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THE EVOLUTION OF ONLINE SALES TAXES AND WHAT'S NEXT FOR STATES

National Bellas Hess to *Quill* to *Wayfair*

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In 1967, the Supreme Court ruled in *National Bellas Hess v. Department of Revenue of Illinois,*[1] that a business must have a physical presence within a state's borders for the state to collect sales taxes from that business. In 1992, the court reaffirmed the physical presence requirement in *Quill Corp. v. North Dakota,* striking down a North Dakota law that required "every person who engages in regular or systematic solicitation of a consumer market in th[e] state" to collect the state's sales tax.[2] North Dakota enacted the law because it feared that residents were eroding the state's sales tax revenue by purchasing goods in catalogues from sellers that did not collect tax.

Over the 51 years since *National Bellas Hess,* the ruling has become increasingly problematic as untaxed online purchases increase and states grapple with collecting revenue from these remote sources:

- America's consumer behavior has shifted further away from brick-and-mortar stores: according to Census, online purchases for the first quarter of 2018 accounted for nearly 10 percent of all retail sales.
- While consumers still technically owed tax on these purchases, few paid this "use" tax. This inability to collect tax on remote sales cost states billions of dollars in tax revenues.
- Although *Quill* allowed Congress to develop a regularized system of sales tax collections, Congress has been unwilling to act.

The Supreme Court's ruling in *South Dakota v. Wayfair, Inc.*[3] gives some clarity to state governments that, in an attempt to work around *Quill*, have passed a wide range of laws in recent years.

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[1] *National Bellas Hess v. Department of Revenue of Illinois*, 386 US 753 (1967). https://www.law.cornell.edu/supremecourt/text/386/753

[2] *Quill Corp. v. North Dakota*, 504 US 298 (1992). https://supreme.justia.com/cases/federal/us/504/298/case.pdf.

[3] *South Dakota v. Wayfair, Inc.*, 585 US ____ (2018). https://www.supremecourt.gov/opinions/17pdf/17-494_j4el.pdf.

"NEXUS" AND BURDENS

The roots of the legal issues surrounding online sales taxes began well before the invention of the home computer. As noted, in 1967 the Supreme Court ruled in *National Bellas Hess* that under the commerce clause of the US Constitution, a state could only require businesses with a physical presence in its state to collect the state's sales tax. In *Quill*, the Supreme Court revisited and preserved the physical presence test. Physical presence is one type of connection to (or "nexus" in) a state. Whether physical presence is required for nexus is at the heart of the online sales tax collection problem.

Sales taxes differ by state. An item may be taxable in one state but exempt in another. Further, localities within a state often have their own rates that are added to the state rate. The Supreme Court argued in *Quill* that deciphering all these different state laws placed an unfair burden on companies not located in that state: A company operating in Delaware shouldn't have to figure out North Dakota's sales tax laws, and requiring it to do so would burden interstate commerce. But a company operating in that state, a company with a sufficient nexus, would be expected to know the law and collect the tax.

As also noted above, consumers owe taxes on remote purchases. All states that impose a sales tax also impose a use tax, which requires consumers to pay a tax on goods purchased outside their state of residence for consumption in their home state that would otherwise be subject to the sales tax. These taxes are often due on resident income taxes and while states increasingly provide an option to include use tax amounts with their income taxes, taxpayers rarely do.

CONGRESS AND THE STREAMLINED SALES TAX AGREEMENT

Since *Quill*, the states and Congress have attempted with limited success to address the sales tax issue.

Coordinated state efforts in 2000 led to what would become the Streamlined Sales and Use Tax Agreement (SSUTA).[4] The SSUTA responded to *Quill* by crafting voluntary guidelines to help states "simplify and modernize sales and use tax administration in order to substantially reduce the burden of tax compliance." The agreement gave states a forum to coordinate sales tax rates and base definitions and to simplify the tax collection process for out-of-state sellers. In the 24 states that adopted the SSUTA, remote sellers collect tax voluntarily and the state covers filing costs and other fees.

Although the Supreme Court gave Congress the opportunity to regularize the system of sales tax collections and many bills were introduced, Congress never acted.

For example, the Marketplace Fairness Act,[5] first introduced in 2011, would have allowed states to require remote sellers to collect sales taxes if the states simplified their tax. States could either join the SSUTA or meet five similar simplification mandates outlined in the bill; the bill also would have exempted businesses with less than $1 million of national sales from collecting sales tax.

Another bill would have the tax on remote sales collected by the state where the seller is located, determining the tax base by the seller's state and the tax rate by the buyer's state.

STATES RESPONSES: CLICKS, COOKIES, AND CONFRONTATION

According to the Tax Foundation, 31 states have passed laws to tax remote sales (Bishop-Henchman 2018). Although most national efforts focused on burdens, many of these state laws addressed nexus by attempting to broaden the definition of physical presence. For example, some states have adopted "click-through nexus," meaning an out-of-state

[4] See the Streamlined Sales and Use Tax Agreement at http://www.streamlinedsalestax.org/.

[5] See the Marketplace Fairness Act at http://marketplacefairness.org/.

business's referral agreement with an in-state website satisfies the physical presence test. Other states adopted "cookie nexus," where a resident's ability to access an out-of-state website or phone app is sufficient for nexus.

The most consequential state response came when South Dakota intentionally drafted a law aimed at forcing the Supreme Court to revisit *Quill*. The law (S.B. 106) requires out-of-state sellers to collect state's sales tax if they sell more than $100,000 worth of goods or complete 200 or more transactions in the state.[6] The state argued the law created an economic presence but did not unfairly burden companies doing business there. In the *Wayfair* decision, the Supreme Court agreed 5-4, upheld the South Dakota law, and overturned *Quill*.

WHAT ARE THE NEW *WAYFAIR* RULES?

The court gave states broad (but not unlimited) authority to require out-of-state sellers to collect taxes.

By overturning *Quill* and *National Bellas Hess,* the court restored the four-pronged test from its 1977 ruling in *Complete Auto Transit, Inc. v. Brady* as the standard for commerce clause disputes over interstate matters.[7] Accordingly, laws in South Dakota and other states will be valid and enforceable if they

1. apply to an activity with a substantial nexus within the taxing state (such as a company with many sales in the state),
2. are fairly apportioned,
3. don't discriminate against interstate commerce, and
4. are fairly related to the services the state provides.

The court was also concerned with compliance burdens and retroactivity, but South Dakota explicitly ruled out making collections retroactive and that membership in SSUTA and the listed minimum activity means it won't be an unfair burden on small retailers.

What's Next after Wayfair?

All 45 states that levy a sales tax and the District of Columbia will consider their own legislation. Some will closely follow South Dakota's rules because the Supreme Court has clearly established a baseline there for minimizing the burden on business. However, other states may try to enact more aggressive legislation, which would trigger new challenges and possibly further court rulings.

And Congress can still decide the matter for good with national legislation that establishes clear rules for online sales taxes. However, no such legislation is currently pending.

BOTTOM LINE: IS THIS A REVENUE WINDFALL FOR STATES? IS IT $8 BILLION OR $34 BILLION?

The ability to require remote sellers to collect sales tax will increase tax revenue, though the amount they will collect is uncertain. Although online sales are increasing, many of the largest online retailers are already collecting and remitting the tax.

In its Supreme Court brief, South Dakota said the inability to require remote sellers to collect the tax costs states $23 billion to $34 billion a year, citing a 2012 National Conference of State Legislators estimate and a 2017 Marketplace Fairness Coalition estimate, respectively.[8] However, the Government

[6] S.B. 106, 2016 Leg., 91st Sess. (SD. 2016). http://dor.sd.gov/Taxes/Business_Taxes/SB106.aspx.

[7] *Complete Auto Transit, Inc. v. Brady*, 430 US 274 (1977) https://supreme.justia.com/cases/federal/us/430/274/case.html.

[8] "Collecting E-Commerce Taxes | E-Fairness Legislation," National Conference of State Legislatures, published November 14, 2014, http://www.ncsl.org/research/fiscal-policy/collecting-ecommerce-taxes-an-interactive-map.aspx; and Marketplace Fairness Coalition. 2017. "$211 Billion in Lost Revenue over the Next 5 Years." New York; International Council of Shopping Centers. http://www.efairness.org/files/united-states.pdf.

Accountability Office (2017) recently estimated the lost revenue is somewhere between $8 billion and $13 billion. The report noted "that state and local governments, under current law, require remote sellers to collect about 75 to 80 percent of the taxes that would be owed if all sellers were required to collect tax on all remote sales at current rates." For example, the country's largest online retailer, Amazon, already collects the tax in every state with a sales tax, though it does so only for its own sales and not those of third-party retailers that use its site.

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