# ***Wayfair Decision***

# States Will Collect Sales Tax From Out-of-State Companies Without Physical Presence Under Groundbreaking Supreme Court Decision

*By Jack Van Coevering, Taylor Gast and Cody Mott, Foster Swift Collins & Smith, PC*

**Editor's Note: This is the first in a series of articles written for MICPA members examining the far-reaching impact of the Supreme Court's decision in South Dakota v. Wayfair, Inc.*

On June 21, the United States Supreme Court reversed 26-year old precedent set in *Quill Corp. v. North Dakota* ("*Quill*") by holding that businesses without a physical presence in a state may be subject to sales tax as a result of making sales into the state.

Any business with sales in multiple states, including online sales, should consider the wide-reaching ramifications of the recent 5-4 *South Dakota v. Wayfair, Inc.* decision. **As a result, companies should expect to see significant state audit and legislative activity in the coming months.** Previous rulings relating more to due process nexus will come to the forefront now that physical presence is not required.

### ***Quill*** **and the Old Standard**

Two constitutional clauses limit the taxing power of the states – the Due Process Clause and the Commerce Clause. Although the two are closely related, the clauses impose distinct limits on a state's ability to tax businesses. The Due Process Clause requires a business to have minimum contacts with the taxing state. If a company purposefully avails itself of another state's market by, for example, making sales or delivering products to residents of a state, then the business has nexus with the state and that state has authority to tax the business.

By contrast, the Commerce Clause imposes additional limits on a state's authority to impose a tax if the tax will burden interstate commerce. In a 1977 case, *Complete Auto Transit, Inc. v. Brady*, the Supreme Court announced a four-part test to determine the constitutionality of a state-levied tax on non-resident taxpayers. A state tax is within the bounds of the commerce clause if it:

(1) applies to an activity with a substantial nexus with the taxing state,
(2) is fairly apportioned,
(3) does not discriminate against interstate commerce, and
(4) is fairly related to the services the State provides.

The *Wayfair* ruling focuses on the "substantial nexus" prong.

In *Quill*, the Court created a bright line physical presence test to determine whether a company has a substantial nexus with the taxing state. Physical presence nexus was a sharp departure from the due process "purposeful availment" test. It allowed retailers that solicited sales online and other businesses without employees or contractors entering or residing in the state that made sales there to be safe harbored from any sales tax collection. A number of states extended this limitation to business level taxes as well, e.g. corporate income tax.

Although the bright line physical presence rule was simple to interpret, states argued that the rule created a tax loophole by allowing internet retailers without a physical presence in a state to benefit from that state's economy without remitting tax dollars. States began to legislate a "statutory" jurisdiction standard to circumvent the restrictions of *Quill.*

Michigan presumes that an out-of-state company is subject to the General Sales Tax Act if the entity has an economic (a volume of sales during the year) or affiliate nexus (working with affiliated companies that have a physical presence in the state), as outlined in Revenue Administrative Bulletin 2015-22. At the same time, "main street businesses" and other businesses with a physical presence in a state were required to pay in, even if the in-state operation was small.

The Court in *Wayfair* acknowledged that the physical presence test caused states to lose an estimated $8 to $33 billion every year.

**The New Standard**

The *Wayfair* ruling eliminates *Quill's* physical presence test, allowing a state to require out-of-state companies to collect and remit that state's sales tax. Although *Quill's* physical presence requirement is overruled, the four-prong *Complete Auto* test remains in effect, and is now the overriding rule that applies when a business disputes a state's authority to impose a tax.

In practice, the *Wayfair* facts are revealing. Wayfair, Overstock.com and Newegg have no employees, real estate or other physical presence in South Dakota. The companies maintain websites accessible by state residents, sell to those residents and ship orders to them. Because the businesses fall under the South Dakota statute by accumulating at least $100,000 in sales or 200 transactions, the Court found that the *Complete Auto* nexus requirement was met absent the physical presence rule. Going forward, businesses with a similar or greater presence in a state should expect the same result.

**Significant Changes Incoming**

The *Wayfair* decision will significantly affect all taxpayers that have a web presence, or sell, deliver, or provide services in other states. Small businesses may not be exempt from the new rules. In other words, a business with 200 small sales in many states will undoubtedly feel the significant burden of calculating, collecting and remitting state sales tax in each of those jurisdictions.

Businesses must now consider whether to register for taxes in states where they have business activities that meet the broad due process nexus standard. These decisions will require taxpayers to consider the quality and quantity of their activity and the various taxing statutes in the state that might now apply to them.

Many states already send nexus questionnaires to out-of-state businesses that are suspected of maintaining nexus there, as permitted by *Direct Marketing Assn.* v. *Brohl,* 814 F. 3d 1129 (Gorsuch, J., concurring). Businesses should expect to see an increase in these questionnaires, and the state auditing activities that inevitably arise because of them.

Businesses should also expect states to ramp up legislation in this area. Many states are likely to align their nexus statutes with the Supreme Court endorsed South Dakota statute. Others may test *Wayfair's* limits by passing standards that are easier to meet. It remains to be seen whether a statute taxing a business with $75,000 or 150 sales, or $50,000 or 100 sales would be permitted, for example.

Finally, companies should note that although *Wayfair* most clearly applies to sales and use tax, its effects will reach corporate income and other state taxes as well. In other words, there is now no question that if a state's corporate income tax applies to a company, then that state's sales and use tax applies as well, and vice versa.

Taxpayers will confront an array of legal analysis, tax and business planning that has not existed in much of the last thirty years. Stay tuned.

***<u>About the Authors</u>***

***Jack Van Coevering*** *chairs Foster Swift Collins & Smith, P.C.'s State and Local Tax practice. For 25 years, Jack has practiced state and local tax, a career that has included government and private sector positions as a Michigan Assistant Attorney General, Administrator of the Michigan Department of Treasury's legal and hearings divisions, former chair of the Michigan Tax Tribunal and private practice.*

***Taylor Gast*** *is an attorney with Foster Swift and practices in the areas of business formation, business transactions, taxation, technology law and employee benefits.*

***Cody Mott*** *is a summer associate with Foster Swift. He is attending law school at Indiana University.*