



27 | 2018

KMLZ VAT NEWSLETTER

Online sellers are liable to local sales taxes in the USA

1. Background to the Judgment

South Dakota, like many US States, taxes the retail sales of goods and services in the state. Sellers are required to collect and remit the tax to the state. If they fail to do so, then in-state consumers are responsible for paying a use tax at the same rate. Unsurprisingly, consumers do not usually remit the use tax. Therefore, US States need to make as many sellers as possible liable to remit sales tax. However, in *National Bellas Hess, Inc. v. Department of Revenue of Ill.* and *Quill Corp. v. North Dakota*, the US Supreme Court held that US States may not require a business to collect its sales tax if the business has no physical presence in the State (hereinafter: “physical nexus”). Consequently, online retailers ensured that they had as few physical nexuses as possible in the relevant US State, thereby avoiding sales tax liabilities. The US Supreme Court’s decisions cause South Dakota to lose between USD 48 and USD 58 million annually. It is estimated that the decisions cause the US States to lose between USD 8 and USD 33 billion every year.

US Supreme Court no longer requires a physical nexus, an economic nexus is sufficient

On 21 June 2018 the US Supreme Court ruled that out-of-state retailers must charge and remit sales tax, even if they do not have a physical nexus in the customer’s US State. It thereby confirmed the economic nexus legislation introduced by South Dakota. Furthermore, the court’s decision effectively overturns contrary earlier rulings. Other US States will follow South Dakota’s example. US and non-US online sellers with customers in the US must now check whether they are affected.

South Dakota has no state income tax. Therefore, it must place substantial reliance on its sales and use taxes. These taxes account for over 60% of its general fund. Against this background, South Dakota introduced a new nexus for sales tax (hereinafter “economic nexus”), which ignores *Bellas Hess* and *Quill*. Accordingly, out-of-state retailers are required to collect and remit sales, if they have an economic nexus in South Dakota. An economic nexus is given, if a seller meets the following conditions, on an annual basis:

- delivers more than USD 100,000 of goods or services into South Dakota; or
- engages in 200 or more separate transactions for the delivery of goods or services into South Dakota.

The Act introducing the economic nexus prohibits its retroactive application. It also provides means for the Act to be appropriately stayed until the constitutionality of the law has been clearly established.



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2. Facts of the Case

The respondents in the case are leading US online retailers (Wayfair, Inc., Overstock.com, Inc., and Newegg, Inc.). None of them have a physical nexus in South Dakota. However, they easily meet the requirements for the newly introduced economic nexus. Nevertheless, the respondents did not collect or remit sales tax for their sales to South Dakotan customers.

Pursuant to the Act's provisions for expeditious judicial review, South Dakota filed a declaratory judgment action against the respondents in state court, seeking a declaration that the requirements of the Act were valid and applicable to respondents. The state also submitted an injunction requiring the respondents to register for licenses to collect and remit sales tax. The respondents moved for summary judgment, arguing that the Act was unconstitutional. Both the state court and the South Dakota Supreme Court affirmed the respondents' move.

3. Decision by the US Supreme Court

The US Supreme Court overruled *Bellas Hess* and *Quill*. It held that the economic nexus is constitutional. According to the court, the physical nexus rule established by *Bellas Hess* and *Quill* is “unsound and incorrect” and “flawed on its own terms”. Inter alia, it creates market distortions by providing a “judicially created tax shelter” for businesses that limit their physical presence in a US State but sell to the state's consumers. The court recognized that taxation of modern e-commerce cannot be based on physical presence. Rather, a substantial virtual connection must suffice. Otherwise, local and out-of-state market participants cannot compete on an even playing field.

The US Supreme Court also took into consideration that 41 US States, two US Territories, and the District of Columbia had requested that it reject the *Quill*'s test.

4. Consequences for the Practice

It is likely that many US States will now follow South Dakota's example and implement an economic nexus. Connecticut, Georgia, Kentucky, Hawaii, Illinois, and Iowa have already done so. Therefore, online retailers must now check whether they are caught by an economic nexus introduced by a US State. This not only applies to US-based retailers but also to foreign retailers, for example from the EU. Where the requirements for an economic nexus are fulfilled, these retailers must register for licenses to collect and remit sales tax in the particular US State.

It is worth noting that there are proposals pending in the US congress, which aim to regulate the taxation of interstate commerce in the USA, e.g. the *No Regulation Without Representation Act of 2017* and the *Marketplace Fairness Act of 2017*. The No Regulation Without Representation Act of 2017 prohibits a state from taxing or regulating a person's activity in interstate commerce, unless the person is physically present in the state during the period in which the tax or regulation is imposed. Accordingly, the Act would reintroduce the *Quill*'s test and would limit sales taxation to sellers with a physical presence in that state. On the other hand, the Marketplace Fairness Act of 2017 authorizes each member state, under the Streamlined Sales and Use Tax Agreement, to require retailers to collect and remit sales taxes with respect to remote sales. This only applies to retailers with annual gross remote sales in the USA exceeding USD 1 million.