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Way(un)fair?

United States Supreme Court Decision Ends State Tax Physical Presence Nexus Test

By Mattew C. Boch

The United States Supreme Court's June decision in *South Dakota v. Wayfair*[1] ended the traditional physical presence requirement for a state to be able to impose a tax obligation. In its place the decision suggests a balancing test between the taxpayer's real or virtual presence and the administrative burdens of a tax system. States are quickly moving to update their laws and regulations to take advantage of this expanded taxing power. Taxpayers selling across state lines face increased risks and compliance burdens as they navigate this new environment.

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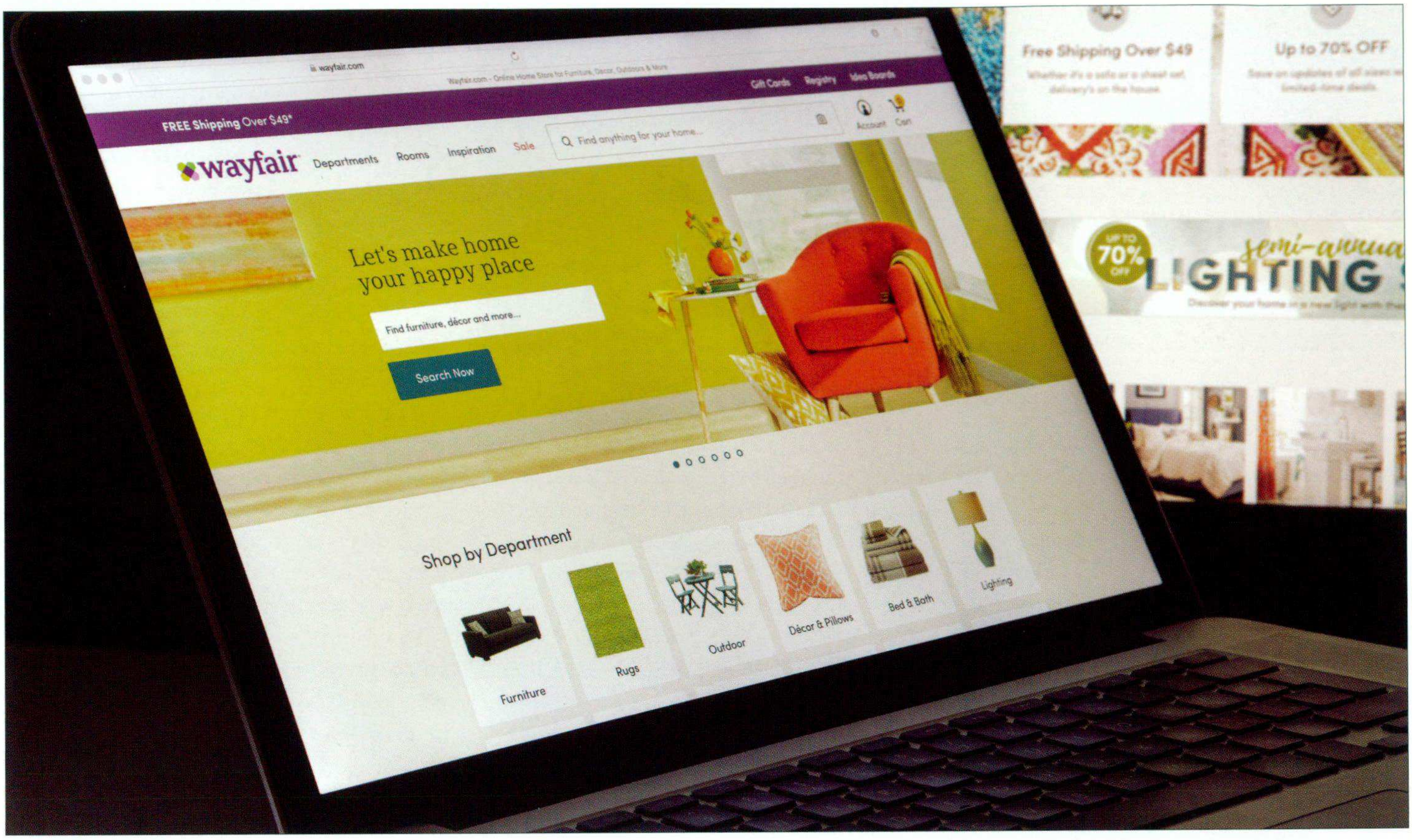
The Physical Presence Rule Came Under Attack as E-Commerce Grew

For 50 years or more, the question of whether a state could impose tax requirements looked to whether the taxpayer had a physical presence in the state. This standard was set out in 1967 in *National Bellas Hess*,[2] which held that a business whose contacts were limited to mail and deliveries by common carrier could not be required to collect tax. A generation later, states tried again with the *Quill* case,[3] where the Supreme Court upheld the physical presence rule in large part under *stare decisis* despite broader changes in underlying Dormant Commerce Clause jurisprudence. For the past 26 years, states, taxpayers, and courts have applied the *Quill* rule that a taxpayer must have more than the slightest physical presence before tax collection obligations can be imposed.

The physical presence rule was crucial to the rise of online commerce. E-commerce websites generally did not collect tax, giving them a competitive advantage over brick-and-mortar retailers that had to collect sales tax. (While consumers have an obligation to self-assess and pay use tax on purchases where tax was not collected, they generally did not do so and states did not make serious efforts to enforce consumer use tax.)

Under this paradigm, states sought to maximize their taxing powers by pushing *Quill* to its limits or circumventing it. To maximize *Quill*, they enacted attributional nexus laws imputing the physical presence of in-state affiliates or independent contractors to the out-of-state seller. This included click-through nexus laws targeting referral marketers. To circumvent, states distinguished income, gross receipts, or other business activity taxes as distinct from sales and use tax collection obligations, and they were generally success-



ful in doing so.[4] They also successfully began enacting statutes that required out-of-state sellers to provide notice and information reporting if they did not collect tax,[5] a trend that would have become widespread if *Wayfair* had upheld the physical presence rule.

It was in a decision involving a jurisdictional question on a challenge to Colorado's use tax information reporting statute where Justice Kennedy's concurrence suggested reconsideration of *Quill*.[6] Several states took up the invitation, one of which was South Dakota.

South Dakota's law establishes nexus if a taxpayer has more than $100,000 of sales or 200 transactions into the state in a calendar year.[7] To speed adjudication, the law was fast tracked by authorizing a state declaratory judgment action with limited discovery and direct appeal to the South Dakota Supreme Court.[8] To avoid unfairness to taxpayers, the law's effect was enjoined while the declaratory judgment action was pending, such that the effect of the law would be prospective only after the *Quill* challenge was litigated.[9] Litigation ensued against several noncollecting out-of-state sellers, and the South Dakota Supreme Court followed *Quill* in holding the South Dakota economic nexus law unconstitutional.[10] South Dakota appealed and *certiorari* was granted.

United States Supreme Court Overturns Physical Presence Rule as Artifact of Outdated Jurisprudence

The *Wayfair* majority opinion overturned *Quill* and reversed and remanded the case to South Dakota for further proceedings. Both doctrinal and policy reasons compelled this result. From a doctrinal perspective, *Quill* was inconsistent with modern *Complete Auto* Commerce Clause tax jurisprudence[11] and had been wrongly upheld under *stare decisis* principles. From a policy perspective, the physical presence rule had evolved into a "judicially created tax shelter" under which interstate commerce avoided paying its fair share of taxes. Physical presence test reliance arguments were rejected since lawfully due state sales and use taxes were being avoided under the physical presence rule.

Instead, under *Wayfair*, a taxpayer's "virtual presence" becomes relevant to the question of nexus. The South Dakota economic nexus thresholds are reasonable because "[t]his quantity of business could not have occurred unless the seller availed itself of the substantial privilege of carrying on business in South Dakota." In addition, the defendants were "large, national companies that undoubtedly maintain an extensive virtual presence."

Wayfair leaves open the question of what constraints remain on state taxing power. The majority opinion notes that "[c]omplex state tax systems could have the effect of discriminating against interstate commerce." Perhaps a *Pike*[12] balancing test between the state's taxing power and the costs of complying with the state's tax regime is the appropriate analysis. The *Wayfair* Court observed that South Dakota's regime appeared designed to avoid discrimination or undue burdens for three reasons: (1) reasonable *de minimis* thresholds, (2) prospective-only application, and (3) tax simplification as part of the Streamlined Sales and Use Tax Agreement.

The 5-4 opinion came with concurrences from Justice Thomas and Justice Gorsuch. These call into question the dormant Commerce Clause more generally and should not practically affect the application and implementation of the majority opinion authored by Justice Kennedy. The dissent, authored by Chief Justice Roberts, would have upheld the physical presence rule based on stare decisis and concerns over the administrative burden on taxpayers.

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States Are Updating Their Sales Tax Laws and Regulations to Capitalize on *Wayfair*

The South Dakota economic nexus law gives a clear framework for states to follow, and states are moving quickly to adopt, update, or implement statutes or regulations. Expect most-to-all states with a sales tax to have an economic nexus statute in effect within a year. Many states adopted copycat laws while *Wayfair* was pending that are now coming into effect. Some states can adopt regulations under broad statutory language as to who has a tax collection obligation. Others will require statutory changes either in a special session or the next regular legislative session. This will be a fast-evolving area, as more and more states put requirements into effect.

A big question for states with laws or regulations on the books is whether to also seek any retroactive assessments. Thus far almost all states seem to be taking a prospective-only approach (with the possible exception of Massachusetts).

States do not have to copy South Dakota in setting their economic nexus thresholds. Perhaps some states will edge down to $75,000 of sales or 150 transactions, or even lower. Minnesota, for example, has adopted thresholds of (1) 100 or more retail sales shipped to the state or (2) 10 or more retail sales shipped to the state that total more than $100,000.[13] Expect to see big states at least copy South Dakota in setting their thresholds, even though the same thresholds for a big state will tend to capture smaller sellers.

Some states face a question of whether and how to simplify their tax systems. About half, including Arkansas, do not have this problem: they are members of the Streamlined Sales and Use Tax Agreement, which requires certain tax structures, definitions, safe harbors, and other simplifications. But the remainder, including the biggest states, have idiosyncratic sales and use tax systems that will be difficult to simplify.

Without simplification, they may be limited in the extent to which they can require out-of-state sellers to collect. Expect many states to develop special simplified tax regimes for out-of-state sellers while leaving in-state sellers to navigate the complexity of existing systems. Louisiana, for example, has created the Louisiana Sales and Use Tax Commission for Remote Sellers, which may administer a simplified tax system for out-of-state sellers while in-state businesses continue to face the state's notoriously complex state and local sales tax system.[14]

The fiscal impact from taxing remote sales should be substantial. The United States Government Accountability Office has estimated an $8 to $13 billion revenue gain to the states from expanded tax collection authority.[15] The competitiveness impact for brick-and-mortar retailers is also significant and should help slow the decline of traditional retailers.

Businesses Now Face Escalating Compliance Obligations and Nexus Risks

Wayfair affects almost every company doing business across state lines. The immediate, obvious impact is mid-to-large remote retailers. They need to begin collecting at least in those states with economic nexus laws in effect. Many foresee the inevitable and are registering for sales tax nationwide. Smaller remote retailers need to monitor states' economic nexus thresholds and begin complying where such thresholds are exceeded. The compliance costs for retailers just over the thresholds can be onerous in comparison with the tax being remitted.

Retailers should not forget about Colorado-style use tax information reporting obligations either. Many states have enacted such laws which are presently in effect. While these use tax reporting laws seem unlikely to spread further given the option of copying South Dakota's economic nexus law, those that are on the books require compliance (or else registering and collecting tax).

Wholesalers should not think that they are immune. South Dakota's law, for example, does not distinguish between taxable and exempt sales. Wholesalers should consider registering where required to do so, even if the tax obligations will be nominal. At the very least, wholesalers need to make sure that they are current on customer resale certificates so that they will be prepared to defend themselves if they get audited.

Remote service providers face a difficult situation. While states generally impose sales tax on all sales of tangible personal property, services are generally nontaxable unless they are enumerated services specifically taxed under state law. States vary exceptionally as to what services are taxable and as to the underlying definitions of taxable services. A remote service provider needs to proceed carefully.

"Cloud-based" service businesses face particularly hard compliance challenges. Most tech startups providing services over the internet have relied on the physical presence rule for protection from a complicated state tax landscape. Different states may tax a business providing services over the internet as data processing services, information services, digital automated services, software licenses, or other theories. Taxability becomes very state- and fact-specific. Many tax compliance software services tend to err on the side of taxation, potentially leading to overcollection and competitive disadvantage.

The *Wayfair* decision is also an opportunity for businesses of all stripes that have potential physical presence nexus exposure for back years to try to come into compliance. Instead of a traditional voluntary disclosure agreement ("VDA") project that would involve paying a few years of back tax and interest, a business can simply register in connection with *Wayfair* and a state's new economic nexus law and then begin complying prospectively. While potential audit exposure for prior years would remain, states are going to be dealing with a flood of new registrants and the audit risk may be remote.

Wayfair's impact is not limited to sales and use taxes either. The new nexus principles would seem to bless imposing income or gross receipts taxes on remote businesses as well. While states had asserted economic nexus for income taxes when *Quill* was the rule, expect them to become more aggressive now that *Wayfair* has replaced *Quill*.

The federal nexus preemption for sellers of tangible personal property under Public Law 86-272[16] remains good law, however. Businesses claiming protection of Public Law 86-272 need to be careful that their activities do not exceed allowable solicitation. Public Law 86-272 does not apply to sales of services or intangible property, and states imposing gross receipts taxes (Nevada, Ohio, Texas, and Washington) generally are not restrained by Public Law 86-272.

In addition to advising their clients, law firms should consider their own state tax compliance positions and risks. While most states do not impose sales tax on legal services, a handful do so (including, oddly enough, South Dakota). States imposing income taxes with market-based sourcing rules also create risk. As applied to legal services, sourcing rules may suggest sourcing to a client's location or to the situs of a particular matter. A lawyer appearing *pro hac vice* in an out-of-state tribunal or advising on an out-of-state real estate transaction may be creating a tax obligation with that state. As a practical matter, most states are not going after small law firms for incidental matters. As state tax agencies' big data resources improve, however, one can envision agencies scraping court records or other public data to identify out-of-state firms to target for tax nexus enforcement.

Arkansas Must Update Its Statutes or Regulations and Determine How to Use the Revenue Gains

To capitalize on *Wayfair*, Arkansas needs a statutory or regulatory change. For remote sales, the critical question is whether a seller is a "vendor" required to collect use tax. The statutory definition of "vendor" does not specify what kind of connection a person has to have in order to be a vendor subject to use tax collection obligations, and so it does not necessarily require amendment.[17] A Department of Finance and Administration (DFA) regulation, however, has articulated the physical presence rule and requires updating or a superseding statutory change: a seller must collect use tax if it "has a physical presence ... to the full extent allowed under the United States Constitution..."[18]

DFA could change its regulation, which could happen in the next few months. Or the General Assembly could pass legislation adjusting the definition of "vendor," either in the 2019 legislative session, or conceivably in a special session later in 2018. Since Arkansas is a Streamlined Sales Tax state, adoption of South Dakota nexus thresholds on a prospective basis through regulation or statute should be straightforward.

The DFA has estimated a $43 million revenue gain from remote seller collection: $24 million for general state revenue, $11 million for dedicated state special revenue, and $8 million for local sales and use taxes.[19] These revenue estimates are on the low end compared to what some speculation had been. For example, the GAO report had suggested a revenue gain of between $123 and $169 million.[20]

The Arkansas policy response will need to take into account statutory triggered tax cuts as well. The special low-rate sales tax on groceries is scheduled to go down to a zero rate now that federal law allows remote seller collection, so long as net available general revenues from such remote sellers exceed 150% of the revenue from the low rate sales tax on groceries.[21] It is anticipated that this condition will be met and that the tax cut will be triggered.

In addition, there is a triggered income tax cut if remote tax collection receipts exceed $70 million.[22] Any such excess revenues would go to reducing the tax rate in one of the brackets in the "middle class" bracket schedule.[23] Given the DFA revenue estimate, it seems unlikely that this cut would be triggered. It would not be surprising for the General Assembly to repeal the triggered cut as part of an overall tax reform bill, and particularly if the tax reform bill simplification includes returning to a single bracket schedule.

***Wayfair* Is Not the Last Word; Expect More Nexus Controversy and Changes**

Wayfair has overruled *Quill* but it has not provided a clear alternative, instead offering essentially a balancing test of contacts and burdens. Expect to see continued controversy and development as states expand their taxing powers and remote taxpayers attempt to resist. Potential areas of controversy or development include:

•Disputes over the complexity of sales and use tax compliance in non-Streamlined states;

•States pushing the limits in reducing the de minimis compliance thresholds lower than those used by South Dakota;

•Increased tax collection or compliance obligations for marketplace providers or other intermediaries;

•Challenges to the more tendentious assertions of nexus from minor physical presence where the economic presence is limited;

•Refund claims or disputes where cautious retailers overcollect from customers;

•Accelerating development and cost reduction in online sales tax compliance, particularly as artificial intelligence is employed; and

•Increased use of big data by states to target businesses for nexus.

Congressional action on state tax nexus is possible but seems unlikely at this time. Congress never took up the opportunity to change the *Quill* physical presence rule. Thus far it seems unlikely to do so given reasonable state responses to *Wayfair*. If states become abusive in going after small, out-of-state taxpayers, however, pressure for congressional action may mount.

The question of when a state has enough authority to tax a remote person doing business across state lines is a fundamental challenge of our federal system of taxation, where states and some localities administer their own taxes. *Wayfair* is arguably an overdue modernization of nexus principles. But by removing the physical presence rule while providing no firm guidance on the outer limit of state taxing power, *Wayfair* leaves uncertainty and exposure, and particularly for small-to-mid-sized businesses engaged in interstate commerce. This unsettled situation will see development in the years to come.

Endnotes:

1. *South Dakota v. Wayfair, Inc.*, 138 S. Ct. 2080 (2018).
2. *National Bellas Hess, Inc. v. Dep't of Revenue of the State of Illinois*, 386 U.S. 753 (1967).
3. *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).
4. *See, e.g., Crutchfield Corp. v. Testa*, 151 Ohio St. 3d 278 (2016).
5. *See Direct Marketing Ass'n v. Brohl*, 814 F.3d 1129 (10th Cir. 2016).
6. *Direct Marketing Ass'n v. Brohl*, 135 S. Ct. 1124, 1134 (2015).
7. S.D. Codified L. § 10-64-2.
8. S.D. Codified L. §§ 10-64-3, 10-64-5.
9. S.D. Codified L. § 10-64-4.
10. *South Dakota v. Wayfair, Inc.*, 901

N.W.2d 754 (S.D. 2017).
11. *See Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977).
12. *Pike v. Bruce Church, Inc.*, 397 U.S. 137 (1970).
13. Minnesota Department of Revenue, "Frequently Asked Questions" for Remote Sellers (accessed Jul. 31, 2018) (available at a link from http://www.revenue.state.mn.us/businesses/sut/Pages/Remote-Sellers.aspx).
14. *See* 2017 La. Acts 274 (H.B. 601).
15. "Sales Taxes: States Could Gain Revenue from Expanded Authority, but Businesses Are Likely to Experience Compliance Costs," GAO-18-114 (Nov. 2017).
16. Codified at 15 U.S.C. § 381.
17. *See* Ark. Code Ann. § 26-53-102(31) ("a person engaged in making sales of tangible personal property, specified digital products, digital codes, or taxable services by mail order, by advertising, or by agent, by peddling ... by soliciting, or by taking orders for such sales for storage, use, distribution, or consumption in this state.").
18. Rule UT-3(M)(2) (defining "vendor").
19. Letter from DFA Deputy Director and Commissioner of Revenue Walter Anger to the Tax Reform and Relief Legislative Task Force (Jul. 20, 2018).
20. GAO-18-114 at 48 (Appendix II). The DFA's letter of July 20, 2018, using GAO's information and adjusting for tax already being collected, put the range at between $38 to $88 million total new revenue.
21. *See* Ark. Code Ann. § 26-52-317.
22. Ark. Code Ann. § 26-51-201(e).
23. The bracket schedule provided by Ark. Code Ann. § 26-51-207(a)(7). Recall that Arkansas is unique in having not only a progressive income tax, but also three separate bracket schedules for incomes below $21,000, between $21,000 and $75,000, and in excess of $75,000. The reduction would apply to the "middle class" bracket schedule. ■