ROCHESTER BUSINESS JOURNAL
RBJ
WWW.RBJ.NET
JULY 27, 2018

States win in Supreme Court ruling on taxing internet sales

TAXING MATTERS
Josh Gewolb

The Supreme Court has upended one of the most basic principles of sales tax law, allowing states to impose sales tax collection duties on out of state companies.

The 5-4 ruling in *Wayfair v. South Dakota*, authored by retiring Justice Anthony M. Kennedy, is a paradigm shift in sales tax, requiring remote sellers to collect tax on their sales nationwide. Companies making sales over the internet will need to take immediate action to address their new responsibilities to collect and remit taxes in multiple additional jurisdictions.

Prior to the decision, based on decades-old Supreme Court precedent, companies were not required to collect sales tax in states where they did not have a physical presence. That rule stemmed from the Supreme Court's 1992 ruling in *Quill v. North Dakota*. In that case, the court held that the existence of customers in the state, without a physical presence, did not establish the type of "nexus" required under the constitution to require that the company collect sales tax.

The *Quill* case concerned an out-of-state catalog retailer—and was decided two years before Amazon founder Jeff Bezos quit his day job to start an online bookstore.

With the rise of internet sales, the impact of *Quill* escalated. Purchasing goods from out-of-state retailers, once relatively rare, became commonplace, as did deliberately purchasing costly items online to avoid having sales tax collected and remitted. To combat the growing revenue loss, states started taking the matter into their own hands. Many established so-called "Amazon laws," which taxed e-commerce retailers if they paid state residents a commission to refer sales—a common practice in the e-commerce industry.

The boldest step was taken by South Dakota. The state enacted a law, which became the subject of the *Wayfair* case, that explicitly tested the physical presence standard in *Quill*. It imposes a tax on remote sellers if they have more than 200 taxable South Dakota sales in a year or sell more than $100,000 in taxable products.

As the *Wayfair* case began to wind its way to the Supreme Court, more than 20 states followed suit with similar laws of their own, some directly tied to a favorable outcome in the *Wayfair* litigation.

On June 21, the Supreme Court issued its decision upholding the South Dakota law and finding its earlier decisions on this topic to be "unsound and incorrect." The court held that the physical presence rule is not a necessary interpretation of the Constitution's commerce clause, and that the rule creates market distortion and treats economically identical actors differently for arbitrary reasons.

The court further reasoned that modern e-commerce does not align analytically with a test that relies on the prior physical presence standard. Finally, it stated that that the physical presence prior rule had inequitable outcomes, giving online retailers an arbitrary advantage by allowing them to help their customers evade a lawful tax.

The court went on to explicitly overrule its prior ruling 1992 ruling, stating that it was as a "false constitutional premise" that is "egregious and harmful."

What does the new landscape look like?

The court did not specifically spell out the level of connection that a retailer must have to a state to be required to collect tax there, but explained that nexus is established when the taxpayer "avails itself of the substantial privilege of carrying on business in that jurisdiction." It is clear under the decision that any state law imposing a tax collection responsibility on remote sellers must provide a reasonable degree of protection to small businesses; however, other than blessing South Dakota's formulation, the law does not explain what the minimum requirements are.

Remitting and collecting tax will be required immediately or in the near future in states that have already enacted provisions that are now permitted under *Wayfair*. States that have not yet enacted such rules will surely move quickly to do so.

There will be clear winners and losers as the post-*Wayfair* world begins to take shape. For the states, the decision is a huge win. Billions of sales tax dollars that were lost to remote commerce each year can now be collected. Brick-and-mortar retailers—both national chains and local operations—will likewise benefit as it will be harder to achieve a sales tax incentive to make purchases online.

The losers are remote sellers, who will need to collect tax in many states. In addition to losing a competitive advantage, remote sellers will face new compliance duties. The sales tax laws are a messy patchwork of state-by-state rules, which will make this complex.

Two dozen states, including South Dakota, have conformed their laws to a common standard, but more than half do not follow its uniform policies. The Court cited South Dakota's adherence to this standard as one reason for its decision to uphold the law, and it is not actually clear whether the decision applies to states that do not do so.

The court did hold that Congress could establish a sales tax system that requires remote sellers to collect tax through its power to regulate interstate commerce. Despite many false starts in the almost 25 years since *Quill*, Congress did not do so. Perhaps *Wayfair* will galvanize Congress to action, though establishing any limitations on the new state powers recognized by the Supreme Court may be politically difficult.

Companies that sell remotely need to take action to make sure that they conform to the new ruling. This includes not only retailers of physical goods, but also sellers of digital goods and services. Complying with these rules requires understanding the often intricate laws of each state in which significant sales are made. The landscape is likely to continue to shift rapidly in the coming months and years. Immediate attention—and continued review as the law develops in multiple jurisdictions—is essential to ensure compliance and avoid audit exposure.

Josh Gewolb is a tax partner at Harter Secrest & Emery LLP.