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Tax Alert – Canada

US sales and use tax ramifications for Canadian e-commerce vendors following US Supreme Court judgment

EY Tax Alerts cover significant tax news, developments and changes in legislation that affect Canadian businesses. They act as technical summaries to keep you on top of the latest tax issues. For more information, please contact your EY advisor or EY Law advisor.

On 21 June 2018, the United States Supreme Court issued its ruling in *South Dakota v. Wayfair*[1] and in a 5-4 decision overturned the physical presence nexus standard for sales and use tax collection. As a result, e-commerce vendors may be required to collect and remit South Dakota sales tax for sales made to South Dakota consumers, even where such vendors do not have any offices, warehouses or employees in the state. Compliance costs for Canadian online vendors could increase substantially if other states decide to enforce sales tax legislation similar to that of South Dakota. States may also seek to impose retroactive assessments.

Legal background

The United States Constitution grants Congress the power "to regulate commerce… among the several States" (the Commerce Clause). The Supreme Court has interpreted the Commerce Clause to restrict a state's authority to regulate interstate commerce; more specifically, state law may not discriminate against or impose undue burdens on interstate commerce. This framework also informs the Court's assessment of the validity of state taxes. Under existing case law, an out-of-state seller was liable for collecting and remitting state sales tax if the seller had a physical presence in the state, such as "retail outlets, solicitors, or property within a State." However, shipping goods into the consumer's state did not, in and of itself, satisfy the physical presence requirement. The physical presence rule was first established in *National Bellas Hess, Inc. v. Department of Revenue of Ill.*[2] and reaffirmed 25 years later in *Quill Corp. v. North Dakota*.[3]

[1] *South Dakota v. Wayfair, Inc.*, Dkt. No. 17-494 (U.S. S. Ct. 21 June 2018).
[2] *National Bellas Hess, Inc.* v. *Department of Revenue of Ill.*, 386 U.S. 753 (1967).
[3] *Quill Corp.* v. *North Dakota*, 504 U.S. 298 (1992).

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Facts

South Dakota levies a sales tax that generally requires sellers to collect and remit the tax to the South Dakota Department of Revenue. In-state consumers are responsible for paying a use tax at the same rate if the seller does not remit the tax. In practice, this meant that South Dakota often relied on state residents to pay the use tax on purchases from out-of-state sellers. Lack of consumer compliance with the use tax resulted in the loss of up to $58 million annually to the state.

In 2016, South Dakota enacted legislation (the Act) requiring an out-of-state seller to collect and remit sales tax if, on an annual basis, the seller delivered more than $100,000 of goods or services into South Dakota or engaged in 200 or more separate transactions for the delivery of goods and services into the state. South Dakota then filed an action in state court against three online retailers (the respondents) that met the threshold requirements of the Act but did not collect the state sales tax.

The state court agreed with the respondents' argument that the Act was unconstitutional and granted summary judgment. The South Dakota Supreme Court affirmed the judgment on the basis that *Quill* "remains the controlling precedent on the issue of Commerce Clause limitations on interstate collection of sales and use taxes."

Judgment

In a 5-4 decision (with two brief concurring opinions) authored by Justice Kennedy, the majority determined that the physical presence rule was an incorrect and unsound interpretation of the Commerce Clause and that physical presence is not necessary to create a substantial nexus with the taxing state. In overturning the rule, the majority decision focused on the realities of modern e-commerce and the rule's practical economic effects. With respect to the argument that the lack of a physical presence rule would unduly burden interstate commerce by imposing prohibitive compliance costs, Justice Kennedy observed that in the modern economy, compliance costs were "largely unrelated" to a retailer's physical presence in a state. For example, a business with one salesperson in every state would be required to collect sales tax in each state, but a business with 500 salespeople in one location and a website accessible in every state would not.

Moreover, the rule could encourage retailers to avoid tax collection by opting not to establish a physical presence in a state, thereby placing local businesses at a competitive disadvantage with remote sellers:

> In effect, Quill has come to serve as a judicially created tax shelter for businesses that decide to limit their physical presence and still sell their goods and services to a State's consumers – something that has become easier and more prevalent as technology has advanced.

The majority also questioned why traditional indicia of a physical presence (such as a warehouse or sales office) should create a substantial nexus with a taxing state, while certain physical aspects of modern technology did not. For example, a website could leave cookies on a customer's hard drive while a customer could download a retailer's app onto their phones. In other words, a business could be present in a state without "being physical in the traditional sense of the term." The Court also observed that efforts by various states to apply the physical presence rule to online retail sales were "proving unworkable" (e.g., "click through" nexus statutes) and that such attempts would be likely to "embroil courts in technical and arbitrary disputes about what counts as physical presence."

As a result, the majority overruled *Bellas Hess* and *Quill*, stating "it is inconsistent with the Court's proper role to ask Congress to address a false constitutional premise of this Court's own creation."

Ramifications for e-commerce retailers

For Canadian online retailers that sell goods and services in the United States, the chief concern is the possibility of retroactive tax assessments. The South Dakota Act foreclosed retroactive application. However, some states have laws on their books that use an "economic/minimum contacts nexus standard." Although the efficacy of such laws was essentially negated by the *Quill* decision, many of them have not been repealed and could theoretically apply to the first sales made by an online retailer in a particular jurisdiction. As a result, online retailers that have not collected state sales tax should explore various amnesty and voluntary disclosure programs offered by the states.

Even if the majority of states decide to forgo retroactive application of such statutes, online retailers could face a raft of increased compliance costs in the near future. The applicable rates and tax bases of state sales taxes vary widely. In his dissent, Chief Justice Roberts cited numerous examples of various state sales tax idiosyncrasies (e.g., New Jersey sales tax applies to yarn purchased for art projects, but not yarn earmarked for sweaters). However, it should be noted that more than half of the 45 sales tax states are party to the *Streamlined Sales and Use Tax Agreement*, an agreement that standardizes taxes to reduce compliance costs and imposes other uniform rules.

It also remains an open question whether Congress will continue to explore legislative options of its own. For example, the *Marketplace Fairness Act of 2017*, if enacted, would allow states to require remote sellers to collect state and local sales and use taxes, subject to a "small seller" exception of $1 million in remote sales annually. A similar piece of pending legislation that would impose sales and use tax collection obligations is the *Remote Transactions Parity Act of 2017*, which would initially impose a small seller threshold of $10 million and phase out the threshold over four years. On the other hand, the *No Regulation Without Representation Act of 2017* would only allow a state to tax or regulate a person's activity in interstate commerce if the person is physically present in the state.

Reminder: Quebec e-commerce measures

In addition to preparing for potential sales tax compliance with jurisdictions in the United States, Canadian online retailers that have no physical or significant presence in Quebec should take note that in accordance with its 2018-19 budget, Quebec has adopted new QST registration and remittance rules that will take effect 1 September 2019.[4] More specifically, Quebec will implement a new mandatory specified registration system applicable to non-Quebec resident suppliers who make supplies of tangible personal property, intangible

[4] Note that non-residents who are located outside Canada and that make taxable supplies in Quebec will be subject to new registration and remittance requirements effective 1 January 2019.

personal property, or services to specified Quebec consumers (i.e., persons who are not QST registrants and who reside in Quebec). A vendor will generally be subject to the new requirements if the value of the consideration for all taxable supplies made by the person to Quebec consumers (i.e., individuals, resident of Quebec) exceeds $30,000.

In addition, digital property and services distribution platforms will have to collect QST on taxable supplies of intangible personal property or services received through the platform by specified Quebec consumers, where the digital platforms control the key elements of the transactions. The specified system will not apply to sales of tangible personal property made through digital platforms.

Registrants under the new specified registration system will not be considered as registrants in accordance with other provisions of the QST regime. Therefore, they will not be able to claim input tax refunds (ITRs) for property and services acquired in the course of their commercial activities. Similarly, recipients registered under the general system who pay QST to a non-Quebec resident supplier registered under the specified registration system may not claim ITRs. However, Quebec will allow non-resident Quebec suppliers to make an election to register under the general QST system if they meet the optional registration requirements.

For further discussion of the Quebec e-commerce proposals, see EY Tax Alert 2018 Issue No. 18,*Quebec announces QST and e-commerce measures*.[5]

Learn more

For more information on this and any other topics that may be of concern, please contact your EY or EY Law Advisor or one of the following professionals:

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[5] It should be noted that the new e-commerce registration measures received royal assent on 12 June 2018. *(An Act to improve the performance of the Société de l'assurance automobile du Québec, to better regulate the digital economy as regards e-commerce, remunerated passenger transportation and tourist accommodation and to amend various legislative provisions L.Q. 2018, c. 18).*

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