

# Wayfair - potential income tax nexus ramifications

## Overview

On June 21, 2018, the U.S. Supreme Court decided what is arguably the most important state tax case of the last 25 years in *Wayfair et. al.*<sup>1</sup> In a 5-4 split decision, the majority overruled the brightest of state tax bright-line rules in overturning the sales/use tax nexus standard of physical presence previously established in *National Bellas Hess* (1967)<sup>2</sup> and later upheld in *Quill* (1992).<sup>3</sup>

For further information on the *Wayfair* decision and the potential implications for remote sellers overall, please see our June 26 tax alert available [here](#). For further information on the potential state tax implications of *Wayfair* for non-US companies with US customers, please see our June 27 tax alert available [here](#).

## Income tax nexus implications of *Wayfair*

While *Wayfair* will have a significant impact on sales and use tax collection obligations, the decision may also impact nexus positions taxpayers have taken with regard to other taxes, notably income tax. Since the Court's decision in *Complete Auto* (1977),<sup>4</sup> a taxpayer's activity must have a substantial nexus with the taxing state to support the imposition of tax. In *Quill*, the Court drew a distinction between nexus required to satisfy the Due Process Clause versus nexus required to satisfy the Commerce Clause, providing the Commerce Clause's "substantial-nexus requirement is not, like due process' minimum contacts requirement, a proxy for notice, but rather a means for limiting state burdens on interstate commerce."<sup>5</sup> Under the *Quill* analysis "a corporation may have the 'minimum contacts' with a taxing State as required by the Due Process Clause, and yet lack the 'substantial nexus' with the State as required by the Commerce Clause."<sup>6</sup>

*Quill* overruled the due process nexus holding of *Bellas Hess* but not the Commerce Clause holding, "grounding the physical presence rule in *Complete Auto's* requirement that a tax have a 'substantial nexus' with the activity being taxed."<sup>7</sup> However, the Court in *Wayfair* has now clearly established that "[p]hysical presence is not necessary to create a substantial nexus."<sup>8</sup>

Whether physical presence is necessary for the imposition of income taxes has been the subject of uncertainty for the last several decades as well. In 1993 the South Carolina Supreme Court held that physical presence was not required for the imposition of income tax, and that *Quill's* physical presence standard was limited to only sales and use tax.<sup>9</sup> To date, however, the Supreme Court has not granted *certiorari* in any such case pertaining to economic nexus. In recent years, a number of states have enacted so-called "factor-based" economic presence nexus standards for income or gross receipts-type taxes.<sup>10</sup> For example, Alabama law provides, effective for tax years beginning after December 31, 2014, that factor-based presence nexus standards exist for business activity for purposes of business privilege tax, income taxes, and

<sup>1</sup> *South Dakota v. Wayfair, Inc., et al.*, No. 17-494 (June 21, 2018) 585 U.S. \_\_\_\_\_. A copy of the decision is available [here](#).

<sup>2</sup> *National Bellas Hess, Inc. v. Department of Revenue*, 386 U.S. 753 (1967).

<sup>3</sup> *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

<sup>4</sup> *Complete Auto Transit Inc. v. Brady*, 430 U.S. 274 (1977).

<sup>5</sup> *Quill Corp. v. North Dakota*, 504 U.S. 298, 313 (1992).

<sup>6</sup> *Id.*

<sup>7</sup> *Wayfair*, U.S. Supreme Court, Dkt. 17-494, (6/21/2018).

<sup>8</sup> *Id.*

<sup>9</sup> *Geoffrey, Inc. v. South Carolina Tax Comm'n*, 313 SC 15 (1993), cert. denied, 510 US 992 (1993).

<sup>10</sup> States with statutes or promulgated administrative rules that apply a factor or sales-based nexus rule for income (or gross receipts) tax purposes currently include Alabama, California, Colorado, Connecticut, New York State, Ohio (Commercial Activity Tax), Tennessee, and Washington (Business & Occupation Tax.)

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financial institution excise taxes if any of the following thresholds are exceeded during the tax period: (1) \$50,000 of property; (2) \$50,000 of payroll; (3) \$500,000 of sales; or (4) 25% of total property, total payroll, or total sales.<sup>11</sup>

In light of the Court's unequivocal statement in *Wayfair* that physical presence is not a necessary element for "substantial nexus," taxpayers will need to revisit positions they may have taken regarding the need for physical presence in order to establish substantial nexus for income taxes, as well as sales/use tax. While the facts at issue in *Wayfair* involved a statute with prospective application, potential retroactive application and enforcement to the effective date of a state's applicable income tax nexus statute or rule is possible. This landmark decision will also receive careful consideration by other states which may seek to enforce or adopt economic factor-based presence nexus provisions in light of the *Wayfair* decision.

### Public Law 86-272 considerations should not be overlooked

The *Wayfair* decision does not overrule P.L. 86-272 in the state income tax setting. While certain states have adopted sales-based nexus provisions for income tax purposes, P.L. 86-272 remains in force and prohibits states from levying a net income tax upon an out of state company if the company's activities in a state are limited to the solicitation of orders for the sale of tangible personal property and the orders are approved and filled from outside the state. More specifically, P.L. 86-272 states "a person shall not be considered to have engaged in business activities within a State during any taxable year merely by reason of sales in such State..."<sup>12</sup>

### Financial statement implications

Companies should evaluate the impact of the decision on their existing tax positions involving nexus (i.e., with respect to income taxes, as well as sales/use tax) and consider what impact, if any, the decision has on both their contingent liabilities and liabilities for unrecognized tax benefits.

Because the decision discussed in this tax alert was rendered on June 21, 2018, any impact of this decision on income taxes should be accounted for in the financial reporting period including June 21, 2018.

## Contacts:

If you have any questions regarding the potential income tax nexus ramifications implications of this important decision, please contact any of the following Deloitte Tax LLP professionals:

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<sup>11</sup> Act 505 (H.B. 49), First Special Session, Laws 2015.

<sup>12</sup> 15 U.S.C. § 381(c).

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