Tax from Out-of-State Sellers

Legislature Must Decide What *Wayfair* Ruling Means for California

As e-commerce continues to grow, there is more opportunity for Californians to buy their goods from retailers located out of state. When Californians buy goods from a California retailer, they must pay a sales tax, which is collected by the seller. When Californians buy goods from out-of-state (or remote) sellers, typically via online purchases, they generally are supposed to pay the state a use tax on those items—at the same rate as the sales tax. Some large out-of-state sellers collect the sales tax on behalf of the consumers, but not all out-of-state sellers do. For decades, the courts have interpreted the U.S. Constitution's commerce clause in a way that limits states' ability to collect the use tax from remote sellers due to a lack of nexus between the state and the retailer. The U.S. Supreme Court's recent decision in *Wayfair* may have changed this limitation for all remote sellers.

SUPREME COURT PRECEDENT PERTAINING TO STATE COLLECTION OF SALES TAX FROM REMOTE SELLERS

In determining whether a state tax unduly burdens interstate commerce in violation of the U.S. Commerce Clause, a key part of the test as set forth by the Supreme Court in *Complete Auto Transit v. Brady* (1977) is whether the taxed activity has a substantial nexus with the taxing state. In *Quill Corp. v. North Dakota* (1992), the Supreme Court held that for remote sellers to have a substantial nexus with a state, they must have some sort of *physical presence i*n the state. After *Quill*, a remote seller had to have some sort of physical presence in a state in order for the state to require remote sellers to remit a use tax.

CALIFORNIA USE TAX COLLECTION REQUIREMENTS BEFORE *WAYFAIR*

Before 2011, remote sellers required to collect a use tax from California purchasers were those with an obvious physical presence in California, including those who:

• Maintain, occupy, or use an office, a place of distribution, a warehouse, a sales room, or some other place of business in California;

• Have any representative, agent, salesperson, canvasser, independent contractor, or solicitor operating in California under the authority of the retailer; or

• Derive rental income from the lease of tangible personal property in California.

In 2011, AB 155 (C. Calderon; D-Montebello/Skinner; D-Berkeley) expanded California's use tax collection requirements within the physical presence test established by *Quill*, requiring that the following, additional types of remote sellers collect a use tax from California customers:

• Remote sellers in the same "commonly controlled group" or corporate family as in-state businesses; and

• Remote sellers who work with in-state affiliates—people who refer potential customers to those retailers via a link on the California seller's website (a click-through arrangement), provided that both of the following conditions are met:

  -the out-of-state retailer's total cumulative sales to purchasers in California referred pursuant to the click-through agreements exceed $10,000 during the preceding 12 months, and

  -the out-of-state retailer also has total cumulative sales to purchasers in California exceeding $1 million within the preceding 12 months.

This change in the law brought in significant revenue to the state. According to the Legislative Analyst's Office, businesses registered under AB 155 paid almost $700 million in use tax in 2016–2017.

AB 155 also expressly tied California's definition of a remote seller to federal law in anticipation of a potential future Supreme

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Court decision, such as *Wayfair*, that would relax or overrule the physical presence test. Specifically, AB 155 defined a "retailer engaged in business in this state" in Revenue and Taxation Code Section 6203 (c) to mean "any retailer that has substantial nexus with this state for purposes of the commerce clause of the United States Constitution and any retailer upon whom federal law permits this state to impose a use tax collection duty."

THE *WAYFAIR* DECISION

In 2016, South Dakota passed a law requiring out-of-state sellers to pay sales tax if they met one of the following conditions during a calendar year:

• The remote seller's gross revenue from sales to South Dakota exceeds $100,000; or

• The remote seller made 200 or more separate sales transactions in South Dakota.

In *South Dakota v. Wayfair, et al.* (2018), South Dakota sued out-of-state sellers—including the online retail giant, Wayfair—who were not complying with its new tax requirements. The lower courts found in favor of the remote sellers based on the precedent of *Quill*, holding that they did not have a physical presence in the state. Then the U.S. Supreme Court—with a five-justice majority—explicitly overturned *Quill's* physical presence test.

The 5-4 split did not follow traditional, ideological lines. Justice Anthony Kennedy authored the majority opinion and was joined by Justices Samuel Alito and Ruth Bader Ginsburg, while Justices Clarence Thomas and Neil Gorsuch wrote concurring opinions.

The majority opinion found *Quill's* physical presence test to be "unsound and incorrect" because it does the following:

• Overlooks the "substantial virtual connections" of most major retailers to states due to "the 'dramatic technological and social changes' of our 'increasingly interconnected economy'" and the vast expansion of e-commerce.

• "Limit[s] states' ability to seek long-term prosperity."

• "Prevent[s] market participants from competing on an even playing field."

The U.S. high court further held the South Dakota law met the substantial nexus requirement established in *Complete Auto* "based on both the economic and virtual contacts" the remote sellers have with South Dakota. Specifically, the court found that making 200 or more sales transactions in South Dakota or selling more than $100,000 worth of goods or services into South Dakota "could not have occurred unless the seller availed itself of the substantial privilege of carrying on business in South Dakota. And respondents are large, national companies that undoubtedly maintain an extensive virtual presence."

The court further considered the fact that South Dakota's law was not applied retroactively as well as features in South Dakota's law that reduce administrative and compliance costs. Specifically, South Dakota follows the Streamlined Sales and Use Tax Agreement (SSUTA), which requires state-level tax administration. The SSUTA also requires the state to provide remote sellers with software to aid in their compliance with the tax law and with a safe harbor from audits for those businesses that use the state-provided software.

Chief Justice John Roberts wrote the dissenting opinion and was joined by Justices Stephen Breyer, Sonia Sotomayor, and Elena Kagan. These justices acknowledged that past decisions in this area were "wrongly decided" due to the expansive growth of e-commerce, but said that *stare decisis* (previous judicial opinions) weighed heavily against overruling *Quill*.

LEGISLATIVE ACTION IN 2019

During a joint hearing of the California Senate Governance and Finance and Assembly Revenue and Taxation committees in fall 2018, legislators stated their intent to work on legislation to define "substantial nexus" for California in the wake of *Wayfair* and cautioned the California Department of Tax and Fee Administration (CDTFA) from moving forward ahead of that process.

A draft legislative proposal to modernize California law in the wake of *Wayfair* that appeared to come from the Brown administration was inadvertently placed online in August. This proposal would have included a $500,000 economic nexus threshold in addition to requiring marketplace facilitators to collect and remit taxes on behalf of their smaller marketplace sellers. This proposed language never materialized into actual legislation.

ADMINISTRATIVE ACTION IN 2018–2019

During its October 2018 *Wayfair* stakeholder meeting, CDTFA officials stated their intent to implement and enforce the South Dakota tax statute upheld by the *Wayfair* Supreme Court here in California.

Despite warnings from the Legislature, in early December 2018, CDTFA officials issued notice that they will soon begin to enforce the South Dakota remote seller collection threshold of greater than $100,000 in sales or more than 200 transactions here in California without any legislative action. CDTFA has cited the "long-arm" provision of the California Revenue and Taxation Code, specifically the previously discussed Section 6203 (c), as the basis of its authority.

Now that the CDTFA has issued a notice without legislative or regulatory action, the nexus standard is potentially subject to challenge on various bases, including: 1) the burden on interstate commerce to comply with the sales and transaction thresholds for numerous local tax districts; 2) a tax increase without a supermajority approval by the California Legislature; and 3) failure to comply with the California Administrative Procedures Act.

CALCHAMBER POSITION

The *Wayfair* court did not rule that South Dakota's tax statute is now the baseline for the entire country. To the contrary, the court carefully evaluated South Dakota's law adopted by South Dakota's legislature and described certain features of that law "designed to prevent discrimination against or undue burdens upon interstate commerce."

California's tax system does not have some of these features. Moreover, California has the largest economy in this country—and the fifth largest in the world—while South Dakota, with its small population, has the 47th largest economy in the United States.

Post-*Wayfair*, it is the job of the Legislature to determine how to expand "substantial nexus" beyond a physical nexus test and to create an economic nexus test suitable to the State of California. CDTFA should refrain from implementing a new tax requirement until the Legislature finalizes its post-*Wayfair* legislation because doing so will cause uncertainty and unnecessary litigation and costs on business.

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