibited states, among other things, from enacting certain taxes on electronic, i.e. internet, commerce. The ITFA was made permanent in 2016. See P.L. 114-125 (2015-2016), § 992(a) (Feb. 24, 2016). As relevant to this case, the ITFA prohibited any state or political subdivision form imposing "discriminatory taxes on electronic commerce." A discriminatory tax was defined, in part, as "any tax imposed by

a State . . .on electronic commerce that . .. imposes an obligation to collect . . . the tax on a different person or entity than in the case of transactions involving similar property, goods services, or information accomplished through other means." § 1105(2)(iii). "Electronic commerce" means, again as relevant to this case, "any transaction conducted over the Internet or through Internet access, comprising the sales . . . or delivery of property, good services or information. . . ." § 1105(3). An intent of the IFTA appears to be to insure that internet vendors are treated by state departments of revenue in the same manner that Quill directed mail order houses be treated

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under the Commerce Clause.

Consistent with the Quill physical presence test and the limitations imposed by Congress under the ITFA, until the Directive issued on April 3, 2017, the Massachusetts DOR had not required an internet retailer to collect and remit sales or use taxes on goods sold for delivery in Massachusetts, if it did not have a physical presence in Massachusetts. The Directive abruptly changed that policy. According to the plaintiffs, without any advance warning to the internet sales industry.

The Directive directs the following new tax collection obligations and processes:

> An Internet vendor with a principal place of business located outside the state is required to register, collect and remit Massachusetts sales or use tax with respect to Massachusetts sale[s] as follows.
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> a. For the six-month period, July 1, 2017, if during the preceding 12 months, July 1, 2016 to June 30, 2017, it had in excess of $500,000 in Massachusetts sales and made sales for delivery into Massachusetts in 100 or more transactions.
> b. For each calendar year beginning with 2018 if during the preceding calendar year it had in excess of $500,000 in Massachusetts sales and made sales for delivery into Massachusetts in 100 or more transactions.

The balance of the Directive is, in substance, an explanation of why the Commissioner believes that this new tax policy does not violate the Commerce Clause. In a "Discussion" section, the Commissioner explains that Quill did not address how "physical presence" should be determined with respect to internet vendors, as the internet was then still in its "infancy." The Commissioner went on to state that "large internet vendors" are physically present in Massachusetts in three ways. First they "invariably own software that is downloaded and used by in-state customers on their computers and communication devices . . . that functions to facilitate or enhance the vendor's in-state sales. Additionally, these vendors "also enhance their customer sales through the complementary use of text data files, or 'cookies.' Cookies are not

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software but as in the case of software are present in the state and serve to facilitate such vendor's in state sales."

Second, "large internet vendors routinely contract with providers of content distribution networks ("CDNs") to use local servers to accelerate the delivery of their web pages to their customers. . . . When that activity takes place in Massachusetts it establishes an in-state physical presence on behalf of such vendor."

Third, "Marge internet vendors routinely contract with other persons as in-state representatives that result in the creation of an in-state physical presence." The Commissioner then goes on to describe some of the

relationships that some of these large internet vendors may have with in-state businesses that provide services to the vendors and/or their customers.

The Directive does not explain how the Commissioner came to know these facts that the Commissioner contends establish that any internet vendor that sells $500,000 worth of goods for delivery into Massachusetts, in at least 100 transactions, is physically present in Massachusetts.

DISCUSSION

The DOR is clearly an agency within the meaning of § 1(2) of the APA. Under §1(5), "'Regulation' includes the whole or any part of every rule, regulation, standard or other requirement of general application and future effect adopted by an agency to implement or interpret the law enforced or administered by it . . . ." [2] § 2 and § 3 of the APA then provide the procedures an agency must follow "[p]rior to the adoption, amendment, or repeal of any regulation." [3] It has long been established that a regulation adopted without compliance with

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[2] The balance of the definition sets out certain exceptions to the general definition of regulation not relevant to this case.

[3] §2 addresses regulations that require a public hearing before promulgation and § 3 those that do not. The court need not consider which type of regulation the substance of the Directive is.

either § 2 or § 3 of the APA has been invalidly enacted and is without force or effect. See Kneeland Liquor, Inc. v. Alcoholic Beverages Control Comm., 345 Mass. 228, 235 (1962).

The Commissioner's principal argument in response to the plaintiffs' claim that the Directive is void for failure to comply with the APA, is that the legislature has exempted the DOR from the requirements of the APA: "In the specific area of taxes, . . . , the Legislature has enacted legislation supplementing the APA and recognizing the [DOR's] authority to announce changes in tax policy through various public written statements—including `directives'—that need not have to comply with the APA's procedural requirements." The Commissioner contends that these legislative exemptions are found in sections 3 and 26(j)(1) of Chapter 62C added by St. 1998, c. 485, §§9, 11. The court disagrees.

With respect to § 3, the Commissioner directs the court to the following sentence:

> The commissioner shall provide public notice to taxpayers of any changes in the tax law,
> including but not limited to, changes in department of revenue policy, regulatory changes, recent court decisions and the department of revenue's policy with regard to recent court decisions by making all regulations, technical information releases, letter rulings, directives, guides and other publications available to the public at the department and at other public facilities at the discretion of the commissioner.

And, as to § 26(j)(1), the following similar sentence:

> The commissioner shall not make any assessment under this chapter if that assessment is based on a change in policy unless such change in policy first is announced to taxpayers pursuant to the promulgation of a validly adopted regulation or the issuance of a technical information

release, directive, administrative procedure or other similar public statement of equivalent formality that explains the change in policy.

In the court's view, these two sentences simply require that the Commissioner provide the public with notice of changes in tax law and these notices must precede any tax assessment made pursuant to that change. Rather, than providing the Commissioner with broad discretion to adopt a change in tax law by either promulgating a regulation or issuing a directive, regardless of the

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nature of the policy change being implemented, it simply lists the different types of notice that the Commissioner may use. Indeed, the first type of change in policy listed is "the promulgation of a validly adopted regulation." The court finds that the Legislature did not, in either sentence, express an intention to relieve the Commissioner of the obligation to comply with the protections afforded regulated persons under the APA when his actions constitute "a requirement of general application and future effect adopted by an agency to implement or interpret the law enforced or administered by it." Id. at 234.

Moreover, consistent with a common sense interpretation of these sections of Chapter 62C, the Commissioner promulgated 830 C.M.R. 62C.3.1(5)(b) which defines a DOR Directive as "a public written statement . . . which provides details or supplementary information; clarifies ambiguities; resolves inconsistencies; or explains or elaborates upon issues, concerning current Department policy, practice or interpretation." [4] The Directive at issue here is not providing details, supplementary information or clarifying some ambiguity regarding existing tax policy. Rather, it was used to announce an abrupt change in the policy concerning an out-of-state internet merchant's new obligation to register with the DOR and then collect and remit sales/use taxes from Massachusetts customers. [5]

Indeed, the need to distinguish between circumstances in which an agency bulletin or notice may be used to clarify or supplement existing policies from those in which a new policy is

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[4] The quoted passage is from the version of 830 C.M.R. § 62C.3.1 in effect on April 3, 2017 when the Directive issued. It has since been amended.

[5] The Commissioner argues that Geoffrey, Inc. v. Comm'r of Revenue, 453 Mass 17 (2009); Aloha Freightways, Inc. v. Comm'r of Revenue, 428 Mass. 418 (1998); and New York Times Co. v. Comm'r of Revenue, 427 Mass. 399 (1998) may be read to suggest that the SJC has implied that the Commissioner may, unlike other agencies, proceed to enact new policies of general application and effect through directives not regulations. The question of whether a directive was announcing a new policy as opposed to providing clarity to existing policies was not raised (or alluded to) in any of those cases. Moreover, in the first two the directives referred to appear to be providing clarity to existing positions; and, the third does not involve a directive at all. The court has not been presented with any case in which the SJC has suggested that the APA does not apply to the DOR in the same manner as other state agencies.

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announced has been well recognized in Massachusetts law. In the seminal decision, Massachusetts General Hospital v. Rate Setting Commission, 371 Mass. 705, 707 (1977), the SJC addressed these two different regulatory

functions and the appropriate means for accomplishing them:

> The parties appear to be in agreement that there is such a thing as an advisory or informational pronouncement by an administrative agency that may be issued lawfully in relation to a regulation (or a statute) without going through the procedures required for promulgation of a regulation. They might also agree that it is no use trying to frame an airtight definition of such pronouncements which would serve to distinguish them from regulations; on the other hand, it may be possible to point to factors of differentiation in light of the functions or purposes that are furthered by notice and hearing in the given context. Formal presentation by the agency with opportunity for 'input' and debate by the persons affected, and deliberate resolution of issues by the officials, may be thought wasteful of time and energy where the agency is intending to fill in the details or clear up an ambiguity of an established policy, rather than to inaugurate a material change of policy. One can imagine, too, that in the degree that what the agency puts forward is complex, or of broad or pervasive coverage, notice and hearing will appear increasingly plausible and useful, so that the agency's proposition will be denominated a regulation.

In the present case, it appears that the Directive was not being used "to fill in the details or clear up an ambiguity of an established policy, rather than to inaugurate a material change of policy." The Directive announced a break with established policy placing new obligations on out-of-state internet vendors to register with the DOR, collect taxes from its customers, account for the collection to the DOR, and to remit the funds to the DOR. [6] Moreover, while it may be that Massachusetts may require these internet merchants to undertake these new obligations without violating the Commerce Clause of the United States Constitution or being preempted by the federal IFTA, these are certainly close questions. The Commissioner himself underscores the potential constitutional problem with the new tax collection policy in the "Discussion" that he

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> [6] The plaintiffs submitted affidavits suggesting that the cost of implementing systems necessary to comply with the Directive would be in excess of $250,000 for each affected internet merchant.

sets out in the Directive, which acknowledges the limitations placed on state taxing authorities by Quill, and then finds facts that he contends establish "physical presence" in Massachusetts for all internet vendors who engage in $500,000 of transactions with Massachusetts customers in a year. The basis for his factual findings is not included in the Discussion. It appears to this court that the Directive is a paradigm example of "a requirement of general application and future effect adopted by an agency to implement or interpret the law enforced or administered by it." Kneeland Liquor, 346 Mass. at 234. Affected persons and businesses should have the opportunity for notice, input, and perhaps debate before it is effective provided them by the APA.

ORDER

For the foregoing reasons, Final Judgment shall enter (a) as to Count One of the Complaint, declaring that the Directive is a regulation promulgated without compliance with Sections 2 or 3 of G.L. Chapter 30A and, therefore, invalid; and (b) as to Counts Two through Four, dismissing these counts without prejudice. [7]

Mitchell H. Kaplan, Justice of the Superior Court

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[7] Nothing in this memorandum of decision should be construed as suggesting this court's position on the merits of the claims asserted in Counts Two through Four. As the court has entered final judgment under Count One, it was unnecessary for the court to address the issue of irreparable injury.