

South Dakota v. Wayfair: Overturning Physical Presence Rule, New Tax Challenges for Multistate Businesses

Sales Taxation Post-Wayfair for Remote Sellers of Goods and Services; Key Tax Planning Considerations

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Today's faculty features:

Edward J. (Ted) Bernert, Partner, **Baker & Hostetler**, Columbus, Ohio

Martin Eisenstein, Managing Partner, **Brann & Isaacson**, Lewiston, Maine

Matthew P. Schaefer, State and Local Tax Partner, **Brann & Isaacson**, Lewiston, Maine

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Overview of Supreme Court Decision Overturning Physical Presence Rule

Edward Bernert, Baker & Hostetler
ebernert@bakerlaw.com

Introduction

The Essence of the *Wayfair* Decision:

- On June 21, 2018, the United States Supreme Court decided *South Dakota v. Wayfair Inc.*, 138 S.Ct. 2080 (2018).
- This was a 5-4 decision.
- The scope of the actual decision of the Majority of the Court was very narrow:
 - Two earlier decisions, *Quill* and *National Bellas Hess*, are overruled.
 - The physical presence test upheld in those two decision is incorrect and should be rejected.

Introduction (cont.)

- Justice Kennedy wrote the majority opinion and was joined by Justices Thomas, Gorsuch, Ginsburg and Alito.
- Chief Justice Roberts wrote the dissent and was joined by Justices Breyer, Sotomayor and Kagan.
- The Court remanded the case back to South Dakota for further proceedings.

Introduction (cont.)

The majority opinion in *Wayfair* failed to resolve several issues that seemed to be before the Court:

- Was the South Dakota statute itself constitutional?
- Because the elimination of the physical presence rule would impose burdens on sellers, especially small and medium sized sellers, what must states do to alleviate those burdens?
- Must a state statute provide a threshold, e.g. 200 separate transactions or \$100,000 in sales annually, and thereby exclude smaller sellers from the collection responsibility to be constitutional?

Introduction (cont.)

- Can the *Wayfair* decision be applied retroactively (and what does “retroactive” mean in this context)?
- What, if any, test should be substituted for the physical presence test?
- What role does Congress have in addressing the admitted burdens being imposed on sellers, especially small sellers, in complying with multiple jurisdictions?

One point is clear: the Majority decision clearly overruled earlier case law of *Bellas Hess* and *Quill*.

Prior Decisions of the Court

National Bellas Hess, Inc. v. Dep't of Revenue of Ill., 368 U.S. 753 (1967).

- Bellas Hess was an out-of-state mail order seller using the mails and telephone to take orders and ship to customers in Illinois.
- Bellas Hess had no people, inventory or other property in Illinois.
- The Court in *Bellas Hess* found that imposing a requirement to collect use tax on mail order sellers violated both the Commerce and Due Process Clauses of U.S. Constitution.

Prior Decisions of the Court (cont.)

- Justice Fortas joined by Justices Black and Douglas dissented on the basis that continuous and systematic solicitation and exploitation of the market was sufficient to require collection.

Prior Decisions of the Court (cont.)

Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977).

- This was not a nexus case in that all of the activities, persons and property were located in-state.
- The importance of *Complete Auto Transit* was two-fold:
 - (1) The Court announced an intention to be more practical and less formalistic in its Commerce Clause decisions.
 - (2) The Court announced a four-part test.

Prior Decisions of the Court (cont.)

- The four part test of *Complete Auto Transit* was that in order to comply with Commerce Clause, a state statute must:
 - (1) apply to an activity with a substantial nexus with the taxing state;
 - (2) be fairly apportioned;
 - (3) not discriminate against instate commerce; and
 - (4) be fairly related to the services the state provides.
- *Complete Auto Transit* was not directly concerned with burdens being placed on sellers in an interstate market.

Prior Decisions of the Court (cont.)

Quill Corp. v. North Dakota, 504 U.S. 298 (1992).

- Mail order seller had no people, inventory or other property (except for some floppy disks sent to customers) in North Dakota.
- The Supreme Court followed *Bellas Hess* and upheld the physical presence rule.

Prior Decisions of the Court (cont.)

Quill Corp. v. North Dakota, 504 U.S. 298 (1992).

- *Quill* was based in large measure on stare decisis (following prior precedent) and the benefit of having a bright line test.
 - The Court found that the intervening precedents, including *Complete Auto Transit*, might not dictate the same answer were the issue to arise for the first time after *Complete Auto Transit*.

Prior Decisions of the Court (cont.)

Quill Corp. v. North Dakota, 504 U.S. 298 (1992).

- The Supreme Court found that Due Process was not violated by the requirement to collect but there was not sufficient nexus for Commerce Clause purposes.
- Per the *Quill* Court, the principles animating the Commerce Clause were different from principles applicable to the Due Process Clause because unlike Due Process, where the issue was notice and fair warning, the Commerce Clause was concerned with structural concerns arising from the regulation of interstate commerce.

Prior Decisions of the Court (cont.)

Quill Corp. v. North Dakota, 504 U.S. 298 (1992).

- Commerce Clause prevents the imposition of undue burdens on interstate commerce.
- Congress can address violations of Commerce Clause but not Due Process.
- Thus, the reliance solely on Commerce Clause by the Court was seen as opening the door and inviting Congress to address the question of when states can require remote sellers to collect sales (use) tax.

Prior Decisions of the Court (cont.)

Quill Corp. v. North Dakota, 504 U.S. 298 (1992).

- The concurring opinions of Scalia, Kennedy and Thomas focused on stare decisis as the basis to uphold the physical presence test rather than the inherent validity of the physical presence test.
- The dissenting opinion by Justice White concluded that the physical presence standard had little value at the time (1992).
- Justice White concluded that the physical presence standard is an “anachronistic notion.”

States Responded to Quill

- Some states entered into the Streamlined Sales and Use Tax Agreement.
- State legislatures enacted statutes to enlarge the jurisdiction to tax.
- State taxing authorities aggressively sought to expand the concept of physical presence by litigation.

Streamlined Sales and Use Tax Agreement (“SSUTA”)

- A coalition of the states representing about a third of the population joined together.
- SSUTA does the following:
 - Standardizes definitions and some procedures.
 - Requires single state-level administration of the tax.
 - Provides access to software provided by the states.
- South Dakota is a member but several of the big states including California, New York, and Texas are not members.

State Legislatures Sought to Expand the Concept of Nexus

- Examples of legislation:
 - Nexus created by in-state affiliates;
 - Click through nexus exists when a resident of the state maintains a website and allows visitors to that website to “click through” to a merchant’s website;
 - Marketplace providers (facilitators) such as Amazon handling sales for other vendors create nexus for the other vendors;

State Legislatures Sought to Expand the Concept of Nexus (cont.)

- Examples of legislation:
 - Downloaded computer applications on in-state computers creates nexus;
 - Computer cookies “on” in-state computers create nexus;
 - Use of computer servers and computer content distribution network providers in-state create nexus; and
 - Use tax notice and reporting require non-collecting vendors to inform customers of the obligation to pay use tax and for the merchant to report to the taxing authority the in-state sales.

Litigation

- There was considerable litigation around the U.S. concerning the meaning of physical presence especially as state laws enhanced the concept.
- The use tax reporting process, which began in Colorado, was widely understood to be a means of inducing remote sellers to collect tax.
- The Colorado reporting process for sales made in-state went to the U.S. Supreme on a procedural question. The case is *Direct Marketing Association v. Brohl*, 135 S.Ct. 1124 (2015).

Litigation (cont.)

- Justice Kennedy penned an extraordinary concurring opinion in the Colorado case inviting the states to re-litigate *Quill*.
- On remand, the Federal Tenth Circuit Court of Appeals, including now Supreme Court Justice Gorsuch, upheld Colorado's use tax reporting process.

Congress

- Over the years, Congress addressed, but never enacted legislation to address *Quill*.
- Several bills were introduced:
 - Marketplace Fairness Act of 2017;
 - Remote Transaction Parity Act of 2017;
 - There were numerous predecessor bills in previous sessions.

Congress (cont.)

- None of these bills passed the House.
- No new legislation has been proposed since *Wayfair* although the House Judiciary Committee has heard testimony after *Wayfair* was decided.

The States' Response to the Concurring Opinion of Justice Kennedy

- The states sought to put together a case to get to the Supreme Court.
 - In 2016, South Dakota S. 106, 2016 Leg. Assembly, 91st Sess. (SD) was passed as an emergency to address imminent harm to the revenue collections in South Dakota.

The States' Response to the Concurring Opinion of Justice Kennedy

- The statute provided that only when on an annual basis the seller delivers more than \$100,000 of goods or services into the state or engages in 200 or more separate transactions is there an obligation to collect.
- The South Dakota statute prohibits retroactive application.
- The South Dakota courts recognized that the statute was invalid under *Quill* and refused to enforce the statute.

Wayfair Moves to the Supreme Court

- The State of South Dakota appealed to the U.S. Supreme Court, which accepted the appeal.
- Many amicus briefs were filed.
- The oral argument was spirited and few were willing to project how the Court would decide.

Wayfair Before the Supreme Court

Decision of Supreme Court in *Wayfair*--The parameters of the issue:

- The Court defines the role of Commerce Clause to prevent:
 - Discrimination
 - Imposition of undue burdens

Wayfair Before the Supreme Court

The briefs filed by the remote sellers and their amici focused on the undue burdens element

The majority seemed more focused on discrimination—the level playing field—than burdens

Reasons Why the Majority Rejected the Physical Presence Standard

- Lost revenue by the states.
- Consumer compliance rates with self-assessing sales taxes are notoriously low.
- The physical presence standard was perceived as giving out-of-state sellers an advantage that creates economic distortions.

Reasons Why the Majority Rejected the Physical Presence Standard

- Over time, the physical presence rule has become more detached from economic reality as new means of selling are employed.
- The physical presence standard does not align with e-commerce.
- The physical presence standard discourages remote sellers from investing in the states other than the home state to avoid taxation.

Reasons Why the Majority Rejected the Physical Presence Standard

- While Due Process and Commerce Clause standards serve different purposes as outlined in *Quill*, the two standards “have significant parallels.”
 - The implicit conclusion being that because the obligation to collect does not offend Due Process, the application of the Commerce Clause, should not alter the conclusion.

Reasons Why the Majority Rejected the Physical Presence Standard

- The physical presence standard is artificial in its entirety and unworkable in practice.
- Stare decisis is not a sufficient reason to continue to use the physical presence standard.
- The physical presence standard is a poor proxy for the costs of compliance with multiple states.

The Majority's Responses to the Assertions that Burdens Would be Imposed on Remote Sellers

The Majority acknowledges that elimination of the physical presence may pose legitimate concerns especially for small businesses.

Eventually, however, software may address the burdens.

The Majority's Responses to the Assertions that Burdens Would be Imposed on Remote Sellers

The Majority points to the South Dakota statute and the Streamlined Sales and Use Tax Agreement (“SSUTA”) as reducing burdens on smaller retailers.

- The South Dakota statute relieves small retailers from collecting the tax by creating annual thresholds of \$100,000 or 200 separate sales.
- The South Dakota statute rejects retroactive application of *Wayfair*.
- South Dakota through its participation in SSUTA simplifies some aspects of compliance.

The Majority of the Court Does Not Either Explicitly Approve or Require the Use of the South Dakota Thresholds

The Majority of the Court does not mandate participation in SSUTA

Justice Kennedy seemed satisfied that the means existed to address the burdens placed on remote sellers while never detailing those means of dealing with the increased compliance requirements and never linking those burden-reducing means to the Constitutional analysis.

The Majority of the Court Does Not Either Explicitly Approve or Require the Use of the South Dakota Thresholds

Justice Kennedy concluded that there was adequate nexus based on the volume of sales and the fact that the three retailers at issue were large entities.

In 2018, the Majority in *Wayfair* expressly states that *Quill* was wrong on its own terms in 1992 when decided.

New Standard to Replace Physical Presence

The Majority never formally articulates the standard to replace the physical presence standard. The Court's statement that most looks like the statement of the rule is that substantial nexus exists:

- When the actor (taxpayer or collector): “avails itself of the substantial privilege of carrying on business in the jurisdiction.”

New Standard to Replace Physical Presence

- The use of the word “avail” invokes the due process standard of “purposeful availment” of the market, meaning some direction of activity in-state, e.g. shipping product into the state or directing marketing efforts into the state.
- The remainder of the characterization of “substantial nexus” as the “substantial privilege of carrying on business” is not defined. Likely, the states will argue that having customers in the states meets the test so long as the magnitude of business is “substantial.”

Focusing on Discrimination Rather Than Imposition of Burdens

The analysis of whether a state statute discriminates against interstate commerce is a central element of Commerce Clause analysis for some state statutory schemes.

The remote sellers in *Wayfair* were focusing on the undue burdens branch of the Commerce Clause analysis rather than discrimination.

Focusing on Discrimination Rather Than Imposition of Burdens

The states argued that the requirements to collect tax were not discriminatory and in fact were designed to “level the playing field.”

The Majority focused on the perceived competitive advantage to the out-of-state sellers, classifying the physical presence standard as creating a tax shelter by permitting sales without adding the tax.

The Majority observed that having a website, what the Majority found to be a pervasive internet presence, is equivalent to having people or property in the state.

The Majority then Cites the “Economic” and “Virtual” Contacts of the Remote Sellers in this Case

Neither of these concepts is developed in the decision.

The Majority seemed unconcerned with providing a usable test to replace physical presence.

The Significance of Substantial Virtual Connections

- When comparing the seller with an in-state sales representative to another seller with an extensive website, the Majority was addressing why the physical presence standard should not be applied.

The Significance of Substantial Virtual Connections

But Justice Kennedy seemed to go further when saying:

- “For example, a company with a website accessible in South Dakota may be said to have a physical presence in the State via the customers’ computers.”
- “A website may leave cookies saved to the customers’ hard drives, or the customers may download the company’s app onto their phones.”
- “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.” Slip. Op. at 15.

The Significance of Substantial Virtual Connections

While these statements were made to support the conclusion that physical presence standard should not be applied, the statements raise questions about whether “virtual connections” create physical presence.

If virtual presence creates physical presence, Justice Kennedy’s arguments could have what appear to be unintended consequences.

Many state statutes focus on physical presence and some taxing authorities have expressed a desire to require compliance, even retroactively, when there is or was physical presence.

The Significance of Substantial Virtual Connections

Thus, the states may seize on the language of the Majority opinion to support a finding of nexus based on physical presence created by the “virtual connections” when that language actually was cited by Justice Kennedy to argue against the application of physical presence as the test.

The implication would be that a remote seller with the quantity or dollar volume of sales below accepted thresholds would have nexus based on a virtual presence in the state created by a website maintained outside the state.

It is not clear that the Majority would have accepted the idea that a robust “virtual presence” alone would create substantial nexus.

Providing Services in Interstate Commerce

In dicta, the Majority declared that sales of goods and services into the state creates nexus and that generally speaking a sale is attributable to its destination.

This is dicta when finding that delivery of services into the state creates nexus because services were not at issue in *Wayfair* although South Dakota is one of the few states that imposes sales tax broadly against services.

The taxation of services based on delivery of services is likely to be an important issue to be litigated in the future.

Dissent

“Bellas Hess was wrongly decided.”

Nevertheless, the Court should decline to overrule *Quill*.

Congress, not the Court, should undertake any needed alteration of the rule.

According to the Dissent, the Majority disregards the costs that will be imposed on retailers.

Congress should deal with the “troubling question” whether the decision should be given retroactive effect.

What Are the New Constitutional Standards for Determining When a Retailer Must Collect Sales Tax?

Matthew Schaefer, Brann & Isaacson
mschaefer@brannlaw.com

As a Matter of Constitutional Law, the Physical Presence Standard is Dead

- Court held that the physical presence rule was an “incorrect interpretation of the Commerce Clause” and that *Quill* was “wrong when it was decided.”
- Court, however, did not attempt to craft a new bright line rule for state sales tax, concluding that the Commerce Clause favor a “sensitive, case-by-case analysis of purposes and effects.”

Applicable Principles From the Court's Commerce Clause Jurisprudence

- *Complete Auto Transit* Four Prong Test.
 - This long-standing test for constitutionality of state tax laws continues to apply.
 - *Wayfair* sets forth a new interpretation of the “substantial nexus” prong.
- Court made clear that core principles of Commerce Clause jurisprudence also apply to state tax laws:
 - States may not discriminate against interstate commerce (part of *Complete Auto*, as well).
 - States may not unduly burden interstate commerce.

New Principle of “Substantial Nexus”

- New standard of “substantial nexus” described by the Court is likely applicable to *all* types of state tax, because *Complete Auto* applies broadly.
 - “Taxpayer ‘avails itself of the substantial privilege of carrying on business’ in that jurisdiction.”
 - Test may be satisfied by, among other things, sufficient “economic and virtual contacts.”

What Are “Economic Contacts”?

- Court’s *Wayfair* decision does not clearly describe the scope of “economic and virtual contacts,” but certain principles are clear.
- Economic contacts:
 - Exist when a retailer has significant sales or transactions for delivery into the state;
 - Court viewed South Dakota’s standards of \$100,000 in sales or 200 thresholds as sufficient.
 - But Court did not address a floor or relative levels.

What Are “Virtual Contacts”?

- “Virtual contacts” are even less clear:
 - Without any factual basis, the Court deemed the large retailers *Wayfair* to “undoubtedly maintain an extensive virtual presence” in the state.
 - Court variously referenced “targeted advertising,” “instant access to most consumers through an internet-enabled device,” a “virtual showroom,” and a “continuous and pervasive virtual presence.”
- For Internet sellers of reasonable size, arguing that the seller lacks “substantial nexus” is unlikely to succeed.

Undue Burdens on Interstate Commerce

- *Wayfair* can be read to reinvigorate the “undue burden” argument under the Commerce Clause.
- Previously, no argument concerning undue burden existed outside of the physical presence standard of “substantial nexus” under *Complete Auto*.
- Post-*Wayfair*, state taxes that satisfy *Complete Auto* must also be evaluated for undue burden.
 - The “daunting complexity and business-development obstacles of nationwide sales tax collection...may pose legitimate concerns,” especially for small sellers.

Undue Burdens on Interstate Commerce (cont.)

- Any retailer, even one with a physical presence in a state, may now argue that a state sales or use tax imposes an undue burden on interstate commerce.
- That said, by replacing the “bright line” *Quill* standard with a “case by case analysis,” the Court may leave many retailers, as a practical matter, with a difficult compliance choice.

Undue Burdens on Interstate Commerce (cont.)

- The Court outlined certain principles that support a constitutional framework.
 - The relevant burdens are those imposed on “companies that do business in multiple states.”
 - A balancing of such burdens against the benefits to the state is consistent with existing precedent in *Pike v. Bruce Church, Inc.*
 - The Court specified certain features of the South Dakota tax system that “appear designed to prevent ... undue burdens upon interstate commerce.”

“*Wayfair* Factors” on Undue Burden

- “[A] safe harbor [for] those who transact only limited business in [the state].”
 - Minimum sales and transactions thresholds;
 - Arguably calibrated to size of state.
- “[N]o obligation to remit the sales tax may be applied retroactively.”
 - Retroactivity risks of double taxation / discrimination;
 - Applying tax retroactively could unduly burden interstate commerce.

“Wayfair Factors” on Undue Burden (cont.)

- Adoption of the Streamlined Sales and Use Tax Agreement (“SSUTA”).
 - Applies across multiple states;
 - SSUTA standardizes taxes and reduces compliance costs through: a single, state level administration; uniform definitions of products and services; simplified tax rate structures; and other uniform rules.
 - SSUTA provides access to sales tax administration software paid for by the State;
 - Sellers using such software are immune from audit liability.

Commerce Clause Framework for State Tax Laws

- Review *Complete Auto* test – four prongs;
- Consider discrimination against interstate commerce;
- Evaluate undue burdens on interstate commerce:
 - Interstate sellers can raise burdens of compliance across multiple states;
 - Balance against state benefits;
 - States with least similarity to South Dakota – lacking the *Wayfair* factors – most vulnerable to challenge.

Due Process Post-*Wayfair*

- Court referenced due process standards to explain that physical presence is also not relevant in determining constitutional limits on state taxing authority.
- Court reaffirmed, however, that the requirements of the Due Process Clause and Commerce Clause are not “identical or coterminous.”
- “Minimum contacts” analysis of due process remains a separate test applicable without regard to presence.
- Due process may have additional significance for sellers of services and digital property.

Requirements of Specific State Sales Tax Laws Post-*Wayfair*

Matthew Schaefer, Brann & Isaacson
mschaefer@brannlaw.com

Post-*Wayfair* Sales Tax Compliance

- ***Major Caveat:*** The situation overall is very fluid – State enforcement positions are still developing and evolving.*
[*This report is as of 8/16/18.]
- States with sales tax systems that are most like South Dakota's regime are the best positioned for enforcement (especially SSUTA states).
- Many states, even non-SSUTA states, are gravitating toward the *Wayfair* factors.
- 15+ states have made no announcement yet.

Next Steps Going Forward for Retailers and States

- Retailers must adjust their sales tax compliance practices based on *Wayfair*.
- States must adjust their laws, as well – inordinately complex sales and use tax laws will likely be challenged.
- Uncertainty will be widespread for the immediate future – for not only sales/use tax, but also state income and franchise taxes.

Wayfair on Remand in State Court

- Case status:
 - Parties discussed an agreed resolution of the case, but could not reach settlement;
 - Statutory injunction remains in place;
 - Ongoing dispute over constitutionality.
- S.D. Governor called a special session of the legislature to convene on September 12, 2018, seeking a change in law to allow enforcement.

Other Lawsuits Where State Statutes Were Enjoined

- Wyoming:
 - Law nearly identical to South Dakota's;
 - The statutory injunction remains in place;
 - Case pending as of 8/16/18.
- Indiana:
 - Law very similar to South Dakota's;
 - State declaratory judgment to be dismissed 10/1/18;
 - Retroactive application foreclosed by court order.

Other Lawsuits Where State Statutes Were Enjoined (cont.)

- Tennessee:
 - Dispute over administrative rule with sales threshold of \$500,000 remains pending;
 - Suit by trade associations challenging law in 2017;
 - Enforcement of rule suspended by court order;
 - Rule also suspended by act of the legislature:
 - May not be enforced until court ruling; and
 - Legislature approves enforcement.
 - Legislature does not convene again until 2019.

Other Lawsuits Where Enforcement Was Not Enjoined

- Massachusetts:
 - Internet Vendor Rule with \$500,000 sales threshold;
 - Challenged by retailer in Virginia Circuit Court;
 - State defendants contesting personal jurisdiction; case pending as of 8/16/18.
- Ohio:
 - Statute with \$500,000 threshold for “software nexus” and “content delivery network nexus”;
 - Motion by state to dismiss suit by trade associations pending as of 8/16/18.

Categories of State Sales Tax Laws

- SSUTA member plus economic thresholds.
 - Approximately 19 states.*
 - [GA, IN, IA, KY, MI, MN, NJ, NC, ND, OH, OK, RI, SD, TN, UT, VT, WA, WI, WY]
- SSUTA only:
 - Approximately 5 states.*
 - [AR, KS, NE, NV, WV]
- Economic threshold only:
 - Approximately 11 states.*
 - [AL, CT, HI, IL, LA, ME, MA, MS, PA, SC, MD]

[*Review as of 8/16/18]

Categories of State Sales Tax Laws

- State laws with no *Wayfair* factors (yet):
 - Approximately 12 states.*
 - [AZ, CA, CO, DC, FL, ID, MO, NM, NY, TX, VA, PR]
- There is a disturbing trend of states adopting economic thresholds without express statutory authorization or a formal rulemaking process (including LA, MI, NJ, NC, SC, WA, and WI)

[*Review as of 8/16/18]

Announced Enforcement Dates*

- Enforcing as of 7/1/18: HI, ME, OK[^], RI[^], VT
[[^]collection or notice and reporting already in effect]
- Enforcing as of 10/1/18: AL, IL, IN, KY, MI, MN, NJ, ND, SC, WA[^], WI, MD (proposed), SD (proposed)
[[^]collection or notice and reporting already in effect]
- Other Early Enforcement Dates: CT (7/1/18 or 12/1/18), MA (**10/1/17**), MS (9/1/18), NC (11/1/18)

[*As of 8/16/18]

Announced Enforcement Dates*

- Enforcing as of 1/1/19 (or after): GA, IA, LA, NE, TN (after), TX (after), UT, WY
 - No date yet: AZ, AR, CA, CO, DC, FL, ID, KS, MO, NV, NM, NY, OH, PA[^], VA, WV
- [[^]collection or notice and reporting already in effect]

[*As of 8/16/18]

Largest States Not Yet Enforcing*

- None of the four largest states (CA, NY, TX, FL) has yet announced a formal enforcement policy.
- California: Has released draft legislative proposal with a \$500,000 sales threshold.
- Texas: Comptroller plans to amend rules for collection in early 2019.
- New York and Florida: The silence is deafening.

[*As of 8/16/18]

Very Aggressive Enforcement in Some States

- States are aggressively pursuing collection:
 - Massachusetts:
 - Pressing claims under the Internet Vendor Rule going back to 10/1/17.
 - Is this retroactive application of *Wayfair* “economic and virtual contacts”?
 - Vermont: Announced 7/1/18 enforcement almost immediately after *Wayfair* decision, even before the mandate issued from the Supreme Court.
 - Maine: Announced 7/1/18 enforcement date, after the fact, on 8/9/18.

Effect On Various Sellers of Products and Services, Including Providers of IT Products and Services

Martin Eisenstein, Brann & Isaacson
meisenstein@brannlaw.com

Categories of Possible Sellers

- Internet Sellers of Products
- Non-Internet Sellers of Goods
- Sellers of Digital Products
- Providers of IT Services
- Companies located outside of the United States
- Marketplaces

Key Features of the New Test

- No bright line but case-by-case
- Substantial Nexus: “Taxpayer ‘avails itself of the substantial privilege of carrying on business’ in that jurisdiction.”
- Common carrier deliveries count:
 - \$100,000 of goods/200 separate transactions
 - Large companies with extensive virtual presence:
 - Cookies and apps

“Some Other Principle”

- Discrimination: In-state retailers vs. interstate sellers
- Undue Burden: The “Wayfair Factors”
 - Size of company and magnitude of sales
 - Retroactivity of the state’s law
 - SSUTA

“Some Other Principle”

- SSUTA
 - Single state level administration
 - Uniform definitions of products and services
 - Simplified tax structures
 - Provides free software
 - Immunity from Liability

Internet Sellers: Substantial Nexus

- Substantial Nexus Questions
 - Is it a relative test by population of state?
 - If sales transactions exceed the threshold but sales are below the dollar amount, is that substantial?
Vice versa?
 - Does the nature of the delivery into the state affect substantial nexus?
 - Company owned trucks? Contract carriers? White glove service?

Internet Sellers of Products: Discrimination

- Turns on state laws and not kind of company
- Prime example of possible discrimination: Origin sourcing states such as CA

Internet Sellers of Products: Undue Burden

- Is there a weighing of the capabilities of the companies vs. the nature of the state's laws?
 - Size of company has some relevance
- Member of SSUTA vs. not a member.
- Single state rate?
- Compensation to retailers for collection?

Non-Internet Sellers of Products

- Types:
 - Pure Mail Order Catalog company
 - Inserts in Magazines and Newspapers
 - Television advertising
- Does the type of promotion affect the test?
 - Substantial nexus? Is virtual presence different?
 - Undue Burden?

Sellers of Digital Products

- Substantial Nexus:
 - No deliveries to the state, such as in *Wayfair*
 - Is the virtual presence of digital products in a state doing business in the state?
- Undue Burden:
 - How does seller learn the buyer's address?
- Discrimination: Sourcing because of place of delivery

Sellers of Digital Products

- PL 86-272
 - *Wayfair* test does not apply, because enacted per Commerce Clause affirmative grant of authority (the power “to regulate Commerce ... among the several States.”) *Wayfair*, slip opinion at 5 (federal legislation controls)
 - Are digital products deemed TPP? *See AccuZIP Inc. v. Director, Division of Taxation*, 25 N.J. Tax 158, 171 (N.J. Tax Court 2009)

Sellers of Digital Products: Due Process Question

- Does a sale of products delivered digitally have “some definite link, some minimum connection between a state and the person” *Wayfair*, slip opinion at 11, quoting *Miller Brothers*
- Does the digital transmission of products constitute sufficient contacts with the state. It is “defendant’s contacts with the forum state itself, not the defendant’s contacts with the persons who reside there,” that create the minimum contacts. *Walden v. Fiore*, 134 S. Ct. 1115, 1122 (2014)

Providers of Services

- Similar factors under Substantial Nexus/Undue Burden/Discrimination/Due Process tests, except that:
 - Fewer if any connections to the state where the buyer benefits from the services or from which the buyer accesses the service and the seller.
 - E.g., Cloud Services
 - E.g., Help desk
 - May be service activities in state; e.g. installation

Providers of Services

- Is there a different test under PL 86-272 for services?
 - Certainly if there are in-state activities of seller
 - I argue in an article in State Tax Notes that if the activities are conducted solely outside of the state, PL 86-272 implicitly exempted from the reach of state tax any income arising from activities occurring entirely outside a state even if engaged in by a seller of services. *See "Public Law 86-272: Sunlight for a Cloud Service," State Tax Notes (5/21/18)*

International Sellers

- Two additional elements to the *Complete Auto* test:
 - Is there a substantial risk of international multiple taxation; i.e., does the foreign country impose a transactional tax?
 - Does the tax prevent the federal government from speaking with one voice; i.e., treaty commitments
- Is an assessment enforceable outside of the U.S.?

Marketplace Facilitators

- CT, IA, MN, and WA require marketplace facilitators whose sales by marketplace sellers exceed a certain threshold to collect and remit the sales tax on such sales
- SC has a proposed ruling.
- OK, PA and RI give the marketplace facilitator the option to collect or comply with notice and reporting.
- Marketplace Facilitator: (1) facilitates a retail sale by an advertisement for the retailer and (2) collects payment for the retailer.

Marketplace Facilitators

- Is there a difference in the analysis?
 - A marketplace facilitator has added burden and costs of determining the taxability of products across many sellers
 - A marketplace facilitator does not benefit from in-state deliveries, as do retailers
 - Is a marketplace facilitator different than a bricks and mortar shopping center?

The *Wayfair* Decision's Implications For Other State Taxes, Including Gross Receipts Taxes and Income Taxes

Edward Bernert, Baker & Hostetler
ebnert@bakerlaw.com

Other Taxes

The implications of the *Wayfair* decision for other state taxes including income and gross receipts taxes.

- The *Wayfair* decision addressed only sales and use taxes and did not implicate income or gross receipts taxes.
- For many years, the nexus standards for all taxes applicable to interstate commerce were essentially the same.

Other Taxes

The courts began to distinguish between (a) sales and use tax cases and (b) income tax cases when addressing nexus.

- The States began arguing that a reading of the *Quill* decision, and its reliance on stare decisis, meant that the physical presence test of *Bellas Hess* and *Quill* should be limited to sales and use tax because, according to the States:
 - The Supreme Court had not expressly applied the physical presence test to other taxes;

Other Taxes

- The Supreme Court was said to have applied the physical presence test in *Quill* only from a desire to follow the *Bellas Hess* decision, which by its terms was limited to sales and use taxes.
- The States speculated that after *Complete Auto Transit*, if the Supreme Court would address a nexus issue for income tax purposes as an original proposition, the Supreme Court would not impose the physical presence test.

Income Taxes

Geoffrey and its progeny.

- The position that the nexus standards for sales and use taxes are different than other taxes was recognized in a decision of the South Carolina Supreme Court in *Geoffrey v. South Carolina Tax Commission*, 437 S.E.2d 13 (S.C. 1993).

Income Taxes

Geoffrey and its progeny (cont.).

- *Geoffrey* was a trademark holding company case in which Toys R Us transferred trademarks to *Geoffrey* and then Toys R Us licensed the marks back and thereby reduced South Carolina and other state income taxes.

The South Carolina Supreme Court concluded that due process nexus was present in that *Geoffrey* purposefully directed its activities at South Carolina by licensing marks for use there.

The Court held that the Commerce Clause did not require that the company have a physical presence in the state, and that the presence of intangible property was alone sufficient to establish nexus.

Income Taxes

Geoffrey and its progeny (cont.).

- The South Carolina Supreme Court in *Geoffrey* suggested that it was “well settled” that physical presence was not required for income tax.
- Commentators have criticized the South Carolina Court’s decision in that the decision seemed to disregard the distinction between Due Process and Commerce Clauses.
- *Geoffrey* was the first in a series of cases, concerning trademark companies, in which state courts held that a physical presence in the state is not required for purposes of state income taxes. See *KFC Corp. v. Iowa Dep’t of Revenue*, 792 N.W.2d 308 (Iowa 2010).

Income Taxes

Geoffrey and its progeny (cont.).

- At least some, if not all, of the decisions concluding that physical presence was not required before a finding of nexus likely were driven at least in part because the cases concerned trademark holding companies.
 - While some trademark holding companies were established as legitimate legal structures, some of these arrangement lacked substance and the holding company arrangement had become notorious as aggressive tax planning.

Income Taxes

Other income tax nexus cases.

At same time that the Courts were using relaxed nexus standards for holding company cases, the courts were evaluating nexus standards in other kinds of nexus cases.

In *Tax Commissioner v. MBNA America Bank, N.A.*, 640 S.E.2d 226 (W.Va. 2006), the bank had no property or employees in West Virginia but issued credit cards to customers in the state and recognized millions of dollars of income attributable to the accounts of West Virginia residents. MBNA promoted its business in West Virginia via mail and telephone solicitation.

Income Taxes

- The West Virginia Supreme Court specifically rejected the *Quill* physical presence test when evaluating the tax on the bank while finding that a “significant economic presence test” is a “better indicator of whether substantial nexus exists for Commerce Clause purposes.”
- Then in *Griffith v. ConAgra Brands, Inc.*, 728 S.E.2d 74 (2012), the West Virginia Supreme Court distinguished *Geoffrey, KFC and MBNA* in holding that an out-of-state company was not subject to West Virginia income tax merely because products bearing its trademarks were sold in the state. The difference in *ConAgra* was that the taxpayer did not itself sell into the state.

Income Taxes

- In *Scioto Ins. Co. v. Oklahoma Tax Comm'n*, 279 P.3d 782 (Okla. 2012), the Oklahoma Supreme Court found that no nexus existed for income tax purposes for an out-of-state company, that had no contact with Oklahoma other than receiving payments from an Oklahoma taxpayer under a contract not made in the state. The Court applied Due Process principles to reach this conclusion.

Income Taxes

Income Tax Nexus Post Wayfair.

- Because the earlier income tax decisions rejected the physical presence standards under *Quill*, it could be argued that the rejection of *Quill* and the physical presence standard in *Wayfair* has no impact on future income tax litigation.
- From a practical perspective, however, Justice Kennedy's Majority decision likely will embolden states and steer the state courts toward a finding of nexus absent Congressional action as discussed below.

Income Taxes

Income Tax Nexus Post Wayfair (cont.).

- Some states have applied a factor nexus standard based on a quantity of sales into the state.
 - The reference to factor nexus is that the calculation of the sales factor becomes the basis for determining nexus.
- These factor nexus standards received an indirect boost from the *Wayfair* decision.
- More states may enact factor nexus standards for income tax purposes going forward.
- In mid-July, Wells Fargo announced that it recognized a \$481 million income tax expense because of *Wayfair*.

PL 86-272

Public Law 86-272 protects some income taxpayers from states' assertion of nexus.

- In 1959, Congress enacted legislation to limit the imposition of net income tax under certain circumstances.
- P.L. 86-272 provides that a state lacks the authority to impose a net income tax on a person if the taxpayer limits its business activities within such state to:
 - the solicitation of orders by such person, or his representative, in such State;

PL 86-272

- when selling tangible personal property;
- when the orders are sent outside the State for approval or rejection; and
- if approved, the orders are filled by shipment or delivery from a point outside of the State.

Note that the protection is limited to net income taxes or taxes based on income.

The protection does not extend to the providing of services, selling intangibles or leasing.

PL 86-272

- Cf. *Wisconsin Dep't of Revenue v William Wrigley, Jr.*, 505 U.S. 214 (1992) for a discussion of the types of activities that are protected for those selling tangible personal property.
- Thus, remote sellers that qualify for the protection of PL 86-272 cannot necessarily be subjected to corporate income tax obligations as a result of merely having customers in the state and making sales over the minimum sales threshold.

PL 86-272

- A company relying on PL 86-272 must confine its activities so that its activities do not void the immunity from state income tax under PL 86-272.
- Some taxpayers are forming coalitions to have Congress extend the reach of PL 86-272 to services and other activities beyond the sale of tangible personal property.
- Some observers wonder if there will be pressure on Congress to eliminate the PL 86-272 protection to align the income tax nexus principles to those applicable to sales and use tax.

Gross Receipts Taxes

- A finding of nexus even absent physical presence was presumed by many states to apply to gross receipts taxes even before *Wayfair*.
- See *Crutchfield Corp. v. Testa*, 151 Ohio St. 3d 278, 2016-Ohio-7760 in which the Ohio Supreme Court upheld a finding of nexus against a remote seller for purposes of the Ohio commercial activity tax, a gross receipts tax, although the entity had no physical presence in Ohio.
- Unlike income taxes, however, PL 86-272 does not apply to gross receipts taxes because the federal statute applies only to net income taxes and taxes based on net income and gross receipts are not based on net income.

Key Considerations and Planning Strategies To Maximize State Tax Risks

Martin Eisenstein, Brann & Isaacson
meisenstein@brannlaw.com

The Case-by-Case Analysis

- Joe Friday:
“ALL WE NEED TO KNOW ARE THE FACTS, MA’AM”
- The material facts are changing daily
- Bringing order to chaos:
 - Excel spreadsheet/matrix of relevant facts
 - Protect as much as possible by attorney client privilege

Bringing Order To Chaos

- THE CATEGORIES OF RELEVANT FACTS:
 - State Laws
 - State Enforcement
 - Burdens Imposed by States
 - Company Features

The Facts

- State Laws:
 - How does the state statute/regulation define a company required to collect the state sales tax?
 - 3 Types:
 - Physical presence
 - Economic presence
 - To full extent of the U.S. Constitution

The Facts

- State Enforcement:
 - State Tax Agency Interpretation
 - Is it consistent with the statute/rule?
 - Announced Date for collection
 - Is it retroactive, in fact or in effect?
 - MA is retroactive, and ME, KY and VT with start dates of 7/1/18 are in effect retroactive.
 - Other states have varying dates.

The Facts

- State Enforcement:
 - Several large states are silent or have uncertain dates
- State Burdens/Discrimination
 - Is it one of the 24 SSUTA states?
 - Does the state have local tax rates
 - Does the state provide for different exemptions at the state and local level
 - NYS; LA; CO

The Facts

- State Burdens/Discrimination
 - Origin sourcing vs. destination sourcing.
 - Does the state have home rule jurisdictions
 - Does the state provide compensation to retailers

Facts Regarding The Company

- Sales nationally and by state
- Nature of company's business, including whether products are taxable in the various states
 - Does the company provide services? Digital Goods?
 - Is the Company able to determine the destination of the goods/services
- Where is the company located?

Facts Regarding The Company

- Order system and platform
 - Are the operating systems customized
- Does the company currently collect and in which states?
- When can the company realistically collect?
 - What are the complications of collecting?
 - Number of separate products
 - Integration with order/return systems

Physical Presence

- Past and Future Activities
 - Application of *Wayfair* or *Quill*
 - Does *Wayfair* protect certain sellers/providers?
 - *Wayfair*: Physical presence is only one of several questions
 - Hypothetical: Sales Reps in home rule states
 - Hypothetical: Sales Reps in CA

Assessing Situation

- Sales tax risks by state
 - Can the Company collect by the due date set forth in the state?
 - Due diligence statement from company
 - Exposures for not collecting, including risk analysis of whether there are constitutional and statutory arguments vs. Costs of collecting
 - Is registration with the SSUTA and use of a CSP a viable alternative?

Assessing Risks

- ASC 450 reserve questions.
- Are there any risks for past activities?
 - FBA? Other physical presence?
- Does *Wayfair* present an opportunity?
- What are income tax risks?
- What about other state taxes?
 - TN, WA, OH gross receipts taxes

Developing Strategy

- Quiet registration?
 - What information must be disclosed?
 - Other state taxes?
- Is a VDA available?
 - State-by-state basis or multistate basis?
- Contract with CSPs
 - Make sure that charges for non-SSUTA states are reasonable

Implementation

- Determine the applicable rate at which to collect?
 - Use tax rate?
 - IL
 - CO
 - Registration at state level but not local level?
 - Exemption of products at state level but not local level?