Interstate Commerce Initiative

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Federalism Concerns Should Be No Bar to Relief For Small Online Sellers

Ever since the Supreme Court handed down its decision in *South Dakota v. Wayfair*, NTUF has urged Congress to consider reforms to cushion the impact of the substantial new tax compliance burdens on small e-retailers selling around the country.

Yet while protecting small businesses from burdensome tax obligations is a core conservative principle, some well-meaning conservatives have concerns about the federal government setting rules about state tax policy. This paper is intended to address those concerns, show why the federal government not only has the power to set ground rules for states seeking to impose economic nexus tax obligations on small sellers, and demonstrate that doing so actually is vital to protect taxpayers from government overreach.

Background: The State of Play in a Post-Wayfair World

To understand why the federal government needs to involve itself in a matter of state sales tax policy, some background context is necessary. Prior to the *Wayfair* decision, states could only require businesses to collect and remit sales taxes on

Key Facts:

Since the 2018 Wayfair decision, states have largely had free rein to impose new tax compliance obligations on small e-retailers, with no federal oversight.

Part of the reason for this federal inaction is concern among some conservatives that instituting a federal framework for economic nexus tax obligations would represent an imposition on states' autonomy.

However, not only does instituting a federal framework fall squarely within the federal government's constitutional powers, but a federal minimum standard would respect states' powers to set their own tax policy while protecting small businesses from burdensome and unnecessary complexity.

behalf of the state if a business had some form of physical presence in that state — be it a storefront, employee, or warehouse. Under this *Quill* rule (so-called after the Supreme Court decision that upheld it), when customers purchased items from out-of-state businesses lacking in-state physical presence, the state could not require the businesses to collect sales tax. Instead, those customers were expected to remit the owed sales tax themselves on their individual tax returns.

In practice, very few customers did so. This created concerns that out-of-state businesses, particularly the growing e-retail industry, enjoyed a tax advantage over brick-and-mortar retailers. To challenge the underlying *Quill* rule, South Dakota passed a law requiring businesses with more than $100,000 in sales in South Dakota or 200 or more transactions with South Dakotans to collect and remit sales taxes on South Dakota's behalf. In *Wayfair*, the Court upheld South Dakota's law, advising states to simplify their sales tax administration to reduce compliance burdens, including through the use of software.

In the years since the *Wayfair* ruling, every state with a sales tax has implemented economic nexus tax obligations along the lines of South Dakota's. But not all states have made the accompanying comprehensive effort at reducing the state sales tax compliance burdens. Consider the checklist of items from *Wayfair*, the factors of South Dakota's law that the Supreme Court pointed to in deciding that the state's law did not impermissibly burden interstate commerce:

- **A safe harbor for small sellers**: All states have by now adopted a dollar threshold to excuse small sellers from having to collect tax in states where they have few sales. However, states have done so mostly by exactly copying South Dakota's $100,000 in sales or 200 transactions threshold, even though South Dakota is the fifth-smallest state in the Union by Gross Domestic Product. Some larger states have increased thresholds, but nowhere near proportionally to population and economic differences. Kansas, meanwhile, had no safe harbor at all between 2019 and 2021.

- **A ban against retroactive enforcement**: While most states have been deterred from retroactive application, a handful of states are attempting to collect sales tax on transactions prior to *Wayfair* from out-of-state businesses who did not then have physical presence. Massachusetts, for instance, is attempting to force sales tax collection on businesses that place "cookies" on in-state user computers, when prior to *Wayfair*, businesses had every right to expect that would not subject them to sales tax collection and remittance obligations under the legal precedent of the time.

- **Streamlined Sales and Use Tax Agreement (SSUTA) membership**: The Court praised South Dakota's membership in SSUTA as a source of easing compliance burdens for interstate sellers. SSUTA is a multistate tax agreement designed to promote simplified tax compliance across multiple states. SSUTA membership entails not just establishing state-level tax administration, but also implementing other elements of uniformity to ease compliance burdens for businesses selling into SSUTA states, including:

    - **State-level tax administration of sales taxes**: All but a handful of states have adopted this, but the outliers are a significant burden on small interstate businesses. NTUF's Taxpayer Defense Center is currently engaged in a lawsuit against the state of Louisiana alongside Halstead Bead, an Arizona-based business that has had to suspend sales to Louisiana because of the state's archaic tax system. There, sellers must comply not only with the state's sales tax code, but also with the separate tax codes and administration of 63 local parishes. Other "home rule" states like Colorado have similarly complex systems that involve local-level tax administration.

    - **Uniform definitions of products and services**

    - **Simplified tax rate structures**

    - **Access to tax compliance software paid for by the state**

> Obviously many more reforms could make compliance even easier for online retailers around the country, but these measures are a baseline bare minimum. Yet less than half of all states are SSUTA members. What's more, not a single state has joined SSUTA since *Wayfair* was handed down.

Clearly, the Supreme Court's vision of an explosion of efforts by states to limit compliance burdens, join SSUTA or similar efforts, and align themselves with South Dakota has not come to pass. Neither has the other element of the Court's optimism: software has proved not to be the *deus ex machina* it was hoped to be. Even in those states where free tax calculation software is provided by the state, many small businesses have found that most software is inadequate for their needs, while the software that is adequate is prohibitively expensive for those selling small amounts. Even free software also involves implementation costs to tie with a business's sales system.

That this change came from a U.S. Supreme Court decision also contributes to a lack of awareness by small businesses on their post-*Wayfair* obligations. Nearly overnight, small- to medium-sized businesses had to go from tracking only their home state's sales tax regime to complying with all the different rates, rules, definitions, and exemptions of state sales tax regime around the country. A year after the *Wayfair* decision, just over half of small business owners were even aware of the decision. While that awareness has since increased, even business owners who may think that they are in compliance may not be given the complexity inherent in trying to comply with all these different rules and regulations.

In the eyes of states, there may be little difference between a business that collects sales tax from customers and holds onto it for its own gain, and a business that never knows or understands it is responsible for collecting sales taxes in the first place. In other words, businesses that are out of compliance with economic nexus obligations are effectively committing tax fraud, and states can go after not just these offending business owners' business assets, but often also personal assets as well — from savings accounts to their children's college funds — should they fail to collect and remit sales taxes. If it is the federal government's expectation that small businesses collect every state's sales tax, then the federal government should play a part in making it achievable for small sellers to comply.

Thus far, most states remain in the honeymoon stage and are enjoying a new source of revenue without yet aggressively auditing businesses that are out of compliance. But some states are beginning to ramp up enforcement of economic nexus rules, and out-of-state small businesses trying to keep their heads down will no longer be able to do so and may owe years' worth of back liability for uncollected tax. In other words, a situation that appears on its face to be quiet now is in fact a ticking time bomb, holding with it the potential to deal a massive blow to the small businesses nationwide.

The Constitution was Designed to Allow Congress to Regulate Interstate Commerce to Protect Federalism

The Founders designed the Constitution to protect interstate commerce, and Congress has the lead role in that defense. Keeping trade within the country free of barriers was a central purpose of the Constitutional Convention, and achieving this goal was the intended purpose of the Constitution empowering Congress to regulate interstate commerce.

In advocating for adopting the federal Constitution, Alexander Hamilton recognized that protecting commerce from state mischief was paramount: "It is indeed evident, on the most superficial view, that there is no object, either as it respects the interests of trade or finance, that more strongly demands a federal superintendence."[1] The Articles of Confederation had failed, creating "occasions of dissatisfaction between the States" as they regulated and taxed each other's goods.[2] If commerce is key to national wealth, then the Articles saw "the lowest point of declension" of trade between the states.[3] James Madison himself was active in the debate on the scope of each provision of the Constitution,

[1] The Federalist No. 22 (Hamilton).
[2] *Id.*
[3] The Federalist No. 15 (Hamilton).

recognizing that "the regulation of Commerce was in its nature indivisible and ought to be wholly under *one* authority," specifically that of Congress.[4] Roger Sherman agreed, that the "power of the U[nited] States to regulate trade being supreme can controul interferences of the State regulations [when] such interferences happen; so that there is no danger to be apprehended from a concurrent jurisdiction."[5]

From the debates on how to protect interstate commerce, what emerged was an express denial of the ability of states to tax imports and exports between the states (save for very limited inspection fees), a limit on the ability of states to tax tonnage of shipping, a general protection of the privileges and immunities of citizenship, and an express grant of authority for the federal government to regulate commerce.[6] Taking each in turn shows that the Commerce Clause — the broadest grant of power among this list — was crafted specifically to address issues such as those presented by state economic nexus laws.

The Commerce Clause has stood as the broadest protector of interstate trade.[7] This grant of Congressional power is essential to make sure citizens in each state can carry on business, particularly sales of goods, anywhere in the country.[8] This is necessary to keep states, particularly large ones, from overpowering smaller states and hurting citizens.

Because remote sellers cannot vote in every state they do business in, and given the tendency of states to export tax burdens and import tax revenues, only federal protection can discourage unfair taxation and excessive regulation of their trade. It is otherwise tempting to outlay taxes on those who have no vote or invent regulations that affect industries in other states. In other words, when taxpayers face taxation and regulation in states that they lack representation in, their elected representatives in the federal government must act to protect them from excessive burdens.

Like any other business, remote sellers should pay what is due. Most are eager to do so, if the compliance burdens can be eased to make it feasible. Congress has a role in assuring in-state and out-of-state businesses are treated fairly. Doing so keeps America's economy strong, as the Founders intended.

Taken together, many of the provisions of the Constitution work to protect trade between the states. It is the Commerce Clause, however, that is the broadest and most appropriate for Congress to use. Far from interfering with our republic, Congress acting to protect interstate trade is fulfilling a core purpose of our Constitution.

Though *Wayfair* effectively greenlit economic nexus laws, in one sense states' power to tax out-of-state businesses is not truly an issue of federalism. Abusive economic nexus laws, where states impose burdensome taxes on those beyond their borders, stretch the bounds of federalism far more than federal action would. Constitutionally, states generally hold sway within their own borders. But outside their borders, state powers are far more restricted on matters of interstate commerce and the need to respect the laws and legal decisions of other states.

In this sense, action by Congress to protect out-of-state businesses is in accordance with federalism rather than at odds with it.

Congressional Action Can Coexist With Independent State Tax Powers

[4] James Madison, "Journal" (Sept. 15, 1787), in The Journal of the Debates in the Convention Which Framed The Constitution of the United States May-September, 1787, 381 (Gaillard Hunt ed.) (1908) https://www.gutenberg.org/files/41095/41095-h/41095-h.htm (emphasis added).
[5] *Id.*
[6] *See* U.S. Const. art. I, § 8, cl. 3 (Commerce Clause); U.S. Const. art. I, § 10, cl. 2 (Import/Export Clause); U.S. Const. art. I, § 10, cl. 3 (Tonnage Clause); U.S. Const. art. IV, § 2 (Privileges and Immunities Clause).
[7] *See*, *e.g.*, *Tenn. Wine & Spirits Retailers Ass'n v. Thomas*, 588 U.S. ___, 139 S. Ct. 2449, 2460–61 (2019).
[8] U.S. Const. art. I, § 8, cl. 3.

NTUF has put together a list of proposed reforms for Congress to consider to relieve the burden of economic nexus sales tax compliance for small businesses. These proposed reforms allow Congress to set "ground rules" for states seeking to enforce economic nexus obligations that prevent a tragedy of the commons and allow for a limited burden on interstate commerce, while simultaneously allowing for states to exercise their right to tax transactions in line with their own tax policies.
This menu of solutions includes, but is not limited to:

- Requiring states to provide businesses with a **single point of contact for collection and audit procedures**, in order to limit confusion and complexity for out-of-state sellers facing obligations in many new states.

- Mandating that states **count only taxable sales towards their economic nexus threshold**, preventing wholesale and other tax-exempt transactions from creating burdensome and unnecessary paperwork obligations.

- Requiring states to **offer the option to pay a single, weighted-average sales tax rate for the entire state**, which would eliminate the need for some businesses to track sales tax rates in dozens, hundreds, or even thousands of local jurisdictions; Texas already does this.

- Preventing states from **retroactively attempting to impose economic nexus tax obligations** going back prior to the *Wayfair* decision**.** Some states still have workaround laws on the books from before *Wayfair* that were legally dubious at the time, but *Wayfair* has made legal challenges to these laws far more difficult. Enforcing these laws retroactively effectively tells businesses that they should have anticipated the shift in the legal landscape that *Wayfair* caused, an unfair expectation.

- **Providing businesses not currently in compliance with state economic nexus rules with relief** as they attempt to come into compliance with state and local laws. The true scale of businesses that are currently or were at one point out of compliance with state economic nexus laws is definitionally hard to pin down, but it surely is massive. Absent relief, millions of businesses will likely be on the hook for sales taxes that they never had the chance to collect in the first place.

While any combination of these reforms would substantially lessen the burden of state sales tax compliance for small remote businesses, none of them would interfere with states' ability to define their own tax bases, set their own tax rates, and decide what is and is not taxable. These core elements of state tax policy would remain entirely under state control.

Rather, the goal — and impact — of federal legislation would be to protect taxpayers from state tax obligations that exceed their ability to effectively comply with them. Taxpayers who make a good faith effort to comply with their tax obligations should never be put in a position where they are simply unable to do so. If states' tax policies are making taxpayers who want to pay what they owe into tax evaders, it is those states' responsibility to amend their tax policies.

Absent state action, federal intervention is justified. The Supreme Court in *Wayfair* charged states to first ensure that any new economic nexus rules would not impermissibly burden interstate commerce, then made some unfortunately faulty assumptions about what that exactly meant. With the benefit of more than four years of hindsight, Congress can and must provide guidelines that are updated with the reality of what states need to do to exercise their taxing power in a way that does not harm the broader economy more than is necessary.

Conclusion

Federalism is an important conservative principle, but it is so because of the need to protect individuals from government overreach. It would be backwards, therefore, to invoke the principle of federalism to prevent progress on creating a federal framework that protects small businesses from overly burdensome state tax policies.

Fortunately, federalism and federal action on *Wayfair* need not be at odds. Even the staunchest defender of federalism would recognize that there are limits to states' ability to impose tax obligations that harm the broader economy — after all, states have no right to impose tariffs on goods imported from other states. Preventing excessive state tax burdens on out-of-state businesses should be viewed through the same lens.

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