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U.S. Supreme Court Overturns *Quill's* Physical Presence Standard

Overview

On June 21, 2018, the U.S. Supreme Court issued its opinion in *South Dakota v. Wayfair, Inc. et al.*,[1] a case challenging South Dakota's anti-*Quill* sales tax nexus law,[2] in which it overturned the decades-old physical presence nexus standard[3] required in order for a state or locality to impose a sales or use tax collection responsibility upon a remote seller.

In a 5-4 decision,[4] the Court overruled its earlier decisions in *Quill* and *National Bellas Hess,*[5] holding that the physical presence rule promulgated under these decisions was "unsound and incorrect."[6] The Court's basis for overturning this 50-year-old nexus standard was grounded in a number of significant bases, including:

- The application of a physical presence requirement is an "incorrect interpretation of the Commerce Clause"[7] particularly when measured in a vastly expanded e-commerce marketplace.
- South Dakota's law does not violate substantial nexus requirements because remote sellers have the potential to maintain a significant virtual presence in the state.
- The principle of *stare decisis* cannot stand when it prohibits states from exercising lawful powers.

This tax alert summarizes the Court's decision in *Wayfair,* addresses potential implications of the Court's overturning *Quill*'s physical presence requirement and offers considerations for taxpayers.

"Substantial Nexus" for Commerce Clause purposes does not require physical presence

States have the authority to regulate interstate commerce to the extent the state does not discriminate against or unduly burden interstate commerce.[8] In its 1967 decision in *National Bellas Hess,*[9] the Court held that the Due Process Clause and the Commerce Clause required physical presence for a state to require a vendor to collect sales or use tax. In its 1977 decision *Complete Auto Transit, Inc. v. Brady,*[10] the Court developed a test sustaining state tax laws under the Commerce Clause if the statute satisfies a four-prong test; the first of which is the tax "applies to an activity with a substantial nexus with the taxing State."[11] In its 1992 decision in *Quill*,[12] the Court overruled its prior determination that physical presence was an element of the Due Process Clause, but reaffirmed that physical presence is necessary to satisfy "substantial nexus" under the Commerce Clause.[13]

In the majority decision authored by Justice Kennedy, the Court criticized the *Quill* decision as flawed, finding that physical presence was not a necessary interpretation of the "substantial nexus" requirement, and that such the requirement deprives a factual analysis of the purposes and effects of the state's nexus law, which "creates rather than resolves market distortions."[14] Noting the hypothetical of a business with one salesperson in every state

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[1] *South Dakota v. Wayfair, Inc., et al.,* No. 17-494 (June 21, 2018) 585 U.S. ___. Opinion available here.
[2] For additional details on the South Dakota law and the U.S. Supreme Court's grant of certiorari in *South Dakota v. Wayfair, Inc.* et al., please see our previously issued MTS tax alert available here.
[3] *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).
[4] Justices Kennedy with Ginsburg, Alito, Gorsuch, with Justices Gorsuch and Thomas concurring, and Chief Justice Roberts with Justices Breyer, Sotomayor, and Kagan dissenting.
[5] *Quill Corp.*, 504 U.S. 298 (1992); 386 U. S. 753; *National Bellas Hess v. Dept. of revenue,* 386 U.S. 753 (1967).
[6] *South Dakota v. Wayfair, Inc., et al.*, 585 U.S. ___, 22 (2018).
[7] *Id.* at 10.
[8] *Id.* at 5-7.
[9] *National Bellas Hess,* 386 U.S. 753 (1967).
[10] *Complete Auto Transit, Inc. v. Brady,* 430 U.S. 274 (1977).
[11] *Complete Auto Transit, Inc.*, 430 U. S. at 279.
[12] *Quill Corp.*, 504 U.S. at 298 (1992).
[13] *Quill* at 311.
[14] *South Dakota v. Wayfair, Inc., et al.*, 585 U.S. ___, at 10-14.

(required to collect sales tax) relative to a company with 500 salespersons in one central location and a website accessible in every state (not required to collect sales tax in every state), Kennedy commented that *Quill* has the potential to "equally or more burden"[15] a small company with diverse physical presence relative to a large remote seller. In the opinion of the Court, "[t]he physical presence rule is a poor proxy for the compliance costs faced by companies that do business in multiple States."[16]

The Court also disputed as "unsound" the contention that the physical presence rule is "clear and easy to apply"[17] stating that it is "proving unworkable" to apply to online retail sales"[18] as states have recently enacted cookie nexus, click through and notice and use tax reporting requirements on out of state retailers.[19] The court noted "statutes of this sort are likely to embroil the courts in technical and arbitrary disputes about what counts as physical presence."[20]

"Substantial Nexus" for Commerce Clause purposes may be satisfied by a remote seller's virtual connections

While *Quill's* physical presence standard "may have seemed like a 'clear,' 'bright-line tes[t]'…[it] now threatens to compound the arbitrary consequences that should have been apparent from the outset."[21] The Court surmised that it "should not maintain a rule that ignores these substantial virtual connections to the State."[22] The Court observed that an online showroom "can show far more inventory, in far more detail, and with greater opportunities for consumer and seller interaction than might be possible for local stores."[23]

The Court also noted that "[a] physical presence requirement for nexus puts retailers with physical presence in the state at a disadvantage to solely online or remote retailers.[24] *Quill* essentially treats "economically identical actors differently, and for arbitrary reasons."[25] The "physical presence rule . . . has limited States' ability to seek long-term prosperity and has prevented market participants from competing on an even playing field."[26]

***Stare decisis* does not support upholding an "error" in constitutional interpretation**

Stating that the judicial doctrine of *stare decisis* "is not an inexorable command,"[27] the Court held that *stare decisis* can no longer support the "Court's prohibition of a valid exercise of the States' sovereign power."[28] The Court "conceded" that while Congress has the authority to change the physical presence rule, Congress cannot change the "constitutional default rule."[29] Noting that the "Internet's prevalence and power have changed the dynamics of the national economy"[30] as well as the massive revenue lost by states, the Court stated "the physical presence rule as defined by *Quill* must give way."[31]

Other features of South Dakota's law potentially avoid discrimination and undue burden on interstate commerce

Turning from the nexus issue to the other elements of the Commerce Clause test of the constitutionality of a state tax, the Court noted that the South Dakota law has "several features that appear designed to prevent discrimination against or undue burdens to interstate commerce."[32] First, the South Dakota law applies a safe harbor to those who transact "only limited business in South Dakota"[33] (i.e., $100k or less in sales, or less than 200 in-state transactions). Second, the existence of an injunction staying any enforcement of the South Dakota

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[15] *Id.* at 12.
[16] *Id.*
[17] *Id.* at 19.
[18] *Id.*
[19] *Id.* at 19-20.
[20] *Id*. at 20.
[21] *Id.* at 15, citing *Quill Corp. v. North Dakota*, 504 U.S. 298, 315 (1992).
[22] *Id.*
[23] *Id.*
[24] *Id.* at 12-13.
[25] *Id.* at 13-14.
[26] *Id.* at 17.
[27] *Id.*, citing *Pearson v. Callahan*, 555 U. S. 223, 233 (2009) (quoting *State Oil Co. v. Khan*, 522 U. S. 3, 20 (1997),
[28] *Id.*
[29] *Id.* at 17-18.
[30] *Id.* at 18.
[31] *Id.*
[32] *Id.* at 23.
[33] *Id.*

law during the litigation "ensures that no obligation to remit the sales tax may be applied retroactively."[34] Third, South Dakota is one of "more than 20 states"[35] that have adopted the Streamlined Sales and Use Tax Agreement requiring certain standardization within the sales and use tax statutes "to reduce administrative and compliance costs" for remote sellers.[36]

Dissent would have left it to Congress to overrule Quill

In the dissent, Chief Justice Roberts asserted that the Court should have "let Congress decide whether to depart from the physical-presence rule."[37] The dissent suggested that *stare decisis* has "special force" in dormant Commerce Clause questions considering Congress has final say over regulation of interstate commerce.[38] Justice Roberts also opined that the Court's acting with "inexplicable sense of urgency"[39] caused the Court to "breezily disregard the costs that its decision will impose on retailers."[40] Thus, the Court did not adequately consider the burden the cost of compliance may have on all retailers and especially, the burden that may be more heavily borne by small businesses.[41] Congress, he noted "may more directly consider the competing interests" and could draft legislation to "provide a nuanced answer to the troubling question whether any change will have retroactive effect."[42]

Sales-based economic nexus statutes in other states

The U.S. Supreme Court decision in *Wayfair* appears to validate South Dakota's law (pending remand to the South Dakota Supreme Court) and may potentially validate other state's sales-based economic sales and use tax nexus laws or administrative rules that fit within the South Dakota framework - i.e., provide a safe harbor for small sellers, prevent retroactive collection and remittance responsibility, and are adopted in a state that is a member of the Streamline Sales and Use Tax Agreement. While many of these states have enjoined enforcement (or delayed the effective date) pending the outcome of *Wayfair*, these statutes are now arguably effective and enforceable or will be shortly after any applicable injunctions are lifted. In addition, states with broadly worded general nexus statutes (e.g., "to the extent permissible under the U.S. Constitution") may issue regulatory guidance to assert similar sales-based nexus provisions consistent with the South Dakota framework.

For states with sales-based economic sales and use tax nexus laws or administrative rules that fall outside of the South Dakota framework, the Court left open the possibility of future constitutional challenges based on the concerns articulated by the Court and discussed above.

At this time, it is unclear how states may respond to *Wayfair* though a number of states have already issued statements, generally to the effect that they are aware of the decision and are studying the implications for taxpayers.[43]

Potential for Congressional response

While previous Congressional proposals to address sales and use tax nexus have stalled,[44] Congress may now be spurred to act given that the Court has overturned *Quill*. For example, Congress could act to reverse the *Wayfair* decision and affirmatively require physical presence as the appropriate nexus standard for sales and use tax purposes. Conversely, Congress could take a more limited approach and require adoption of the Streamlined Sales and Use Tax Agreement, or similar simplification requirements, for states wishing to impose tax on remote sellers through enactment of sales-based nexus standards.

Considerations

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[34] *Id.*
[35] *Id.*
[36] *Id.* The Court's opinion may not foreclose a challenge from small businesses that South Dakota's Act, or another state's economic nexus law, discriminates against or is unduly burdensome to interstate commerce in the absence of *Quill* and *National Bellas Hess* based on facts and circumstances.
[37] *South Dakota v. Wayfair, Inc., et al.*, 585 U.S. ___, at dissent p. 8.
[38] *Id.* at dissent, p. 2, quoting *Quill Corp.*, 504 U. S., at 305.
[39] *Id.* at dissent, p. 4
[40] *Id.* at dissent, p. 5
[41] *Id.* at dissent, p. 5-6.
[42] *Id.* at dissent, p. 7.
[43] For example, the Washington Department of Revenue website has been updated with the following statement: "We are examining the decision and its implications for businesses and taxpayers, and we are working with other states to make the transition as smooth as possible for businesses."
[44] Marketplace Fairness Act of 2013, 113 S. 336 passed the Senate; Marketplace Fairness Act of 2015, S. 698, introduced by Senator Mike Enzi R-Wyo. on March 25, 2015, but stalled after introduction.

Now that the U.S. Supreme Court has overturned the physical presence standard required for a state to impose a sales or use tax collection obligation, taxpayers should consider the following as part of their compliance readiness analysis:

- Is a state's previously-enacted sales-based nexus provision now effective? If so, is it retroactive?
- Do the taxpayer's business activities or virtual connections in the state amount to "substantial nexus"?
- Does the state's regime impose any unreasonable burdens to collection?
- Will states provide guidance on effective date, registration and compliance assistance and enforcement?
- Whether IT systems are in place to begin collecting sales tax in states with economic nexus sales and use tax statutes.
- Whether existing IT systems are compatible with existing service providers or will new IT system implementations be required.
- Application of the Streamlined Sales and Use Tax Agreement tools and systems.
- Whether current financial statement positions need to be reconsidered
- In states with use tax notification requirements based upon a lower sales threshold amount, whether compliance with notification requirements, voluntarily registration, or another approach is appropriate considering current resources.
- How sales of products or services would be characterized in relevant states.
- Whether the required customer data is available to determine how to source sales if a sales and use tax obligation is imposed.
- Whether the increased compliance burden makes outsourcing sales and use tax compliance functions to a third-party a cost-effective alternative.

At this time, state approaches to enforcement remain uncertain, but delays in planning to meet these obligations may result in additional compliance costs and interruption to business operations. Companies are encouraged to consult with their indirect tax advisors to review the technical and logistical considerations that should be addressed now that *Wayfair* has been decided.

This important decision will be the subject of close scrutiny by affected remote sellers as well as states which may seek to adopt sales and use tax nexus provisions similar to those now upheld as constitutional in South Dakota. In this regard, please consider attending our Special Edition Dbriefs Webcast - *SCOTUS on Wayfair case: The path forward for sales-and-use tax reporting* – which will be held on June 29 at noon, EST. Invitation details are available here.

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