What's Next for Remote Sellers After *Wayfair*

By Michael P. Duffy, Esq.

The June 2018 Supreme Court decision in South Dakota v. Wayfair, Inc. *repealed the sales tax "physical presence" standard required by* Quill Corp. v. North Dakota. *In doing so, the Supreme Court opened the door for states to impose a sales tax collection obligation on large and medium-size out-of-state retailers operating over the internet.*

In what is probably the biggest state and local tax case of the past decade, the Supreme Court last month released its long-awaited opinion in *South Dakota v. Wayfair, Inc*. As was generally expected by state tax practitioners, the *Wayfair* opinion overturned the Supreme Court's widely criticized 1992 holding in *Quill Corp. v. North Dakota*. Broadly speaking, the repeal of *Quill* means that states are now permitted to impose a sales tax collection obligation on an out-of-state retailer, even if such retailer does not have any sort of physical presence in the state of the customer.

OVERVIEW

Quill itself has long been considered an anachronism. For instance, the departure from physical presence as the exclusive means of asserting state power over a party began with the Supreme Court's 1945 decision in *International Shoe Co. v. Washington.* In that case, the Supreme Court established that the Due Process Clause supported a state's assertion of personal jurisdiction over an out-of-state corporation based on the corporation's "minimum contacts" in the forum state. A series of cases following *International Shoe* provided that these minimum contacts are established when a party intentionally engages in transactions with customers in a forum state or purposefully avails itself of that state's market.

Unlike the concept of personal jurisdiction, a state's authority to tax the activities of remote parties is regulated jointly by both the Due Process Clause and the Dormant Commerce Clause. The two clauses together have been read to limit a state's power to tax an out-of-state party to instances where the taxpayer has a constitutionally sufficient connection with the state seeking to impose a tax obligation. The Supreme Court refers to this constitutionally required minimum level of connection to impose a tax obligation as "nexus."

The degree to which "minimum contacts" and "nexus" are different has been the subject of significant debate over the past 40 years. Obviously, the Due Process Clause's minimum contacts standard does not require a taxpayer's physical presence. The Supreme Court expressly stated this conclusion in *Quill*. But the degree to which the Dormant Commerce Clause imposes additional restrictions has been less clear.

In deciding *Quill* in 1992, the Supreme Court held that the Dormant Commerce Clause required a remote seller to have a physical presence in the jurisdiction of the state of the customer in order for that state to impose a sales tax collection obligation on the seller. The seller in *Quill* solicited sales from North Dakota customers through mail-order catalogs, and used common carriers for shipping. Following *Quill*, it was an open question whether the physical presence standard should be applied to all manner of state tax obligations, or the holding was limited to only sales tax obligations.

The Supreme Court appeared to limit the applicability of *Quill's* physical presence standard in more recent years to sales tax obligations only. For example, in the late 2000s, the Supreme Court declined to consider appeals of two high-profile state income tax cases that relied on the use of "economic nexus" theories to establish the requisite connection between the state and the seller. The connection in *Tax Comm'r of State of W. Va. v. MBNA America Bank N.A.* involved a taxpayer generating receipts from offering credit cards to in-state residents, and the basis in *Lanco, Inc. v. Division of Taxation* involved an out-of-state taxpayer receiving licensing fees earned from in-state usage. The state supreme courts in West Virginia and New Jersey, respectively, found both of those connections to be sufficient to justify the imposition of an income tax obligation on the out-of-state parties.

The Supreme Court's refusal since then to hear either *MBNA* or *Lanco* on appeal has been interpreted as its acceptance of economic nexus theory in principle, at least with respect to the imposition of a state income tax liability. Still, the *Quill* physical presence standard persisted for sales tax obligations up until last month.

WHAT IS ACTUALLY IN THE *WAYFAIR* DECISION?

Wayfair decided exactly one issue: It repealed *Quill's* physical presence standard as applied to sales tax. The Supreme Court made its determination in the context of a challenge to S.B. No. 106, a South Dakota bill that, among other things, created an economic nexus standard for out-of-state retailers.

Technically, all other remaining Dormant Commerce Clause challenges to S.B. No. 106 were remanded to courts in South Dakota. As a result, it is theoretically possible, although unlikely, that S.B. No. 106 may ultimately be found unconstitutional on some other ground. I say this outcome is unlikely because the Supreme Court's discussion of S.B. No. 106 appeared to approve of certain features in the statute, especially

when considered in the context of South Dakota's overall sales and use tax compliance regime.

S.B. No. 106 imposes a collection and remittance obligation on out-of-state sellers that cross a bright-line sales threshold. The threshold was set at either $100,000 or more in sales or 200 or more separate transactions with South Dakota customers in any given year. The structure of S.B. No. 106 was clearly inspired by various model sales tax nexus proposals that have been floating around in recent years, including the widely discussed federal Marketplace Fairness Act and the Multistate Tax Commission's Sales and Use Tax Nexus Model Statute. It should be noted, however, that the Marketplace Fairness Act set the dollar threshold at a much higher $1,000,000 in sales per year.

The Supreme Court focused on several features of S.B. No. 106 in its review. In particular, four aspects of S.B. No. 106 were identified as supporting its constitutionality: the fact that South Dakota was a member of the Streamlined Sales and Use Tax Agreement, the fact that South Dakota offered free software to out-of-state vendors to assist in meeting their compliance burdens, the fact that the bill prohibited retroactive enforcement, and the fact that enforcement of the bill was stayed until its constitutionality was validated. Whether or not the presence or absence of any one of these features would have impacted the Supreme Court's ultimate finding has yet to be determined, but states at least have fairly strong guidance on best practices for revising their sales tax nexus statutes for remote sellers going forward. In this sense, the case is also a major shot in the arm for the Streamlined Sales and Use Tax Agreement.

THE RUN-UP TO *WAYFAIR* IS ALMOST AS IMPORTANT AS THE ACTUAL DECISION

The Supreme Court's decision to overturn *Quill* needs to be considered in the context of the past two years. As the case made its way up to and past the Supreme Court of South Dakota, approximately 20 states jumped on the bandwagon and passed similar nexus laws for remote sellers. Revenue considerations aside, much of this legislative action was aimed at creating a large enough controversy that the Supreme Court would essentially have to resolve the issue. As a result, with so many states jumping the gun, some uncertainty exists as to exactly what will be tolerated going forward from a constitutional perspective.

For a local example, consider Massachusetts. In 2017, the Massachusetts Department of Revenue issued Directive 17-1, which required internet retailers with sales in excess of $500,000 or 100 or more transactions with delivery to Massachusetts customers during the six-month period ending December 31, 2017, to begin collecting sales. The directive took the position that *Quill* applies to mail-order vendors but does not apply to sales made over the internet because the installation of software on an in-state customer's computer creates a sufficient physical presence. From a constitutional standpoint, the directive was not especially persuasive, but the point was obviously to have some sort of written administrative policy in place in the event *Wayfair* created a surprise opportunity for Massachusetts to begin taxing out-of-state vendors. Less than three months after Directive 17-1 was issued, it was withdrawn in Directive 17-2. Ostensibly, the Massachusetts Department of Revenue repealed Directive 17-1 because the department was aware that it could not make such a significant change in the state's long-standing nexus policy without enacting new statutes or at least engaging in formal administrative rulemaking. However, after a formal notice-and-comment period, the substance of Directive 17-1 was later codified in 830 Code Mass. Regs. 64H.1.7. The Department of Revenue takes the position that the new nexus regulation is effective against internet retailers as of September 22, 2017. It is an open issue whether the roughly nine-month gap between the effective date of the regulation and the *Wayfair* decision will result in liability for internet vendors.

Rhode Island took an approach different from that of Massachusetts, and in 2017 included in its annual budget a series of statutes collectively known as the Non-Collecting Retailers, Referrers and Retail Sale Facilitators Act which require out-of-state vendors who interact with customers through installed software to report their activities to the Division of Taxation. Borrowing from S.B. No. 106, the reporting standard is inapplicable to out-of-state vendors unless they have sales in excess of $100,000 or 200 or more separate transactions with in-state customers in a given calendar year. Vendors subject to the Act must either register for and begin collecting sales tax, or alternatively agree to provide to customers a series of notices and disclaimers reminding them that they may be liable for use tax on their purchases. Vendors opting for compliance by issuing notices to customers must also report in-state customer data to the Division of Taxation. The reporting framework permits the Division of Taxation to both identify customers that have unreported use tax liability and identify out-of-state vendors that may be taking aggressive nexus positions. The Sale Facilitators Act went into effect on August 17, 2017, and is almost certainly enforceable in light of *Wayfair*.

WHAT IS THE PRACTICAL IMPACT FOR MOST BUSINESSES?

The practical impact of *Wayfair* is that the numerous statutes passed by various states over the past two years now likely have teeth, and taxpayers should expect another round of nexus statutes copying S.B. No. 106 to be forthcoming. For remote sellers operating under the assumption that a state's economic nexus or reporting standard previously was unenforceable, *Wayfair* clearly blows up this assumption.

Harder questions persist concerning the degree to which retroactive liability will be permitted, and what effect membership in the Streamlined Sales and Use Tax Agreement has on an economic nexus standard's constitutionality. On this subject, it is worth pointing out that Rhode Island is currently a full member state of the Streamlined Sales and Use Tax Agreement, and Massachusetts is not.

On the plus side, Rhode Islanders may be in for some bonus rate relief. Under R.I. Gen. Laws 44-18-18, the sales tax rate is supposed to drop from 7.0% to 6.5% on all sales "upon passage of any federal law which authorizes states to require remote sellers to collect and remit sales and use taxes. . . ." Although it is unclear whether the rate relief is effective when federal laws change due to judicial action, the underlying rationale behind the lowering of the rate was that if out-of-state vendors were paying their fair share, the burden on local businesses and consumers could be reduced. The Division of Taxation has yet to issue any guidance on this topic, but hopefully it will have some official statement out shortly.

OBVIOUS WINNERS ARE RETAILERS OF BIG-TICKET ITEMS

The big question now is what impact collecting sales tax on out-of-state internet purchases will have on consumer behaviors. One of the historic reasons for keeping *Quill* since the early 2000s was based not on policy but on practicality; this fledgling thing called the internet needed to be free from excessive burdens and regulations so that companies in that space had time to grow and develop. In 2018, a mature internet is clearly upon us.

The Supreme Court discussed at length the reasons for repealing *Quill*, focusing on the unfair advantage remote sellers had in generating sales that were not subject to sales tax. But this remote seller advantage may have been somewhat illusory, as many internet sellers also have additional shipping and logistics costs that functionally operate as taxes, at least from the perspective of consumers. The combination of both shipping and sales tax on certain big-ticket or luxury purchases may consequently create sticker shock. On the other hand, for retailers with significant distribution networks or affiliates already in various states, sales tax was almost certainly already being collected. The *Wayfair* decision should not change this practice.

I suspect that for businesses that rely on customers seeking an absolute lowest price, *Wayfair* will have a measurable impact on whether customers will want to continue bargain hunting on the internet. One need only look at the full list of parties in the *Wayfair* decision, which included online furniture and high-end electronics sellers, to find out which businesses felt they had the most to lose from the abrogation of *Quill.* In any event, the cost difference between local retailers and internet sellers with minimal geographic footprints has been narrowed.

And finally, to the extent that Congress believes the prospect of businesses having to collect sales tax in states where their sales are as low as $100,000 is unpalatable, it retains the power to pass some version of the Marketplace Fairness Act. Whether there is any interest in this area following *Wayfair* has yet to be determined. **FT**

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