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Insight: Is it 'Fair' to Require Remote Sellers to Collect Sales Tax?

Oral arguments in *South Dakota v. Wayfair*, arguably one of the biggest state tax cases ever before the U.S. Supreme Court, were held April 17. In this article, Ryan LLC's Mark Nachbar discusses the arguments and the likely outcome of the case

BY MARK L. NACHBAR

Last month, the U.S. Supreme Court heard oral arguments on the long-awaited debate as to whether physical presence is an appropriate prerequisite to require a remote seller to collect sales tax. This issue goes back over 50 years, to the Court's decision in *National Bellas Hess Inc. v. Department of Revenue*, 386 U.S. 753, (May 8, 1967), followed by the 1992 decision in *Quill Corp. v. North Dakota*, 504 U.S. 298, (May 26, 1992). In the *Bellas Hess* decision, the justices were not convinced that the solicitation of sales through systematic mailings into a state utilized the protection and services of the taxing state. The Court concluded that the taxpayer was not required to collect sales tax on items shipped into the taxing jurisdiction. *Quill* brought the discussion forward 25 years, and the facts changed from mailing paper catalogs into a state to providing in-state customers with electronic catalogs. Again, the court analyzed the two constitutional provisions controlling this issue: the due process clause and the commerce clause. The justices concluded that although a taxpayer may be on notice under the due process clause that it may have had a collection obligation, the requirement to collect the tax, without a physical presence in the state violated the commerce clause of the constitution.

Mark L. Nachbar is a Principal at Ryan, LLC. He has over 35 years of experience delivering multistate tax services to corporate enterprises. Mark focuses on minimizing corporate tax liabilities and limiting corporate tax exposures. In addition, Mark has provided state credit and incentive services to many corporate enterprises.

In *South Dakota v. Wayfair*, the South Dakota Legislature specifically designed a statute to test the validity of the physical presence requirement in the environment that exists 25 years after the *Quill* decision was rendered (*South Dakota v. Wayfair, Inc.*, South Dakota Supreme Court, No. 28160, 2017 S.D. LEXIS 111, September 13, 2017). In today's electronic commerce environment, South Dakota seeks to require all remote sellers of goods that have more than $100,000 in annual sales or 200 transactions in the state to collect sales tax. Note that the question has never been whether the state can collect a tax on goods sold into the state. The question has always been how does the state collect these taxes.

Oral Arguments in 'Wayfair' That brings us to the oral arguments in *Wayfair*, held before the Supreme Court April 17. Justice Kennedy had invited a challenge to the holding in *Quill* in his concurring opinion in *Direct Marketing Association v. Brohl,* 575 U.S. ___ (2015) How-

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ever, his voice was notably absent during the *Wayfair* questioning.

Not more than a minute into his presentation for the state, the South Dakota's Attorney General, Marty Jackley, was questioned about the true nature of the case by Justice Sotomayor. She stated that it is the consumer's responsibility to pay the tax and recommended that the state find a way to collect the tax from them. Justice Sotomayor was most concerned about the ability of a state to retroactively pursue remote sellers under a redefined standard. The concerns about retroactivity were also voiced by Justices Breyer and Alito. However, the Court has recently declined requests to review retroactive cases and may be reluctant to rule in favor of a situation that invites retroactive pursuits of taxpayers (*Dot Foods Inc. v. Washington Department of Revenue*, petition for cert. denied May 22, 2017 and *IBM Corp. v. Mich. Dept. of Treasury*, petition for cert. denied, No. 16-698 Dkt. No. 16-698 (U.S. S. Ct. May 22, 2017)).

The Court was also troubled by a lack of concise and determinable estimates as to the cost of complying with the South Dakota law. Counsel for the state argued that the cost of compliance was quite minimal, while counsel for Wayfair estimated the costs for small remote retailers to be quite prohibitive. The lack of a record at a lower court level seemed to frustrate the state's position. The South Dakota statute was designed to provoke a constitutional challenge that did not leave much of a record in the South Dakota courts. This strategy may have hurt the state's case, as Justices Sotomayor, Roberts, and Breyer were all concerned with the conflicting cost of compliance estimates presented by both sides.

Justices Kagan, Breyer and Sotomayor seemed to prefer congressional rather than judicial action in this area. The Court invited Congress to act on this issue when it issued its decision in *Quill*, yet that body has not passed a statute concerning sales tax collection. Justices Ginsberg and Kennedy seemed to think that an action by the Court will encourage congress to act.

'Complete Auto' and the Dormant Commerce Clause

While the constitutional nexus tests espoused in *Complete Auto* and *Pike* were mentioned, they were not thoroughly examined in the oral arguments. In particular, the fourth prong of *Complete Auto* was not examined with respect to the facts in this case. *Complete Auto* calls for the statute to be ''fairly related'' to the services provided by the state. While the ''fairly related'' prong was not discussed in the *Wayfair* oral arguments, nor was it discussed in *Quill*, it was a central theme in the *Bellas Hess* case and is very relevant to today's economic environment.

Although *Bellas Hess* was decided in 1967, 10 years prior to the pronouncement of the four prong *Complete Auto* test, it is one of the few cases that fully analyzes a state's ability to impose a tax requirement when the state does not provide value to the taxpayer. In *Bellas Hess*, the Court, quoting *Freeman v. Hewitt*, 29 U.S. 249 (1946) at 253 stated that ''[s]tate taxation falling on interstate commerce. . .can only be justified as designed to make such commerce bear a fair share of the cost of the local government whose protection it enjoys.'' The Court goes on to say that the ''simple but controlling question is whether the state has given anything for which it can ask return'' (*Wisconsin v. J.C. Penney Co*., 311 U.S. 435, 444). The dissent in *Bellas Hess* finds the state resources used by the taxpayer were the Illinois banking and credit facilities, because *Bellas Hess* granted company credit directly to in-state consumers. In *Wayfair*, the only credit facilities are third parties, such that Wayfair is not using the in-state banking and credit facilities. This is true for most remote sellers.

There has not been a tremendous amount of analysis by the Supreme Court since it established the ''fairly related'' test in *Complete Auto*. *Complete Auto* sets forth the test that to comply with the dormant commerce clause, a tax must meet a four-prong test: (1) there is substantial nexus between the taxing jurisdiction and the taxpayer; (2) the tax does not discriminate against interstate commerce; (3) the tax is fairly apportioned; and (4) the tax is fairly related to the services provided by the state. However, the Court's opinion in *Complete Auto* does not necessarily focus on these tests but rather focuses on whether a tax on the ''privilege of doing business'' in a state is unconstitutional. The Court held that there was no prohibition of a privilege tax as long as the tax met the four-prong test.

Thus, we must turn to other analyses for more detailed insights into the term ''fairly related''. The most recent case which provides an analysis is *Oklahoma Tax Commission v. Jefferson Lines, Inc*. 514 U. S. 175. (April 3, 1995). *Jefferson Lines* dealt with the ability of a state to require the collection of a sales tax on bus tickets sold in Oklahoma.

The Court stated that there need not be a direct accounting or benefit of the services provided to the taxpayer, but that interstate commerce must pay its fair share of the expenses that contribute to the cost of governmental services. Those costs include ''police and fire protection, *along with* the usual and usually forgotten advantages conferred by the State's maintenance of a civilized society.'' [emphasis added] In *Jefferson Lines*, the taxpayer was receiving all three services as it maintained a ticket office in the state and operated transportation vehicles in the state. The phrase ''along with'' would indicate that the maintenance of an organized society alone would not confer the requirement to collect the tax. In *Wayfair*, there is no physical presence in the state. *Wayfair* does not benefit from services provided by the state other than the maintenance of a civilized society. This factor standing on its own should not create a tax collection obligation.

The *Jefferson Lines* case refers to an older case decided in closer proximity to the *Complete Auto* ruling: *Commonwealth Edison, et al. v. Montana et al*, 453 U.S. 609 (July 2, 1981). The issue in the *Commonwealth Edison* case was whether a coal severance tax was fairly related to the services provided by the state. The Montana coal severance tax is levied at rates up to 30 percent of the coal's contract sales price. The taxpayer argued that the tax was unfairly related to the services provided by the state because the tax was out of proportion with the taxpayer's activities in the state. The Court reasoned that the fourth prong of *Complete Auto* does not require a dollar for dollar matching of services received to tax paid, but rather requires that ''the measure of the tax be reasonably related to the extent of the taxpayer's contact with the State''. The Court again refers to police and fire protection as well as a trained workforce and the maintenance of a civilized society as benefits afforded by the state. But again, the taxpayer had a physical presence in the state and benefited from all of these services.

The most recent U.S. Supreme Court case relying on the *Complete Auto* test is *Comptroller of the Treasury* *of Maryland v. Wynne* 35 S. Ct. 1787 (2015). That case involved whether a county-level tax on an in-state resident that did not provide for a credit for taxes paid to other states violated the dormant commerce clause of the Constitution. In the Court's discussion as to why an in-state resident should not be afforded less protection under the dormant commerce clause than a corporation, the Court states that ''corporations also benefit heavily from state and local services. Trucks hauling a corporation's supplies and goods, and vehicles transporting its employees, use local roads. Corporations call upon local police and fire departments to protect their facilities. Corporations rely on local schools to educate prospective employees, and the availability of good schools and other government services are features that may aid a corporation in attracting and retaining employees.'' Again, the Court looks to tangible services that a taxpayer receives from the taxing authority in determining the constitutionality of a tax. Yet the Court never enunciates the ''fairly related'' test in *Complete Auto*.

Another interesting aspect to the *Wynne* case lies in the dissents. Justice Scalia authored a dissent, with which Justice Thomas concurred and wrote an additional dissent. The gist of both of their opinions was that the dormant commerce clause is invalid. Both justices specifically attack the *Complete Auto* tests. Justice Thomas also notes that one of the flaws with the dormant commerce clause is its instability. Since no principle anchors the dormant commerce clause, it must be constantly reinterpreted based on a changing economic environment.

Justice Ginsburg also penned a dissent, and she was joined by Justices Scalia and Kagan. The essence of her opinion rested on the premise that a state cannot be restrained from imposing a tax on all the income of its residents. The position in part relies on the resident's ability to change the taxing regime by invoking his ability to vote and change tax policy. The Court determined that this requirement did not need to be analyzed under the dormant commerce clause.

Further Applications of the 'Fairly Related' Test The issue of a tax obligation that is fairly related to the services provided by the state is not limited to transaction taxes. In the context of more and more states enacting single-sales-factor-apportionment statutes coupled with an economic presence standard for income tax purposes, this underutilized prong of *Complete Auto* has equal application in the income tax arena. While economic nexus standards for income tax purposes have been upheld by several state supreme courts, it has not yet been tested at the U.S. Supreme Court level (See: *Crutchfield, Inc. v. Testa*, Ohio Supreme Court, No. 2016-Ohio-7760, November 17, 2016; *Couchot v. Ohio State Lottery Comm.*, 659 N.E. 2d 1225 (1996); *Capital One Bank Massachusetts Commr. of Revenue*, 899 N.E. 2d 76 (2009); *MBNA Am. Bank, N.S. v Indiana Dept. of State Revenue,* 895 N.E. 2d 140 (Ind. Tax 2008); *KFC Corp. v. Iowa Dept. of Revenue,* 792 N.W. 2d 308 (2010); and *J.C. Penney Natl. Bank v. Johnson,* 19 S.W. 3d 831 (Tenn. App. 1999)). Although in the most recent decision, the taxpayer, Crutchfield, had been granted an extended time to appeal its case to the U.S. Supreme Court, the case settled prior to the petition for certiorari being filed.

In *Crutchfield*, the Ohio supreme court was tasked with determining whether physical presence in Ohio was required for the imposition of the Commercial Activity Tax (CAT). The court analyzed this issue under the scrutiny of the *Complete Auto* test. Quoting from their decision in *United Air Lines Inc., v. Poterfield*, 276 N.E. 2d 629 (1971), the court advised that ''(1) a state may not levy a tax for the privilege of engaging in interstate commerce *** and (2) interstate commerce must pay its way in relation to the immediate benefits and protections afforded it by the state.'' The court then found these requirements to be related to ''taxable incident'', not the ''substantial nexus'' requirement of *Complete Auto*. However, they never looked at this issue as it relates to the ''fairly related'' test in *Complete Auto*.

The court then analyzed the *Quill* physical presence requirement as it related to the imposition of the CAT. It found that physical presence is not a necessary condition for imposing a business privilege tax such as the CAT, ''as long as the privilege tax is imposed with an adequate quantitative standard that ensures the taxpayer's nexus with the state is substantial.'' The *Crutchfield* court notes that ''when a state statute regulates evenhandedly to effectuate a legitimate local public interest, and its effects on interstate commerce are only incidental, it will be upheld unless the burden imposed on such commerce is clearly excessive in relation to the putative local benefits.'' The court concludes that the $500,000 sales receipt threshold for the imposition of the CAT would indicate that the tax burden is not ''clearly excessive'' to the imposition of the tax. One could infer that this dicta could be equated to the ''fairly related'' test. Yet, the court merely concluded that the $500,000 was not clearly excessive. The court never found that the tax imposed was ''fairly related'' to the benefit afforded by the state.

The ''fairly related'' test could have played a more prominent role in the *Wayfair* case. This test could also have significant applicability in market-based, single-factor apportionment regimes, where out-of-state taxpayers are charged with supporting state and local governments, even though they do not substantially benefit from governmental services. While the results of the application of ''fairly related'' test may insert less predictability in the validity of state tax, it may lead to a more ''fair'' result related to the burdens imposed on a taxpayer, as ''related to'' the benefits provided by the taxing authority.

A Potential Solution While the ''fairly related'' issue was not presented in *Wayfair*, the Court did acknowledge that a solution to under-collected taxes has been crafted by the state of Colorado by way of an information-reporting statute. During oral arguments, Justice Gorsuch asked the question as to whether there is less a burden by asking a remote retailer to collect and turn over data to a state, or to directly collect the tax due. The respondent's attorney, Mr. George Isaacson, contended that the latter, information collection, is less burdensome, but he did not have any statistics to support his assertion. However, Justice Ginsburg postulated that it is more likely for the state to collect the tax if the seller were required to collect the tax. Of course, the state's ability to collect the tax is not the issue here. It is whether an undue burden is placed on the seller to collect the tax. If an alternate way to collect the tax is available to the state, although it may be more burdensome for the state to do so, it should not override the rights of the remote seller.

Justices Sotomayor and Roberts and the Attorney General for South Dakota, Mr. Marty Jackley, discussed the balancing act of when the burdens imposed by a state impairs interstate commerce. Mr. Jackley introduced the *Pike v. Bruce Church, Inc.*, 397 U.S. 137 (1970) case as the Court's safeguard to prohibit undue burdens on interstate commerce. *Pike* involved a labeling issue for the origin of certain fruit. The state attempted to require locally grown fruit to be packed and labeled in-state, rather than in an adjacent state. The Court found that the state regulation unduly burdened interstate commerce. Citing its decision in *Huron Cement Co. v. Detroit,* 362 U.S. 440 (1960) at 443, ''where the statute regulated evenhandedly to effectuate a legitimate local public interest, and its effects on interstate commerce are only incidental, it will be upheld unless the burden imposed on such commerce is clearly excessive in relation to the putative local benefits''. The Court goes on to say where there is a legitimate local purpose to the rule, the burden placed on interstate commerce will be accepted dependent on the local interest involved and ''whether it could be promoted as well with a lesser impact on interstate activities''. If the information reporting requirements as envisioned by the Colorado law are less burdensome than the collection requirements imposed by the South Dakota statute, the former should prevail.

Where the case seemed to be going was to continue to invite Congress to craft a solution to the collection of tax by remote sellers. While acknowledging that Congress has not acted on this issue in the 26 years since *Quill*, a number of the Justices spoke to the need for Congressional action. In fact, Justices Ginsburg and Breyer looked to Congressional action in light of the Court's recent decision in *U.S. v. Microsoft Corporation*, 584 U.S. __, April 17, 2018. At issue in *Microsoft* was the government's ability to subpoena information stored in databases outside of the United States. While the Court was deliberating the *Microsoft* case, Congress expanded subpoena powers to include overseas data, but retains the right to challenge a subpoena if the information requested violates the laws of the country in which the data is hosted (Oral arguments in *Microsoft* were held on February 27, 2018; decision rendered on April 17, 2018). This new law, referred to as the CLOUD Act, was signed by President Donald Trump as part of the government spending bill on March 23. *Microsoft* indicates that Congress may be prone to act, even if an issue on its radar is pending before the Court. In fact, federal remote sales tax collection legislation is currently being held by the House Judiciary Committee. Committee Chair Bob Goodlatte (R-Va.) is reportedly holding the legislation because it will undoubtedly pass the committee and the House floor (See ''Why Goodlatte blocks remote seller proposals,'' 2018 STT 81-3, April 26, 2018). Clearly Congress is willing and able to act to solve this issue.

Likely Outcome Based on their participation, or lack thereof, in the *Wayfair* oral arguments, one might infer that Justice Thomas will vote to overturn *Quill*, not based on the physical presence issue, but rather from his belief that a decision based on the dormant commerce clause is invalid. Justice Ginsberg's position does not seem to be related to her dissent in *Wynne*. Since corporations don't vote, her dissent in *Wynne* would not appear to be relevant here. Her questions would indicate that she is more concerned about the discrimination between in-state and out-of-state retailers, if one is required to collect the tax and the other is not. While she would like to see Congress act, she believes it is the Court's duty to correct its mistake in *Quill*. Justice Kagan does not have those concerns, and based on her comments, she believes that the retailers that supposedly ''benefit'' from the current structure, e.g. Amazon.com Inc., eBay Inc. and Etsy Inc., would continue to benefit from overturning *Quill*. She surmises that small retailers would use these platforms to sell their goods, and pay these companies fees to collect and remit sales and use taxes on their behalf.

It is this author's viewpoint that if Colorado's information reporting requirements are less burdensome to interstate commerce, the South Dakota law at issue should be held to be unconstitutional. If states do not believe that their use tax obligations will be satisfied by directly taxing consumers, it is up to those states to push Congress to act on existing legislation that would enact a Federal standard for use tax collection by remote sellers.

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