NEW YORK FINALLY ISSUES GUIDANCE ON SALES TAX ECONOMIC NEXUS

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State and Local Tax Alert
January 16, 2019

Introduction

New York is one of the most, if not the most, aggressive states when it comes to tax enforcement. That's why it was a bit confusing when the New York State Department of Taxation and Finance (the "Tax Department") remained uncharacteristically silent following the landmark Supreme Court decision in *South Dakota v. Wayfair*. But that's finally changed! On January 15, 2019, the Tax Department issued a Notice explaining its position on economic nexus for sales tax purposes. In this alert, we'll (1) provide a brief review of how the *Wayfair* case changed tax administration, (2) discuss New York's new guidance, and (3) address some of the potential issues that are likely to arise as a result of this new guidance.

Wayfair Review

The Wayfair case had a profound impact on sales tax administration. As a result, numerous commentators have written about the case's impacts, including us. You can see our prior blog posts here and here. The bottom line is that before *Wayfair*, states could require out-of-state vendors to collect and remit sales tax on sales to customers within a state ***only*** if the out-of-state vendor was physically present in the state. To put it another way, before a state could require a vendor to collect its sales tax, that vendor had to be physically present in the state (e.g., through people or property).

But all this changed with *Wayfair*. The Supreme Court reviewed this physical presence test and basically concluded that it no longer made sense given the rise of the internet and our digital economy. The last time the Supreme Court reviewed this issue in 1992, in a case called *Quill Corp. v. North Dakota*, less than 2% of Americans had internet access. Fast forward to today and the Court opined that when it decided *Quill*, it could not envision a scenario where the world's largest retailer (Amazon) would be a remote seller. In other words, because of the internet, vendors no longer need to be physically present in a state in order for them to take advantage of the state's marketplace and derive significant revenue from the state. So, according to the Court, because the way we transact business changed, our rule governing sales tax compliance also had to change.

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South Dakota provided the Court with a possible new rule. The state passed a law that said even if an out-of-state vendor didn't have physical presence in the state, it would still have to collect and remit South Dakota sales tax if it had enough of an ***economic presence***. South Dakota defined the requisite economic presence to be: either $100,000 in sales to South Dakota customers, or more than 200 transactions in the state. Though the Supreme Court did not officially deem this specific standard to be constitutionally valid, it did remove the physical presence requirement when considering whether a vendor is required to collect and remit a state's sales tax. The case was then sent back to the South Dakota state courts to determine whether the law's economic presence thresholds were constitutionally valid. As we previously discussed, the parties eventually settled, and these thresholds remain the law in the state.

The Wake of Wayfair

Since *Wayfair*, of the 46 jurisdictions that impose a general sales and use tax (45 states and the District of Columbia), 41 have previously either passed legislation, enacted an administrative rule, or have a pending proposal for economic nexus. Most of these states followed the *Wayfair* model, choosing $100,000 in sales or 200 transactions, though some variation has occurred. Until January 15, 2019, New York was one of the five holdout states where no guidance was forthcoming (the other holdouts being Arizona, Florida, Kansas and New Mexico – note that Alaska, Delaware, Montana, New Hampshire and Oregon do not impose a general sales and use tax).

As you can see, the vast majority of states jumped on the *Wayfair* bandwagon. And why wouldn't you? It's foolish not to impose economic nexus if your state has a general sales tax because it would result in a competitive disadvantage for instate businesses. Here's how it plays out: if a state doesn't impose economic nexus, then out-of-state vendors with no physical presence don't have to charge tax, while instate vendors, who are physically present in the state, do (as you can see, physical presence is still a consideration, even if *Wayfair* has diminished its significance). States won't want to have to require their own businesses to charge more (i.e., the tax) than their out-of-state competitors – yes, we know all customers are supposed to self-remit use tax if they are not charged sales tax, but come on.

With the issuance of Notice N-19-1, New York officially joined the ranks of the states that impose economic nexus. According to the Notice, an out-of-state vendor with no physical presence will be required to collect and remit New York sales tax if, during the immediately preceding four sales tax quarters:

1. the business made more than $300,000 in sales of tangible personal property delivered in the state; **AND**
2. the business conducted more than 100 sales of tangible personal property delivered in the state.

As you can see, New York's economic nexus law imposes different thresholds than those reviewed by the Supreme Court in *Wayfair*. The dollar amount is significantly higher, while the transaction count is significantly lower. And most important, New York's rule imposes an "AND" test, rather than an "OR" test. As we'll see, this has significant ramifications.

Open Questions Regarding New York's Guidance

You have questions, we have answers! Here's what you need to know about New York's new guidance:

Question: Doesn't New York have to pass a law (or at least a formal regulation) in order to impose economic nexus?

According to the Notice, the Tax Department is taking the position that *Wayfair* caused certain seemingly dormant provisions in New York's Tax Law to become "immediately effective."

The Notice cites Tax Law sections 1101(b)(8)(i)(E) and 1101(b)(8)(iv). Section 1101(b)(8)(i)(E) basically says that if a seller systematically solicits business in the state by any means (including over the internet, though the law does not explicitly use that word) then it qualifies as a "vendor." Other provisions of the law obligate "vendors" to collect and remit tax on taxable sales. But Section 1101(b)(8)(i)(E) also contains important limiting language. It only applies if, "such solicitation satisfies the nexus requirement of the United States constitution." Well, after the *Wayfair* decision, and the demise of the physical presence requirement, remote systematic solicitation can now theoretically satisfy constitutional nexus requirements.

But what type of systematic solicitation satisfies constitutional nexus requirements? That brings us to the second section cited by the Tax Department in its Notice. Tax Law section 1101(b)(8)(iv) establishes a presumption that a seller will be systematically soliciting in the state if during the immediately preceding four sales tax periods, the total amount of sales from property delivered into the state exceeds $300,000 and the seller made more than 100 sales of property into the state. So here we find the legal basis for New York's economic nexus threshold.

So while we have been subtlety criticizing NY for being late in providing guidance regarding economic nexus, one could credibly argue that New York has been way ahead of the game by inserting economic nexus into its law, even if the provisions remained dormant while physical presence was the law of the land. Because of this, the Tax Department believes that the state already has the legal foundation to immediately impose economic nexus.

Question: So when does New York's economic nexus rule become effective

Now! Because the Notice is so new, the Tax Department hasn't had the opportunity to expound on how it plans to enforce economic nexus. But if we're reading the Notice correctly, it looks like economic nexus has been in force since the *Wayfair* decision was decided, even if the Tax Department is just now getting around to telling us so. The Notice states that *Wayfair*, "eliminated the prohibition on a state imposing sales tax collection responsibilities on businesses that have no physical presence in that state. Due to this ruling, certain existing provisions in the New York State Tax Law that define a sales tax vendor immediately became effective." So if the provisions became effective as of the ruling, then economic nexus has been in force in New York since June 21, 2018.

If New York ends up enforcing economic nexus beginning as of June 21, 2018, it could face a significant legal challenge. It is important to note that nearly all states that have imposed economic nexus have done so on a prospective basis only. The vast majority of these new state laws/rules took force in the fourth quarter of 2018 or as of January 1, 2019. And in all cases, these dates were after the enactment of the new law or publication of the new rule (Massachusetts has argued that its "cookie nexus" provision has always been constitutional and became effective October 1, 2017). This is consistent with the Court's ruling in *Wayfair*. One of the Court's key considerations was the compliance burden the rule change would create. And the Court specifically noted that South Dakota's law was prospective only. A rule that is enforced retroactively to a date prior to the announcement of the rule could, under a *Wayfair* analysis, jeopardize the rule's constitutionality. Unfortunately, we have informally heard from Tax Department sources that retroactive application is a possibility, at least in certain circumstances.

Moreover, the *Wayfair* Court cited other provisions that eased the compliance burden of economic nexus. For example, South Dakota is a full member of the Streamlined Sales and Use Tax Agreement ("SSUTA"). As a full member, the state's sales tax law is more uniform and consistent with the sales tax laws in force in other member states. New York has a notoriously complex sales tax law and the state is not a member of the SSUTA. Thus, we think it might be a bit of a stretch when the Tax Department's Notice states that *Wayfair* "eliminated the prohibition on a state imposing sales tax collection responsibilities on businesses that have no physical presence in that state." We think a more accurate statement would read, "*Wayfair* established the potential constitutionality of economic nexus, provided certain other safeguards designed to ease the compliance burden are also in place."

Question: **What types of out-of-state businesses can still sell into New York without having to collect and remit the state's sales tax?**

First, it is important to recognize that both the Tax Department's Notice and the Tax Law apply these economic presence provisions exclusively to sales of ***tangible personal property***. Thus, out-of-state ***service*** providers with no physical presence in the state have a reasonable legal position that they are under no legal obligation to collect and remit New York tax. For example, if a New York customer purchases a taxable information service from a seller located exclusively out-of-state, the service provider appears to be able to sell the service without collecting and remitting the New York tax (again, the customer has an obligation to pay use tax on the transaction).

But a word of caution is in order. New York taxes software as the sale of tangible personal property (even if the software is remotely accessed and not actually transferred to the customer – i.e., a software-as-a-service model). Moreover, software is invariably used in conjunction with online services (for example, remote payroll processing, inventory tracking, business data management, etc.). Thus, any service that utilizes software that the customer accesses could allow the Tax Department to argue that it is taxing a sale of software (tangible personal property) and not the sale of a service.

Second, it is important to note that because New York's economic nexus rule establishes an "AND" test, out-of-state vendors can transact a significant amount of business and still not have a sales tax collection obligation. Here's an example: let's say I'm a high-end online art dealer or auction house with no physical presence in New York. The items I sell typically cost a couple hundred thousand dollars and up. But I only hold auctions sporadically throughout the year and have customers located across the country. In a given year I might make 50 sales to New York customers, the total amount of which will exceed several million dollars. Despite the high amount of revenue I receive from New York customers, I am not obligated to collect and remit tax on those transactions because while I am above the $300,000 threshold, I am below the 100 transaction threshold. And because New York's economic nexus test is an "AND" test, I need to satisfy both parts before the state can obligate me to collect and remit. Connecticut has a similar rule ($250,000 in sales AND 200 transactions). This makes New York and Connecticut outliers. The vast majority of states impose an "OR" test similar to the law at issue in the *Wayfair* case.

So despite New York's aggressive tax compliance reputation, the state has actually taken a more conservative approach to economic nexus. Of course, New York could mitigate its seeming generosity by taking a restrictive view of what qualifies as a transaction. Several states have indicated that the transaction threshold will be tied to the number of invoices issued. This seems like a reasonable approach. But a state could potentially argue that if an invoice contains several items, the sale of each item qualifies as a separate transaction for economic nexus purposes. Again, we'll just have to wait and see how New York enforces this new rule.

Other Unanswered Questions

No doubt there are several unanswered questions that will need to be fleshed out in the coming months. For example:

- Are wholesale transactions counted towards the applicable thresholds?
- Will the state expand its economic nexus to cover services?
- Will the state amend its Tax Law to align with the South Dakota model, or is this it?
- If nexus is now based on thresholds calculated during a rolling period (i.e., "immediately preceding four sales tax quarters"), is the Tax Department really going to respect a vendor's position that it had nexus intermittently (i.e., quarter by quarter) if the vendor is close to the threshold limits?
- And does the answer above change if the sales are continuing transactions (e.g., monthly payments as part of an annual subscription)?
- What about the new proposed budget legislation that would require marketplace providers to collect sales tax on taxable sales of tangible personal property that they facilitate (see proposed budget legislation Memorandum in Support at Part G)? Maybe the answer is to sell through a marketplace and make them deal with the sales tax!

As of now, we don't have answers to these questions. So we'll await further guidance. Stay tuned for updates on how the Tax Department is enforcing this new provision.