Sales Tax and Corporate Income Tax Compliance After *Wayfair*

by Matthew A. Morris

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In this article, Morris assesses the sales tax and corporate income tax landscape post-*Wayfair*.

As many other practitioners have already noted, the U.S. Supreme Court in *South Dakota v. Wayfair Inc.*[1] marked the end of the physical presence requirement for states to impose sales tax withholding and remittance obligations on out-of-state retailers. What is less clear, however, is what impact *Wayfair* will have on (a) pre-*Wayfair* sales tax statutes and regulations that have not yet been amended to conform with South Dakota's pure economic nexus provisions and (b) the imposition of state corporate income taxes on companies that might have new exposure to state sales taxes under a pure economic nexus standard.

The physical presence requirement — which was squarely addressed in *National Bellas Hess v. Department of Revenue*[2] and then further elaborated on in *Quill Corp. v. North Dakota*[3] — basically provided that a state cannot impose a sales tax obligation on an out-of-state seller unless the seller maintains some form of physical presence in that state. The Court has traditionally interpreted the physical presence requirement broadly — for example, the Court in *Scripto Inc. v. Carson*[4] upheld the imposition of Florida use tax on a Georgia company's sale of office supplies to Florida customers when the company had no employees in Florida and made all its sales through independent contractors. But before *Wayfair* the Court consistently adhered to the general principle that the out-of-state seller had to maintain some physical presence in the taxing state — either directly in the form of stores[5] or sales offices in the taxing state[6] or indirectly in the form of independent contractors selling to customers in the taxing state.[7]

South Dakota in *Wayfair* played its hand brilliantly: to address the millions in lost revenue attributable to the failure of large online retailers to collect and remit sales taxes on sales to South Dakota residents (estimated by the South Dakota Department of Revenue to be between $48 million and $58 million annually[8]), its Legislature passed a law authorizing the imposition of sales tax obligations on out-of-state sellers purely on the basis of that seller's economic nexus with South Dakota.[9] This law was basically an open invitation for the South Dakota Supreme Court to declare the law unconstitutional under the physical presence requirements of *National Bellas Hess* and *Quill Corp.* and for the state to then appeal this decision to the U.S. Supreme Court.[10]

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[1] 588 U.S. _____ (2018).

[2] 386 U.S. 753 (1967).

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

[4] 362 U.S. 207 (1960).

[5] *See D.H. Holmes Co. Ltd. v. McNamara*, 486 U.S. 24 (1988).

[6] *See National Geographic Society v. Board of Equalization*, 430 U.S. 551 (1977).

[7] *See Scripto*.

[8] *Wayfair*, slip op. at 2.

[9] *Id*. at 3. ("The Act 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.").

[10] *Id*. at 4.

Fortune favors the bold, and South Dakota's pure economic nexus statute was one of the boldest pieces of sales tax legislation in all 50 states. The other states that enacted pure economic sales tax nexus laws before *Wayfair* were Alabama, Indiana, Maine, Mississippi, North Dakota, Pennsylvania, Tennessee, Vermont, Washington, and Wyoming.[11] In addition to the pure economic nexus states listed above, other states before *Wayfair* combined economic nexus with some type of proxy for physical presence. For example, Massachusetts's relatively new but pre-*Wayfair* sales tax regulation, pejoratively referred to by state and local tax practitioners as the "cookie nexus" regulation, adopts an economic nexus standard by requiring sellers to have more than $500,000 in Massachusetts sales from transactions completed over the internet and 100 or more transactions resulting in a delivery into Massachusetts, but it still adheres to the physical presence requirement by mandating that the online seller maintain a proxy for physical presence in the form of in-state software (apps) or ancillary data (cookies), contracts resulting in the use of in-state servers and other computer hardware, or contracts with "online marketplace facilitators" resulting in in-state services such as payment processing, order management, or return processing.[12]

Emboldened by *Wayfair*, many states have already started to enact new sales tax laws that are essentially identical to South Dakota's pure economic nexus statute.[13] But what does *Wayfair* mean for states like Massachusetts that retain some form of physical presence requirement, either directly or by proxy, before the effective date of post-*Wayfair* legislation? And what impact will *Wayfair* have, if any, on state corporate income tax compliance?

In answering the first question, practitioners must be mindful that *Wayfair* does not automatically establish an economic nexus standard that applies in all 50 states absent implementing legislation or regulations. The question before the U.S. Supreme Court in *Wayfair* was "whether South Dakota may require remote sellers to collect and remit the tax without some additional connection to the state."[14] A state's action to enforce sales tax withholding obligations on out-of-state sellers has to proceed on the basis of a statute that authorizes that enforcement action or, at the very least, a regulation that represents the revenue department's reasonable interpretation of the applicable sales tax statute.[15] A state cannot start assessing sales tax on remote sellers that do not fall squarely within the plain language of that state's sales tax law and should therefore not be able to assess remote sellers retroactively without first amending its sales tax statute or promulgating a regulation implementing the economic nexus principles in South Dakota's sales tax statute.[16] Many states are now going to follow South Dakota's lead in adopting a pure economic nexus standard in new sales tax laws, but those states are unlikely to prevail when trying to apply the *Wayfair* nexus standards retroactively.

Regarding corporate income taxes, the academic answer is that *Wayfair* should not change anything, but the practical answer is that it will change everything. The traditional rule is that if a taxpayer has nexus with a particular state for sales tax purposes, then that taxpayer will also have nexus for corporate income tax purposes (although the inverse is not necessarily true). This is because the Court in *Quill* and *National Bellas Hess* specifically held that the physical presence

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[11] *See* map of economic nexus states pre-*Wayfair*. Mo Bell-Jacobs and Brian Kirkell, "Economic Sales and Use Tax Nexus Laws," RSM, Jan. 18, 2018.

[12] *See* 830 Mass. Code Regs. 64H.1.7(1)(b)(2) and 64H.1.7(3) (eff. Sept. 22, 2017).

[13] *See, e.g.*, Haw. Rev. Stat. section 237-1, by 2018 Hawaii Laws Act 41 (S.B. 2514) (eff. July 1, 2018); Ala. Rule 810-6-2-.90.03, Ala. Dept. of Rev., by Ala. Act 2018-539 (eff. Oct. 1, 2018); Conn. Gen. Stat. section 12-407(a)(12) and (15), by Public Acts 2018, No. 18-152, sections 2 and 3 (eff. Dec. 1, 2018).

[14] *Wayfair*, slip op. at 10.

[15] *See Miller Bros. Co. v. State of Maryland*, 347 U.S. 340, 342, 74 S. Ct. 535, 537, 98 L. Ed. 744 (1954) ("It is a venerable if trite observation that seizure of property by the State under pretext of taxation when there is no jurisdiction or power to tax is simple confiscation and a denial of due process of law.").

[16] *Wayfair*, slip op. at 21-22 ("[R]etroactive liability risks a double tax burden in violation of the Court's apportionment jurisprudence because it would make both the buyer and the seller legally liable for collecting and remitting the tax on a transaction intended to be taxed only once."); *see also id.*, Brief for Law Professors et al. as *Amici Curiae*, 2018 WL 1203458 at *7 n.5 ("[E]ven if retroactive enforcement against remote retailers is not invalidated as discriminatory against interstate commerce, a state's attempt to collect sales taxes on transactions several years in the past might well place burdens on those retailers which would be deemed excessive in relation to the putative local benefits, and thus the effort could fail on those grounds.") (internal quotations and citation omitted).

requirement for sales tax purposes satisfies the "substantial nexus" requirement under the four-prong test of *Complete Auto Transit v. Brady*,[17] but refused to adopt a similar bright-line rule for corporate income taxes. As a result of this lack of clarity regarding the boundaries of state authority to assert nexus for corporate income tax purposes, most states took the position (well before *Wayfair*) that the threshold for establishing substantial nexus for corporate income taxes was a significantly lower bar for the state to clear than the physical presence requirement of *Quill*.

A landmark case in this area is *Geoffrey Inc. v. State Tax Commission*,[18] in which the South Carolina Supreme Court held that the economic activities of intellectual property holding company Geoffrey Inc., which included licensing trademarks to Toys-R-Us stores located in South Carolina, was sufficient to establish substantial nexus for corporate income tax purposes even though Geoffrey had no employees, contractors, or other indicia of physical presence in South Carolina. Other cases have further established a state's authority to assert substantial nexus for corporate income tax (and Ohio commercial activity tax) purposes over retailers and other businesses that have no physical presence in the state.[19]

The logical result of cases such as *Geoffrey*, *MBNA*, *Capital One*, and *Overstock.com* should have been that large online retailers would allocate state income taxes in all states in which they conducted a significant amount of business with vendors or customers. The reality, however, is that many retailers — even after cases such as *Geoffrey* — registered for corporate income taxes only in those states in which they registered for sales taxes.[20] Even non-retailers with a significant economic presence in all 50 states have traditionally been reluctant to allocate corporate income tax to states in which those companies have no physical presence.[21]

After *Wayfair*, there are no longer any bright-line rules for what constitutes substantial nexus for sales tax purposes. We now know that substantial nexus can be established by economic nexus alone, which obviously increases the sales tax collections exposure for retailers that sell to a significant number of customers in a particular state but may not have had a physical presence in that state. Online retailers that have historically paired their sales and income tax registrations are understandably concerned about their exposure to additional corporate income taxes and additional sales tax collections in states in which they have not previously registered for either tax type. Because states have never been constrained by the physical presence requirement of *Quill* for corporate income tax purposes, states should be able to assess corporate income taxes retroactively without the legal barriers associated with assessing sales taxes for pre-*Wayfair* tax periods.

While most large online retailers are in the process of preparing for major changes to their sales tax collection obligations on a prospective basis, retailers and non-retailers alike also must account for the possibility that *Wayfair* will open the door for corporate income tax assessments for past, present, and future tax periods. It remains to be seen how state tax authorities will address the

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[17] 430 U.S. 274 (1977).

[18] 437 S.E.2d 13 (S.C. 1993), *cert. denied*, 510 U.S. 992 (1993).

[19] *See, e.g.*, *Tax Commissioner of West Virginia v. MBNA America Bank, N.A.*, 640 S.E. 2d 226 (W. Va. 2006), *cert. denied sub nom.*, *FIA Card Services, N.A. v. Tax Commissioner of West Virginia*, 551 U.S. 1141 (2007) (substantial nexus for corporate income tax purposes established by significant gross receipts from in-state customers despite company's lack of physical presence in state); *Capital One Bank v. Commissioner of Revenue*, 899 N.E. 2d 76 (Mass. 2009) (banks' solicitation of and gross receipts from Massachusetts customers, use of Massachusetts banking and credit facilities, and use of the Massachusetts court system to enforce cardholder contracts sufficient to establish substantial nexus for corporate income tax purposes despite company's lack of physical presence in state); and *Overstock.com Inc. v. New York State Department of Taxation and Finance*, 2013 slip op. 02102 (Mar. 28, 2013) (upholding the constitutionality of New York's "Internet tax," which asserts nexus over out-of-state retailers that enter into commission-based website advertising agreements with New York-based affiliates). Even states without a corporate income tax have successfully argued that physical presence is not a prerequisite for imposing gross receipt taxes such as the Ohio commercial activity tax (CAT). *See e.g.*, *Crutchfield Corp. v. Testa*, 151 Ohio St. 3d 278, 289, 88 N.E.3d 900, 910 (2016) ("We hold today that although a physical presence in the state may furnish a sufficient basis for finding a substantial nexus, *Quill*'s holding that physical presence is a *necessary condition for imposing the tax obligation* does not apply to a business-privilege tax such as the CAT, as long as the privilege tax is imposed with an adequate quantitative standard that ensures that the taxpayer's nexus with the state is substantial.") (emphasis in original).

[20] *See, e.g.*, *Lanco Inc. v. Director, Division of Taxation*, 22 N.J.Tax 636 (2005) (Lanco, which licenses intellectual property to Lane Bryant for use in retail stores nationwide, is subject to corporate income tax in New Jersey despite not being subject to sales and use tax in New Jersey).

[21] *See, e.g.*, Michael Rappaport, "Wells Fargo's $481 Million Tax Surprise," *The Wall Street Journal*, July 13, 2018. Wells Fargo allocated an additional $481 million for state tax reserves after the *Wayfair* decision to account for additional exposure to state income taxes.

inevitable surge in new registrations for online retailers and whether these states will offer penalty and tax period lookback relief to these taxpayers by means of *Wayfair*-themed voluntary disclosure initiatives. One thing is certain: *Wayfair* has fundamentally changed the sales tax landscape nationwide and is forcing all businesses with receipts from customers in multiple states to reevaluate their exposure to sales tax collection and income tax payment obligations. ■