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U.S. Supreme Court Decision Permits States to Tax Online Retailers Without Any In-State Physical Presence

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The U.S. Supreme Court has released a much-anticipated decision in *South Dakota v Wayfair, Inc.*, which overturned the Court's decades-old limitation on states' power to assert sales tax jurisdiction over out-of-state sellers. In this strongly worded opinion, released on June 21, 2018, the Court took the unusual step of categorically overturning one of its prior decisions, *Quill Corp. v North Dakota*, 504 U.S. 298 (1992), which the Court criticized as "unsound and incorrect." The *Wayfair* case is the Court's most significant state tax decision in at least 30 years.

Background

Under the Court's interpretation of the U.S. Constitution's commerce clause, a state cannot exercise its taxing power with respect to an out-of-state seller of goods or services unless the seller has certain "minimum contacts" with the state. Decided before the advent of the Internet, the *Quill* case affirmed the Court's position that a state could not tax an out-of-state retailer unless the retailer had a physical presence in the state – so, for example, a retailer that solicited customers and consummated sales by sending catalogues to residents of a state through the mail could not be required to collect and remit that state's sales tax unless the retailer had a physical presence, such as a store or warehouse, in that state.¹

As access to the Internet became more widespread during the late 1990s and early 2000s, online retailers were able to conduct massive amounts of business in states where they lacked a physical presence without collecting sales tax on behalf of those states. In *Wayfair*, the Court called this state of affairs a "judicially created tax shelter" that, according to the Court, caused the states to lose between \$8 and \$33 billion every year.

The mounting losses generated a contentious debate between consumers and online businesses, on the one hand, and state governments and traditional retailers, on the other. States became increasingly creative as they tried to bring online sales into their taxing jurisdictions, for instance, by creating the so-called affiliate nexus standard aimed at platforms such as the "Fulfillment by Amazon" program. The U.S. Congress balked at measures that would be viewed as raising taxes, but the hardship on the states could not be ignored.

Despite Congress's inaction, the individual states began enacting aggressive statutes to impose sales tax nexus on online retailers, even though the constitutionality of such measures was in question. The South Dakota statute at issue in *Wayfair* imposes sales tax nexus on any seller that delivers more than \$100,000 of goods or services into South Dakota or engages in 200 or more separate transactions for the delivery of goods or services into the state. The *Wayfair* decision seems to have held that South Dakota's model of remote nexus, at least, is in fact constitutional.

The *Wayfair* Opinion

The Court criticized *Quill* on three main grounds. First, the Court found that *Quill*'s physical presence test was not a "necessary interpretation" of the Court's substantial nexus requirement, because physical presence is not the only type of minimum contact that can establish substantial nexus between a business and a state. Second, the Court found that *Quill* "creates rather than resolves market distortions" by putting in-state sellers at an "unfair and unjust" competitive disadvantage with respect to remote sellers. Third, the Court found that *Quill* imposes an "arbitrary, formalistic distinction" by, for example, requiring an online retailer with an in-state warehouse to

collect sales tax but allowing an online retailer with a warehouse located just across the state's border to make sales to state residents free of sales tax.

These criticisms amount to an overarching concern with fairness, not only for the bricks-and-mortar competitors of online businesses but also for the states themselves, which provide essential services that enable e-commerce to take place. According to the Court, "there is nothing unfair about requiring companies that avail themselves of the States' benefits to bear an equal share of the burden of tax collection." In the words of the Court, the physical presence rule of *Quill* "has limited States' ability to seek long-term prosperity and has prevented market participants from competing on an even playing field."

The *Wayfair* opinion is also notable because of its extensive concern with the effect of technology on the modern economy. The Court even hinted at a new test for substantial nexus based on "substantial virtual connections" to a state, which would be a type of physical presence established via customers' computers through, for example, cookies left on customers' hard drives or apps downloaded onto customers' phones. According to the Court, "a business may be present in a State in a meaningful way without that presence being physical in the traditional sense of the term."

Income Tax Nexus

The *Wayfair* case has extended the states' taxing power with respect to sales tax, but the case does not affect the states' income tax jurisdiction — at least with respect to remote sellers of tangible property. The states' income tax jurisdiction is subject to a limitation imposed by Congress in 1959 known as "P.L. 86-272," which provides that a state may not impose income tax on a nonresident if the only business activities of the nonresident in the state consist of the solicitation of orders for sales of tangible personal property, provided that the orders are sent outside the state for approval or rejection, and, if approved, are filled by shipment or delivery from a point outside the state. Because of this rule, remote sellers of goods are still protected from state income taxes despite the Court's holding in *Wayfair*.

States may tax a nonresident's income if all of the criteria of P.L. 86-272 are not met, and P.L. 86-272 does not protect nonresidents from taxes other than income taxes. Accordingly, states may be able to rely on *Wayfair* to extend their taxing jurisdiction with respect to taxes that are not covered by P.L. 86-272, such as income taxes with respect to the provision of services or excise taxes and other taxes that are not based on net income. In addition, emboldened by their victory in *Wayfair*, states may mount judicial or legislative challenges to P.L. 86-272 in an effort to extend their income tax jurisdiction to remote online retailers.

International Considerations

Foreign sellers should be especially concerned in the aftermath of *Wayfair*. As a result of *Wayfair*, individual states and other localities may assert that foreign sellers with online customers in the United States are required to collect and remit sales tax.

Tax treaties generally protect foreign sellers from U.S. federal income tax liability if a seller does not have a "permanent establishment," which is similar to a physical presence, in the United States. The United States' tax treaties, however, do not expressly apply to state taxes. Therefore, foreign sellers of services and, if the rule of P.L. 86-272 is changed, foreign sellers of goods may find themselves subject to state income tax liability, even though an applicable tax treaty protects them from federal income tax liability.

Although the United States has not supported the base erosion and profit shifting initiative (BEPS) of the Organisation for Economic Co-operation and Development (OECD), the South Dakota statute at issue in *Wayfair* shares features of the "digital permanent establishment" described in BEPS Action 1, "Addressing the Tax Challenges of the Digital Economy." Under a digital permanent establishment provision, an online business would have a permanent establishment in a country if the business generated more than a threshold amount of revenue from that country, the business had more than a threshold number of users in the country, or the business concludes more than a threshold number of contracts with residents of a country. This is reminiscent of South Dakota's statute, which is based on the number of or dollar amount of sales. The similarity of the OECD and South Dakota approaches might lead one to question how long the U.S. Treasury Department can cling to traditional models for determining the limits of the United States' taxing jurisdiction.

Conclusion

The impact of the new rule could be immense, as there are almost 10,000 state and local sales tax jurisdictions in the United States.² At the oral arguments for the *Wayfair* case, the suggestion was made that a single sale would be sufficient to subject a remote seller to sales tax in a jurisdiction. Since these states and localities have an incentive to make their nexus standards as low as possible, the compliance burden for online retailers could turn out to be mind-boggling. Companies that provide tax compliance software may be the biggest winners in the *Wayfair* case.

¹ Under a state's "use tax," a state resident who purchases goods through the mail is required to pay tax on the sale if the seller does not collect sales tax. In theory, a state's use tax should make the state whole for uncollectable sales taxes. Compliance with use taxes is notoriously low, however.

² Some states, such as Texas and Missouri, have well over a thousand each, while some other states have a single sales tax jurisdiction or even none at all. See "[State Sales Tax Jurisdictions Approach 10,000](#)."

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