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# ISSUE BRIEF

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National Taxpayers Union Foundation

## *South Dakota v. Wayfair*: What It Means

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The Supreme Court's 5-4 decision in the landmark case *South Dakota v. Wayfair* sent shockwaves through the world of online retail and state tax policy. In abandoning its decades-old precedent barring states from imposing taxes on retailers without a physical presence in the state, the Court has opened a Pandora's box of new taxing powers. States are scrambling to seize new cross-border taxing authority, causing significant disruptions to interstate commerce.

In the process, they are unearthing difficult issues that lawmakers at both the state and federal level did not anticipate prior to the Court's surprisingly fast resolution of the *Wayfair* case. Unless these matters are resolved, the result will be a "new normal" of state tax power that was unimaginable even a few years ago, with small businesses and internet entrepreneurs in particular bearing the brunt of tax bureaucrats' efforts to secure new revenue.

### Background

Last year, South Dakota passed a law granting itself the power to tax businesses with no physical presence in the state. The statute said that any business making more than \$100,000 in sales or more than 200 transactions into the state would now be subject to its tax collection and remittance requirements, even if the business had no property or employees in the state. The problem: the law clearly conflicted with Supreme Court jurisprudence as it stood at the time.

In the 1992 case *Quill v. North Dakota*, the Supreme Court ruled that businesses must have a "physical presence" in the state to be subjected to sales taxes. Consistent with [past rulings](#), *Quill* required that a business have a store, office, warehouse, or sales representative physically in a state to be [liable for](#) tax collection requirements of that state. This standard protected businesses of all kinds, both brick-and-mortar and remote sellers, from being forced to comply with the sales tax rules of states with which they have no tangible connection.

The "physical presence" standard faced strong opposition from states and big-box retailers seeking to force new tax collection obligations on remote retailers. Whereas internet retail was an economic afterthought in 1992, e-commerce represented [9.5 percent](#) of total retail sales in the first quarter of 2018. Some used this growth to advocate for expanded tax power based not on tangible physical presence, but on more nebulous measures of "economic nexus" with a state. South Dakota's 2017 law was the culmination of decades of lobbying, backed by millions of dollars, to advance the cause of tax power that can reach as far as the internet itself.

By overturning the precedents established by *Quill* and the 1967 case *National Bellas Hess v. Illinois*, the Supreme Court has blessed years of attempts by states to extend their taxing powers to ensnare not just residents but any entity with even limited business transactions in any state. This shift away from a “physical presence” nexus standard to “economic nexus” changes the very nature of state tax power, with widespread ramifications.

This debate is a smaller, domestic version of fights that large, successful American technology companies find themselves in internationally. The European Union (EU) and the Organization for Economic Cooperation and Development (OECD) have for years been considering (and in some cases employing) various discriminatory tax policy and enforcement schemes intended to intimidate American companies abroad. The [latest proposals](#) could even target those companies that have no physical presence in certain EU member countries. These efforts employ the same logic the *Wayfair* majority used—that tax power need not be bound by geography or tangible connection to a jurisdiction. And these schemes are advanced for the same reason that states targeted out-of-state sellers: governments love nothing more than targeting entities with no power at the ballot box for tax collection.

### **The ruling - what it said, and what it didn't say**

In *Wayfair*, the Court agreed with the assessment of these states. A 5-4 majority [blasted](#) the *Quill* decision as creating 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.” Because of *Quill*, the Court concluded, states were being artificially constrained in their tax collection ability, resulting in revenue shortfalls. In effect, the *Wayfair* Court invalidated the *Quill* Court’s physical presence nexus standard for sales tax collection, in favor of the more nebulous “economic nexus” standard embodied in South Dakota’s law.

As a technical matter, however, the Court’s actual holding was relatively limited because it focused only on whether or not to abrogate the *Quill* nexus standard. As such, it did not definitively establish that South Dakota’s law was constitutional. Instead, the Supreme Court vacated the decision of the South Dakota Supreme Court, which had invalidated the statute by relying on *Quill*, and remanded it back to them for further proceedings.

In doing so, it indicated that the lower court should evaluate whether the law might be found to be unconstitutional under another area of jurisprudence. Practically speaking, this means that some of the biggest questions about state tax power in the internet age remain unanswered, as the Court declined to firmly establish clear new standards for constitutional taxation consistent with the demands of the Commerce Clause and Due Process Clause. Those standards will continue to be shaped to modern circumstances by future litigation.

As to its policy reasoning, the Court makes several missteps. First, it substantially overstates the revenue shortfall supposedly afflicting states. Consider this paragraph from the opinion in *Wayfair*:

Wayfair offers to sell a vast selection of furnishings. Its advertising seeks to create an image of beautiful, peaceful homes, but it also says that “[o]ne of the best things about buying through Wayfair is that we do not have to charge sales tax.” What Wayfair ignores in its subtle offer to assist in tax evasion is that creating a dream home assumes solvent state and local governments. State taxes fund the police and fire departments that protect the homes containing their customers’ furniture and ensure goods are safely delivered; maintain the public roads and municipal services that allow communication

with and access to customers; support the “sound local banking institutions to support credit transactions [and] courts to ensure collection of the purchase price,” and help create the “climate of consumer confidence” that facilitates sales.

The Court’s rhetoric, suggesting that basic government services are not being provided due to lost tax revenue, is out of line with the reality of the situation. In late 2017, the Government Accountability Office [estimated](#) that the amount of revenue states do not collect adds up to a grand total of between \$8 billion and \$13 billion nationwide. This is a drop in the bucket for states, constituting between roughly 0.5 percent and 0.75 percent of state budgets, which total approximately \$1.7 trillion.

For South Dakota, this translated to around \$50 million per year in lost revenue. For context, that’s [about the amount of revenue](#) South Dakota forgoes each year due to its tax exemption for livestock feed, which goes untaxed because it’s a business input. Anyone arguing that this livestock feed tax exemption was bankrupting the state would be laughed out of the room. In any case, the purported budget challenges associated with this uncollected revenue didn’t prevent the state from achieving its sixth straight year of [surplus](#) in 2017, ending the cycle with roughly \$8 million left over.

But the *Wayfair* decision was about far more than a few extra dollars in state coffers — it was about the fate of smaller online retailers as well. The Court largely dismissed these concerns in its opinion, writing:

Respondents argue that “the physical presence rule has permitted start-ups and small businesses to use the Internet as a means to grow their companies and access a national market, without exposing them to the daunting complexity and business-development obstacles of nationwide sales tax collection.” These burdens may pose legitimate concerns in some instances, particularly for small businesses that make a small volume of sales to customers in many States. State taxes differ, not only in the rate imposed but also in the categories of goods that are taxed and, sometimes, the relevant date of purchase. Eventually, software that is available at a reasonable cost may make it easier for small businesses to cope with these problems. Indeed, as the physical presence rule no longer controls, those systems may well become available in a short period of time, either from private providers or from state taxing agencies themselves. And in all events, Congress may legislate to address these problems if it deems it necessary and fit to do so.

But the concerns of small online retailers are immediate and legitimate, and the *Wayfair* decision has started to tilt the scales against them. As the Court notes, the internet has served as a means of allowing new retailers to reach the same consumer base that established nationwide retailers already have access to. It can be extremely difficult for new retailers to contend with the complexity inherent in a system with 45 states (and D.C.) having their own sales tax regimes and an estimated [12,000 tax jurisdictions](#).

Tax compliance is already a greater burden for smaller retailers. A 2014 [study](#) by the National Association of Manufacturers found that the cost of tax compliance was over \$1,500 per employee for businesses with fewer than 50 employees, but under \$700 for businesses with more than 100 employees.

Considering that many affected businesses will be small groups selling products on platforms like Etsy, this cost could be prohibitive. The giants of retail, such as Amazon and Walmart, already have physical presence in the form of stores or distribution warehouses spread across the country. This means that they [already collected sales tax](#), and the *Wayfair* decision won’t change their tax bills much. It will be

the small retailers that have to invest the substantial time and effort into complying with multiple tax regimes, or possibly change their business models.

## **Questions abound post-Wayfair**

In its wake, the *Wayfair* court leaves complexity, confusion, and unanswered questions. As two state tax practitioners recently [wrote](#), “the only thing any player can be certain of post-*Wayfair* is that a playing field might exist. But no player can be certain of the field’s markings, location, or boundaries. Nor does any player know whether it is on the playing field at all.” This is no way to resolve important tax and regulatory jurisdiction matters, and yet it is what was foisted upon the American economy when the Supreme Court handed *Wayfair* to an ill-prepared nation.

The Court gave relatively little guidance to states and businesses seeking clarity on tax obligations. Most of the opinion is spent laying out the reasoning for overturning *Quill*, leaving relatively little direction to states. The Court’s guidance, such as it is, is contained in but a few sentences discussing why it viewed South Dakota’s statute positively.

First, the Act applies a safe harbor to those who transact only limited business in South Dakota. Second, the Act ensures that no obligation to remit the sales tax may be applied retroactively. Third, South Dakota is one of more than 20 States that have adopted the Streamlined Sales and Use Tax Agreement. This system standardizes taxes to reduce administrative and compliance costs.

The silver lining here, if there is one, is that the Court recognized the important distinction between large businesses and smaller ones. While the internet sales tax debate has for many years been characterized as a competition of brick-and-mortar vs. online, in truth it is more accurate to say it’s one of big vs. small. In positively citing the small seller exception in South Dakota’s law, the Court gave some support to the notion that states ought to distinguish between large businesses with many resources to handle tax compliance and smaller ones that would be crippled by complex tax obligations. Even this guidance is subject to dispute, however, since it is quite broad and not contained in the actual holding of the Court.

## **Conclusion**

Important questions about state sales tax power after *Wayfair* have been left unanswered. Among them are ongoing uncertainty about how states are establishing transaction and dollar amount thresholds at which businesses are mandated to collect sales tax, the extent to which states will impose back-taxes, and how tax is collected for sales on so-called “marketplace” websites like Etsy. In future papers, NTUF will look into these questions, and many others, in more depth.

The *Wayfair* decision invited chaos by overruling *Quill*. Consumers and businesses, particularly smaller ones, will pay the price absent swift legislative action to protect them. The time is now for lawmakers and the policy community to begin the difficult work of evaluating and containing the fallout.

### About the Authors

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