Supreme Court Ruling in *South Dakota v. Wayfair Inc.* Updates Physical Nexus Standards and Sales Tax Collection Policies

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ABSTRACT

In the case of *South Dakota v. Wayfair Inc.*, the U.S. Supreme Court overturned controlling cases addressing standards and guidelines for sales tax collections. These precedent cases, in existence for decades, formed the basis for competitive advantages that the E-commerce industry held over traditional commerce. These two cases held that an out-of-state seller's liability to collect and remit sales tax to the consumer's respective state depended on whether the seller had a physical presence in that state. This research paper examines several issues leading to this recent Supreme Court decision. Additionally, coordinated state efforts in 2000 led to what would become the Streamlined Sales and Use Tax Agreement (SSUTA). The SSUTA offered voluntary guidelines to assist states in modernizing sales tax collection policies. Future implications of the *South Dakota v. Wayfair Inc.*, decision upon commerce policy and sales tax collections are explored.

Introduction

On June 21, 2018, in the case of *South Dakota v. Wayfair Inc.*, the U.S. Supreme Court overturned precedent cases from 1967 (*National Bellas Hess v. Illinois Department of Revenue*) and 1992 (*Quill Corporation v. North Dakota*). For decades, these precedent cases formed the basis for an advantage that the E-commerce industry held over traditional, brick and mortar-based commerce. These two cases held that an out-of-state seller's liability to collect and remit sales tax to the consumer's respective state depended on whether the seller had a physical presence (referred to as nexus) in that state. Many virtual retailers were permitted to avoid collecting sales tax and subsequently held pricing advantages over traditional brick and mortar retailers.

This research paper examines several issues leading to this recent Supreme Court Decision in *South Dakota v. Wayfair Inc.* Since *Quill*, individual states and the U.S. Congress have attempted, with limited success, to clarify the sales tax collection issue. For example, coordinated state efforts in 2000 led to what would become the Streamlined Sales and Use Tax Agreement (SSUTA). The SSUTA responded to *Quill* by crafting voluntary compliance guidelines to assist states in simplifying and modernizing sales and use tax administration. The primary goal was to reduce the burden of sales tax compliance upon individual states. *Wayfair* will provide direction and clarification in areas such as policy in reference to sales tax collections. Future implications of this landmark decision upon commerce and sales tax collections are explored.

Overview of Sales Tax

Sales tax is levied on the purchase of certain goods and services, imposed at the state and/or local levels. There are only five states that do not impose a sales tax – Alaska, Delaware, Montana, New Hampshire, and Oregon. Typically, the seller collects the tax from customers and remits the funds to the appropriate state or local government. In states that impose a sales tax, buyers are responsible for use tax if they purchase an item from a vendor in another state that would have been taxable if bought within the state of residence. Sales and use tax are mutually exclusive, meaning that only one tax applies to a single transaction. Therefore, if the customer purchases a taxable product or service in his or her resident state, the customer pays sales tax; if the customer purchases the same item from a vendor in another state, the customer pays use tax to his or her resident state.

Use tax was initially imposed due to mail-order and catalog sales, when the out-of-state business also had a physical presence in the taxing state. Out-of-state sales were not as widespread as they are now through E-commerce. Although use tax is imposed on the out-of-state transaction for the buyer, use tax reporting and payment are often voluntary. In addition, buyers are often unaware of the use tax liability for which they are responsible (Cavanaugh, 2012). Therefore, use tax compliance is not as high as sales tax compliance.

States depend on sales tax revenue to varying degrees. States with no sales tax rely more heavily on other sources of revenue such as property or income tax. However, in 2016, general sales tax in Texas amounted to 62% of total taxes collected by the state; in Florida this amount was slightly less but a still substantial 59%. For these and many other states, sales tax revenue is vital to the state budget. States have begun to adopt new sales tax laws that redefine the "nexus," or physical presence, criteria for taxation of internet-based retail transactions. However, the states cannot place a substantial or "undue" burden on interstate commerce. Sales and use taxation have become more cumbersome, as the number of taxing jurisdictions continues to increase. As of June 30, 2017, there were 10,708 sales tax jurisdictions in the United States (South Dakota v. Wayfair, Inc., et al., 2018).

National Bellas Hess v. Illinois Department of Revenue (1967)

In 1967, the state of Illinois wanted to collect sales tax from National Bellas Hess, a mail order company located in Missouri. This U.S. Supreme Court case reinforced two Constitutional provisions that relate to the states' ability to impose sales tax. States must not violate either the Interstate Commerce Clause of the U.S. Constitution or the Due Process Clause of the 14th Amendment. The concept of the Interstate Commerce Clause is that states cannot enact laws that impose an undue burden on commerce between states. According to the Due Process Clause, a state must have a "minimal connection" with the business on which it seeks to impose a sales tax. The case re-established that the seller must have a "substantial nexus" with the state in order for the state to impose sales tax (Ropp & McNamara, 2014). When the case was decided in 1967, a substantial nexus was not as difficult to define. It was typically a physical presence through an office, warehouse, retail location, or employees. This decision formed the initial groundwork for the collection of online sales tax (Bennett & Elson, 2016.)

Quill Corporation v. North Dakota (1992)

Quill Corporation is a Delaware office supply mail-order company headquartered in Illinois. In 1992, the state of North Dakota believed that it was owed use tax from Quill because its residents purchased items from the company's catalog. The Supreme Court again ruled that this would violate the Interstate Commerce Clause because it would unduly burden the company, which would be required to calculate, collect, and remit sales tax to thousands of jurisdictions. In addition, the court ruled that there was no substantial nexus with North Dakota (Ropp & McNarmara, 2014). The case again reinforced the definition of "nexus" as physical presence in the respective taxing state (Holderness, 2018).

In the decades since this decision, commerce in the United States has evolved, along with the perceived definition of "nexus." Sales and use tax collection have been further complicated by the rise of E-commerce and online retail transactions.

"Amazon Tax" Law

In 2008, the state of New York issued tax guidance in hopes of collecting sales tax from out-of-state online retailers. Amazon.com had been highly criticized by traditional retailers and state governments for not collecting sales tax in several states that imposed the tax (Ropp & McNamara, 2014). In response, New York adopted its "click-through" nexus statute South Dakota v. Wayfair, Inc., et al., 2018). The expanded "nexus" definition includes online retail transactions when a customer clicks a link on an in-state website that takes them to an out-of-state vendor's website (Klamm & Zuber, 2012). Eighteen other states have now followed suit, enacting similar statutes (South Dakota v. Wayfair, Inc., et al., 2018).

South Dakota v. Wayfair, Inc. (2018)

In 2016, South Dakota enacted a law requiring out-of-state vendors with more than $100,000 in sales or at least 200 separate transactions to collect and remit sales tax. Wayfair, Inc., a leading online retailer of household goods, along with other major virtual retailers argued that the act was unconstitutional. In June 2018, the U. S. Supreme Court overruled *Quill* and *National Bellas Hess*, stating the physical presence rule is an incorrect interpretation of the Commerce Clause. According to the Court, physical presence is not required to generate a substantial nexus. A substantial presence or nexus can also be created based on the economic activities and virtual connections of a business within a state. Nexus is established when a seller has the substantial privilege of conducting business in a jurisdiction and therefore becomes liable to collect and remit sales tax. The court noted the South Dakota system, in consideration of the Commerce Clause, attempts to reduce the burden of sales tax compliance for remote sellers. For example, the South Dakota act applies prospectively and establishes sales thresholds which provide a safe harbor for sellers without a substantial presence. In addition, South Dakota adopted the Streamlined Sales and Use Tax Agreement (South Dakota v. Wayfair, Inc., et al., 2018).

Streamlined Sales and Use Tax Agreement (SSUTA)

In 2005 the Streamlined Sales and Use Tax Agreement (SSUTA) became effective. This agreement was the result of coordinated state efforts to increase sales tax collections while concurrently decreasing the burden of compliance for remote sellers (Hofmann, McSwain & McSwain, 2013). Significant sales tax compliance burdens arise for several reasons. First, there are over 10,000 state and local sales tax jurisdictions in the country. Each jurisdiction has its own tax rate, definition of taxable items, acceptable tax-exempt items, remote seller effective dates, and sales thresholds. To complicate matters the registration process can be different for each state. Some states require registration in each jurisdiction while others allow for a single state level registration. A remote seller may need a sales analysis by jurisdiction just to determine sales tax registration requirements (Brennan, Jr., 2019). Of the 45 states that levy a sales tax, 35 also have local sales tax rates. Furthermore, state and local requirements may change as definitions, dates, rates, and regulations are updated. Since the *Wayfair* decision in 2018, most states have adopted revised sales tax collection laws.

In addition to expanding sales tax collections for the states, a major objective of the SSUTA is to significantly reduce the compliance burden for remote sellers by streamlining the system. Two key features of the agreement are uniformity and simplicity. Member states must agree on uniform definitions of sales tax terms, uniform state and local tax bases, uniform sourcing rules, and uniform administration of exempt sales. The state and local tax rates are simplified as well as the tax return format and remittance process. Administration of all sales tax is done at the state level. States pay an annual fee to fund the system and must also meet certain technology requirements. States may also need to make changes to existing regulations to meet all the requirements of the agreement (SST State Guide, 2019). The agreement benefits remote sellers by providing one application to register in all member states rather than registering in each taxing jurisdiction. Other incentives are a single location for administration, free sales tax administration software, and limited amnesty for prior sales (Hutchens, 2015).

The Streamlined Sales and Use Tax Agreement provides guidance for remote sellers for each state. Table 1 reflects the current status of membership in the SSUTA. To date, 24 of 45 taxing states have adopted the requirements of the SSUTA. The most recent activity was in 2014 when Ohio moved from associate to full membership. Associate members, such as Tennessee, have achieved substantial compliance with the SSUTA terms but not with each required provision.

Table 1: SSUTA Member States

State	Streamlined Sales Tax Member	State	Streamlined Sales Tax Member
Arkansas	2008	North Dakota	2005
Georgia	2011	Ohio	2014
Indiana	2005	Oklahoma	2005
Iowa	2005	Rhode Island	2007
Kansas	2005	South Dakota	2005
Kentucky	2005	Tennessee	2005 (Associate)
Michigan	2005	Utah	2012
Minnesota	2005	Vermont	2007
Nebraska	2005	Washington	2008
Nevada	2008	West Virginia	2005
New Jersey	2005	Wisconsin	2009
North Carolina	2005	Wyoming	2008

Source: https://www.streamlinedsalestax.org

Since the *Wayfair* decision in 2018, most states have enacted or changed economic presence effective dates and thresholds as indicated in Table 2. All but three taxing states have established effective dates for compliance. Proposed economic nexus legislation failed to pass in Florida, Kansas, and Missouri. In *Wayfair* the thresholds set by South Dakota of $100,000 in sales or 200 transactions were noted as a safe harbor for small sellers. Thirty-five states have set thresholds like South Dakota although several have eliminated the transaction threshold. Of the SSUTA member states, 19 established the same thresholds as South Dakota.

Critics of the SSUTA note that only 24 states have made the necessary changes to their sales tax regulations to obtain membership. This lack of participation by larger states may indicate the costs to join may be greater than any benefits (Hutchens, 2015). Staying in compliance with the detailed requirements of the SSUTA may also prove difficult. The governor of Kansas recently vetoed a bill which, if passed, would have put the state out of compliance with the SSUTA simply over differing definitions of food items (Cole, 2019). Establishing and maintaining acceptable uniform definitions and tax bases will continue to be a challenge for member states and any states seeking membership (Hofmann, McSwain & McSwain, 2013).

States will face challenges in simplifying the sales tax compliance process whether they are members of the SSUTA or not. Some states, such as Alabama, have already taken steps to address the issue. Alabama conforms to the South Dakota characteristics by setting a small seller threshold of $250,000 and applying the economic presence date prospectively. However, Alabama did not seek membership in the SSUTA and instead set up its own Simplified Sellers Use Tax Program (SSUT). This program allows sellers without a physical presence to collect, report, and remit a flat 8% sellers use tax on all sales into the state. Amnesty is provided for periods preceding October 2019 and sellers have a single point system to file all state and local sales taxes.

Future implications & Conclusion

The U. S. Supreme Court's landmark decision in *Wayfair* will impact states and remote sellers across the board. The scope of activity a state may choose to tax can be far wider than sales tax. Remote sellers may need to determine liability for income tax, franchise tax, and other types of business tax. Potential burdens for sellers include meeting the various tax return requirements, accounting software compliance, multiple state audits of sales tax returns and proper recording of any contingent liabilities in the financial statements (Brennan, Jr., 2019). As states seek to expand tax collections, the increased burdens on sellers may violate the Interstate

Commerce Clause and lead to Congressional action. The Streamlined Sales and Use Tax Agreement may be a solution to bring uniformity and simplicity to a burdensome sales tax system.

Table 2: Remote Seller Guidance (Individual States)

State	Economic Nexus Compliance Date	Sales Thresholds	Streamlined Sales Tax Member
Alabama	10/1/2018	$250,000	*
Arizona	10/1/2019|2020|2021	$200,000|$150,000|$100,000	*
Arkansas	7/1/2019	$100,000 or 200 transactions	2008
California	4/1/2019	$500,000	*
Colorado	12/1/2018	$100,000	*
Connecticut	7/1/2019	$100,000 and 200 transactions	*
Florida	N/A	NA	*
Georgia	1/1/2019|1/1/2020	$250,000 or 200 transactions|$100,000 or 200	2011
Hawaii	7/1/2018	$100,000 or 200 transactions	*
Idaho	6/1/2019	$100,000	*
Illinois	10/1/2018	$100,000 or 200 transactions	*
Indiana	10/1/2018	$100,000 or 200 transactions	2005
Iowa	1/1/2019	$100,000 or 200 transactions	2005
Kansas	N/A-per constitution and laws of U.S.	N/A	2005
Kentucky	10/1/2018	$100,000 or 200 transactions	2005
Louisiana	No later than 7/1/2020	$100,000 or 200 transactions	*
Maine	7/1/2018	$100,000 or 200 transactions	*
Maryland	10/1/2018	$100,000 or 200 transactions	*
Massachusetts	10/1/2017	$500,000 and 100 transactions	*
Michigan	10/1/2018	$100,000 or 200 transactions	2005
Minnesota	10/1/2018	$100,000 in 10 transactions or 100 transactions	2005
Mississippi	9/1/2018	$250,000	*
Missouri	N/A	N/A	*
Nebraska	1/1/2019	$100,000 or 200 transactions	2005
Nevada	10/1/2018	$100,000 or 200 transactions	2008
New Jersey	11/1/2018	$100,000 or 200 transactions	2005
New Mexico	7/1/2019	$100,000	*
New York	6/21/2018	$300,000 and 100 transactions	*

North Carolina	11/1/2018	$100,000 or 200 transactions	2005
North Dakota	10/1/2018	$100,000 or 200 transactions	2005
Ohio	8/21/2019	$100,000 or 200 transactions	2014
Oklahoma	11/1/2019	$100,000	2005
Pennsylvania	7/1/2019	$100,000	*
Rhode Island	7/1/2019	$100,000 or 200 transactions	2007
South Carolina	11/1/2018	$100,000	*
South Dakota	11/1/2018	$100,000 or 200 transactions	2005
Tennessee	10/1/2019	$500,000	2005, Associate
Texas	10/1/2019	$500,000	*
Utah	1/1/2019	$100,000 or 200 transactions	2012
Vermont	7/1/2018	$100,000 or 200 transactions	2007
Virginia	7/1/2019	$100,000 or 200 transactions	*
Washington	10/1/2018	$100,000	2008
West Virginia	1/1/2019	$100,000 or 200 transactions	2005
Wisconsin	10/1/2018	$100,000 or 200 transactions	2009
Wyoming	2/1/2019	$100,000 or 200 transactions	2008

* Current data as of July 2019
Table excludes five non-sales tax states (AK, DE, MT, NH, OR) District of Columbia and Puerto Rico.

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