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United States Supreme Court Overturns Physical Presence Rule for State Sales Tax Collection

The United States Supreme Court, in a 5-4 decision in *South Dakota v. Wayfair* (https://www.supremecourt.gov/opinions/17pdf/17-494_j4el.pdf), overturned the "physical presence" rule of *National Bellas Hess, Inc. v. Department of Revenue of Ill.*, 386 U.S. 753 (1967), and Q*uill Corp. v. North Dakota*, 504 U.S. 298 (1992). The two cases held that a state could not require a business that had no physical presence therein to collect its sales tax. Additionally, a physical presence did not exist solely by mere shipment of goods into the consumer's state. In such a situation, consumers are required to report and remit sales tax on the goods they purchased from the remote seller. Unsurprisingly, consumer compliance with such a requirement is very low. The retail market has significantly changed since the time these cases were decided, and there are now several online retailers that make significant sales to consumers but are not required to collect and remit sales tax in the consumer's state because the retailer has no physical presence therein. As such, many states are missing out on a large source of potential revenue.

In *Wayfair*, the Court was asked to review a South Dakota law that requires businesses that do not meet the physical presence rule to nonetheless collect and remit South Dakota sales tax if such business, on an annual basis, delivers more than $100,000 of goods or services into South Dakota or is engaged in 200 or more separate transactions for the delivery of goods or services into South Dakota. This law was passed in 2016 in response to South Dakota's inability to collect sales tax from remote sellers and/or the consumers to whom the sellers sold goods and services, which was "causing revenue losses and imminent harm" to the state. The defendants in the case, Wayfair, Inc., Overstock.com and Newegg, Inc., are all major online retailers in the United States, none of which had a physical presence in South Dakota and none of which were collecting and remitting sales tax to South Dakota.

The Court's opinion relies on its interpretation of the Commerce Clause of the U.S. Constitution, Art. I, §8, cl.3. In previous cases, the Court has held that a state may regulate interstate commerce as long as its regulations do not discriminate against nor impose undue burdens on interstate commerce. Further, the Court has held that a state tax will be sustained "so long as it (1) applies to an activity with a substantial nexus with the taxing State, (2) [is] fairly apportioned, (3) does not discriminate against interstate commerce, and (4) is fairly related to the services the state provides." The physical presence rule from *Bellas Hess* and *Quill* derived from the requirement that an activity have a "substantial nexus" with the taxing state. In *Wayfair*, the Court overturned the physical presence rule by holding that (a) the physical presence rule is an incorrect interpretation of the Commerce Clause because (i) it is not a necessary interpretation of the substantial nexus requirement, (ii) the test creates rather than resolves market distortions by creating an incentive for businesses to avoid physical presence in multiple states and (iii) the physical presence rule treats economically identical actors differently for arbitrary reasons; and (b) the physical presence test is an "extraordinary imposition by the Judiciary on States' authority to collect taxes and perform critical public functions," since it helps consumers buying from remote retailers evade a lawful tax and unfairly shifts the burden onto consumers who buy from competitors with a physical presence in a state. Further, in the absence of the physical presence test in *Bellas Hess* and *Quill*, the Court held that

the thresholds set by the South Dakota law satisfied the substantial nexus requirement set forth above.

The Court remanded the case to the Supreme Court of South Dakota to determine if "some other principle in the Court's Commerce Clause doctrine" might invalidate the South Dakota law. However, it did note that the law was "designed to prevent discrimination against or undue burdens upon interstate commerce" because the law applies a safe harbor for limited business activities in South Dakota; collection and remittance is not applied retroactively; and South Dakota has adopted the Streamlined Sales and Use Tax Agreement, which standardizes taxes to reduce administrative and compliance costs (one of more than 20 member states). The dissenting opinion, while agreeing with most of the rationale of the majority opinion, however, held that this issue should be left to Congress to fix.

Minnesota already has issued a press release on the *Wayfair* decision, which provides sales tax collection and remittance guidance to sellers. The press release states that Minnesota will provide additional guidance in light of the decision within 30 days, and that sellers that are interested in collecting and remitting sales tax in Minnesota should register using the Streamlined Sales Tax Registration System that covers 24 member states.

Additionally, the following states have legislation similar to South Dakota's that requires the collection and remittance of sales tax in such state if certain receipt and/or transaction thresholds are met that establish a nexus with the state: Alabama, Connecticut, Georgia, Hawaii, Illinois, Iowa, Kentucky, Louisiana and Oklahoma. Other state legislative bodies have considered similar economic nexus legislation, but have either deferred it or, in the case of New Jersey, urged Congress to take federal action. Pennsylvania and Washington already required sales and use tax collection and remittance for third-party sellers. (Alaska, Delaware, Montana, New Hampshire and Oregon do not impose a state sales tax.)

Retailers that are not currently collecting and remitting sales tax in states in which they may have an economic nexus, but not a physical presence, should immediately consult a tax professional to ensure they are in compliance with their collection and remittance duties.

IRS Designates Certain Tracts as Qualified Opportunity Zones

The IRS issued Notice 2018-48 (https://www.irs.gov/pub/irs-drop/n-18-48.pdf) listing the population census tracts that the Secretary of the Treasury designates as qualified opportunity zones. A qualified opportunity zone is an economically distressed community where new investments, under certain conditions, may be eligible for preferential tax treatment in order to spur economic development and job creation in such community.

IRS Issues Proposed Treasury Regulations Regarding the Allocating of Partnership Liabilities in Disguised Sales

The IRS issued proposed regulations (REG-131186-17 (https://www.federalregister.gov/documents/2018/06/19/2018-13129/proposed-removal-of-temporary-regulations-on-a-partners-share-of-a-partnership-liability-for)) under Section 707 regarding allocations of partnership liabilities for disguised sale purposes. (Section references are to the Internal Revenue Code of 1986, as amended.) The proposed regulations would generally withdraw and remove earlier proposed and temporary regulations issued in 2016 and reinstate the final regulations that were previously in effect.

ABA Members Request Qualified Business Income Guidance on Service Trades or Businesses

The American Bar Association Section of Taxation submitted comments (https://www.americanbar.org/content/dam/aba/administrative/taxation/policy/061818comments.authcheckdam.pdf) to the IRS requesting guidance on the scope of a specified service trade or business within the meaning of Section 199A, which was added by the 2017 legislation commonly known as the Tax Cuts and Jobs Act.

ICI Submits Letter to the IRS Suggesting Items for Inclusion on Priority Guidance Plan

The Investment Company Institute submitted a letter (https://www.stradley.com/~/media/Files/Publications/2018/06/ICI%20Letter%20to%20IRS%20June%2014%202018.pdf) to the IRS requesting guidance on issues resulting from the Tax Cuts and Jobs Act that affect regulated investment companies and their shareholders, such as Section 199A qualified business income deduction, Section 163(j) interest expense limitation and Section 965 transition tax on deferred foreign income.

Nareit Requests Guidance From the IRS on the Qualified Business Income Deduction

Nareit submitted a letter (https://www.reit.com/sites/default/files/Nareit-PGP-Recommendations-2018-19-Final.pdf) to the IRS requesting guidance on issues resulting from the Tax Cuts and Jobs Act that affect real estate investment trusts, including guidance that Section 199A applies to shareholders investing in REITs through regulated investment companies.

ABA Members Request That UBTI Rules Be Delayed Until Final Regulations Are Issued

The American Bar Association Section of Taxation submitted comments (https://www.americanbar.org/content/dam/aba/administrative/taxation/policy/062118comments.authcheckdam.pdf) to the IRS requesting that new Section 512(a)(6), which requires that organizations separately calculate UBTI for each unrelated trade or business, be

delayed in implementation until the IRS issues guidance defining what constitutes "each such trade or business."

IRS Practice Unit Addresses Interest Capitalization for Some Assets

The IRS released a practice unit (https://www.irs.gov/pub/irs-utl/inv_p_203_01_01_01.pdf) on the steps used to determine the amount of interest that must be capitalized under Section 263A(f) when a taxpayer produces "designated property."

Connecticut Issues Guidance on the Calculation of the Pass-Through Entity Tax

The Connecticut Department of Revenue Services issued guidance (http://www.ct.gov/drs/lib/drs/forms/1-2018/composite/ocg-6-passthroughtaxguidance.pdf) for taxpayers regarding the calculation of the pass-through entity tax for purposes of making estimated tax payments. The guidance covers who is subject to the tax; how it is calculated, including the default and alternative methods; and other issues.

Texas Tax Amnesty Program Expires on June 29, 2018

The Texas Tax Amnesty Program (https://comptroller.texas.gov/tax-amnesty/), which provides taxpayers with relief from state penalty and interest due on taxes owed to the state, is set to expire on June 29, 2018. See our prior coverage here (https://www.stradley.com/insights/publications/2018/03/tax-insights-march-21-2018).


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