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Congressional Responses to *Wayfair*

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By deciding as it did in *South Dakota v. Wayfair*, the Supreme Court upended decades of precedent by throwing out its decision in *Quill v. North Dakota*, which established that a business must have a physical presence in a state before being required to collect its sales tax. Now states all across the country are scrambling to seize new tax power for themselves, potentially harming interstate commerce in the process. As states and businesses alike rush to adapt to this uncertain environment, Congress has an important role to play in defending the vitality of internet retail and reaffirming principles of federalism and limited government.

Any response from federal policymakers addressing the fallout from *Wayfair* should have four main components:

1. A ban on retroactive tax collection
2. A temporary moratorium on enforcement of state legislation
3. A reasonable small-seller exception that protects small businesses from new compliance costs and allows them to adjust to new compliance burdens.
4. Avenues for securing injunctive relief for businesses exposed to questionably constitutional state statutes.

By addressing these near-term concerns, Congress would give itself the time and space necessary to pursue comprehensive solutions to the sales tax issue while ensuring that interstate commerce and business operations are protected from the worst abuses of states.

Ban on Retroactive Collection

Any responsible federal reaction to the *Wayfair* decision should include a ban on retroactive tax obligations. Though the *Wayfair* court approvingly highlighted South Dakota's commitment to prospective-only application, it did not explicitly say that states could not collect sales taxes retroactively. Because of this, some states may be tempted to pursue retroactive application of their tax laws, which would prove enormously unfair and damaging to the economy.

Many state economic nexus laws lack statutory language prohibiting retroactive collection, and some tax officials may feel bound to enforce the law as of its effective date, even if that fell prior to *Wayfair* being decided. For example, Florida's Attorney General has already said that state attorneys may apply the *Wayfair* ruling retroactively to defend against refund claims or other types of tax litigation. Massachusetts recently announced that it would enforce its "cookie nexus" tax regulation all the way back to October 2017, months before the Supreme Court was even petitioned to hear *Wayfair*. These are unlikely to be the only scenarios where states take liberties with regard to retroactivity.

Congress should act to preclude imposition of retroactive tax obligations in order to provide certainty to businesses and to preserve important principles of fairness.

Apart from the unfairness of imposing retroactive tax obligations, it is also unclear whether or not doing so would pass constitutional muster. Jurisprudence relating to retroactive taxes does not provide a definitive answer as to their constitutionality, meaning that any business facing a back-tax obligation could be embroiled in expensive and time-consuming litigation. Furthermore, retroactive assessment would likely constitute impermissible double-taxation. Though sales tax may not have been collected on transactions prior to *Wayfair*, consumers may well have paid the legally-owed use tax on such sales at the individual level.

But the risk is not limited only to retroactive *assessment* of taxes, as states would likely have free reign to conduct retroactive *audits* even if they commit to prospective-only collection. For years, states have moved aggressively to seek information about the business conduct of out-of-state retailers to facilitate their tax collection schemes. It stands to reason that many auditors will use the opening provided in *Wayfair* to conduct backward-looking audits to help them establish tax obligations. Businesses previously protected by *Quill* may have significant difficulty in complying with such audits, since many will lack complete information about transactions where they were under no legal obligation to collect and remit sales tax.

Nor is the retroactivity threat limited only to sales taxes. Wells Fargo shocked many observers when it announced that it was setting aside $481 million in a reserve fund for what it sees as potential *income* tax obligations it might face post-*Wayfair*. While more information is needed, it's likely that at least some of those obligations will be retroactive.

To make matters worse, statutes of limitations provide no protection in this realm. The clock for such a limitation doesn't start until a return has been filed, but of course the fact that economic nexus statutes were unconstitutional until June 21, 2018 means that no returns will have been filed for most non-resident businesses. That means that back tax liability is effectively unlimited according to the letter of the law in many states.

Congress should act to preclude imposition of retroactive tax obligations in order to provide certainty to businesses and to preserve important principles of fairness. This could be achieved with relatively simple language prohibiting states from imposing tax obligations on remote sellers for sales prior to June 21, 2018 when *Wayfair* was decided. By clearly precluding states from attempting to assess or audit retroactive taxes, Congress can prevent impetuous tax collectors from harming their states' economies while also providing greater clarity and certainty about the scope of post-*Wayfair* taxation.

Moratorium

Perhaps unsurprisingly, overeager state tax bureaucrats are acting as though small and medium sellers are prepared to adapt to the new economic nexus rules almost overnight. Many states have been making their post-*Wayfair* economic nexus legislation effective October 1, 2018 though some went for the earlier date of July 1, 2018 and others have chosen a later date of January 1, 2019.

The problem is that businesses are not prepared to deal with the added compliance burden. *Thomson Reuters* estimated in mid-August, almost two months after the *Wayfair* decision was released, that a mere 8 percent of medium-sized firms are prepared to cope with economic nexus taxation. Small businesses are undoubtedly even worse off.

Furthermore, in their rush to put legislation on the books, states are sacrificing procedure and due diligence. Many states, including North Carolina and Michigan, have not even bothered to draft new legislation — their state Departments of Revenue simply put out notices that essentially create an entirely new tax collection standard with little or no statutory basis.

> *Federal legislation that prohibits states from implementing collection standards until June 1, 2019, or perhaps earlier, would ensure states and businesses have time to respond appropriately to Wayfair.*

The result is uncertainty for online retailers already facing down the daunting task of complying with an exponentially larger number of tax regimes. State economic nexus legislation often leaves open questions such as whether revenue must be taxable to apply towards a small-seller exception. Vague legislation, brought on by states' haste to access revenue, could end up punishing small sellers who guess wrong.

Supporters of *Wayfair* would argue that tax compliance software companies will be the ones to step in and solve this problem. Yet software companies are not the *deus ex machina* that they appear to be. For one, there are serious questions about whether or not they have sufficient capacity to absorb the enormous flood of businesses needing tax compliance assistance. Thousands of companies are staring down the barrel of new tax obligations in hundreds (or even thousands) of new tax jurisdictions, placing major strains on what was previously a relatively sleepy line of business.

Additionally, software providers are no more able to solve the problem of sales tax complexity on their own than TurboTax was able to solve income tax complexity on its own. Ultimately, the difficulty in properly complying with sales tax law comes not from lack of computing power to do the necessary math, but from humans needing to make determinations about whether an item is taxable or not. Simply contracting with a software company is not sufficient to navigate the difficulties of mapping products to tax law.

The solution, then, is to remove the time crunch that is making state legislators and tax bureaucrats be so uncautious. Federal legislation that prohibited states from implementing collection standards until June 1, 2019, or perhaps a somewhat earlier date, would ensure that many states that don't have regular sessions until the start of 2019 are able to respond to *Wayfair* appropriately and would give businesses the certainty of nearly a year to bring themselves into compliance with the new world order as it relates to sales tax.

Revenue Thresholds

The Court stated that South Dakota's law provides a "reasonable degree of protection" by exempting businesses with revenues under $100,000 within the state or perform less than 200 transactions within the state. States such as New Jersey have taken these numbers as gospel, drafting bills that also exempt businesses with fewer than 200 sales or sales below $100,000 within the state.

> *While Congress and the states work on a comprehensive solution to sales tax challenges, the responsible move would be to shield small sellers from the predations of out-of-state tax collectors.*

The problem: New Jersey is not South Dakota. The state has a GDP that is nearly 12 times larger than South Dakota's, and a population over 10 times as large. Those thresholds will be triggered far earlier for an online retailer in New Jersey than in South Dakota. Were the thresholds to be properly scaled to account for the states' sizes, an online retailer would need approximately $1.2 million in sales and around 2,050 transactions within the state of New Jersey in order for the exemption to function similarly to South Dakota's. If revenue and transaction thresholds are not properly scaled, they will provide far less protection to small online retailers than the Court's *Wayfair* reasoning endorses, and that protection will vary widely from state to state.

Further, some states are moving to use even lower thresholds. Pennsylvania's pre-existing economic nexus statute utilized a threshold of just $10,000 in sales to the state, ensnaring many more retailers than a $100,000 limit would. Oklahoma's economic nexus law sets the threshold at the same level. Washington State has decided to use $10,000 in sales for its "report-or-collect" mandate, meaning retailers making more than that amount in sales would be required either to collect the state's tax or report to revenue officials details on the transactions so the state can collect use tax directly from individuals.

And there are serious questions about how such standards are actually defined. For example, in most statutes it is unclear whether or not tax-exempt sales, such as business-to-business transactions or services which are generally not subject to sales tax, are meant to count toward the transaction thresholds. Some states like South Carolina have provided guidance that even tax-exempt sales will count toward thresholds, while others have stayed silent on the matter.

Additionally, it is worth remembering that small retailers who end up below the thresholds are not entirely free from compliance burdens. Audits can affect businesses that approach the thresholds, and any business that believes it could conceivably approach the thresholds will be responsible for keeping track of its transactions. In practice, this means that sellers must begin tracking information from the very first sale into a state, since they may eventually surpass a mandatory collection threshold.

A nationwide small-seller exception would serve two purposes. On the one hand, it would allow Congress to pre-empt states that are attempting to set small-seller thresholds that are far too low, such as Pennsylvania or Oklahoma. Yet Congress would also be able to avoid the aforementioned loophole that larger states are taking advantage of — taking revenue and transaction thresholds that the Supreme Court approved for the 47th largest state in the Union and applying them to far larger states.

The Small Business Administration defines a retail establishment as "small" at revenue levels up to $38.5 million per year. While this may sound high at first glance, it reflects the fact that the retail industry as a whole operates on very thin profit margins. As a result, large gross revenues translate to relatively small operations. Congress could simply incorporate the SBA's definition into its own small seller exception language to ensure that it continues to match market realities, or it could choose a number — ideally no less than $10 million — and embed it into statute, ensuring that an inflation adjustment is provided.

In the long run, the best way to protect businesses from excessive compliance obligations from a thicket of tax laws in states where they have no presence is not to create a permanent class of businesses that don't collect out-of-state taxes while others do. It's to dramatically simplify sales tax codes across the country and to ensure that only a business' home state can hold them accountable for tax collection. If Congress and the states can work together toward such a goal, it would obviate the need for a small seller exception in the first place. But until such a solution is on the horizon, the responsible move would be to shield smaller sellers from the predations of out-of-state tax collectors.

Injunctive Relief

The Supreme Court may have signaled that it preferred legislative barriers to retroactivity and substantial safe harbors for small sellers for state online sales tax laws, but the relatively indirect language of the *Wayfair* decision means that online retailers may find it difficult to secure relief against an unconstitutional scheme.

For instance, Colorado has indicated that it will impose collection obligations despite the fact that its sales tax system is a complicated mess which does not bear any resemblance to the simplified system the Court cited approvingly in *Wayfair*. Additionally, it maintains a "notice and reporting" statute on the books which could conflict with new standards governing tax obligations. Despite the fact that Colorado's approach is likely unconstitutional, most courts would be unlikely to take the step of issuing an injunction or temporary restraining order to prevent its implementation due to the relative vagueness of the standards set out in *Wayfair*. In order to effectively challenge the constitutionality of Colorado's approach, a small business would be required to face assessment under the new law and sue the state. While a suit worked

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its way through the courts, the small business in question would need to continue complying with the rule. That could potentially take years and millions of dollars — a daunting proposition for even the largest of businesses. Faced with such a choice, most businesses would rationally choose to cut their losses and comply with the law, even if they felt it was unconstitutional.

Congress could address this problem in several ways. First, it could simply write a provision into any *Wayfair* response legislation establishing original jurisdiction for matters pursuant to the law in district courts. This was the approach taken in H.R. 2887, the "No Regulation Without Representation Act," which would have instituted a physical presence standard for taxation and regulation. That bill included an original jurisdiction provision, including specific mention of injunctive relief for taxpayers facing enforcement contrary to its standard.

A more comprehensive approach, however, would be to directly modify the Tax Injunction Act, the Anti-Injunction Act, the Declaratory Judgment Act, or any other relevant statutes to allow taxpayers to seek an injunction against any tax assessment made by a state where they lack physical presence.

This would leave in place the basic structure of such laws since any in-state action would continue to be bound by them. But there should be a lower bar for taxpayers to clear to defend themselves against an enforcement action arising from a state with which they have no tangible physical connection, given the difficulty of defending oneself in a far-away court.

While care would have to be taken to fully evaluate the consequences of such an action, limiting the aforementioned statutes in such a manner would be consistent with Congress's power since it only makes a modification for state efforts to regulate interstate commerce pursuant to newly-granted power bestowed by the Supreme Court. Because the Court granted states vast new powers to regulate interstate commerce, it is incumbent upon Congress to update its laws to allow taxpayers to defend themselves from overzealous tax collectors.

Current proposals

There are two pieces of legislation that have been introduced post-*Wayfair* that address some of the elements laid out in this paper.

H.R. 6724, the "Protecting Businesses from Burdensome Compliance Act"

The first is H.R. 6724, the "Protecting Businesses from Burdensome Compliance Act" introduced by Rep. Bob Gibbs (R-OH). This legislation would prohibit retroactive tax collection and would require states to a utilize a uniform sales tax base, a uniform sales tax rate, and centralized collection before accessing any collection authority pursuant to *Wayfair*. It would effectively delay phase-in of any collection laws since it prohibits collection prior to January 1, 2019. The legislation also prohibits localities from imposing their own sales tax obligations.

Conceptually, Gibbs' legislation takes steps in the right direction by banning retroactivity and by modestly delaying implementation of post-*Wayfair* collection laws. And its requirements for tax simplification similarly point in the right direction, even if they are incomplete at best. A much fuller list of simplifications, including uniform rules for rounding and consistent definitions for transaction terms, would be necessary to truly streamline tax collection. The trade association NetChoice has laid out an excellent and comprehensive list of simplifications that would more fully achieve the goal of minimizing sales tax complexity.

Unfortunately, there appears to be a rather large loophole that could significantly undermine any beneficial impact the bill might have if it were to pass. Section 2 of the legislation bans tax or information collection from retailers "if such seller does not have a physical presence in such state at the time of such purchase." It then goes on to define an exception to that prohibition for sales taking place after the effective date into states that comply with its central collection and uniformity standards. However, the legislation never actually defines "physical presence," leaving an opening to any state that wants to avoid its provisions.

Because "physical presence" is not carefully defined, in effect it leaves that definition up to states and whatever they deem as physical presence. As such, it is likely to fall victim to exactly the same kind of aggressive state action that ultimately led to the downfall of *Quill* and physical nexus standards in the first place. States spent years attempting to define everything, from affiliate advertising relationships with in-state websites to the use of browser cookies, as constituting physical presence. These efforts to "define nexus down" to include even the most tangential, non-physical connections is in part what led South Dakota to challenge *Quill* head-on in hopes that the Supreme Court would throw it out, which of course it eventually did. Absent a strong definition of physical presence in the statute, the Gibbs approach would be circumvented by the very same states that spent years circumventing *Quill*.

H.R. 6824, the "Online Sales Simplicity and Small Business Relief Act"

The other post-*Wayfair* bill is a bipartisan piece of legislation introduced by Rep. Jim Sensenbrenner (R-WI), Rep. John Duncan (R-SC), Rep. Anna Eshoo (D-CA), and Rep. Zoe Lofgren (D-CA). Called the "Online Sales Simplicity and Small Business Relief Act," the bill attracted significant attention at introduction based on its bipartisan sponsor list and the fact that its lead sponsor, Rep. Sensenbrenner, had introduced legislation prior to *Wayfair* that would effectively embed a *Quill*-like physical presence standard in statute.

The bill does three things. First, it bans taxation on remote sellers for any sales prior to June 21, 2018, the date that *Wayfair* was decided. Second, it delays implementation of state post-*Wayfair* laws to January 1, 2019 to allow for what it calls an "orderly phase-in of compliance obligations." Third, it establishes a small seller exception of $10 million in gross annual receipts, protecting businesses under that threshold from compliance obligations.

The Online Sales Simplicity and Small Business Relief Act would provide significant protection to businesses both large and small as they navigate the challenges of the post-Wayfair world.

Unlike the Gibbs bill, Sensenbrenner's legislation does take care to define the term "physical presence." It specifies that having employees or property in a state do constitute presence, while establishing that "limited or transient" business activity does not. Most importantly, this definition closes the door on aggressive state actions to define affiliate advertising relationships, so-called "click-through" or "attributional" connections, or delivery of browser cookies as constituting physical presence. As a result, the Online Sales Simplicity and Small Business Relief Act would provide significant protection to businesses both large and small as they navigate the challenges of the post-*Wayfair* world.

Unfortunately, neither the Gibbs bill nor the Sensenbrenner bill contain language that would provide businesses easier access to injunctive relief against a state's tax scheme. This would leave many companies vulnerable to overbearing state revenue collectors, forcing them to engage in expensive and time-consuming litigation in order to secure relief from an unconstitutional tax scheme.

Conclusion

The Supreme Court's decision in *Wayfair* threatens to undermine the retail sector and weigh down businesses all across the country with heavy tax burdens. As the body constitutionally-empowered to maintain the free flow of interstate commerce, it is incumbent upon Congress to take swift action to reaffirm important principles of limited government, federalism, and free markets in internet commerce. Legislation to ban retroactive taxation, delay implementation of remote sales tax laws, protect smaller sellers, and establish paths to injunctive relief would do exactly that, creating a smoother path for Congress and the states to pursue much-needed comprehensive solutions to this vexing policy area.

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