

Is There a Fair Way Forward after *Wayfair*? Assessing the Effect in California of the United States Supreme Court's Recent Decision

Wayfair: The Decision and Legal Landscape

Annette Nellen, CPA, Esq.
Professor

College of Business
San José State University

<http://www.sjsu.edu/people/annette.nellen>

<http://www.21stcenturytaxation.com>

Outline of Testimony for Joint Informational Hearing: Assembly Committee on Revenue and Taxation Senate Governance and Finance Committee

October 15, 2018

1. Basics of U.S. Supreme Court's decision in [*Wayfair*](#)
 - a. The “physical presence rule of *Quill* is unsound and incorrect.”
 - b. The physical presence standard should not be the standard for the “substantial nexus,” first part of the four-part test of *Complete Auto Transit* (430 U.S. 274, 279 (1977)).
 - c. Physical presence is an “arbitrary, formalistic” measure.
 - d. South Dakota's sales tax collection requirement protects interstate commerce by ensuring “sufficient nexus” based on both “economic and virtual contacts” sellers have with the state. Three features of South Dakota law ([S. 106](#) (2016)) support this: (1) safe harbor for limited business activity, (2) no retroactive application, and (3) a system to reduce administrative and compliance costs.
 - i. The Court did not find that all remote sellers can be subject to a state's taxes.
 - e. Case remanded to South Dakota Supreme Court to reconsider in light of the Court's new substantial nexus standard, which does not require a physical presence.
2. Significance of the decision – *South Dakota v. Wayfair, Inc.*, 138 S. Ct. 2080 (6/21/18)
 - a. Overturns 51 years of state tax precedent.
 - i. *Quill Corp. v. North Dakota*, 502 U.S. 808 (1992)
 1. Physical presence required for sales tax nexus per Commerce Clause of U.S. Constitution

- a. Must be more than “slightest presence” to meet “substantial nexus” requirement of the Commerce Clause (a few floppy diskettes in the state is not sufficient).
 - b. Modification from *National Bellas Hess* (1967) in that physical presence is not required for Due Process clause of the 14th Amendment. Differences exist between Due Process and Commerce Clauses.
2. Fundamental differences between Due Process and Commerce Clauses:

Due Process	Commerce Clause
Congress cannot change	Congress controls
<p>“Requires some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax.”</p> <p>Involves “fundamental fairness of governmental activity.”</p>	<p>“the Commerce Clause, and its nexus requirement, are informed not so much by concerns about fairness for the individual defendant as by structural concerns about the effects of state regulation on the national economy.”</p> <p>Limits “state burdens on interstate commerce.”</p>
Purposeful availment is enough; physical presence not necessary.	Physical presence required.

“The *Complete Auto* analysis reflects these concerns about the national economy. The second and third parts of that analysis, which require fair apportionment and non discrimination, prohibit taxes that pass an unfair share of the tax burden onto interstate commerce. The first and fourth prongs, which require a substantial nexus and a relationship between the tax and State provided services, limit the reach of State taxing authority so as to ensure that State taxation does not unduly burden interstate commerce. Thus, the "substantial nexus" requirement is not, like due process' "minimum contacts" requirement, a proxy for notice, but rather a means for limiting state burdens on interstate commerce. Accordingly, contrary to the State's suggestion, a corporation may have the "minimum contacts" with a taxing State as required by the Due Process Clause, and yet lack the

"substantial nexus" with that State as required by the Commerce Clause."

- ii. *National Bellas Hess, Inc. v. Dept. of Revenue of Ill.*, 386 U.S. 753 (1967)
 - 1. Due Process and Commerce Clause are closely related.
 - 2. If only contact with state is by mail or common carrier, no sales tax collection obligation exists.
 - a. No local benefits received so no fair share of government costs to bear.
 - b. Would impede "free conduct of its interstate business."
 - c. If every state and local jurisdiction required use tax collection, it "could entangle National's interstate business in a virtual welter of complicated obligations to local jurisdictions with no legitimate claim to impose 'a fair share of the cost of the local government.'"
- b. Effect on e-commerce, technology and consumer purchases
 - i. The 1992 holding in *Quill* helped shape business decisions in the e-commerce arena that primarily began in the mid-1990s with the start of Amazon.com and eBay, both of which only operate online. Of course, advances in technology was the key driver for the e-commerce phenomenon.
 - ii. What will be effect of *Wayfair* on e-commerce, technology and consumer purchases?
- c. Effect on state and local government revenues and overall tax systems
 - i. The *Quill* decision had a significant impact on the shape of state tax systems as states replaced lost sales and use tax with other revenues and found ways to broaden the meaning of physical presence.
 - 1. Lost sales and use tax was due to weak use tax compliance by consumers and state limitations on collection from vendors.
 - ii. What might be the effect of *Wayfair* on state and local government revenues and overall tax systems?
- d. Effect on other state and local taxes
 - i. The *Wayfair* decision will affect state and local revenues and some businesses beyond sales tax. This new disavowance of the need for physical presence for sales tax obligations also applies to income and other taxes.
- e. Effects on many stakeholders

More later + Nellen, "A Wayfair Whirlwind of Stakeholder Considerations – Part 1," *State Tax Notes*, 10/15/18.

- f. The decision might change Commerce Clause interpretations outside of state tax laws.

3. The *Wayfair* Decision

- a. 5-4 decision.
- b. The Court concluded that its “physical presence rule of *Quill* is unsound and incorrect.”
- c. Key facts:
 - i. 2016 - South Dakota enacted S. 106 to require certain remote sellers to collect sales tax. This was emergency legislation due to a need for revenue. Sellers were required to act as if they had a physical presence in the state and collect sales tax if, on an annual basis, they deliver over \$100,000 of goods or services into the state or had 200 or more transactions of in-state deliveries. The change applied prospectively with a delay pending a showing of constitutionality.
 - ii. South Dakota brought action against three sellers - Wayfair, Inc., Overstock.com, Inc. and Newegg, Inc.
 - 1. All are large companies with over \$1 billion of annual sales.
 - 2. None had physical presence in South Dakota.
 - iii. South Dakota lost in state courts due to the *Quill* physical presence requirement for sales tax nexus.
- d. Timeline:
 - i. October 2017 – South Dakota files petition with U.S. Supreme Court.
 - ii. January 2018 - writ of certiorari granted.
 - iii. April 2018 - oral arguments.
 - iv. Over [50 amicus curiae briefs](#) filed.
 - v. June 21, 2018 - decision issued with Justice Kennedy writing the majority opinion.
- e. U.S. Supreme Court held that physical presence is the wrong standard for commerce clause /sales tax nexus purposes.
 - i. Focus on dormant Commerce Clause jurisprudence dating back to the 1824 decision in *Gibbons v. Ogden*.
 - 1. Modern doctrine is based upon “two primary principles that mark the boundaries of a State’s authority to regulate interstate commerce”: state laws may neither discriminate against interstate commerce nor impose undue burdens on such commerce.
 - ii. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977) addresses Commerce Clause requirements for “the validity of state taxes.” Under

this four-part test, a state tax meets commerce clause standards if it “(1) applies to an activity with a substantial nexus with the taxing State, (2) is fairly apportioned, (3) does not discriminate against interstate commerce, and (4) is fairly related to the services the State provides.”

- iii. Physical presence is contrary to modern Commerce Clause application, and is an “arbitrary, formalistic” measure. It does not “put businesses on an even playing field” as it does not consider the size of businesses and imposes a “competitive disadvantage” for businesses with a physical presence compared to non-present sellers.
- iv. Technology used in e-commerce has given rise to new types of connections between a retailer and a state. A “virtual showroom can show far more inventory, in far more detail, and with greater opportunities for consumer and seller interaction than might be possible for local stores.”
- v. A rule “that ignores these substantial virtual connections to the State” should not be retained.

f. Majority concerns with dissenters

- i. Dissent: Congress should exercise its authority under the Commerce Clause to indicate when states may impose sales tax obligations on remote sellers.
- ii. Majority objection: “It is inconsistent with the Court’s proper role to ask Congress to address a false constitutional premise of this Court’s own creation. . . . It is currently the Court, and not Congress, that is limiting the lawful prerogatives of the States.”

g. Features of South Dakota Law That Protect Interstate Commerce

- i. *Safe harbor for limited business activity*: South Dakota law only requires remote sellers who annually have over \$100,000 of sales of goods or services into the state or 200 or more transactions.
- ii. *No retroactive application*: There is no obligation to remit sales tax for years preceding the effective date of the state’s remote sales law.
- iii. *A system to reduce administrative and compliance costs*: South Dakota follows the Streamlined Sales and Use Tax Agreement (“[SSUTA](#)”). The SSUTA requires uniform definitions, state level tax administration, and the provision of compliance software to sellers with audit protection to those who use it.

4. Longstanding arguments of a changed world mandating a change in vendor sales tax obligations.

- a. North Dakota Supreme Court – the world has changed since *Bellas Hess (N.D v. Quill Corp., 470 NW2d 203 (ND SCt 1991))*.
 - i. Changes in economy, society and commerce.

- ii. Legal analysis under Commerce and Due Process Clauses.
- iii. Larger mail order industry.
- iv. Technological advances:
 - 1. New ways to communicate and market goods.
 - 2. Automated accounting systems.
 - 3. Advancements in computer technology.
- v. “should stress economic realities rather than artificial benchmarks”
- b. Arguments by states and other after U.S. Supreme Court’s ruling in *Quill* in 1992.
- c. Majority arguments in *Wayfair* also noted technology changes warrant reconsideration of the *Quill* decision.
- d. Also concerns in *Bellas Hess* dissent and *Wayfair* majority opinions about creating a tax haven or shelter for mail order or e-commerce under the physical presence standard for sales tax nexus.
 - i. “*Quill* creates rather than resolves market distortions. In effect, it is a judicially created tax shelter for businesses that limit their physical presence in a State but sell their goods and services to the State’s consumers, something that has become easier and more prevalent as technology has advanced. The rule also produces an incentive to avoid physical presence in multiple States, affecting development that might be efficient or desirable.” [*Wayfair*]

5. Stakeholder Considerations

- a. State lawmakers
 - i. What does the *Wayfair* decision mean for states?
 - 1. Is [South Dakota’s S 106](#) standard the minimum or maximum standard to meet the “substantial nexus” standard of *Complete Auto Transit*?
 - a. [S 106](#) provides:

“Notwithstanding any other provision of law, any seller selling tangible personal property, products transferred electronically, or services for delivery into South Dakota, who does not have a physical presence in the state, is subject to chapters 10-45 and 10-52, shall remit the sales tax and shall follow all applicable procedures and requirements of law as if the seller had a physical presence in the state, provided the seller meets either of the following criteria in the previous calendar year or the current calendar year:

- (1) The seller's gross revenue from the sale of tangible personal property, any product transferred electronically, or services delivered into South Dakota exceeds one hundred thousand dollars; or
 - (2) The seller sold tangible personal property, any product transferred electronically, or services for delivery into South Dakota in two hundred or more separate transactions.”
- b. How important is it that a state adopt the Streamlined Sales and Use Tax Agreement (SSUTA) or some of its features such as provision of software and audit protection for using it?
2. What is the appropriate measure for nexus without physical presence defining it? Is it taxable sales? All sales? Number of transactions even if low value ones? Something else?
3. How should any measure of gross receipts apply? South Dakota’s S 106 applies the measure to the prior calendar year or the current year. This likely is insufficient lead time for the vendor to get the necessary tools and processes in place to collect and perhaps even for the state tax agency to offer assistance and ensure proper and timely compliance.
4. Will litigation result by a standard that is too low, such as 200 transactions of \$1 each?
5. When will nexus begin and end under any new standard and within the *Wayfair* decision?
- ii. What is the appropriate nexus standard given not only the *Wayfair* decision, but enforcement considerations and realities?
 1. Costs: South Dakota has a population of about 870,000 while California has a population of 39.5 million. Thus, there will be far more vendors subject to California sales and use tax collection in California than in South Dakota. These vendors will be located both inside and outside of the U.S.
 - a. Adoption of the South Dakota nexus standard in California will require additional resources, such as for personnel and technology, for the CDTFA.
 - b. Consideration should be given to finding the right balance of tax administration over non-present vendors with use tax enforcement by in-state consumers and businesses.

Note: Use tax compliance by consumers and businesses will still be required as many sellers will not have

collection obligations under a new nexus standard based on the *Wayfair* decision.

2. Fairness: Can all vendors subject to collection under a new standard be treated similarly in terms of enforcement?
 3. Authority: Rev. & Tax. Sec. 6203(c) provides that “retailer engaged in business in this state” “means any retailer that has substantial nexus with this state for purposes of the commerce clause of the law United States Constitution and any retailer upon whom federal law permits this state to impose a use tax collection duty.” This implies that vendors could (or should) assume that collection is required after June 21, 2018 if they meet the South Dakota SB 106 standard, without legislative action. Due to California not adopting the SSUTA, the benefits of a stated effective date, assurance of adequate resources for the taxpayer assistance and enforcement, fairness, and certainty, legislative action seems desirable.
- iii. What are other states doing in response to the *Wayfair* decision?
1. Many are adopting the South Dakota standard, often effective October 1 or November 1, 2018.
 2. Some are still studying the decision.
 3. States vary in whether legislation is needed to change the nexus standard or the tax agency may take action.

Resources:

- (1) Nellen, 21st Century Taxation blog, [“State Reactions to Wayfair Decision”](#).
 - (2) Dion, SalesTaxSupport.com blog, [“States Follow South Dakota: A By-State Guide on Economic Nexus”](#).
- iv. With a change in California’s nexus standard, what other changes are appropriate such as rate reduction, clarification or removal of special rules, sourcing (origin versus destination approach), vendor discount, an amnesty period, etc.?
- v. How will any state changes affect local governments? What do local governments desire?
- vi. Consider the guidelines in [“Principles of State Implementation after *South Dakota v. Wayfair*”](#) of the National Conference of State Legislators (6/29/18) (NCSL).
- vii. Is congressional action desired, such as for helping California vendors not face complexity in dealing with the sales and use tax laws of other states?
- b. Other stakeholder groups in terms of effect and possible actions in light of the *Wayfair* decision include:

- i. State tax agencies
- ii. Local governments
- iii. Multistate government organizations
- iv. Congress
- v. International government organizations, such as the OECD
- vi. Sellers and marketplace facilitators
- vii. Customers
- viii. Tax advisers

See Nellen, “A Wayfair Whirlwind of Stakeholder Considerations – Part 1,” *State Tax Notes*, 10/15/18; and Part 2, forthcoming.

6. Opportunities in Revisiting State and Local Sales and Use Taxes Rules

- a. The *Quill* physical presence was not a clear standard in many situations such as occasional employee visits to a state, and interactions with one or more persons in the state. Rev. & Tax. Sec. 6203 defining “retailer engaged in business in this state” is lengthy with multiple special rules, such as the so-called “Amazon rule” at Sec. 6203(c)(5).
 - i. Opportunity to provide a more certain, simple standard within the bounds of the *Wayfair* decision.
- b. The *Quill* physical presence can result in seemingly unfair results, such as a large company with large sales in the state yet no physical presence not required to collect tax versus a small vendor with small sales in a state but a physical presence even to train customers for a few days or a small amount of inventory on an irregular basis.
 - i. Opportunity to provide a fairer and more equitable standard within the bounds of the *Wayfair* decision.
- c. California’s sales and use tax rate is high relative to other states.
 - i. Opportunity to lower the rate if a new nexus standard within the *Wayfair* decision results in greater collection of sales and use tax relative to past efforts of consumers and businesses self-reporting use tax.
 - 1. A 2017 GAO report estimates that “potential revenue gains from expanded tax collection authority on remote sales” for 2017 for California is between \$1 billion and \$1.7 billion. [GAO, *Sales Taxes: States Could Gain Revenue from Expanded Authority, but Businesses Are Likely to Experience Compliance Costs*, [GAO-18-114](#), Nov. 2017, p. 48.]
 - 2. State sales tax rates range from 4% to 7.25% (California) with a median rate of 5.75%. [Federation of Tax Administrators (FTA), [“State Sales Tax Rates and Vendor Discounts”](#) at 1/1/18.]

- ii. Opportunity to revisit the sales tax base to also help lower the rate in ways appropriate for a sales tax (for example, tax should apply to final consumption, not to business purchases).
- d. California's sales and use tax does not fully meet [principles of good tax policy](#) such as equity, neutrality, simplicity and certainty.
 - i. Opportunity (and perhaps need) to clarify and update occasional sales rule, drop shipment rule, vendor discount or compensation, and others.
 - ii. Opportunity to review exemptions, such as the one for certain foreign purchases under Rev. & Tax Sec. 6405.