

WASHINGTON UPDATE

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An Update on Sales and Use Tax Collection After *Wayfair*

When a consumer in Virginia or New York purchases a sweater from L.L. Bean's catalogue, a taxable transaction has taken place. Because the sweater is being shipped to New York or Virginia, however, there is no sales tax liability to Maine, where L.L. Bean is located. The reason for this is that the interstate commerce clause and the Fourteenth Amendment have been interpreted to prohibit a tax on a sale that takes place in another state, that is, the state where the consumer resides and into which the goods or merchandise are being shipped. Nonetheless, the consumer is liable for a use tax (instead of a sales tax) on the cost of the sweater to New York or Virginia, because he or she will "use" the sweater in that state. Thus, the use tax fills a gap when the sales tax does not apply. Although many or almost all consumers have paid the use tax, few were aware at the time that they were doing so.

For example, a consumer who purchases a car in New Jersey but is a resident of New York, or a person who buys a car in Maryland but is a resident of Virginia, has to pay a use tax when he or she registers the vehicle in the state of residence. The problem with the use tax had arisen in the past in instances where the state lacks a practical way to make the purchaser pay the use tax (*i.e.*, when registration of the item is not feasible). For example, when consumers had purchased smaller items, such as mail-order goods, they would rarely pay the use tax on such items. As a result, unless direct marketers or other remote sellers were required to collect the use tax from consumers and remit payment to the various states, the use tax remained largely uncollected.

In 2018, the Supreme Court addressed the problem of use tax collection by ruling in *South Dakota v. Wayfair* that a state could require any remote seller who has an economic connection with it to collect and remit its use tax for sales to purchasers within that state. In doing so, the Supreme Court struck down its physical presence requirement that had been in effect since its 1967 decision in *National Bellas Hess* (reaffirmed in its 1992 *Quill* decision), upon which remote sellers had relied to avoid collecting use tax on sales to customers in states in many instances.

The *Wayfair* case involved South Dakota's economic nexus law, which requires out-of-state retailers with "economic presence" in the state, *i.e.*, those with retail sales of at least \$100,000 or with at least 200 transactions annually with South Dakota residents, to collect and remit sales and use taxes effective May 1, 2016. As such, the South Dakota statute exempts small merchants. Moreover, the statute provides that it would be applied

prospectively only if its constitutionality is upheld. In overturning *National Bellas Hess* and *Quill*, the court specifically held that physical presence is not required to meet the “substantial nexus” requirement. The court concluded that South Dakota had established that Wayfair and the other remote sellers had substantial nexus with the state through their “extensive virtual presence.”

Although physical presence is no longer required before a remote seller must collect and remit a state’s sales and use tax, *Wayfair* does not provide states with a broad and absolute right to enact or enforce all types of economic nexus laws. South Dakota included several safeguards in its law to prevent it from violating the interstate commerce clause: (1) the law has a safe harbor provision that permits merchants to transact business in the state below certain specific thresholds, (2) the law is not retroactive, and (3) South Dakota is a member of the Streamlined Sales and Use Tax Agreement, which reduces administrative and compliance costs for taxpayers and even provides state-funded sales tax administration software.

An important question that is lurking in the background is the impact on the incentive and overall marketplace now that the Supreme Court has modernized its state sales and use tax jurisprudence and eliminated the outmoded and illogical physical presence requirement. Remote sellers now find themselves treated the same way as brick and mortar retailers when it comes to collecting sales and use taxes.

At least 38 states so far have imposed an obligation on remote sellers, and it seems likely that the other seven states that impose sales and use taxes will do so soon. The starting date for collecting and remitting use taxes varies by state. (Here are two useful links to effective dates: <https://www.salestaxinstitute.com/resources/remote-seller-nexus-chart> and <https://www.avalara.com/us/en/learn/sales-tax/south-dakota-wayfair.html>) For example, California did not require remote sellers to collect and remit its sales and use tax until April 1, 2019. Moreover, the collection and payment obligation applies only if total retail sales to California residents exceed \$500,000 annually. Illinois required remote sellers to collect and remit its sales and use tax on October 1, 2018. Illinois has the same *de minimis* thresholds as South Dakota, *i.e.*, it applies to those with retail sales of at least \$100,000 or with at least 200 transactions annually with Illinois residents. Although New York’s law requiring collection and payment went into effect on the date of the Supreme Court’s decision in *Wayfair*, June 21, 2018, New York does not appear to have enforced its law until 2019. New York’s *de minimis* thresholds are retail sales of at least \$300,000 and with at least 100 transactions annually with New York residents. Suffice it to say, remote sellers should be collecting and remitting sales/use taxes now, even if some states will not require it until October 1, 2019. (Texas is one such state, and its *de minimis* threshold is the same as California’s, annual retail sales to Texas residents over \$500,000.)

Each state may also have different requirements for filing and paying sales and use taxes. For example, New York has four filing quarters for sales/use taxes, the quarters ending on May 31, August 31, November 30, and February 28/29 of the following year. Out-of-state vendors must register as a vendor in states where they must

collect sales/use taxes. Thus, even if the effects of the holding in *Wayfair* on various remote sellers are not clear or obvious, each such seller should have begun to review its business operations and have taken the following steps:

1. Determined the states where it does business and their level of importance.
2. Ascertained the statutory sales/use tax regimes in those states
3. Ascertained what is required to comply with the sales use tax collection regimes in each of those states. This requires familiarity with filing requirements, processes for collecting and paying the correct amount of sales/use tax, effective dates, and a determination of *de minimis* thresholds.
4. Ensured that the business is compliant and remains so.
5. Reviewed the operations of the business to determine any indirect effects of sales/use tax collection. For example, customers who were used to avoiding sales/use tax by buying remotely may decide to stop buying. Consider the effects of shipping costs when added to tax costs.

Finally, it is worth noting that taking shortcuts in a backhanded way of trying to comply with use tax collection may lead to even bigger problems than outright noncompliance. For example, some liquor stores with substantial interstate business have found it time consuming and difficult to register to sell alcohol in every state. Rather than call attention to themselves, they pretend to comply by imposing their home state's sales tax on all sales. This approach is fraught with considerable danger.

If their stores are in high sales/use tax jurisdictions such as New York or California, those retailers have been collecting higher tax rates, 9% or higher, than the sales/use tax rates in effect in the customer's home state. For example, if the store collects a California sales tax that is 9% when it should have collected sales tax of 6% for Virginia, it would have overcharged that customer by 3%. While 3% on an order of \$500 is not much (\$15), the difference can be substantial when applied to all customers over a long period. Inasmuch as there is no colorable legal justification for the sales tax overcharges, the retailers are leaving themselves open to being sued in class action litigation under state consumer protection laws, some of which permit triple damages for unfair or fraudulent sales practices.

In any case, the *Wayfair* decision has ushered in a new era of sales and use tax compliance. Most retailers can no longer ignore sales and use tax collection on remote sales. The sooner they become familiar with the sales and use tax collection regimes of the states in which they conduct business, the more likely it is that they can avoid costly audits, additional taxes, and penalties. Any multistate retailer that has not already done so should immediately review its business operations to ensure that it is collecting and remitting sales and use taxes to every state in which it conducts business.