WASHINGTON UPDATE

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The Potential Impact of Requiring Sellers with No Physical Presence to Collect Sales and Use Tax

The Supreme Court has held in two separate cases decided in 1967 and 1992 that the interstate commerce clause of the U.S. Constitution prohibits a state from requiring an out-of-state vendor who solicits sales by mail-order catalogues to collect use tax for sales made to customers in that state when the vendor lacked outlets, sales representatives, or other significant property in the state. Those two cases were *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992) and *National Bellas Hess, Inc. v. Department of Revenue*, 386 U.S. 753 (1967). In so doing, the Supreme Court established a ''bright line'' physical presence test. Without physical presence, the seller does not have ''substantial nexus'' with a state and cannot be required to collect its use tax.

In the *Quill* case, the Supreme Court held that Congress was nonetheless free to require remote sellers to collect and remit a state's use taxes when they sell to residents of that state under its power to regulate interstate commerce. Thus, the court reasoned that ''Congress is now free to decide whether, when, and to what extent the States may burden interstate mail-order concerns with a duty to collect use taxes,'' pursuant to its power to regulate commerce among the several states. [*Quill*, 504 U.S. at 318.] Although the Court was sympathetic to the plight of the states that are faced with an erosion of their sales and use tax base, it was even more sympathetic to the argument that businesses had reasonably relied on *National Bellas Hess* for 25 years.

Predictably, Congress has not taken any action to permit states to require remote sellers to collect their use taxes. As a result, it has fallen to the Supreme Court to impose that requirement as soon as the opportunity presents itself. In that regard, Alabama and South Dakota have taken important first steps in that process by amending their state sales tax laws to require out-of-state vendors without physical presence to collect their use tax in direct violation of *Quill*. Alabama adopted a new sales tax regulation that requires large out-of-state sellers to collect and remit its state sales and use tax effective as of January 1, 2016. For these purposes, a large retailer is defined as one with retail sales over $250,000 per year. [*See* Ala. Rule 810-6-2-.90.03; Ala. Code §40-23-68 (2016).] Likewise, South Dakota enacted a law that requires out-of-state retailers with "economic presence" in the state, *i.e.*, those with retail sales of at least $100,000 or with at least 200 transactions annually with South Dakota residents, to collect and remit sales and use taxes effective May 1, 2016.

The newly enacted sales tax laws of Alabama and South Dakota are clearly unconstitutional under *Quill*, and both states know this fact. Their goal was to commence the litigation process that could get one or more cases before the Supreme Court. Neither

state expected to have its new statute or regulations or upheld by any lower court because of *Quill*, but the states were willing to lose at every turn before either case is eligible to be heard by the U.S. Supreme Court. The strategy of the states has finally paid off because on January 12, 2018 the Supreme Court agreed to hear *South Dakota v. Wayfair, Inc.*, a case challenging the constitutionality of South Dakota's newly enacted sales and use tax law. Now we shall see if the Supreme Court is willing to acknowledge the changed and ever-changing nature of retail sales.

By the end of June 2018, the Supreme Court can decide once and for all if *Quill* is to remain good law, or the circumstances under which states may impose sales and use tax collection obligations on remote sellers. The oral arguments in the *Wayfair* case indicated that the outcome of the case is far from certain. While the court is sympathetic to the argument that states are losing a great deal of revenue, it is also grappling with the argument that businesses have relied on *Quill* for 26 years and the fact that Congress has not chosen to impose a use tax collection obligation on remote sellers.

An important question that is lurking in the background is the impact on the incentive and overall marketplace if the Supreme Court modernizes its state sales and use tax jurisprudence and eliminates the outmoded and illogical physical presence requirement. Should that occur, remote sellers would find themselves treated the same way as brick and mortar retailers when it comes to collecting sales and use taxes. The effects of such a ruling on various remote sellers are not clear.

The 45 states that impose sales and use taxes assert that they could collect an estimated $26 billion in sales and use taxes on products sold remotely (on-line and by mail order) according to the National Governors Association. In November 2017, the Government Accountability Office estimated the potential revenue for states to be between $8.5 billion and $13.4 billion annually, though the GAO also warned that businesses will face compliance costs. Presently, nearly all that revenue goes uncollected.

The large on-line retailers like Amazon.com are already voluntarily collecting sales and use taxes in every state, regardless of physical presence. Therefore, the Supreme Court's decision will have no effect on how most large retailers conduct business. Small sellers will be at a disadvantage, however. For smaller companies, the cost of compliance (investing in technology like Vertex Indirect Tax O Series that assists with collecting and remitting sales and use tax and filing the appropriate forms) would eat into profit margins. It would be very helpful if states or Congress were to exempt small remote sellers from sales and use tax collection.

In the incentive marketplace, the employer or other customer would prefer a "turn key" incentive program and would not want to be responsible for collecting, reporting, and remitting sales or use taxes. The onus on performing these functions is bound to end up falling on incentive firms. Therefore, incentive firms that are not doing so already need to be prepared to add the cost of sales and use tax compliance into their programs. As with traditional retailers, the administrative compliance costs are bound to hurt smaller incentive firms more than larger ones.

There is even less clarity where promotional products companies are concerned. On the one hand, it would seem simpler if there were no sales use tax collection obligation without physical presence. On the other hand, and perhaps more importantly, promotional products companies are often required to collect and remit sales and use taxes on behalf of their customers. For these companies, it would be much more useful if Congress and/or the states were able to simplify and harmonize sales and use tax collection and reporting.

If the Supreme Court overturns *Quill*, the winners are bound to be state governments and large electronic retailers and catalogs. The former will be able to tap into another source of revenue, while the latter will enjoy another advantage over smaller competitors due their ability to absorb compliance costs more easily. The losers may end up being smaller retailers due to the very same compliance costs. Either way, it would best serve everyone if states were work together to simplify their sales and use tax statutes and perhaps exempt small remote retailers from having to collect such taxes.