

# Credit Research Foundation Education Brief

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## U.S. Supreme Court's Recent Decision May Slow Trend Towards Online Retail

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Online retailers have long held a competitive advantage over brick-and-mortar retailers by virtue of Supreme Court decisions that barred states from imposing sales tax on businesses that do not have a physical presence in a state. But all of that may change as a result of the Supreme Court's landmark decision in *South Dakota v. Wayfair*, which was the subject of a portion of the panel discussion moderated by Cooley at the CRF Credit and Accounts Receivable Spring Forum in March 2018 in San Antonio. In one of the last opinions authored by Justice Kennedy (who recently announced his retirement), the Supreme Court voted 5-4 to uphold South Dakota's sales tax law, which required businesses with sales over \$100,000 or more than 200 different transactions with residents in the state to collect sales tax.

The legality of South Dakota's sales tax law was before the Supreme Court because of the Constitution's Commerce Clause, which prohibits states from taking actions that unduly burden or interfere with interstate commerce. In prior decisions, the Supreme Court had ruled that businesses needed to have a physical presence in a state in order for sales tax laws to satisfy the Commerce Clause. The Supreme Court overruled that precedent in *Wayfair*, finding that South Dakota could impose sales tax on out-of-state businesses because those businesses availed themselves of the "substantial privilege of carrying on business" in the state and were "large national companies that undoubtedly maintain an extensive virtual presence."

Although the Supreme Court eliminated the physical presence requirement, it did not establish a new standard for determining when a business “avails itself” of the substantial privilege of carrying on business in a state. However, the Supreme Court did set two important limitations on its decision. First, a state cannot discriminate against out-of-state businesses. Second, a state cannot place an “undue burden” on interstate commerce. While the Supreme Court did not explain how states could violate these two prohibitions, it noted that South Dakota’s law, which requires collections only for future sales and exempts small retailers, is likely acceptable.

Significantly, the Supreme Court also noted that state tax systems cannot be too “complex” and should be designed to limit compliance costs. But existing sales tax laws may already run afoul of this requirement. For example, in its *amicus* brief in the Supreme Court, eBay noted that there are more than 10,000 taxing jurisdictions in the United States, including counties, cities, towns, and other political subdivisions. Each of these taxing authorities may impose their own local sales tax, complete with unique exemptions, tax rates, and regulations. Wayfair estimated the aggregate cost of compliance for affected online retailers to be \$13.5 billion, without accounting for audits and other administrative expenses. While businesses can utilize software such as TaxCloud or Vertex to attempt to comply, the efficacy and cost-effectiveness of such software is unclear, and they are likely insufficient to protect retailers from expensive audits by taxing authorities.

The high cost of compliance may lead to Congressional legislation designed to shield online retailers from becoming subject to a dizzying array of state tax regimes. Indeed, states are already racing to revise their sales tax laws to comply with *Wayfair*. The Supreme Court gave Congress an opening to “address these problems if it deems it necessary and fit to do so.” But given the current political climate, it is not likely that Congress could tackle an issue of such complexity, particularly prior to the 2018 midterm elections.

The decision may also give rise to additional court cases regarding whether a particular state’s sales tax system is so complex that it imposes an undue burden on interstate commerce. By way of example, Chicago taxes bottled water, soda, non-soda drinks, candy, and groceries at different tax rates. Some states are also considering enacting legislation to protect their businesses, which could create a patchwork of conflicting state laws for online retailers to comply with. For instance, New Hampshire’s legislature is considering a law that would require out-of-state taxing authorities to comply with regulations and receive written authority before collecting sales tax from New Hampshire businesses. Justice Kennedy’s retirement from the Supreme Court may give hope to new challenges to sales tax laws given that he was the deciding vote in favor of eliminating the physical presence requirement. A new justice could disagree and find that the burden of complying with a particularly complex sales tax law constitutes an unconstitutional burden on interstate commerce.

Despite the costs *Wayfair* could impose on online retailers, its practical effects on the retail market may be muted by the overall consumer trend towards online retail, which accounted for 9% of all U.S. retail sales in 2017 and is expected to rise to 12.4% by 2020. Any marginal increase in the price of goods as a result of sales tax could be offset by the convenience of online shopping, including the ability to quickly comparison shop. And many large online retailers such as Amazon already collect sales tax nationwide, further limiting the practical effects of *Wayfair*. Price-conscious consumers may also order products from foreign retailers. While foreign retailers are theoretically required to collect sales tax, it is difficult for states to enforce those laws or collect funds from retailers in other countries. Whether congressional action or further litigation can solve some of the problems created by *Wayfair* remains to be seen. But it is clear that the days of online retailers dodging sales tax has ended, with uncertain and potentially costly effects on consumers and retailers alike.