

Responding to the *Wayfair* Decision in Big Sky Country

APRIL 11, 2019

BY: ANDREW MOYLAN, ANDREW WILFORD &
BRENT MEAD

Introduction

In June of last year, the Supreme Court came to a final decision in the case of *South Dakota v. Wayfair*. South Dakota had passed a law granting itself the power to tax out-of-state businesses that made sales in their state, in direct contravention to precedent established in the 1992 case *Quill v. North Dakota*. In *Wayfair*, a 5-4 majority decided to overrule decades of precedent governing when businesses were liable for collecting sales taxes on behalf of states, setting off a scramble by businesses and states to react to the changes. Now, it's up to legislators in Helena to decide for Montanans how to respond.

Prior to the *Wayfair* case, liability for sales tax collection was determined by a “physical nexus” standard as established by the *Quill* precedent. Essentially, if a business headquartered out of state had some form of tangible physical presence within a state — be it an employee based within the state, a retail outlet, or a warehouse — it was liable to collect and remit sales tax for sales made to that state. Without physical presence, however, out-of-state businesses could not be required to collect and remit sales tax. This common-sense standard protected small businesses, including many in Montana, from being exposed to the complex sales tax regimes of states where they had no presence.

The Court's decision in *Wayfair* effectively overturned the physical presence standard, providing tacit approval to “economic nexus” statutes that established collection and remittance liability for out-

Key Facts:



As a state with no sales tax, the impact of the Supreme Court's decision in the *Wayfair* case on internet sales taxes will be particularly negative in Montana.



Legislators should oppose misguided attempts to take advantage of the decision to impose an unpopular general sales tax, and should instead provide for study of comprehensive tax reform in interim committee.



An interim committee could explore methods of protecting Montana businesses from out-of-state tax bureaucrats while modernizing the state's tax code.

of-state businesses if they exceeded a set amount of transactions or sales value to customers within the state.

States around the country quickly began passing economic nexus statutes to capture a new revenue source. Some states' revenue departments, such as that of Michigan, even attempted to change the rules by administrative action, claiming the court case alone as sufficient authority to enforce sales tax collection liability on out-of-state businesses.¹

The problem with this scramble to enforce previously unconstitutional rules is that it leaves businesses with little time to react. While the biggest e-retailers, such as Walmart and Amazon, already had physical presence around the country and were relatively unaffected by the *Wayfair* decision, a report by *Thomson Reuters* released almost two months after the *Wayfair* decision came out determined that just 8 percent of medium-sized firms were prepared to deal with the increased tax compliance burden.² Given that many states' economic nexus legislation went into effect October 1 of last year, that's a major problem.

This leaves Montana in a difficult position. The state has made a sovereign decision not to impose a general sales tax of its own, contributing to Montana's attractive and unique tax climate relative to other states. As a result, many Montana-based retailers have never had to collect sales tax at all, leaving them uniquely unprepared for a world in which they're required to collect taxes for dozens of other states where they have no presence. At the same time, the need for comprehensive tax reform looms large, and some are even advocating for the implementation of a general sales tax within the state.

Moving forward, Montana legislators should resist the urge to implement half-baked policies intended to "take advantage" of the *Wayfair* decision. Instead, it should take steps to comprehensively explore protections for Big Sky State businesses and ensure that any future reforms implemented do not increase burdens for taxpayers.

Montana's Current Tax System

Despite record revenue projections for this biennium, policymakers may feel pressure to raise tax rates or to seek new sources of revenue. The Supreme Court's decision in *Wayfair* has unfortunately only added fuel to this fire, with renewed discussion of adding a sales tax.

Montana voters have historically rejected the idea of a general sales tax. Most recently, in 1993, voters rejected a plan that would partially replace income and property taxes – but not eliminate them – with a four percent sales tax. This is but one example of many in a long line of attempts to impose a sales tax in the state, all of which were turned back by significant public and political opposition. The 1968 slogan "Pay more? What for?" has rung true for more than half a century, despite vigorous attempts to break the no-sales-tax dam.³

The largest share of Montana's state tax revenue, at nearly 50 percent, comes from individual (45 percent) and corporate (5 percent) income taxes.⁴ While the state does not levy a general statewide sales tax, certain goods and services are subject to a sales tax. Combined, these sales taxes make up just over 14 percent of state tax revenues. The remaining state tax revenues come from severance taxes (13 percent), property taxes (10.5 percent), gas taxes (7 percent) and motor vehicle registrations (5.5 percent). Local tax revenue is nearly entirely made up of property tax revenue (96.5 percent).

¹ Lafaive, Michael, and Wilford, Andrew. "Mich. tax bureaucrats burden small businesses," *The Detroit News*, January 29, 2019.

² Paladino, Alex. "Tax day of reckoning comes for e-commerce companies," *ThomsonReuters*, August 15, 2018.

³ Kohn, Jay. "The 1968 slogan that derailed a sales tax in Montana," *MTN News*, March 5, 2019.

⁴ Montana Department of Revenue, "Biennial Report," December 17, 2018.

The recent history of revenue collections shows that while revenues from secondary sources such as oil and gas collections have decreased, increases in individual income tax collections have outpaced that loss. The result is that while revenue from oil and gas collections has fallen dramatically from 2009 highs of \$150 million, the state is projected to see 4.8% revenue growth from the 2019 biennium to the 2021 biennium — which will result in historic levels of revenue.

Despite this optimistic short-term forecast, there are warning signs on the horizon. Much like the rest of the country, Montana faces an expanding elderly population combined with stagnant growth in working age populations.

Montana has not seen the working age cohort (ages 25-64) reach even 1 percent growth since 2010, and the expected growth for the next three years is 0.0 percent.⁵ At the same time, population growth among Montanans aged 65+ has averaged 3 percent since 2010. Should these trends continue, the shrinking working-age population will find it more difficult to finance a growing retirement and healthcare industry.

A growing healthcare sector relative to the rest of the economy would have significant impacts on statewide income tax revenue. On average, \$1 million in sales at a hospital generates less than \$14,000 in state and local taxes (primarily through income taxes levied against employee salaries). Meanwhile, \$1 million in sales in the coal industry generates \$177,000 in state and local taxes. In aggregate, hospitals generate more than \$6 billion each year in sales and pay less in taxes than coal companies which generate less than \$1 billion in sales.⁶

These shifts place a high premium on getting tax reform right, since neither the current tax code nor a modified code with a poor structure will provide the competitive, stable system needed to attract new businesses and foster economic growth.

Responding to *Wayfair*

Regardless of how Montana chooses to approach comprehensive tax reform, it must confront the question of how the *Wayfair* decision affects online retailers within the state. Even without any legislative action, the reality is that hundreds of Montana-based retailers will be required to collect tax on items they sell to customers in states where they have no physical presence.

While this would be a shock to the system in any state, it is particularly difficult to handle given that many Montana-based businesses have never had to collect a sales tax of any kind. Those with locations only in Montana had no obligation to collect any other state's sales tax, and obviously their home state didn't impose one on them. That means that some Big Sky businesses are implementing sales tax collection systems for the very first time. Thus, the *Wayfair* decision is having a disproportionately negative impact on non-sales tax states.

In response, another non-sales tax state, New Hampshire, contemplated an aggressive approach to protect its businesses from having to comply with other states' sales tax regimes.⁷ Lawmakers there introduced legislation that would have made it difficult for out-of-state tax collectors to target Granite State businesses, including certain registration and certification requirements. While this pugnacious response to the Supreme Court's decision was understandable given the negative impacts likely to be visited upon New Hampshire businesses, the bill did raise legal questions that could have placed the state in the crosshairs of litigation. This, among other factors, helped contribute to the legislation's failure.

⁵ CDC WONDER, "State Population Projections 2004-2030," Centers for Disease Control, 2019.

⁶ Morrison, Stephanie and Schaefer, Sam. "Approximate Combined Taxes on \$1 Million Sales By Selected Industries," Montana Legislative Branch, March 13, 2018.

⁷ Bookman, Todd. "N.H. Looks to Take 'Aggressive' Position Following SCOTUS *Wayfair* Sales Tax Ruling," NHPR New Hampshire Public Radio, October 24, 2018.

Other states like California have taken a more accommodating approach, passing legislation to implement new sales tax collection obligations in search of added revenue.^{8,9} Among the more problematic responses are states like the aforementioned Michigan and North Carolina, where officials in their respective tax agencies simply issued new regulations imposing new tax collection rules without any clear statutory basis. This represents not only a clear usurping of the legitimate authority of the legislative branch, it also poses significant practical challenges to businesses forced to comply with the new rules. As one example, brief administrative rulings are unequal to the task of providing guidance and support regarding software to help sellers across the country in implementing their tax code.

In Montana, some legislators have aligned themselves more with California than New Hampshire by looking to seize upon *Wayfair* as an opportunity to impose a general sales tax in the state. Representative Kerry White introduced HB 300, which would impose a statewide sales tax of 2.5 percent while eliminating local property tax levies. Included in this legislation is a section on remote sales taking advantage of the *Wayfair* ruling to seize new tax power for Montana over businesses located outside the state.

This legislation would fundamentally alter the character of Montana's tax code. Most notably, it would sacrifice the unique sales tax-free nature of Montana's tax code, part of a business tax climate that ranks 6th best in the nation according to the Tax Foundation.¹⁰ It would also implement an internet sales tax provision similar to those of other states that are now being weaponized against Montana businesses in the wake of the *Wayfair* decision.

Tax Reform in 2019 and Beyond

Instead of pursuing half-baked approaches to implement an unpopular sales tax in the wake of *Wayfair*, a better approach would be to look at comprehensive reform that recognizes Montana's changing economy by broadening the tax base and lowering rates. The Montana Legislature has not undertaken a comprehensive study of the state's tax system in many years. Given the state's changing demographics, revenue base, and shifting demands between local property taxpayers and general state taxes, it makes good sense for the Legislature to approve a study of these issues in the context of an interim committee. Such a study would give these important questions the time and attention they deserve so that legislators can be informed enough to weigh the positives and negatives of any changes to tax law.

The foundation of any tax reform study should be identifying what budgetary needs look like in the future. The committee should then identify how to raise necessary revenue without harming Montana businesses and consumers with heavier burdens, with an emphasis on strengthening the state's highly-competitive tax climate. An important factor in protecting that climate is looking to protect Montana-based businesses from the long arm of out-of-state tax collectors taking advantage of the Supreme Court's decision in *Wayfair*.

For instance, legislators could consider directing the Montana Attorney General's office to investigate and address any instances of states looking to impose unconstitutionally burdensome tax collection schemes on Montana businesses. If a state like Louisiana, with its incredibly complex sales tax code, attempts to collect taxes from Montanans despite not coming even close to meeting constitutional scrutiny, the Attorney General's office should use every tool at its disposal to protect Montana businesses from those collection requirements.¹¹ That could include direct engagement with counterparts in those states to mediate or support of legal challenges brought by Montanans, among other options.

⁸ "Remote Seller Nexus Chart," Sales Tax Institute, retrieved on April 3, 2019.

⁹ Wiley, Hannah. "Buy stuff online? New California tax law tax effect Monday, but the rules might change," Sacramento Bee, March 28, 2019.

¹⁰ Walczak, Jared et. al. "2019 State Business Tax Climate Index," Tax Foundation, September 26, 2018.

¹¹ Bishop-Henchman, Joseph et. al. "Post-Wayfair Options For States," Tax Foundation, August 29, 2018.

Additionally, legislators could consider passing a law like the one that allowed electronics retailer Crutchfield to bring suit against the state of Massachusetts and its onerous “cookie nexus” law.¹² In that case, Crutchfield filed suit in its home state of Virginia pursuant to a law that allows businesses to seek a declaratory judgment against a state seeking tax collection if the business has no physical presence in that state.¹³

While the physical presence standard has unfortunately been gutted by the Supreme Court, legislators could use the Virginia law as a model to match with post-*Wayfair* circumstances by granting the right to seek declaratory judgment in Montana courts against collection efforts by a state that does not meet the standards laid out by the Supreme Court in *Wayfair*. Those standards include such important measures as a significant safe harbor exempting small sellers, central administration of sales tax, and efforts to simplify sales tax rules, among others. Any state not meeting those standards should not be allowed to impose its laws on Montana-based sellers.

Conclusion

Reforms like these, and many others not mentioned here, should be the subject of a thorough analysis in interim committee. We hope that as part of any such undertaking, Montana Legislators will devote significant time to in-depth analysis of the state’s tax code, the *Wayfair* decision’s impact on Montana-based businesses, and the potential impacts of various policy responses to the case.

About the Authors

Andrew Moylan and Andrew Wilford lead the Interstate Commerce Initiative at the National Taxpayers Union Foundation (NTUF), a project which seeks to protect taxpayers from the pernicious effects of states attempting to exercise power outside their borders. NTUF is a nonpartisan research and educational organization that shows Americans how taxes, government spending, and regulations affect them.

Brent Mead is CEO of the Montana Policy Institute, a free-market think tank devoted to the principles of free enterprise, government transparency, and individual freedom.

¹² Maple, Tracy. “Crutchfield sues to block Massachusetts from collecting online sales tax,” DigitalCommerce360, October 25, 2017.

¹³ Virginia Code §8.01-184.1 (2005).