Out-of-state Privileges for Internet Sales after *Wayfair*.

By Calvin H. Johnson[1*]

In *South Dakota v. Wayfair, Inc.*,[2] the U.S. Supreme Court overruled its prior decisions in *Quill*[3] and *Bella Hess*[4] to allow a state to collect sales tax on internet sales even though the vendor has no "brick and mortar" store, warehouse or other physical presence in the state. Texas has been losing an estimated $1.1 billion a year in tax collections from the old physical-presence requirement.[5] Texas needs to exploit the new rule now. So do other states.[6] The money would be well spent for the highest-priority state needs. The revenue would also just come from actually collecting tax from people who are supposed to be paying tax already, but don't.[7] In-state Texas merchants who have been withholding sales tax will love the new level-playing field.

Notwithstanding the states' big win in *Wayfair*, out-of-state sellers have been lobbying hard for special privileges and exemptions not available to their in-state competitors. Out of state sellers do not vote in state and their arguments are not very good but they have nonetheless had considerable success. For example, remote sellers have been asking for a uniform multi-state tax base and a single check to cover all the sales tax within a state. They have also successfully lobbied for exemptions from state sales taxes. The Texas comptroller has given an administrative exemption from Texas sales tax of $500,000, notwithstanding the statute which allows no such exemption. The exemption is wildly too high given the increasingly modest costs of computer collection on internet sales.

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[2] South Dakota v. Wayfair, Inc., 138 S. Ct. 2080 (2018).

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

[4] National Bellas Hess, Inc. v. Department of Revenue of Ill., 386 U.S. 753 (1967).

[5] Emma Platoff, *Texas Could Gain Hundreds of Millions of Dollars after Supreme Court Rules on Taxing Online Purchases*, TEXAS TRIBUNE, June 21, 2018, https://www.texastribune.org/2018/06/21/supreme-court-online-sales-tax-texas/ (reporting estimate from Texas State comptroller's office).

[6] Nationwide, estimates of state revenue loss range from $3 to $33 billion a year. *See Wayfair*, slip op. at 1. The National Conference of State Legislators estimates a $23 billion annual revenue loss nation-wide. *Collecting E-Commerce Taxes | E-Fairness Legislation* (2014), https://www.ncsl.org/research/fiscal-policy/collecting-ecommerce-taxes-an-interactive-map.aspx.

[7] Texas like many states has a use tax under which the Texas buyer is supposed to pay a clone of sales tax when the seller does not withhold sales tax (https://comptroller.texas.gov/taxes/sales/use-tax.php), but compliance rates are very low. *See Wayfair*, slip op. at 1 (citing findings of 4% compliance.)

Out-of-state merchants do not need to be given *any* competitive advantage after *Wayfair*. If they draw revenue from Texas, they can be asked to pay tax on it and the requirement is enforceable. The Constitution prohibits discrimination against out of sellers, but *Wayfair* does not sanction privileges in their favor. Neither the uniform tax base nor the exemptions higher than what in-state merchants get is necessary or appropriate.

1. Source of Non-discrimination Requirement

Prohibition on a state's discrimination against out-of-state Americans is fundamental to the Union. The thirteen colonies joined together to defeat the most powerful nation on earth in a long and hard war under the banner of "United We Stand, Divided We Fall." As the states joined together, they were intensely jealous of the privileges that might be available to inhabitants of other states that would not be available to their own people.[8] The Articles of Confederation provided that the "better to secure and perpetuate mutual friendship and intercourse among the people of the different states in this union," the inhabitants of any state shall:

"enjoy all the privileges of trade and commerce in another state and

"be subject to the same duties, impositions and restrictions as the inhabitants" of that state.[9]

It is an oft-repeated bit of bad history that the states abused each other under the Articles of Confederation which the Constitution was adopted to fix. Favoring a state's own inhabitants, however, was prohibited by the Articles. The prohibition was almost uniformly obeyed. Most violations were a side effect of trying to stop smuggling of imports that avoided state import taxes by going through a neighboring state. In the most important case of state defection from the norm, the offending state was shamed into compliance.[10] The prohibition, as articulated by the Articles, carried over into the Constitution and remains a strong force.[11]

On the other hand, there is no ground post-*Wayfair*, for any provision *favoring* out-of-state vendors over in-state rules. *Wayfair* overruled the *Quill-Bella Hess* physical-presence

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[8] Calvin Johnson, *Homage to Clio: The Historical Continuity from the Articles of Confederation into the Constitution*, 20 CONST. COMMENTARY 463, 477-483 (2004) (listing illustrations of the strong norm against a state's disfavoring out of state inhabitants in the Constitutional debates.)

[9] ARTICLES OF CONFEDERATION OF 1781, art. IV, para. 1 (paragraph breaks added for clarity).

[10] Johnson, *supra* note 8, at 481-82. The most serious violation of the rule prohibiting discrimination against out of state Americans was the 1% Virginia tax on imports, which did not have the usual exemption for goods of American growth or manufacture. Virginia was shamed into adopting the exemption for goods of American growth or manufacture in January 1788, soon before its ratification of the Constitution.

[11] Johnson, *supra* note 8, at 477-83 argues that the prohibition against state regulations or taxes that discriminate against out-of-state citizens carried over from Articles of Confederation into the Constitution because it was intensely expressed in the debates, and not challenged. It seems to have been left unexpressed only because it was not challenged and was not at issue. Ordinary things of a culture are assumed and continue because the loom of history is not ripped out every night, but the cloth continues intact. Many fundamental things are not written down. We all speak prose and breathe air, for instance, but never say that in a Constitution.

requirement because it in effect was "a judicially created tax shelter for businesses that limit their physical presence in a State."[12] "Helping … customers evade a lawful tax," the Court said, "unfairly shifts an increased share of the taxes to those consumers who buy from competitors with a physical presence in the State. It is essential to public confidence in the tax system that the Court avoid creating inequitable exceptions."[13] The exemption also warped behavior because it produced an "incentive to avoid physical presence … that might be efficient or desirable."[14] The physical presence requirement also disproportionately hurt low-population states because vendors with a brick and mortar store more often put it in a dense population center.[15] "[It] is 'not the purpose of the [C]ommerce [C]lause to relieve those engaged in interstate commerce from their just share of state tax burden," the Court said.[16]

The Constitution's commerce clause also requires that a firm have minimum contacts or nexus with the state before it can be subject to state action. But the minimum contacts for tax are sufficiently satisfied by the remote seller gaining sales revenue from Texas even if by internet. As *Wayfair* put it,

> "It has long been settled" that the sale of goods or services "has a sufficient nexus to the State in which the sale is consummated to be treated as a local transaction taxable by that State." *Oklahoma Tax Comm'n* v. *Jefferson Lines, Inc.*, 514 U. S. 175, 184 (1995); see also 2 C.Trost & P. Hartman, Federal Limitations on State and Local Taxation 2d §11:1, p. 471 (2003) ("Generally speaking, a sale is attributable to its destination").

An out-of-state seller can be made to assume that it may extract revenue from Texas only subject to Texas taxes, including the withholding of sales tax. Out-of-state sellers are not Churches, which can assume that pretax receipts are entirely theirs to keep. Commercial enterprises are entitled to keep only the after-tax revenues.

Notwithstanding that there is no legal basis for advantage to out of state sellers, the remote sellers have been lobbying hard and often achieving special privileges on internet sales. They have asked for a nation-wide simplified tax base, and for exemptions from withholding sales taxes that are way in excess of any extra burden of collection that they might face

A. Simplified Tax Base?

Before the Supreme Court ruling in *Wayfair*, twenty-three mostly low-population states that had fewer brick and mortar stores and warehouses tried to appease the physical presence rule by adopting a uniform tax base, a single tax rate for the entire state and payment to only one state office. South Dakota also adopted a $100,000 annual exemption and gave out free software that was immune from audit. None of that is necessary or appropriate post-*Wayfair*.

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[12] South Dakota v. Wayfair, Inc., 138 S. Ct. 2080, 2084 (2018).
[13] *Id*. at 2086.
[14] *Id*. at 2084.
[15] US Gov't Accounting Office, Sales Taxes: States Could Gain Revenue from Expanded Authority, but Businesses Are Likely to Experience Compliance Costs 1, 12-13 (Dec. 18, 2017), https://www.gao.gov/products/GAO-18-114.
[16] *Wayfair*, 138 S. Ct. at 2084 (citing Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 279 (1997)).

Sales taxes inevitably require a state to make a myriad of policy decisions about what is exempted and what is subject to tax and the distinctions pile up over time. States commonly exempt home-consumed food from tax, for example, as a relief for the poor, but do not exempt candy. But then a line must be drawn. Texas exempts juice and frozen juice bars that are more than fifty percent real juice because they are a food, but taxes fruit drinks and juice bars with less than fifty percent juice as nonfood confections.[17] I for one suspect the fifty percent line is not easily enforced. Texas does not exempt restaurant food even though it exempts food taken away to eat elsewhere.[18] If the merchant delivers a fork with the Cinnamon Bun it is restaurant food, but without the fork, it is not.

Texas exempts goods from sales tax if the buyer will certify that the goods are purchased for resale or lease.[19] Texas exempts oil and gas products from sales because it has a separate serious tax on oil and gas.[20] States that have legalized marijuana sales tax the sales at high rates, but then exempt the sales from adding on the regular sales tax. Across the country, diapers and feminine hygiene products are sometimes exempted and sometimes not.

Taxes are also passed in a democracy by trade-off and bargaining, commonly by amateur legislators, and the legislature does not recodify very often so very old decisions remain in the law. The result is never perfectly pretty nor uniform. If you like laws or sausage, watch neither being made.

The South Dakota tax at issue in *Wayfair* conformed to the Streamlined Sales and Use Tax Agreement (hereinafter "the Agreement"), which twenty-three states have joined. The Agreement reduces the compliance cost of sales tax. There is a uniform sale tax base under the agreement, applicable for all twenty-three states who have entered the Agreement. The rate has to be uniform throughout the state and the payment goes to only one state-wide bureau. Big cities are not allowed a different rate, nor a base particularized to their local needs. South Dakota also provides free software that is immune from audit.[21]

Texas is not going to adopt uniform sales tax base. Do not mess with it. Bigger cities need higher sales taxes than are needed in the vast stretch of desert where there is not much demand for government services, and Texas has both big cities and desert. Texas has made political decisions about the oil and gas industry, for example, in complete disregard of what any other state in the union wants to do about their tax on oil and gas sales. The decisions that Texas has made on its sales tax are right for Texas, because Texas made them, but there is no reason to think that Texas decisions are right for Rhode Island, Hawaii or Idaho, and vice versa.

Free government-provided software might work, moreover, but might not. The hard part of sales tax hardware is not multiplying a tax base by a tax rate but integrating the program into a merchant's existing internal accounting software so that collection and payment are automatic

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[17] TEX. TAX CODE § 151.314(c-1) (2017).
[18] TEX. TAX CODE § 151.314(c-3)(2) (2017).
[19] TEX. TAX CODE, § 151.054(a) (1987).
[20] TEX. TAX CODE §§ 151.308(a)(7), 151.308(b) (2015).
[21] *Wayfair*, slip op. at 23.

and seamless. If the internal accounting software changes, the sales tax program needs to conform to it. There is a large competitive industry working on sales tax software. It can adapt quickly to changes in both the taxpayers own internal accounting software and the law. With competition, costs drop. Software issued by a state, however, under the multi-state sales tax agreement is not going to adapt so quickly

Texas is not going to adapt to any uniform multi-state tax base, but it does not have to. The requirement is non-discrimination, not an easy life. Non-discrimination allows Texas to impose complicated rules, even arbitrary rules on out of state merchants. All Texas has to do is to impose the same complicated arbitrary rules and the same burden on its own people and compensate the out-of-state merchants for any excess burden that survives.

B. Excess burden?

Discrimination against out-of-state vendors, if any, can be adequately met by Texas giving out of state merchants compensation, against their tax due, for the excess costs that they bear that are not borne by in-state merchants.[22] Fortunately, the costs of collecting sales tax is now computer driven and competition among commercial products has reduced the core cost of compliance down to something on the order of a penny a transaction and reduced excess cost that out-of-state merchants bear to a quibble.

Collection of sales tax is now computer-program driven and the cost is very modest. As long as the state does not stop competition, the cost will become more modest. Those familiar with multistate collection say that because the software used for multistate collection is easily scaled up: retailers already using some collection software even for local sales have low cost in adding more zip codes all the way up to the full 12,000 zip codes in the nation.[23] Fifty-state sales taxes are built into the basic Quick Books, the most popular program for small business internal accounting, at zero extra cost. Quick Books will calculate the tax and add it automatically to the customer invoice.[24] Competing programs will update what they state as the 600 annual changes to sales tax, but not quite for free. Taxify will calculate sales tax in all fifty states and do automatic filing and remittance on to 20,000 transactions for $247 a month, which turns out to be as low as 1.2 cents per transaction.[25] TaxJar charges $199 a month for 20,000 transactions,[26] essentially a penny per transaction.

Small in-state merchants bear more than a penny a transaction because they need to cover the initial set up cost. The competitive penny a transaction range is the marginal cost only once the system is set up. As long as small in-state merchants are asked to bear the set-up costs, however, then equity requires that small remote sellers bear the same burden.

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[22] David Gamage & Devin Heckman, *A Better Way Forward for State Taxation of E-Commerce*, 92 BOSTON U. L. REV. 483, 487 (2012).

[23] US Gov. Accounting Office, "*supra* note 15, at 15.

[24] *Sales Tax Simplified*, QUICKBOOKS, https://quickbooks.intuit.com/accounting/sales-tax/

[25] *Pricing*, TAXIFY, https://taxify.co/pricing/.

[26] *Pricing*, TAXJAR, https://www.taxjar.com/comparisons/taxjar-vs-avalara/#pricing.

It is also no more expensive to access the state's sales tax website to see and pay over the sales tax from an out-of-state computer terminal than it is from an in-state computer terminal. It is no more expensive to remit sales tax once the program is set up than it is to process the customer's credit card for the underlying revenue extracted from Texas.

Texas also needs to avoid giving a protective monopoly to any one company on compliance with its sales tax. The monopoly will stop in its tracks the inevitable drop in cost of compliance that vigorous competition will produce. I am not sure the comptroller's office appreciates how quickly it can stop the drop in compliance costs.

Tax collection also does not need to be perfect to be good enough. The case of an out of state vendor who fails to claim a legal exemption for a drink that is more fifty-one percent real juice is not going to bring down the roof. On an ongoing basis, the Texas legislature has a motive to exempt from tax "de minimis" transactions, defined here as transactions where the administrative cost of compliance and collection is larger than the revenue that might be achieved. The definition of too small for tax applied to Texans would of course be available for non-Texans. A good faith decision on defining the level of too small to be worth it that applies to both Texans and non-Texans cannot be viewed as a discrimination against out of state competition. These are after all issues of defining trivia, and a trivial tax on small amounts cannot be allowed to defeat a whole sales tax regime. One also assumes, under the law in action, a trivial tax on small amounts, even if technically due, will not usually be paid or contested or collected

Texas exempts from sales tax "occasional sales," defined to include sales of one or two items during a year.[27] It also exempts sales under $3000 of property, like clothing or furnishings, originally purchased for personal use.[28] The exemption would of course be available for out of state individuals selling their used stuff on EBay into Texas, as well as for Texans. But out of state exemptions need to be the same as in state exemptions and no more.

The *Wayfair* court asked whether out-of-state merchants received benefits from Texas commensurate with their burden.[29] The answer is of course: The seller is getting revenue from Texas, and sales taxes are under ten percent of that benefit.

The merchant, including out-of-state merchants, get benefits from the state's uses of the revenue. The Texas sales tax is a tax on Texans on their purchase of goods and services. In return for their taxes, Texan purchasers get the tangible benefits of fire and police protection, roads and schools, among other things. Merchants collect and remit the tax, but they can pass on the tax and indeed the basic cost of its collections to their customers, especially in an ideal post-Wayfair world in which their on-line competitors do not get to avoid collecting the tax. Texas services such as public schools go to the customer, not the merchant, but the merchants do get to assume roads to bring in customers, or deliver goods and public safety that helps "create the

[27] TEX. TAX CODE, § 151.304 (2007).
[28] *Id.*
[29] *Wayfair*, slip op. at 16-17.

'climate of consumer confidence, that facilitates sales."[30] Basically though, merchants are willing to bear the costs of collection because they get access to customer dollars. They get the revenue, less only the sales tax. They are willing to bear the costs of collection – getting driven down to a penny a transaction -- much as they are willing to bear a 5 percent credit card merchant charges --to get access to the customer's dollars.

C. Leave it to Congress?

Wayfair was a 5-4 decision, but the four dissenting judges did not defend the old physical presence requirement, but only said that it was appropriate for Congress rather than courts to change the status quo.[31] Under the dormant commerce clause, it is conceded that Congress can make or change the rules for defense of out of state merchants, but the courts can and do enforce the fundamental prohibition on out-of-state discriminations in absence of Congressional action. Prohibition of discrimination against out of state Americans was fundamental to the formation of a union of all for one, one for all, that won our independence and remains part of the cement that holds the united states together.

As a matter of political economics, it is almost impossible for Congress to take an action to raise state taxes. Raising taxes are always painful for an elected official, and when the benefit of the revenue goes to another jurisdiction, then the Congress would get all the blame for the taxes and none of the credit for the good things that the Texas revenue is used for. Congress has had fifty years since *Bella Hess* was decided to fix a rule that is treated unanimously by the Court as a bad rule. Congress can come in and act if it wants to revise the Court's decision. Waiting for fifty years to see if Congress is going to act independently is probably enough. Commercial enterprises are entitled to keep only the after-tax revenues.

D. Excess Exemptions.

The Texas comptroller's office recently announced an administrative rule, notwithstanding the statute which has no such rule, that it will not enforce the legal obligation to collect sales tax on remote sellers whose total Texas revenue is less than $500,000 a year. That $500,000 exemption is too high. The proper standard is parity between in-state and remote merchants. If Texas imposes burdensome taxes on Texans, it can and should impose them on out-of-state vendors. If Texas merchants are not getting offered a half-million-dollar exemption from sales tax, then neither should the remote sellers.

There are no constitutional grounds for a provision favoring out-of-state vendors. As noted, the Supreme Court overruled the old physical presence requirement because it was in effect "a judicially created tax shelter for businesses that limit their physical presence in a State." It is "not the purpose of the commerce clause," the court wrote, "to relieve those engaged in interstate commerce from their just share of state tax burden." The justices continued: "It is

[30] *Id.* at 17.

[31] South Dakota v. Wayfair, Inc., 138 S. Ct. 2080, 2101, 2104 (Roberts, J., dissenting) (stating that *Bella Hess* was wrongly decided and that the issue should be left to Congress).

essential to public confidence in the tax system that the Court avoid creating inequitable exceptions."

The $500,000 exemption, even the South Dakota $100,000, is way too high, given the increasingly modest cost of computer collection on internet sales. Thanks to the internet and a competitive market for sales tax software, the cost of sales tax compliance is cheap and, with competition, will get cheaper. The commercial software providers say they can keep up with 300 changes in sales tax a year, tack the sales tax onto the customer invoice, collect the tax from the sales price and pay it over to the states, all for about a penny a transaction. It is essentially the same cost to comply with Texas tax from an out-of-state terminal as it is from a Texas terminal. The $500,000 exemption is far too high for what is basically penny-a-transaction compliance cost.