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States Prevail Over E-Commerce Companies in Battle for Sales Taxes

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News

The U.S. Supreme Court issued a landmark decision on June 21, 2018 in *South Dakota v. Wayfair, Inc.*, which held that states may require retailers to collect sales taxes even if the retailer had no physical presence in the state.

Background

Since 1967, a business selling goods and services into a state where it did not have a “physical presence,” (e.g., employees, stores, etc.) could avoid collecting or remitting sales taxes to the state it was selling into. The Supreme Court of the United States in *Bellas Hess, Inc. v. Department of Revenue of Ill.* and *Quill Corp. v. North Dakota*, held that a retailer’s physical presence was necessary to establish a “substantial nexus” with the state imposing the sales or use tax.

Supreme Court Decision

In *South Dakota v. Wayfair, Inc.*, the U.S. Supreme Court overturned this 50-year-old precedent on June 21, 2018. Justice Kennedy, writing for the majority explained, “the central dispute [between South Dakota and Wayfair] is whether [a state can] require remote sellers to collect and remit [sales taxes] without some additional connection to the State.” The Court’s answer was unequivocal. Physical presence is not necessary to require collection and remittance of sales taxes. The jurisprudential effect of *Wayfair* was to overturn *Bellas Hess* and *Quill*.

In *Bellas Hess*, the Court reversed the Supreme Court of Illinois, which had required mail-order company Bellas Hess to collect and pay Illinois use taxes. Bellas Hess lacked employees, a physical location, and real or personal property in Illinois. In other words, Bellas Hess lacked a physical presence in Illinois, which meant due process was not satisfied. Further, the Court explained, the absence of physical presence meant that Bellas Hess’s business was purely interstate commerce and exclusively Congress’s domain to regulate.

The Court again, in *Quill*, examined the issue of an out-of-state retailer lacking a physical presence in a taxing authority. This time however, Quill—another mail-order company—had established sufficient economic contacts with North Dakota to satisfy Due Process requirements. However, without a physical location or representatives in the state, the Court ruled that a substantial nexus was not established.



But *Wayfair* was a paradigm shift. First, the Court explained that an out-of-state business need not have physical presence to satisfy the demands of Due Process. The modern economy, and internet connectivity, made evident that *Quill*'s physical presence requirement was artificial; an anachronism in the Cyber Age.

Second, the Court was concerned *Quill* incentivized businesses to avoid physical presence in the taxing jurisdiction. The majority was wary that this judicially created tax shelter generated undesirable market distortions. The effect of *Quill*, Justice Kennedy believed, was to treat retailers inequitably. In the opinion of the majority, "there [was] nothing unfair about requiring companies that avail themselves of the States' benefits to bear an equal share of the burden of tax collection."

Third, *Quill* imposed "an arbitrary, formalistic distinction," which flew in the face of the Court's modern Commerce Clause precedents, which favored "a sensitive, case-by-case analysis of purposes and effects." For example, an in-state shoe store with one location and few employees must collect and remit taxes. But a competing shoe store just over the border with only a virtual presence (e.g., online store and/or mobile application) is unencumbered by the need to collect and remit sales taxes. The Court was concerned that the physical presence requirement might even have affected desirable business development like building warehouses and distribution centers.

Impact

It is a rare occasion when a Supreme Court case moves stock markets. After the *Wayfair* decision, Amazon's and Wayfair's stock was down two-thirds of a percent, while eBay's and Etsy's were down more than two percent. Considering that 89% of Americans have internet access, Amazon is the world's biggest retailer, and e-commerce retail sales were estimated at \$453.5 billion last year, *Wayfair*'s impact on the stock price of e-commerce companies makes sense. In 2017, e-commerce sales outpaced traditional retail at a rate of four to one. Thus, *Wayfair*'s impact will expand.

The decision may be a windfall for state taxing authorities. The Court noted state losses on sales tax revenue from out-of-state retailers were estimated to grow from \$8 to \$33 billion. However, this raises the question: must every out-of-state person or business collect and remit sales taxes?

States will likely not be able to tax all out of state retailers because of the potential for the undue burden that could be imposed on small retailers who only have a modest number of sales into a jurisdiction. The Supreme Court, it seems, has deemed South Dakota's *de minimis* rule as an appropriate baseline for state taxing regimes. Only those out-of state retailers that conduct a "considerable" amount of business with South Dakota's residents need to collect and remit sales taxes. South Dakota defines a considerable amount as the sale of more than \$100,000 of goods and services or at least 200 separate sales transactions.

The boundary of a state's taxing authority must rest upon two constitutional principles. States may not discriminate against interstate commerce; nor may they impose undue burdens on interstate commerce. States wishing to tax out-of-state retailers should craft legislation using the guidelines set forth in *Complete Auto Transit, Inc. v. Brad*. To this end, the Court will sustain a state's tax so long as it: (1) applies to an activity with a substantial nexus with the taxing state, (2) is fairly apportioned, (3) does not discriminate against interstate commerce, and (4) is fairly related to the services the state provides.



The Court concluded that South Dakota did not run afoul of the first prong of *Complete Auto's* tests but remanded the case to the South Dakota Supreme Court to test South Dakota's law against the other prongs. The Court emphasized South Dakota's participation in the Streamlined Sales and Use Tax Agreement ("SSUTA"), *de minimis* rule, and lack of retroactivity as important factors in preventing discrimination against and undue burdens on small retailers. The expectation is that because the South Dakota law passed constitutional muster that other states will adopt similar thresholds for taxing internet retailers.

Significant Impact on International Commerce

Non-U.S. retailers may not be expecting the potentially significant impact the Court's decision will have on their sales activities. However, under the Supreme Court's rationale, a non-U.S. business that does not have a permanent establishment in the United States could find itself required to collect a state's sales tax even without the requisite nexus to be subject to income tax in the United States.

Takeaways

The Court appeared to appreciate that South Dakota's law afforded small merchants a reasonable degree of protection. South Dakota's statute only requires the collection and remittance of sales taxes if a considerable amount of business is conducted and is not retroactive. Thus, challenges might arise if other states install thresholds far lower than South Dakota's, apply sales taxes retroactively, and are not members of SSUTA.

Of note, out-of-state retailers should expect states to "race to the bottom," by adopting South Dakota's minimum dollar and transactional thresholds. Of concern for businesses is the estimated 10,000 to 12,000 taxing authorities in America. It remains to be seen if every out-of-state retailer needs to file a business license with every one of those taxing authorities. An even more pressing question: how does *Wayfair* affect foreign retailers?

Ultimately, Congress may step in to resolve these myriad tax issues. For example, novel versions of the Marketplace Fairness Act of 2013, the Remote Transaction Parity Act of 2017, and the No Regulation Without Representation Act of 2017, are all pieces of legislation currently pending before Congress.



If you have any questions concerning these developing issues, please do not hesitate to contact the following Los Angeles Paul Hastings lawyer:

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