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MEMORANDUM

TO: Governor's Council on Tax Reform

FROM: Mark A. Burghart
Secretary of Revenue

RE: *South Dakota v. Wayfair, Inc.* and Notice 19-04 – Sales Tax Requirements for Retailers Doing Business in Kansas

DATE: September 25, 2019

Thank you for the opportunity to address the issues arising from the United States Supreme Court decision in *South Dakota v. Wayfair, Inc.* which addresses the state's ability to require out-of-state retailers to collect and remit a state's sales and use tax issued on June 21, 2018 and Notice 19-04 – Sales Tax Requirements for Retailers Doing Business in Kansas, issued by the Kansas Department of Revenue on August 1, 2019. Set forth below you will find the legislative history for the controlling statute, relevant case law and legal basis for the Notice issued by the Department.

<u>History of Kansas Sales/Compensating Tax Regime</u>

In 1937, the Kansas Legislature enacted the Kansas Retailers' Sales Tax Act at K.S.A. 79-3601 *et seq*. That enactment imposed sales tax on the sales of tangible personal property and certain enumerated services in the state. At the same time, the Legislature enacted a complimentary compensating use tax at K.S.A. 79-3701 *et seq*. That Act provides that a tax shall be collected from every person in this state for the privilege of using, storing or consuming within this state any article of tangible personal property. The use tax is required or Kansas businesses would be at a distinct competitive disadvantage with out-of-state retailers.

Eight years later, in 1945, the Legislature enacted K.S.A. 79-3705c which required retailers doing business in the state and making sales of tangible personal property for use, storage or consumption to collect the compensating use tax from the consumer.

Subsequently, in 1990, the Legislature amended the definition of retailer doing business in the state in K.S.A. 79-3702(h) to include any retailer "... engaging in regular or systematic solicitation of sales of tangible personal property in this state by the distribution of catalogs, periodicals, advertising flyers, or other advertising, by means of print, radio or television media, or by mail, telegraphy, telephone, computer data base, cable, optic, microwave or other communication system for the purpose of effecting retail sales of tangible personal property…" The definition was amended at that time in anticipation of what was hoped to be a favorable United States Supreme Court decision that would overturn the case of *National Bellas Hess v. Illinois Department of Revenue*, 386 U.S. 753 (1967) which had provided that a state could not require an out-of-state retailer to collect a state's compensating use tax if the retailer's only connection with the state was through common carrier or the U.S. mail. 1990 S.B. 488 passed the Kansas House of Representatives, 117-4 and the Kansas Senate, 37-0.

That same statutory definition was again amended in 2003 to provide that a retailer doing business in the state means "… (G) any retailer who has any other contact with this state that would allow this state to require the retailer to collect and remit tax under the provisions of the constitution and laws of the United States." Once again, this statutory change was designed to posture Kansas such that it could take advantage of any favorable United States Supreme Court decision that would overturn the physical presence requirement established in *National Bellas Hess*. 2003 H.B. 2416 passed the Kansas House of Representatives 122-0 and the Kansas Senate 38-1.

The legislative plan to structure the tax code to take full advantage of favorable court rulings has been in place for 29 years. As discussed below, the decision in *South Dakota v. Wayfair, Inc.,* 585 U.S. ___ (2018) has removed any constitutional impediment to the enforcement of the tax collection statute which is now presumed to be constitutional.

<u>Nature and Basis of Sales and Compensating Taxes</u>

As noted above, the taxes in question (sales and compensating taxes) are not "new" taxes. The Kansas Legislature enacted both taxes in 1937 to impose a tax on the gross receipts received from the sale of tangible personal property and certain enumerated services. The legal incidence of the taxes falls on the final consumer (purchaser). The retailer does not "pay" either tax. The retailer's obligation is to collect the tax from the purchaser and remit those taxes to the Department. This distinction may seem insignificant, but it is not.

For a number of years, states that have a retailers' sales tax as a part of their tax base, have sought a dual-purpose sales tax policy when approaching application of their sales taxes against sales made by out-of-state retailers: 1) to ensure a secure, continued sales tax base; and, 2) to maintain an equitable balance between in-state, brick-and-mortar retailers and out-of-state retailers selling into their state. Since the tax was, by statute, legally due from the in-state purchaser (no matter if they purchased from an in-state retailer or an out-of-state retailer), and since the retailer (whether an in-state retailer or out-of-state retailer) had an equal burden to collect and remit, the goal of equitable balance was achieved.

In the early years of sales tax, out-of-state retailers operated through salesmen entering a state and soliciting orders. States had little difficulty in requiring those retailers to comply with their respective sales tax laws because of the retailers' physical presence in their state.

As marketing became more sophisticated in the 1950s and '60s, the advent of mail-order business made it possible for customers to browse through catalogs mailed to them at home, fill out an order form and have the product shipped directly to them via common carrier with no other contact from the retailer whatsoever. The retailer, with no physical presence in the state, often did not comply with the state sales tax statutes. This deprived the state of exercising its dual tax policy of both securing tax revenue and providing a level playing field for in-state and out-of-state retailers.

States attempted to impose their taxes against out-of-state retailers, and the retailers raised both Due Process and Commerce Clause defenses resulting in a patchwork of decisions with no satisfying, uniform legal standard(s).

United States Supreme Court History

The back and forth struggle between states and out-of-state retailers culminated in *National Bellas Hess, Inc. v. Illinois Department of Revenue*, 386 U.S. 753 (1967), where the United States Supreme Court concluded that a mail order business could not be subjected to a state's tax collection duty based merely upon the retailer's in-state contacts of mail and common carrier delivery (*i.e.*, that some in-state property interest or representational activity was necessary). National Bellas Hess was a mail order house with its principal place of business in Missouri. It owned no tangible property in Illinois, had no sales outlets, representatives and did not advertise in Illinois. The Court justified its ruling in *National Bellas Hess* on both Commerce Clause and Due Process Clause grounds. Much of the Court's analysis focused on the burden of compliance on out-of-state retailers at the time due to the variety of tax compliance provisions among the states.

In *Quill v. North Dakota*, 504 U.S. 298 (1992), the Court was asked to re-visit its decision in *National Bellas Hess* in part because significant questions had arisen as to whether *National Bellas Hess* had become economically outdated in the intervening twenty-five years since it had been decided, or whether it continued to reflect the Court's then-current state tax constitutional doctrine. *Quill* was a Delaware corporation with offices and warehouses in Illinois, California and Georgia. None of its employees worked or resided in North Dakota and its ownership of tangible property in North Dakota was insignificant. *Quill* sold office equipment and supplies; it solicited business through catalogs, flyers, advertisements in national periodicals and telephone calls.

The Court suggested that, given the advances in its jurisprudential logic, it would not have reached the same conclusion in *National Bellas Hess* if the question in that case were a matter of first impression. But the Court retained the holding in *National Bellas Hess* on the basis of *stare decisis*, particularly because it presumed that later growth in the mail order industry may have been due in part to the holding in that earlier case. Also, the Court feared that revocation of the rule from *National Bellas Hess* could result in the practical consequence that mail order companies could be forced to pay a large amount of retroactive tax.

The Court in *Quill* suggested that, although it had modernized its state tax jurisdiction analysis after *National Bellas Hess,* it was now taking a step backwards. The Court re-affirmed its holding in *National Bellas Hess* in part on the theory that Congress was better suited to address the questions presented - a result that the Court specifically invited.

To facilitate this result, the Court explicitly based its decision on Commerce Clause grounds, and stated that it was no longer justified on Due Process grounds, thus enabling Congress to reconsider the rule. State sales tax cases decided post-*Quill* are generally consistent with this analysis.

Enter *Wayfair*

In 2016, South Dakota enacted legislation designed to present a straight-up assault on *Quill*. South Dakota's statutory scheme is quite similar to the one Kansas has had since 1937. South Dakota announced its intention to begin enforcement of its laws, as an invitation to a suit to enjoin it from so doing. South Dakota's statutes specified that they would be effective prospectively only, and those retailers with 200 or fewer sales transactions and less than $100,000.00 in annual gross sales would not be subject to the collect and remit requirements. The former (prospective only) was to address Due Process "fair notice" and the latter two (200 or $100,000.00) were designed to address concerns previously expressed by the Court of an undue financial burden for smaller retailers to comply with various states' laws. It should be noted that South Dakota is also a member of the Streamlined Sales Tax Agreement.

As noted above, since there are still some remnants of Due Process barriers that could be raised in the aftermath of *Quill,* South Dakota needed to address not only Commerce Clause but Due Process Clause concerns as well. Even as the Court in *Quill* was removing the Due Process component from the state sales tax nexus analysis with the specific goal of eliciting Congressional action, the Court suggested that Due Process principles remained significant as a state tax jurisprudential tool.

The Court has observed that claims concerning the application of the Commerce Clause and Due Process Clause in matters of state tax jurisdiction are "closely related." The Court stated that the two clauses impose distinct limits on the taxing powers of the states, but suggested that those distinctions are not meaningful when evaluating a nexus question outside the realm of sales tax.

On June 21, 2018, the Court in *South Dakota v. Wayfair, Inc.*, 585 U.S. ___ (2018) reversed its holding in *Quill* and removed the physical presence barrier to the collect and remit requirements of state tax statutes on sales made by out-of-state retailers to in-state purchasers.

In its decision, the Court noted that while an out-of-state retailer may not have a physical presence in a state, it was clear to the Court that through the internet they have an economic and pervasive virtual nexus (or presence) in the state that obligated them to collect and remit a state's taxes.

Nexus Post *Wayfair*

Nexus in general means a connection. The term nexus is used in tax law to describe a situation in which a business has a "nexus" or tax presence in a particular state or states. A nexus is basically a connection between a taxing jurisdiction, like a state, and an entity like a business that must collect or pay the tax. Everything about nexus has to do with "presence." The terms are, for all intents and purposes, interchangeable.

The Court noted the internet retailer's economic presence in South Dakota as sufficient to require them to comply with South Dakota's collect and remit requirements. While there is no specific shared definition of economic nexus, or presence, across the 50 states, the simplest way of determining sales tax nexus is economic nexus, which is basically just sales in the state.

The *Wayfair* Court said that the older ways of determining tax nexus were "artificial and anachronistic" and that states have the right to require online retailers to charge and collect sales tax from online buyers.

Wayfair did not alter pre-existing jurisdictional principles; it merely sought to eliminate the physical presence rule, and to explain the effect of that elimination on retailers that were formerly protected. Implicitly, then, *Wayfair* conceded that the physical presence rule derived from *National Bellas Hess* and *Quill* was incorrect, and it re-posited that the relevant nexus considerations are rooted in due process.

Under *Wayfair*, nexus determinations for sales tax are primarily controlled by the Due Process Clause of the U.S. Constitution, which only requires a definite link or minimal connection between a state and the entity it wants to tax. Due process likewise requires that a state tax be adequately noticed, otherwise fair, and applied to remote retailers engaged in significant in-state market exploitation.

The latter is key: a retailer can be engaged in significant market exploitation without generating significant sales. Many (most) on-line retailers use various apps and cookies to market their products, track consumers (both on websites they visit – cookies, and physical location – apps.). These cookies and apps send data back to the retailer that can use that data to tailor and offer more on-line incentives (digital coupons, percentages off, other related products, etc.) purposefully directed at, and to avail itself of, the in-state market. They also have interactive "warehouses" and "showrooms", Artificial Intelligence to communicate with consumers, and other on-line features, all designed to hook and keep in-state consumers. The *Wayfair* Court acknowledged this type of significant connection or nexus with a state when it specifically noted cookies and apps and their uses, and the "pervasive" in-state virtual presence of on-line retailers.

It should be noted that the *Wayfair* decision did not establish, as a matter of constitutional jurisprudence, a bright-line test when it mentioned the four elements of South Dakota law ($100,000, 200 transactions, member of Streamlined and prospective only). All the Court noted were the features of South Dakota's statute and how those provisions did not create a burden for Wayfair, and the other two remote retailers in that case. While the Court acknowledged that South Dakota's laws were sufficient to avoid any undue burden on retailers, the Court did not hold that those features were necessary, or exclusive, to avoid an undue burden for retailers.

If the elements of the South Dakota law were a constitutionally mandated check list, then membership in Streamlined would be required (no additional states have joined Streamlined since *Wayfair* was handed down), as would the 200 transactions requirement (most states have not adopted the 200 transactions threshold, and some which initially did, have since struck them from their statutes).

Kansas Statute Under *Wayfair*

Most states that impose sales taxes have enacted statutes, regulations and procedures to allow sales tax collection for online sales. As noted above, Kansas adopted its version of economic nexus or presence in 2003 at K.S.A. 79-3702, and specifically, subsection (h)(1)(F):

> "(h) (1) "Retailer doing business in this state" or any like term, means: (A) Any retailer maintaining in this state, permanently, temporarily, directly or indirectly through a subsidiary, agent or representative, an office, distribution house, sales house, warehouse or other place of business;

(B) any retailer utilizing an employee, independent contractor, agent, representative, salesperson, canvasser, solicitor or other person operating in this state either permanently or temporarily, for the purpose of selling, delivering, installing, assembling, servicing, repairing, soliciting sales or the taking of orders for tangible personal property;
(C) any retailer, including a contractor, repair person or other service provider, who enters this state to perform services that are enumerated in K.S.A. 79-3603, and amendments thereto, and who is required to secure a retailer's sales tax registration certificate before performing those services;
(D) any retailer deriving rental receipts from a lease of tangible personal property situated in this state;
(E) any person regularly maintaining a stock of tangible personal property in this state for sale in the normal course of business; and
(F) any retailer who has any other contact with this state that would allow this state to require the retailer to collect and remit tax under the provisions of the constitution and laws of the United States.
(2) A retailer shall be presumed to be doing business in this state if any of the following occur:
(A) Any person, other than a common carrier acting in its capacity as such, that has nexus with the state sufficient to require such person to collect and remit taxes under the provisions of the constitution and laws of the United States if such person were making taxable retail sales of tangible personal property or services in this state:
(i) Sells the same or a substantially similar line of products as the retailer and does so under the same or a substantially similar business name;
(ii) maintains a distribution house, sales house, warehouse or similar place of business in Kansas that delivers or facilitates the sale or delivery of property sold by the retailer to consumers;
(iii) uses trademarks, service marks, or trade names in the state that are the same or substantially similar to those used by the retailer;
(iv) delivers, installs, assembles or performs maintenance services for the retailer's customers within the state;
(v) facilitates the retailer's delivery of property to customers in the state by allowing the retailer's customers to pick up property sold by the retailer at an office, distribution facility, warehouse, storage place or similar place of business maintained by the person in the state;
(vi) has a franchisee or licensee operating under its trade name if the franchisee or the licensee is required to collect the tax under the Kansas retailers' sales tax act; or
(vii) conducts any other activities in the state that are significantly associated with the retailer's ability to establish and maintain a market in the state for the retailer's sales.
(B) Any affiliated person conducting activities in this state described in subparagraph (A) or (C) has nexus with this state sufficient to require such person to collect and remit taxes under the provisions of the constitution and laws of the United States if such person were making taxable retail sales of tangible personal property or services in this state.

(C) The retailer enters into an agreement with one or more residents of this state under which the resident, for a commission or other consideration, directly or indirectly refers potential customers, whether by a link or an internet website, by telemarketing, by an in-person oral presentation, or otherwise, to the retailer, if the cumulative gross receipts from sales by the retailer to customers in the state who are referred to the retailer by all residents with this type of an agreement with the retailer is in excess of $10,000 during the preceding 12 months. This presumption may be rebutted by submitting proof that the residents with whom the retailer has an agreement did not engage in any activity within the state that was significantly associated with the retailer's ability to establish or maintain the retailer's market in the state during the preceding 12 months. Such proof may consist of sworn written statements from all of the residents with whom the retailer has an agreement stating that they did not engage in any solicitation in the state on behalf of the retailer during the preceding year, provided that such statements were provided and obtained in good faith. This subparagraph shall take effect 90 days after the enactment of this statute and shall apply to sales made and uses occurring on or after the effective date of this subparagraph and without regard to the date the retailer and the resident entered into the agreement described in this subparagraph. The term "preceding 12 months" as used in this subparagraph includes the 12 months commencing prior to the effective date of this subparagraph.

(D) The presumptions in subparagraphs (A) and (B) may be rebutted by demonstrating that the activities of the person or affiliated person in the state are not significantly associated with the retailer's ability to establish or maintain a market in this state for the retailer's sales.

(3) The processing of orders electronically, by fax, telephone, the internet or other electronic ordering process, does not relieve a retailer of responsibility for collection of the tax from the purchaser if the retailer is doing business in this state pursuant to this section."

The statutory changes in 2003 were intended to posture Kansas such that it could immediately take advantage of favorable United Supreme Court rulings and thus allow Kansas to: (1) collect taxes that are properly due and owing and (2) level the tax playing field between in-state and out-of-state retailers.

Undue Burden - Due Process After *Wayfair*

Assuming, *arguendo*, that the due process nexus considerations do contain an element of undue burden attached to them, there are multiple ways states have addressed their taxes' perceived burden to make it less "undue," thereby satisfying both due process and undue burden considerations simultaneously.

To avoid harming smaller retailers, many states have a minimum annual amount of sales, below which no sales tax is charged for online sales. Another way to avoid harming smaller retailers (thus satisfying undue burden claims) is their registration through the Streamlined Sales Tax Project (of which Kansas is a member).

A retailer (large or small) that contracts with a Certified Service Provider (CSP) through Streamlined has the following benefits (at no charge to the retailer):

a. **Registration and Registration Updates** – A retailer contracting with a CSP can go through the CSP to register and to update registration data with all Streamlined Member States.

b. **Tax Calculation** – The CSP integrates its system with the retailer's system to determine what's taxable, the applicable state and local rates and the amount of tax to collect at the time of the sale.

c. **Free Monthly Return Preparation and Filing** – The CSP prepares and files the applicable sales tax returns with the Streamlined Member States. The volunteer retailer that contracts with a CSP is not charged a filing fee from the CSP since the CSP is compensated by the Streamlined Member State.

d. **Audits** – The CSP responds to and provides supporting documentation with respect to notices of sales and use tax audits by the Streamlined Member States. The CSP must also provide the Streamlined Member States with transactional data supporting the monthly remittances for volunteer retailers. During an audit of a volunteer retailer, the Streamlined Member States must go through the CSP to conduct the audit, rather than contacting the retailer directly. Audit questions are presented to the CSP. The CSP then reaches out to the volunteer retailer to collect any additional supporting documentation required for the audit. A retailer that is not a volunteer will be contacted directly by the state.

e. **Liability Relief** – Retailers that contract with a CSP are not liable for errors in calculating the incorrect tax that result from the retailer or the CSP relying on erroneous data provided by a Streamlined Member State on tax rates, boundaries, taxing jurisdictions or incorrect data in the library section of the state's taxability matrix.

Essentially, undue burden is measured in dollars: when a retailer’s expenses in complying with a state’s tax scheme is too high for the taxes it collects and remits. Happily, that is not an issue in Kansas. Kansas pays for each and every one of the compliance functions noted above. The retailer pays nothing.

Because Kansas’ membership in Streamlined simplifies the compliance process of all retailers, including small retailers, and Kansas is paying the costs of compliance for all remote retailers, including small retailers of less than $100,000 into Kansas, it is difficult to see what burden is being borne by any retailer, large or small.

Membership in Streamlined was a key component of the argument made by many states’ Attorneys General in their *amicus* Brief before the *Wayfair* Court. Forty-one states, including Kansas, argued before the Court at page 23 of their *amicus* that, “[i]n many cases, including in the 24 States that are members of the Streamlined Sales and Use Tax Agreement (“SSUTA”), a uniform electronic return format eases compliance even more. In fact, the entire collection and remittance process under SSUTA can be accomplished through certified third-party service providers that are paid for by the member States and made available to retailers at no charge. The availability of these service providers and electronic filing methods removes any conceivable burden that collection obligations might otherwise impose on retailers.”

A further protection for out-of-state retailers was noted by the Attorneys General at page 24 of their *amicus*, “[t]he financial burden of compliance is also made easy on the backend for those retailers that discover they may have inadvertently failed to accurately collect and remit the tax. Thirty-Eight States and the District of Columbia participate in the Multistate Voluntary Disclosure Program. The program allows retailers with potential tax liabilities in multiple States to negotiate a penalty-free settlement through the Multistate Tax Commission. By negotiating a single settlement through the Commission that satisfies all obligations in the participating States, the program offers retailers a faster, more efficient, and less costly resolution than approaching each State separately." It should be noted that Kansas is a full participant in the Voluntary Disclosure Program.

Last, as emphasized above, K.S.A. 79-3702(h)(2)(D) also offers those who do not believe that they have sufficient nexus with Kansas to be obligated to collect and remit an opportunity to demonstrate that the activities of the person or affiliated person in the state are not significantly associated with the retailer's ability to establish or maintain a market in this state for the retailer's sales. This provides even further "burden relief" for small retailers.

<u>Notice 19-04</u>

Kansas has had a statute in place since 2003 that meets the constitutional requirements as enunciated under *Wayfair*. There is nothing more to be added or interpreted statutorily or constitutionally.

Thus, the Department, charged with the duty to administer and enforce the sales tax laws of Kansas (See, K.S.A. 79-3618, K.S.A. 79-3702(b)), published Notice 19-04. This notice did nothing more than publicize the *Wayfair* decision, the controlling Kansas statute, and the directions for how retailers can begin to comply with the Kansas statute.

In keeping with Kansas' long history of accepting voluntary compliance agreements (as noted by the *amici* Attorneys General), the Notice also suggested that if a market place facilitator desired to voluntarily comply with Kansas collect and remit requirements, they should contact the Department and obtain a voluntary compliance agreement.

The Department's Notice is not a regulation with the force of law. No regulation is needed. The law is plain, unambiguous and is self-executing.

K.S.A. 79-3702 was purposefully written to be as extensive as constitutionally permissible. *See* 79-3702(h)(1)(F), (h)(2)(A) and (h)(2)(B). Apart from any action by the Department, the statute possessed the latent potential to have expanded reach depending on constitutional interpretation. As an administrative agency, the Department could not regulate in such a way to extend the reach of what was permissible, because its authority to regulate may not go beyond the constitutional reach of the statute it is implementing or administering. *See e.g. Pemco, Inc. v. Kansas Dep't of Revenue*, 258 Kan. 717, Syl. ¶ 2, (1995). *Wayfair*, however, effectively expanded the definition of those who, under K.S.A. 79-3702(h)(1)(F), have "nexus with the state sufficient to require such person to collect and remit taxes under the provisions of the constitution and laws of the United States." The Court's decision in *Wayfair* changed the permissible scope of K.S.A. 79-3702 as of that date. The Department did not change any agency policy by virtue of Notice 19-04. In fact, Notice 19-04 is wholly consistent with a natural interpretation of the existing statute and regulation, K.S.A. 79-3702 and K.A.R. 92-20-7, in light of *Wayfair*. Rather, Notice 19-04 was issuing public notice of a change in the existing state of the law that occurred completely outside of anything the Department did, or any change of position or policy on the part of the Department.

Summary

In summary, the Department is merely enforcing a self-executing statute overwhelmingly approved by the Legislature that is presumed to be constitutional. The Department is not implementing a change in tax policy. The legislative plan to quickly respond to a favorable United States Supreme Court decision on the issue of the tax collection obligations for remote retailers has been in place for 29 years. There is no constitutional requirement that a collect and remit statutory provision contain a *de minimis* threshold for out-of-state retailers. Out-of-state retailers, including small retailers, have no compliance burden if such retailers are registered through the Streamline Sales Tax Agreement.

Thank you for the opportunity to address the *Wayfair* decision and its impact on Kansas tax collections. I would be happy to answer and questions you might have.