

Taxing Digital Sales in the United States

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U.S. Treasury Viewpoint

- ▶ European Commission and several OECD MSs under pressure to find ways to impose income taxes on remote sales and on profits that result from local user input
- ▶ The U.S. Treasury opposes these initiatives, believing such tax rules would harm U.S. tech companies
- ▶ U.S. wants to tax the profits, and starting this year, it will tax them without deferral under the GILTI

U.S. Viewpoint

"The U.S. firmly opposes proposals by any country to single out digital companies. Some of these companies are among the greatest contributors to U.S. job creation and economic growth. Imposing new and redundant tax burdens would inhibit growth and ultimately harm workers and consumers. I fully support international cooperation to address broader tax challenges arising from the modern economy and to put the international tax system on a more sustainable footing."

--U.S. Treasury Secretary Steven T. Mnuchin, in statement regarding the OECD report, March 16, 2018

U.S. Viewpoint

- ▶ Among other reasons for opposing digital taxation:
 - ▶ We already have a mechanism for taxing remote sales—consumption taxation
 - ▶ Cleaving off digital companies for special taxation will create sectoral distortions
 - ▶ Many definitional problems, etc.

Background to *Wayfair*, a
U.S. Supreme Court case
decided last Thursday...

Two Thresholds to Tax

- ▶ In order for a tax to be legal in the U.S., it must meet two constitutional thresholds:
 - ▶ Due Process
 - ▶ Commerce Clause

Due Process Nexus

- ▶ To tax, a U.S. state must have **due process jurisdiction**
- ▶ The Due Process Clause constrains the State's power to burden interstate commerce, requiring that a "minimum connection" exist between the state and what it is trying to tax.
- ▶ Standard is "minimum contacts" sufficient to prevent "offend traditional notions of fair play and substantial justice" *International Shoe* (1945)
- ▶ No physical presence requirement. *Burger King* (1985).

Dormant Commerce Clause

Text: “The Congress shall have Power...To regulate Commerce with foreign nations, and among the several states, and with the Indian Tribes”

(Article I, Section 8)

Interpretation: Because Congress has **exclusive power** to regulate interstate commerce, the states may not (1) discriminate against or (2) unduly burden interstate commerce.

Complete Auto (1967) Test

- ▶ A tax will be sustained against a Commerce Clause challenge as long as it:
 - 1) “is applied to an activity with a **substantial nexus** with the taxing state”
 - 2) “is fairly apportioned”
 - 3) “does not discriminate against interstate commerce”
 - 4) “is fairly related to the services provided by the state”

Two Nexus Requirements

- ▶ Due Process nexus (fundamental fairness)
 - ▶ Dormant Commerce Clause nexus (protects interstate commerce)
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- ▶ These standards are not the same... so a state can have DP nexus without DCC nexus
 - ▶ This difference matters for digital sales.

Bellas Hess (1967)

- ▶ Decided three weeks after *Complete Auto*
- ▶ Interprets dormant Commerce Clause nexus
- ▶ Bellas Hess was a mail-order service with its principal place of business in Missouri; it had nothing in Illinois.
- ▶ Only “presence” in Illinois was mailing catalogues and flyers to customers there

Bellas Hess (1967)

- ▶ Holding: a vendor whose only contacts with the state are by mail lacks the “substantial nexus” required by the Commerce Clause, so a state cannot require it to collect and remit sales taxes owed by consumers
- ▶ Came to be known as the “physical presence requirement”
- ▶ Court was concerned about subjecting interstate sellers to a variety of changing tax rules in tens of thousands of local taxing jurisdictions

Between Bellas Hess and Quill

- ▶ The Supreme Court brought due process nexus and dormant Commerce Clause nexus closer and closer together, so that a state that had due process nexus would almost always have dormant Commerce Clause nexus
- ▶ Out-of-state sellers became liable for income taxes even in states where they lacked physical presence
- ▶ But sales tax collection was a last hold-out for the dormant Commerce Clause “physical presence requirement”

Quill Corp. v. North Dakota (1992)

- ▶ Supreme Court revisited with physical presence requirement in the early 1990s in *Quill*
- ▶ People thought the Court would overturn *Bellas Hess* because the Court had eliminated the physical presence requirement for income taxation

Quill Corp. v. North Dakota (1992)

- ▶ BUT... the Court re-affirmed *Bellas Hess*
 - ▶ “Although in our cases subsequent to *Bellas Hess* and concerning other types of taxes we have not adopted a similar bright-line, physical-presence requirement, our reasoning in those cases does not compel that we now reject the rule that *Bellas Hess* established.”
- ▶ Court liked the bright line
- ▶ Was still concerned about the difficulty of applying with rules of lots of different taxing jurisdictions
- ▶ It also was reluctant to overrule itself

Between *Quill* and *Wayfair*: The Growth of Digital Retail

- ▶ The U.S. Census Bureau estimated that digital retail sales in the U.S. in 2017 totaled over \$452 billion, or 9% of all retail sales and a 16% increase from 2016
- ▶ It estimated total digital retail sales for the first quarter of 2018 at \$123.7 billion, an increase of ~3.9% from the fourth quarter of 2017
 - ▶ *This is disputed data.
- ▶ In any case, digital sales are not a huge portion of overall sales. In 2008, the Bureau estimated that just 3.5% of total retail sales were e-commerce sales
 - ▶ In its brief, Wayfair argued that relevant data indicates retail ecommerce actually comprises a smaller percentage of total retail sales than catalog sales did in 1992 when *Quill* was decided. Brief of Respondents, *Wayfair v. South Dakota*, No. 17-494 (Sup. Ct. 2018).
- ▶ Revenue loss estimates range widely, from \$8 to \$33 billion annually.

Between *Quill* and *Wayfair*: *Standardization*

- ▶ About half the states are members of the Streamlined Sales and Use Tax Association (SSUTA)
- ▶ Standardizes sales tax bases
- ▶ State sales tax bases are highly variable—imagine the cookie-or-cake dispute—but on the *local*, rather than national scale!
- ▶ Online sellers have legitimate concerns about costs of compliance because standardization projects have only partially succeeded, and many states don't participate in standardization.

Between *Quill* and *Wayfair*: End-running “Physical Presence”

- ▶ “Today, determining physical presence is an increasingly fraught and difficult question mostly because modern commerce just does not map onto traditional notions of ‘physical’ presence in obvious ways. Does the presence of the Overstock.com app on consumers’ smartphones count? Does its interactive storefront on desktop computers? What consequence is there if these companies install uninvited ‘cookies’ on users’ devices that monitor their online interactions and provide targeted advertising?”
Brief of Petitioner, *Wayfair v. South Dakota*, No. 17-494 (Sup. Ct. 2018).
- ▶ The physical presence rule forced states to get creative...

Between *Quill* and *Wayfair*: End-running “Physical Presence”

- ▶ To get around *Quill*, Colorado enacted a law imposing onerous reporting requirements on out-of-state sellers whose gross sales in CO exceed \$100,000:
 - ▶ Residents who purchase goods from retailer that does not collect sales or use taxes must file return, remit taxes directly to Dept. of Revenue
 - ▶ Noncollecting retailers must notify CO customers of requirement, report tax-related info to customers and to Dept. of Revenue. Must provide this notice during each transaction with purchaser, subject to \$5 penalty for each transaction in which it fails to do so
 - ▶ By Jan. 31 of each year, each noncollecting retailer must also send report to all CO customers who bought more than \$500 from retailer in previous year, listing dates, categories, amounts of those purchases, include notice of tax
 - ▶ By Mar. 1 of each year, retailer must send statement to Dept. of Revenue listing names of CO customers, addresses, total amount each CO customer paid for CO purchases in prior year

DMA sues, claiming Colorado law is unconstitutional. *Direct Mktg. Ass’n v. Brohl* (Sup. Ct. 2015).

Time to Overturn *Quill*?

- ▶ Supreme Court upheld Colorado's reporting requirements
- ▶ Justice Kennedy (and now) Justice Gorsuch suggested it was time to reconsider *Quill*
 - ▶ J. Kennedy: "Although online businesses may not have a physical presence in some States, the Web has, in many ways, brought the average American closer to most major retailers...Given these changes in technology and consumer sophistication, it is unwise to delay any longer a reconsideration of the Court's holding in *Quill*. A case questionable even when decided, *Quill* now harms States to a degree far greater than could have been anticipated earlier." *Direct Mktg. Ass'n v. Brohl*, Sup. Ct. 2015 (J. Kennedy, concurring)
 - ▶ J. Gorsuch: "*Quill*'s very reasoning...seems deliberately designed to ensure that *Bellas Hess*'s precedential island would never expand but would, if anything, wash away with the tides of time." *DMA v. Brohl II*, 10th Cir. 2016 (J. Gorsuch, concurring with Circuit Court's holding in favor of Colorado)

South Dakota Responds to the Justices' Invitation

- ▶ 2016: South Dakota enacted Senate Bill 106, "An act to provide for the collection of sales tax from certain remote sellers" (SDCL Chapter 10-64)
- ▶ Act amended sales tax code to require any seller that does not have a physical presence in the state to report sales tax based on statutory thresholds of \$100,000 in sales or 200 transactions for delivery into South Dakota in the previous or current calendar year
- ▶ SD needed a test case: the legislature devised the standards such that SCOTUS decision would be necessary to change existing doctrine in order for Act to be enforced
- ▶ (Supreme Court considers the case on appeal from lower courts' summary judgment in favor of the online retailers)

Wayfair v. South Dakota

- ▶ U.S. Solicitor General's office argues *in favor* of South Dakota, that is, in favor of imposing burdens on out-of-state sellers:
 - ▶ "A constitutional rule exempting certain out-of-state retailers from applicable state-tax-collection requirements imposes a competitive disadvantage on in-state retailers and encourages the State's citizens to take their business elsewhere."
 - ▶ "A state law that prevents a business from capitalizing on its customers' desire to avoid paying taxes they lawfully owe does not 'burden' the business, or interstate commerce, at least in any constitutionally relevant sense."

--Brief of the United States as Amicus Curiae Supporting Petitioner, *Wayfair v. South Dakota*, No. 17-494 (Sup. Ct. 2018).

Time to “Kill Quill”?

- ▶ Before the oral argument, everyone thought that the Supreme Court was sure to “kill Quill.”
- ▶ It was roundly agreed that Quill was not only a mistaken interpretation of the law, but an especially damaging one because it introduced unwarranted advantages for out-of-state sellers that lacked physical presence
 - ▶ Amazon beats Borders
 - ▶ Giant online retailer beats mom-and-pop store
- ▶ It also induced online sellers to avoid establishing physical presence in any new states, thereby ironically inhibiting some forms of interstate commerce

The Line to Hear the Oral Argument



The Oral Argument Raised Doubts...

- ▶ Justices expressed concern that they were not given facts they could rely on
 - ▶ J. Breyer: “[W]hy is it...[that] you [petitioner and respondent] have wildly different estimates of costs, revenues, and what states are losing or not?”
- ▶ They also expressed concerns about retroactivity and the possibility that compliance obligations would strangle small businesses in red tape
 - ▶ S.D.’s lawyer argued that overturning Quill would mean that an out-of-state seller would trigger the collection obligation upon its very first (and possibly only) sale into the state.
 - ▶ What about the Etsy crafters selling their crocheted doilies and jam? Can they really be expected to comply with the tax rules of 50,000 localities?
 - ▶ There was discussion about whether software already existed or would be produced that could help sellers comply

By now, many of you know...

- ▶ SCOTUS killed Quill.
 - ▶ More than 50 years after *Bellas Hess*
 - ▶ More than 25 years after *Quill*
- ▶ Close case (5-4), but even the dissenters agreed that Quill was wrongly decided, They just thought that stare decisis should prevail, and if a change was needed, it should come from Congress.

But what does it mean?

- ▶ Narrow holding: dormant Commerce Clause does not require physical presence before a state may impose a sales tax obligation
- ▶ But what the Court doesn't tell us is what IS required
 - ▶ It approved of SD's rule
 - ▶ 200 sales annually (Etsy sellers excluded)
 - ▶ Or \$200,000 in sales
 - ▶ SD is a SSSUTA state
 - ▶ We may get standardization around these thresholds, since they have judicial approval
- ▶ Congress may act—either to prevent states from obliging remote sellers to collect or by fixing a uniform threshold.

What this case was not about

- ▶ Wayfair was not about remote sellers' liability for tax. It was about their obligation to collect and remit sales taxes for which their customers were liable
- ▶ Remote sellers were already liable for income tax in the states where they do business under both the Due Process and dormant Commerce Clauses. *Bellas Hess* and *Quill* had established an "island" of exemption regarding their susceptibility to sales tax collection obligations
 - ▶ Wayfair brought sales tax in line with the rest of the Court's dormant Commerce Clause doctrine, eliminating the physical-presence requirement
- ▶ Business income apportionment in the United States is via formula, and different state have different formulas

Open questions

- ▶ Retroactivity
- ▶ What is the standard by which courts should judge the new sales tax collection statutes the states devise?
 - ▶ Court didn't specify, but it mentioned all of
 - ▶ *Pike* balancing -- the court weighs the state's interest in regulating against the burden the regulation imposes on interstate commerce to determine if the burden is "undue"
 - ▶ Apportionment (internal consistency)
 - ▶ Discrimination (also internal consistency)
 - ▶ And even dormant Commerce Clause nexus is still alive and differs (no one's sure how much, but not a lot) from Due Process nexus

Congress can intervene

- ▶ Could standardize
 - ▶ E.g., the threshold (e.g., number of sales)
 - ▶ E.g., the base and rates
- ▶ Could forbid
 - ▶ The states from taxing remote sellers that lack physical presence
- ▶ Congress has broad powers to control state taxation under the Commerce Clause, but it rarely exercises them
 - ▶ One exception is the Internet Tax Freedom Act, which bans taxing internet access, and it also bans “multiple or discriminatory taxes on electronic commerce.” It’s a Clinton-era federal law (1998) that would likely ban all the forms of digital taxation now being considered if any U.S. state tried to adopt them

► Thank you!