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In this edition of Inside Deloitte, the authors consider the U.S. Supreme Court's recent decision to revisit the *Quill* physical presence nexus standard in *Wayfair*, as well as some common ways that states have expanded the notion of what is physical presence, the recent trend toward adoption of economic presence sales and use tax nexus thresholds, and various compliance readiness considerations given that a Court decision in *Wayfair* is anticipated this summer.

On January 12 the U.S. Supreme Court granted certiorari in *South Dakota v. Wayfair Inc.*,¹ a case challenging South Dakota's anti-*Quill* sales tax nexus law. This significant development suggests that the Supreme Court may be ready to reconsider the decades-old physical presence nexus standard² required for a state or locality to impose a sales or use tax collection responsibility on a remote seller.

In *Quill*, the Court affirmed the existence of a bright-line physical presence standard for substantial nexus under the commerce clause before a state or locality may impose a duty to collect use tax on a remote vendor.³ In a direct challenge to the *Quill* physical presence requirement, South Dakota enacted legislation in 2016 (S.B. 106) providing that a seller — without a physical presence in the state — is required to collect sales tax if, in the previous or current calendar year, its sales exceed \$100,000 or the seller has 200 or more separate transactions into South Dakota.⁴

Noting that “the inability to effectively collect the sales or use tax from remote sellers . . . is seriously eroding the sales tax base of [South Dakota], causing revenue losses and imminent harm to [South Dakota] through the loss of critical funding for state and local services,”⁵ S.B. 106 also authorizes the state to initiate a declaratory judgment action to provide the “most expeditious possible review of the

¹ *South Dakota v. Wayfair Inc.*, 901 N.W.2d 754 (S.D. 2017), cert. granted (U.S. Jan. 12, 2018) (No. 17-494).

² *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

³ *Id.*

⁴ S.B. 106, 2016 Legislative Assembly, Reg. Sess. (S.D. 2016), as codified under S.D. Codified Laws section 10-64-1 through section 10-64-8.

⁵ S.D. Codified Laws section 10-64-1.

constitutionality of this law”⁶ — which it brought forth in a circuit court soon after the legislation’s enactment against several large online retailers.

The filing of this declaratory action by South Dakota on April 28, 2016, thus operated as an injunction during the pendency of the action, prohibiting any state entity from enforcing S.B. 106’s economic nexus collection provisions against taxpayers that do not affirmatively consent or otherwise voluntarily remit the sales tax for the period when its constitutionality is being challenged.⁷ If the constitutionality of those South Dakota nexus provisions is upheld and any injunction against the enforcement of this law is lifted, S.B. 106 provides that the state will assess and apply its economic nexus tax collection obligations “from that date forward with respect to any taxpayer covered by the injunction.”⁸

On September 13 the South Dakota Supreme Court affirmed the lower circuit court’s 2017 holding that struck down the law as unconstitutional in violation of the *Quill* physical presence standard, stating that “however persuasive the State’s arguments on the merits of revisiting the issue, *Quill* has not been overruled.”⁹

In the petition for writ of certiorari, South Dakota presented the single question whether the Supreme Court should “abrogate *Quill*’s sales-tax-only, physical-presence requirement.”¹⁰ In granting certiorari, the Court may be prepared to provide its view on the relevance of a physical presence sales and use tax nexus standard in a 21st century e-commerce environment. Oral arguments before the Court are scheduled for April 17, and a decision is anticipated in late June.

Generally speaking, that pending challenge before the Court is not unexpected given comments by Justice Anthony M. Kennedy in the Court’s 2015 decision in *Direct Marketing*

Association v. Brohl.¹¹ In a concurring opinion, Kennedy stated:

There is a powerful case to be made that a retailer doing extensive business within a State has a sufficiently “substantial nexus” to justify imposing some minor tax-collection duty, even if that business is done through mail or the Internet. After all, “interstate commerce may be required to pay its fair share of state taxes.” [Citation omitted.] This argument has grown stronger, and the cause more urgent, with time. When the Court decided *Quill*, mail-order sales in the United States totaled \$180 billion. [Citation omitted.] But, in 1992, the Internet was in its infancy. By 2008, e-commerce sales alone totaled \$3.16 trillion per year in the United States. [Citation omitted.]

Given these changes in technology and consumer sophistication, it is unwise to delay any longer a reconsideration of the Court’s holding in *Quill*. A case questionable even when decided, *Quill* now harms States to a degree far greater than could have been anticipated earlier. [Citation omitted.] It should be left in place only if a powerful showing can be made that its rationale is still correct.¹²

State Bills Pushing Nexus Limits

Even before *Wayfair*, states have enacted laws in the last decade that have expanded the notion of physical presence nexus for purposes of imposing a sales and use tax collection (or notice) responsibility on out-of-state sellers. Those laws have generally fallen into one of the following three categories:

- **Click-through nexus:** A rebuttable presumption of nexus exists that an out-of-state seller has nexus in the state if it enters into an agreement with an in-state online advertiser, in which the advertiser is

⁶S.D. Codified Laws section 10-64-3.

⁷S.D. Codified Laws section 10-64-4.

⁸S.D. Codified Laws section 10-64-7.

⁹*South Dakota v. Wayfair Inc.*, 901 N.W.2d 754 (S.D. 2017).

¹⁰Petition for Writ of Certiorari, *South Dakota v. Wayfair Inc.*, 901 N.W.2d 754 (S.D. 2017), cert. granted (U.S. Jan. 12, 2018) (No. 17-494).

¹¹*Direct Marketing Association v. Brohl*, 135 S. Ct. 1124, 1134-35 (2015) (Kennedy, J. concurring).

¹²*Id.*

compensated on a commission or a per-click basis for referring potential customers to the out-of-state seller's website.

- **Affiliate nexus:** A presumption of nexus exists if the out-of-state seller is a member of an affiliated group of corporations and any parent or subsidiary in the affiliated group has nexus with the state.
- **Notification and information reporting:** If a remote seller does not have nexus or collect and remit sales tax, some states require the retailer to notify both the customers and the state department of revenue that the customer may have a use tax obligation for the taxable purchases the customer made. (Note that penalties for failure to comply with these notification requirements can be substantial.)

Regardless of the outcome of *Wayfair*, the above laws remain in place for taxpayers to consider when evaluating their current filing obligations and any associated risks with current filing positions.

Directly Challenging *Quill*

As noted, Kennedy's remarks in *DMA* directly challenged the ongoing relevance of a physical presence nexus requirement for sales and use taxes. Since then, more than 10 states have enacted sales- or transaction-based economic nexus provisions imposing a sales and use tax collection duty on an out-of-state seller who makes retail sales of tangible personal property into the state if (1) its retail sales exceed a certain monetary threshold set by the state, or (2) it reaches a certain number of transactions in one year as set by the state.¹³ S.B. 106 is an example.

What Taxpayers May Want to Consider

While the outcome of *Wayfair* (as well as how states or Congress may respond if *Quill* is overturned) cannot be predicted, it is important that taxpayers review their compliance readiness

given that a decision is imminent. Considerations include:

- whether IT systems are in place to begin collecting if *Quill* is overturned;
- whether existing IT systems are compatible with existing commercial sales tax service providers or new IT system implementations will be required;
- whether current financial statement positions have considered recent changes in state sales tax laws and regulations, such as click-through, affiliate, or economic nexus or notification requirements;
- in states with notification requirements, whether compliance with notification requirements, voluntarily registration, or another approach is appropriate considering a company's current resources;
- how current sales of products or services would be characterized for sales-tax-base purposes in relevant states;
- whether the required customer data are available to determine how to properly source sales if a sales and use tax obligation is imposed; and
- whether the potential increased compliance burden makes outsourcing sales and use tax compliance functions to a third party a cost-effective alternative.

Conclusion

If the *Quill* physical presence requirement is overturned, the sales and use tax nexus landscape will change dramatically and, as a result, large and small companies may require significant changes to their internal systems and processes. In this respect, a delay in planning for and addressing the outcome of *Wayfair* may result in additional costs and business interruptions, considering the potential expedited and compressed solution timelines. Companies are therefore encouraged to consult with their indirect tax advisers to review the many technical and logistical considerations that should be addressed before the Court's holding in *Wayfair*. ■

¹³ As of this writing, those states include Alabama, Indiana, Maine, Massachusetts, Mississippi, North Dakota, Ohio, Pennsylvania, Rhode Island, South Dakota, Tennessee, Vermont, Washington, and Wyoming.