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Wayfair decision continues to make waves

By Brent Watson, CPA

Many CPAs don't focus on sales tax matters. However, CPAs in public practice as well as those in corporate finance should be aware that the recent U.S. Supreme Court decision in South Dakota v. Wayfair, Inc. will have a major impact on many companies. News coverage commonly reported this decision would force e-commerce sellers like e-Bay and Land's End to begin collecting sales taxes. (Larger sellers, like Amazon, had already begun collecting sales tax.) However, the impact will be felt far beyond this, affecting not only myriads of small online sellers, but also traditional brick-and-mortar businesses, including wholesalers and manufacturers that have multi-state sales.

What was the Wayfair decision?

On June 21, 2018, by a 5-4 vote, the Court's ruling radically overturned foundational tenets of sales tax law pertaining to nexus, a concept meaning a taxpayer has sufficient connection with a state to allow the state to impose its sales tax laws on that taxpayer. In doing so, the Court reversed its own rulings issued over the past 51 years (National Bellas Hess, Inc. v. Department of Revenue of Ill.; 1967 , and Quill v. North Dakota; 1992), which had stipulated that in order to comply with the commerce clause of the U.S. Constitution , a physical presence test must be met for states to impose their sales tax laws on a seller. In the Quill case, the Court stated substantial physical presence was required to establish nexus.

Since the Quill case was decided in 1992, two factors have undermined the physical presence test for nexus. First, e-commerce emerged and grew explosively. Traditional retailers saw this as a threat to their businesses (partly because remote sellers were not required to collect sales tax); while state tax departments saw this as a threat to sales tax collections.

Second, as a result of the first factor, states, with backing by brick-and-mortar retailers, continually enacted laws imposing sales tax collection duties on out-of-state sellers based on very minimal levels of presence in their respective states. This was made possible because the Court's original decisions did not define the term "substantial physical presence" and because of inaction by Congress, despite a clear invitation by the Court for them to clarify the nexus issue.

When the Wayfair decision was issued, 31 states required tax collection by sellers who had very minimal physical presence in a state, such as airport stopovers by employees, contracts with in-state advertisers (even via a click-through on a computer screen) or by placing website cookies on computers within the state. Perhaps the final nail in the coffin for the physical presence standard was the passage of laws in the past two years requiring sellers with no physical presence in a state to either comply with burdensome 1099-like reporting duties or to collect total sales tax for that state whenever an annual sales threshold (some being as low as $10,000) was exceeded. This was made possible by the Court's refusal to act in a 2015 case, Brohl v. DMA , to overturn a Colorado law that first imposed these requirements. Enacting these requirements practically spelled the end of the physical presence test, as compliance with notification laws is costlier than collecting tax.

Based on the Court's decision, the new question for judges evaluating constitutionality of a sales tax imposition, instead of asking whether a state's laws sufficiently meets a physical presence test, is asking whether the tax discriminates against interstate commerce. If complying with a state's tax system is sufficiently burdensome on an interstate seller, it is unconstitutional, regardless of the level of the seller's physical presence in the state.

The Court expressed concern for undue and costly burdens imposed on small sellers to comply with overly complex sales tax laws in 45 states plus the District of Columbia and Puerto Rico, as well as hundreds of locally administered taxes in some states. As of the date of this writing, those agencies collect tax for more than 11,000 tax jurisdictions. In 2017, more than 700 of those units had rate changes, while hundreds more were affected by annexations. Adding to this complexity is the lack of uniformity in acceptance of sales tax exemption certificates, issues with drop shipments, states where locally ruled units have laws differing from state law, and constantly changing tax laws in all of these units. These combined factors create a crushing burden for any multi-state seller.

The Court pointed to South Dakota's participation in the Streamlined Sales and Use Tax Agreement (SSUTA) as a factor in approving of South Dakota's law. SSUTA is a group of 24 states that have cooperatively simplified many complexities. The Court carefully evaluated South Dakota's law , noting six features showing it was "designed to prevent discrimination against or undue burdens upon interstate commerce." These six features are (1) a safe harbor excluding those who sell only limited amounts in South Dakota (the SD threshold was $100,000 in annual sales or 200 sales transactions annually); (2) no retroactive tax collection; (3) single, state-level administration of sales taxes; (4) a simplified tax rate structure; (5) uniform definitions and other rules; and (6) access to software provided by the state with immunity for those who rely on it. Items three through six are products of SSUTA initiatives.

The justices who dissented in Wayfair emphatically stated the basis of their decision was that it is Congress's domain to enact law to regulate interstate commerce, stating, "…any alteration to those rules with the potential to disrupt the development of such a critical segment of the economy should be undertaken by Congress." The dissent argued Congress is better able to consider the competing interests and has more flexibility than the Court in crafting a solution. Additionally, the Court's written majority opinion affirmed Congress's authority to act, in effect inviting Congress to enact uniform laws to regulate taxation of interstate sales. The Court in Quill made a similar suggestion in 1992.

Additionally, the dissenting opinion noted the majority disregarded costs that would be incurred by retailers to collect and remit tax on e-commerce sales, which will fall disproportionately on small retailers. This is an excellent opportunity for Congress to bring a measure of simplicity to relieve excessive costs for multi-state businesses. The Court's decision was specific to South Dakota's law. It does little to specify what level of sales is required to create nexus, nor does it address locally administered taxes, the complex maze affecting businesses for physical presence rules when sales are not above the sales threshold or any of the other complexities resulting from inconsistent state rules.

Now that Wayfair has been decided, what conclusions can be drawn, and how should remote sellers react?

First, the physical presence test is not eliminated. Unless Congress enacts such a standard, the confirmation that states can impose an economic threshold does not replace the requirement for a seller with physical presence to collect tax. Sellers whose employees (or contract worker agents) sell, install, repair or deliver in company vehicles on a regular basis or have inventory in a state will have exposure for nexus in that state. Additionally, marketplace providers are still faced with laws in some states compelling them to collect tax for third-party sellers. In other states, those third-party sellers face nexus because their fulfillment vendor holds their inventory in various states. Taxpayers should continue to evaluate their footprints in states for physical presence irrespective of the new economic nexus standards.

Second, most states will attempt to enact laws similar to the South Dakota law to impose their tax on an economic nexus basis. Many have already passed such laws. Three states (Alabama , Massachusetts and Tennessee) enacted regulations imposing these standards without passing such laws, but such impositions are of doubtful legal standing. For states like Alabama, Colorado and Louisiana that have numerous locally administered taxes separately reported to those jurisdictions, imposition of economic nexus thresholds seems likely to be challenged on the basis that their sales tax laws are not sufficiently simplified and are not state-administered as specified in the Court's ruling. Taxpayers having multi-state sales should assume—for planning purposes, in the opinion of this author—that by Jan. 1, 2019, they will likely face imposition of tax on an economic basis in most states, and at this juncture, the best (and only) standards to consider are those by South Dakota—$100,000 in sales or 200 sales transactions annually.

Third, because this decision was strongly based on simplification and did not address locally administered taxes, it did not create authority for them to impose their taxes on an economic nexus. That does not mean locally administered jurisdictions such as Denver or Orleans Parish, for example, will not attempt to impose their taxes on this basis, nor does it guarantee such efforts will be ruled invalid. While this is an open question, it seems unlikely locally administered jurisdictions will ultimately be able to rely on an economic nexus threshold. Since collection of these taxes is so burdensome for small businesses, until and unless Congress acts or further legal decisions clarify this issue, businesses may be forced to weigh the cost of compliance

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against the risk of assessment should these jurisdictions pass such laws.

Fourth, because it is likely many companies will report taxes in additional states, taxpayers with multi-state sales should consider implementing sales tax software to add tax to invoicing and to report the taxes. Similarly, with collection of taxes in additional states, exemption certificates will need to be obtained and managed for those states. Taxpayers might consider implementing software to facilitate these processes.

Lastly, Wayfair's broad impact may extend to income tax. The Court's decision to approve economic nexus thresholds in the sales tax context may validate economic nexus statutes and court decisions applicable to state income taxes. Wayfair may encourage more states to enact income tax laws that implement a bright-line nexus standard. Taxpayers should take this into consideration when deciding in which states they should report income taxes.

One shoe has dropped. The states won their argument that it is time to modernize the imposition of sales taxes to fit the new economic reality. Now it is time for the other shoe to drop. It is time for simplification to allow businesses to comply with these crippling impositions caused by unnecessarily inconsistent and burdensome state requirements. Because most states have not acted to simplify their laws (with the exception of Arizona, which recently did away with locally administered taxes) and the Court has rightfully refused to act as a legislative body, only Congress can right this wrong. Now the question is whether or not Congress will come to the aide of small businesses reeling under the impact of these expanded sales tax burdens.

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It was about 2:30 p.m. on a July Sunday and while water bottles are provided for the ride, air conditioning was calling out to us. Prairie Artesian Ales was a great place to stop for a refreshing beverage and a nice place to sit. One of the primary spots on the Bikes + Brews tour, Prairie offered a brewery tour and tasty samplings of watermelon gose, Read but No Reply, and sour ale, No Way Frose.

After a brief pause for beer, we stopped to appreciate Wayne Coyne's art gallery, The Womb. The building mural, perhaps the most colorful in downtown, instigated many laws about how murals and public art get approval.

After crossing Broadway, we stopped for cookies from Elemental Coffee Company. Another quick break and a water refill was exactly what I needed.

As we made our way back to home base, we stopped at the federal building. Ryan

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offered an interesting architecture lesson on the style of rocks used and the shape and design of the building. Also, did you know there are 46 stars on the grounds because Oklahoma was the 46th state?

Next we took a quick jaunt over to Leadership Square to see the statue erected after the oil bust in the 80s. I learned "Galaxy" by Alexander Liberman is the largest of Oklahoma City's early public art works. It was erected to bring brightness into the city after a depressing economic downturn.

By this point, I was feeling unstoppable. (Literally, I could not stop and I bumped into another bike because I forgot my hand brake.) We made our final stop in front of the Civic Center and discussed the art deco themes throughout the older buildings on that side of the city.

As we made our final stretch back to home base, I reflected on my trip. I learned quite a bit and saw some new sights.

I enjoyed the chance to see my city from a different point of view. The world really does look different from two wheels.