Supreme Court Abandons Physical Presence Standard: An In-Depth Look at South Dakota v. Wayfair

By Sarah Horn (J.D., Editor, Checkpoint Catalyst), Jill McNally (J.D., Editor, Checkpoint), Rebecca Newton-Clarke (J.D., Senior Editor, Checkpoint Catalyst), and Melissa Oaks (J.D., LL.M., Managing Editor, Checkpoint Catalyst)

On June 21, 2018, the U.S. Supreme Court issued a decision in *South Dakota v. Wayfair*, **1** overturning the physical presence standard espoused in *Quill v. North Dakota* **2** and *National Bellas Hess v. Department of Revenue of Ill*. **3** In a strongly worded opinion, the Court held that the physical presence rule in *Quill* is an "unsound and incorrect" interpretation of the Commerce Clause that has created unfair and unjust marketplace distortions favoring remote sellers and causing states to lose out on enormous amounts of tax revenue. The Court ruled that the correct standard in determining the constitutionality of a state tax law is whether the tax applies to an activity that has "substantial nexus" with the taxing state. The case involves South Dakota's economic nexus law, which imposes tax collection and remittance duties on out-of-state sellers meeting gross sales and transaction volume thresholds. In overturning its prior precedents the Court determined that physical presence is not required to meet the "substantial nexus" requirement laid out in *Complete Auto Transit.* The Court held that the respondents had established substantial nexus in this case through "extensive virtual presence." **4** (***Click here to read the ruling in South Dakota v. Wayfair, Inc., U.S. S.Ct., Dkt. No. 17-494, 06/21/2018.)***

Since the U.S. Supreme Court's 1992 decision in *Quill v. North Dakota*, the standard for whether a state can require an out-of-state retailer to collect and remit sales tax has been physical presence. In *Quill*, the Court affirmed and elaborated upon its prior decision in *Bellas Hess*. **5** A seller had to have property, people, or some other physical connection with a state to be required to collect and remit sales tax. As a complement to the sales tax, states impose use taxes that require the in-state purchaser to pay tax on taxable items on which no sales tax was paid. Very few consumers comply with use tax requirements. With the rise of the digital economy, states began to lose out on significant sales tax revenues because

they were unable to tax online/internet sales under physical presence nexus standards.

Following *Quill*, states have engaged in various nexus expansion gambits. Over the past decade, assertions of click-through nexus (pioneered by New York) and affiliate nexus have become commonplace. When the U.S. Supreme Court denied certiorari in the appeal of the New York high court's *Overstock* **6** ruling upholding click-through nexus, the states became emboldened. They grew bolder still following dicta by Justice Kennedy in *Direct Marketing v. Brohl* **7** suggesting that "There is a powerful case to be made that a retailer doing extensive business within a State has a sufficiently 'substantial nexus' to justify imposing some minor tax-collection duty, even if that business is done through mail or the Internet." He urged the Court to revisit the physical presence standard, contending that "[T]he Internet has caused far-reaching systematic and structural changes in the economy, and.... it is unwise to delay any longer a reconsideration of the Court's holding in *Quill*." At the time, Justice Gorsuch sat on the 10th Circuit, which ultimately decided that case and upheld Colorado's remote seller notice and reporting requirements irrespective of physical presence. **8** He characterized the physical presence rule as an "analytical oddity" that "seems deliberately designed" to be overturned.

The *Wayfair* case examines the constitutionality of a 2016 South Dakota economic nexus law that imposes sales tax collection and remittance requirements on out-of-state sellers delivering more than $100,000 of goods or services into South Dakota or engaging in 200 or more separate transactions for the delivery of goods or services into South Dakota. The law was enacted by the South Dakota legislature as part of an emergency declaration to prevent erosion of the state's sales tax base. It followed the release of a suggested model economic nexus law from the National Conference of State Legislatures, though it did not conform to the model law entirely. South Dakota does not impose an income tax and therefore relies on sales and use tax revenue to fund essential state services. South Dakota enforced the act by filing a declaratory judgment action against three major online retailers with no physical presence in the state: Wayfair, Newegg, and Overstock. Following state court decisions in favor of the retailers, South Dakota appealed to the U.S. Supreme Court.

Noting that the issue of sales and use tax nexus turns on the interpretation of the Commerce Clause, the Court began its analysis with a lengthy review of its Commerce Clause jurisprudence, going back as far as the early nineteenth century. The Commerce Clause grants Congress the authority to regulate interstate commerce. A negative corollary, often called the Dormant or Negative Commerce Clause, prohibits the states from passing laws that either facially discriminate against or place undue burdens on interstate commerce. In the context of state taxation, the Court endorsed the four-prong test in ***Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977)**, which builds upon Commerce Clause principles, as the correct analytical framework. *Complete Auto* provides that a state tax will be upheld if it "(1) applies to an activity with substantial nexus with the taxing state, (2) is fairly apportioned, (3) does not discriminate against interstate commerce, and (4) is fairly related to the services the state provides."

The question, then, is whether an activity must meet *Quill's* physical presence standard to have substantial nexus with a taxing state. The Court ruled that it does not. Substantial nexus exists when a taxpayer "avails itself of the substantial privilege of carrying on a business in that jurisdiction." It can be

established on the basis of both "economic and virtual contacts" with a state. In the case of South Dakota's economic nexus law, the law's sales volume and dollar amount thresholds were high enough for the Court to find that a seller meeting those thresholds would have clearly availed itself of the privilege of doing business in South Dakota. Further, the Court noted that the specific respondents (Wayfair, Newegg, and Overstock) are large companies that "undoubtedly maintain an extensive virtual presence." The Court also observed that targeted advertising and electronic sales may allow a business to have substantial virtual connections to a state without traditional physical presence. Interestingly, the Court noted that other functions of e-commerce, such as websites leaving cookies on customer hard drives and apps that can be downloaded on customer phones, may be considered to create almost a physical presence in a taxing state. The court noted the Ohio law and Massachusetts regulation that assert cookie nexus; Iowa recently enacted a law asserting cookie nexus as well. These are discussed in a bit more detail below.

The Court not only overruled the physical presence standards of both *Quill* and *Bellas Hess*, but eviscerated the rule that physical presence is required for sales tax nexus. Writing for the majority, Justice Kennedy's biting commentary on *Quill* likened the physical presence requirement to a "judicially created tax shelter" that has created marketplace distortions and unfair and unjust incentives to avoid physical presence in various states. Local businesses are put at a significant disadvantage compared to remote vendors. Justice Kennedy noted that the physical presence rule is "artificial in its entirety" and goes against modern Commerce Clause jurisprudence's emphasis on marketplace dynamics, not "anachronistic formalisms." Specifically discussing Wayfair, Justice Kennedy described the company's business model of advertising that it did not have to charge sales tax as a "subtle offer to assist in tax evasion." Justice Kennedy further mused that Wayfair's image of selling items for beautifully decorated dream homes would not be possible without solvent local and state governments.

According to Justice Kennedy, although the law passes the Complete Auto Transit test, 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. That said, South Dakota's tax system includes several features that appear designed to prevent discrimination against or undue burdens upon interstate commerce."

Practical Effects

The *Quill* standard has never been easy to implement. In the years since the Court's 1992 decision, companies have structured companies in creative ways and taken other steps to try to avoid setting a toe into more than one or two jurisdictions.

While *Wayfair* clearly overturns the physical presence requirement, it does not provide states carte blanche to enact or enforce all forms of economic nexus laws. South Dakota's law has several features that prevented it from running afoul of Commerce Clause protections: (1) the law has a safe harbor

provision for transacting limited business in the state that does not meet the specific thresholds, (2) the law is not retroactive, and (3) South Dakota is a member of the Streamlined Sales and Use Tax Agreement, which reduces administrative and compliance costs for taxpayers and even provides state-funded sales tax administration software. Other states with economic nexus provisions will need to apply the same test in determining whether those provisions pass constitutional muster.

In recent years, a growing number of states have followed South Dakota and enacted economic nexus laws that intentionally flout the physical presence requirement by asserting nexus based on the number and/or dollar amount of sales into the state. Connecticut, the most recent state to enact an economic nexus law, targets out-of-state sellers making $250,000 in gross receipts and engaging in 200 or more retail sales into Connecticut during a 12-month period. The new nexus standard, which goes into effect on December 1, 2018, also redefines retailers to include marketplace facilitators. Some states, such as Iowa, Ohio, and (through regulations adopted by its taxing agency) Massachusetts, assert the kind of cookie or app nexus discussed by the Court in *Wayfair*. Each of these states will need to apply the *Wayfair* test in determining whether its standard is constitutional.

A number of states have also enacted detailed notice and reporting laws for out-of-state sellers. Often these are tied to a dollar threshold of taxable sales into the state. Many are cumbersome and impose stiff penalties for noncompliance. Colorado pioneered this approach, and its law was upheld in *Direct Marketing Ass'n v. Brohl*. **9** A handful of states (Georgia, Oklahoma, Pennsylvania, Rhode Island, and Washington) have notice and reporting requirements that are explicitly the default alternative to registering to collect and remit the tax under elective economic nexus provisions.

With the vast majority of states urging the Court to overturn the physical presence rule, the states' appetite for asserting nexus against out-of-state retailers is not in question. It is important to bear in mind that many states have laws on the books that by their plain language exceed the physical presence standard and assert nexus based on remote solicitation and resulting in-state sales. Traditionally, taxing agencies in those states tended to accept the physical presence standard and have adopted regulations or issued guidance to that effect, but with the physical presence rule eradicated, those are likely to be repealed or rescinded in short order. A number of states have laws asserting nexus to the greatest extent permitted by the U.S. Constitution and federal law.

For example, Florida law broadly defines dealers having nexus with the state to include, among other things, every person who "solicits business either by direct representatives, indirect representatives, or manufacturer's agents; by distribution of catalogs or other advertising matter; or by any other means whatsoever," and because of these solicitations receives orders for tangible personal property from consumers for use, consumption, distribution, and storage for use or consumption in the state. **10** A ruling of Florida's high court limited the law, establishing that the substantial nexus requirements of the Commerce Clause require a dealer to have some type of physical presence in Florida, and more than insubstantial solicitation activities in the state, for the state to assert nexus against the dealer. **11**

New York's nexus law defines an out-of-state vendor having nexus with the state to include a person

who solicits business "by distribution of catalogs or other advertising matter, without regard to whether such distribution is the result of regular or systematic solicitation," if the person has some additional connection with the state that satisfies the nexus requirements of the U.S. Constitution and if because of the solicitation the person makes taxable sales into New York. **12**

Businesses can expect to see rapid expansion of nexus assertions in light of the *Wayfair* standard. As discussed above, however, the *Wayfair* decision still places constraints on nexus. Although states like New York and Florida have laws the plain language of which might allow them to make broad assertions of nexus, those states are not members of the Streamlined Sales and Use Tax Agreement. Barring legislative action, taxing agencies in states like these will undoubtedly face challenges if they expand their assertions of nexus to include contacts that do not meet the physical presence rule. Out-of-state retailers lacking physical contacts could successfully argue, under the new *Wayfair* standard, that the burden of compliance is too high in states that do not conform to the SSUTA. Whether those challenges would succeed is uncertain but far from unlikely.

Given the Court's conclusion that "physical presence is not necessary to create substantial nexus," this decision will impact other state taxes, such as corporate income taxes, which could apply to the income of an entity conducting significant business activities in a state without having a physical presence there. Economic nexus laws in the sales and use tax environment are an import from the corporate income tax realm. Most state and federal courts have taken the position that the physical presence standard does not apply in the corporate income tax environment, and many states have been emboldened to enact "factor presence" laws tied to sales, property or payroll in the state. The U.S. Supreme Court has consistently declined to hear challenges to those laws, and with the test announced in Wayfair more states may follow suit. Changes are likely to be especially pronounced in the handful of states that have taken the position that physical presence is necessary for the state to assert corporate income tax nexus against a corporation.

Dissent

In overturning *National Bellas Hess* and *Quill*, the Court has effectively overturned half a century of precedent. Dissenting Chief Justice Roberts, joined by Justices Breyer, Sotomayor, and Kagan, took particular note of this fact, observing that departing from the doctrine of stare decisis is "an 'exceptional action'" requiring a "'special justification,'" even moreso when the Court is ruling in matters where Congress has "'primary authority.'" The dissenting Justices pointed out this is the third time the Court has addressed the physical presence standard and state that "[w]hatever salience the adage 'third time's a charm' has in daily life, it a poor guide to Supreme Court decisionmaking."

Although critical of the Majority's overruling of those cases, Justice Roberts acknowledged that "*Bellas Hess* was wrongly decided." The dissent expressed concern, however, that discarding the physical-presence rule at a time when e-commerce is flourishing could be disruptive, and contend that any change to the established rules should come from Congress as was stated in *Quill*.

In response to the majority's "inexplicable sense of urgency" in overturning established jurisprudence, Chief Justice Roberts also pointed out that many of the "behemoth" online retailers, such as Amazon, have already begun collecting and remitting the tax (regardless of whether they have a physical presence in a state) and that the revenue loss to states is "receding with time." (p.5) As was the case in *Quill*, the dissent is concerned with the effect of the ruling on small businesses who will feel the full weight of the Court's decision.

1 *South Dakota v. Wayfair, Inc.,* U.S. S.Ct., Dkt. No. 17-494, 06/21/2018.

2 Quill Corp. v. North Dakota By and Through Heitkamp, (1992, U.S.) 504 U.S. 298 , **112 S. Ct. 1904** , **119 L. Ed. 2d 91** .

3 National Bellas Hess, Inc. v. Department of Revenue of State of Ill., (1967, U.S.) 386 U.S. 753 , **87 S. Ct. 1389** , **18 L. Ed. 2d 505** .

4 Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977) .

5 Quill Corp. v. North Dakota By and Through Heitkamp, (1992, U.S.) 504 U.S. 298 , **112 S. Ct. 1904** , **119 L. Ed. 2d 91** .

6 Overstock.com, Inc. v. New York State Dept. of Taxation and Finance, (2013, N.Y.) 20 N.Y.3d 586, 965 N.Y.S.2d 61, 987 N.E.2d 621, 2013 N.Y. Slip Op. 02102

7 Direct Marketing Ass'n v. Brohl, **(2015, U.S.) 135 S. Ct. 1124** .

8 Direct Marketing Ass'n v. Brohl, **(2015, U.S.) 135 S. Ct. 1124** .

9 Direct Marketing Ass'n v. Brohl, **(2015, U.S.) 135 S. Ct. 1124** .

10 Fla. Stat. § 212.06(2) .

11 Department of Revenue v. Share Intern., Inc. (FN: 676 So.2d 1362 (Fla. 1996) .

12 N.Y. Tax Law § 1101(b)(8)(i)(E) .

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