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U.S. Supreme Court Expands States' Extraterritorial Taxing Authority

States now have the power to tax out-of-state companies that make sales to in-state consumers, according to a U.S. Supreme Court decision with potentially far-reaching consequences. In *South Dakota v. Wayfair, Inc.* (No. 17-494, June 21, 2018), the Court overruled its prior precedents that limited state taxes to only those companies having a physical presence in the taxing state.

The *Wayfair* decision is widely expected to benefit state and local governments by increasing revenues from existing sales taxes, particularly on internet-based commerce. Lacking the ability to collect sales taxes from out-of-state sellers, many states have imposed use taxes on in-state consumers; however, use taxes are difficult to enforce and the rate of compliance is extremely low.

The "physical presence" rule was established in *National Bellas-Hess, Inc. v. Illinois*, 386 U.S. 753 (1967) and confirmed in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), both of which are now overruled. The Court determined that the bright-line physical presence rule undermined the constitutional principles of the Commerce Clause and ignored the realities of the modern economy.

In the place of a bright-line rule, courts considering the taxability of out-of-state activity must determine whether the activity has a "substantial nexus" with the taxing state, as one part of a four-part test set forth in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977). The precise meaning of "substantial nexus" is uncertain. In *Wayfair*, the Court determined that a substantial nexus existed because South Dakota sought to tax only those out-of-state companies making more than $100,000 of in-state sales or engaging in 200 or more separate in-state transactions. The *Wayfair* Court further approved of South Dakota's ban on retroactive application of its taxes as well as its entry into the Streamlined Sales and Use Tax Agreement ("SSUTA"). SSUTA is a multistate compact among 24 states (including Washington) seeking to standardize tax collections and reduce the compliance burden on companies.

In 2017, the Washington Legislature enacted legislation ("EHB 2163") intending, within the framework of *Bellas-Hess* and *Quill*, to increase revenue and consumer compliance with payment of use taxes through notice and reporting requirements on out-of-state companies. The *Wayfair* decision suggests that EHB 2163's requirements are enforceable, and it also introduces a more straightforward possibility for legislative consideration: collecting Washington state and local sales taxes directly from out-of-state companies.

In Washington, the physical presence rule has also limited collections of business and occupation ("B&O") taxes. *Wayfair* did not address the extraterritorial limits of B&O taxes, although it suggested

that "[c]omplex state tax systems could have the effect of discriminating against interstate commerce" in a manner prohibited by the *Complete Auto* test.

These and many other important issues are expected to be addressed in future court rulings, state and federal legislation, and administrative action. As the Court noted, Congress has the power under the Commerce Clause effectively to change the rule announced in *Wayfair*.

Pacifica's public finance attorneys will continue to monitor developments affecting the resources available to state and local governments, and will propose modifications to the standard securities disclosures for bonds that are payable from sales taxes or other taxes affected by the *Wayfair* decision.

If you have any questions on these tax law topics of interest to state and municipal bond issuers, please contact any of our public finance attorneys.

Alison Benge	Alison.Benge@pacificalawgroup.com	206.602.1210
Deanna Gregory	Deanna.Gregory@pacificalawgroup.com	206.245.1716
Faith Li Pettis	Faith.Pettis@pacificalawgroup.com	206.245.1715
Stacey Lewis	Stacey.Lewis@pacificalawgroup.com	206.245.1714
Jon Jurich	Jon.Jurich@pacificalawgroup.com	206.245.1717
Will Singer	Will.Singer@pacificalawgroup.com	206.602.1216

To subscribe to our mailing list, please contact Mia Wiltse at Mia.Wiltse@pacificalawgroup.com.

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