Sales Tax on Internet Purchases

Cross References

• *Wayfair, Inc.,* U.S. Supreme Court, June 21, 2018

States often impose a sales tax on the purchase of consumer goods. The tax is generally collected by the seller of the consumer goods when a customer makes a purchase. The seller then remits the tax that is collected to the state taxing authority. If for some reason the sales tax is not collected and remitted to the state by the seller, then in-state consumers are separately responsible for paying a use tax at the same rate. Many states employ this kind of complementary sales and use tax regime.

In two earlier cases, the U.S. Supreme Court held that an out-of-state seller's liability to collect and remit the tax to the consumer's state depended on whether the seller had a physical presence in that state, but that mere shipment of goods into the consumer's state, following an order from a catalog, did not satisfy the physical presence requirement. In such a case, the consumer would then be responsible for paying the use tax on the out-of-state purchase. Consumer compliance rates are notoriously low. Some reports have estimated a 4% collection rate for the use tax. States lose $8 to $33 billion annually from uncollected use tax.

The state of South Dakota does not have an income tax. It collects 60% of its general fund from sales and use taxes. It estimates lost revenue of $48 to $58 million annually from uncollected use tax. In 2016, South Dakota enacted a law requiring certain out-of-state sellers to collect and remit sales tax as if the seller had a physical presence in the state. The law applies only to sellers that, on an annual basis, deliver more than $100,000 of goods or services into the state or engage in 200 or more separate transactions for the delivery of goods or services into the state.

The taxpayers in this case are merchants with no employees or real estate in South Dakota. Each merchant meets the minimum sales or transaction requirements of the South Dakota law, but none of them collects South Dakota sales tax. South Dakota then asked the Supreme Court to reconsider the scope and validity of the physical presence rule that was mandated by previous Supreme Court cases.

The Commerce Clause in the U.S. Constitution grants Congress the power to regulate Commerce between the states. In general, Congress has left it to the courts to formulate the rules that preserve the free flow of interstate commerce. There is a long history of court rulings that have determined the extent to which a state may regulate commerce. The court has previously ruled that the imposition on the seller to collect tax from the purchaser does not violate the Commerce Clause. The only limitation is that there must be a substantial nexus with the taxing state. This nexus requirement means that there must be some definite link, some minimum connection, between a state and the person, property, or transaction the state seeks to tax.

In previous Supreme Court rulings, the majority in the court expressed concern that without the physical presence rule, a state tax might unduly burden interstate commerce by subjecting retailers to tax-collection obligations in thousands of different taxing jurisdictions. But the administrative costs of compliance are not necessarily related to whether or not a business has a physical presence in a state. For example, a business with one salesperson in each state has a physical presence in each state and must collect sales tax under the physical presence rule. Whereas a business with 500 salespersons in one central location and a website accessible in every state does not have a physical presence in each state and thus is not required to collect sales tax. The court stated the physical presence rule is a poor proxy for the compliance costs faced by companies that do business in multiple states.

This rule puts both local businesses and many interstate businesses with physical presences at a competitive disadvantage relative to out-of-state sellers without a physical presence. Out-of-state sellers can avoid the regulatory burdens of tax collection and can offer lower prices caused by the widespread failure of consumers to pay the use tax on their own. In effect, these previous court rulings have come to serve as a judicially created tax shelter for businesses that decide to limit their physical presence and still sell their goods and services to a state's consumers. It also produces an incentive to avoid physical presence in multiple states. The court stated the Commerce Clause must not prefer interstate commerce only to the point where a merchant physically crosses state borders. Rejecting the physical presence rule is necessary to ensure that artificial competitive advantages are not created by the court. States should not be prevented from collecting lawful taxes through a physical presence rule that can be satisfied only if there is an employee or a building in the state.

Another tax loophole created by the physical presence rule is illustrated by the following example. One business sells furniture online. It stocks a few items of inventory in a small warehouse in North Sioux City, South Dakota. The second sells furniture online with a warehouse just across the border in South Sioux City, Nebraska. By reason of its physical presence, the first business must collect and remit a tax on all of its sales to customers in South Dakota, even those sales that have nothing to do with the warehouse in South Dakota. But under the physical presence rule, the second hypothetical seller cannot be subject to the same tax for the sales of the same items made through an internet presence. The court stated this distinction simply makes no sense.

Modern e-commerce does not align analytically with a test that relies on the sort of physical presence defined in the previous court rulings. 41 states, 2 territories, and the District of Columbia have now asked the Supreme Court to reject the physical presence rule. Allowing out-of-state sellers to escape an obligation to remit a lawful state tax is unfair and unjust to those competitors, both local and out-of-state, who must remit the tax.

The court also noted that the internet's prevalence and power have changed the dynamics of the national economy since 1992 when the Supreme Court last ruled on the physical presence rule. The court concluded that the physical presence rule is unsound and incorrect.

The next question in this particular case is whether or not the South Dakota law established nexus based on both the economic and virtual contacts the taxpayer has with the state. The South Dakota law applies only to sellers that deliver more than $100,000 of goods or services into the state or engage in 200 or more separate transactions for the delivery of goods and services into the state on an annual basis. This quantity of business could not have occurred unless the seller availed itself of the substantial privilege of carrying on business in South Dakota. The court stated that South Dakota's tax system includes several features that appear designed to prevent discrimination against or undue burdens upon interstate commerce. It standardizes taxes to reduce administrative and compliance costs. It requires a single, state level tax administration, uniform definitions of products and services, simplified tax rate structures, and other uniform rules. It also provides sellers access to sales tax administration software paid for by the state. Sellers who choose to use such software are immune from audit liability. Based upon these facts, the court found that the South Dakota law meets the nexus requirement.

The court vacated the previous court rulings and remanded the case back to the lower court for further proceedings consistent with this opinion.

Author's Comment

The dissenting judges who argued in favor of keeping the physical presence test said that e-commerce has grown into a significant and vibrant part of our national economy against the backdrop of established rules. Any alteration to those rules with the potential to disrupt the development of such a critical segment of the economy should be undertaken by Congress, not the court.