



State & Local Tax Alert

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U.S. Supreme Court Wayfair Decision

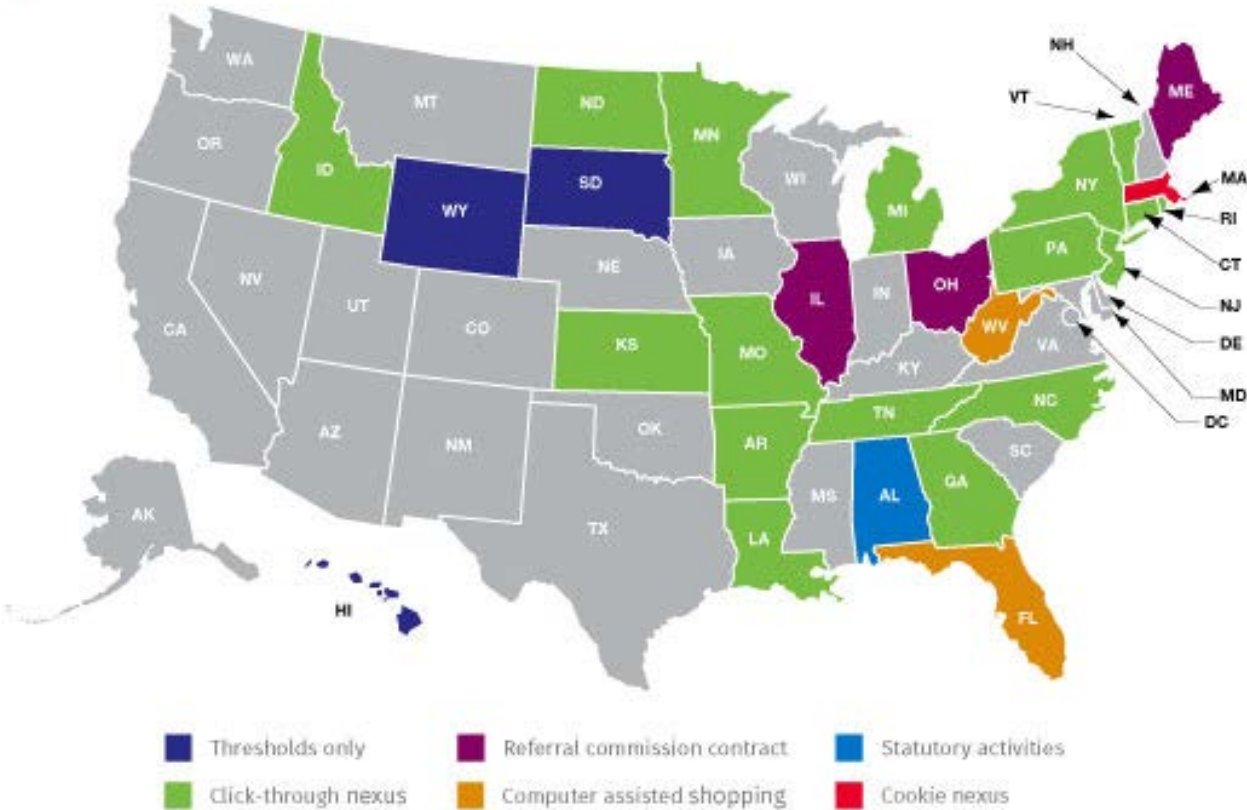
Supreme Court Overturns Quill

In a 5 to 4 decision, the U.S. Supreme Court has held that *Quill Corp. v. North Dakota*, 504 U. S. 298, and *National Bellas Hess, Inc. v. Department of Revenue of Ill.*, 386 U. S. 753, are overruled because Quill's physical presence rule is unsound and incorrect.

The impact of the decision is far-reaching, as states are now free to levy taxes on sales of goods and services regardless of whether the seller has a physical presence in the state. Due process requirements, unrelated to those required by the "Commerce Clause" of the Constitution would still apply, as would other nexus tests of the Commerce Clause. While the door is open for states to require sellers without a physical presence to collect and pay sales taxes, it is by no means a carte blanche for a state to subject any and all interstate commerce to state sales taxes.

In the aftermath of the decision, it appears the expectation should be that states will immediately amend their sales tax statutes to allow for the levy of taxes on sellers without a physical presence in the state, subject to the requirements established by the Court. The next battle may well be to establish what amount of sales or other level of economic presence constitutes enough of a nexus with the state.

**Sales and Use Tax Nexus:
Sales/Economic Presence Threshold**



Note: All color-coded states have a statutory sales/economic threshold test.

ISSUES AT STAKE

In January 2018, the U.S. Supreme Court announced that it would hear oral arguments in *South Dakota v. Wayfair*, which addressed whether the Court should abrogate *Quill Corp. v. North Dakota*'s sales-tax-only, physical-presence requirement. If the Court overturned the physical presence requirement, states could require out-of-state retailers selling goods and services in their states to collect sales tax.

The Court heard oral arguments in the case in April 2018.

History of the Physical Presence Standard

Before the decision in *Wayfair*, a state could compel an out-of-state seller to collect sales tax if the seller had a "physical presence" in the state. The physical presence standard has its history in U.S. Supreme Court interpretation of the U.S. Constitution.

In a series of cases, the U.S. Supreme Court established a general rule of “substantial nexus” which requires an out-of-state seller to have a physical presence in a state before that state can require the seller to collect and remit sales and use taxes. Physical presence can be created by employees or other agents, property owned or leased in the state, or other factors.

National Bellas Hess

The state of Illinois sought to hold a mail order company located outside Illinois liable for Illinois sales tax in the 1967 case of *National Bellas Hess, Inc. v. Dept of Revenue of Ill.*, 386 US 753. The company solicited sales in Illinois and other states by mailing catalogs and flyers to state residents. The company also delivered products, using mail or common carrier.

The Supreme Court held those activities were not sufficient to create minimum contacts with a state, as required under the Due Process Clause, before the state could tax an out-of-state business. The seller did not have fair warning that catalog sales would subject it to tax in other states. Further, imposing tax liability on a business because of these activities violated the Commerce Clause. Sellers that solicited sales by mail and then delivered goods in a state would be unduly burdened by having to collect sales tax for that state. Mail and common carrier deliveries are not sufficient connections with a state to justify the state imposing a sales tax collection requirement on a business. Under *National Bellas Hess*, a business must have a physical presence in a state to have nexus for sales tax purposes.

Complete Auto

The Court next established in *Complete Auto Transit, Inc. v. Brady* in 1977 that a state may tax exclusively interstate commerce as long as that tax does not conflict with the requirements of the Commerce Clause. The Court established a four-prong test for allowing such a tax, the first prong of which requires that the tax apply to an activity with a substantial nexus with the taxing state.

Quill

In 1992, the Supreme Court barred North Dakota from requiring an out-of-state mail-order company to collect use tax on goods sold to North Dakota customers. The company solicited business in North Dakota using catalogs and flyers, advertisements, and telephone calls. The Court reasoned that, under the dormant Commerce Clause, the company could not be liable for North Dakota sales tax because it had no outlets, sales representatives, or significant property in North Dakota.

In *Quill Corp. v. North Dakota*, 504 US 298, the Supreme Court made a distinction between:

- the Due Process Clause minimum contacts requirement; and
- the Commerce Clause substantial nexus requirement.

The Court distinguished the two clauses, concluding that each Clause addressed a different constitutional concern. The Due Process Clause addresses the fundamental fairness of governmental activity. The focus of the Due Process minimum contacts test is whether a taxpayer has fair warning that its activity may subject it to tax in another jurisdiction. In contrast, the Commerce Clause concerns the effects of state regulation on the national economy. The

focus of the Commerce Clause substantial nexus test is whether a state tax places impermissible burdens on interstate commerce.

In *Quill*, the Supreme Court upheld the physical presence requirement for sales tax nexus. A business may be constitutionally subject to due process in a state, but that does not mean it also necessarily has the presence required to create nexus as required by the Commerce Clause for the state to impose tax on it.

- **COMMENT.** The Quill Court's distinction means Congress, not the Court, has the power to decide under what standards a business has sales tax nexus with a state.

South Dakota's Remote Seller Law

With no income tax, South Dakota relies on sales taxes for funding. From the state's perspective, it loses massive tax revenue to internet retailers that don't collect South Dakota sales tax. It passed legislation that requires out-of-state retailers to collect South Dakota sales tax if the retailer:

- had annual gross revenue of more than \$100,000 from sales in South Dakota; or
- completed more than 200 sales annually in South Dakota.

South Dakota included an appeals process in the legislation that would expedite any taxpayer challenges to it.

After the law was enacted, South Dakota sent notices to several companies about the new law and advised the companies to register to collect South Dakota sales tax. When the sellers did not register, the state sought a declaratory judgment against them. Eventually, the case was heard in a South Dakota circuit court. That court found in favor of the sellers, and the South Dakota Supreme Court affirmed, following *Quill*. *The state then appealed to the U.S. Supreme Court.*

SUPREME COURT'S HOLDING

Justice Kennedy, writing for the majority, states that the *Complete Auto* substantial nexus requirement with the taxing state is satisfied based on both the economic and virtual contacts the respondents have with the state. The opinion went on to make a number of points in overruling *Quill*.

- The physical presence rule is an incorrect interpretation of the Commerce Clause and is not a necessary interpretation of *Complete Auto*'s substantial nexus requirement (closely related to the due process requirement) that there be some minimum connection between a state and the person, property, or transaction it seeks to tax. A business does not need a physical presence in a state to satisfy the demands of due process. When considering whether a state may levy a tax, Due Process and Commerce Clause standards have significant, though not identical, parallels.
- *Quill* creates rather than resolves market distortions in that it is a judicially created tax shelter for businesses that limit their physical presence in a state but sell their goods and services to the state's consumers.
- *Quill* imposes the sort of arbitrary and formalistic distinctions that the Court's modern Commerce Clause precedents disavow. Economically identical entities are treated differently for arbitrary reasons. A business that maintains a few items in an in-state warehouse must collect and remit tax on its in-state sales

whereas a remote seller with a pervasive Internet presence cannot be subject to the same tax for in-state sales of the same items.

- *Quill's* physical presence rule is artificial in its entirety. Modern e-commerce does not align with a test that relies on physical presence as defined in *Quill*. The Court should not maintain a rule that ignores substantial virtual connections to the state.
- The physical presence rule of *Quill* is also an extraordinary imposition by the Judiciary on states' authority to collect taxes and perform critical public functions. Allowing Wayfair's customers to evade a lawful tax unfairly shifts an increased share of the taxes to consumers who buy from competitors with an in-state physical presence.
- *Stare decisis* can no longer support the Court's prohibition of a valid exercise of the states' sovereign power. If the Court's Commerce Clause decisions prohibit states from exercising their lawful sovereign powers, the Court should correct the error. It is inconsistent with the Court's proper role to ask Congress to address a false constitutional premise created by the Court. The Internet revolution has made *Quill's* original error all the more egregious and harmful. Attempts to apply the physical presence rule to online retail sales have proved unworkable.
- Arguments for reliance on *Quill's* physical presence rule based on its clarity are misplaced because the rule is no longer a clear or easily applicable standard. Other aspects of the Court's Commerce Clause doctrine can protect against any undue burden on interstate commerce. The potential for such issues to arise in some later case does not justify retaining an artificial and anachronistic rule that deprives states of vast revenues from major businesses.

The Court also noted that South Dakota's tax system includes several features designed to prevent discrimination against or undue burdens upon interstate commerce:

- The Act applies a safe harbor to those who transact only limited business in South Dakota;
- It ensures that no obligation to remit the sales tax may be applied retroactively; and
- South Dakota has adopted the Streamlined Sales and Use Tax Agreement, which: (1) standardizes taxes; (2) requires a single, state-level tax administration, uniform definitions of products and services, simplified tax rate structures, and other uniform rules; and (3) 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.

Dissenting opinion

A dissenting opinion, written by Chief Justice Roberts and joined by Justices Breyer, Sotomayor, and Kagan, states that although *Bellas Hess* was wrongly decided, state and local jurisdictions are already able to collect approximately 80% of the tax revenue that would be available if there were no physical presence rule. The dissenting Justices state that the Court should not act on this important question of current economic policy solely to redress a mistake it made over 50 years ago. Rather, the question should be left to Congress.

STATE AND BUSINESS CONSEQUENCES

The decision opens the door for states to enact laws that require remote sellers to collect and remit sales or use tax regardless of whether they have a physical presence in the taxing jurisdiction. However, it is by no means a free-for-all. States are still required to limit their taxation to sellers and service providers where a substantial nexus exists

with the state. Further, the opinion does not address any due process requirements, only those established by the Commerce Clause.

Of particular note, the majority points out that the substantial nexus requirements are present because of the required value of goods delivered (\$100,000) and the number of transactions engaged (200) in order to be subject to tax by the South Dakota law, but it does not say whether this is a threshold requirement or simply indicative of a substantial nexus.

- **COMMENT.** While the court established that the physical presence requirement was no longer a “clear and easy” rule to apply, it may have established a new, less clear rule for establishing substantial nexus. If \$100,000 in sales and 200 transactions is sufficient, what about \$75,000 in sales and 150 transactions? Indeed, the future of this issue may require decisions by the Court on this point.

The short-term outcome of this opinion is that states will likely act quickly to amend their sales tax statutes to reflect the holding of the Court and begin levying sales and use tax on any interstate commerce that has substantial nexus. Longer-term, states may begin pushing the envelope of the requirements of the holding, trying to stretch the definition of substantial nexus.

- **IMPACT.** Any retailer or service provider will likely have to implement or change internal systems to respond to new state statutes. In many cases, these entities may already have systems set up for any jurisdiction where they already have a physical presence and were collecting tax under the Quill standard, but it is feasible that some entities may only have a physical presence in a jurisdiction without a sales tax, and will now have to implement such a system to enable sales out of state.

If you have any questions, please contact your tax advisor or:

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