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The U.S. Supreme Court's decision in *South Dakota v. Wayfair* has significant implications for remote sales taxation, but that isn't the only area the case reaches. In this article, McDermott Will & Emery's Alysse McLoughlin and Mark Yopp discuss the impact of *Wayfair* on tax rules concerning traveling employees.

INSIGHT: Withholding Judgment: The Impact of 'Wayfair' on Personal Income Tax Withholding



By ALYSSE McLOUGHLIN AND MARK YOPP

States reacting to *South Dakota v. Wayfair, Inc.*, No. 17-494, 585 U.S. ___ (2018) have primarily focused on the effects of the case on sales and use tax, and to a lesser extent, the effects on corporate income tax. Specifically, states have been reviewing how they can best apply the Supreme Court's determination that physical presence is not necessary for a finding of nexus for Commerce Clause purposes for those two taxes.

Although the impact on these two taxes is significant, we believe that states, taxpayers, and practitioners should also focus on the impact of the case on personal income tax and withholding tax rules concerning traveling employees. The *Wayfair* decision has underscored what has always been true: lack of limits in imposing personal income tax on individuals and in imposing withholding tax obligations on companies violates the Commerce Clause. Specifically, although the *Wayfair* court concluded that physical presence was not required for nexus, there is also no discussion in the decision that physical presence is *sufficient* for the imposition of tax.

Accordingly, states must revise their personal income tax and withholding tax rules in consideration of the emphasis the Supreme Court placed in *Wayfair* on the impact that undue burdens can have in determining whether a tax or a collection obligation violates the Commerce Clause. Limitations must be placed in the personal income tax and withholding tax rules to address and limit the burdens arising from the current rules imposed with respect to traveling employees. A handful of states have thresholds for the number of days a person is required to be in the state before the imposition of a personal income tax, mostly by administrative guidance; the rest of the states should follow suit.

The dormant Commerce Clause prevents the placement of undue burdens on interstate commerce, even in the absence of discrimination. As the Supreme Court has long held, the “negative or dormant implication of the Commerce Clause prohibits state taxation . . . or regulation . . . that discriminates against or unduly burdens interstate commerce and thereby ‘imped[es] free private trade in the national marketplace.’” *General Motors Corp. v. Tracy*, 519 U.S. 278, 287 (1997) (citing *Quill Corp. v. North Dakota*, 504 U.S. 298, 312-13 (1992); *Brown-Forman Distillers Corp. v. New York State Liquor Authority*, 476 U.S. 573, 578-79 (1986), and quoting *Reeves, Inc. v. Stake*, 447 U.S. 429, 437 (1980)).

Notably, the *Wayfair* decision rested in part on dormant Commerce Clause cases that were not necessarily related to tax. While most Commerce Clause cases arise in the context of a discriminatory state or local statute, “neutral” statutes (i.e., statutes that do not discriminate against interstate commerce on their face) will also be struck if their deleterious impact on interstate commerce outweighs the local benefits or the interests of the state in exercising its police powers to regulate uniquely local matters (health, public safety, etc.). *Gen-*

eral Motors, 519 U.S. at 299 (“even nondiscriminatory state legislation may be invalid under the dormant Commerce Clause when, in the words of the so-called *Pike* undue burden test, ‘the burden imposed on [interstate] commerce is clearly excessive in relation to the putative local benefits.’”)

The focus on the level of undue burdens placed on interstate commerce was particularly emphasized in *Wayfair*, with such burdens being deemed insufficient as compared to the benefits afforded to the state by being able to impose a sales tax collection obligation on out-of-state vendors. In its analysis, the Court first examined the burdens that would be imposed on out-of-state businesses by the imposition of a sales tax collection obligation:

These burdens may pose legitimate concerns in some instances, particularly for small business that make a small volume of sales to customers in many States. State taxes differ, not only in the rate imposed but also in the categories of goods that are taxed and, sometimes, the relevant date of purchase.

After acknowledging the potential burdens, however, the Court noted that South Dakota’s statute provided protection to out-of-state merchants with a small amount of activity in the state.

In this case, however, South Dakota affords small merchants a reasonable degree of protection. ***The law at issue requires a merchant to collect the tax only if it does a considerable amount of business in the State; the law is not retroactive; and South Dakota is a party to the Streamlined Sales and Use Tax Agreement . . . (emphasis added)***

Thus, the Supreme Court acknowledged the burdens imposed on out-of-state vendors but determined that South Dakota could impose such burdens because South Dakota had taken pains to reduce the burden borne by small merchants, and those burdens were outweighed by the benefits to the state. In addition, the Court noted that the physical presence test itself provided out-of-state vendors with a commercial advantage as customers in a state could pay less for a product that was purchased from an out-of-state vendor. The Court did not think that it was the Court’s place to draft rules that would provide a commercial benefit to some companies over others.

The Court thus applied its long-standing balancing test in determining whether discrimination exists because of the undue burdens imposed on commerce. More specifically, in *Wayfair* the Court emphasized the validity of its previous decision in *Pike v. Bruce Church, Inc.*, 197 U.S. 137, 142 (1970), when the Court noted that “state laws that [r]egulate evenhandedly to effectuate a legitimate local public interest . . . will be upheld **unless the burden imposed on such commerce is clearly excessive in relation to the putative local benefits.**” *Id.* (emphasis added).

Pursuant to this same rationale, states are violating the Commerce Clause by imposing their personal income tax obligations on individuals and withholding tax obligations on employers; most states employ virtually no limits on the applicability of their statutes, with many states imposing tax on ‘day-one dollar-one.’ There are only a handful of states with clearly stated bright-line thresholds. See, *Mobile Workforce Briefing Book*, Sept. 9, 2009.

South Dakota took pains to reduce the burdens placed on small merchants pursuant to South Dakota’s sales tax collection obligation rules by providing thresh-

olds before a sales tax collection obligation was incurred, making the sales tax collection obligation prospective only, and imposing uniform rules through its participation in the Streamlined Sales and Use Tax Agreement. These factors were very important to the Court in reaching its decision:

Complex state tax systems could have the effect of discrimination against interstate commerce. Concerns that complex state tax systems could be a burden on small businesses are answered in part by noting that, as discussed below, there are various plans already in place to simplify collection; and since in-state businesses pay the taxes as well, the risk of discrimination against out-of-state sellers is avoided. And, if some small businesses with only *de minimis* contacts seek relief from collection systems thought to be a burden, those entities may still do so under other theories. These issues are not before the Court in the instant case; but their potential to arise in some later case cannot justify retaining this artificial, anachronistic rule that deprives States of vast revenues from major businesses.

However, with respect to personal income taxes imposed on traveling employees, most states have not taken similar measures. Thus, an individual that travels substantially for business could have to file many returns, even if the amount of time spent in each location is minimal. This is clearly an undue burden on an individual who has to complete and file his or her own returns. Furthermore, the unlimited withholding tax rules and the inconsistencies between such rules place a significant burden on businesses to track each of their employees’ travel and file returns in all applicable states.

Labor pool is proper subject of Commerce Clause protection. There can be little doubt that the workers for whom multistate employers must perform employment tax withholding are a part of commerce, coming within the protections of the Commerce Clause. The New York Court of Appeals has confirmed that the “interstate labor market” is the proper subject of Commerce Clause protection in striking New York’s discriminatory non-resident “commuter tax.” *City of New York v. State of New York*, 94 N.Y.2d 577, 730 N.E.2d 920, 709 N.Y.S.2d 122 (N.Y. 1999).

In fact, the New York Court of Appeals in the commuter tax case specifically rejected New York State’s argument that *Tamagni v. Tax Appeals Tribunal of the State of New York*, 91 N.Y.2d 530, 695 N.E.2d 1125, 673 N.Y.S.2d 44 (N.Y. 1998), *cert. den.*, 525 U.S. 931, stood for the proposition that the Commerce Clause does not protect workers. *City of New York*, 91 N.Y.2d at 538. The State had argued that commuters cannot be commerce, and thus receive no dormant Commerce Clause protection. The taxpayers in *Tamagni* were taxed by New York State on intangible income “based solely on the Tamagnis’ status as New York residents, ‘without regard to any specific commercial or economic transaction or activity.’” *Id.* In contrast, the commuter tax was “assessed against the interstate labor market per se” and clearly implicated the Commerce Clause.

The burden is equally clear at the employer level, where the “macro” effects of labor force burdens—such as employment tax withholding compliance—arguably have even greater impact on the employer’s business decisions and activities in interstate commerce. Beyond the fiscal burden on employees subject to personal in-

come tax impositions, employers face the compliance burden of dealing with complex, unclear and sometimes contradictory withholding requirements. Moreover, these issues will often be triggered by employee decisions to relocate that are beyond the employer's control (sometimes, without the employer's knowledge).

Indeed, Congress previously acted to relieve steamship companies of the obligation to withhold state taxes from the wages of certain seamen employed on vessels engaged in interstate commerce. 46 U.S.C.A. Section 691 (1959). This legislation only barred the employers' withholding obligation, while leaving intact the obligation of the individual seamen to pay state income taxes. *Alaska v. Petronia*, 69 Wn.2d 460, 418 P.2d 755 (Wash. 1966) (discussing history of the federal act), *app. dism'd*, 389 U.S. 7 (1967).

Congress has also passed laws outside the context of specific industries that are necessarily interstate (railroad, shipping, etc.). Public Law 104-95 restricts the power of the states to tax pension income for certain individuals moving from state to state. An even stronger argument can be made that the burdens placed on employers of those workers—namely, requirements that those employers undertake the tax collection responsibilities for the states—also lie ultimately within Congress' power to govern interstate commerce.

Employers can make a strong case that the dormant Commerce Clause should preclude excessive state level burdens on the flow of interstate commerce, including the flow of workers across state lines and the myriad tax collection responsibilities that follow for the employers of those workers. This area is, constitutionally, the sole province of Congress, and the need for uniformity arguably must prevent states from creating or from enforcing their unique and complex employment tax withholding requirements.

Uniformity in state and local employment tax withholding requirements is essential to the functioning of commerce. The broad variation among and complexity of state and local employment tax withholding requirements make exacting compliance virtually impossible.

In fact, many jurisdictions have never addressed the withholding required for certain specialized forms of compensation, such as stock options. As with other areas where complex and varying state laws are precluded by the need for national uniformity, employers may find protection against these compliance burdens in the Commerce Clause.

While each state may be quick to point blame at the other states that impose personal income withholding requirements—not to mention the large number of local jurisdictions that do so—the overall administrative burden on a national scale caused by the complexity of each jurisdiction's rules may be sufficient to invoke the protections of the dormant Commerce Clause. As in the context of inconsistent transportation regulations that stifle the travel of interstate commerce, the overwhelming complexity of employment tax withholding laws across the country indisputably could discourage businesses from sending workers into new jurisdictions and stymie the flow of interstate commerce.

In response to such an argument, states are likely to point out that Congress has affirmatively acted to preclude state employment withholding tax requirements for certain categories of employers that have inherently interstate businesses—including certain railroads, airlines and shipping vessels. The states would thus contend (under the principle of *inclusio unius est exclusio alterius*) that Congress' action to relieve the withholding tax responsibilities of some but not *all* employers with interstate employees indicates that this area is not one in which uniformity is needed. In response, an employer could note that Congressional silence is the foundation of the entire jurisprudence of the “dormant” Commerce Clause and thus can carry no weight here. See *Johnson v. Transportation Agency, Santa Clara County*, 480 U.S. 616, 672 (1987) (noting generally that it is impossible to assert with any degree of assurance the meaning of congressional failure to act).

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