



LH Frishkoff & Company  
Accounting ▸ Tax ▸ Assurance



*The U.S. Supreme Court's Wayfair Decision –  
What Does It Mean to My Business ?*

# Executive Summary

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## The Imminent Changing of the Sales & Use Tax Landscape: Effects of the South Dakota v. Wayfair Decision

The recent “buzz” in the sales and use tax community (Yes, there is a sales and use tax community) has centered around the United States Supreme Court ruling issued on June 21, 2018 in the South Dakota v. Wayfair case. With a 5-4 Court ruling, states will now have the ability to require out-of-state sellers to register, collect and pay use tax on sales made to their state.

The issues surrounding the application of state sales tax have always been a minefield of compliance challenges which the Wayfair decision has made infinitely more complicated. We are not surprised about these developments as the experts for the longest time have stated that the “physical presence test” in order to create nexus with a state is flawed. Further, with the upsurge of cross-state line sales fueled by the internet it was only a matter of time until the seminal case in this field, Quill Corp v. North Dakota (1992) , was challenged and overturned.

It is interesting to note that most states have comprehensive sales and use tax statutes, the latter of which places the burden on the purchaser to pay a use tax for products brought into a state unless they are specifically exempt from tax. Compliance in this area has traditionally been very lax and most sales tax audits in New York, for example, result in some sort of deficiency finding. Also, New York State income tax returns currently require residents to specifically report whether you have made any out-of-state purchases for which use tax is owed.

So, where does this leave us moving forward?

We expect that nearly all states with a sales tax statute to enact legislation in order to take full advantage of this ruling. It is anticipated that states which heavily rely upon sales tax revenues (such as South Dakota) and states who have large, developed economies (such as New York and California) will be the first states to pioneer into this uncharted territory. We have provided insights into five potential paths this sales and use tax matter may embark on which are discussed on pages 9-15.

## Executive Summary

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One thing we can all count on ... the upcoming sales and use tax changes will place an even greater compliance burden on the backs of inter-state sellers who will need to know the regulations and requirements within each state. We suggest the following course of action for businesses that sell in multiple states:

1. Implement a comprehensive sales tax software program that covers all states and municipalities. Most mainstream accounting software program include sales tax modules. It may be more efficient to use a cloud-based system in order to receive timely regulatory updates.
2. Outsource the sales and use tax requirements to a third party. There are a number of vendors who offer these services.
3. Develop the compliance capability in-house.

LHF can provide these services and we maintain our own subscriptions from nationally accredited software providers. If you prefer, we can help you develop a transformational blueprint which can seamlessly integrate the sales and use tax compliance function in-house.

# What is the Difference Between Sales and Use Tax ?

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## What is the Difference Between Sales and Use Tax?

### Sales Tax

As you are aware, *sales tax* is imposed by state and local tax authorities and applies to certain tangible property and services transactions.

### Use Tax

Similarly, *use tax* applies if you purchase certain tangible personal property or services outside of your state and use it within your state. Therefore, generally use tax is determined by the final destination of the tangible personal property or where the services are performed.

For example, if a New York business purchases goods from New Jersey and the goods are shipped to New York for use in your business – then your business is required to report and pay use tax to New York State on the purchase of these goods.

Additionally, you are required to report and pay use tax to your state of residence on out-of-state purchases even if the out-of-state seller charges you sales tax. Under this scenario, you must file and pay the full amount of use tax to your resident state. However, you do receive a sales tax “credit” for the amount of sale tax you were charged by the vendor on your out-of-state purchase.

**Example:** You purchase office furniture from a Pennsylvania store for \$10,000. The vendor charges you a total of \$10,600 that includes Pennsylvania sales tax, which is currently 6%. The furniture is delivered to your office in New York City. The sales tax rate in New York City is 8.875%.

The business should file a New York State use tax return and pay \$287.50 to New York State.

|                                  |                   |                     |
|----------------------------------|-------------------|---------------------|
| New York City Sale Tax           | \$887.50          | (\$10,000 x 8.875%) |
| less Pennsylvania Sales Tax Paid | <u>(\$600.00)</u> | (\$10,000 x 6%)     |
| Use Tax Due to New York State    | \$287.50          |                     |

# Significant Nexus Requirement

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## Prior Law: “Physical Nexus” Required

### *Background: Use Tax Law Before This Decision*

As retail supply chains have transformed into business models where remote sellers conduct business over the internet and ship goods to out-of-state customers, various state and local tax authorities have been pursuing avenues to require these remote sellers to register, collect and pay use tax on their out-of-state sales.

Prior to the recent *South Dakota v. Wayfair* case ruling, two United States Supreme Court cases clearly established the precedent on how and when states and localities could impose use tax in this situation.

In *National Bellas Hess v. Department of Revenue of Illinois (1967)* and *Quill Corp v. North Dakota (1992)*, the United States Supreme Court heard arguments on this matter of contention.

The Court ruled that a seller had to have “significant nexus” with a state in order for that state to require the seller to register, collect and remit sales tax. Further, in order for a seller to be considered to have significant nexus with a state, the seller had to be physically present in the state. A seller that lacked any direct or attributed physical presence in a state could not be considered to have significant nexus with that state.

More specifically, the “Commerce Clause” prohibited state and local tax authorities from requiring a business the duty of use tax registration, collection and payment upon a remote seller whose only connection with customers in a particular state is by common carrier or mail. In other words, a physical presence of the seller within a state was necessary for a state or local tax authority to require the seller to register, collect and pay use tax on its out-of-state sales.

The writing was on the wall, however, as the justices did articulate in their opinion in 1967 and 1992 that requiring a physical presence was a “serious injustice” to the states and that the law had become “further removed from economic reality”. It was clear that the Court was prompting the United States Congress to revisit the sales and use tax laws and level the economic playing field.

## Significant Nexus Requirement

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### New Law After Wayfair Ruling: “Physical Nexus or Economic Nexus”

#### Economic Nexus

Generally, a seller must have “significant nexus” in a state before that state can require a seller to register, collect and remit use tax to the state. Nexus is defined as a “presence, central link or connection with that state”.

Under the prior Court rulings, a seller’s physical presence within a state was required to create nexus with a state. Consequently, a seller’s physical presence was necessary in order for a state to be able to require a seller to register, collect and pay use tax to the state.

As a result of the Wayfair ruling, the Court now ruled that an Economic nexus also created significant nexus within a state (in addition to a physical presence test). Now, a seller that has an economic nexus within a state also gives the state the ability to require a seller to register, collect and remit use tax to the state.



In the aftermath of the Wayfair ruling last month, the physical presence only precedents previously established by National Bellas Hess v. Department of Revenue of Illinois (1967) and Quill Corp v. North Dakota (1992) have been overturned and states may now require remote sellers to register, collect and remit use tax on transactions with its customers if the seller has a physical nexus or an economic nexus with a state.

## Significant Nexus Requirement

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### Internet-transacted Sales

Until now, internet-transacted sales have long escaped the grasp of being subject to use tax by state and local tax authorities because a seller may not have had a physical presence in the state. Now, on-line retailers who meet or exceed state-prescribed economic nexus thresholds will be considered to have economic nexus with the state and will be subject to use tax as a result.

Given the uncertainty of next steps and the anticipated chaos on the horizon, we do expect the United States Congress to address this use tax issue and standardize regulations. All states are currently reviewing both their use tax and nexus laws at this time. We anticipate that each state will publish its economic nexus regulations in the coming months.



## Recent Congressional Action

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### [U.S. House of Representatives: House Judiciary Committee Hearings](#)

On July 24, 2018, the House Judiciary Committee held a hearing concerning the U.S. Supreme Court ruling issued on June 21, 2018 in the *South Dakota v. Wayfair* case. The House Judiciary Committee regulates interstate commerce and, as such, governs the imposition on these types of taxes. The goal of the hearing was to examine and assess whether, and to what extent, the U.S. Congress should intervene in this matter.

LHF observed the 2 hour and 14 minute House Judiciary Committee Hearing which specifically addressed the longstanding rule that, under the Constitution's Commerce Clause, the states may not impose sales tax collection duties on remote sellers with no physical presence in the taxing state.

House Judiciary Committee Chairman Bob Goodlatte (R-Va) delivered a statement "Examining the Wayfair Decision and its Ramifications for Consumers and Small Businesses". The Chairman elaborated that "although the U.S. Supreme Court was asked to address the bright-line physical presence standard, they should have left the resolution of this matter to the U.S. Congress".

Chairman Goodlatte was clearly unhappy that the Court decided to weigh in on a matter he felt is a legislative matter, adding "Our Founders were also clear on the issue of no regulation without representation. Unfortunately, the Supreme Court's recent decision violates this founding principle". The Chairman's point is that a state can now impose a tax against a taxpayer who does not reside in the state and does not have the ability to vote for the state's elected officials who enact its tax laws.

The Chairman continued that there are "over 10,000 sales tax jurisdictions, each with different rates, rules, exemptions, product definitions, thresholds for liability and the power to audit". He was also concerned about a state's ability to have retroactive taxation where "sellers could be held liable for sales taxes they never collected from consumers, meaning the taxes would come out of the sellers' pockets".

## Recent Congressional Action

### U.S. House of Representatives: House Judiciary Committee Hearings, Cont'd

Finally, the House Judiciary Committee expressed concerns about “a ripple-effect of removing the physical presence standard in other areas of state taxation and regulation”. It is anticipated that states will now have the green light to take more aggressive approaches on all areas of taxation as a result of this ruling. The Committee pointed out that “Wells Fargo took a \$481 million charge on July 12, 2018 for “business activity taxes” the state may impose now that the physical presence standard is gone”.

Limited taxation groups believe the economic nexus standard for on-line purchases was litigated to open the door for states to impose sales tax on banking financial transactions and crowd-funding alternative financing.

States will not have the dominion to require foreign overseas sellers to register, collect and remit sales tax. Sovereign countries are not likely subject to U.S. state law. Therefore, there still may be an uneven playing field as it pertains to foreign on-line retailers.

The Multi-state Tax Commission and other sales tax industry organizations were in attendance at the hearing and all posed critical questions concerning the implementation of this new standard as well as a multitude of technical questions left unanswered as a result of this U.S. Supreme Court ruling.

No timetable or next steps was voiced by the House Judiciary Committee.



## Potential Short-term Options for Sales & Use Tax

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### Option #1:

#### The U.S. Congress Issues A Moratorium

The House Judiciary Committee may issue a moratorium prohibiting all states and localities from making any changes to their current sales and use tax regulations for a specified period of time. This will give the Committee ample time to thoroughly examine the issues and determine any due course of action.



### Option #2:

#### The U.S. Congress Codifies Sales & Use Tax Regulations

The U.S. Congress may enact regulations codifying National sales and use taxation – a solution strongly articulated by the U.S. Supreme Court in their rulings. LHF believes this will ultimately be the requisite solution.

However, given the complexity of the issues and that mid-term elections are upcoming in November, it is highly unlikely any Congressional legislation will be drafted or enacted in 2018.

## Potential Short-term Options for Sales & Use Tax

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### Option #3:

#### States Enact Legislation Independently

State sales tax divisions have been burning the midnight oil since the U.S. Supreme Court handed down this ruling. After all, industry experts have estimated that this tax law change will generate more than \$25 billion in new annual use tax revenues. In 2017, the National Retail Federation reported that 9.5% of all retail sales occurred on-line.

State sales tax divisions do not currently have the policies, procedures or bandwidth to enact and implement this tax law change. Also, states do not have any finalized compliance forms nor the capacity to handle the registration and collection of these new out-of-state use tax revenues. Although many states are targeting the 4<sup>th</sup> quarter of 2018 to implement changes to their sales and use tax regulations, this is likely a best case scenario.

#### New York

New York policymakers are taking a close look at the U.S. Supreme Court's decision but it is unclear what action they will take in light of the decision. The New York State Department of Taxation and Finance said the matter is "currently under review". However, as recently as February 2018, the Department went on record advocating for the requirement for remote on-line sellers to register, collect and remit sales tax.

Although Governor Mario Cuomo has proposed a requirement that large on-line retailers register, collect and remit sales tax when they sell to New York residents, his proposals have not passed the New York State Legislature for the past three years.

Even the New York State Mayors Association supports "*immediate* legislation to require on-line retailers to collect sales tax whether they operate remotely or not".

## Potential Short-term Options for Sales & Use Tax

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### Option #3:

#### States Enact Legislation Independently

##### California

Recently, the State of California unintentionally leaked a draft of proposed legislation containing new tax collection rules for retailers as an employee inadvertently posted the draft regulations on the State's website.

The draft notice stated that “a retailer may now have a substantial nexus with California without having a physical presence in the state. Also, federal law now permits California to begin requiring retailers to collect use tax if the retailers have similar levels of sales activity in this state as those in the South Dakota law, regardless of whether they have a physical presence in California”.

The draft indicated that the law would be effective August 1, 2018. Therefore, as of this date affected retailers would be responsible for the use tax on its sales into the State of California - whether or not the retailer actually charged the use tax to the end consumer.

The notice continued by stating “In response to the recent U.S. Supreme Court decision in *South Dakota v. Wayfair, Inc.*, that certain retailers are required to register with the California Department of Tax and Fee Administration (‘CDTFA’) and to collect California use tax starting August 1, 2018, if they meet any one of the following thresholds”.

The two primary determining threshold factors would require retailers to register, collect and remit use tax if:

- 1) “The cumulative sales price of the retailer’s sales of tangible personal property for delivery in California exceeds \$100,000, *or*
- 2) The retailer sold tangible personal property for delivery in California in 200 or more separate transactions”.

## Potential Short-term Options for Sales & Use Tax

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### Option #3:

#### States Enact Legislation Independently

##### California

The CDTFE has since removed the draft notice from its website and a CDTFE representative stated that “the document was an unofficial, internal-use only document that was inadvertently placed on the CDTFE website”. The representative continued by saying that the draft “was not intended for publication, and that the CDTFE is currently evaluating its next steps in the wake of the Wayfair decision”.

##### Its all about the money

At the end of the day, the ability to expand a state’s tax base is all about money. This is a perfect windfall scenario for state elected officials for two main reasons.

First, state residents are currently being taxed to the maximum the residents can afford. In the current economic climate, there is not much more money available for states to collect from its residents. This new tax will bring in new money without affecting its residents financially.

Second, the out-of-state retailers do not have voting rights within the taxing state. In essence, its taxation without representation. As a result, out-of-state retailers have little recourse when it comes to the taxes that will be imposed upon on. To bring the thought full circle, the implementation of these new tax regulations should not have any negative consequences to re-election campaigns because the new tax laws did not affect the constituents.

## Potential Short-term Options for Sales & Use Tax

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### Option #4:

### Implementation of the Streamlined Sales and Use Tax Agreement ('SSUTA')

#### *Streamlined Sales Tax Governing Board*

For two decades, several states and industry organizations had the vision and determination to try a construct a fair and formalized national policy for the imposition of sales and use taxes. The Streamlined Sales Tax Governing Board was established to simplify and make uniform the numerous tax regulations and rates.

Since its inception, more than 1,100 retailers and 24 states have registered with the streamlining group. New Jersey, Michigan and North Carolina are among the largest of the states who adjusted their sales and use tax laws to fully comply with the Streamlined Sales Tax group's standards.

The Group requires its membership to comply with and sign a Streamlined Sales and Use Tax Agreement ('SSUTA'). States' compliance with SSUTA is annually certified by the Streamlined Sales Tax Governing Board. Noticeably absent from this membership are New York and California. Retail establishments such as Wal-Mart, Borders, and JC Penney, and the National Retail Federation all support the Streamlined Sales Tax group.

Other large on-line retailers, such as Amazon and Overstock, do not support the group at this time. These retailers do support a nationwide law that would provide relief to on-line retailers from navigating the patchwork of voluminous state and local sales tax laws.

# The 24 States Who Have Joined SSUTA

## The 24 States Who Have Joined SSUTA

The screenshot shows the website for the Streamlined Sales Tax Governing Board, Inc. The main content area is titled "State Info" and features a section for "Streamline Sales Tax State Members". This section is divided into "Full Members" and "Associate Members".

**Full Members** - A full member state is a state that is in compliance with the Streamlined Sales and Use Tax Agreement through its laws, rules, regulations, and policies.

**Associate Members** - An associate state is a state that has achieved substantial compliance with the terms of the Agreement taken as a whole, but not necessarily each provision, measured qualitatively.

The "Full Members" list includes: Arkansas, Georgia, Indiana, Iowa, Kansas, Kentucky, Michigan, Minnesota, Nebraska, Nevada, New Jersey, North Carolina, North Dakota, Ohio, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, Vermont, Washington, West Virginia, and Wyoming.

The "Associate Members" list includes: Tennessee.

The sidebar on the left contains a "State Info" menu with the following items: State Taxability Matrix, Current State Tax Rates, Rate and Boundary Files Information, State Sales Tax Holidays, States Offering Amnesty, and a list of the 24 states.

## Potential Short-term Options for Sales & Use Tax

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### Option #5:

#### U.S. Congress Does Nothing

Although unlikely, the U.S. Congress can choose not to take any action at this time. The U.S. Congress has previously demonstrated the inability to take the lead on issues and let situations unfold organically over time.

The U.S. Congress can choose to wait for action by the states, especially states with larger economies such as New York and California. States may develop sales and use tax regulations without guidance or tax law enacted by the U.S. Congress.

LHF imagines this would create a “wild west” environment in the short-term ... at least until the states iron out the challenges they face on the sales and use tax front. The credible threat of Congressional action alone may be an effective incentive for states not to over-reach or abuse their taxing authority. It is believed states would not want to provoke Congressional action.

The U.S. Congress keeping a close eye on the states’ taxation policies is not the only check and balance on this issue. If the state tax authorities become too aggressive as a result of this ruling, states will also attract significant blowback from the large on-line retailers who will undoubtedly try to rein in those states through legal action.

## Talk to Us

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### The L.H. Frishkoff & Company LLP Team

After your review of the key elements of this Tax Alert, we encourage you to discuss with us any concerns you may have regarding this judicial ruling and how this ruling may impact your business going forward.

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