

States May Require Sales Tax Collection by Out-of-State Internet Sellers

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Out-of-state internet sellers do not need to be physically located in a state for the state to require the seller to collect sales taxes from its customers. The U.S. Supreme Court overturned a decades old law in *South Dakota v. Wayfair, Inc.*, holding that the “physical presence” rule, which limits states’ taxing powers under the U.S. Constitution’s Commerce Clause, does not fit modern e-commerce.

The Commerce Clause prohibits state laws from discriminating against interstate commerce and imposing undue burdens on interstate commerce. It requires that state tax laws 1) apply to an activity with a “substantial nexus” to the taxing state, 2) be fairly apportioned, 3) not discriminate against interstate commerce, and 4) be fairly related to the services the state provides. Before the South Dakota decision, the Court’s rule was that a “substantial nexus” requires a seller to have a physical presence in the taxing state.

In South Dakota, the Court re-examined its rule and found that requiring a physical presence for sellers’ obligation to collect sales taxes gives out-of-state sellers an advantage, does not reflect economic reality, and causes states to lose significant tax revenues. The Court concluded that the rule is simply that the obligation to collect sales taxes applies to an activity with a substantial nexus to the taxing state. In South Dakota, the law only requires collection of sales taxes by sellers that deliver more than \$100,000 of goods or services into the state or that engage in 200 or more separate transactions annually. The Court found these conditions provide a substantial nexus, even if a seller does not have a physical presence in the state.

The Court left open the possibility that South Dakota’s law might be invalid under one of the other three requirements of the Commerce Clause doctrine and sent the case back to the lower courts. However, the Court observed that South Dakota’s tax system includes several features that may prevent discrimination against interstate commerce or undue burdens upon interstate commerce. These include a safe harbor for sellers that transact limited business in the state, no retroactive application of the law, and a standardized tax system

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Robin D. Harris

Trisha Ortiz

that reduces administrative and compliance costs.

What does this mean for California sales taxes? Even before South Dakota, California's law requires retailers to collect sales taxes as long as they have a "substantial nexus" to California. Now that the U. S. Supreme Court has decided that physical presence is not required, the State should be providing policies and procedures for determining which out-of-state internet sales activities meet its "substantial nexus" requirement. Local governments that have their own sales taxes must adopt local laws that mirror California's law. So, the anticipated State policies and procedures will determine how South Dakota affects local sales tax collections.

For advice concerning the effect of this decision, please contact **Trisha Ortiz**, **Robin Harris**, or any member of the firm's Public Law Department.