Beyond *Wayfair*: Implications For State and Foreign Taxes

by Paul Jones and Jad Chamseddine

As the post-*Wayfair* landscape firms up, it's clear the case could have applications beyond remote sellers, reaching into states' authority to pursue business taxes using economic nexus, the adoption of factor presence nexus standards, and even the tax policies of European countries.

That potential has not been lost on taxing authorities and experts who expect years of lawmaking and litigation to explore the boundaries of the landmark decision in *South Dakota v. Wayfair Inc.* beyond online sales taxation.

The Near Term

The U.S. Supreme Court's majority opinion in *Wayfair* implicitly endorsed South Dakota's centralized, simplified sales tax regime and its economic nexus threshold — $100,000 in annual remote sales into the state, or 200-plus sales into South Dakota in a year — as satisfying the commerce clause's prohibition on tax regimes that overly burden interstate commerce.

"*Wayfair* took the most favorable set of facts and said, 'This works,'" said H. William Mahaffey of Lewis Roca Rothgerber Christie LLP. "Where the real game will be played in the future" is how the decision applies to jurisdictions with "wildly varying sales taxes."

Experts said they anticipate some litigation over how states implement the decision, but Walter Hellerstein, a law professor at the University of Georgia School of Law and author of several treatises on state taxation, said any lawsuits that do ensue won't dramatically change the tenets set out in *Wayfair*. "There's always going to be litigation at the margins," he said.

States have thus far sought to model their regulations as closely as possible off of South Dakota's remote seller law to avoid not only legal challenges but also congressional legislation preempting states' new remote sales tax authority. But some states "aren't going to simplify their sales tax regimes the way South Dakota" — a member of the Streamlined Sales and Use Tax Agreement — has done, according to David Gamage, a tax expert at the Indiana University

Maurer School of Law. And "just copying South Dakota's thresholds for dollar values and number of transactions" won't necessarily guard against commerce clause challenges to states' rules, he said.

Sources cite the emergency remote seller regulations issued by Colorado, which has a complex local sales tax regime, as an example of a move that could trigger litigation over how much of a tax collection compliance burden states can impose on remote sellers post-*Wayfair*. "Colorado's quite possibly going to be the most interesting first test case, if they go forward with what's suggested," Gamage said. "I wouldn't be at all surprised if that gets challenged."

Adam Thimmesch, associate professor of law at the University of Nebraska-Lincoln, predicted that states' desire to avoid litigation and congressional intervention will mean that the pressure is going to be on non-SSUTA states to make compliance easier for remote retailers. Rachel Simon of Rutan & Tucker LLP said that over time, more states may adopt greater streamlining and centralization of sales tax administration.

> ***'Just copying South Dakota's thresholds for dollar values and number of transactions' won't necessarily guard against commerce clause challenges to states' rules, Gamage said.***

Sales volume thresholds will likely also be scrutinized. For example, Mahaffey said, states like California and New York would potentially have a hard time justifying the imposition of sales tax collection obligations on remote retailers with just $100,000 in annual in-state sales, given those states' population sizes and complicated sales tax regimes. A seller could argue that it had not really availed itself of the California marketplace in the same way that it would have if it had made that volume of sales into South Dakota, Mahaffey said.

That argument was recently made at the Streamlined Sales Tax Governing Board meeting in St. Louis by Steve DelBianco of NetChoice, who lamented the fact that states with much larger gross domestic product numbers are emulating the South Dakota law. "Most have simply copied the South Dakota threshold even though those states are significantly larger," he said. Citing New Jersey, which recently adopted the same $100,000 threshold, DelBianco said the state should have a $1.2 million small-seller exception based on its annual GDP.

California policymakers floated a $500,000 gross annual sales threshold for remote sales near the end of the 2018 legislative session. The state "doesn't have that much to lose revenue-wise from having a higher threshold," and a low one might flunk the *Wayfair* test, Gamage said, adding that higher thresholds would also spare tax enforcement resources from being wasted.

States also have the ability to require online marketplace operators to collect taxes on third-party sales, allowing states to capture some revenue from small sellers without directly burdening them.

For states that can't easily simplify their sales tax administration, setting a higher threshold than South Dakota's or adopting other features of South Dakota's sales tax regime could help insulate them from challenges. A court might say, "You don't have to simplify, but if you don't, you need a higher threshold, or if you don't simplify or have a higher threshold, you need to provide free software" or vendor compensation, said Darien Shanske, a law professor at the University of California, Davis.

There may also need to be clarification on how thresholds are defined. Some items, like jewelry, have a high sales price, so a few transactions might trigger compliance by "small businesses that may not have the administrative wherewithal to collect and remit," Simon said, suggesting that states could modify nexus standards to only require collection by a seller when both the value and number of its transactions surpass preestablished thresholds.

Additional Fallout

The overturning of *Quill Corp. v. North Dakota* has numerous consequences for states and sellers. In addition to applying to sales of tangible personal property, it affirms states' ability to obligate remote businesses to comply with laws requiring sales and use tax remittance for sales of digital goods and services.

"Now it's clear these jurisdictions have taxing nexus," and that could create complicated sourcing issues, such as for remote providers of cloud computing services, Mahaffey said.

The *Wayfair* ruling also raises the question of if, and how, states will address uncollected taxes on sales made before the decision. States have largely avoided applying the decision retroactively, given its implicit stance against such efforts, and courts "would undertake a fair amount of scrutiny surrounding any retroactive application," said Valerie Dickerson of Deloitte Tax LLP.

But there still could be attempts. Steve Wlodychak of EY noted that a recent argument made by Florida in *Global Hookah Distributors Inc. v. Florida* sought to apply *Wayfair* retroactively to tobacco excise taxes — rather than sales taxes — that the state claims are owed by a foreign seller. "I found that to be an ominous development," Wlodychak said.

Numerous state laws enacted pre-*Wayfair* that were designed to circumvent the now-defunct physical presence standard — including "click-through" nexus laws and statutes requiring out-of-state retailers to report or remit sales taxes owed by their in-state customers — are still on the books. Thimmesch said those statutes retain some utility, both as a sort of backup or "bootstrap" nexus and as a means for states to seek sales and use taxes for some of the transactions made before *Quill* was overturned.

"Cookie nexus" laws — which assert that cookies installed by sellers on customers' laptops qualify as physical presence — were ripe for legal challenge when *Wayfair* was decided. Noting that Massachusetts has indicated that it will apply its cookie nexus rules to pre-*Wayfair* sales, Thimmesch said that in cases in which sellers sue over such applications, judges could either rule on the statute, or possibly buck the question and decide for simplicity's sake to apply the *Wayfair* decision retroactively. "It's something people might not be expecting," according to Thimmesch.

However, in the long term, Hellerstein predicted that many pre-*Wayfair* laws created as workarounds to the physical presence standard are destined for the statutory scrapheap. "We don't need crazy laws like click-through nexus anymore," he said. He also predicted the demise of *Direct Marketing Association v. Brohl*-style reporting laws. "A lot of complexity will go away. Life will be simpler."

The overturning of *Quill* could also possibly provide sales tax relief to some sellers. Shanske noted that the *Wayfair* majority essentially decided that "the physical presence test is arbitrary." He said some small sellers could potentially use that to argue against requirements to collect and remit sales taxes in particular circumstances, such as when a business has only a marginal physical presence and low sales in a state.

Andrew Yates of Alston & Bird LLP agreed, saying that while "most states who have looked at the question have said taxpayers still have nexus based on physical presence alone," it's unclear the extent to which *Wayfair* supports that idea. It's possible "that there is a minimal amount of physical presence that would not provide substantial nexus" with a state, he said.

A practical benefit for some businesses could be that the ruling makes it easier for them to "clear their books" of old, unpaid tax liabilities in anticipation of being sold. "Any number of businesses which do business on an interstate basis have a cloud hanging over their heads, because they've had physical nexus but they've never complied with sales and income tax laws," Mahaffey said. During a sale, buyers often demand that such liability be addressed, but the difficulty of catching up and reconciling with states by engaging in voluntary disclosure can be daunting.

Now, "people are suggesting, 'OK, as soon as these *Wayfair* statutes get passed, you can start filing and move forward prospectively,'" Mahaffey said. "It doesn't get rid of the history" but after a few years of compliance, the outstanding liability from before "gets old and cold," he added.

Another potential effect of the ruling that could prove more vexing to remote sellers is the risk that complying with states' new remote sales tax laws could also raise their exposure to litigation. "Some sophisticated plaintiffs' lawyers are going to . . . bring actions against the vendors" for accidental overcollection of taxes from customers, Mahaffey said.

Given that some remote retailers now face the complexity of complying with multiple states' sales tax regimes for the first time, the risk is potentially significant. And while states may seek to indemnify businesses that comply with their rules, those protections could be challenged.

Simon said there's also the question whether sales thresholds might potentially be used to establish that out-of-state sellers are "doing business" in a state. Pre-*Wayfair*, "typically that [criteria] was similar to the sales tax nexus . . . inventory in-state, et cetera," she said. But if states "amend their statutes in a way that sort of mirrors the thresholds in the *Wayfair* case, and follows the sales tax nexus," then that could subject remote retailers to "personal jurisdiction," making it easier to pursue lawsuits against them in those states. Although prior court rulings run counter to that notion, "there's a question whether that rationale would still apply," Simon added.

Foreign Vendor Compliance

One notable question post-*Wayfair* is whether states might seek to enforce remote seller obligations on foreign vendors. On its face, the law is clear — "The state cannot haul a French company into a U.S. court if the French company engages solely in activity outside the United States," Wlodychak told *Tax Notes*.

Moreover, "a French company selling into the U.S. can't be treated worse than an American company," Hellerstein said. "If they have no physical presence and they don't exceed the threshold, they're fine, they don't have a legal obligation."

But complications arise when sales do exceed the threshold and foreign companies refuse to collect and remit a state's sales tax. States don't have jurisdiction to enforce the law if vendors don't comply, according to Hellerstein. "The state doesn't have the feet on the ground to go after the company," he said.

It's possible that concerns over states missing out on significant revenue from foreign vendors are overblown, according to University of Connecticut School of Law professor Richard D. Pomp. But "it does pose a theoretical problem," he said. In the case of a foreign company with no physical presence in the United States, Pomp said, a state could see if the foreign vendor has any assets in the United States that might suffice.

"If the company doesn't collect, it will receive an assessment, and if they do nothing about that assessment, the state could have it enforced by a sister state through the full faith and credit clause," Pomp said. But to enforce the law, the company must have assets in the country. "Maybe they have a bank account," Pomp suggested. Mahaffey said a computer server might also do. But even then, trying to collect could be time-consuming for states.

Wlodychak agreed that states don't have much recourse in going after foreign vendors, but he noted that evading the law could ultimately present problems in the future for those companies. "If a company doesn't file a sales tax return, the statute of limitations never runs," creating latent liability that will exist indefinitely until it is satisfied, he said. In particular, "this could become a problem for the company if it wants to expand through a merger or an acquisition," because once a successor company does business in the United States, it would have to pay the outstanding assessment, creating headaches for the acquirers, he added.

> ***'We don't need crazy laws like click-through nexus anymore,' Hellerstein said.***

"For state sales tax purposes, we have successor liability provisions," Wlodychak said. "So regardless of whether they exit through a stock sale or an asset sale, those future purchases will be a hook for that latent liability."

Some American retailers are concerned that foreign vendors will receive a competitive advantage if their sales tax obligations aren't effectively enforced. Pomp said it wouldn't be inconceivable for a foreign vendor to set up shop in Mexico and service states in the South and Southwest through a distribution center close to the U.S. border, allowing the company to ship its goods into the United States while evading states' sales taxes.

Hellerstein suggested that the United States could copy a model used by some European countries and use customs officials to tax goods entering the country. Pomp agreed, saying it would be theoretically possible for customs officials to work with states to tax goods coming into the United States, suggesting "it would work like a tax on tobacco."

"We could start seeing states working with U.S. customs officials and start requisitioning goods from these companies that are not complying," Wlodychak said. "It sounds like a logistical nightmare, but it can theoretically happen."

While tasking customs officials with taxing goods entering the country may seem outdated and unnecessarily complicated, advances in technology could facilitate a different way of taxing those goods. One way is to levy tax in real time and have credit card companies collect the tax. This enforcement method could be used on foreign and domestic vendors. Hellerstein said, however, that credit card companies would likely resist such a change and claim that they wouldn't know what was being purchased, and thus wouldn't know how to tag the sale with the correct state and local tax.

"There are lots of ways in which technology advances over the next years may affect the sales tax collection process, whether it is through the intermediary, or through the third party," Hellerstein said, and suggested making the sales tax collection and remittance process as easy as possible for companies to follow because of the lack of a viable and easy enforcement method.

Beyond Sales and Use Tax

While *Wayfair* has dramatically altered the nation's sales tax environment, experts say the decision will have a significant effect on the broader state business tax environment as well. The overturning of the physical presence requirement for sales tax remittance marks the end of a unique, long-standing limit on governments' power to require tax compliance by remote businesses, which experts agree strongly reinforces the authority of states to apply business activity taxes based on companies' economic nexus.

According to Shanske, it promotes "a way of looking at state taxing issues that is not formalistic" and a view that "in general, the federal courts should not be looking for ways to prevent states from exercising their sovereign power" absent dormant commerce clause violations.

Thimmesch said the question whether a state can mandate compliance with a tax law now depends in large part on the "*Pike* balancing test" from *Pike v. Bruce Church Inc.* (1970), which assesses whether the burden on taxpayers is too excessive.

Yates said his firm has been "advising clients to consider the implications for income tax," adding that *Wayfair* "does make economic nexus for income tax a little more solid."

While most states already have economic nexus rules for applying BAT, experts say there was still some theoretical uncertainty whether some form of physical presence was necessary for states to pursue those taxes from out-of-state companies. *Wayfair* has ended any remaining debate and will likely advance states' use of economic nexus to pursue business taxes, sources said. "To the extent there was any question as to whether the physical presence rule applied to corporate income taxes, that's gone," Thimmesch said.

Experts said Wells Fargo's recent decision to reduce its earnings by $481 million in anticipation of additional state income tax liabilities is evidence of how *Wayfair* could affect a company's perceived state tax exposure.

Shanske said he was surprised by Wells Fargo's decision. "Despite what I thought was the overwhelming consensus about the factor presence nexus standard being permissible with respect to corporate income tax, we find out Wells Fargo has been assuming that was a close question."

Other businesses may want to broadly review their circumstances, according to Dickerson. "Taxpayers are in this situation where they need to rethink their understanding of their facts" and what constitutes substantial nexus under case law, she said.

Remote retailers that now have to register and remit states' sales taxes for the first time may have to worry about whether they have increased exposure to other state business taxes. Mahaffey said he believes states will more aggressively pursue BAT from remote vendors. Although the Interstate Income Act of 1959 (P.L. 86-272) narrowly bars states from levying net income taxes on sellers of tangible personal property (TPP) who limit their in-state activities to soliciting sales, Mahaffey noted that the provision doesn't extend to sales of services and sales of intangible products to consumers. "For people selling . . . or licensing intellectual property or intangibles like music or video [or] books or games — it just opens the door," he said.

Mahaffey also noted that P.L. 86-272 doesn't protect remote retailers from non-income taxes, such as a gross receipts tax.

Dickerson said she anticipates that businesses "are probably going to look at 86-272 [to] see if it can be read more broadly" and to gauge the full extent to which it might protect remote vendors from state income taxation. According to Thimmesch, if states move toward "more expansive" economic nexus standards for income tax, there could also be a future debate over whether P.L. 86-272 should be modified to apply to out-of-state sellers of intangibles and services as well as sellers of TPP.

"You could imagine there would be some political pressure generated by those groups, as they're being differently treated" than businesses selling TPP, Thimmesch said.

Wayfair could also provide some guidance for how states should pursue business taxes generally. "There's a sense in which we may have a more unified nexus standard for different types of state taxes," based in part on the *Wayfair* model, with which to examine "whether the state is doing enough to minimize excess compliance burdens," Gamage said.

For example, "there's a question for other taxes what the minimum nexus standard is for . . . remote businesses that do small amounts of business [in] a state," Gamage said. "It's reasonable to infer post-*Wayfair* that . . . to survive a challenge, there should be de minimis protections for taxes other than just sales and use tax."

Shanske also predicted that litigation over remote sales tax laws enacted in the wake of *Wayfair* could also influence rules governing states' pursuit of other business taxes. "There hasn't been much law really articulating the contours of what is substantial nexus for purposes of the corporate income tax," he said. If litigation fleshes out the *Wayfair* decision, "presumably there will be some cross-fertilization" that could help address corporate tax questions as well.

Thimmesch said that post-*Wayfair*, more states may move to adopt standards based on the Multistate Tax Commission's factor presence nexus standard for business activity taxes, which asserts nexus based on factors such as property and payroll location, and also in cases in which a business has over $500,000 in sales in a state.

States may "gravitate towards that as kind of a South Dakota-like quantitative" threshold, Thimmesch said. Some sources also speculate that *Wayfair* could push more states to consider adoption of single-sales-factor apportionment. Policymakers may say, "Let's have sales be our sole apportionment factor . . . for income tax purposes," according to Mahaffey.

International Influence

Wayfair's impact on the U.S. business tax environment is extensive enough that some experts think the fallout may stir ideas overseas. Although its repercussions are overwhelmingly domestic, the case did not go unnoticed abroad. "It is fair to say that proponents of digital taxes in foreign countries got a lift from the *Wayfair* decision," Robert Kovacev of Norton Rose Fulbright US LLP said.

This has been especially true of some countries in the European Union that want to tax companies that have a "significant digital presence" but that lack a PE. "It is similar to the physical presence rule," Pomp said regarding the international concept of PE. "And like the physical presence rule, it has become antiquated," he added.

PE was designed to allow companies to test the waters of another country to see if there was viable profit potential before they were subject to tax. "If they thought the business would be fruitful, they would take the next step and open an office or a warehouse," Pomp said.

The push to alter EU rules to capture revenue from the digital economy uses many of the same arguments put forth by the states in their quest to overturn the physical presence rule. In both cases, proponents point to the internet as the great disrupter. "Our pre-internet rules do not allow our member states to tax digital companies operating in Europe when they have little or no physical presence here," EU Tax Commissioner Pierre Moscovici has said.

Discussions to alter rules on taxing the digital economy have been ongoing for years and predate *Wayfair*. "It is not as if they were waiting with bated breath to see what our Supreme Court is about to do," Pomp said. And although some countries felt a boost following the *Wayfair* ruling, it is only psychological, according to some experts. "*Wayfair* is a sales tax case, not an income tax case," Kovacev said. "Other than psychologically, it doesn't help digital tax proponents."

Carol Doran Klein, vice president and international tax counsel for the United States Council for International Business, agrees. "People will try to use [*Wayfair*] to make their case," she said. "But this is a U.S. Supreme Court case about sales taxes."

> ***Pomp said that like the physical presence rule, the concept of a permanent establishment 'has become antiquated.'***

Kovacev explained that the main proposal suggested by the OECD would require amendment of treaties because it would "invent" the concept of virtual PE. This would allow countries to start taxing some technology companies that aren't physically present. "You can't really do that under the current treaty system because those treaties define permanent establishment, and those definitions don't include virtual PE," he explained.

But not everyone supports new measures aimed at taxing big technology companies. "The *Wayfair* case came down at the right or wrong time depending on where you stand," Hellerstein said. Some low-tax countries like Ireland and Luxembourg have voiced their displeasure at the attempts to change the definition. The United States, despite backing the concept of economic nexus in *Wayfair*, opposes the concept of a virtual PE.

"Most of the companies that would be subject to that tax come from Silicon Valley," Kovacev said, referring to the large technology companies hailing from Northern California. "The U.S. has taken a very strong stance against these types of proposals, obviously because they seem uniquely designed to disadvantage U.S. tech companies," he added.

But just as states took matters into their own hands to create novel approaches to tax remote vendors by introducing concepts such as click-through nexus and cookie nexus when Congress failed to act after *Quill*, the EU is also going down the same path.

The proposed rules laid out by Moscovici would implement a 3 percent revenue-based digital services tax on companies with a "significant digital presence." A company would be taxed if revenue from digital services exceeds €7 million, it has more than 100,000 users, or it has more than 3,000 online business contracts.

"They're making the digital tax a tax on gross revenue as opposed to income," Kovacev said. "That way the income tax treaties still apply, and they don't have to worry about renegotiating them."

Hellerstein said it's best for the United States to be active in negotiating the possibility of taxing digital companies, because the "horse is out of the barn."

"Countries aren't just going to let revenue slip out of their hands and will find another way of taxing those companies," Hellerstein said, adding that archaic tax rules, whether in the United States or in Europe, will continue to change as the world modernizes. "Life was about selling tangible personal property," he said. "That is very old-world."

Kovacev said there is no turning back now. "Everybody will have to come to terms with the new digitizing economy and how that gets taxed," he said. ■