

## Tennessee Internet Sales Tax Collections after *Wayfair*

In *South Dakota v. Wayfair, Inc.*,<sup>1</sup> the Supreme Court evaluated South Dakota Senate Bill 106<sup>2</sup> against the dormant Commerce Clause doctrine. In its holding, the Court abolished the physical presence rule previously required under *Quill*<sup>3</sup> and *Bellas Hess*,<sup>4</sup> but did not address a number of significant questions, reviewed below. But based on the relevant factors outlined in the Supreme Court's opinion in *Wayfair*, it is likely that if Tennessee were to require out-of-state (internet) sales and use tax collection using the method already in statute but not yet enabled, the requirement would be upheld against a constitutional challenge.

### Wayfair

The procedural nature of *South Dakota v. Wayfair, Inc.*—heard on appeal from a grant of summary judgment in favor of the State by the South Dakota Supreme Court—dictated that the Court issue a legally-narrow ruling. Disposing of the physical presence rule and holding that *Wayfair*'s virtual presence in South Dakota satisfied the substantial nexus requirement of *Complete Auto*,<sup>5</sup> the Court continued: “The question remains whether some other principle in the Court's Commerce Clause doctrine might invalidate the Act. Because the *Quill* physical presence rule was an obvious barrier to the Act's validity, these issues have not yet been litigated or briefed, and so the Court need not resolve them here.”<sup>6</sup> Thus, the exact circumstances under which a state can constitutionally require out-of-state sellers to collect and remit sales tax are still unclear.

Despite the lack of specificity, the Court provided some guidance in its opinion. After dispensing with the narrow issue of substantial nexus in South Dakota's favor, the Court paid particular attention to the fact that “South Dakota's tax system includes

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<sup>1</sup> [585 U.S.](#) (2018).

<sup>2</sup> 2016 South Dakota Senate Bill 106 (“An Act to provide for the collection of sales taxes from certain remote sellers, to establish certain Legislative findings, and to declare an emergency.”).

<sup>3</sup> *Quill Corp. v. North Dakota*, [504 U.S. 298](#) (1992).

<sup>4</sup> *National Bellas Hess v. Department of Revenue of Ill.*, [386 U.S. 753](#) (1967).

<sup>5</sup> See *Complete Auto Transit, Inc. v. Brady*, [430 U.S. 274](#), 279 (1977) (The Court's decisions have “sustained a tax against Commerce Clause challenge when the tax is applied to an activity with a *substantial nexus* with the taxing State...”) (emphasis added).

<sup>6</sup> 585 U.S., at \_\_\_ (slip op., at 23).

several features that appear designed to prevent discrimination against or undue burdens upon interstate commerce.”<sup>7</sup> The Court explained that South Dakota’s taxing method provides “a reasonable degree of protection”<sup>8</sup> for interstate commerce, highlighting three distinct aspects:

“First, the Act applies a safe harbor to those who transact only limited business in South Dakota. Second, the Act ensures that no obligation to remit the sales tax may be applied retroactively. Third, South Dakota is one of more than 20 States that have adopted the Streamlined Sales and Use Tax Agreement.”<sup>9</sup>

Although nonbinding dicta—expressions in an opinion that go beyond the facts of the case and therefore are not binding in subsequent cases as legal precedent but are strong persuasive authority—this portion of the opinion is noteworthy for Tennessee specifically because it demonstrates that the Court looks favorably upon certain aspects of South Dakota’s tax method. That the Court explicitly emphasized these features, even though they were not essential to the central holding, provides a shade of guidance to lower courts and states. Lower courts—both state and federal—are likely to assess subsequently litigated state tax methods comparatively against South Dakota’s “reasonable degree of protection.” Additionally, states—including Tennessee—with state sales taxes, are likely to construct their collection methods with similar features. Ultimately, tax methods that incorporate the three highlighted factors from *Wayfair* are more likely to be upheld in legal challenges.

## **Tennessee’s Reasonable Degree of Protection**

### ***Limited Business***

First, without the physical presence rule, the Court explained that *Complete Auto’s* test simply requires a substantial nexus with the taxing State, and that “such a nexus is established when the taxpayer [or collector] ‘avails itself of the substantial privilege of carrying on business’ in that jurisdiction.”<sup>10</sup> Based on *Wayfair’s* both “economic and virtual contacts,” the Court said, in this case “the nexus is clearly sufficient.”<sup>11</sup> The

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<sup>7</sup> *Id.*

<sup>8</sup> *Id.*, at \_\_\_ (slip op., at 21).

<sup>9</sup> *Id.*, at \_\_\_ (slip op., at 23).

<sup>10</sup> *Id.*, at \_\_\_ (slip op., at 22) (quoting *Polar Tankers, Inc. v. City of Valdez*, 557 U.S. 1, 11 (2009)).

<sup>11</sup> *Id.*

Court noted that South Dakota’s law applies only to sellers that deliver more than \$100,000 of goods or services or engage in 200 or more separate transactions to deliver goods and services into the state on an annual basis, and concluded that “[t]his quantity of business could not have occurred unless the seller availed itself of the substantial privilege of carrying on business.”<sup>12</sup> Therefore, the Court reasoned, “the substantial nexus requirement of *Complete Auto* is satisfied in this case.”<sup>13</sup> The *Wayfair* decision does not explicitly define substantial nexus, but the fact that South Dakota’s \$100,000/200 transactions threshold was sufficient to establish the required substantial nexus provides an example states and lower courts can use as a measuring stick when evaluating other tax methods.

In 2016, the Tennessee Department of Revenue promulgated Rule 1320-05-01-.129(2) (“Rule 129”), which governs out-of-state dealers, including those without a physical presence in the state.<sup>14</sup> Rule 129 dictates that those out-of-state dealers “who engage in regular or systematic solicitation of consumers...through any means” and exceed \$500,000 in sales in the previous twelve months have a substantial nexus with the state, and are therefore responsible for registering with the Department and collecting and remitting sales and use tax on taxable personal property.<sup>15</sup>

Out-of-state dealers began to register before the March 1, 2017, deadline (set in Rule 129(a)), and were to begin collecting sales tax by July 1, 2017.<sup>16</sup> However, the rule was litigated, and to avoid confusion while the court challenge was pending, the Department of Revenue, along with the challengers and the Chancery Court for Davidson County, agreed to delay enforcement of the rule.<sup>17</sup> Then the General Assembly, concerned about the rule’s constitutionality, amended the omnibus (rules) bill to prohibit enforcement of the rule until the General Assembly decides whether to lift the prohibition.<sup>18</sup> The Department of Revenue confirmed that it won’t enforce the rule until after the legislature gets a chance to review it.<sup>19</sup>

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<sup>12</sup> *Id.*, at \_\_\_ (slip op., at 23).

<sup>13</sup> *Id.*

<sup>14</sup> Rules and Regulations of the State of Tennessee, Section 1320-05-01-.129(2). See Appendix A.

<sup>15</sup> *Id.*

<sup>16</sup> Department of Revenue Notice #17-01.

<sup>17</sup> Tennessee Department of Revenue Notice #17-12 and *American Catalog Mailers Ass’n v. Tennessee Department of Revenue*.

<sup>18</sup> Public Chapter 452, Acts of 2017. See Appendix B.

<sup>19</sup> July 13, 2018, [interview with David Gerregano](#), Commissioner of the Department of Revenue.

Although the General Assembly prohibited the Department of Revenue from putting the rule into effect “until [a] court’s ruling [on the constitutionality of the rule] has been fully reviewed and rule 1320-05-01-.129(2) has been approved by the general assembly pursuant to Tennessee Code Annotated, Section 4-5-226,<sup>20</sup>”<sup>21</sup> the rule would create a similar practical effect to South Dakota’s tax statute, establishing what the *Wayfair* Court called “a safe harbor”<sup>22</sup> for those dealers only transacting limited business in the state. Given the Court held that dealers exceeding South Dakota’s statutory threshold availed themselves of the “substantial privilege of carrying on business,”<sup>23</sup> it follows logically that courts are also likely to deem that out-of-state dealers who meet Tennessee’s \$500,000 threshold have a substantial nexus with the state.

Moreover, Rule 129 is likely further bolstered because it does not contain a threshold for individual transactions. Unlike South Dakota’s 200 individual transactions limitation, Tennessee does not impose a certain number of transactions—regardless of sales amount—that trigger the duty to collect and remit sales and use tax.<sup>24</sup> This provides protection for smaller businesses that do not exceed the \$500,000 sales amount but may transact a large number of individual sales, especially for relatively cheap goods and services. In short, the \$500,000 threshold implemented by Rule 129 is likely to be constitutionally acceptable if challenged in the courts.

### ***Retroactive Application***

Second, the Court highlighted that South Dakota’s method “ensures that no obligation to remit the sales tax may be applied retroactively.”<sup>25</sup> Specifically, the South Dakota authorizing statute provides: “No obligation to remit the sales tax required by this Act may be applied retroactively.”<sup>26</sup> The Court did not provide any further explanation as to the importance of prohibiting retroactive tax liability or the weight such a factor should be given in evaluating tax methods; however, it is significant that the Court mentioned the prohibition at all. Given that the bar on retroactive liability did not play a role in the Court’s resolution of the narrow procedural issue before it, underlining the provision provides a sort of guidepost for lower courts and states to follow.

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<sup>20</sup> Tennessee Code Annotated, Section 4-5-226 (“Expiration of rules—Review by general assembly.”).

<sup>21</sup> Public Chapter 452, Acts of 2017. See Appendix B.

<sup>22</sup> 585 U.S. \_\_\_\_ (slip op., at 23).

<sup>23</sup> *Id.*

<sup>24</sup> See Rules and Regulations of the State of Tennessee, Section 1320-05-01-.129(2). See Appendix A.

<sup>25</sup> 585 U.S. \_\_\_\_ (slip op., at 23).

<sup>26</sup> 2016 South Dakota Senate Bill 106, Section 5.

Tennessee has no unqualified prohibition on retroactive liability for failure to collect and remit sales tax. Rule 129 makes no mention of retroactive application in its text<sup>27</sup> and is intended to apply prospectively.<sup>28</sup> Sellers must meet certain criteria to be released from liability for uncollected sales taxes under statute. Tennessee Code Annotated, Section 67-6-537 provides that certain sellers are “not liable for sales or use tax not collected from its customers prior to the date of its registration [with the Department of Revenue], nor liable for any related interest or penalty.”<sup>29</sup> To qualify for protection under Section 537, sellers must: (1) register “within twelve (12) months of the effective date of this state’s becoming a member in substantial compliance with the [Streamlined Sales and Use Tax] agreement”; (2) have not been registered during the twelve month period preceding Tennessee becoming “a member in substantial compliance with the agreement,”<sup>30</sup> or becoming “an associate member of the agreement”<sup>31</sup>; and (3) have “no audit or assessment pending...and the department has not notified the seller that it will be the subject of an audit.”<sup>32</sup> In short, out-of-state dealers will not be liable for collecting sales taxes retroactively provided they register with the Department of Revenue within twelve months of the effective date of the state’s participation in the Streamlined Sales and Use Tax Agreement.

Although Tennessee’s treatment of retroactive liability differs from South Dakota’s, it likely would not hamper Tennessee’s effort to collect sales taxes from out-of-state dealers with no physical presence. The state has enacted laws and promulgated rules that put it in substantial compliance with the Streamlined Sales and Use Tax Agreement, which requires retroactive protection only for those sellers that register to collect and remit sales taxes within twelve months of the state’s participation in the Agreement. That South Dakota went beyond the requirements of the Agreement in enacting its statute is likely of reduced consequence given the totality of Tennessee’s other actions to implement the majority of the Agreement. Therefore, a court is likely to uphold Tennessee’s retroactive protection statute as part of the larger tax collection method.

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<sup>27</sup> See Rules and Regulations of the State of Tennessee, Section 1320-05-01-.129(2).

<sup>28</sup> See July 13, 2018, interview with David Gerregano, Commissioner of the Department of Revenue and Tennessee Department of State Rulemaking Hearing Rule(s) Filing Form (SS-7039), [Department of Revenue Rule 1320-05-01-.129](#), at 10 (Filed Oct. 3, 2016).

<sup>29</sup> Tennessee Code Annotated, Section [67-6-537\(b\)](#).

<sup>30</sup> *Id.* Section 537(a)(2)(A).

<sup>31</sup> *Id.* Section 537(a)(2)(B).

<sup>32</sup> *Id.* Section 537(a)(3).

## **Streamlined Sales and Use Tax Agreement**

Third, the *Wayfair* majority underscored that South Dakota has adopted the Streamlined Sales and Use Tax Agreement (SSUTA). Emerging from the Streamlined Sales and Use Tax Project, the SSUTA represents a national effort by states to simplify and modernize the administration of state and local sales tax laws. Assessing the SSUTA, the Court noted:

“[The SSUTA] system standardizes taxes to reduce administrative and compliance costs: It requires [1] a single, state level tax administration, [2] uniform definitions of products and services, [3] simplified tax rate structures, and [4] other uniform rules. It also provides [5] sellers access to sales tax administration software paid for by the State. [6] Sellers who choose to use such software are immune from audit liability.”<sup>33</sup>

Highlighting functions and objectives of the SSUTA in non-binding dicta demonstrates that the Court holds the predominant goal of reducing administrative and compliance costs in high regard, despite its indirect influence on the narrow issue presented in *Wayfair*. Moreover, pointing to specific provisions provides a degree of guidance to lower courts in terms of which parts of an overall tax collection method weigh in favor of constitutionality. Therefore, to bolster the constitutional validity of its tax collection method, it would be advantageous for Tennessee to adopt at least some version of the six provisions.

Tennessee’s history with the SSUTA stretches back to the agreement’s inception, in 2001, when the General Assembly initially enacted legislation directing the state to enter into multi-state discussions “to review or amend the terms of the [SSUTA] to simplify and modernize sales and use tax administration in order to reduce substantially the burden of tax compliance for all sellers and for all types of commerce.”<sup>34</sup> In 2003, the General Assembly passed legislation to comply with provisions of the SSUTA,<sup>35</sup> and Tennessee became an associate member state to the agreement on October 1, 2005.<sup>36</sup> Although South Dakota is a full member to the agreement, and Tennessee is not, it is not likely to have a significant effect on the validity of Tennessee’s tax method. The

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<sup>33</sup> 585 U.S. \_\_\_\_ (slip op., at 23).

<sup>34</sup> Simplified Sales and Use Tax Administration Act, Public Chapter 312, Acts of 2001.

<sup>35</sup> See Public Chapter 357, Acts of 2003.

<sup>36</sup> “Streamlined Sales Tax,” Tennessee Department of Revenue (available at: <https://www.tn.gov/revenue/taxes/sales-and-use-tax/streamlined-sales-tax.html>).

*Wayfair* Court focused much more on the overarching goal of reducing administrative and compliance costs than it did on the specifics of South Dakota’s membership status.

Following admittance as an associate member, Tennessee enacted additional legislation in 2007<sup>37</sup> and 2008<sup>38</sup> to further bring the state’s tax statutes into compliance with SSUTA requirements. Several statutory changes became effective in 2008 and 2009; however, the effective date of numerous provisions was delayed on multiple occasions by the General Assembly.<sup>39</sup> In 2017, the General Assembly again postponed the effective date of additional changes needed to bring Tennessee into compliance with the SSUTA, deferring implementation until July 1, 2019.<sup>40</sup> Despite delayed implementation, the validity of Tennessee’s tax method is likely to be assessed in light of the six items listed by the *Wayfair* Court.

### **(1) Single, State Level Tax Administration**

In terms of a single, state level tax administration, Tennessee’s collection method likely weighs in favor of constitutional validity. Specifically, the Commissioner of Revenue is charged with the administration and collection of sales and use taxes, including both the state rate<sup>41</sup> and the local option rate.<sup>42</sup> Moreover, Rule 129 explicitly states that dealers with a substantial nexus to the state “shall register with the *Department* for sales and use tax purposes and shall report and pay the appropriate tax to the *Department*.”<sup>43</sup> Thus, Tennessee’s single, state level administration is likely to bolster the overall tax method’s constitutional validity.

### **(2) Uniform Definitions of Goods and Services**

Tennessee’s tax collection method is likely strengthened concerning uniform goods and services definitions. The SSUTA posits a library of definitions, and states are required to adopt definitions that are substantially similar in language. Aside from bundled

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<sup>37</sup> Public Chapter 602, Acts of 2007.

<sup>38</sup> Public Chapter 1106, Acts of 2008.

<sup>39</sup> See Public Chapter 602, Acts of 2007, Section 187, as amended by Public Chapter 530, Acts of 2009, Section 35, and as further amended by Public Chapter 72, Acts of 2011, Section 1, and as further amended by Public Chapter 480, Acts of 2013, Section 1, and as further amended by Public Chapter 273, Acts of 2015, Section 3.

<sup>40</sup> Public Chapter 193, Acts of 2017.

<sup>41</sup> Tennessee Code Annotated, Section 67-6-401.

<sup>42</sup> Tennessee Code Annotated, Section 67-6-710(a)(1).

<sup>43</sup> Rules and Regulations of the State of Tennessee, Section 1320-05-01-.129(1) (emphasis added).

transactions, Tennessee has already enacted substantially similar definitions that are also not contrary to definitions contained in the SSUTA.<sup>44</sup> The definition for bundled transactions is also scheduled to change so as to comply with the SSUTA on July 1, 2019.<sup>45</sup> Given that the state is already in almost total compliance with SSUTA's product and service definitions, this factor is likely in Tennessee's favor.

### **(3) Simplified Tax Rate Structures**

Under the SSUTA, no member states "shall have multiple state sales and use tax rates on items of personal property or services, except that a member state may impose a single additional rate...on food and food ingredients and drugs."<sup>46</sup> Tennessee's current statutory structure presents a unique situation. While most tangible goods are taxed at the state rate of seven percent (7%)<sup>47</sup>, the state does not meet the requirement of a single state sales rate, as various products are taxed at differing rates.<sup>48</sup> Statutory changes scheduled to take effect July 1, 2019, however, will bring the state into compliance with SSUTA, repealing the varying tax rates,<sup>49</sup> leaving one state tax rate for most tangible property, and another for food and food ingredients.<sup>50</sup>

Additionally, member states with "local jurisdictions that levy a sales or use tax shall not have more than one local sales tax rate or more than one local use tax rate per local jurisdiction."<sup>51</sup> Current Tennessee law stipulates that in lieu of applicable local-option rates—which vary from jurisdiction to jurisdiction but are capped at 2.75%—out-of-state "dealers with no location in this state may choose to pay . . . local tax at the rate of two and twenty-five hundredths percent (2.25%) of the sales price on all sales made in this state."<sup>52</sup> This potentially reduces administrative burdens on sellers by allowing them to pay a uniform statewide rate rather than each jurisdiction's individual local-option rate. The planned 2019 statutory changes will eliminate the uniform statewide

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<sup>44</sup> See Tennessee Code Annotated, Sections 67-6-102 et seq. and 67-6-905(a)(1-12).

<sup>45</sup> Public Chapter 193, Acts of 2017.

<sup>46</sup> [Streamlined Sales and Use Tax Agreement](#) (SSUTA), Section 308(A) (May 3, 2018).

<sup>47</sup> Tennessee Code Annotated, Section 67-6-202(a).

<sup>48</sup> See [Tennessee Certificate of Compliance](#), Section 308(A1) (August 1, 2017).

<sup>49</sup> See Public Chapter 602, Acts of 2007 Tenn. Pub. Ch. 602.

<sup>50</sup> Tennessee Certificate of Compliance, Section 308(A2).

<sup>51</sup> SSUTA, at Section 308(B).

<sup>52</sup> Tennessee Code Annotated, Section 67-6-702(f).

rate option,<sup>53</sup> leaving one local-option rate per city or county on the vast majority of goods and services<sup>54</sup>

Regardless of whether the 2019 statutory changes are implemented, it is likely that Tennessee’s tax rates are standardized enough to satisfy a court, thus providing more weight to the state’s case for upholding its tax collection method.

#### **(4) Other Uniform Rules**

Although this point was mentioned only briefly by the Court, it is likely that Tennessee’s legislative actions are enough to satisfy a reviewing court. According to the Department of Revenue, the state has already adopted uniform rules, such as uniform remittance procedures, uniform recovery of bad debts, uniform sales tax holiday definitions and procedures, uniform rounding rule, uniform customer refund procedures, and uniform specified digital products provisions.<sup>55</sup> Additionally, a number of rules concerning general sourcing, direct mail sourcing, and telecommunications sourcing are scheduled to take effect July 1, 2019.<sup>56</sup> Altogether, Tennessee’s adoption and enactment of uniform rules required under the SSUTA is likely to weigh in favor of upholding the state’s tax collection method.

#### **(5) Access to Sales Tax Administration Software Paid for by the State**

The SSUTA divides sellers into categories based on the process used to calculate the amount of tax due to states. Model 1 sellers choose a certified service provider (CSP) “as an agent to perform all the seller's sales or use tax functions, other than the seller's obligation to remit tax on its own purchases.”<sup>57</sup> Model 2 sellers use a preapproved certified automated system (CAS) that calculates the amount of tax due on each transaction.<sup>58</sup> Model 3 sellers are those that use their own “proprietary automated sales tax system that has been certified as a CAS,” have sales in at least five member states, and total annual revenue of at least five hundred million dollars.<sup>59</sup> CSPs apply to and are approved by the SSSUTA Governing Board, permitting CSPs to then enter into

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<sup>53</sup> See Public Chapter 602, Acts of 2007.

<sup>54</sup> See Tennessee Certificate of Compliance, Section 308(B1).

<sup>55</sup> Tennessee Department of Revenue, [2017 Recertification Letter](#) to Streamlined Sales and Use Tax Governing Board, Inc., at 1 (July 31, 2017).

<sup>56</sup> *Id.*, at 2.

<sup>57</sup> SSUTA, Section 205.

<sup>58</sup> *Id.*, at 206.

<sup>59</sup> *Id.*, at 207.

contracts with individual member states to collect and remit sales taxes.<sup>60</sup> Each member state to the agreement—including Tennessee as an associate member—is also required to review and approve software submitted to the Governing Board for certification as a CAS “to determine that the program accurately reflects the taxability of the product categories included in the program.”<sup>61</sup> Tennessee has adopted and codified these requirements,<sup>62</sup> lending more credibility to the state’s collection method.

Additionally, Sections 601 and 602 of the SSUTA stipulate that member states shall provide monetary allowances to CSPs in Model 1 and to Model 2 sellers.<sup>63</sup> This means that CSPs make their money not by charging the sellers that utilize their services, but instead by keeping a portion of the tax revenue generated and due to the states from those Model 1 sellers.<sup>64</sup> Similarly, Model 2 sellers retain a percentage of the tax generated and due, but only for up to twenty-four months after the seller registers through the agreement’s central registration process.<sup>65</sup> Tennessee has enacted statutes to meet this requirement under the agreement,<sup>66</sup> and therefore, this prong of the *Wayfair* Court’s dicta likely bolsters the state’s effort to collect sales tax from out-of-state dealers with no physical presence.

## **(6) Immunity from Audit Liability**

The final feature of South Dakota’s tax method mentioned in *Wayfair* is the immunity provided to out-of-state sellers that use an approved CAS. The SSUTA dictates that member states shall relieve CSPs and sellers from liability for having charged and collected the incorrect amount of taxes resulting from the seller or CSP relying on erroneous data provided by a member state on tax rates, boundaries, or taxing jurisdiction assignments.”<sup>67</sup> Tennessee has enacted this provision in statute, refusing to impose liability for incorrectly collected taxes for dealers and CSPs when relying on “erroneous data provided by the commissioner [of the Department of Revenue] on tax rates, boundaries, or taxing jurisdiction assignments.”<sup>68</sup> Accordingly, Tennessee’s sales

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<sup>60</sup> *See id.*, at 501.

<sup>61</sup> *Id.*, at 502(A).

<sup>62</sup> Tennessee Code Annotated, Sections 67-6-102 and 67-6-504.

<sup>63</sup> SSUTA, Art. VI.

<sup>64</sup> *See id.*, at 601.

<sup>65</sup> *See id.*, at 602.

<sup>66</sup> *See* Tennessee Code Annotated, Section 67-6-509(d).

<sup>67</sup> SSUTA, Section 306.

<sup>68</sup> Tennessee Code Annotated, [Section 67-6-533\(a\)](#).

tax collection method includes the immunity from liability provisions pointed to by the Court in *Wayfair*.