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Sales Tax Class Actions Raise Red Flags For Retailers

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A slew of recent class actions have retailers and other businesses that accept or issue coupons double-checking their sales tax collection practices. These lawsuits are not cut-and-dried, but they risk upending an industry built on streamlined, efficient practices and customer convenience.

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Interplay Between Taxes and Coupons

All but five states have some form of statewide sales tax and 38 states also authorize at least one form of local sales taxes. Sales taxes are usually paid by customers when they purchase goods or services subject to the tax. To simplify tax collection and administration, sales tax is usually collected by retailers on behalf of the state at the time of the sale. Collected taxes are then held in trust for the state until they are remitted by the retailer. Alternatively, in some states, including Illinois, the tax is imposed on the retailer, which collects use tax from the customer as reimbursement at the time of the sale.

Sales taxes are based on the retailer's gross receipts from the transaction. As that name suggests, gross receipts include all consideration received by the retailer, including cash and credits, and are measured without deductions for the cost of the goods, shipping costs, interest or any other expense. In order to properly determine the sales tax base, the retailer must consider receipts from all sources attributable to that transaction.

The determination of the sales tax base can present problems for retailers when coupons and other forms of discounts are accepted.

Coupons come in two broad and self-descriptive categories: manufacturer-issued coupons and store-issued coupons. Manufacturer-issued coupons are issued by the manufacturers of retail goods. When a customer presents a manufacturer-issued coupon to a retailer, the retailer is fully or partially reimbursed by the manufacturer, and the loss in revenue is absorbed by the manufacturer. Conversely, a store-issued coupon is issued by the retailer itself, so when a customer presents a store-issued coupon to a retailer, the retailer is not reimbursed by another party and the loss in revenue is absorbed by the retailer.

Under the sales tax regulations of many states, including Illinois, store-issued coupons constitute a

reduction in the retailer's gross receipts. Accordingly, the sales tax liability is reduced. On the other hand, manufacturer-issued coupons do not generally reduce the retailer's gross receipts, because the retailer is reimbursed by the manufacturer.

Consider how this practice becomes complicated in situations where the sales tax is borne by the retailer and reimbursed by the customer, as in Illinois. In the case of manufacturer-issued coupons, the tax owed by the retailer is on the higher, undiscounted price (because the retailer receives gross receipts from both the customer and the manufacturer). But the customer would ordinarily only owe use tax on the amount expended by the customer (i.e., the discounted amount). To address this issue, an Illinois regulation provides that, while "technically, the coupon issuer … owes the corresponding use tax on the value of the coupon," in many cases "the coupon issuer incorporates language into the coupon that requires the bearer ... to assume this use tax liability." In other words, the fine print on the coupon can allow the tax burden to shift onto the customer.

Plaintiffs' Theories and their Consequences

Several class actions have recently been filed against national retailers in Illinois and elsewhere capitalizing on the confusion surrounding sales taxes and coupons. In each case, the customer allegedly presented a manufacturer-issued coupon that did not have language shifting the tax burden to the customer. The retailers collected tax on the full, undiscounted price of the goods as they would do with any other manufacturer-issued coupon.

In the complaints, the plaintiffs argue the retailers violated the Illinois Consumer Fraud Act by collecting tax on the coupon amount and were unjustly enriched as a result. The plaintiffs seek compensatory damages, punitive damages of at least 1 percent of annual revenues from each retailer's Illinois stores during the years in issue, and fees and costs.

In another recent lawsuit, a Florida plaintiff filed a class action against a wholesale club retailer, alleging the retailer collected sales tax on the full price of merchandise when the goods were discounted as a result of the store-issued discounts, rather than manufacturer-issued discounts. The complaint alleges violations of Florida's Deceptive and Unfair Trade Practices Act, fraud, and unjust enrichment, among other things.

Whatever the merits of these lawsuits, they present problems for retailers beyond the potential damages in any individual case. The lawsuits put retailers between a tax-collecting rock and a litigious hard place. On one hand, retailers can err on the side of undercollecting sales tax, but in doing so, they risk being audited by taxing authorities; those audits can result in the payment of penalties and interest, and potentially risk the loss of the retailer's license. On the other hand, retailers can err toward overcollecting sales tax, but in doing so they expose themselves to class actions and their associated expenses and negative publicity.

Further, if the courts endorse the arguments of the class action litigants, retail clerks would need to carefully read — and understand the implications of — the fine print on every coupon presented, and self-service lanes may have to disallow the use of manufacturer-issued coupons. These changes would be significant burdens in an industry built on customer convenience.

Best Practices to Cut Exposure

Sales tax compliance is already complicated enough for retailers doing business in multiple jurisdictions. Even the best point-of-sale systems can have problems determining whether to collect tax under the thousands of fact patterns that arise daily. Each state and locality has its own tax rate, tax base and

exemptions from that base. A bag of coffee, for example, may or may not be taxable in a particular jurisdiction; the presentation of a coupon for that coffee only muddies the water further.

While there is no practical way to fully eliminate exposure to these types of lawsuits, retailers should consider several best practices that can reduce that exposure while also managing audit risk.

First, retailers should regularly review their tax collection process in all jurisdictions where they do business and ensure they are diligently complying with each jurisdiction's unique sales tax rules. In-house attorneys and accountants should regularly compare the retailer's practices with the requirements of the jurisdiction and engage outside counsel familiar with the nuances of the jurisdiction when questions arise.

When a retailer is uncertain how a particular discount should be classified for tax purposes, particularly in jurisdictions without specific rules relating to such discounts, retailers should also consider seeking regulatory guidance from the taxing authorities. Assuming retailers comply with the guidance, administrative rulings can provide retailers with a level of protection against damages in lawsuits while simultaneously reducing exposure to audits. It would be impractical to seek a ruling for every fact pattern in every jurisdiction, however, so retailers should be selective in which rulings to pursue.

Due to their size and scale of operations, national retailers often have significant influence with their vendors. Because many of the issues in the recent lawsuits revolve around manufacturer-issued coupons, and specifically their lack of language shifting the tax burden to the customer, retailers may want to work with vendors to ensure that the appropriate tax-shifting language is on every coupon. Manufacturers should be open to this language, as the burden of the use tax on the coupon amount otherwise may fall to the manufacturer.

Finally, and more fundamentally, retailers should ensure that the entire amount of sales tax they collect is remitted to the proper taxing authority. While this is a fairly rudimentary best practice, some class action defenses, such as the voluntary payment doctrine which states that voluntarily paid taxes cannot be recovered even if such payment was erroneous, may only be available when the tax is collected and remitted. Further, if the retailer does not retain the tax that is allegedly collected erroneously, the case for unjust enrichment is made arguably weaker. Of course, overcollecting sales tax and failing to remit it exposes the retailer to fire from both sides.

No system can practically and perfectly consider every possible variation relating to the taxability of products sold by local and national retailers, but those retailers not already in the crosshairs of class action litigants should take every opportunity to reduce their exposure, before they find themselves the next target.

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