Memorandum

CITY OF DALLAS

DATE June 22, 2018

TO Honorable Mayor and Members of the City Council

SUBJECT **Remote Retailers Sales Tax – US Supreme Court Ruling**

On June 21, 2018, the Supreme Court overturned *Quill v. North Dakota and National Bellas Hess v. Illinois* in a 5-4 decision. For the past 51 years, these two decisions have disallowed state and local governments from requiring remote retailers to collect and remit sales tax.

Sales tax fairness has been an important component of the City's federal legislative program. Staff will continue to update Council as the implications of this court ruling are further analyzed. Ralph Garboushian, our Washington consultant, has provided a summary of the decision which is attached.

It is important to note that Texas has not adopted the Streamlined Sales and Use Tax Agreement. However, in his opinion, Justice Kennedy specifically outlines the parameters of the streamlined agreement, leaving the door open for states to act but without necessarily adopting the agreement. In either case, the Texas Comptroller will likely have to ask the legislature to enact changes to Texas' sales tax regime before the Comptroller can compel out-of-state retailers to collect and remit sales taxes. Joining the streamlined agreement and enacting its model legislation would be the easiest way to conform to the opinion, but Justice Kennedy appears to have left room for states to do it without necessarily adopting the streamlined agreement.

If you have additional questions or concerns, please contact Brett Wilkinson, Managing Director, Office of Strategic Partnerships and Government Affairs.

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SALES TAX FAIRNESS

Supreme Court overturns *Quill* and *Bellas Hess*. In a 5-4 ruling in *Wayfair v. South Dakota*, the Supreme Court overturned two previous rulings, *Quill v. North Dakota* and *National Bellas Hess v. Illinois*. Those two decisions have barred state and local governments from requiring remote retailers to collect and remit sales tax for 51 years.

Details of how collection of sales taxes from remote retailers can proceed must still be worked out by a lower court. Thus, the full and final impact of this week's decision is difficult to gauge, especially since the decision places parameters on how the lower courts and then states should proceed. Nevertheless, state and local governments can claim victory on a key issue that has had a major impact on their revenue and on local retailers and commercial real estate markets, especially in recent decades as the shift to online shopping has robbed state and local governments of billions of dollars in revenue and placed traditional brick-and-mortar retailers at a disadvantage.

In its 1967 *Bellas Hess* decision, the Court held that under the Due Process and Commerce Clauses of the Constitution, states could not compel a retailer without a physical presence in the state to collect and remit sales taxes. In its 1992 *Quill* decision, the Court overruled its Due Process holding but not its Commerce Clause holding. (Note that the constitutionality of the sales taxes were never in question, just whether the states could require remote retailers to collect and remit the sales taxes.)

In this week's *South Dakota v. Wayfair* decision, the Court overruled the Commerce Clause ruling made in *Bellas Hess* and upheld in *Quill*. Writing for the majority, Justice Anthony Kennedy based the decision on a critique of the physical nexus requirement outlined in *Bellas Hess* and *Quill*, writing that the physical presence rule outlined by *Quill* and B*ellas Hess* is "unsound and incorrect."

Most of Kennedy's opinion goes on to outline why. At the most basic level, Kennedy argues that the physical presence test is an incorrect interpretation of both the Commerce Clause and previous rulings that a taxed entity have "substantial nexus" with the activity being taxed. More specifically, Kennedy writes:

> "The physical presence test has long been criticized as giving out-of-state sellers an advantage. Each year, it becomes further removed from economic reality and results in significant revenue losses to the States. These critiques underscore that the rule, both as first formulated and as applied today, is an incorrect interpretation of the Commerce Clause."

Expanding on his assertion, Kennedy outlines three specific flaws in the physical presence test:

1. The physical presence test is not a necessary interpretation of the nexus test and sellers who engage in a significant quantity of business in a state such as Wayfair and other

retailers involved in the case "are large, national companies that undoubtedly maintain an extensive virtual presence."

2. *Quill* creates rather than resolves market distortions – in effect it "is a judicially created tax shelter for businesses that limit their physical presence in a State but sell their goods and services to the State's consumers, something that has become easier and more prevalent as technology has advanced."
3. *"Quill* imposes the sort of arbitrary, formalistic distinction that the Court's modern Commerce Clause precedents disavow in favor of a sensitive, case-by-case analysis of purposes and effects."

A lower court must still work out the details of how the *Wayfair* decision will be implemented. The justices remanded the underlying case and the South Dakota statue in question to a lower court. However, in his opinion, Kennedy lays out the parameters to guide the lower court. Those parameters are based on the Court's ruling that while the physical presence test is not a barrier to the validity of the underlying South Dakota statute, other barriers have not yet been litigated.

Nevertheless, Kennedy cites three features of the South Dakota statute "that appear to be designed to prevent discrimination against or undue burdens upon interstate commerce."

- "First, the Act applies a safe harbor to those who transact only limited business in South Dakota.
- "Second, the Act ensures that no obligation to remit the sales tax may be applied retroactively."
- "Third, South Dakota is one of more than 20 states that have adopted the Streamlined Sales and Use Tax Agreement."

The South Dakota statute exempts sellers that deliver less than $100,000 of goods or services into South Dakota or engage in fewer than 200 transactions for the delivery of goods and services into South annually. The Streamlined Sales and Use Tax Agreement requires a single, state level administrator of remote sales taxes, uniform definition of products and services, simplified tax rate structures, and provides sellers access to sales tax administration software at no cost.

Chief Justice John Roberts wrote the dissent, arguing that Congress rather than the Court should address an issue so important to a large part of the economy. It is important to note that Roberts agrees that *Bellas Hess* and *Quill* "were wrongly decided for many of the reasons given by the Court." But he concludes that "The Court should not act on this important question of current economic policy, solely to expiate a mistake it made 50 years ago." (Kennedy replies to this criticism, writing "It is inconsistent with this Court's proper role to ask Congress to address a false constitutional premise of this own Court's creation." Cynics might note that regardless of whether you agree with Roberts or with Kennedy on that broad principle, as a practical matter Congress, particularly the House, has avoided addressing the issue of sales tax fairness for years.)

In closing, state and local government officials who have worked on this issue for years will appreciate the following from Kennedy' opinion, which can only be read as a strong rebuke of the retailers involved in this case:

> "In essence, respondents ask this Court to retain a rule that allows their customers to escape payment of sales taxes – taxes that are essential to create and secure the active market they supply with goods and services. An example may suffice. Wayfair offers to sell a vast selection of furnishings. Its advertising seeks to create an image of beautiful, peaceful homes but it also says that "one of the best things about buying through Wayfair is that we do not charge sales tax." What Wayfair ignores in its subtle offer to assist in tax evasion is that creating a dream home assumes solvent state and local governments."

The decision is at: https://bit.ly/2lmAMwR.