THE NATIONAL LAW REVIEW

Remote Sellers Must Now Collect and Pay State Sales Taxes

Tuesday, July 3, 2018

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Tax
Litigation / Trial Practice
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The U.S. Supreme Court has overturned 26 years of precedent to rule that a state may compel out-of-state, or “remote,” sellers to collect sales tax from consumers who make purchases within the state. *See South Dakota v. Wayfair, Inc.*, No. 17-494, 585 U.S. ---, 2018 WL 3058015 (June 21, 2018). The Court ruled that a state may do so even where the seller does not have a “physical presence” in the state, such as employees or tangible assets. Although the decision by its terms applies to any “out-of-state” seller, the ruling is squarely aimed at online retailers, who previously reaped a competitive advantage at the expense of brick-and-mortar businesses by avoiding the costs of complying with state sales tax collection and payment laws, as well as a perceived price advantage over brick-and-mortar businesses.

The Ruling

Responding to what it termed a fiscal “emergency” arising from its eroding sales tax base, South Dakota in 2016 passed a law requiring out-of-state sellers to collect and pay sales tax to the state as if the seller had a physical presence there. The law deems physical presence to exist where, on an annual basis, an out-of-state seller either delivers more than $100,000 of goods or services into the state or engages in 200 or more separate transactions for the delivery of goods or services into the state. Unlike similar laws enacted in other states, South Dakota’s law specifically prohibits the state from applying it retroactively to already completed transactions. The law on its face directly conflicted with the U.S. Supreme Court’s decision in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), which required a physical presence as a precondition to a state requiring an out-of-state seller to collect sales tax from consumers and pay it to the state. The law was clearly intended to force the issue for resolution on a national scale.

After recounting the evolution of its Commerce Clause jurisprudence, the Court overturned its physical presence rule, concluding that the rule had become “further removed from economic reality and results in significant revenue losses to the States,” is “flawed on its own terms,” is a “judicially created tax shelter for businesses that decide to limit their physical presence and still sell their goods and services to a State’s consumers – something that has become easier and more prevalent as technology has advanced,” and “ignores [the] substantial virtual connections to the State” that an out-of-state seller can maintain. Turning next to the validity of South Dakota’s law under its decision in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), which sets forth the rules for determining when a state can tax interstate commercial activity, the Court held that the $100,000 sales or 200 completed transactions thresholds were sufficient proxies to establish the “substantial nexus” required for a state to apply its tax laws to an out-of-state seller that avails itself of the privilege of doing business in the state.

Immediate Next Steps

Businesses must decide what to do in response in response to *Wayfair*. Our suggested steps include:

- **Taxable Activities Review.** Businesses should review the applicable authority in states in which they transact business and determine whether their activities are taxable. Next, they should determine whether their activities, in the aggregate, meet any minimum dollar or transaction frequency thresholds that may apply to trigger sales, or other, tax obligations. Such due diligence review is good practice that should be done on a periodic basis, and paradigm shifts such as *Wayfair* serve as a good reminder or trigger for such reviews.

- **Decision to Collect and Remit.** Now that *Wayfair* is the law, businesses that meet minimum thresholds established by the states, or arguably have substantial nexus, must decide whether to register for tax or buy a ticket to the audit lottery. Many states are already rushing to pass legislation consistent with *Wayfair* (*e.g.*, New Jersey), and voluntary disclosure initiatives to quickly and efficiently register sellers, and begin recognizing revenue from sellers affected by *Wayfair*, are popping up. There may even be the potential for a specialized voluntary disclosure program run by the Multistate Tax Commission similar to other special voluntary disclosure programs that the organization has recently administered. (*See* the Multistate Tax Commission Wayfair Meeting Agenda for more information.) These compliance initiatives or voluntary disclosure programs following a landmark case like *Wayfair* are often the best course for a business, rather than abruptly registering to collect and remit or waiting on the sidelines; however, this is a facts-and-circumstances analysis that should be discussed with your tax adviser. In any case, taxpayers should do an analysis to identify the states where they have had a historically high volume of activity but have not collected sales tax to weigh the potential exposure.
- **State Implementation Timeline.** For businesses that are affected by *Wayfair* a common concern is timing. The National Conference of State Legislatures' State and Local Tax Task Force has suggested that states provide a grace period, until January 2019, for strictly enforced compliance. This is in line with the way states often implement significant shifts in policy, such as new withholding tax obligations, which require extensive administrative adjustments by taxpayers. However, some states are already on record imposing strict, immediate compliance deadlines. For example, Vermont has a July 1 effective date on its new nexus statute and has confirmed that it does not intend to offer an administrative grace period for taxpayers.
- **"Virtual Physical Presence" States and the Possibility of Retroactivity.** In light of *Wayfair*, it seems unlikely (but not impossible) that the retroactive enforcement of sales tax collection laws will pass muster in court. However, in the absence of a clear prohibition on retroactive enforcement, states could still seek to do so, potentially making state compliance initiatives or voluntary disclosure programs post-*Wayfair* more attractive. This is especially true in states such as Massachusetts that have had "virtual physical presence" standards in place for some time now. *Wayfair* suggested that battles over the technicalities of whether such virtual presence is in fact physical presence could rage on, providing what some may deem to be legitimacy to these state provisions which could lead to aggressive retroactive enforcement. These virtual physical presence states have the potential to be the most problematic for taxpayers.

Legal and Business Considerations

The *Wayfair* decision has the potential to affect any business that sells taxable goods or services to out-of-state buyers. Below are some observations and possible planning points:

- **Substantial Nexus.** The threshold for establishing "substantial nexus" in the sales tax context is now the same as for most other state taxes. While Wayfair dealt with sales tax, the $100,000/200 completed transactions standard could apply to other state taxes, such as gross receipts taxes or corporate net income taxes. Many states already have similar "dollar/transaction" threshold standards for these taxes, which are often based on the Multistate Tax Commission's (MTC) model factor presence nexus standard. The MTC would deem a business to have substantial nexus if it had either $50,000 of property or payroll attributable to the state, it had $500,000 of sales attributable to the state, or at least 25 percent of the business's total yearly gross receipts are attributed to the state. The *Wayfair*decision may embolden states to more aggressively enforce their statutory nexus thresholds, or adopt such thresholds. In any case, businesses should be sure that they are compliant with the nexus thresholds already in place in various states, and businesses with activities in many states should consider conducting a nexus review.

- **Retroactive Application of Sales Tax Collection Obligations.** The Supreme Court emphasized that South Dakota's law prohibited retroactivity, and the Court concluded that this prohibition prevents discrimination against or the imposition of undue burdens on interstate commerce and alleviates the risk of double taxation. Thus, the path of least resistance for states is to copy South Dakota's model, and not mount a push to collect tax on past sales. In fact, a key distinction between the *Quill* decision (where the state lost) and *Wayfair* (where the state won) was that the state in *Quill* pushed for retroactivity. Should states attempt to impose sales tax collection obligations retroactively, there are strong arguments to be made by taxpayers that such attempts violate constitutional restrictions and result in double taxation.

- **International Retailers.** Unless there is a provision in a tax treaty that exempts citizens of a contracting party from local taxation, sellers that are not based in the United States will also be subject to state sales tax collection and payment obligations on sales made into the United States.

- **Taxable Goods and Services.** State law still determines what is a taxable sale and what is not, and the *Wayfair* decision does not change this. Determining whether a particular good or service is taxable under state law is often cumbersome and involves judgment calls and business decisions. To close budget holes, states have been interpreting their statutes more aggressively to subject more transactions (especially transactions involving electronic goods and services) to sales tax. Given the heightened focus on sales tax, doing periodic reviews of the goods and services sold in the states in which you do business is the best way to manage risk in this area.
- **Return to Brick-and-Mortar.** Sellers (and especially online-only retailers) that have avoided leasing or purchasing real estate in their key markets may consider doing so now that the unique cost savings from transacting business online are gone. Importantly, while the 2017 federal tax reform law capped the deduction that individual taxpayers can take for real property taxes (and state income taxes) at $10,000, this cap does not apply to real estate taxes assessed on real property used in a trade or business.
- **Congressional Response Unlikely.** Chief Justice Roberts and Justices Breyer, Sotomayor and Kagan dissented from the Court's opinion, arguing that any alteration of the physical presence rule should be undertaken by Congress rather than the courts. The majority opinion also hypothesized that Congress could still weigh in to establish a minimum nexus threshold. However, in the 26 years since *Quill* was decided, and despite significant lobbying efforts by state governments and the introduction of many draft bills, no law revising the physical presence rule was ever passed. As such, *Wayfair* is very possibly the last word on the subject for the foreseeable future.