Analysis

Wayfair: signposting a fairer way for global taxation?

Speed read

In *South Dakota v Wayfair Inc.*, the US Supreme Court has overturned the rule in *Quill* that a taxpayer must have a physical presence in a state for its activities to have the sufficient 'substantial nexus' necessary for it to be required to collect and remit sales and use taxes. The ruling is, of course, important for US state tax and could have far-reaching ramifications for out-of-state entities (both US and international) carrying on business in the US. More intriguingly, the *Wayfair* case addresses one of the core challenges faced in international tax – realigning taxation with economic substance and value creation in the age of digitalisation.

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The Supreme Court of the United States (the court) handed down its decision in *South Dakota v Wayfair Inc.* (2018) 585 US (*Wayfair*) on 21 June 2018.

Wayfair concerned a challenge to a South Dakota law requiring a retailer, which has no physical presence in the state, to collect sales tax from its South Dakota consumers 'as if the seller had a physical presence in the State'. In the absence of the law, South Dakota would have had to rely on its resident consumers paying the tax on purchases from out-of-state sellers themselves. As the court noted, compliance rates were unsurprisingly low.

The law, however, appeared to flout a constitutional principle that a state may not require a business that has no physical presence there to collect and remit sales taxes. That principle emanates from the power of Congress '[t]o regulate Commerce … among the several States' (the commerce clause). Congress has generally left it to the court to interpret the commerce clause and define rules ensuring frictionless interstate commerce. The principle was established under two rulings of the court – *National Bellas Hess Inc. v Department of Revenue of Illinois* (1967) 386 US 753 (*Bellas Hess*) and *Quill Corp. v North Dakota* (1992) 504 US 298 (*Quill*) – and this became known as the physical presence rule in *Quill*.

The rule in *Quill* meant that a physical presence is required for an activity to have the sufficient 'substantial nexus' with a state (which is one of four prerequisites for a valid state tax following *Complete Auto Transit Inc. v Brady* (1977) 430 US 274).The traditional justification for *Quill* was that it protected businesses from undue compliance burdens on interstate commerce.

The court in *Wayfair* (retiring Justice Kennedy delivering the opinion for the majority) has:

- overruled its previous decisions in *Bellas Hess* and *Quill* (held to be 'flawed on its own terms'); and
- decided an out-of-state seller need not have a physical presence in a state in order to have 'substantial nexus' there.

Wayfair is, of course, noteworthy for a number of state-tax reasons in the US.

It also has the potential to have global relevance. The issues in the case echo some of the key debates on the future of international tax law. The existing international framework continues to struggle with how best to apply its core concepts of 'taxable presence', 'value creation' and 'profit attribution' to a globalised economy; struggles exacerbated by the growing prominence of challenges presented by the fourth industrial revolution.

US *Wayfair*

The court *did not* hold that the South Dakotan law meets the *Complete Auto* test in full or that it satisfied the commerce clause. It simply ruled that the physical presence rule in *Quill* for determining whether a remote seller has substantial nexus with the state is no more because it:

- represented a judicially created tax incentive for business to avoid having a physical presence in a state (thereby distorting the market); and
- arbitrarily treated sellers differently – compare, for example, a small business with a warehouse in South Dakota (caught by *Quill*) with a nationwide online retailer without one (escapes *Quill*).

The court went further, concluding:

> 'When the day-to-day functions of marketing and distribution in the modern economy are considered, it becomes evident that *Quill*'s physical presence rule is artificial … in its entirety. Modern e-commerce does not align analytically with a test that relies on the sort of physical presence defined in *Quill* … the continuous and pervasive virtual presence of retailers today is, under *Quill*, simply irrelevant. This Court should not maintain a rule that ignores these substantial virtual connections to the State.'

What, then, constitutes 'substantial nexus' in the US? The court has concluded, following *Polar Tankers Inc. v City of Valdez* (2009) 557 US 1, that 'such a nexus is established when the taxpayer [or collector] "avails itself of the substantial privilege of carrying on business" in that jurisdiction.' On any assessment, that is a low threshold.

Interestingly, the court observed that the South Dakotan law incorporated three features to ensure the obligations imposed on remote retailers would not discriminate against (nor be unduly burdensome on) interstate commerce:

- First, obligations only arise if the seller has at least:
  - taxable sales of US$100,000 annually; or
  - 200 taxable sale transactions annually.
- Second, the obligations cannot apply retroactively.

- Third, South Dakota has joined the Streamlined Sales and Use Tax Agreement (SSUTA) (see bit.ly/2NV9FpV). The SSUTA is a multi-state agreement to simplify and align sales tax collection and administration across states and remove or reduce the undue burdens on all sellers.

The way forward

The issues considered in *Wayfair* are not abstract legal constructs. The application of the physical presence rule in *Quill* has not been bloodless. It has deprived state governments of billions of dollars of tax revenue on sales by internet-based remote retailers. It epitomises the unequal treatment of 'click' and 'brick' by contributing to the demise of small local retailers and the proliferation of dead (or dying) main streets and shopping malls. The resulting unemployment and economic blight have further strained local government resources.

The court appears to be signalling to the South Dakota Supreme Court its view that the South Dakotan law passes constitutional muster. The court also appears to be signalling to *all* states with a sales tax that they should enact similar laws, incorporating the favourable characteristics of the South Dakota law, if they wish to require remote sellers to collect and remit the tax.

Putting to one side the possibility that Congress could enact a law to reinstate *Quill* (and reverse *Wayfair*) and any delays caused by the mid-term elections, do not be surprised to see more states:

- forego the retroactive enforcement of sales tax collection and remission obligations;
- introduce a minimum threshold to protect small scale enterprises; and
- join the SSUTA.

The way towards fairer taxation might have been signposted, but the journey in the US is far from complete.

International *Wayfair*

A particular passage in *Wayfair* hints at its relevance to the debate on how the international tax system can address the dual challenges of base erosion and profit shifting (BEPS) and the digitalisation of the globalised economy:

> 'The Internet revolution has made *Quill*'s original error all the more egregious and harmful. The *Quill* Court did not have before it the present realities of the interstate marketplace, where the Internet's prevalence and power have changed the dynamics of the national economy. The expansion of e-commerce has also increased the revenue shortfall faced by States seeking to collect their sales … taxes, leading the South Dakota Legislature to declare an emergency.'

It is easy to extrapolate these problems to the global level. For *Quill*, read 'taxable presence' or 'permanent establishment' (PE); for states, read sovereign nations; for sales taxes, read just taxes; and for South Dakota legislature, read national governments.

As in South Dakota, the changing global economic dynamic, and the ability of multinational enterprises to 'game' the system, has damaged countries' tax revenue recovery. The financial crisis amplified the severity of the impact and the accelerating digital revolution is likely to tighten the squeeze still further.

Fair substance

The OECD's BEPS project produced a series of reports, minimum standards and recommendations across 15 'actions' structured around three broad pillars, namely:

- coherence (i.e. smoothing the interaction between domestic laws);
- transparency and certainty (i.e. disclosure and information exchange); and
- substance (i.e. realigning taxation with economic substance and value creation).

The tax challenges arising from the digitalisation of the economy are most obvious under the substance pillar. Digitalised businesses are able to access multiple markets across borders without the need for a substantial (if any) local physical presence: the 'scale without mass' problem. The international tax system considers whether a non-resident entity is carrying on a business through a PE (i.e. has a taxable presence) there. The digitalisation of business models puts pressure on the current formulation of a PE.

The *Wayfair* case considers when an entity's activities have 'substantial nexus' with a state to create the obligation to collect and remit sales tax, i.e. when an entity has a taxable presence there. The conclusion of the court was that an entity that merely avails itself of the privilege of doing business in a jurisdiction assumes the necessary nexus. Adopting BEPS language, the economic substance of the transaction is where the buyer resides, irrespective of the existence of a (traditionally understood) PE.

The parallels between *Wayfair* and the OECD's work considering the possible need to extend the definition of a PE to encompass a virtual PE, is remarkable. The conclusion in *Wayfair* that carrying on a business in a jurisdiction establishes taxable presence is a simple and radical solution to the problem. If doing business in a country 'as if the [entity] had a physical presence' became the new normal, the effect would reverberate throughout the international tax system.

Way too far?

The parallels should not be overstated. *Wayfair* deals with a traditional (albeit remote) retailer of real goods; not a highly digitalised business, rich in movable intangible property and business models built around user-participation, data collection and advertising.

In addition, *Wayfair* concerns consumption tax, whereas the OECD's work concentrates on corporate income tax. While, on the one hand, the case considers issues of taxable presence for the purposes of tax administration and compliance, it says little or nothing (primarily because it does not need to) about the much more fundamental issues of 'value creation' and 'profit attribution'.

The original 2015 report on BEPS Action 1 (addressing the tax challenges of the digital economy) recommended that VAT on cross-border, business to consumer transactions (such as those considered in *Wayfair*) *should* be paid in the jurisdiction of consumption, where the customer is located, and outlined mechanisms to facilitate its efficient collection.

VAT is supposed to work that way. VAT is, like a sales tax, a tax on consumption. The European Union's proposals to introduce the 'definitive VAT system' build on the fundamental principles that VAT is chargeable in the 'destination' jurisdiction, and that the seller is liable for it and responsible for charging and collecting it. In addition, addressing the particular problems posed by remote sellers in the digitalised economy, the UK has unilaterally introduced rules that make the operators of online marketplaces jointly and severally liable for the UK VAT payable on supplies by remote sellers via those marketplaces. Colombia has already implemented similar rules and Germany is expected to follow suit.

Digitally fair

It would be equally wrong to focus on the differences.

Within a week of the OECD's non-committal interim report, *Tax challenges arising from digitalisation*, the European Commission (EC) released its own more assertive proposals for taxation in the digitalised economy. The EC plan is summarised in more detail in Murray Clayson's article in this journal (see 'Tax reform in the digital economy: recent OECD and EC activity', *Tax Journal*, 6 April 2018). In brief, the EC would recognise a 'digital PE', allowing a member state to tax profits, *even if a company does not have a physical presence* in that member state, if any one of three conditions (relating to revenues from digital services, the number of 'users', or the number of business contracts, in any year) is met. The formulation, complete with threshold, resonates with the design features of South Dakota's law.

In addition, there has been a slew of unilateral measures (proposed, threatened or adopted by multiple jurisdictions) seeking to protect immediately tax bases in the absence of internationally accepted rules.

Way fairer?

The problem is real. The digitalisation of the global economy is creating a fiscal distortion. The risk, however, is that extending the concept of what constitutes substantial nexus, taxable presence or PE too far deprives it of any real relevance. In a globalised economy, making an entity liable to account for tax somewhere simply because it has a certain number of customers (or users), or 'avails itself of the … privilege of carrying on business' there, means (subject to meeting several disparate, and possibly arbitrary, thresholds) many businesses could have a taxable presence almost everywhere.

Lowering the threshold for having a taxable presence too much simply kicks the tax policy can down the lane. Quite apart from the resultant compliance obligations, administrative burdens and need to implement appropriate processes and systems in multiple jurisdictions, the concepts of 'value creation' and 'profit attribution' necessarily assume immense strain in the effort to realign taxation with economic substance. Acceptance that 'user participation' is an appropriate indicator of value creation is not universal and difficulties (and disputes) in attributing profit to the place economic value is created will naturally follow.

Recognition of digital, or virtual, PEs under international tax law is probably inevitable. The court has signalled the likely way ahead in *Wayfair*. What is essential, however, is that robust new standards for identifying and measuring 'value creation' for tax purposes accompany it. Resolving that puzzle is probably the OECD's most pressing current challenge but equally one that could show the way to identifying 'fair taxation'. ■

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- ▶ Tax reform in the digital economy: recent OECD and EC activity (Murray Clayson, 4.4.18)
- ▶ 30 questions on BEPS (Jill Gatehouse & Susie Brain, 29.10.15)