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Wayfair, Inc.: Analysis from an Income Tax Perspective

The guidance provided by the Court in *Wayfair* may have application in all areas of state taxation to which the Commerce Clause applies.

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On June 21, 2018, *South Dakota v. Wayfair, Inc., et al. (Wayfair)* was decided by the U.S. Supreme Court.[1]

Though *Wayfair* specifically considered whether the South Dakota sales and use tax statute was valid under the Commerce Clause of the U.S. Constitution, the guidance provided by the Court may have application in all areas of state taxation to which the Commerce Clause applies.[2] This article discusses the effect of the *Wayfair* decision on state income taxes and includes a discussion of prior rulings to highlight the implication of *Wayfair* on income taxation.

Commerce Clause

The purpose of the Commerce Clause is to protect the U.S. economy from state-imposed tariff-like actions that might harm it. The Supreme Court consistently has held that the Commerce Clause contains a negative command prohibiting certain state taxation even when Congress has failed to legislate on the subject. The Commerce Clause prevents a state from retreating into economic isolation or jeopardizing the welfare of the nation, as it would do if it were free to place burdens on the flow of commerce across its borders.

The Commerce Clause thus "reflect[s] a central concern of the Framers that was an immediate reason for calling the Constitutional Convention: the conviction that in order to succeed, the new Union would have to avoid the tendencies toward economic Balkanization that had plagued relations among the Colonies and later among the States under the Articles of Confederation."[3]

Due Process Clause

Like the Commerce Clause, the Due Process Clause prohibits certain state taxation. Unlike the Commerce Clause, the Due Process Clause prohibitions cannot be trumped by an act of Congress. While the Commerce Clause focuses on protecting the U.S. economy, the Due Process Clause focuses on ensuring fairness. One limitation the clauses have in common is that a taxpayer must have sufficient nexus with the state before the state can impose a tax. The *Quill* decision[4] ruled that the standard of nexus for Due Process Clause purposes is different from the standard for Commerce Clause purposes, and though the *Wayfair* decision modified the *Quill* decision, the Wayfair court still indicated that these two standards are similar but not coterminous.

Complete Auto Transit

In its 1977 ruling in *Complete Auto Transit, Inc. v. Brady*,[5] the U.S. Supreme Court established the modern day four-prong test used to determine whether a state tax is valid under the Commerce Clause. All subsequent rulings addressing the Commerce Clause, including *Quill and Wayfair*, have measured whether state tax is being challenged (sales or income tax) by the following four-prong test. The tax must pass all four tests to be valid.

- Substantial nexus: There must be a clear enough connection (nexus) between a state and a potential taxpayer to impose a tax.
- Nondiscrimination: The tax cannot discriminate against interstate commerce in favor of intrastate commerce.
- Fair apportionment: The state may only tax activity that is fairly apportioned to the state.
- Fair relationship to services provided by the state: The tax must have a fair relationship to services provided by the state.

Books could be written on the meaning of each prong of the test because uncertainty persists. As a result, there has been a mass of litigation on the Commerce Clause issue over the years. The prong that was the subject of litigation in *Wayfair and Quill* was the substantial nexus prong, which the remainder of this article addresses.

Substantial nexus: Pre-Quill

Before *Quill*, U.S. Supreme Court cases ruling that nexus existed involved a fact pattern in which the taxpayer had a substantial physical presence in the state. Based on a reading of U.S. Supreme Court cases up to that time, state tax practitioners had formed the opinion that a substantial physical presence was required before a state could subject a person to sales, income, or any other type of tax. Physical presence could be created via salesperson employees[6] or independent contractors making sales on the company's behalf.[7] Though having a physical presence was considered a requirement of substantial nexus, such presence in and of itself in a state was not sufficient to establish nexus where the presence was not substantial and the taxpayer did not purposefully avail itself of the state's market.[8]

Economic nexus: *Quill*

In *Quill*, North Dakota challenged the long-standing presumption that a physical presence is required before nexus can be established. However, the U.S. Supreme Court adhered to precedent and ruled against the state. In reaching its decision, the Court provided guidance in three areas that are pertinent to this discussion.

Purposefully avails itself of the benefits of an economic market

The *Quill* ruling established that nexus for due process purposes may be established if the entity being taxed purposefully availed itself of the state's economic market. The Court stated: "Applying these principles, we have held that if a foreign corporation purposefully avails itself of the benefits of an economic market in the forum State, it may subject itself to the State's in personam jurisdiction even if it has no physical presence in the State."

In support of this position, the Court cited *Burger King Corp. v. Rudzewicz*, 471 U.S. 462 (1985), a nontax jurisdictional case. This connection created by purposefully availing oneself of a market has become known as "economic nexus."

Distinction between Due Process Clause and Commerce Clause nexus

Similar to the Commerce Clause, the Due Process Clause has a multi-pronged test that must be met for a state tax to be valid. The two prongs are nexus and fair apportionment. Prior to the *Quill* decision, the nexus threshold for due process and the nexus threshold of the Commerce Clause were considered one and the same. The *Quill* ruling changed this because it stated that due process nexus required minimal connections that were satisfied through purposefully availing oneself of the state's economic market, or in other words, through economic nexus.

However, the Court also stated that the Commerce Clause has a higher nexus threshold than the Due Process Clause because the primary function of due process is to assure fairness, and the primary function of the Commerce Clause is to protect the U.S. economy from discriminatory practices of the states. In part, the Court stated the following:

> Due process centrally concerns the fundamental fairness of governmental activity. Thus, at the most general level, the due process nexus analysis requires that we ask whether an individual's connections with a State are substantial enough to legitimate the State's exercise of power over him. We have, therefore, often identified 'notice' or 'fair warning' as the analytic touchstone of due process nexus analysis. In contrast, the Commerce Clause, and its nexus requirement, are informed not so much by concerns about fairness for the individual defendant as by structural concerns about the effects of state regulation on the national economy . . . .
>
> Thus, the 'substantial nexus' requirement is not, like due process' 'minimum contacts' requirement, a proxy for notice, but rather a means for limiting state burdens on interstate commerce. Accordingly, contrary to the State's suggestion, a corporation may have the 'minimum contacts' with a taxing State as required by the Due Process Clause, and yet lack the 'substantial nexus' with that State as required by the Commerce Clause.

Quill's ambiguous language started the economic nexus controversy

Prior to *Quill*, the Court did not in any significant way indicate that the Commerce Clause would require a different nexus standard for income tax than for sales and use tax. However, in *Quill* the Court ruled very clearly that a bright-line physical presence standard exists for sales tax purposes because the case was a sales tax case. The Court created confusion in the state and local tax arena with the following language:

> Although we have not, in our review of other types of taxes, articulated the same physical presence requirement that *Bellas Hess* established for sales and use taxes, that silence does not imply repudiation of the *Bellas Hess* rule . . . ."
>
> In sum, 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 in the area of sales and use taxes. To the contrary, the continuing value of a bright line rule in this area and the doctrine and principles of stare decisis indicate that the *Bellas Hess* rule remains good law. For these reasons, we disagree with the North Dakota Supreme Court's conclusion that the time has come to renounce the bright line test of *Bellas Hess*.

In summary, the *Quill* decision:

- Clearly established that economic nexus (purposefully availing oneself of the state's market) was in and of itself sufficient to create nexus for due process purposes, but that something more may be required for Commerce Clause purposes.
- Clearly established for sales and use tax collection purposes that a physical presence must be a component of the substantial nexus for Commerce Clause purposes.
- Raised the idea that a physical presence may not be required for Commerce Clause nexus in the area of income tax.

Post-*Quill*, Pre-*Wayfair* economic nexus controversy

Many states read *Quill* to support the notion that economic nexus, if it was substantial, would in and of itself meet the substantial nexus requirements of the Commerce Clause in the area of income tax. Many states either passed new statutes adding economic nexus principles to their doing-business statutes or implemented economic nexus administratively. Taxpayers litigated the issue in the state court systems, and in most cases the taxpayer did not prevail. Many of these cases were appealed to the U.S. Supreme Court, which refused to hear the appeals.[9]

Many taxpayers argued that while the Court ruled that economic nexus met the Due Process Clause standard, it did not meet the Commerce Clause standard for nexus. In fact, the Court stated that the Commerce Clause demanded a higher nexus threshold. The ambiguous language in *Quill* regarding a bright-line physical presence test did not necessarily justify the states' position that economic nexus meets the Commerce Clause nexus standard for income tax purposes.[10] At a minimum, it is fair to say that *Quill* created uncertainty with respect to state income taxes.

Companies that take an uncertain tax position (for instance, not filing a return in a state based on *Quill*) are required to record a full reserve under U.S. GAAP (Accounting Standards Codification (ASC) 740-10) if the company concludes the uncertain tax position, on its merits, is not more likely to succeed if adjudicated. Many companies that did not file in a state merely due to economic nexus did not record a full ASC 740-10 reserve for this uncertain position because they felt the position would succeed if adjudicated by the U.S. Supreme Court. The *Wayfair* decision could change this position for many taxpayers.[11]

Wayfair: Economic nexus/virtual nexus

Wayfair revisited *Quill* and overturned its bright-line physical presence nexus standard. There were several noteworthy points about this case that could affect state income taxation:

The Court affirmed the Complete *Auto Transit* analysis

Though the Court rejected *Quill*, it made clear that it was not rejecting the traditional four-prong test of *Complete Auto Transit*. The rejection of *Quill* was a rejection of a prior interpretation of one of the prongs, but the four-prong test still stands as the test of the validity of state taxation under the Commerce Clause, including the need for substantial nexus. A few of the Court's statement on this issue included the following:

- The Court explained the now-accepted framework for state taxation in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977).[12]
- The Court will sustain a tax so long as it (1) applies to an activity with a substantial nexus with the taxing state, (2) is fairly apportioned, (3) does not discriminate against interstate commerce, and (4) is fairly related to the services the state provides.[13]
- The physical presence rule is not a necessary interpretation of the requirement that a state tax must be "applied to an activity with a substantial nexus with the taxing State."[14]

In sum, the four-prong test and the substantial nexus requirement of *Complete Auto Transit* were affirmed. Though a sufficient connection with the taxing state could be achieved through means other than a physical presence, the connection—whether physical, economic, virtual, or a combination thereof—must be substantial.

The Court provided guidance to measure substantial nexus

The Court did not leave a bright-line test for determining whether the substantial nexus threshold of the Commerce Clause is reached. However, statements in *Wayfair* provide guidance in determining whether the threshold of substantial nexus has been surpassed.

The nexus requirements of the Due Process Clause and the Commerce Clause are closely related but not coterminous. The Court stated: "This nexus requirement is 'closely related,' *Bellas Hess*, 386 U. S., at 756, to the due process requirement that there be 'some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax,' . . . . Due Process and Commerce Clause standards may not be identical or coterminous, but there are significant parallels."

Wayfair merely states that the thresholds are similar, but not the same. However, *Quill* made it clear that substantial nexus for Commerce Clause purposes was greater than the minimal connection required for due process. Recall that in *Quill*, the purposeful availing one's self of the state's economy created nexus for due process purposes. Additionally, *Quill* established that the nexus threshold for the Commerce Clause was higher than for the Due Process Clause. It appears that *Wayfair* did not overturn this concept; it merely overturned the physical presence requirement.

Targeted advertising coupled with instant access to a virtual storefront website can meet the threshold. The Court stated: "The 'dramatic technological and social changes' of our 'increasingly interconnected economy' mean that buyers are 'closer to most major retailers' than ever before – 'regardless of how close or far the nearest storefront.' *Direct Marketing Assn. v. Brohl*, 575 U.S. (2015) (Kennedy, J., concurring). Between targeted advertising and instant access to most consumers via any internet-enabled device, 'a business may be present in a State in a meaningful way without' that presence 'being physical in the traditional sense of the term.'"[15]

A business making a small volume of sales in the state in some instances might not meet the substantial nexus threshold. On this point the Court stated: "Respondents argue that 'the physical presence rule has permitted start-ups and small businesses to use the internet as a means to grow their companies and access a national market, without exposing them to the daunting complexity and business-development obstacles of nationwide sales tax collection.' Brief for Respondents 29. These burdens may pose legitimate concerns in some instances, particularly for small businesses that make a small volume of sales to customers in many States."[16]

With regard to this point, it should be noted that the Court believes this issue will go away as cheaper software becomes available. And if this issue became too much of a problem, the Court has indicated that Congress could fix it. Because South Dakota's statute applied only to vendors making more than $100,000 of sales in the state and South Dakota was a member of the Streamline Sales and Use Tax Agreement (SSUTA), the Court decided that the state's statues did not raise this concern. The $100,000 threshold assured that only taxpayers that make significant sales are subject to the compliance requirements. In addition, since the state was a member of the SSUTA, taxpayers are protected from a compliance process that would vary significantly from other states.

From an income tax perspective, this issue raises an interesting question. The Multistate Tax Commission (MTC) was formed years ago to promote uniformity in income tax systems and apportionment methodologies. At its inception, many states adopted the Multistate Tax Compact rules, but later moved away from them, adopting a single-factor apportionment formula and other provisions that shifted the tax burden to corporations located outside the state but selling into the state. In today's income tax compliance environment, few states follow the Compact sourcing provisions completely. The lack of uniformity arguably is more important for income tax purposes than sales tax purposes as many taxpayers could be subject to double taxation on their income due to this lack of uniformity.

For example, consider a law firm, XYZ, located solely in State A that provides a service to a client in State B. State A apportions service income based on costs of performance (location of employees) and State B uses market-based apportionment (location of customer). XYZ would be subject to tax on the same income in both states.

Additionally, the average compliance cost of filing an income tax return is significantly greater than the average compliance cost of filing a sales tax return—more than 10 times the cost of a sales tax return. It could be argued that the sales volume nexus threshold for income tax should be higher than the sales volume threshold for sales tax. It also could be argued that the sales volume nexus threshold for a state that adopts the Compact standard would be lower than the sales volume threshold for a state that does not do so.

Substantial nexus is established when a taxpayer avails itself of the substantial privilege of carrying on business in the state. The Court announced the new nexus standard as follows: "[S]uch a nexus is established when the taxpayer [or collector] 'avails itself of the substantial privilege of carrying on business in that jurisdiction.'"[17]

Two points need to be highlighted about this new nexus pronouncement. First, the standard appears to be the same for direct taxes, like income taxes, and indirect taxes, like sales taxes. For this reason, the Court referred to both the taxpayer on whom a direct tax is imposed and the collector on whom an indirect tax is imposed. Second, this standard is very similar to the due process standard articulated in *Quill*.[18] These two standards are juxtaposed below:

- *Quill* Due Process Clause nexus standard: "Applying these principles, we have held that if a foreign corporation purposefully avails itself of the benefits of an economic market in the forum State, it may subject itself to the State's in personam jurisdiction even if it has no physical presence in the State."
- *Wayfair* Commerce Clause nexus standard: "[S]uch a nexus is established when the taxpayer [or collector] avails itself of the substantial privilege of carrying on business in that jurisdiction."

This juxtaposition highlights some significant similarities and differences between *Quill* Due Process Clause nexus and *Wayfair* Commerce Clause nexus.

Economic nexus. Availing one's self of the benefits of a state's economy could create nexus.

Purposefulness. The *Quill* Due Process Clause standard requires purposefulness. This purposefulness often is established via targeted marketing (as is clear in the *Wayfair* case) or the lack of purposefulness can also be shown through the lack of targeted marketing (as was the case in *Miller Bros.*[19]). Though the *Wayfair* definition of economic nexus does not specifically include the word "purposefully," the case implies that this purposeful requirement exists for two reasons. First, as stated earlier, the Court implied the adoption of the *Quill* standard that the Commerce Clause threshold is equal to the Due Process Clause threshold plus something more. Therefore, if purposefulness is required for Due Process Clause nexus, it also would be required for Commerce Clause nexus. Second, as stated earlier, the Court states that an online store website plus directed adverting would meet the nexus standard. The addition of the advertising component to the Court's statement seems to indicate that purposefulness of exploiting the market is required.

Substantial. Unlike the *Quill* Due Process Clause nexus definition, the *Wayfair* definition contains the word "substantial." Prior cases state that nexus must be substantial to meet the Commerce Clause threshold. However, the way substantial is used in the *Wayfair* definition is somewhat ambiguous. It is unclear what is being modified by the word "substantial." An alternative reading is that availing one's self of the privilege of economically or virtually carrying on business in the state is, in and of itself, substantial, regardless of the magnitude of the transactions in the state. Another alternative reading is that availing oneself of the state's market (whether economically, virtually, or physically) must be substantial before the threshold is met. This alternative reading appears more consistent with prior cases and the overall language in *Wayfair*. In other words, a small transaction in the state, in and of itself, would not create nexus. Instead, the overall transactions in the state must reach a substantial level before the Commerce Clause nexus threshold is met.

The Court is reluctant to use the Commerce Clause

As more of the judges on the Court have a strict interpretation philosophy, the Court is very reluctant to use the Commerce Clause to overturn a state's right to tax. This is a state's rights issue. On this issue, the Court stated:

> The physical presence rule as defined and enforced in *Bellas Hess* and *Quill* is not just a technical legal problem—it is an extraordinary imposition by the Judiciary on States' authority to collect taxes and perform critical public functions. Forty-one States, two Territories, and the District of Columbia now ask this Court to reject the test formulated in *Quill*. See Brief for Colorado et al. as Amici Curiae. *Quill*'s physical presence rule intrudes on States' reasonable choices in enacting their tax systems. And that it allows remote sellers to escape an obligation to remit a lawful state tax is unfair and unjust. It is unfair and unjust to those competitors, both local and out of State, who must remit the tax; to the consumers who pay the tax; and to the States that seek fair enforcement of the sales tax, a tax many States for many years have considered an indispensable source for raising revenue.

The Court is not saying that the Commerce Clause should never be used to limit a state's ability to tax. However, the Court clearly is reluctant to interfere in this area when the specific right to regulate the taxation of interstate commerce was given to Congress.

Looking ahead

The recent *Wayfair* decision provides guidance not just for sales and use tax purposes, but for all nexus determinations made under the Commerce Clause. While expressing its reluctance to use the Commerce Clause, the Court affirmed the *Complete Auto Transit* analysis. The Court concluded that nexus is established when the taxpayer or collector avails itself of the substantial privilege of carrying on business in a jurisdiction, thus clarifying that economic or virtual nexus can meet the nexus threshold of the Commerce Clause. Taxpayers that were relying on the *Wayfair* decision to confirm authoritatively that they did not have nexus are certain to be disappointed.

Learn more

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[1] Dkt. No. 17-494.

[2] The Commerce Clause of the U.S. Constitution grants Congress the right to regulate the taxation of interstate commerce. If Congress does not act to regulate the taxation of interstate commerce, the Dormant Commerce Clause concept applies. For example, in 1959 Congress passed P.L. 86-272, which limits a state's abilities to tax income derived from the state in certain situations. Similarly, in 1998 Congress passed the Internet Tax Freedom Act, which likewise limits a state's ability to tax certain transactions. When an act of Congress applies, the provisions of that act, not the principles discussed in this article, apply to determine if a state tax is valid.

[3] *Wardair Canada Inc. v. Florida Dep't of Revenue*, 477 U.S. 1, 7 (1986), quoting *Hughes v. Oklahoma*, 441 U.S. 322, 325-326 (1979). *See also* The Federalist Nos. 42 (J. Madison), 7 (A. Hamilton), and 11 (A. Hamilton).

[4] *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

[5] 430 U.S. 274.

[6] *International Shoe Co. v. Washington*, 326 U.S. 310 (1945).

[7] *Scripto, Inc. v. Carson*, 362 U.S. 207 (1960).

[8] *Miller Bros. Co. v. Maryland*, 347 U.S. 340 (1954). In *Miller Bros.*, the U.S. Supreme Court ruled that nexus did not exist even though the taxpayer was delivering product into the state in its own trucks. Though *Miller Bros* is an older case, the Court in *Wayfair* cited Miller *Bros.* in support of its conclusions, validating *Miller Bros.* continued viability.

[9] Though most state supreme court cases ruled in favor of the state on this issue, some ruled in favor of the taxpayer. In *Acme Royalty Co. v. Director of Revenue*, 96 S.W.3d 72 (2002) the Missouri Supreme Court ruled that a taxpayer, whose only connection to the state was deriving income for the licensing of trademarks and trade names to a related corporation, did not have nexus. *See also J.C. Penney National Bank v. Commissioner*, 19 S.W.3d 831 (Tenn. Ct. App. 1999), in which the Tennessee Court of Appeals ruled that the bank did not have nexus for income tax purposes in Tennessee because it lacked a physical presence.

[10] *See J.C. Penney National Bank v. Commissioner*, 19 S.W.3d 831 (Tenn. Ct. App. 1999).

[11] For example, Wells Fargo issued a news release on July 13, 2018, stating in part that "[t]he Company's effective income tax rate was 25.9 percent for second quarter 2018 and included net discrete income tax expense of $481 million mostly related to state income taxes. Discrete income tax expenses in the second quarter were driven by the Company's adjustment to its state income tax reserves following the recent U.S. Supreme Court decision in *South Dakota v. Wayfair* and by the true-up of certain state income tax accruals."

[12] *Wayfair*, slip op. at 7.

[13] *Id., slip op.* at 8.

[14] *Id., slip op.* at 10.

[15] *Id., slip op.* at 15.

[16] *Id., slip op.* at 20-21.

[17] *Id., slip op.* at 22. It should be noted that this new nexus standard was articulated in a property tax case (*Polar Tankers, Inc. v. City of Valdez*, 557 U. S. 1 (2009)). This case addressed the apportionment prong, not the nexus prong, of the Due Process Clause and the Commerce Clause.

[18] It should be noted that *Wayfair* only overturned *Quill* with regard to its bright line physical presence rule. It did not overturn its ruling on due process nexus.

[19] In *Miller Bros.*, the taxpayer focused its advertising in its home state, but the advertising happened to also be delivered to the neighboring state of Maryland. Maryland customers drove to a Miller Bros. store located out of state to purchase goods and Miller Bros. delivered the goods to Maryland in its own trucks. The Court ruled there was no nexus because Miller Bros. did not purposefully direct its advertising or marketing to Maryland. *Miller Bros.* was cited in *Wayfair*, and though it is an older case, it arguably still is a very strong precedent because of its focus on purposefully availing oneself of a state's market.