

NovioTax Latest ruling in US highlights importance of managing tax compliance in digital economy

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On 21 June 2018, the US Supreme Court issued its highly anticipated decision in *South Dakota v. Wayfair*. In the context of the current debate on the taxation of the digital economy and observing the March, 2018 EC proposals this decision may have a significant impact. The case was even called the “tax case of the millennium” and will basically change not only the US sales tax landscape but will also have far-reaching implications for non-US businesses supplying goods and services to the U.S.

Interaction with the current debate on the taxation of the digital economy

Already in 2013 the G20/OECD’s BEPS Project highlighted the concerns expressed around the world about tax planning by multinational enterprises that exploit gaps in the interaction of international tax laws to artificially reduce taxable income or shift profits to low-tax jurisdictions. This is particularly relevant for the digital economy, as its business models and the features of increasing digitisation are perceived as exacerbating the profit shifting exposure. It is therefore no surprise that the OECD recently emphasized the taxation of the digital economy as the most ‘urgent’ area for attention.

The OECD is currently working on bridging the gap between different countries’ perspectives and is aiming to issue a final report on this topic in 2019 or 2020 at the latest. Recently, EU governments have agreed that tax rules should be changed to increase levies on digital services that are currently undertaxed. In March 2018, for instance, the EC included the concept of virtual permanent establishment and / or significant digital presence in its proposals on digital taxation. At the same time as the debates in OECD and EU context continue, countries individually enact laws and provide guidelines on this topic. In recent years we have already seen legislative amendments in India (2018) and Israel (2016) dealing with the concept of digital presence. Most recently, on June 21, 2018, the US Supreme Court issued its ruling in *South Dakota vs. Wayfair*.

Background of the case

In 1967’s *National Bellas Hess* decision, the US Supreme Court decided that in order for a state to require a remote seller to collect sales tax, the remote seller must have physical presence in that state. The court stated that unless the retailer maintained a physical presence such as “retail outlets, solicitors, or property within a state,”¹ the state lacked the power to require that retailer to collect a local use tax. The physical presence rule, said the Supreme Court, was necessary to prevent undue burden on interstate commerce.

In 1992’s *Quill* decision, the Court was called upon to revise the physical presence rule. This case, like *National Bellas Hess*, involves a state’s attempt to require an out-of-state mail-order house that has neither outlets nor sales representatives in the State to collect and pay a use tax on goods purchased for use within the state.² Despite of the fact that the court issued an order overruling part of the *National Bellas Hess* ruling, the physical presence rule remained unaffected. The decision in *Quill* slightly distinguished itself from *National Bellas Hess* by ruling that physical presence was not necessary for a state to impose a duty to collect under the Due Process Clause of the US Constitution, but physical presence was still necessary for a state’s use tax on a foreign vendor under the Dormant Commerce Clause of the US Constitution.

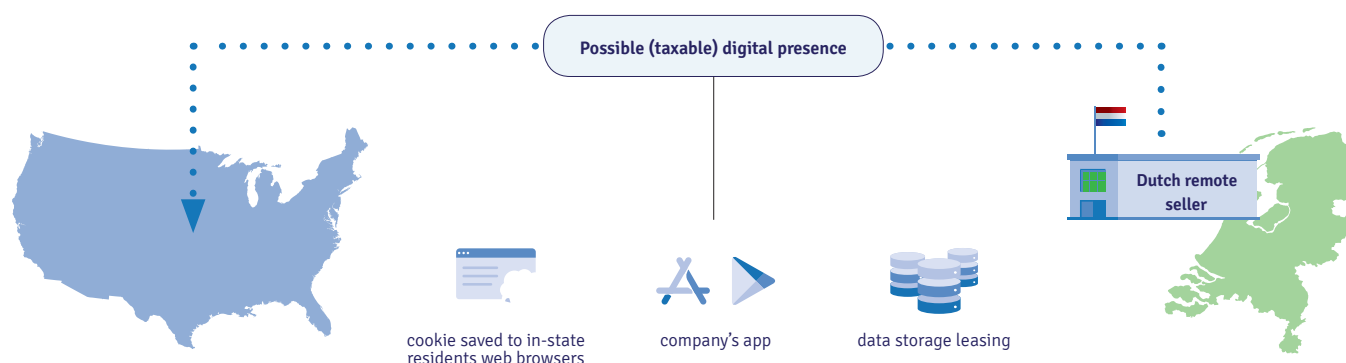
¹ *National Bellas Hess, Inc. v. Department of Revenue of Ill.*, 386 U. S., at 758.

² *Quill Corp. v. North Dakota*, 504 U. S., at 301.

National Bellas Hess and Quill offered a competitive advantage to remote sellers

Both decisions have been widely criticized. By giving some online retailers an arbitrary advantage over their competitors who collect state sales taxes, *Quill's* physical presence rule has prevented market participants from competing on an even playing field. They ultimately created a tax loophole that resulted in competitive benefits for remote sellers.

Consider, for example, two businesses that sell hygiene instruments (i.e. toothbrushes) online. The first stocks a few items of inventory in a small warehouse in the US. The second is a company located in the Netherlands, which uses a major warehouse in the Netherlands, and maintains a sophisticated website with a virtual showroom accessible in the US, Germany, the UK and France. Based on its physical presence, the business with the small warehouse in the US must collect and remit a tax on all of its sales to customers from the US (even those sales that have nothing to do with the warehouse). But, under *Quill*, the Dutch company cannot be subject to the same tax for the sales of the same items made through the Internet presence in the US. Hence, the Netherlands company has a competitive advantage compared to the US competitor. Observing the day-to-day functions of marketing and distribution in the digital economy, it is evident that the physical presence rule is artificial.



South Dakota vs. Wayfair (2018)

In *South Dakota vs. Wayfair*, the US Supreme Court held that the “physical-presence requirement” in *Quill* was unsound and an incorrect interpretation of the relevant legislation. According to a majority of the Court, this doctrine had become “further removed from economic reality” and was “resulting in significant state revenue losses”. In its analysis, the US Supreme Court explained that the “physical presence standard” is not a necessary interpretation of the requirement to have “substantial nexus with the taxing state”. The Court also expressed that the *Quill* doctrine had effectively become a “judicially created tax shelter for businesses that decide to limit their physical presence and still sell their goods and services to in-state consumers – something that has become easier and more prevalent as technology has advanced”. The US Supreme Court advocated for a more sensitive, case-by-case analysis over the physical presence standard, which it referred to as “artificial in its entirety”.

Impact on US digital sales taxation and EC proposals?

The Supreme Court’s analysis in *South Dakota vs. Wayfair* seems to copy the virtual permanent establishment standard (“significant digital presence”) proposed by the European Commission in its digital taxation proposals presented in March 2018. This concept is perceived to be one of the solutions to tax the digital economy. Although, at first sight, *South Dakota vs. Wayfair* seems to support a taxable nexus based on economic or virtual connections, it needs to be considered that *South Dakota vs. Wayfair* involved an indirect taxation case (i.e. sales taxes at state level in the U.S.), whereas the EC proposals in the context of digital economy are related to direct taxes.³

³ A. Bal, *South Dakota v. Wayfair - the global impact*, IBFD White Papers, Amsterdam : IBFD, 2018, p. 4.

In the area of indirect taxation, it is generally accepted that the supplier does not need to have any physical presence in the country of his customer. Typically the jurisdiction where the customer has its residence has the taxation right. In this context one could say that *South Dakota vs. Wayfair* effectively creates a level playing field between residents and non-residents by deeming non-resident suppliers to have a digital presence in the jurisdiction of the customer. Of course there is a striking difference between direct and indirect taxes. For purposes of creating a level playing field between residents and non-residents it is however interesting to see what the future brings and / or whether digital presence or nexus should be understood any differently from both points of view (direct and indirect taxes).

Takeaways

- To start off, *South Dakota vs. Wayfair* will have a huge impact on remote sellers. As a result of the Supreme Court's decision, states are no longer constrained by the *Quill* standards and may require remote sellers to collect sales taxes. States will probably begin requiring (remote) sellers, including Dutch companies, operating in the digital marketplace to collect and remit sales taxes on services and goods supplied to customers within particular states, regardless of the Netherlands company physical absence in that state. Hence, Dutch companies selling digital goods and/or supplying services into the US without actual presence (such as internet companies) are recommended to monitor the US developments following the *South Dakota vs. Wayfair* decision.
- Interestingly, however, *South Dakota vs. Wayfair* made it clear that for indirect taxation purposes non-resident sellers operating on the internet may be deemed to have a digital nexus at source in the country of the customer. Ultimately the comparison made in *South Dakota vs. Wayfair* is between the physical place of business of resident shops vs. the deemed digital nexus of the non-resident company. This comparison makes sense to create a level playing field. Otherwise the non-resident (internet) company would be entitled to a competitive advantage opposite to the local shop. This comparison between residents and non-residents however is similar as the debate on taxation of the digital economy in direct taxes. It will be interesting to see how and if *South Dakota vs. Wayfair* will inspire tax authorities and government institutions. Companies doing business in other countries with a focus on digital selling are recommended to monitor these discussions.

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