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"Examining the *Wayfair* Decision and its Ramifications for Consumers and Small Businesses"

Hearing Before the Committee on the Judiciary
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Chairman Goodlatte, Ranking Member Nadler, and Members of the Committee.

My name is Andrew Pincus, and I am a partner in the law firm Mayer Brown LLP. I am honored to appear before the Committee today.

A significant part of my law practices focuses on Supreme Court and appellate litigation, and I represented eBay, Inc., and independent small businesses in all 50 States that operate on eBay's Marketplace platform as *amici curiae* before the Supreme Court in *South Dakota v. Wayfair, Inc*. From 1997 through 2000 I served as General Counsel of the United States Department of Commerce; from 1998-2000 I was a member of the Advisory Commission on Electronic Commerce established by the Internet Tax Freedom Act.

The Supreme Court's *Wayfair* decision significantly changes the legal landscape governing States' power to require tax collection. But it replaces relatively clear rules with tremendous uncertainty.

The burden of that uncertainty is falling most heavily on small businesses—which are being forced to choose between complying with costly sales tax collection obligations that could well be unconstitutional or suffering onerous penalties if they decide not to comply and the obligations are later upheld by a court.

But *Wayfair*'s impact is not limited to sales taxes. It opens the door to the imposition of new tax collection and payment obligations on a whole range of businesses for many different types of taxes. These businesses, too, face tremendous uncertainty regarding the Constitution's limits on state taxing power.

In virtually every context other than taxation, individuals and businesses subject to a state or federal law that could violate the Constitution are able to go to court and obtain a judicial determination regarding their constitutional claim ***before*** they are obligated to comply with the law.

Even though the power to tax has long been recognized as "the power to destroy"—as Chief Justice Marshall put it in 1819[1]—constitutional challenges to tax laws typically cannot be asserted until after the victim of the unconstitutional tax has shouldered the burden of collecting and paying the state or federal government. Whatever the merits of that rule in contexts in which constitutional rules are clear, it imposes unfair hardship when those rules are changing and uncertain—as they are today as a result of the *Wayfair* decision.

What *Wayfair* Decided – And What The Supreme Court Did Not Decide

The *Wayfair* case presented a specific, targeted question to the Supreme Court—and the Court's decision was correspondingly narrow.

[1] *McCulloch v. Maryland*, 17 U.S. 316, 327 (1819).

The key legal context was the Supreme Court's prior decisions in *Quill Corp. v. North Dakota*[2] and *National Bellas Hess, Inc. v. Department of Revenue of Illinois*.[3] *Bellas Hess* held that a State could not "impose the duty of use tax collection and payment upon a seller whose only connection with customers in the State is by common carrier or the United States mail."[4] It upheld the "sharp distinction" between "mail order sellers with retail outlets, solicitors, or property within a State, and those who do no more than communicate with customers in the State by mail or common carrier as part of a general interstate business."[5]

Quill held that this physical presence rule could not be justified by due process principles, and overruled *Bellas Hess* to the extent it rested on the Due Process Clause.[6] But *Quill* refused to overturn *Bellas Hess*'s Commerce Clause rationale.[7]

South Dakota in 2016 enacted a new sales tax designed to create a test case to obtain a Supreme Court decision overruling *Quill*. The State's certiorari petition presented the following question: "Should this Court abrogate *Quill*'s sales-tax-only, physical-presence requirement?"[8]

The Court's holding was limited to answering that question. It stated: "the Court concludes that the physical presence rule of *Quill* is unsound and incorrect. The Court's decisions in *Quill Corp.* v. *North Dakota*, 504 U. S. 298 (1992), and *National Bellas Hess, Inc.* v. *Department of Revenue of Ill.*, 386 U. S. 753 (1967), should be, and now are, overruled."[9]

Importantly, the Court expressly ***did not*** hold the South Dakota statute constitutional. To the contrary, it explained that the Commerce Clause imposes limitations on State's taxation authority and directed the South Dakota Supreme Court to consider on remand the other constitutional issues raised by the case.

First, the Court pointed out that its Commerce Clause precedents require a state tax to satisfy four requirements. The law must (1) apply "to an activity with a substantial nexus with the taxing State"; (2) must be "fairly apportioned"; (3) may not "discriminate against interstate commerce"; and (4) must be "fairly related to the services the State provides."[10]

Second, the Court explained that under its general Commerce Clause jurisprudence, no state law, whether a tax or regulation, may "impose undue burdens on interstate commerce."[11]

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[2] 504 U.S. 298 (1992).

[3] 386 U.S. 753 (1967).

[4] *Id*. at 758.

[5] *Id*.

[6] 504 U.S. at 306-08.

[7] *Id*. at 309-319.

[8] No. 17-494 Pet. for Cert. at i, *South Dakota v. Wayfair, Inc*., 138 S. Ct. 2080 (2018).

[9] 138 S. Ct. 2080, 2099 (2018).

[10] *Id*. at 2091.

[11] *Id*. at 2090-91.

The Supreme Court in *Wayfair* resolved only one of these five issues—the "substantial nexus" requirement. It stated that "'such a nexus is established when the taxpayer [or collector] "avails itself of the substantial privilege of carrying on business" in that jurisdiction.'"[12]

The Court found that standard satisfied on the facts before it. The Court observed that the three companies that challenged the South Dakota statute—Wayfair, Inc., Overstock.com, Inc., and Newegg, Inc.—"are large, national companies that undoubtedly maintain an extensive virtual presence."[13] And these companies more than satisfied the South Dakota statute's requirements of $100,000 in annual sales or 200 or more separate transactions into the State, which constituted "a quantity of business that could not have occurred unless the seller availed itself of the substantial privilege of carrying on business in South Dakota."[14]

Other constitutional issues, the Court said, had "not yet been litigated or briefed , and so the Court need not resolve them here,"[15] and the Court did not decide them. The Court did note that "South Dakota's tax system includes several features that appear designed to prevent discrimination against or undue burdens upon interstate commerce"—citing the requirement of annual sales of $100,000 or 200 transactions; the prohibition of retroactive taxation; and the adoption of the Streamlined Sales and Use Tax Agreement, which standardizes taxes and reduces administrative and compliance costs.[16]

But the Court clearly did not reach a conclusion regarding either the discrimination or undue burden questions, expressly stating that "[a]ny remaining claims regarding the application of the Commerce Clause . . . may be addressed in the first instance on remand."[17]

Unresolved Issues Regarding the Constitutionality of Subjecting Small Businesses to Tax Collection Obligations

The parties in Wayfair were three very large companies. For example, Wayfair and Overstock have annual net revenues of more than $1 billion.[18] The Supreme Court therefore was not required to determine how the Commerce Clause limits on States' taxation authority apply with respect to small businesses.

But the Court nonetheless went out of its way to make clear that the Commerce Clause analysis could well be different with respect to small businesses—and in particular that the Commerce Clause might prohibit the application to small businesses of tax collection laws that can constitutionally be applied to large companies.

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[12] *Id*. at 2099 (*quoting Polar Tankers, Inc. v. City of Valdez*, 557 U.S. 1, 11 (2009)).

[13] *Id*. at 2099.

[14] *Id*.

[15] *Id*.

[16] *Id*.

[17] *Id*. at 2100.

[18] *Id*. at 2089.

In commenting on the South Dakota statute, for example, the Court observed that it "requires a merchant to collect the tax only if it does a considerable amount of business in the State; the law is not retroactive; and South Dakota is a party to the Streamlined Sales and Use Tax Agreement," which standardizes taxes and reduces administrative and compliance costs.[19]

Even more important, the Court recognized that the "burdens" of complying with the complexity of multiple state tax collection requirements "may pose legitimate concerns in some instances, particularly for small businesses that make a small volume of sales to customers in many States."[20] And it stated that "if some small businesses with only *de minimis* contacts seek relief from collection systems thought to be a burden, those entities may still do so."[21]

Moreover, those comments relate only to Commerce Clause limits on state authority.

Wayfair did not involve any question regarding the separate constitutional protections provided by the Due Process Clause that are particularly relevant with respect to state burdens on small businesses. A state law would have to comply with due process before it could lawfully be applied to a small business.

The Supreme Court has made clear that due process principles impose constraints on a State's power to tax and regulate that are "analytically distinct" from those imposed by the Commerce Clause.[22] "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."[23] In other words, due process requires "some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax."[24]

This requirement demands that the defendant "'deliberately' . . . engage[] in significant activities *within* a State" or "creat[e] '*continuing* obligations' between himself and residents of the forum."[25] Under these principles, "an individual's contract with an out-of-state party *alone*" cannot "automatically establish sufficient minimum contacts" for the exercise of jurisdiction.[26] Rather, due process requires some act by which the regulated party "purposefully 'reach[es] out beyond' their State," as by "entering in a contractual relationship that 'envision[s] continuing and wide-reaching contacts' in the forum state."[27]

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[19] *Id*. at 2098.

[20] *Id*.

[21] *Id*. at 2099.

[22] *Quill*, 504 U.S. at 305.

[23] *Id*. at 312.

[24] *Id*. at 306 (quoting *Miller Bros. Co.* v. *Maryland*, 347 U.S. 340, 344-345 (1954)).

[25] *Burger King Corp.* v. *Rudzewicz*, 471 U.S. 462, 475-476 (1985) (emphasis added) (quotations omitted).

[26] *Id.* at 478.

[27] *Walden* v. *Fiore*, 134 S. Ct. 1115, 1122 (2014). (quoting *Burger King*, 471 U.S. at 473, 480).

The Supreme Court addressed these issues in the *Miller Brothers* case. There, Maryland attempted to collect a use tax from a Delaware vendor that sold items to Maryland residents, noting that the vendor's "advertising with Delaware papers and radio stations, though not especially directed to Maryland inhabitants, reached, and was known to reach, their notice."[28] The Supreme Court rejected that argument. It held that such "incidental effects of general advertising" were not sufficient to show the business's "invasion or exploitation of the consumer market *in Maryland*."[29] Nor was it sufficient that the business "delivered some purchases to common carriers consigned to Maryland addresses," and even delivered products to Maryland in "its own vehicles."[30] As the Court held, "the burden of collecting or paying" the purchaser's tax "cannot be shifted to a foreign merchant in the absence of some jurisdictional basis not present here."[31]

This reasoning applies fully to an online seller, whose website also "reach[es]" buyers in the taxing State and whose products are delivered to purchasers there. The mere fact that the online seller enters into transactions with in-state customers therefore is not by itself sufficient—the State may impose its requirement only if the out-of-state seller has "continuing and wide-reaching contacts" in the State.

Particularly for small businesses, therefore, due process principles are likely to provide an additional layer of constitutional protection—above and beyond whatever protection is available under the Commerce Clause.

Post-*Wayfair* Uncertainty Regarding Small Businesses' Sales Tax Collection Obligations

The Supreme Court's *Wayfair* decision has created considerable uncertainty and confusion regarding sales tax collection obligations.

Even though the Supreme Court did not find the South Dakota statute constitutional—and specifically left a number of constitutional questions to be resolved on remand—States are moving to enforce tax collection obligations on out-of-state sellers.

Many jurisdictions already had tax collection laws on their books that could not be applied to out-of-state sellers pre-*Wayfair*, because they did not require physical presence. With the physical presence requirement eliminated, a number of these States are moving to force out-of-state sellers to comply with those laws.

That is true even though a June 29, 2018 statement issued by the National Council of State Legislatures (NCSL), *Principles of State Implementation after South Dakota v. Wayfair*,[32] suggested that state policymakers consider waiting until January 1, 2019 to implement collection obligations; issue clear guidance as to start dates; provide as much advance notice as possible;

[28] 347 U.S. at 342.

[29] *Id*. at 347 (emphasis added).

[30] *Id*. at 342.

[31] *Id*. at 357.

[32] http://www.ncsl.org/documents/taskforces/SALT_SD_vs_Wayfair.pdf.

avoid retroactive application; and, if not a party to the Streamlined Sales and Use Tax Agreement, take action to simplify registration and centralize the certified software provider process.

Actions by these States threaten small sellers with unconstitutional obligations:

- ***May out-of-state small businesses be held liable retroactively and obligated to remit sales taxes on pre-*Wayfair *sales?***

  A significant number of States have laws permitting the retroactive imposition of sales tax collection obligations—28 States according to the *Wayfair amicus* brief filed by the Tax Executives Institute.[33] And some States have already announced that they plan to require remittance of taxes for pre-*Wayfair* sales.[34]

  The Supreme Court specifically cited the South Dakota statute's prohibition of retroactive obligations as a factor favoring its constitutionality under the Commerce Clause's anti-discrimination and burden on interstate commerce standards.[35] The position taken by these States raises serious constitutional concerns, under both the Commerce and Due Process Clauses—particularly as applied to small businesses.

- ***What is the constitutional standard for subjecting an out-of-state small business to sales tax collection obligations?***

  A number of States' laws impose tax collection obligations at levels much lower than the South Dakota statute. For example, Pennsylvania, Oklahoma, and Washington have each set a $10,000 threshold for imposing tax collection obligations on remote sellers.[36] Other States have no small business exclusion at all in their current statutes and regulations. Those laws appear to violate the Commerce Clause and the Due Process Clause.

  Other States have adopted, or are planning to adopt, the South Dakota statute's test of $100,000 in annual sales or 200 transactions, apparently taking the position that the standard represents a "safe harbor" for all States.[37] But the Supreme Court ***did not*** hold that South Dakota could impose tax collection obligations on a small business

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[33] https://www.supremecourt.gov/DocketPDF/17/17-494/42364/20180404155656952_17-494bsacTaxExecutives-InstituteInc.pdf.

[34] https://www.mass.gov/news/us-supreme-court-releases-decision-on-wayfair-online-sales-tax-case-regulation-830-cmr-64h17; http://www.tax.ri.gov/notice/Remote_seller_FAQs_07_06_18.pdf.

[35] *Wayfair*, 138 S. Ct. at 2099; *see* page 3, *supra*.

[36] Pa. Act 43 (H.B. 542), Laws 2017; Okla. H.B. 1019, Laws 2018, Second Extraordinary Session; Wash. H.B. 2163, Laws 2017.

[37] For example, Wisconsin has stated that it will adopt this standard by regulation and asserted that "*Wayfair* . . . approved a small seller exception for sellers who do not have annual sales of products and services into the state of (1) more than $100,000, or (2) 200 or more separate transactions." State of Wisconsin Dep't of Revenue, *Remote Sellers - Wayfair Decision*, https://www.revenue.wi.gov/Pages/Businesses/remote-sellers.aspx.

based on that standard—the question was not presented because none of the parties in *Wayfair* was a small business.

More fundamentally, the Court expressly indicated that the test for determining the permissibility under the Commerce Clause of imposing a tax collection obligation on a small business does not turn on a state-by-state analysis, because the "burdens" of complying with the complexity of multiple state tax collection requirements "may pose legitimate concerns in some instances, particularly for small businesses that make a small volume of sales to customers in many States."[38] In other words, subjecting a small business that does business in multiple States to complex, inconsistent obligations may violate the Constitution—even if it might be permissible to require the small business to collect taxes with respect to sales to one state, or to several states with consistent tax rules.

And that analysis does not take into account the additional protections for small businesses under the Due Process Clause—discussed above[39]—that require stronger connections between a private party and a State to enable the State to subject the private party to a tax or regulatory obligation.

For both the Commerce Clause and Due Process Clause analysis, it is highly relevant that South Dakota is the fourth smallest State by population. Even if a $100,000 annual sales/200 annual transactions test were sufficient to establish a sufficient connection between a seller and South Dakota, it surely could not be sufficient to establish a sufficient connection with a much more populous State such as California, Texas, or Pennsylvania. Otherwise a business with only $1 million in annual revenue, which is an extremely small business, could be forced to collect taxes under the wholly different regimes of ten different States. That is the definition of both a burden on interstate commerce as well as an unfair regulatory obligation violative of due process.

- ***May States attempt to circumvent the constitutional protections for small businesses by imposing tax collection obligations on on-line marketplaces?***

  A number of States have enacted provisions that would require online marketplaces to collect sales tax on behalf of the sellers using their platforms.[40] These provisions are subject to challenge on a number of different grounds.

  To begin with, they likely violate the Internet Tax Freedom Act's prohibition of "discriminatory taxes on electronic commerce."[41] That statute defines

[38] *Wayfair*, 138 S. Ct. at 2098.

[39] *See* pages 4-5, *supra*.

[40] *See, e.g.*, Ala. H.B. 470 (2018); Ariz. Transaction Privilege Tax Ruling TPR 16-3 (Sept. 20, 2016); Conn. Act 18-152 (2018); Iowa Senate File 2417 (2018); Minn. H.F. 1; Okla. H.B. 1019 (2018); Pa. Act 43 of 2017; R.I. H.B. 5175; Wash. Ch. 28, 2017 Laws 3d Spec. Session (codifying Engrossed H.B. 2163)

[41] Pub. L. No. 105–277, § 1101(a)(2), 112 Stat. 2681-719 (1998).

"discriminatory" to include "impos[ing] an obligation to collect or pay the tax on a different person or entity than in the case of transactions involving similar property, goods, services, or information accomplished through other means."[42] Because States do not impose a similar requirement on operators of physical sales locations—such as flea markets or antique shows—they may not impose it on operators of online marketplaces.

Furthermore, marketplaces do not make sales in or target sales to particular States. They accordingly lack the substantial connection necessary to permit the exercise of taxing authority under either the Commerce Clause or the Due Process Clause.

More fundamentally, small businesses will bear the burden of these marketplace requirements, because there is no practical way for a marketplace to determine the taxability and tax rate for the hundreds of thousands of different products that individual sellers offer for sale. For that reason, the constitutional protections applicable to small businesses would still apply.

Fundamental Unfairness To Small Businesses Forced To Comply With Laws That May Be Unconstitutional

Individuals and businesses threatened with unconstitutional state action outside the tax context virtually always have an opportunity to seek court protection before they are obligated to comply with the unconstitutional law. The cause of action provided by 42 U.S.C. § 1983 as well as an equitable action implied under the relevant constitutional provision provide access to federal court.

But small businesses faced with the unconstitutional post-*Wayfair* burdens just described almost certainly will ***not*** be able to seek a judicial determination of the legality of the state requirements before they are obligated to comply.

The federal Tax Injunction Act[43] bars federal courts from interfering with state tax administration as long as "a plain, speedy and efficient remedy may be had in the courts of such State." And that standard is satisfied even if the only state remedy is an opportunity to sue for a refund—and the State does not allow a party to sue for a declaratory judgment or an injunction invalidating the tax obligation before compliance is required.

Not surprisingly, virtually every State limits its remedies in this manner—permitting only suits for refunds and barring declaratory judgment or injunctive actions. California's provision, embodied in the State Constitution, is typical: "[n]o legal or equitable process shall issue in any proceeding in any court against this State … to prevent or enjoin the collection of any tax."[44]

Even in the very few States that permit declaratory judgment actions, moreover, state tax authorities typically argue that the taxpayer must exhaust administrative remedies (even though

[42] *Id*. § 1105(2)(A)(iii).

[43] 28 U.S.C. § 1341.

[44] California Constitution, Article XIII, § 32; *see also, e.g.,*Tex. Code Ann.§§ 112.101(a), 112.108.

those administrative bodies virtually always lack authority to adjudicate constitutional challenges), and also may contend that constitutional challenges are not ripe until after the tax is paid. The possibility of relief even through these few state declaratory judgment actions is therefore often illusory.

That leaves small businesses faced with a tax collection law they believe to be unconstitutional with two equally unacceptable alternatives. Comply with the law, taking on additional costs that will impose a heavy burden on the business—and hope for vindication after years of litigation. Or refuse to comply and risk draconian financial penalties, including payment of the uncollected sales taxes as well as additional penalties and fines, as well as possible criminal sanctions, if the law is subsequently found constitutional.

How could any small business risk future financial ruin? As a result, unconstitutional state taxes are likely to go unchallenged if there is no opportunity for a pre-compliance challenge. And small businesses will be forced to take on significant new financial and administrative burdens—many of which may be unconstitutional.

Wayfair's Implications for Expanded State Taxing Power Beyond the Sales Tax Context

The discussion of *Wayfair* has understandably focused on its implications for state sales tax collection obligations. But the decision has much broader consequences.

First, States may seek to impose new sales taxes or professional services taxes on the sale of digital goods and provision of services of all types to customers in the State, and impose accompanying collection obligations on sellers or service providers that have no physical presence in the State:

- Accountants, lawyers, doctors, architects, and others who provide services over the phone or Internet;
- Online education and training services;
- Sellers of digital products, such as software and applications ("apps"), electronic books, games and e-cards who sell and deliver their products over the phone or Internet; and
- Online software services.

Indeed, several States have already moved to subject online music and video services to sales tax collection obligations, including, Arkansas,[45] Florida,[46] Pennsylvania[47] North Carolina,[48] and Washington.[49] Localities, such as the City of Chicago[50] have also started to tax streaming.

Second, due to the lack of conformity in computing States' income taxes, particularly the apportionment formula employed, companies lacking an in-state physical presence are easy targets for multiple taxation. Here is an example:

> Wonderful Words sells digital books nationwide, including 80% of its books to customers in Big State, which uses a single-factor apportionment formula based on sales and has adopted "market sourcing," which looks to where a business's customers are located. Wonderful Words only has offices and personnel in Small State, and sells 20% of its e-books to customers in Small State, which uses a three-factor apportionment formula based on sales, property and payroll. Wonderful Words earns $500. Wonderful Words would have $400 ($500 x 80%) of its income subject to tax by Big State and $366.67 ($500 x 20%+100%+100%/3) of its income subject to tax in Small State. Wonderful Words is thus subject to tax on $766.67 of income even though it earned only $500.

Third, the elimination of the physical presence standard is likely to lead States to become more aggressive in asserting the power to collect income taxes. Thus, one major bank has already announced during a recent quarterly earnings call that it was facing a tax expense of nearly $500 million as a result of potential state income tax liabilities in the wake of *Wayfair*.[51]

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Thank you again for the opportunity to appear before the Committee. I look forward to answering your questions.

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[45] Ark. Code Ann. § 26-52-301(3)(c)(i); Opin. No. 20180124 (Ark. Dep't of Revenue, Apr. 9, 2018).

[46] Fla. Stat. § 202.11(6); Fla. Tech. Assistance Advisement No. 10A-031 (Fla. Dep't of Revenue, June 28, 2010) (communications services tax).

[47] Act 84 of 2016; *Tax on Digital Products* http://www.revenue.pa.gov/GeneralTaxInformation/Tax%20Types%20and%20Information/SUT/Documents/digital_products_tax_qa.pdf.

[48] N.C. Gen. Sta. § 105-164.4(6b).

[49] https://dor.wa.gov/get-form-or-publication/publications-subject/tax-topics/digital-entertainment.

[50] Chi. Mun. Code 4-156-010; Amusement Tax Ruling # 5

[51] Wells Fargo, *Wells Fargo Reports $5.2 Billion in Quarterly Net Income* at 4 (July 13, 2018), https://www08.wellsfargomedia.com/assets/pdf/about/investor-relations/earnings/second-quarter-2018-earnings.pdf.