IN SOUTH DAKOTA V. WAYFAIR, THE U.S. SUPREME COURT RULES THE PHYSICAL PRESENCE RULE IS “INCORRECT”, OVERTURNS QUILL

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Summary

On June 21, 2018, the Supreme Court of the United States issued its widely anticipated decision in *South Dakota v. Wayfair, et al*. No. 17-494. In a 5-4 decision, the Court held that the physical presence rule for state tax jurisdiction is incorrect and not a requirement under the Commerce Clause of the U.S. Constitution. As a follow-up to our Alert announcing the decision, we now provide an in-depth analysis of the Court’s *Wayfair* opinion and some thoughts as to the impact of what is likely the most significant state tax decision from the Court in at least 50 years.

Details

Background

In *Quill Corp. v. North Dakota (1992)*, the Court affirmed its 1967 decision in *National Bellas Hess, Inc. v. Dept. of Revenue of Illinois,* and decided that the substantial nexus requirement of the Commerce Clause of the U.S. Constitution (U.S. Const., Art. I, Section 8, cl. 3) requires a taxpayer (or tax collector) to have a physical presence in a state before the state can impose a state tax (or tax collection obligation). Because the Due Process Clause of the Fourteenth Amendment to the U.S. Constitution also limits state taxing authority, it was also implicated in *Quill*. Although the Court in *National Bellas Hess* held that the physical presence rule also applied to Due Process Clause “minimum contacts” nexus, the *Quill* Court overruled *National Bellas Hess* in that regard. Thus, starting in 1992, while the Court ruled a physical presence was required for substantial nexus under the Commerce Clause (at least for sales and use taxes), it was not required under the Due Process Clause. Instead, after *Quill,* due process minimum contacts nexus only required a taxpayer to have purposefully directed economic activity at a state’s market. As a result, while the Commerce Clause and Due Process Clause nexus requirements were joined in 1967, they were separated in 1992, but now they have apparently been re-joined in 2018.

In a direct challenge to the physical presence rule, South Dakota, like a number of other states, enacted an economic presence nexus statute for sales and use tax collection in 2016. Under that statute, a remote seller is required to collect and remit sales tax if: (1) the seller’s South Dakota sales exceed $100,000; or (2) the seller has more than 200 separate sales transactions into South Dakota. Wayfair, Inc., and two other internet retailers, Overstock.com, Inc. and Newegg, Inc. have no physical presence in South Dakota and challenged the statute in state court. Because the lower state courts could not overturn U.S. Supreme Court precedent, *Quill* and *National Bellas Hess,* they held for Wayfair et al. South Dakota petitioned the Court for a writ of certiorari, which was granted on January 12, 2018.

Justice Kennedy authored the opinion for the five Justice majority (joined by Justices Thomas, Ginsburg, Alito, and Gorsuch). In summary, the Majority ruled that the “physical presence rule, both as first formulated and as applied today, is an incorrect interpretation of the Commerce Clause.” Further, the Majority ruled that South Dakota’s $100,000 of sales or 200 separate sales transactions statutory standard to impose the tax collection obligation satisfied the Court’s substantial nexus requirement with regard to the Commerce Clause. However, the case was remanded to the South Dakota Supreme Court for further proceedings to determine if any other features of the South Dakota law discriminated against or unduly burdened interstate commerce.

Justice Thomas and Justice Gorsuch each authored their own concurring opinions.

Chief Justice Roberts authored the four Justice dissenting opinion (joined by Justices Breyer, Sotomayor, and Kagan).

The Majority Opinion

The *Wayfair* decision involved the substantial nexus requirement of the "now-accepted framework for state taxation" set forth in 1977 in *Complete Auto Transit, Inc. v. Brady.* In *Complete Auto,* the Court ruled that a state tax must satisfy a four-prong test to withstand scrutiny under the Commerce Clause. To satisfy the Commerce Clause under the *Complete Auto* test, a state tax (1) must apply to an activity that has a substantial nexus with the state, (2) must not discriminate against interstate commerce, (3) must be fairly apportioned, and (4) must fairly relate to services provided by the state. After reviewing the history of the Court's Commerce Clause jurisprudence, the Court ruled that "*Quill* is flawed on its own terms. First, the physical presence rule is not a necessary interpretation" of the substantial nexus requirement. "Second, *Quill* creates rather than resolves market distortions. And third, *Quill* imposes the sort of arbitrary, formalistic distinction that the Court's modern Commerce Clause precedents disavow."

After acknowledging the criticisms of the physical presence rule, the Court set about to tear down piece-by-piece the physical presence rule of *Quill*. A consistent theme to the *Wayfair* decision was the Court's view that the physical presence rule had become further removed from economic reality each year that passed since 1992.

"*Quill* is flawed"

The Majority reasoned that the physical presence rule is not a necessary interpretation of the substantial nexus requirement. Many of the same reasons set forth by the Court in *Quill* for rejecting the physical presence rule with respect to Due Process Clause minimum contacts nexus were applied for now rejecting its application under the Commerce Clause. In short, the Court found that the physical presence rule has no relationship to compliance costs. The Court used the example of a retailer with one salesperson in each state compared to an internet retailer with a central warehouse and 500 employees located in one state. The former retailer would have a physical presence and tax collection obligation in multiple states, while the latter would not. According to the Court, a small retailer with diverse physical presence would be equally or more burdened by compliance costs as a large remote retailer.

The Majority placed heavy emphasis on its view that *Quill* created market distortions. Echoing the arguments of many states (and traditional retailers), the Court viewed the physical presence rule as placing local businesses and interstate businesses with physical presence at a competitive disadvantage compared to internet retailers. In what will likely become famous dicta, the Court remarked that "*Quill* has come to serve as a judicially created tax shelter . . ."

Likewise, the Majority considers *Quill* and the physical presence rule arbitrary and formalistic, and a standard that treats economically identical actors differently. "The basic principles of the Court's Commerce Clause jurisprudence are grounded in functional, marketplace dynamics; and States can and should consider those realities in enacting and enforcing their tax laws." With advances in internet-selling technology, the Court noted that a remote seller may have a meaningful presence in a state that is not physical.

In concluding that *Quill* and the physical presence rule is flawed, the Majority viewed the rule as a judicial imposition on states' sovereign taxing authority. The Majority opined that the physical presence rule allows remote sellers to take advantage of the benefits of a state's market without sharing the burden of tax collection. Again, by creating competitive disadvantages, the Majority viewed the physical presence rule in 2018 as harming federalism and free markets.

Stare Decisis No Longer Supports the Physical Presence Rule

Quill's affirmation of the physical presence rule was based on a number of reasons, but *stare decisis* (i.e., retailers' settled expectations and reliance on the physical presence rule announced in *National Bellas Hess*) was significant among them. The Majority viewed *Quill* and its physical presence rule as a “false constitutional premise of this Court's own creation” that only the Court, not Congress, could correct. Interestingly, the Majority viewed the various state laws seeking to push the envelope of physical presence from “click-through nexus” to “cookie nexus” to use tax notice and reporting statutes as demonstrative examples of the difficulty in applying the physical presence rule (and illustrating that it is not clear or easy to apply and generates controversy and litigation).

While the doctrine of *stare decisis* protects taxpayers' reliance interests, the Majority reasoned that tax avoidance (by consumers) and competitive advantages resulting from the physical presence rule are not legitimate reliance interests of remote sellers.

As a result, the physical presence rule of *Quill* and *National Bellas Hess* was overruled.

If not Physical Presence, Then What Constitutes Substantial Nexus?

Overruling *Quill* and *National Bellas Hess* is the easy part. Even if the physical presence rule has come to promote tax avoidance by consumers and competitive advantages for remote sellers, what now is substantial nexus? As mentioned in the introduction, we've now come full circle since 1967, but the Commerce Clause/Due Process Clause nexus limitations on state taxing authority are now virtual and economic, not physical.

According to the Majority, substantial nexus under the Commerce Clause now exists “when the taxpayer [or collector] ‘avails itself of the substantial privilege of carrying on business' in a state,” citing *Polar Tankers, Inc. v. City of Valdez,* 557 U.S. 1, 11 (2009). And there you have it. But what does that mean?

The Majority provided only a limited explanation. South Dakota's statutory requirement of a remote seller's $100,000 of sales to South Dakota consumers or 200 separate sales transactions with South Dakota consumers was viewed by the Majority as sufficient for substantial nexus.

There's Always a Remand

Although the Court viewed South Dakota's statutory standard as sufficient for purposes of substantial nexus under the Commerce Clause, the case was remanded to the South Dakota Supreme Court on the question of whether another of the *Complete Auto* Commerce Clause principles could be violated. Nonetheless, the Court suggested that other features of the South Dakota statute “appear designed to prevent discrimination against or undue burdens upon interstate commerce.” Perhaps most significantly, according to the Court the South Dakota statute “ensures that no obligation to remit the sales tax may be applied retroactively.” Thus, it would appear that other states that have enacted similar statutes, but whose statutes are not similarly proscribed from retroactive application, could be vulnerable to constitutional challenge. In addition, the Court also emphasized that South Dakota's membership in the Streamlined Sales and Use Tax Agreement and the state providing access to sales tax administration software paid for by the state were also indicative that the statute did not discriminate against or impose undue burdens on interstate commerce.

The Dissenting Opinion

The Chief Justice in his dissenting opinion, while acknowledging that *National Bellas Hess* was “wrongly decided,” believed that the physical presence rule should be retained. Largely on the basis of the doctrine of *stare decisis* and the compliance costs and burdens that would be

imposed on small businesses by the elimination of the physical presence rule, the Chief Justice, joined by Justices Breyer, Kagan, and Sotomayor, dissented from the Majority opinion. For many of the same reasons given by the Majority with respect to the growth of the internet retail industry, the dissent viewed these as reasons to retain the physical presence rule. Further, the dissent believed that Congress, not the Court, was better placed to address the issue.

What’s Next?

Perhaps nothing, since the enactment of Public Law 86-272 (15 U.S.C. section 381 et seq.) in 1959, alters the landscape of state taxation as much as will now occur after the *Wayfair* decision. The impact of the decision extends beyond internet retailers and beyond sales and use taxes.

In addition to South Dakota, 21 other states have enacted similar economic nexus statutes. More than targeting remote sellers, a number of these statutes are also aimed at “marketplace facilitators” and “referrers.” While some of these state statutes will likely be enforced immediately, the effective dates for some of the statutes were contingent on the *Quill* decision being overturned, which has now occurred. Thus, enforcement could be immediate in some states and delayed in others pending further administrative guidance. Challenges to these statutes are pending in Alabama, Indiana, Ohio, Tennessee, and Wyoming, which will now likely be resolved in the states’ favors, although it could take some time for the legal process to be resolved (and injunctions lifted, if applicable). With South Dakota’s success, it is now likely that other states that have not enacted a similar economic nexus statute will follow suit (or Departments of Revenue will not wait and will issue their own rules or regulations.)

Overnight, remote sellers, marketplace facilitators, service providers, licensors of software, and other businesses that have provided services to or delivered their products to customers from a remote location will have to start complying with state and local sales and use taxes. The Court’s *Wayfair* decision seems to place substantial confidence in sales and use tax automated compliance software and its continuing evolution, but the devil is in the details. Not only must sales tax compliance software fit a particular remote seller’s or service provider’s business parameters, it must also be capable of administering sales and use tax compliance across numerous state and local jurisdictions, myriad and often changing exemptions, managing different product and service taxability definitions across states, among other necessary features.

Wayfair’s overruling of *Quill* and the physical presence rule is not just a sales and use tax development. Economic nexus began as an income tax concept with the 1993 South Carolina Supreme Court decision in *Geoffrey, Inc. v. Tax Commission.* A number of states read dicta in *Quill* as limiting the decision and physical presence rule to sales and use taxes. After a number of states were handed state court victories through the 1990s and 2000s, none of which the U.S. Supreme Court agreed to hear on appeal, economic nexus for corporate income tax purposes earned a sort of begrudging legitimacy. While the corporate income tax notion of economic nexus was birthed in response to businesses engaged in licensing intangible property or providing financial services, more recently some states have enacted “factor presence” nexus statutes that, in addition to other “bright-line nexus” thresholds, may impose income tax nexus when an out-of-state business has a certain dollar volume of sales sourced to the state (usually $500,000 or more). While the aforementioned Public Law 86-272 still protects businesses that sell only tangible personal property, it is no protection from these income tax nexus statutes for service providers, franchisors, lessors, or licensors of intangibles. Further, *Wayfair* now suggests that the threshold could be reduced to as low as $100,000 or 200 transactions and still withstand Commerce Clause scrutiny.

Will Congress finally be motivated to act? In 1959, it was a taxpayer defeat in *Northwestern States Portland Cement Co. v. Minnesota,* which motivated Congress to act and pass Public Law 86-272 and protect sellers of tangible personal property who engaged only in solicitation

activities in a state. Could *Wayfair* turn out to be a pyrrhic victory for states? Alternatively, will Congress take the Court at its word and view state taxation of remote sellers to be a problem created and then solved by the Court?

BDO Insights

- *Wayfair* is a watershed moment in state taxation. The decision will have wide-ranging implications for all businesses, not just internet retailers, as well as consumers, and state and local governments.
- Overnight, *Wayfair* changes a remote seller’s considerations from “do I have physical presence” to “how do I comply with all of the state and local jurisdictions where I deliver my products or services?”
- Almost half of the states that impose sales and use taxes had economic nexus statutes similar to South Dakota’s prior to the *Wayfair*. It is reasonable to expect that most, if not all, of the remaining states that impose sales and use taxes will now go this route.
- The decision is also sure to embolden states that have been imposing economic nexus for income tax purposes for a number of years and is supportive of economic “factor-presence nexus” statutes that some states have enacted in recent years.
- Taxpayers affected by the *Wayfair* decision should consult with their financial statement auditor and tax advisor to evaluate and determine the potential financial statement implications under ASC 740, including the impact on current and deferred taxes, uncertain tax benefits, and disclosures, as well as with respect to sales/use and indirect taxes under ASC 450, including impact on reserves and accruals.