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Wayfair: Sales Tax Formalism and Income Tax Nexus

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In this edition of Academic Perspectives on SALT, the authors, in the second of a series of articles on *Wayfair*, discuss sales tax formalism and the extent to which it survives post-*Wayfair*.

The Supreme Court's recent decision in *South Dakota v. Wayfair Inc.* is perhaps the most important state and local tax decision in recent decades.[1] However, the Court's ruling in *Wayfair* was rather narrow, leaving many important questions unanswered. This is the second in a series of articles evaluating *Wayfair* and analyzing some of the questions raised by that opinion.[2] In this article, we address issues related to sales tax formalism and income tax nexus.

Wayfair and Sales Tax Formalism

The *Wayfair* Court's reversal of *Quill Corp. v. North Dakota*[3] was consistent with the Court's general trend away from formalism in its dormant commerce clause cases, and the Court partially justified its decision on that ground.[4] But the physical presence rule was not the only historic formalism implicated in *Wayfair*. Since the 1940s, the Court has prevented states from imposing their sales taxes on transactions that are completed out of state.[5] Nevertheless, the Court allows states to impose economically equivalent use taxes on the in-state consumption of the purchased items.[6] To avoid discrimination against interstate commerce, states' use tax rates are set at or below their sales tax rates and states provide credits against their use taxes for any sales taxes previously paid. This system is economically equivalent to destination sourcing the sales tax, but states must abide by this formal structure.

The source of this formalism is the Court's 1944 decision in *McLeod v. Dilworth*.[7] That case involved a challenge to an Arkansas sales tax that

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[1] *South Dakota v. Wayfair*, 138 S. Ct. 2080 (2018).

[2] Our first article tackled some of the more immediate interpretive questions raised by *Wayfair*, such as how a state should approach dealing with questions about substantial nexus and undue burden. That article recommended that states take note of the features of South Dakota's law that appealed to the Court and aim to replicate or improve on those features to the extent possible. Adam Thimmesch, Darien Shanske, and David Gamage, "*Wayfair*: Substantial Nexus and Undue Burden," *State Tax Notes*, Aug. 2, 2018, p. 447.

[3] 504 U.S. 298 (1992).

[4] *Wayfair*, 138 S. Ct. at 2094-95.

[5] *McLeod v. Dilworth*, 322 U.S. 327 (1944).

[6] *General Trading Co. v. Iowa*, 322 U.S. 335 (1944).

[7] *Dilworth*, 322 U.S. at 327.

applied to transactions consummated out of state but shipped to Arkansas customers. The Court struck down that sales tax as unconstitutional even though it recognized the broad equivalency of state sales and use taxes and upheld the imposition of the latter in a case that it decided the same day.[8] The Court based its holding on the fact that the two taxes were "different in conception" and "assessments upon different transactions."[9]

The *Dilworth* formalism has stood since the 1940s. Yet it is unclear whether and to what extent this formalism still holds post-*Wayfair*. The South Dakota statute that was challenged in *Wayfair* conflicted with both *Quill* and *Dilworth* by requiring remote vendors to collect the state's sales tax rather than its use tax.[10] The litigation, however, focused only on the *Quill* precedent. Neither the parties nor the Court addressed the *Dilworth* issue.

It is unclear to us whether the Court consciously avoided the issue or whether the Court just did not appreciate that aspect of the case. Justice Anthony M. Kennedy's opinion explicitly noted that the South Dakota statute imposed a sales tax collection obligation, but the reference seems to have been more colloquial than technical. Read in its entirety, *Wayfair* suggests that the Court viewed the difference in the taxes as a difference in who remits them — sales taxes being collected and remitted by vendors and use taxes being paid directly by consumers.[11] That distinction is largely true, of course, but it is not the relevant substantive distinction between the two taxes. The *Dilworth* Court was right — the taxes are "different in conception" and "assessments upon different transactions."[12]

It may be that the *Wayfair* Court was willing to ignore this issue because the parties did not raise it. The majority opinion did state that "all concede that taxing the sales in question here is lawful."[13] Perhaps that was the Court's way of saying that the *Dilworth* issue had been waived, but it is unclear. The Court remanded the case to the South Dakota courts to resolve other non-*Quill* objections. The biggest issue flagged by the Court was whether South Dakota's law would fail the balancing test of *Pike v. Bruce Church*,[14] but it may be that the South Dakota statute also remains vulnerable under *Dilworth.* The Court certainly did not explicitly overrule that case in *Wayfair*.

The uncertainty involving this issue leads us to conclude that the better course for states would be to continue to abide by the *Dilworth* formalism and to enact their economic nexus standards through their use tax systems. It seems unlikely that the Court will clarify this area of law any time soon, if ever. Nevertheless, if states want to adopt sales tax collection obligations using the South Dakota model, they will need to ensure that their statutes impose the tax as a substantive matter. South Dakota's law appears to do so because the state is a member of the Streamlined Sales and Use Tax Agreement, which sources sales to where customers take delivery of property if they use a shipping company to pick up their orders.[15] States that have adopted the SSUTA should therefore not have a problem with this issue, but other states might. If they are going to impose sales tax collection obligations, they should ensure that their statutes operate similarly.

Ultimately, this is an issue that is easy to plan around. States can follow the historic *Dilworth* formalism and require remote vendors to collect their use taxes. However, if states want to follow South Dakota's lead, they should ensure that their statutes impose sales tax on out-of-state sales. Though we do not think the Court meant to overrule *Dilworth* by implication, this is an issue worth watching. In our increasingly interconnected economy, we can imagine states

[8] *General Trading Co.*, 322 U.S. at 335.

[9] *Dilworth*, 322 U.S. at 330.

[10] S.B. 106, 2016 Leg. Assembly, 91st Sess. (S.D. 2016).

[11] *Wayfair*, 138 S. Ct. at 2087 ("When a consumer purchases goods or services, the consumer's State often imposes a sales tax. This case requires the Court to determine when an out-of-state seller can be required to collect and remit that tax." (*Id.* at 2088) "South Dakota has a sales tax. . . . Sellers are generally required to collect and remit this tax. If for some reason the sales tax is not remitted by the seller, then in-state consumers are separately responsible for paying a use tax at the same rate." (*Id.*) "Under this Court's decisions in *Bellas Hess* and *Quill*, South Dakota may not require a business to collect its sales tax if the business lacks a physical presence in the State.").

[12] *Dilworth*, 322 U.S. at 330.

[13] *Wayfair*, 138 S. Ct. at 2087.

[14] 397 U.S. 137 (1970).

[15] S.D. Codified Laws sections 10-45-2, 10-45-108; S.D. Admin. R. section 64:06:01:62(1); and Streamlined Sales and Use Tax Agreement sections 310, 311.

having good reasons to tax or regulate transactions arguably consummated entirely out of state.[16] If the formalism of *Dilworth* is no more, then the states might be able to tax such transactions.

Wayfair and Income Tax Nexus

On July 13 Wells Fargo CFO John Shrewsberry announced that the company was making a $481 million adjustment to its earnings based on *Wayfair*.[17] That adjustment was not because of the company's potential sales tax exposure, but rather because some of its affiliated entities had been relying on *Quill* to avoid paying income taxes in some states. That position does not appear to have been unique to Wells Fargo,[18] but it was aggressive. States and taxpayers have debated whether *Quill* applies to income taxes for some time, but state courts have nearly universally held that it does not.[19] Wells Fargo apparently did not agree, and technically the question was undecided because the Supreme Court had declined to opine on the issue. *Wayfair* leaves no doubt, and by reversing *Quill*, the Court settled this issue.

What the Court did not settle regarding income taxes is the same question it left open regarding sales taxes — how far can states go with nexus? As we discussed in our prior article,[20] the Court referred to its *Polar Tankers*[21] opinion in stating that "nexus is established when the taxpayer [or collector] 'avails itself of the substantial privilege of carrying on business' in that jurisdiction."[22] The *Wayfair* Court then analyzed respondents' nexus by reference to their "economic and virtual contacts" with South Dakota.[23] Unfortunately, the Court did not expand on what those terms meant or when they were sufficient for nexus. The Court merely stated that South Dakota's threshold amounts — $100,000 in sales or 200 transactions — were sufficient to ensure that respondents had the required economic contacts and that respondents' statuses as "large, national companies" meant that they "undoubtedly maintain an extensive virtual presence."[24]

The Court's limited nexus analysis does not provide much direct guidance for states or taxpayers, but this is hardly surprising. The Court's minimal approach was entirely consistent with how state courts had decided economic nexus cases over the last two decades.[25] It was also consistent with the Court's general desire to craft its decisions as narrowly as possible. Nevertheless, states and taxpayers can glean some guidance by looking at the origin of the physical presence rule, the facts at issue in *Wayfair*, and the nature of the state income tax.

First, we know that *Quill* and *National Bellas Hess*[26] imposed the physical presence rule largely because of the perceived compliance burdens associated with sales tax collections,[27] and that those burdens are largely attributable to the large number of local jurisdictions with consumption tax authority and the differences in tax bases among jurisdictions. In addition, notwithstanding the continued existence of those compliance costs, the *Wayfair* Court found that South Dakota's sales thresholds were high enough to satisfy the nexus requirement in a post-*Quill* world. This means that $100,001 of sales or 200 transactions is enough of an economic connection to justify the compliance costs associated with use tax collections.

How does the compliance cost of state corporate income taxes compare? Certainly there

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[16] *Association for Accessible Medicines v. Frosh*, 887 F.3d 664 (4th Cir. 2018) (striking down Maryland's attempt to control specified drug prices because "it controls the price of transactions that occur wholly outside the state"). For critical discussion of this decision, see Shanske and Jane Horvath, "Maryland's Generic Drug Pricing Law Is Constitutional: A Recent Decision Misunderstands the Structure of the Industry," Health Affairs Blog (June 22, 2018).

[17] *See* Andrea Muse, "Wells Fargo Adjusts Income Tax Reserves Following *Wayfair*," *State Tax Notes*, July 17, 2018, p. 397.

[18] *See id.* (quoting a prominent accounting firm leader as saying that "the physical presence standard has long been thought to apply for determinations of substantial nexus for state income tax purposes").

[19] *See* Thimmesch, "The Illusory Promise of Economic Nexus," 13 *Fla. Tax Rev.* 157, 173–75 (2012).

[20] *Supra* note 2.

[21] *Polar Tankers Inc. v. City of Valdez*, 557 U.S. 1 (2009).

[22] *Wayfair*, 138 S. Ct. at 2099.

[23] *Id.*

[24] *Id.* Earlier in the Court's opinion, it discussed "virtual presences" in the context of "virtual showrooms," presumably a website. *Id.* at 2095.

[25] *See* Thimmesch, *supra* note 19, at 173-181 (discussing how state courts have defined economic nexus).

[26] *National Bellas Hess v. Department of Revenue of Illinois*, 386 U.S. 753 (1967).

[27] *See* Gamage and Devin Heckman, "A Better Way Forward for State Taxation of E-Commerce," 92 *B.U. L. Rev.* 483, 493-94 (2012).

are far fewer jurisdictions that levy corporate income taxes and they generally resemble one another, including by piggybacking on the federal income tax for purposes of defining the tax base. Of course, the corporate income tax is likely a more complicated tax for many taxpayers for other reasons.[28] We don't have a strong opinion as to how this should come out except to note that states adopting factor nexus thresholds should be confident that their tests will withstand scrutiny as long as their thresholds do not dip unreasonably low relative to the *Wayfair* thresholds. The $500,000 threshold contained in the Multistate Tax Commission's model law seems safe, as does Michigan's lower $350,000 threshold.[29] It is not difficult to see that even lower thresholds could pass constitutional muster based on *Wayfair*.

Not all states will want to adopt quantitative rules, and, notably, many states currently apply qualitative standards.[30] Opining on the constitutionality of those standards is more difficult and those standards may be more susceptible to challenge than are bright-line rules if they do not provide protections for smaller businesses. We would therefore recommend that states with nexus standards adopt de minimis protections, at least administratively, if they want to avoid challenge. States should have little economic interest in pursuing taxpayers with low in-state income in any event, so establishing minimum protections for taxpayers seems advisable to avoid costly litigation. De minimis rules can also put taxpayers on notice as to what levels of sales will draw scrutiny and help to fight against taxpayer recalcitrance.

Of course, nexus is not the only constraint on state corporate income taxes. States remain bound by Public Law 86-272,[31] and they apparently also must ensure that their statutes do not run afoul of the Court's *Pike* balancing test.[32] The constraints of P.L. 86-272 are familiar, however, and it is unlikely that any corporate income tax we know of would fail *Pike* balancing. ■

[28] *Compare Tax Commissioner of West Virginia v. MBNA America Bank N.A.*, 640 S.E.2d 226, 233-234 (W. Va. 2007) (majority justifying a less exacting nexus threshold for income taxes based on the lower compliance burdens associated with those taxes) with *id.* at 240 (dissent arguing that corporate income taxes are more burdensome).

[29] *See* Mich. Comp. Laws section 206.621(1).

[30] *See* Thimmesch, *supra* note 19, at 181-84.

[31] Though there is an argument that the broad concept of nexus in *Wayfair* will narrow the interpretation of "solicitation" in P.L. 86-272. *See* Jaye Calhoun and William J. Kollarik II, "Implications of the Supreme Court's Historic Decision in Wayfair," *State Tax Notes*, July 9, 2018, p. 125.

[32] *Supra* note 2.