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SCOTUS: The Crucial Case of South Dakota v. Wayfair and its Impacts for the Taxation of the Digital Economy

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The well-known expression "butterfly effect" comes from chaos theory, and it refers to the idea that a butterfly could flap its wings in Brazil and, through ripple effect, set off a tornado in Texas. Bringing this expression into the tax world, a decision by a domestic court on a seemingly domestic tax matter could trigger far-reaching implications for tax scholarship elsewhere. Today, this (particularly colossal) butterfly is the Supreme Court of the United States (SCOTUS), and the tornado might be the ongoing feud between scholars and government authorities over the thorny issue of taxing the digital economy.

On June 21, 2018, in the case of South Dakota v. Wayfair *et al*, the Supreme Court decided by a tight majority vote (5-4) that U.S. states can collect sales taxes from most online retailers. Specifically, the Court ruled that its previous decisions on the application of the Commerce Clause were based on an "unsound and incorrect" *physical presence rule*, which has given a historical advantage to out-of-state sellers in interstate trade. Just look at the strength of Justice Kennedy's statement in this excerpt of the majority vote:

> *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, not just "at its edges," […], but in its entirety. Modern e-commerce does not align analytically with a test that relies on the sort of physical presence defined in Quill. And the Court should not maintain a rule that ignores substantial virtual connections to the State.*

The majority vote goes on to claim that the Court should be "vigilant" in correcting errors established by *stare decisis* and that it should not "ask Congress to address a false constitutional premise of [its] own creation." Those are eminently constitutional matters of South Dakota v. Wayfair, which is why I will not address them in this article (but constitutionalists will have a field day with this stuff, I am sure). The main point for tax purposes is that the Court used the first prong of a test previously applied in the case of Complete Auto Transit, Inc. v. Brady (1977) to state that South Dakota can impose a tax on an activity with a **substantial nexus** to its territory. Regarding the respondents in this case, the opinion stated that they engage in a significant quantity of business in South Dakota, and that they "are large, national companies that undoubtedly maintain an extensive virtual presence," which is why they should be regarded as subject to tax in South Dakota, even though they are not physically present in South Dakota.

Before we move to the implications of South Dakota v. Wayfair *et al* to the larger, international debate about the taxation of the digital economy, we should first highlight the most relevant arguments raised by both the majority (Justices Kennedy, Thomas, Ginsburg, Alito and Gorsuch) and the minority (Chief Justice Roberts and Justices Breyer, Sotomayor and Kagan) in this case. Please find a brief summary of those arguments in the topics below

Majority opinion

The old "physical presence" rule. Under the rule established by the Supreme Court in previous cases, National Bellas Hess, Inc. v. Department of Revenue of Ill. (1967), and Quill Corp. v. North Dakota (1992), an out-of-state seller's liability to collect and remit a tax to the consumer's State depended on whether the seller had a physical presence in that State; however, the mere shipment of goods into the consumer's State, following an order from a catalog, did not satisfy that requirement. In his narration of the Bellas Hess case, Justice Kennedy cites the dissenting opinion of Justice Fortas, joined by Justices Black and Douglas, which claimed, even back in 1967, that the "large-scale, systematic, continuous solicitation and exploitation of the Illinois consumer market is a sufficient 'nexus' to require Bellas Hess to collect from Illinois customers and to remit the use tax." Also, in his narration of the Quill case, Justice Kennedy comments that three Justices (Justices Scalia, Thomas and himself) "based their decision to uphold the physical presence rule on *stare decisis* alone," and that Justice White dissented by saying that "there is no relationship between the physical-presence/nexus rule the Court retains and Commerce Clause considerations that allegedly justify it."

In his scathing criticism of the physical presence rule, Justice Kennedy **(i)** states that the rule becomes "further removed from economic reality and results in significant revenue losses to the states" year after year. He also **(ii)** cites two precedents under which 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," affirming the validity of a principle well-known to the Value-Added Tax (VAT) specialists in Europe, i.e., the destination principle. Finally, Justice Kennedy **(iii)** claims that the physical presence rule is "a poor proxy for the compliance costs faced by companies that do business in multiple States," and gives the following example to illustrate how the application of that rule leads to unfairness between interstate traders in the United States:

> *Consider, for example, two businesses that sell furniture online. The first stocks a few items of inventory in a small warehouse in North Sioux City, South Dakota. The second uses a major warehouse just across the border in South Sioux City, Nebraska, and maintains a sophisticated website with a virtual showroom accessible in every State, including South Dakota. By reason of its physical presence, the first business must collect and remit a tax on all of its sales to customers from South Dakota, even those sales that have nothing to do with the warehouse. […] But, under Quill, the second, hypothetical seller cannot be subject to the same tax for the sales of the same items made through a pervasive Internet presence. This distinction simply makes no sense.*

The budgetary side of the majority vote. Justice Kennedy dedicates a part of his opinion to criticize the unfairness created in interstate trade by the baseless application of the physical presence rule (Justice Gorsuch, in his concurring opinion on page **31**, goes on to say that the two precedents in Bellas Hess and Quill have, for years, "enforced a judicially created tax break for out-of-state Internet and mail-order firms at the expense of in-state brick-and-mortar rivals"). Specifically, after referring to the advertising of Wayfair, which offered not charging sales tax as an *advantage* to its customers, Justice Kennedy stated that the company should be concerned with the budgetary implications of its assistance in “tax evasion” to customers in South Dakota. In his words:

> *According to respondents, it is unfair to stymie their tax-free solicitation of customers. But there is nothing unfair about requiring companies that avail themselves of the States’ benefits to bear an equal share of the burden of tax collection. Fairness dictates quite the opposite result. Helping respondents’ customers evade a lawful tax unfairly shifts to those consumers who buy from their competitors with a physical presence that satisfies Quill—even one warehouse or one salesperson—an increased share of the taxes. It is essential to public confidence in the tax system that the Court avoid creating inequitable exceptions.*

This statement of Justice Kennedy is, at its core, an application of the famous benefit principle. This is the idea that taxes, particularly income taxes, should be imposed on persons for availing themselves of “benefits” provided by the source jurisdiction (e.g., a stable democracy, a well-organized financial system, security and infrastructure), but it is by no means unquestioned in tax scholarship.[1] In fairness, the point raised by Justice Kennedy is and will always remain relevant in the realm of cross-border taxation (whether interstate or international), which is the access provided by the source jurisdiction (and, in this case, the consumer’s jurisdiction) to structural benefits that must be paid for, and paid for by those persons and businesses that use them to further their interests. However, the counterarguments here are **(i)** that a larger, centralized structure of a company in one state requires that state to provide further security to that company’s business activities, and **(ii)** that the benefit principle can be stretched to justify local and state taxation to places well beyond the residence of consumers, and, at that point, administrability and compliance costs would turn its application into the world’s most complicated maze.

The better, though less evident, notion of “substantial nexus”. After several pages of criticism against the physical presence rule, one would expect the Supreme Court to define in minute detail what the remaining Complete Auto standard of “substantial nexus” is all about, but that did not happen here. Justice Kennedy first referred to a case (Polar Tankers, Inc. v. City of Valdez (2009)) in which Justice Breyer stated that a substantial nexus is established “when the taxpayer [or collector] ‘avails itself of the substantial privilege of carrying on business’ in that jurisdiction.” The Polar Tankers case refers to a personal property tax, which is not in the same ballpark of a sales tax, and the text of the ordinance challenged in that case referred to the Tonnage Clause, which is based on “privilege of entering, trading in, or lying in a port,” so that may have played an important role on the use of the term “privilege” in this definition. Actually, the term only confuses the application of the substantial nexus, because one thing is **(i)** the rationale for the application of the standard (i.e., the benefit principle or the benefits rationale), and another thing is **(ii)** the standard itself, which should guide taxpayers in figuring out whether their nexus to a certain jurisdiction is “substantial” or not.

The definition of “substantial nexus” in the vote of Justice Kennedy is further obscured by the specifics of this case. Here, the Act of South Dakota (S. 106) is textually applicable to “sellers that deliver more than $100,000 of goods or services into South Dakota or engage in 200 or more separate transactions for the delivery of goods and services into the state on an annual basis.” From that statement, Justice Kennedy argues that this quantity of business “could not have occurred unless the seller availed itself of the substantial privilege of carrying on business in South Dakota,” and that because respondents are “large, national companies that undoubtedly maintain an extensive virtual presence,” it follows that they have met the “substantial nexus” rule regarding the state of South Dakota, and should therefore be subject to sales tax in that state. The question is, would Justice Kennedy have reached the same conclusion under a threshold of $50,000? How about 100 or more separate transactions? How about 200 transactions, but both "segregated" and "combined" in their delivery of goods and services into South Dakota? In fact, what if the companies in question were not large e-retailers, but startups with little to no online presence, or only with a Kickstarter or Indiegogo campaign to their names? At this point, the definition of "substantial nexus" is close in clarity to Justice Stewart's non-definition of "hardcore pornography" in Jacobellis v. Ohio (1964), which, much to my personal distaste, has been used extensively by international tax practitioners when they do not know what a particular term-of-art means in practice. However, surrendering to the *vox populi* in this instance, let me quote it here:

> *I shall not today attempt further to define the kinds of material I understand to be embraced within that shorthand description, and perhaps I could never succeed in intelligibly doing so. But I know it when I see it, and the motion picture involved in this case is not that.*

The last part of Justice Kennedy's opinion refers to a matter that is important for *this case*, but not immediately relevant to the broader issue of the taxation of the digital economy. I am referring here to the "reasonable" structure of the South Dakota legislation that prevents out-of-state companies from claiming that they are unduly burdened by the requirement for local collection of state taxes (suppose South Dakota legislation contained none of the provisions listed by Justice Kennedy on page **28**; an assessment of whether specific out-of-state persons have a "substantial nexus" to South Dakota should not, in principle, rely on the inexistence of those provisions). The only (truly) relevant feature of this discussion is the logical and fair requirement that jurisdictions intending to tax out-of-state companies do so taking into account their difficulties in complying with in-state legislation (which, by definition, they do not know or are used to, because they are not physically present in the relevant state). This is similarly applicable to the taxation of the digital economy on the basis of online sales, data transfers, equalization levies and other shenanigans in line with the now passé BEPS Action 1 Final Report, which should be accompanied by domestic legal provisions that **(i)** are transparent to non-resident persons, that **(ii)** facilitate tax collection on a transactional basis, and that **(iii)** account for competing jurisdictional claims over the taxable basis of income, sales, services and other economic manifestations.

Minority opinion

This relevant enough for the Congress to decide, not this Court. Chief Justice Roberts recognizes that the decision in Bellas Hess was incorrect, but expressly declines the "invitation" to abandon the physical presence rule, because this is an important question of current economic policy, and the Court should not act on it to the detriment of Congress. Regarding Quill, the Chief Justice stated:

> *This is neither the first, nor the second, but the third time this Court has been asked whether a State may obligate sellers with no physical presence within its borders to collect tax on sales to residents. Whatever salience the adage "third time's a charm" has in daily life, it is a poor guide to Supreme Court decisionmaking. If stare decisis applied with special force in Quill, it should be an even greater impediment to overruling precedent now, particularly since this Court in Quill "tossed [the ball] into Congress's court, for acceptance or not as that branch elects."*

The point raised by the minority opinion is interesting, because it also refers to "three bills addressing the issue [of modifying the ‘substantial nexus’ rule or doing away with the ‘physical presence rule’]” that are currently pending in the U.S. Congress. Chief Justice Roberts claims that, even though Congress can continue to pursue a legislated solution to this impasse between states, the majority opinion has now changed the “ground rules” and potentially removed the attention of state officials from working with the Congress to “securing new tax revenue from remote retailers.” The general argument of the minority opinion, which is restrictive of judicial control when Congress is the appropriate body to analyze and improve on the issue at hand, is laudable. It should be inscribed on gold plaques in Supreme Courts across the globe, and it is very important for the issue of taxing the digital economy. As I stated in the previous part of this article, I agree with most of the contentions made by Justice Kennedy (even though I criticize his abstract and, oddly enough, case-specific definition proposed for the “substantial nexus” rule), but I believe those should be legislated and subject to intense popular scrutiny, so that a democratic solution is pursued rather than a principled, but potentially illegitimate rule. Moving to the realm of international taxation, for example, I would severely criticize a judicial decision that applied a VAT on the basis of a “substance over form” doctrine, just as I criticized in the past a decision from the Brazilian Administrative Court of Tax Appeals (CARF) that created a Permanent Establishment (PE) in Brazil simply because the local subsidiary of the holding company in France hired numerous services from France (the infamous Faurecia case, which, sadly, is not the only one of its kind). Those magical solutions to new problems in the field of taxation provide us, tax practitioners across the globe, with fun and interesting work; they are, however, poorly suited to enhance tax policy, whether in the United States, Brazil, or anywhere else.

The burden of the new “substantial nexus” rule will fall on small businesses. As correctly pointed out by Chief Justice Roberts, the majority opinion “breezily disregards the costs that its decision will impose on retailers.” He goes on to state that over 10,000 jurisdictions levy sales taxes, each with “different tax rates, different rules governing tax-exempt goods and services, different product category definitions, and different standards for determining whether an out-of-state seller has a substantial presence” in the jurisdiction. This goes back to my question about Kickstarter and Indiegogo startups: they are evidently in the business of reaching as many customers as possible via the Internet, and cross-border or multi-state compliance will be a problem for them. Again, though from a policy standpoint I agree with the general comments of Justice Kennedy on this issue, I believe the blanket application of a new “substantial nexus” approach to small businesses will simply turn tax lawyers into the most sought-after professionals in recent American history. Though that is far from being a downside for me, it will be a downside for business activity and entrepreneurship; my personal philosophy is that I prefer assisting businesses in new ventures, driven by a pre-tax business purpose, to assisting them in new legal obstacles to existing business activities. Certainly makes meetings much more upbeat and productive in the long run.

The impact for the taxation of the digital economy

One of the main issues with taxing the digital economy, of course, is that everybody wants a slice of the pie (and, in terms of VAT vis-à-vis income tax policy, a preliminary question here would be “what pie, exactly?”). The other issue is whether we should attempt to tax the digital economy using the existing legal framework (a solution that is aptly criticized by many authors, among them Sérgio André Rocha[2] and Yariv Brauner[3]) or a new framework, one that is dangerously peppered with old standards. After all, if we disregard the source-residence duality in international taxation, why should we be concerned with designing rules for a digital PE? Should we use the same transfer pricing rules for apportioning income on the basis of sales, services and intangibles?

As far as VAT is concerned, should jurisdictions follow on the footsteps of Korea and the Brazilian state of São Paulo, which have created a "deemed presence" of non-resident e-retailers in their territory, just so they can impose a domestic tax on what would otherwise be a foreign transaction (or, in the realm of income tax, foreign-sourced income)? Those are the *questions du jour* of analysts and commentators in many countries, and the fact that we are yet to come up with a harmonized solution for them means we still have a long way to address their underlying concerns.

The decision of the U.S. Supreme Court on South Dakota v. Wayfair *et al* is a testament to the perceived unfairness of taxing online retailers and service providers only on the basis of physical presence (which, for income tax purposes, is the whole point of recent PE debates). What we can take from it is **(i)** the notion that a "substantial nexus" no longer relies on a physical connection to a particular jurisdiction, whether by means of employees resident in that jurisdiction, or a warehouse, or even a storefront of some sort. Also, **(ii)** deciding between the appropriate nexus that would allow jurisdictions to impose relevant taxes (and, in this case, South Dakota argued that over 60% of its general fund are derived from its sales tax) is a key policy issue for any democracy, and its far-reaching economic implications may extend well beyond the grasp of even the most prepared tax lawyers, let alone judges in a domestic Court of Law. We should therefore strive for a more democratic solution, one that is able to harmonize the interests of competing jurisdictions and provide a measure of "compliance ease" for traders anywhere in the country or the world, whether they are multinational and large corporations, or medium-sized companies, or even local startups that are trying to make it big in Internet commerce. A better policy solution in this case is neither simple, nor straightforward, and, in this author's opinion, it should not be produced by the Judiciary Power of any jurisdiction.

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[1] See, for example, the comments of Stephen Shay et al about the "benefits rationale" as a justification for source taxation of non-resident income in SHAY, Stephen E.; FLEMING JR., Clifton; and PERONI, Robert J. *What's Source Got to Do with It? Source Rules and U.S. International Taxation*. Tax Law Review, Volume 56. New York: NYU, 2002.

[2] See ROCHA, Sérgio André. *Old Bottles or New Bottles: Time to Break the Bottle! In Favor of Broader Source Country Taxing Rights*. Kluwer International Tax Blog, published on June 20, 2018. Available at: <http://kluwertaxblog.com/2018/06/20/old-bottles-new-bottles-time-break-bottle-favor-broader-source-country-taxing-rights/>.

[3] See BRAUNER, Yariv. *Taxing the Digital Economy Post-BEPS, Seriously*. Intertax, Volume 46, Issue 6/7, pp. 462-465. Kluwer Law. Available at: <https://www.kluwerlawonline.com/abstract.php?area=Journals&id=TAXI2018050>.

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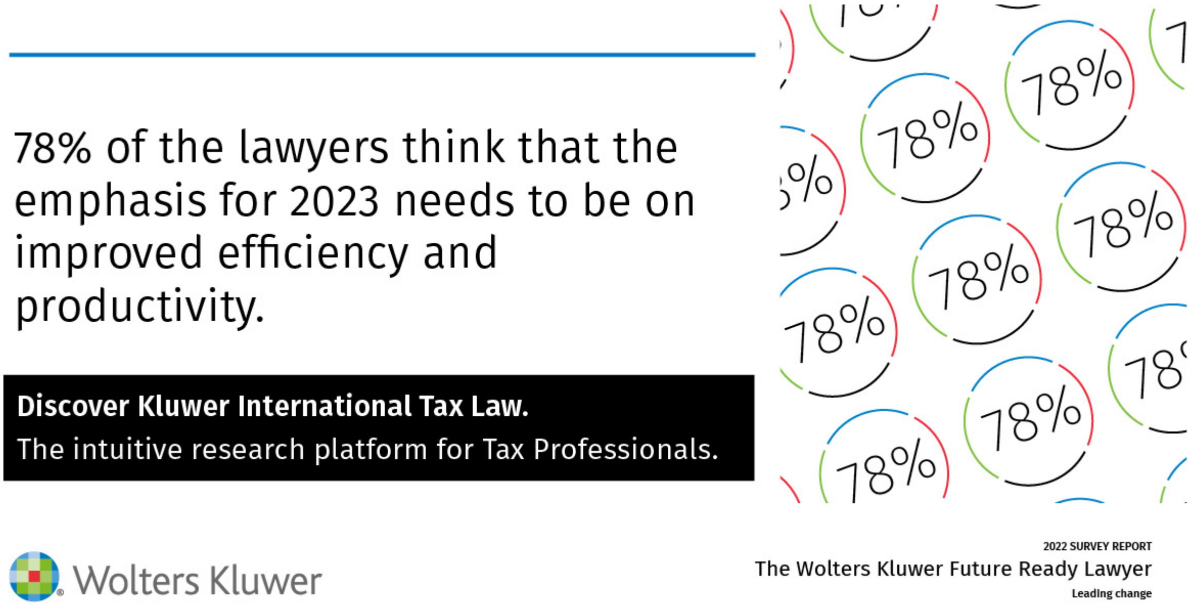

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