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OPINION

‘Wayfair’: for small online retailers, future uncertain

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On June 21, the U.S. Supreme Court upended the online retail industry, giving states the power to force online retailers to collect sales tax from sales to consumers.

Prior to the landmark *South Dakota v. Wayfair* decision, the Department of Revenue in Massachusetts was unable to force online retailers that did not have a physical presence in the commonwealth to collect and pay over sales tax on goods sold to consumers in the state.

The Supreme Court’s 5-4 decision in *Wayfair* overruled 50 years of precedent and dramatically altered the tax rules for states, online retailers, and brick-and-mortar retailers.

The decision creates a level playing field for brick-and-mortar retailers by allowing states to collect sales tax that has evaded collection in many online transactions. Massachusetts small businesses with an online retail business, however, are now faced with substantial increases in their cost of doing business.

History

The 5-4 decision in *Wayfair* overruled the Supreme Court’s divisive 1992 rule in *Quill Corp. v. North Dakota*, which states have tried to “kill” for years through lawsuits and regulation.

To understand the significance of *Wayfair*, it is necessary to understand some of the history leading up to it.

National Bellas Hess

In *National Bellas Hess v. Department of Revenue of Illinois*, 386 U.S. 753 (1967), the Supreme Court ruled that a mail-order reseller was not required to collect sales tax unless it had some physical contact with the state.

Located in Missouri, National Bellas Hess was a mail-order seller of various consumer products. It owned no tangible property in Illinois and had no sales outlets, representatives, telephone listing, or solicitors in that state. It mailed catalogs to customers, and orders for merchandise were mailed to its Missouri plant. Goods were sent to customers by mail or common carrier.

The state of Illinois attempted to force National Bellas Hess to collect sales tax from its customers. The Supreme Court held that the commerce clause prohibits a state from imposing the duty of use tax collection and payment upon a seller whose only connection with customers in the state is by common carrier or by mail.

Complete Auto

Ten years later, a unanimous Supreme Court ruled in favor of Mississippi in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977).

Complete Auto was an auto transporter that moved vehicles from the railhead at Jackson, Mississippi, to dealerships.

The Mississippi State Tax Commission levied a tax on Complete Auto “for the privilege of engaging or continuing in business or doing business” in the state. Complete Auto argued that the tax was unconstitutional because Complete Auto was part of an interstate operation and that such a tax is therefore a violation of the commerce clause.

The Supreme Court held that businesses involved in interstate commerce should assume a just share of the state tax burden and established four criteria to be met for a state tax to be valid and not an unreasonable burden on interstate commerce: The tax must be (1) based on an activity connected to the state, (2) fairly apportioned, (3) nondiscriminatory, and (4) related to state services provided by the state.

Quill

In 1992, the Supreme Court revisited *National Bellas Hess* and *Complete Auto* in *Quill Corp. v. North Dakota*.

North Dakota argued that under due process, Quill Corp. had established a presence in North Dakota as the floppy disks holding Quill’s software provided to North Dakota customers were physically located in their state.

The court stated that the commerce clause gives the federal government power to regulate interstate commerce and prohibits certain state actions, such as applying duties that interfere with trade among the states. The court also concluded that *Complete Auto* did not limit or undo its holding in *National Bellas Hess*.

The court held that a corporation can have the minimum contacts required by due process and still fall short of the substantial nexus required by the dormant commerce clause. The court also stated that the bright-line rule of *National Bellas Hess* “furthers the ends” of the dormant commerce clause.

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The law after ‘Wayfair’

Writing for the majority, Justice Anthony Kennedy stressed the impact of modern technology.

“It is not clear why a single employee or a single warehouse should create a substantial nexus while ‘physical’ aspects of pervasive modern technology should not,” Kennedy wrote. “For example, a company with a website accessible in South Dakota may be said to have a physical presence in the State via the customers’ computers. A website may leave cookies saved to the customers’ hard drives, or customers may download the company’s app onto their phones.”

Although the court struck down *Quill*, it said the four-pronged test from *Complete Auto* remains the standard for commerce clause disputes. The court did not rule whether South Dakota’s economic nexus law would be valid under the *Complete Auto* analysis and remanded the case for further proceedings.

Justice Kennedy’s opinion, however, suggested that South Dakota’s sales tax law would likely pass muster and noted the following in support: (1) the $100,000 sales and 200 transaction “safe harbor” that could not be exceeded “unless the seller availed itself of the substantial privilege of carrying on a business in South Dakota”; (2) the law’s protection against retroactive application; and (3) South Dakota’s adoption of the Streamlined Sales and Use Tax Agreement.

In the dissenting opinion, the Chief Justice John Roberts wrote that it should be left up to Congress to regulate commerce and that the court’s ruling may have torpedoed attempts by Congress to find a legislative solution that could apply to all states.

“Armed with today’s decision, state officials can be expected to redirect their attention from working with Congress on a national solution, to securing new tax revenue from remote retailer,” Roberts wrote.

Impact in Massachusetts

For Massachusetts, the ability to require sales tax collection from all online sellers last year would have meant between $169 million and $279 million in additional revenue, a GAO report found.

The question remaining after *Wayfair* is whether Massachusetts’ sales tax nexus law, DOR Directive 17-1, is constitutional.

Directive 17-1 applies to online retailers who sell more than $500,000 in tangible personal property to Massachusetts consumers in more than 100 transactions, requiring them to register and collect sales tax on sales to Massachusetts consumers. This “safe harbor” provision appears to provide online retailers greater protection than what the Supreme Court seemed to indicate was sufficient for South Dakota’s tax authority.

Thus, Massachusetts would likely satisfy the fourth prong of *Complete Auto* since online retailers will enjoy the benefit of being able to avail themselves of Massachusetts state courts for potential disputes with consumers and police protection to ensure safe delivery of their product.

Brick-and-mortar retailers

Massachusetts brick-and-mortar retailers can now feel like they are operating on a level playing field with online retailers. The proliferation of smart phones and internet access allows for direct price comparison while shopping in stores. Sales tax, however, may no longer be a factor in such comparison shopping, as the tax may now be collected both for in-store and online purchases.

Small businesses faced with soaring costs

Small businesses with an online presence will now need to comply with the laws of as many as potentially 10,000 or so state and local jurisdictions across the country. As Chief Justice Roberts argued in his dissent, states applying their own rules and regulations to the collection of sales taxes from online sellers “will likely prove baffling for many retailers,” with the burden falling “disproportionately on small businesses.”

Take the following examples noted in Chief Justice Roberts’ opinion: “Texas taxes sales of plain deodorant at 6.25 percent but imposes no tax on deodorant with antiperspirant,” Roberts wrote. “Illinois categorizes Twix and Snickers bars — chocolate and caramel confections usually displayed side-by-side in the candy aisle — as food and candy, respectively (Twix have flour; Snickers don’t), and taxes them differently.”

Although the majority opinion noted the availability and anticipated proliferation of sales tax management software, it remains to be seen whether software that is robust enough to keep up with changes in sales tax laws across 10,000 jurisdictions will actually be cost effective. Moreover, software does not prevent audits.

Indeed, anyone who has endured a sales and use tax audit in Massachusetts knows that it is a tedious and time-consuming process. Retailers must have all transactions documented properly and be prepared to have register tapes or whatever other information is used to record individual transactions, including exemption certificates.

The auditor will have the right to require the business to show sales tax returns; excise tax returns; documentation for use tax, retail sales tax, business and occupational tax; and all critical records related to the business.

In addition, the auditor will require a business to produce bank records to compare the sales tax returns to actual sales.

Takeaway

The *Wayfair* decision gives states that rely on sales tax as a source of revenue the opportunity to collect what is owed and levels the playing field somewhat between online and brick-and-mortar retailers.

Large online retailers, such as Amazon, that already voluntarily collect sales tax will be able to absorb the additional cost of doing business much easier than small businesses. Small online retailers are left with a great deal of uncertainty over when to collect sales tax, how to do it efficiently, and how to comply. MLW

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