July 23, 2018

## Review of Sales Tax Language in SDCL 10-64-9

BACKGROUND

In 2016, the Legislature passed HB 1182, which increased the state sales tax, state use tax, excise tax on farm machinery, and amusement device tax from 4.0% to 4.5%. Section 19 of that bill, now codified in SDCL 10-64-9, allows for an offset to the tax increase if the state is able to "enforce" another 2016 law (SB 106) which allows the state to require certain remote sellers to collect and remit sales tax. The offset provision in SDCL 10-64-9 reads as follows:

> If the state is able to enforce the obligation to collect and remit sales tax on remote sellers who deliver tangible personal property, products transferred electronically, or services directly to the citizens of South Dakota, the additional net revenue from such obligation shall be used to reduce the rate of certain taxes. The rate of tax imposed by §§ 10-45-2, 10-45-5, 10-45-5.3, 10-45-6, 10-45-6.1, 10-45-6.2, 10-45-8, 10-45-71, 10-46-2.1, 10-46-2.2, 10-46-58, 10-46-69, 10-46-69.1, 10-46-69.2, 10-46E-1, and 10-58-1 shall be reduced by one-tenth percent on July first following the calendar year for which each additional twenty million dollar increment of net revenue is collected and remitted by such remote sellers. However, the rate of tax imposed by §§ 10-45-2, 10-45-5, 10-45-5.3, 10-45-6, 10-45-6.1, 10-45-6.2, 10-45-8, 10-45-71, 10-46-2.1, 10-46-2.2, 10-46-58, 10-46-69, 10-46-69.1, 10-46-69.2, 10-46E-1, and 10-58-1 may not be reduced below four percent pursuant to the provisions of this section.

On June 21 the United States Supreme Court issued its decision in *South Dakota v. Wayfair*, overruling the "physical presence" standard and remanding the case back to our South Dakota courts for further action. The state received official notice of the case being remanded back to the South Dakota Supreme Court on July 23. Subject to the timeline of the continued litigation, it is likely that South Dakota will soon be able to "enforce" SB 106, which requires remote sellers to collect and remit sales tax. At present, the Governor's Office, Bureau of Finance and Management, and Department of Revenue are reviewing SDCL 10-64-9. The issues and corresponding decision points regarding the sales tax offset language are outlined below.

DECISION POINTS

### 1. When can the state "enforce" the requirement that remote sellers collect and remit sales tax?

The law at issue in *Wayfair*, SB 106, is not enforceable at this time. Although the United States Supreme Court's ruling was favorable to the state, the case was remanded back to the South Dakota court system for further legal proceedings. The case and the status of our law are not yet settled. Further, the trial court's March 2017 order granting summary judgment in favor of Wayfair put in place an injunction that remains in effect today. The injunction prohibits the state from enforcing SB 106. Once the injunction is lifted, the state can begin to enforce SB 106, which will trigger SDCL 10-64-9.

Given the favorable language in the United States Supreme Court's *Wayfair* opinion, many sellers may see the "writing on the wall" and begin to either voluntarily collect and remit sales tax or begin preparations to do so. These efforts, however, are voluntary and not based on South Dakota's ability to enforce its law.

### 2. How should the state calculate "additional net revenue"?

"Additional net revenue" will begin to accrue after the injunction is lifted, and SB 106 can be enforced. Pursuant to the law, the first possible date a reduction in the tax rate could take effect is July 1, 2019. Whether or not certain taxes are lowered on July 1, 2019, depends on how much "additional net revenue" is collected in calendar year 2018 after the injunction is lifted. Based on estimates, it is highly unlikely that $20 million in additional net

revenue will be collected in calendar year 2018. In that case, the first date a reduction in the tax rate could take effect is July 1, 2020, and the reduction would be based on the additional net revenue received in calendar year 2019.

There are two ideas as to how "additional net revenue" could be calculated:

(1) additional net revenue is only that revenue that is collected from new licensees that obtain a sales tax license and begin collecting and remitting sales tax after the state can enforce the law, or

(2) additional net revenue is calculated based on the amount of additional money the state collects after the state can enforce its law regardless of whether the licensee had been licensed before or after the state could enforce the law.

If the state proceeds under the first approach, collections from businesses that voluntarily collect and remit sales tax would not be included in the state's calculation of "additional net revenue." There would be two lists: (1) businesses that collected and remitted sales tax prior to enforcement of the law and (2) businesses that agreed to collect and remit sales tax only after the state began enforcing its law.

If the state proceeds under the second approach, growth in remittances from businesses that voluntarily collect and remit sales tax would be included in the calculation of "additional net revenue". Under this approach, the calculation of "additional net revenue" could include all funds from new licensees and any additional taxes received from those who had been voluntary licensees.

**3. If the state receives more than $20M of additional net revenue in a calendar year, do the additional funds carry-over to the next year's calculation?**

The law provides that sales tax "shall be reduced by one-tenth percent on July first following the calendar year for which each additional twenty million dollar increment of net revenue is collected and remitted by" remote sellers. It is not clear whether the $20M in additional net revenue calculation should be done by calendar year or on a rolling basis.

This is best explained through an example. If, in a given year, the state collects $30M in additional net revenue, $20M of that total would trigger a reduction in the tax rate of 0.1%. How the remaining $10M should be treated is unclear.

Under one interpretation, that $10M, being less than $20M, would not trigger a further tax rate reduction, but it would go into the base for sales tax collections upon which additional net revenue would be calculated for the following year.

Under the other interpretation, that $10M "rolls over" into the following year, meaning that only another $10M in additional net revenue would trigger an additional 0.1% tax rate reduction.

**4. Is the "shall be reduced" language self-executing?**

The law provides that the sales tax rate "shall be reduced" but it is unclear whether this provision is self-executing. Who reduces the tax rate? If the Department of Revenue determines that the law requires it to lower the tax rate, does the law require that the Department automatically adjust the tax rate, or must the Department of Revenue wait for the Legislature to take action and amend the tax rate in statute? An analogy could be drawn to the inflation factor in the school funding formula. Although it requires an inflationary increase, that increase is not automatic – the Legislature has to enact it each year.

ADDITIONAL CONSIDERATIONS

The law as adopted in 2016 is premised on the notion that $20M in revenue roughly equates to 0.1% in sales tax. Based on the FY2019 adopted sales tax base estimate (the base excludes audit collections, boat tax, off-road vehicle tax, mobile tax; these are small add-ons to the total sales tax estimate) a 0.1% tax rate reduction in the sales tax actually equals a loss in revenue of approximately $22.6M. This means that the "offset" is not dollar-for-dollar; a $20 million increase in sales tax collections would result in a loss of $22.6 million in revenue due to the tax rate decrease. Further, as the sales tax base grows with inflation and economic expansion, that net loss would increase each year.

There is a second consideration related to sales tax assessed on internet access. At present, South Dakota is one of seven states that assess a sales tax on internet access charges. States such as South Dakota that taxed internet access prior to October 1, 1998, could continue to implement those taxes pursuant to a grandfather clause included in the federal Internet Tax Freedom Act (1998). The federal Trade Facilitation and Trade Enforcement Act of 2015 temporarily extended that grandfather clause through June 30, 2020. Absent further intervention by Congress, which is unlikely, South Dakota will no longer be able to enforce its internet access tax, which will result in a loss of revenue to the state. Based on the FY2017 numbers, the loss of net revenue in FY2021 is estimated to be between $12M-$15M for the state and $7M-$10M for the municipalities/tribes.

RECOMMENDATION

Because SDCL 10-64-9 is subject to varying interpretations on multiple points, it is recommended that legislation be brought in 2019 to clarify how the state will proceed regarding the above issues. Any application of this statute in its current form is likely to lead to litigation, regardless of which interpretation is adopted.