WASHINGTON UPDATE

Incentive Federation, Inc.
June 26, 2018

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The Supreme Court Requires Sellers Without Physical Presence to Collect Sales and Use Tax

The Supreme Court had 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 had established a ''bright line'' physical presence test. Without physical presence in a state, the seller was not deemed to have ''substantial nexus'' with that state and could not 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 were 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 did not take any action to permit states to require remote sellers to collect their use taxes. As a result, 26 years after *Quill*, it fell to the Supreme Court to impose that requirement when the opportunity presented itself. As a result, on June 21, 2018, the court held in *South Dakota v. Wayfair, Inc.*, 585 U.S. ___ (2018), that the physical presence requirement it imposed in *National Bellas Hess* and *Quill* was "unsound and incorrect" in the current age of the Internet and electronic commerce. Those two cases that had created a sales and use tax environment that gave out-of-state sellers an unfair advantage over local brick and mortar retailers are no longer in effect.

In *Wayfair*, the court reiterated that the correct standard in determining the constitutionality of a state sales and use tax law is set forth in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977), which held that state taxes are constitutional as long as they (1) apply to an activity with a substantial nexus with the taxing state, (2) are fairly apportioned, (3) do not discriminate against interstate commerce, and (4) are fairly related to the services the state provides. Therefore, a state tax is constitutional if it applies to an activity that has "substantial nexus" with the taxing state, and the court held that substantial nexus is not equivalent to physical presence.

The case involves South Dakota's economic nexus law, which 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. As such, the South Dakota statute exempts small merchants. Moreover, the statute provides that it would be applied prospectively only if its constitutionality is upheld. In overturning *National Bellas Hess* and *Quill*, the court specifically held that physical presence is not required to meet the "substantial nexus" requirement set forth in *Complete Auto Transit*. The court concluded that South Dakota had established that Wayfair and the other remote sellers had substantial nexus with the state through their "extensive virtual presence."

An important question that is lurking in the background is the impact on the incentive and overall marketplace now that the Supreme Court has modernized its state sales and use tax jurisprudence and eliminated the outmoded and illogical physical presence requirement. Henceforth, 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 the holding in *Wayfair* on various remote sellers are not as clear or obvious.

Although physical presence is no longer required before a remote seller must collect and remit a state's sales and use tax, *Wayfair* does not provide states with a broad and absolute right to enact or enforce all types of economic nexus laws. South Dakota included several safeguards in its law to prevent it from violating the interstate commerce clause: (1) the law has a safe harbor provision that permits merchants to transact business in the state below certain specific thresholds, (2) the law is not retroactive, and (3) South Dakota is a member of the Streamlined Sales and Use Tax Agreement, which reduces administrative and compliance costs for taxpayers and even provides state-funded sales tax administration software. Other states with economic nexus provisions will need to ensure that their statutes and regulations satisfy the requirements of the commerce clause and *Complete Auto Transit*.

In any case, the 45 states that impose sales and use taxes have argued that, without the physical presence test, they should be able to 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. Until now, nearly all that revenue went uncollected.

The large on-line retailers like Amazon.com have been voluntarily collecting sales and use taxes in every state already, 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 erode profit margins. Accordingly, 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 like 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 have not begun doing so already need to start adding 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 have been simpler if there were no sales use tax collection obligation without physical presence. On the other hand, and perhaps more importantly, promotional products companies were often required to collect and remit sales and use taxes on behalf of their customers, even before the *Wayfair* case. As with incentive houses, it would be beneficial to promotional products companies if Congress and/or the states were able to simplify and harmonize sales and use tax collection and reporting.

When the Supreme Court overruled *National Bellas Hess* and *Quill*, the winners were state governments and large electronic retailers and catalogs. The former will be able to tap into a source of lost 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), even if states were to enact economic nexus laws with reasonable exemptions for such retailers. Either way, it would best serve everyone if states worked together to simplify their sales and use tax statutes and perhaps exempt small remote retailers from having to collect such taxes. States could take an important first step in that process by joining the Streamlined Sales and Use Tax Agreement.