SCOTUS Brings State Tax Laws In Line With 21st Century Life

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The U.S. Supreme Court has overturned 26 years of precedent in the landmark decision of 'South Dakota v. Wayfair.' Online retailers may now have to collect sales tax even in states where they don't have a physical presence.

On June 21, the United States Supreme Court, in a 5-4 decision, overturned 26 years of precedent in the landmark decision of *South Dakota v. Wayfair*, 585 U.S. ___ (2018). In overturning the pre-internet era decision of *Quill v. North Dakota*, 504 U.S. 298 (1992), the Supreme Court held that a South Dakota law requiring certain out-of-state sellers to collect and remit sales tax regardless of whether they had a *physical presence* in South Dakota was permissible under the Commerce Clause of the United States Constitution.

Since *Quill*, the standard for whether a state may require an out-of-state retailer to collect and remit sales tax had been physical presence. In *Quill*, the court affirmed its prior decision in *National Bellas Hess v. Department of Revenue of Illinois,* 386 U.S. 753 (1967), which required a seller to have property, people or some other physical connection within the taxing state in order to be required to collect from the buyer and remit to the state in which the buyer resides, a sales tax. Under *Quill*, online retailers without a physical presence in a state were not required to collect sales tax on goods that they shipped into such state. This resulted in significant tax avoidance; not to mention, an unfair advantage over traditional “brick and mortar” stores which were required to collect the tax. Over the years, with the advent of new technology and the internet, local retailers found it increasingly more difficult to compete with online retailers who could sell their products to a customer without the imposition of a

sales tax which local, brick-and-mortar retailers were required to collect. Although the consumer still had an obligation to remit a use tax which was equal to the sales tax that the local retailer would have collected, the majority of consumers did not pay this tax.

Wayfair centered on the constitutionality of a South Dakota statute (S.B. 106) which was challenged by three online, remote companies: Wayfair (a home goods and furniture retailer); Overstock.com (a retailer of a variety of products from home goods to jewelry); and Newegg (a consumer electronics retailer). None of the companies had a physical presence in the state of South Dakota. Statute S.B. 106 required remote retailers, like these three companies, with annual in-state sales that exceeded $100,000 or which engaged in 200 or more separate transactions for the delivery of goods into the state, to collect and remit sales tax to South Dakota.

South Dakota's argument as to the validity of the tax centered around three distinct points. First, the state argued that local businesses were placed at a competitive disadvantage relative to remote sellers since consumers would much rather purchase items from an online store without the imposition of sales tax than to visit a brick-and-mortar store and be forced to pay the tax. Second, South Dakota argued that states were losing billions of dollars in sales tax revenue due to the boom of the internet since *Quill*. Finally, since South Dakota does not have an income tax, South Dakota relies on sales and use tax revenue to fund state services. In essence, South Dakota argued that the physical presence requirement was outdated and resulted in an unfair result. On the other hand, the challengers to the South Dakota tax asked the court to retain the current status quo.

Writing for the majority, Justice Anthony Kennedy held that states had the power to require out-of-state retailers to collect and remit sales tax on sales to in-state residents. "Because the physical presence rule of *Quill* is unsound and incorrect, *Quill Corp. v. North Dakota … and National Bellas Hess, Inc. v. Department of Revenue of Ill.,* are overruled." The court analyzed the United States Constitution's Commerce Clause and found *Quill* to be "flawed on its own terms," noting, that "*Quill* creates rather than resolves market distortions." In his opinion for the court, Justice Kennedy said that the physical presence rule as defined in *Quill*and *Bellas Hess* "is an extraordinary imposition by the judiciary on states' authority to collect taxes and perform critical public functions." He acknowledged that 41 states, two U.S. territories and the District of Columbia had all joined an amicus brief on the side of

South Dakota which asked the court to reject *Quill.* Justice Kennedy stated that the physical presence rule was "unsound and incorrect." He declared that "[the physical presence test] is unfair and unjust to those competitors, both local and out of State, who must remit the tax; to the consumers who pay the tax; and to the States that seek fair enforcement of the sales tax, a tax many States for many years have considered an indispensable source for raising revenue."

Over the course of the last 26 years, e-commerce has completely revolutionized the economy and the way that consumers purchase goods. Yet, the *Quill* standard produced an incentive for retailers to intentionally avoid establishing a physical presence in certain states. Justice Kennedy noted that the physical presence rule "is a judicially created tax shelter for businesses that limit their physical presence in a State but sell their goods and services to the State's consumers, something that has become easier and more prevalent as technology has advanced." Further, the court "should not prevent states from collecting lawful taxes through a physical presence rule that can be satisfied only if there is an employee or building in the State." The court determined that "when the day-to-day functions of marketing and distribution in the modern economy are considered, it is all the more evident that the physical presence rule is artificial in its entirety." As such, in overturning *Quill* and *National Bellas Hess*, the court eliminated any requirement that physical presence is required for sales tax.

Following *Wayfair*, it is clear that the physical presence requirement is overturned, and online retailers will need to begin collecting taxes in each of the states that have enacted rules requiring collection. Nevertheless, the Supreme Court did not provide any specific guidelines with respect to the state taxation of in-state citizens on out-of-state purchases. The Supreme Court held that South Dakota's law is permissible since it has several features that prevented it from running afoul of the Commerce Clause, including: (i) a safe harbor provision to those retailers who transact a limited amount of business in the state (i.e., for South Dakota, annual in-state sales that exceed $100,000, or 200 or more transactions into the state); (ii) the law is not retroactive; and (iii) South Dakota is one of more than 20 states that have adopted the Streamlined Sales and Use Tax Agreement, which reduces administrative and compliance costs for taxpayers. However, the court did not provide any guidance with respect to when such a tax would be unconstitutionally prohibited.

There has been significant discussion following the *Wayfair* decision on whether the Supreme Court's ruling in favor of South Dakota might encourage Congress to exercise its authority to regulate interstate commerce and resolve the new questions raised by the court. Congress has the power to regulate interstate commerce and, therefore, Congress may now push for uniformity and simplification of sales tax rules. Several bills in the House of Representatives (the Remote Transactions Parity Act of 2017, H.R. 2193, and the No Regulation Without Representation Act, H.R. 2887) and the Senate (the Marketplace Fairness Act of 2017, S. 976) were introduced in 2017 pertaining to interstate tax collection; however, Congress failed to move forward with these measures. Since small businesses trying to compete online may be adversely affected by the *Wayfair* decision and may be required to collect sales tax in all states in which they deliver goods, including different sales tax requirements in each state, small business will likely press Congress to act. On the other hand, individual states will likely now establish new laws specifically defining the treatment of e-commerce within and without its borders utilizing the same (or similar) economic nexus standard as South Dakota.

Specifically, in New Jersey, lawmakers introduced Senate Bill 2794 and Assembly Bill 4261, which passed both houses shortly after the *Wayfair* decision, and which are now collectively known as Assembly Bill 4261. The bill provides for collection of sales tax from certain remote sellers and now requires Governor Murphy's signature to become law. If passed, the law would take effect on Oct. 1. Under the bill, remote sellers would be required to collect and remit New Jersey sales taxes if they have: (i) 200 or more separate annual sales transactions, or (ii) $100,000 or more in annual gross receipts from sales into the state. The bill also includes sales tax collection and reporting requirements for marketplace facilitators, which means any person or business who provides a forum to a retailer to advertise, promote and list a retailer's products, and who also collects receipts from the customer and remits payment to the retailer.

It is clear that as a result of the *Wayfair* decision there will be far-reaching ramifications to businesses. New Jersey businesses will need to immediately evaluate whether they are required to charge sales tax in other jurisdictions. In addition, many businesses located outside of New Jersey will need to examine their approach to the collection of New Jersey sales tax and be prepared to collect and remit New Jersey sales tax from consumers.

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