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SALT Alert!

SALT Alert! 2018-10: U.S. Supreme Court Overturns *Quill*

The U.S. Supreme Court today decided in favor of the State in *South Dakota v. Wayfair, Inc.,* overruling the long-standing rule that an out-of-state seller must have a physical presence in a state before the state can require the seller to collect sales and use taxes. In the 5-4 decision authored by Justice Kennedy, the Court concluded that the physical presence sales and use tax nexus rule was "unsound and incorrect." As such, the Court's decisions in *Quill Corp. v. North Dakota*, 504 U. S. 298 (1992), and *National Bellas Hess, Inc. v. Department of Revenue of Ill.*, 386 U. S. 753 (1967), "should be, and now are, overruled." The Court then vacated the South Dakota Supreme Court decision that held in favor of the taxpayers and remanded the case to the state court for "further proceedings not inconsistent with this opinion."

Background

In 2016, South Dakota became the first state to enact a pure economic nexus statute for sales and use tax collection purposes. Specifically, effective May 1, 2016, all entities with annual sales in South Dakota exceeding $100,000 or with more than 200 separate transactions in the state were required to collect and remit South Dakota sales and use tax. The economic nexus law was quickly challenged and the South Dakota Supreme Court held that the state was bound to follow established U.S. Supreme Court precedent. The state court determined that a law imposing economic nexus standards on remote retailers was not valid in light of the *Quill* physical presence standard. South Dakota subsequently filed a petition for certiorari, which was granted, and oral argument was held on April 17, 2018.

The *Wayfair* Decision

The Court's opinion can be characterized as a complete repudiation of the physical presence rule. After walking through the history that lead to the 1992 *Quill* decision, the opinion noted that "the physical presence rule has 'been the target of criticism over many years from many quarters.'" Further, the Court explained that "[e]ach year, the physical presence rule becomes further removed from economic reality and results in significant revenue losses to the States."

The majority was not done. "*Quill* is flawed on its own terms." In the Court's view, the physical presence rule "is not a necessary interpretation of the requirement that a state tax must be 'applied to an activity with a substantial nexus with the taxing State.'" Second, "*Quill* creates rather than resolves market distortions." And finally, "*Quill* imposes the sort of

arbitrary, formalistic distinction that the Court's modern Commerce Clause precedents disavow."

The Court reasoned that the administrative costs of compliance are largely unrelated to whether a seller happens to have a physical presence in the state. Acknowledging that multistate business may be faced with significant compliance costs, the Court suggested that other aspects of constitutional analysis, presumably the undue burdens doctrine, can "better and more accurately address any potential burdens on interstate commerce."

The Court also explained that a primary purpose of the Commerce Clause was to prevent states from engaging in economic discrimination. Nevertheless, the Court concluded that the physical presence rule puts businesses with a physical presence in a state at a competitive disadvantage to remote sellers. In the Court's view, the purpose of the Commerce Clause is not to relieve those engaged in multistate businesses from their "just share" of state tax burdens. And, the Court said, "it is certainly not the purpose of the Commerce Clause to permit the judiciary to create market distortions."

The Court noted that the physical presence rule has served as a "judicially created tax shelter" for remote businesses that exploit a state's market by selling goods to in-state customers. The physical presence rule helps purchasers "evade a lawful tax" and unfairly shifts the tax burden to those customers who buy from competitors with a physical presence in the state. "Rejecting the physical presence rule is necessary to ensure that artificial competitive advantages are not created by this Court's precedents."

> *In the name of federalism and free markets,* Quill *does harm to both. The physical presence rule it defines has limited States' ability to seek long-term prosperity and has prevented market participants from competing on an even playing field.*

The Court rejected the taxpayers' plea for stare decisis, concluding that any reliance on the physical presence standard was "misplaced." Click-through nexus statutes and notice and reporting requirements have eroded the degree on which sellers can rely on the physical presence standard. Further, the Court concluded, "[s]tatutes of this sort are likely to embroil courts in technical and arbitrary disputes about what counts as physical presence."

After overturning the *Quill* physical presence rule and declaring it "unsound and incorrect," the Court looked at whether South Dakota's law comports with the "substantial nexus" prong of the *Complete Auto* test for determining whether a state tax is constitutional. Observing that the law applies only to retailers that sell more than $100,000 of goods or services into South Dakota or engage in 200 or more separate transactions for the delivery of goods and services into the state, the Court found that that nexus "is clearly sufficient based on both the economic and virtual contacts" the sellers had with South Dakota. In the Court's view, this "quantity of business" could not have occurred unless a seller "availed itself of the substantial privilege of carrying on business in South Dakota." Because the taxpayers at issue are national companies that "undoubtedly maintain an extensive virtual presence," the Court concluded that the substantial nexus requirement of *Complete Auto* was satisfied.

Although the Court recognized that the following issues were not before it, the Court observed that "South Dakota's tax system includes several features that appear designed to prevent discrimination against or undue burdens upon interstate commerce." First, the South Dakota law "applies a safe harbor to those who transact only limited business in South Dakota." Second, the law "ensures that no obligation to remit the sales tax may be applied retroactively." Third, "South Dakota is one of more than 20 States that have adopted the Streamlined Sales and Use Tax Agreement," which "standardizes taxes to reduce administrative and compliance costs." The Agreement requires "a single, state level tax administration, uniform definitions of products and services, simplified tax rate

structures, and other uniform rules." It also provides sellers "access to sales tax administration software paid for by the State." Sellers who choose to use such software are immune from audit liability. The Court acknowledged that these issues were not briefed or litigated, but suggested that any remaining claims should be addressed on remand by the Supreme Court of South Dakota.

Concurring and dissenting opinions

In a short concurring opinion, Justice Thomas acknowledged that he should have joined Justice White's dissenting opinion in *Quill*. "[I]t is never too late to 'surrende[r] former views to a better considered position," he wrote, quoting *McGrath v. Kristensen,* 340 U.S. 162, 78 (1950) (Jackson, J., concurring).

Justice Gorsuch wrote a concurring opinion to express his concerns about past dormant Commerce Clause jurisprudence, but acknowledged those concerns "are questions for another day."

Chief Justice Roberts wrote a persuasive dissent, in which Justices Breyer, Sotomayor, and Kagan joined. Although the dissent agreed that the original case of *Bellas Hess* was "wrongly decided," the dissent cautioned that the change could have a significant effect on the national economy. And, therefore "[a]ny alteration to those rules with the potential to disrupt the development of such a critical segment of the economy should be undertaken by Congress." The dissent noted that the bar for overturning precedent is higher when Congress has primary authority for an issue "and can, if it wishes, override this Court's decisions with contrary legislation." The burden borne by the party advocating the abandonment of established precedent is greater than usual, "even where the error is a matter of serious concern, provided correction can be made by legislation." Further, the dissent expressed concern that the Court's opinion "may have waylaid Congress' consideration of the issue."

Noting that a GAO report had determined that state and local governments already collect approximately 80 percent of the tax revenue they would collect if the physical presence rule was not in place, and the fact that sales tax compliance software "is still in its infancy," the dissent cautioned that the decision "will surely have the effect of dampening opportunities for commerce in a broad range of new markets."

Next steps

Because the decision has been remanded, the timing on the resolution in South Dakota is somewhat uncertain. However, what is very clear is that physical presence is no longer the prevailing standard that states are bound by and that taxpayers can rely on.

Over a dozen states have laws identical or substantially similar to South Dakota's. In certain of these states, the state taxing authorities were enjoined from enforcing the law pending the Wayfair *decision. Taxpayers should expect those states to begin enforcing these laws in the near future. In addition, other states are likely to act quickly to enact their own economic nexus standards and thresholds, or interpret existing laws to capture sellers without a physical presence in the state.*

Sellers wishing to challenge these laws will likely need to establish that the state's law violates some other principle in the Court's Commerce Clause jurisprudence and lacks "features ... designed to prevent discrimination against or undue burdens upon interstate commerce." For example, sellers may argue that an undue burden is imposed by a state with a decentralized system that requires returns to be filed in numerous local jurisdictions.