Wayfair and its Impact on Income Tax Nexus

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A Look Ahead

- **Life Before *Wayfair***
- ***South Dakota v. Wayfair, Inc.***
- **Incidental Effects of *Wayfair***
- **Factor-Presence Nexus Standard**
- **Market-Based Sourcing**
- **Due Process Clause Implications**
- **Public Law 86-272**

Life Before *Wayfair*

- ***Quill* - Division in nexus standards**
  - "Despite the similarity in phrasing, the nexus requirements of the Due Process and Commerce Clauses are not identical. The two standards are animated by different constitutional concerns and policies."
  - Pre-Wayfair Substantial Nexus (Commerce Clause)
    - Sales tax - required physical presence in the state
    - Income tax - less certainty, but already trending to economic presence
  - Due Process Nexus required "minimum contacts" and "purposeful direction" to the state

Life Before *Wayfair*

- **Several states challenged the boundaries of income tax nexus to tax entities with "economic presence" in their state beyond physical presence**
  - New Hampshire
    - Economic presence – evidenced by a *purposeful direction* of business toward the state examined in light of the frequency, quantity, and systematic nature of a business organization's economic contacts with the state
  - Oregon
    - Economic presence – the taxpayer regularly takes advantage of Oregon's economy to produce income
    - *Capital One Auto v. Department of Revenue* – Oregon Tax Court upheld the statute stating "substantial nexus can be established by economic presence alone"

Life Before *Wayfair* (Cont'd)

- **State high courts across the U.S. have held economic presence is sufficient to establish a substantial nexus under the Commerce Clause for their corporate income tax and gross receipts tax**
  - South Carolina – *Geoffrey v. South Carolina Tax Commission* – licensing intangibles, such as trademarks, in a state and "deriving income from their use" will establish a substantial nexus with the state for purposes of income tax
  - New Jersey – *Lanco v. Director, Division of Taxation* – even if a corporation has no physical presence, if it derives income from NJ source due to a license agreement, the state can collect income tax without violating the Constitution
  - West Virginia – *Tax Commissioner v. MBNA America Bank* – state can assess income and franchise tax on a corporation if it has a substantial economic presence in the state, which is evaluated by looking at if a corporation engaged in "systematic and continuous business activity in the State" that "produced significant gross receipts"
  - Ohio – *Crutchfield Corp. v. Testa* – upheld factor presence test to impose gross receipts tax on out of state sellers of tangible personal property

South Dakota v. Wayfair, Inc.
138 S. Ct. 2080 (2018)

- **Background**
  - South Dakota statute imposed sales/use tax on remote sellers that had $100,000 (annual) of sales to South Dakota residents or engaged in 200 or more transactions as a direct challenge to *Quill Corp. v. North Dakota*
- **Holding**
  - Overruled the physical presence rule of *Quill*
  - State may require sellers with no physical presence in the state to collect and remit sales tax for goods sold within the state as long as they have a substantial nexus with the taxing state
  - Substantial nexus – when taxpayer avails itself of the substantial privilege of carrying on business in that jurisdiction
  - Marriage of nexus standards?
    - "When considering whether a State may levy a tax, Due Process and Commerce Clause standards may not be identical or coterminous, but there are significant parallels."
  - Examine economic and virtual contacts the seller has with the state

Incidental Effects Following *Wayfair*

- **Application of substantial nexus standard in context of income tax**
  - While the decision concerned sales/use tax, the Court in *Wayfair* did not explicitly discuss the application of substantial nexus to income tax
  - Nonetheless, the dormant Commerce Clause is not violated by using economic presence as the standard for nexus in the sales/use tax context, there is arguably no barrier to it being used in the income tax context
  - *Wayfair* lends support for state statutes and court decisions affirming that substantial nexus can be found in the case of income tax if a corporation has economic presence in the state

Incidental Effects Following *Wayfair* (Cont'd)

- **Supreme Court has repeatedly refused to hear challenges regarding nexus standards in the area of income tax**
  - The Supreme Court has declined to accept cases where a state supreme court considered economic presence enough to satisfy the substantial nexus requirement under the dormant Commerce Clause – examples:
    - West Virginia
      - *Tax Comm'r v. MBNA America Bank* – if a corporation has a substantial economic presence in the state, income and franchise taxes may be collected by the state
      - *Griffith v. ConAgra Brands* – WV Supreme Court reversed an assessment of income tax on a licensor of intangibles based on the actions of unrelated third party licensees
    - Massachusetts – *Capital One Bank v. Comm'r of Revenue* – economic activity of Capital One, including solicitation and providing financial services to Massachusetts consumers, was enough to establish a substantial nexus to justify imposing an income tax on Capital One

Incidental Effects Following *Wayfair* (Cont'd)

- **Reliance interest is not so reliable**
  - *Wayfair* discussed how reliance interests based upon the Court's previous decision in *Quill* were misplaced due to the tax distortion that resulted from the physical presence rule
  - *Stare decisis* only encompasses "legitimate reliance interests," which do not include tax avoidance
  - *Wayfair* arguably stands for the proposition that *stare decisis* and reliance interests will not protect corporations who take advantage of distortions in tax law to achieve the most advantageous tax scenarios, specifically when a distortion gives one corporation an unfair advantage over another

Incidental Effects Following *Wayfair* (Cont'd)

- **Undue burden analysis**
  - Revival of *Pike v. Brice Church* balancing test?
    - Examine the burden on interstate commerce versus local (government) benefit
  - The Court was not persuaded by the argument that complex tax systems would create a burden on interstate commerce, and instead encouraged those small businesses with *de minimis* contacts to pursue other theories
    - Possible "Other Theories:"
      - Small businesses with *de minimis* activities in the state would likely fall within the safe harbor of 200 transactions or $100,000 in sales
      - The Court may have been referencing the established legal principle that *de minimis* business activities cannot create nexus. As stated in *Wisconsin Dept. of Revenue v. Wrigley*, "*de minimis non curat lex* ("the law cares not for trifles")."
  - Does the complex tax systems issues plan the same role for income tax that is plays in the sales / use tax area?

Incidental Effects Following *Wayfair* (Cont'd)

- **Retroactivity**
  - The South Dakota statute at issue in *Wayfair* did not apply to taxpayers retroactively
  - When analyzing the South Dakota statute, the statute not applying retroactively was a feature of the system that was "designed to prevent discrimination against or undue burdens upon interstate commerce"
  - However, the Court stated that retroactivity as a concern for taxpayers does not justify retaining misplaced precedent that "deprives States of vast revenues from major businesses"
  - This could be read that even though the Court appreciated that South Dakota's statute did not apply retroactively, a statute that did apply retroactively may pass Constitutional muster in situations where there a large distortions in the market
  - States don't believe Quill's physical presence rule eve applied to income taxes and so don't see a retroactivity issue with economic nexus for income taxes

Incidental Effects Following *Wayfair* (Cont'd)

- **Factor-Based Standards**
  - *Wayfair* sets the standard for "economic presence" as delivering more than $100,000 of goods or services (sales) or engaging in 200 or more transactions
  - The Court stated that this quantity of business would not have been possible "unless the seller availed itself of the substantial privilege of carrying on business in South Dakota"
  - Similar factor-based standards are likely to emerge in the income tax arena (and some already have)
  - Does the MTC factor presence nexus income tax statute satisfy the same constitutional concerns addressed by SD's 200 transaction or $100,000 threshold for sales tax?

Factor-Presence Nexus Standard

Net Income and Gross Receipt Taxes

- **Multistate Tax Commission model rule**
  - Nexus will be established with a state due to business activity if the taxpayer exceeds any of the following thresholds:
    - $50,000 of property,
    - $50,000 of payroll,
    - $500,000 of sales, or
    - 25% of total property, total payroll, or total sales

Factor-Presence Nexus Standard (Cont'd)

Net Income and Gross Receipt Taxes

- **State courts have upheld statutes establishing factor-presence nexus standard**
  - Ohio – *Crutchfield v. Testa* – $500,000 sales receipt threshold "satisfies the substantial-nexus standard under dormant Commerce Clause"
- **States adopting these statutes will likely increase following *Wayfair***
  - States currently applying factor-presence standards – Alabama, California, Colorado, Connecticut, Michigan, New York, Ohio, Tennessee, and Virginia

Market Based Sourcing and Nexus

- National trend - market based sourcing statutes have been enacted in 27 states
  - Sourcing sales of tangible personal property to the delivery location
  - Sourcing sales of services to the state where the service is delivered or where the customer receives a benefit
  - Sourcing of sales of intangible property to the state where customer uses *or has the right to use* the property
- Substantial nexus must be established before market based sourcing can be applied to a corporation without a physical presence in the state
  - Now that physical presence is not required for substantial nexus, what are the limits?
  - If the a sale is sourced to a state based on where the *purchaser* receives a benefit or uses the property, can the actions of a *purchaser* create nexus for the *seller*?
    - A looming issue for dealers of intangible property and content creators
      - *NASCAR Holdings, Inc. v. Jeffrey A. McClain* (Ohio Board of Tax Appeals)

Due Process Clause Implications

- **Due process may now be the only limit on state power to tax corporations**
  - *Is there a difference between Due Process and Commerce Clause nexus standards?*
  - *Quill* eliminated the physical presence requirement to satisfy the Due Process clause, which requires a link between the state and the transaction it seeks to tax
  - To satisfy the Due Process clause, a corporation must “purposefully direct its activities at” a specific state
  - For states that have enacted market based sourcing, this means corporations who may have receipts sourced to a particular state, but did not direct activity at consumers in that state, may be able to use the Due Process clause to protect themselves from state income tax

Public Law 86-272

- **PL 86-272**
  - States cannot impose net income tax on income derived within a State by any person from interstate commerce if the corporation's only business activities are solicitation of orders for tangible personal property that are approved or rejected outside the state and shipment and delivery is filled from somewhere outside the state
  - Federal law applies even in states that have enacted factor-presence nexus standards or where the courts have allowed for an economic presence nexus standard
- **Following *Wayfair*, PL 86-272 is still applicable to sellers of tangible personal property**
  - The question then becomes, what are protected business activities under PL 86-272 and what are not protected business activities?
  - Massachusetts – "cookie" nexus regulation: internet vendors have physical presence in Massachusetts due to the use of software which Massachusetts considers a property interest
  - If statutes like the one in Massachusetts survive Constitutional challenge, the use of cookies or software in a state could constitute physical presence, taking corporations involved in selling tangible personal property out of the umbrella of protection offered by PL 86-272

Time to Update Public Law 86-272?

- **Should PL 86-272 extend to sellers of intangible property and services?**
  - PL 86-272 was enacted in 1959 – the economy has changed greatly since then
    - In 1959, services made up 48.8% of the U.S. Private Sector GDP
    - In 2015, services made up 78.9% of the U.S. Private Sector GDP
- **Does anyone just sell TPP anymore?**
- **What does it mean to “approve an order” out of the state when the transaction is completed online?**
  - The internet is everywhere and nowhere all the time
- **New economy, new tax policy?**

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