1325 G Street N.W., Suite 950
Washington, DC 20005
202.464.6200
www.taxfoundation.org

Post-Wayfair Options for Congress

Joseph Bishop-Henchman
Executive Vice President, Tax Foundation

Hearing on Examining the Wayfair Decision and Its Ramifications for Consumers and Small Businesses

Before the
United States House of Representatives
Committee on the Judiciary

July 24, 2018

Chairman Goodlatte, Ranking Member Nadler, and members of the committee:

The Tax Foundation is pleased to submit this written testimony. In addition to testifying frequently before this Committee and its subcommittees on this topic, we also were the only entity asked by both parties in the *South Dakota v. Wayfair* case to submit a brief on their side. We ultimately filed a brief in support of neither party, urging the Court to uphold the South Dakota law while articulating a clear standard that would invalidate other, more aggressive nexus laws. As a Section 501(c)(3) nonprofit, nonpartisan organization, we take no position on any pending legislation.

Complete Auto Remains the Rule, As Modified by *Wayfair*

The *South Dakota v. Wayfair* decision of June 21, 2018 changes how courts will evaluate the constitutionality of state laws taxing interstate commerce. The overall test, the *Complete Auto* test, does not change: a state law is only valid if there is (1) substantial nexus, a sufficient connection between the state and the taxpayer; (2) fair apportionment, the state not taxing beyond its fair share of interstate commerce; (3) nondiscrimination, the state not taxing out-of-state activity or taxpayers while exempting in-state activity or taxpayers; and the tax is (4) fairly related, to services provided to the taxpayer. What changed in *Wayfair* is how nexus is evaluated.

Prior to *Wayfair*, the test was whether the seller was physically present in the taxing jurisdiction. After *Wayfair*, the test now is whether the state tax law places excessive or discriminatory burdens on interstate commerce.

Current Status of State Compliance with The *Wayfair* Checklist

The Court provided a checklist of factors present in the South Dakota law that strongly suggested why it would be constitutional under this standard:

1. **Safe harbor**: exclude "those who transact only limited business" in the state. (South Dakota's is $100,000 in sales or 200 transactions.)
2. **No retroactive collection**.
3. **Single state-level administration** of all sales taxes in the state.
4. **Uniform definitions** of products and services.
5. **Rates**: Simplified tax rate structure. (South Dakota requires the same tax base between state and local sales tax, has only three sales tax rates, and limited exemptions from the tax.)
6. **Software**: Access to sales tax administration software provided by the state.
7. **Immunity**: Sellers who use the software are not liable for errors derived from relying on it.

We are evaluating current state laws in light of this *Wayfair* checklist but estimate that nine states are currently fully compliant with this checklist (Georgia, Indiana, Iowa, Kentucky, North Dakota, South Dakota, Utah, Vermont, and Wyoming). A tenth state, New Jersey, is close: both houses of New Jersey's legislature have passed enabling legislation to address #1 and #2 on the checklist, and it is pending on the Governor's desk. New Jersey otherwise complies with #3 through #7 of the list.

An additional thirteen states have completed items 3 through 7 of the list automatically through membership in the Streamlined Sales Tax Project, but have not yet passed enabling legislation to make them compliant with items 1 and 2 of the *Wayfair* checklist (Arkansas, Kansas, Michigan, Minnesota, Nebraska, Nevada, North Carolina, Ohio, Oklahoma, Rhode Island, Washington, West Virginia, and Wisconsin).

Of the remaining twenty-two states plus the District of Columbia with a sales tax, significant state actions would be required before remote seller sales tax collection could proceed without it being an excessive burden on interstate commerce. This list includes large states such as Arizona, California, Florida, Illinois, Massachusetts, New York, and Texas. These states have so far resisted any sales tax simplifications or adherence to uniform rules. They are therefore the most likely to seek tax collection without improving their sales taxes as envisioned by *Wayfair*.

Alabama was considered by many experts in likely danger of pursuing retroactive collection, but its state Department of Revenue announced on July 3 that it would seek to collect only from October 1, 2018, prospectively. Two states have promulgated revenue rules currently seeking collection prior to the date of the *Wayfair* decision: Mississippi (transactions after December 1, 2017) and Tennessee (transactions after July 1, 2017). Comments by officials of both states suggest they will abandon these efforts to instead pursue legislation similar to South Dakota's. Several states have recently-passed effective dates: Hawaii (January 1, 2018), Kentucky (July 1, 2018), Minnesota (June 21, 2018), Oklahoma (July 1, 2018), and Pennsylvania (March 1, 2018). No other state has

announced retroactive collection although the vast majority of states have yet to adopt enabling legislation that would specify effective dates.

Also of interest are a number of state statutes adopted under the old *Quill* framework to redefine physical presence to encompass a number of activities: twenty-two states adopted affiliate nexus laws, ten states adopted notice-and-reporting laws, and three states have cookie nexus laws. Are these still valid?

Finally, it is worth noting that many states are likely to use the *Wayfair* decision as an opportunity to reform their state tax systems. Alabama, Arizona, Colorado, and Louisiana impose significant compliance costs on their retailers, and the need to comply with *Wayfair* may enable them to overcome internal resistance to a better sales tax system. Several states, such as Missouri and Utah, have proposed that the additional revenue from internet sales tax be used to cut other taxes.

Congressional Option 1: Codify the *Wayfair* Checklist

One option is for Congress to pass a statute preempting states from collecting sales tax on interstate commerce unless the state complies with the seven elements of the *Wayfair* checklist. This action would remove uncertainty and possible threats from even one or two states deviating from the list, by ensuring that tax compliance and financial reporting burdens do not materialize.

Such a statute could read:

> *No state or locality may impose any state or local sales or use tax liability or collection responsibility on interstate commerce for any tax period unless that state (1) provides a safe harbor excluding those who transact only limited business in the state, of at least $100,000 in sales or 200 transactions in the prior year; (2) bars retroactive collection of liabilities prior to July 1, 2018, or the effective date of legislation, whichever is later; (3) provides for single state-level administration of all sales and use taxes in the state; (4) adheres to uniform definitions of products and services; (5) requires the same tax base between state sales taxes and local sales taxes, and minimizes special sales tax rates on different products; (6) provides access to sales tax administration software provided for free by the state; and (7) grants immunity to sellers for errors derived from relying on state-certified software.*

Congressional Option 2: Fix Retroactivity Threat

An option for Congress, in combination with Options 1 and 3, or separately, is to avoid the unanticipated consequence of publicly-traded firms restating their financials to account for dangers relating to retroactive collection of all state taxes under an economic presence standard.

Such a statute could read:

> *No state or locality may rely upon the new constitutional standard for substantial nexus articulated by the United States Supreme Court in South Dakota v. Wayfair for purposes of imposing any state or local tax liability or collection responsibility for any tax period beginning prior to [date].*

The effective date should be after, and enactment date should be prior, to the Q3 financial reporting end date of September 30, 2018.

Congressional Option 3: Codify the *Complete Auto* Test

Because Congress has never codified the *Complete Auto* test, two justices and many commentators believe it is not the role of courts to curb aggressive state tax laws. Two justices, Justices Clarence Thomas and Justice Neil Gorsuch, were in the *Wayfair* majority because they do not believe the courts are empowered to invalidate state tax laws without explicit direction by Congress. A blatantly discriminatory Maryland tax was only struck down in *Maryland v. Wynne* (2015) by a 5 to 4 vote, in part because Justices Antonin Scalia and Thomas refused to restrain state tax authority due to lack of a congressional statute. (A bare majority of the Court, made up of Chief Justice John Roberts and Justices Anthony Kennedy, Stephen Breyer, Samuel Alito, and Sonia Sotomayor, applied the *Complete Auto* test and struck down the law.) The Supreme Court and other courts have often declined to hear taxpayer appeals in some part due to the reticence to exercise authority absent congressional direction.

Congress could resolve this lack of clarity to empower the courts to evaluate the constitutionality of state taxes on interstate commerce by codifying the existing *Complete Auto* test into law.

Such a statute could read:

> *No state shall impose any tax on interstate commerce unless that tax (a) has substantial nexus with the taxing state, a sufficient and clear connection between a state and a potential taxpayer; and (b) is nondiscriminatory between in-state activity and out-of-state activity; and (c) is fairly apportioned, designed to tax only the state's fair share of interstate activity; and (d) is fairly related to services provided by the state, with the taxpayer enjoying state-provided services while in the state. The federal courts shall have jurisdiction to hear cases relating to this section.*

This version would have the benefit of giving direction to the courts on what they need to be enforcing, providing a standard for states to adhere to while reserving their legitimate tax powers, and is essentially status quo law that is being haphazardly followed at present. This proposal would not resolve the definition of substantial nexus, leaving proponents of economic nexus and physical presence nexus non-victorious, but again in a way reflecting the status quo and letting individual case law and narrow congressional enactments in particular areas find the right trade-offs. But it would check tax exportation, the immediate problem, in the forum best suited for resolving individual disputes: the courts.

Congressional Option 4: Adopt Stricter Protections or a Different Nexus Standard

In the past several years Congress has considered a variety of proposals relating to state taxation. Congress retains the power to enact any of these notwithstanding the *Wayfair* decision. However, it should be cautioned that the physical presence rule did not prove an effective limit on aggressive state tax authority, and re-enacting it would not protect small sellers from state tax authority. Prior to the *Wayfair* decision, thirty-one states had enacted laws to collect sales tax on internet sales to their residents notwithstanding the physical presence limitation.

Proposals such as BATSA, Mobile Workforce, and Digital Goods sought a stricter standard than just physical presence, seeking to exclude or at least define de minimis activity that may involve fleeting or brief physical presence without substantial economic activity in a state. These proposals could be bundled together with a similar enactment on sales tax, or with stricter protections on top of the *Wayfair* checklist, such as audit authority limitations. A danger is that without a consensus on an appropriate nexus standard, such legislation may be difficult to be enacted.

Congressional Option 5: Do Nothing

Finally, Congress can choose to not act to preempt states from activities they have yet to engage in. In the month since the *Wayfair* decision, no state has enacted legislation that does not conform to the *Wayfair* checklist. Congress could choose to wait for action by states, especially a large state such as California or New York. If such a state were to join the Streamlined Sales Tax Agreement, that would significantly reduce the danger of states deviating from the *Wayfair* checklist. Similarly, if such a state were to seek collection authority without adopting the simplification and reduction in taxpayer burden envisioned by the *Wayfair* checklist, that would significantly increase the danger of states deviating from that checklist.

The credible but unacted-upon threat of congressional intervention may prove to be effective at limiting state tax authority, with no state choosing to pass a law to provoke congressional action.

Conclusion

We at the Tax Foundation have received inquiries from officials in nearly every state since the *Wayfair* decision was handed out. Our counsel has been to hew to the *Wayfair* checklist. We're then asked what we think Congress will do. Congress has several options for acting, and should not let the years-old conflict over desirable nexus standard get in the way of needed clarity on the areas of retroactivity, audit authority, the *Complete Auto* test, and legislation such as Mobile Workforce, Digital Goods, and BATSA. The nexus standard adopted in *Wayfair* by the Supreme Court is appropriate, given that the sales and use tax is borne, legally and economically, by residents of South Dakota making purchases online.

Thank you for the opportunity to submit this testimony. If we can provide any additional materials or answer any questions, please let us know. I may be reached at 202-464-6200 and henchman@taxfoundation.org.