

Wayfair and Income Tax

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Note to Practitioners and Advisors: There is some good-useful stuff is in the endnotes.

Note to Business Owners: If you operate a business that has customers in multiple-states or transacts business on the internet, this article addresses issues you need to consider – probably soon.

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Precis – The Wayfair Decision

In June 2018 the Supreme Court, ruling in *South Dakota v. Wayfair*,ⁱ allowed states to impose sales tax on purchases made by buyers in the state's jurisdiction from out-of-state sellers, even if the seller has no physical presence in the taxing state. Their decision overturned longstanding practice, rejecting the "physical presence" test as "unsound and incorrect."ⁱⁱ

The Wayfair decision responds to the realities of the internet market;ⁱⁱⁱ internet companies do not need to be physically present in a market to sell to customers in it.

Where internet company sales are not sales taxable;

- 1) state revenues are depressed,
- 2) internet companies reap the jurisdiction's market and legal benefits without "paying for them,"^{iv}
- 3) local sellers' market competitiveness is undermined.

In the last 18 months, over thirty states have adopted Wayfair-like sales tax statutes - proving, if nothing else, that state legislatures respond efficiently to developments that benefit their budgets.

Wayfair meets Income Taxation

When Wayfair was decided, we (and a whole lot of other analysts) sensed a broader multi-state tax policy dilemma - If the Court could overturn Quill, why should states continue to abide by Public Law 86-272?^v The reasoning behind 86-272 mirrors Quill's reasoning, but 86-272 applies to state income tax. Wayfair applies to sales tax.

If states stop complying with 86-272, or adopt rules that defy it, will the Court back them up?

Pennsylvania just fired the first shot in the Wayfair War:

Commencing January 1, 2020 Pennsylvania will impose corporate income tax on companies that have no offices, employees, or property in PA's jurisdiction.^{vi} As under Wayfair for sales tax, sales to PA consumers will determine income tax nexus and the selling-company's income tax exposure. PA cites Wayfair as the legal basis for its position. PA's tax-law also acknowledges and abides by the Wayfair Court's restrictions on state authority to tax "outside sellers."

So, Now What Happens?

We correctly predicted that states will follow Wayfair's currents into the income tax arena. Most states can't really afford not to – which made this an easy call. We have more predictions:

1. Other states will adopt income tax standards that invoke Wayfair's nexus implications. (Again, an easy call. About a dozen state already have proposals in place.)
2. There will be a whole lot of litigation around the new standard; beginning with Pennsylvania's. (Litigation in America? I suppose that's an easy call as well.)
3. States will win, and sellers will lose.
4. State "wins" enshrine the "market economic" nexus standard from Wayfair and render most P.L. 86-272 "physical presence" precedents moot.
5. Chaos will reign during the transition. We do not expect Congress to intervene quickly to impose a national standard – as they did when P.L.86-272 was adopted.
6. ***Significantly more small and mid-sized businesses will face multi-state tax issues – and will need to adjust their record keeping and compliance regimes to accommodate them.***

One More Observation: A Wayfair inspired nexus standard for income tax shares many attributes of the “digital taxes” proposed in several countries.

The digital taxes are akin to excises. They apply more like Wayfair than do “economic market” income tax standards – but shift the tax burden (temporarily) from consumers to sellers.^{vii} In many ways they are more predictable and administratively simpler than Wayfair inspired income taxes.

Digital taxes and the Wayfair standard are administrable only if selling companies prepare for them. If you are not prepared, expect to be blindsided.

By the way, Who Cares?

If you are a small or mid-size business (especially if you do business on the internet):

Determine where your customers are located, how much business you do with them, and what the reporting thresholds are in that location.^{viii} At least for a while (forever, if Congress doesn’t get its act together), reporting thresholds will differ between jurisdictions.

If you are below the reporting thresholds, don’t worry about it right now. Hopefully, you’ll grow into them.^{ix} Don’t wait for your advisors to discover the exposure (it may be too late by then) – take personal control of your situation.

Talk to your advisors (especially those who deal with sales tax). Make sure they know about this exposure. If they don’t, give them a copy of this paper. It’s not much, but it may put them on the right track.

You may pay more for advisory services – for the reasons we mention in the next section. Talk to your advisors; Make allowance in your budget.

The Wayfair standard creates planning and organizational opportunities. For example, if the Wayfair standard creates nexus where you had none under the 86-272 standard, maybe it’s time to open that branch-office subsidiary you deliberately avoided because of 86-272. Talk to your advisors about it; Do a mind probe for their other ideas.

And, Our strongest suggestion: Unless you, or someone on your staff, has intimate knowledge of this subject, please don’t even think about DIY’ing it! It really is a minefield. If your advisors can’t or won’t help – find someone qualified who will.

If you are a practitioner or advisor:

First Impact; Tax Compliance: The Wayfair standard lowers the threshold for multi-state planning and compliance engagements; far more businesses will file multi-state sales and income tax returns. Many of those businesses will need planning and compliance assistance.

The multi-state regimen, even before gauging Wayfair’s impact, is complex. Small or mid-sized business clients’ DIY or in house-solutions will not be reliable in many cases. Your clients expect you to fill that void.

At the very least, the Wayfair standard alters practitioner due diligence requirements. Due diligence for even small-company engagements will now, if the Wayfair standard spreads to income tax, require practitioners to explore multi-state exposures to both sales and income tax. Add those inquiries to your SOP.

Increased due diligence implies additional time devoted to every return. Adjust your peak-season scheduling to compensate. If, like SJR Management, your practice consists almost entirely of small and mid-sized businesses – you may need to add staff. That staff will probably be expensive. Multi-state issues require advanced (experienced) knowledge.

Most practitioners will need to allot more time and dollars for continuing education. Unless Congress devises a uniform standard, as they did with P.L. 86-272 (we consider that unlikely), you need to stay abreast of developments in, practically speaking, every state that imposes either a sales tax or income tax and a few that currently don't. Develop in-house expertise (with respect to income tax) and/or find a way to out-source multi-state sales or income tax compliance. (SJR Management already outsources all our sales tax compliance – we've got no horse in this race.)

Practitioners who work with small or mid-size businesses: Consider a monitoring program; contact each business client on a regular basis to discuss Wayfair threshold issues. For practitioner/managers (e.g. out-source CFOs) monitoring is absolutely essential. Supplement the monitoring program with an “issue awareness” campaign. Teach your clients to recognize multi-state issues as they arise – and to contact you to deal with (fix) them.

Note: Monitoring and client situational awareness programs provide side-benefits (besides avoiding negligence, E&O claims, and those awkward “how come you never told me” conversations); better client relations. Heck, some clients may even pay you for the effort!

Since we've raised the “client relations” bugaboo; consider a client education program that lets clients know why your services are going to cost more!

The Wayfair Standard creates business expansion opportunities across the advisor skill set spectrum:

- Adopt this niche! Use your sales funnel to generate leads and additional business.
- Learn about IRC 351, 355 and 368 (Corporate formation and reorganization) and their Subchapter K counterparts. You will probably encounter some very remunerative work opportunities.
- Systems designers; Explore opportunities to update, upgrade, reinstall or redesign existing systems. Accommodate the new tax regime or automate the process.
- Data crunchers; increase your worth to clients by adding location information to the database. Come tax time, your clients will thank you, maybe even pay more for your input. BTW: this is easy to do in the higher end versions of QBO. Use of the “location” field. Different approaches are equally easy to implement in other software.

Those are just the opportunities we thought of off the top of our heads. There are undoubtedly dozens more.

Endnotes:

ⁱ South Dakota's law appears to have been tailored to both provoke and withstand Court scrutiny. Wayfair was the first to take the lure. See also, our discussion of Justice Kennedy's concurring opinion in *Direct Marketing Association v. Brohl*, below.

ⁱⁱ Wayfair overturns the result in *Quill Corp. v. North Dakota* (1992) which barred states from imposing sales tax or collection obligations on companies that had no physical presence (employees, assets, or sales) in the state, and tidies up elements of *National Bellas Hess v. Illinois* (1967)

A deeper reading of Wayfair reveals a stark change in the way this Court interprets the "Dormant Commerce Clause" (inferred from the Commerce Clause in Article I of the US Constitution) and how the Court applies *stare decisis*. That discussion is beyond the scope of this article.

ⁱⁱⁱ The writing that forecasts Quill's sunset has been on the wall since the Court's decision in *Direct Marketing Association v. Brohl* (DMA) (initiated in 2010, settled in favor of DMA in 2015).

In DMA the State's law was rejected based on the Tax Injunction Act. However, Justice Kennedy's concurring opinion outlined a path around the Act and the necessity to do so. Justice Kennedy wrote "it is unwise to delay any longer a reconsideration of the Court's holding in Quill" thus "inviting" a challenge. Kennedy noted that DMA "does not raise this issue in a manner appropriate for the court to address it" Wayfair addresses Kennedy's reservations.

^{iv} In most states, sellers do not "pay sales tax." Sellers are the state's agent to collect the tax from purchasers, who bear the tax.

Multiple jurisdictions and local rules impose significant collections, compliance and reporting costs on multi-state sellers. Last time the Tax Foundation counted, there were just shy of 10,000 (9,998) jurisdictions, each with their own rate and many with their own rules. Missouri leads the pack with 1,515 jurisdictions. California, in case you are wondering has a relatively modest 235 jurisdictions, and New York has but 84. Ten states have the bare minimum, one jurisdiction.

Side note: Back in the dark ages - early eighties - when SJR Management first ventured into multi-state, we were shocked to discover there were about 1,300 sales-tax jurisdictions. The jurisdictional issues have now become so complex that we delegate this compliance task to firms that specialize in the field. Ditto, for property tax compliance, which has become almost as convoluted.

^v P.L. 86-272 was a direct response to *Brown-Forman v. Collector of Revenue* (Louisiana), a 1958 case which limited states' authority to impose income tax on "them durned furiners" (out-of-state sellers). As with Quill, P.L. 86-272 endorses income tax jurisdiction only when the out-of-state seller has a "physical presence" in the state (More than "missionary" sales, transitory physical assets or employees). A massive body of interpretation, several revisions of the law itself and its accepted interpretations, and a nationwide organization of state tax administrators owe their existence to this law.

^{vi} Pennsylvania Department of Revenue Corporation Tax Bulletin 2019-04, issued September 30th, 2019, applies a Wayfair-like "economic market" nexus standard (loosely interpreted – sales to Pennsylvania customers that exceed a threshold amount create nexus for income tax) in place of their previous P.L. 86-272 physical presence nexus standard. Like the Wayfair rule, PA's income tax statute appears to be tailored both to provoke and withstand litigation and embraces threshold and retroactivity restrictions the Court mentions in Wayfair.

^{vii} Maybe I lack imagination (or charity) but I can't imagine companies permanently bearing the burden of digital tax without passing some or all of it along to consumers.

^{viii} Caution: Some jurisdictions will have both dollar and volume thresholds. Be cautious of the distinction between “or” and “and.” Thresholds like “500,000 in sales OR 200 transactions” generate anomalous determinations: the business up the street sells a \$490,000 machine in a single transaction – does not have to report. You sell 210 sticks of gum to 201 customers at 8 cents apiece (16.80 total sale) – You must report. Hopefully, state legislatures will avoid this kind of shoddy drafting – but then again...they’re not especially noted for their foresight.

^{ix} More Income: The best cure we know of for high taxes or tax exposure! Worst case scenario – the Fed and the state take 47%. You get the rest. Everybody goes home happy!