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TO: Members
Wisconsin Legislature

FROM: Bob Lang, Director

SUBJECT: *South Dakota v. Wayfair, Inc.* - Sales and Use Tax Collections on Remote Sales

This memorandum provides information regarding the collection of state sales and use tax on remote sales made by out-of-state sellers to buyers in Wisconsin. Specifically, this memorandum discusses the recently decided U.S. Supreme Court case, *South Dakota v. Wayfair, Inc.*, and the ramifications for state tax collections. This office prepared this memorandum in consultation with staff of the Legislative Reference Bureau and the Legislative Council.

Sales and Use Tax on Remote Sales

Wisconsin imposes a general sales and use tax at a rate of five percent on the sales price or purchase price of taxable goods and services used and sold in this state. The sales tax is imposed on retailers for the privilege of making taxable sales in the state and is usually passed on by a retailer to its customers. The use tax is imposed as a complement to the sales tax to prevent consumers from avoiding tax by purchasing taxable goods in other states and to allow state merchants to compete on an equal basis with sellers in other states that have lower (or nonexistent) sales tax rates. A credit is allowed for sales tax properly paid in the other state. An enforceable use tax assures the equal taxation of all purchases by state residents and gives no competitive advantage to either resident or nonresident sellers.

Wisconsin is a member of the Streamlined Sales and Use Tax Agreement (SSUTA) and allows remote sellers to either register to collect and remit sales and use tax to the state using their own software system or remit tax through a certified service provider. Certified service providers maintain a database of taxable and nontaxable goods and services, as well as tax rates for each taxing jurisdiction within each member state. States are required under the SSUTA to monitor the database for accuracy regarding their respective taxing jurisdiction. Wisconsin requires remote sellers to collect the 5% state sales and use tax, the 0.5% county sales and use tax, and the 0.1% professional stadium park district sales and use tax.

Nexus Under the Physical Presence Test. Every retailer engaged in business in Wisconsin that makes sales of taxable goods and services that are sourced to this state must collect sales and use tax from their purchasers and remit payment to the Department of Revenue (DOR). Current law defines all vendors as retailers engaged in business within the state for use tax purposes if they sell tangible personal property or other taxable items or services for storage, use, or other consumption in Wisconsin "unless otherwise limited by federal law."

The U.S. Constitution imposes two limitations on a state's taxing jurisdiction: the due process clause (requiring a minimum connection between the taxpayer's interstate activities and the state); and the commerce clause (requiring a substantial connection between the state and the taxed activity). The traditional test laid out by the U.S. Supreme Court in *Complete Auto Transit, Inc. v. Brady* determines if a tax unfairly burdens interstate commerce. This requires that the tax: (a) applies to an activity with a substantial nexus with the taxing state; (b) is fairly apportioned; (c) does not discriminate against interstate commerce; and (d) is fairly related to the services the state provides.

In *Quill Corp. v. North Dakota,* the Supreme Court upheld longstanding precedent that the substantial nexus test under "a" above requires states to establish a retailer's physical presence in the state in order to impose sales and use tax. This means that the seller must have some sort of operations physically located in the state, such as offices, stores, warehouses, property, or employees. The Supreme Court held that when this nexus is absent, states' efforts to collect taxes on remote sales place an undue burden on interstate commerce and thereby violate the U.S. Constitution.

As a result of *Quill*, out-of-state sellers were not required to collect tax on sales to Wisconsin customers if the sellers lacked a physical presence in the state. In these cases, use tax was imposed upon the consumer on the purchase price of goods and services used or consumed within the tax jurisdiction. However, this required consumers to self-report use tax on their remote purchases, which consumers often fail to do.

The inability of states to enforce a tax collection obligation on out-of-state sellers that do not have a physical presence within the state has resulted in substantial amounts of forgone revenues. The expansion of e-commerce in recent years has called into question the validity of *Quill's* physical presence standard and, as a result, numerous states have enacted laws that attempt to work around, or undermine, *Quill*.

South Dakota v. Wayfair, Inc. In 2016, South Dakota enacted an economic nexus threshold to establish tax jurisdiction over remote sellers without any requirement for physical presence in the state. South Dakota extends nexus to remote sellers if: (a) they conduct 200 or more annual transactions with consumers in the state; or (b) their annual sales into the state exceed $100,000.

In 2017, South Dakota sued several internet sellers in state court, seeking a declaratory judgment that they were required to collect sales and use tax pursuant to its economic nexus standard. After the state circuit court and supreme court ruled in favor of the online sellers pursuant to the *Quill* physical presence rule, South Dakota appealed to the U.S. Supreme Court.

On June 21, 2018, the U.S. Supreme Court in *South Dakota v. Wayfair, Inc.* overturned *Quill's* physical presence requirement. As a result, states may now require out-of-state sellers lacking a physical presence in the state to collect tax on remote sales so long as imposition of the tax meets the traditional *Complete Auto* test to determine substantial nexus regardless of whether the seller has a physical presence in the state. The Supreme Court found that South Dakota's economic threshold of 200 annual transactions or $100,000 in annual sales coupled with the online sellers' extensive virtual presence in South Dakota was sufficient to meet that standard.

The Supreme Court remanded the case back to state court for further review under the *Complete Auto* test. In doing so, the Supreme Court noted that South Dakota's law included several features designed to prevent discrimination against, or undue burdens on, interstate commerce. First, South Dakota's economic threshold provides a safe harbor for retailers with limited sales in the state. Second, South Dakota's law does not apply retroactively to sales that have already occurred. Third, South Dakota has adopted the SSUTA, which requires a single state level tax administration, uniform definitions of products and services, and simplified tax rate structures. Finally, South Dakota provides sellers with free tax administration software. Sellers who collect and remit tax in reliance on this software are not subject to penalties for errors in compliance.

Current Wisconsin Law. Because *Wayfair* overturned *Quill's* physical presence requirement, the manner in which state law is "otherwise limited by federal law" has been modified with regard to extending nexus to remote out-of-state sellers. DOR indicates that current law now requires it to begin collecting tax on remote sales. However, unlike South Dakota, the Wisconsin statutes do not specifically provide for an electronic nexus threshold. Therefore, it is unclear that requiring out-of-state vendors to collect tax without changes to the statutes or administrative code would comport with the *Complete Auto* test. DOR is currently reviewing this issue.

Fiscal Impact. Based on information supplied by DOR and the U.S. Census Bureau, it is estimated that expanding sales and use tax collection obligations to out-of-state vendors in compliance with the *Wayfair* decision would increase state sales and use taxes by $120 million on an annual basis. This estimate is expressed in 2018-19 dollars and assumes Wisconsin would utilize a safe harbor provision for remote sellers similar to the economic thresholds enacted by South Dakota. If changes were made to the administrative code or the statutes such that DOR could extend nexus to remote sellers beginning October 1, 2018, it is estimated that state sales and use tax revenues would increase by $90 million in 2018-19 and $120 million in 2019-20. Further, it is estimated that county and professional stadium park district sales and use tax collections would increase by $7.7 million in 2018-19 and by $10.3 million in 2019-20.

Automatic Individual Income Tax Rate Reductions

Current law establishes four tax brackets under the individual income tax, that vary by filing status, and assigns a marginal tax rate to each bracket. The rate structure is cumulative so that each marginal tax rate applies only to income that falls within the corresponding bracket. The brackets are indexed annually for changes in inflation, based on the Consumer Price Index for August of the year preceding the tax year. Consequently, the most recent indexing applied to tax year 2018.

Under a provision created in 2013 Wisconsin Act 20, as amended by 2017 Wisconsin Act 59, state law establishes procedures for reducing state individual income taxes by modifying the rate and bracket structure if certain conditions are met. The provision specifies that additional state sales and use tax revenues resulting from **"any federal law"** that expands the state's ability to require out-of-state sellers to collect and remit tax on remote sales to Wisconsin residents be used to reduce income tax rates. First, DOR is required to determine how much additional revenue has been collected by the state during the first 12 months following the date on which the state begins collecting additional taxes as a result of the federal law. Second, DOR is required to determine how much the individual income tax rates could be reduced in the following taxable year so that income tax revenues would decrease by an amount equal to the estimated increased state sales and use tax revenues (excluding any increased county or professional stadium park district revenues). The individual income tax rate reductions must be calculated in proportion to the share of gross tax attributable to each of the tax brackets in effect during the most recently completed taxable year. After DOR has prepared these estimates and tax rate calculations, DOR is required to certify the revenue estimates and new tax rates to the Secretary of the Department of Administration, the Governor, and the Legislature. The new tax rates would take effect in the taxable year beginning after DOR's certification.

At the time Act 20 was enacted, there were Congressional efforts to override the *Quill* decision by permitting states to impose the sales and use tax on retailers who lacked a physical presence in their state. The Act 20 provision likely presumed a Congressional law change would serve as its trigger. Nonetheless, given that the law of *Quill* has been reversed, the U.S. Supreme Court's *Wayfair* decision could reasonably be construed as "any federal law" triggering the Act 20 provision. Assuming additional legislation or an administrative rule change is needed before the 12-month sales tax collection period can begin, income tax changes could occur as early as tax year 2020, but could occur in tax year 2021, or thereafter.

At this time, the individual income tax brackets for tax year 2020 are not known. Therefore, an estimate of the effects of the Act 20 provision for tax year 2020 may not be reliable. However, DOR has provided data to this office from an income tax simulation for tax year 2017 that provides gross tax amounts by tax bracket. That data was used to produce the following table that reports the estimated tax decrease and tax rate change for each of the four tax rates, assuming the Act 20 provision had produced a $120 million gross tax reduction in tax year 2017.

Estimated Change in Tax Rates Under Act 20 Automatic Income Tax Decrease
Based on a Simulation for Tax Year 2017
($ in Millions)

Current Law Tax Rates	Gross Tax by Tax Rate	Percent of Gross Tax	Estimated Tax Decrease	Estimated Tax Rate	Estimated Reduction in Tax Rate
4.00%	$1,044.9	10.7%	-$12.9	3.95%	-0.05
5.84	1,256.0	12.9	-15.4	5.77	-0.07
6.27	5,431.8	55.7	-66.9	6.19	-0.08
7.65	2,013.1	20.7	-24.8	7.56	-0.09

For tax year 2017, statewide gross taxes are estimated at $9,745.8 million, and the estimated tax shares generated by the four rates range from 10.7% for the 4.00% rate to 55.7% for the 6.27% rate. Based on these percentages, the Act 20 provisions would have allocated proportionate reductions to each rate or bracket that total $120 million statewide. Each rate would be reduced by an estimated 1.2%, and those rates are reported in the column labelled "Estimated Tax Rate." Although the percentage reduction is uniform, the absolute reduction, reported in the last column, increases with each rate.

A uniform reduction would occur for taxpayers, as all taxpayers would experience a 1.2% reduction in gross tax liability, but taxpayers subject to higher marginal tax rates would experience larger dollar reductions in gross taxes than taxpayers subject only to lower marginal rates. The table below shows that taxpayers with gross taxable income entirely subject to the 4.00% rate in tax year 2017 would have had a gross tax reduction of $3 per taxpayer, whereas the average taxpayer subject to the 7.65% tax rate would have had a gross tax reduction of $592. The average reduction in gross taxes is estimated at $52 per taxpayer.

Estimated Reduction in Average Gross Tax Liability for Taxpayers whose Last Dollar of Gross Taxable Income Falls In Each Bracket in Tax Year 2017

Current Law Tax Rate	Average Gross Tax Per Filer	Estimated Tax Rate	Average Reduction in Gross Tax
4.00%	$221	3.95%	-$3
5.84	820	5.77	-10
6.27	4,433	6.19	-55
7.65	48,058	7.56	-592
All Filers	$4,184	N.A.	-$52

If the Act 20 provision takes effect in tax year 2020, the percentage reduction in taxes is likely to be less than 1.2%, and the average tax reduction is likely to be less than $52 because the amount of statewide gross taxes and the number of taxpayers are expected to increase. Also, this analysis does not consider the effect of state tax credits on individual income taxpayers' tax liabilities.

Finally, a literal reading of the Act 20 provision could lead to the conclusion that income tax rates would decrease for one year, but return to their higher, current law levels in subsequent years. Relative to the year of the sales tax determination, the provision directs DOR to reduce the rates "in the following taxable year." To resolve any confusion regarding the application of the tax rate reduction, the Legislature may want to amend the provision to clarify the directive.

Budget Stabilization Fund

Under s. 16.518 of the statutes, if actual general fund tax collections for any fiscal year exceed the amount projected in the biennial budget act, one-half of that additional amount shall be deposited into the budget stabilization fund. Depending upon the timing of when the state would begin to collect sales tax revenues under *Wayfair*, it is possible that actual tax collections in 2018-19 could exceed the amounts projected for that year in the 2017-19 budget act. If this were to occur, some revenues would transfer to the stabilization fund and less revenue would be deposited in the general fund in 2018-19 than the amounts described above. The statutes can reasonably be interpreted to suggest that both the full reduction in the individual income tax rates and the transfer to the budget stabilization fund could occur.

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