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Wayfair in the Context of Income Tax

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The U.S. Supreme Court's *Wayfair* decision was a sales tax case. But its nexus analysis applies equally in the context of an income tax. And when we do apply it in that context, we see several notable distinctions.

Retroactivity

It was in June this year that the Court issued its *Wayfair* decision, overruling *Quill* and holding that the dormant commerce clause does not require a physical presence for nexus, rather sufficient economic or virtual presence may be enough. Unlike legislative enactments of new laws, which are generally presumed to be prospective; judicial decisions interpreting existing laws generally apply retroactively, as well as prospectively. A whole body of case law exists around the question of retroactivity, and no doubt its application to *Wayfair* will be carefully researched at some point. But in the meantime, the U.S. Supreme Court's *Wayfair* opinion itself implies that its revised constitutional interpretation is retroactive.[1]

Assuming that the *Wayfair* decision applies retroactively, states are not required to enforce it in that manner. In fact, the Court encouraged states to enforce economic nexus standards prospectively to avoid imposing an undue burden on interstate commerce. Perhaps in response to the Court's urging and the risk of attracting a federal congressional override, guidance issued by South Dakota and other states in the wake of *Wayfair* is clear that enforcement of economic nexus for sales and use tax will be prospective only.

However, other than in one state, Texas, no such guarantees have been announced for income taxpayers.[2] This may be because a majority rule had emerged in state court cases that the *Quill* physical presence requirement never did apply in the context of an income tax.[3] To be fair, that majority rule was not free from doubt in states where the issue had not been litigated. For example, in a California case involving the state corporate franchise tax – for which the state's legislature had previously enacted a factor presence, economic nexus statute – a state court of appeal quoted extensively from *Quill* before observing, in a footnote, that it need not decide in "this" case whether *Quill's* physical presence rule applied to the franchise tax.[4]

This doesn't necessarily mean a state will or can immediately apply the new constitutional interpretation retroactively, or even prospectively. Other provisions of the federal constitution limit states' ability to impose their income tax on out-of-state taxpayers. For example, the due process clause of the fourteenth amendment may require a state to issue some form of guidance to taxpayers before it begins enforcing an economic nexus standard. There may be state law limits as well, where a state had (or has) statutes or other guidance limiting the exercise of its jurisdiction to taxpayers with physical presence.[5]

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[1] *South Dakota v. Wayfair*, 138 S.Ct. 2080, 2099 (2018).

[2] Despite the *Wayfair* decision, Texas continues to apply the physical presence requirement for franchise tax purposes, until further notice. Private Letter Ruling, No. 201809005L (Tex. Comptroller Sept. 7, 2018).

[3] *e.g., Geoffrey, Inc. v. S.C. Tax Comm'n*, 437 S.E.2d 13, 23 (S.C. 1993).

[4] *Harley-Davidson, Inc. et al., v. Franchise Tax Board,* 237 Cal.App.4th 193, 212, FN 11 (2015)

[5] See, e.g., *Alabama Dep't of Rev. v. Scholastic Book Clubs, Inc.*, No. CV-16-900562, *10 (Ala. Civ. App. 2018). This is a sales tax case, but illustrates the concept of state limits through regulation.

Until the retroactivity question is explicitly resolved, it may remain an area of some uncertainty for income taxpayers, more-so than sales taxpayers.

Nexus with the taxpayer, based on sales in the state
Wayfair tells us that having sales "in a state" may indicate the seller is "carrying on a business" there, which could mean it has some form of connection – economic or virtual, if not physical – sufficient to establish a "substantial nexus" and authorize the state to require payment of a tax.[6] How do we know when a sale is "in" a state? It's pretty clear, and states are fairly uniform, when it comes to sourcing sales of tangible personal property – in both a legal and practical sense, and for both sales and income tax purposes. For sales tax purposes, sales of tangible property are typically sourced based on "destination." Similarly for income tax purposes, sales of tangible property are typically sourced to the location where the property is "delivered." Neither of these rules is particularly difficult to interpret or apply.

But that's not the case when it comes to sales of services or intangible property; especially when the customer itself is a multistate business. While sales taxes primarily apply to sales of tangible property, notable exceptions include telecommunication services, management services, utility services, and digital goods. The sales tax sourcing of digital goods, in particular, has proven to be notoriously difficult. And, unlike sales taxes, income taxes apply generally to services and intangibles, and states have yet to coalesce around a uniform sourcing rule. (see tables 1 and 2). So, if the proposition is that having sales in the state may lead to a tax obligation, the question can quickly become to which state a sale should be sourced. Especially in an income tax context dealing with services or intangibles, it's not always clear and taxpayers may end up with different answers in different states.

Sales sourcing of services for income tax purposes[7]

Market based sourcing customer activity	Market based sourcing taxpayer activity	Cost of performance
Benefit received	***Service delivered***	— Alaska
— Arizona (elective)*	— Alabama	— Arkansas
— California*	— District of Columbia*	— Delaware
— Iowa*	— Kentucky* (beg. 2018)	— Florida
— Michigan*	— Louisiana*	— Hawaii
— Missouri* (SSF beg. 2020)	— Massachusetts	— Idaho
— New Jersey* (beg. 2019)	— Montana (beg. 2018)	— Indiana*
— New York*	— Oregon (beg. 2018)*	— Kansas
— Ohio (CAT)	— Pennsylvania*	— Mississippi
— Rhode Island*	— Tennessee	— New Hampshire
— Utah* (SSF phase in)	— Colorado (beg. 2019)*	— New Mexico
— Washington (B&O)	***Service performed***	— North Carolina*
— Wisconsin*	— New Jersey	— North Dakota
Service received	— South Carolina	— Texas*
— Illinois*	— Texas	— Vermont
— Maine*		— Virginia
— Minnesota*		— West Virginia
Service used		
— Connecticut*		
Customer located		
— Georgia*		
— Maryland* (SSF phase in)		
— Nebraska*		
— Oklahoma		

[6] *South Dakota v. Wayfair,* 138 S.Ct. 2080, 2099 (2018).
[7] States with asterisks also generally require single sales or receipts factor apportionment.

Sales sourcing of intangibles for income tax purposes

Market use	Cost of performance	Other
— Alabama — California — Connecticut — District of Colombia — Georgia — Illinois — Iowa — Louisiana — Maine — Massachusetts — Michigan — Minnesota — Montana — Nebraska — New Jersey — New York — North Carolina — Oregon — Rhode Island — South Carolina — Tennessee — Utah	— Alaska — Arizona — Arkansas — Delaware — Florida — Hawaii — Idaho — Indiana — Kansas — Kentucky — Mississippi — Missouri — New Hampshire — New Mexico — North Dakota — Pennsylvania — Virginia — West Virginia	***Commercial domicile*** — Texas — Oklahoma ***Other*** — Colorado (as TPP) — Maryland (no guidance) — Vermont (receipts earned) — Wisconsin (use, commercial domicile, or billing)

Nexus with the income

In *Wayfair*, the only question was whether the state had nexus with out-of-state sellers, such that the state could require those sellers to collect or pay a tax. The sellers conceded that the state had nexus with, and thus could tax, their sales. "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."[8]

In an income tax context, the thing subject to tax is not a transaction, it's income. And the question of whether a state has nexus with a taxpayer's income is not a simple one. It's also not a new one, of course. The answer lies in the due process underpinnings of the unitary business principle and formulary apportionment. Essentially, a state can only tax income if it's arising from taxpayer activity conducted within the state. A state can tax an apportioned share of income arising from taxpayer activity conducted outside the state, but only if that out-of-state activity has some concrete connection (is unitary) with a taxpayer activity conducted inside the state.[9] The tax policy rationale for including a sales factor in the apportionment formula is that a sale in the state likely indicates some market-related taxpayer activity is occurring there, which is giving rise to income, which the state may then tax. But in some cases, sourced sales may not reflect taxpayer activity in the state. And when they don't, they may not be sufficient, by themselves, to establish nexus with the income the state seeks to tax.

For example, even if we're certain where the sale of a service or digital good should be sourced under state law, some state laws may be more a reflection of where customer activity is taking place, than where the seller is carrying on its business. Is the place where a customer has customers, or where a customer enjoys a benefit, or where a customer makes use of a product, necessarily the place where the seller is carrying on its own business? In some cases, it may not be. In those cases, that form of sales factor sourcing – based on customer activity –

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[8] *Wayfair,* 138 S.Ct. 2080, 2092-93 (2018) (quoting *Oklahoma Tax Comm'n* v. *Jefferson Lines, Inc.*, 514 U. S. 175, 184 (1995) and 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").

[9] *Mobil Oil Corp v. Commissioner of Taxes of Vermont*, 445 U.S. 425, 436-437 (1980).

may not be a good indication of where taxpayer activity is taking place that's giving rise to the income. And in those cases, we may see increased controversy in the future.

Public Law 86-272 protections

A likely result of *Wayfair* is that states will assert nexus over more taxpayers. In the context of income tax, this could mean more taxpayers will want to consider whether they're entitled to the protections of Public Law 86-272, a federal statute that prevents a state from imposing its income tax in certain limited situations, even though the state would otherwise have the constitutional authority (nexus) to do so.[10] So Public Law 86-272 could soon be carrying a much heavier load. But the statute is almost 60 years old. Invoking its protections today can sometimes feel a bit like fitting a 2018 peg into a 1959 hole. There are interpretational gaps which states may try to close. And again, the result may be increased controversy in the future.

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[10] Pub. L. No. 86-272, Title I, § 101, 73 Stat. 555 (1959).