



Physical Presence Requirement Overturned by Supreme Court

On June 21, 2018, in a 5-4 decision, the U.S Supreme Court (“Court”) issued an opinion in *South Dakota v. Wayfair* (U.S., No. 17-494), overturning its precedents in *National Bellas Hess Inc. v. Department of Revenue of Illinois* (1967) and *Quill Corp. v. North Dakota* (1992). The decision eliminated the decades-old “physical presence” requirement for sales and use tax nexus. The case centered on a South Dakota law enacted in 2016 that imposes sales tax collection responsibilities on certain remote sellers, based on either the dollar amount or volume of sales into the state. In an opinion written by Justice Kennedy, the Court expressly overruled *Quill*, saying that the physical presence rule is “unsound and incorrect.” The Court determined the South Dakota statute satisfies the substantial nexus standard that is a component of the Commerce Clause and remanded the case to the South Dakota Supreme Court to consider whether the statute could be challenged on an alternative basis.

Background

The states’ ability to impose sales and use tax collection obligations on sellers is limited by the Due Process and Commerce Clauses of the U.S. Constitution. Under the Due Process Clause, a seller must have “minimum contacts” with a state before the state can require the seller to collect and remit sales tax. While this low threshold can be easily met, *National Bellas Hess* interpreted the Commerce Clause to require the seller to have a physical presence. The Court further interpreted the Commerce Clause standard ten years later in another case, *Complete Auto Transit Inc. v. Brady*. The Court defined the Commerce Clause standard using a four-prong test which specified that a state tax must:

- Apply to an activity with “substantial nexus” in the taxing state,
- Be fairly apportioned,
- Not discriminate against interstate commerce. and
- Be fairly related to the services provided by the taxing state.

The Supreme Court upheld the *National Bellas Hess* physical presence standard in *Quill* for establishing substantial nexus specific to sales and use tax collection responsibilities. Therefore, a state could not require a taxpayer to collect sales and use tax when the seller did not have physical presence in the state. Since this case was decided in 1992, states have aggressively attempted to pursue nexus policies that push the envelope as to what constitutes physical presence within a state.

South Dakota’s Economic Nexus and *Wayfair* Case

In March of 2016, South Dakota enacted S.B. 106 which required certain remote sellers to register for, collect, and remit South Dakota sales tax. A remote seller has sales tax nexus with South Dakota if the seller, in the current or the previous year:

- Had gross revenue from sales of taxable goods and services delivered into the state exceeding \$100,000; or



- Sold taxable goods and services for delivery into the state in 200 or more separate transactions.

The law was purposefully designed without the physical presence requirement so as to create an express route to the U.S. Supreme Court in hopes of overturning the *Quill* precedent. The case quickly moved through the South Dakota courts and was granted certiorari by the U.S. Supreme Court in January 2018. The Court heard oral arguments on April 18, 2018, and released its decision on June 21, 2018.

According to the Court, the physical presence rule continues to move further from economic reality and is causing states to experience a loss of sales tax revenue. It therefore concluded that the physical presence rule is not a correct interpretation of the Commerce Clause, and that *Quill* is flawed on its own terms. The Court stated that:

- The physical presence rule is not a necessary interpretation of the substantial nexus requirement under *Complete Auto Transit*, and the administrative burdens of compliance are unrelated to the level of physical presence.
- *Quill* causes rather than resolves market distortion. The physical presence rule provides businesses with an incentive to avoid creating physical presence while local businesses and brick and mortar sellers are placed at an economic disadvantage.
- “*Quill* imposes the sort of arbitrary, formalistic distinction that the Court’s modern Commerce Clause precedents disavow.”

The Court’s ruling effectively struck down the physical presence requirement. It held that substantial nexus required by *Complete Auto Transit* “is clearly sufficient based on both the economic and virtual contacts” and was in fact achieved by the remote sellers in South Dakota. However, it did not issue a blanket approval of the economic nexus policies. The Court did cite several features of South Dakota’s law that weighed in favor of upholding it, including:

- The law’s provision of a sales threshold protecting de minimis sellers (i.e., the \$100,000 of sales or 200 transactions minimum thresholds)
- Assurance that the obligation to remit sales tax would not be retroactive
- The state’s membership in the Streamlined Sales and Use Tax Agreement (SSUTA)

It is important to note that the Court stopped short of formally declaring South Dakota’s law valid in the absence of *Quill*. The Court made it clear that *Quill* (physical presence) was no longer part of any Commerce Clause test for the states’ ability to impose taxes. The Court left open on remand whether the law satisfies the remaining three prongs of *Complete Auto Transit*, specifically whether the tax is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the taxing state.

Observations and Commentary

The sales tax nexus standard as it has been known for over fifty years has been fundamentally changed by eliminating the physical presence rule, as previously interpreted by the Court in *National Bellas Hess* and *Quill*, from the Commerce Clause. This “economic nexus” case impacts



thousands of state and local jurisdictions across the United States that impose a sales or use tax. The most immediate impact will be on sellers with a significant virtual or economic presence in a state that asserts economic nexus. Sellers who operate through either local, in-person contacts or the use of traditional brick and mortar stores will not be impacted.

Sellers delivering taxable products or services into a state that imposes economic nexus rules will need to determine whether their sales surpass the dollar amount or transaction volume thresholds for establishing nexus in the state. It is important to note that, under a particular state's rules, both the dollar and volume thresholds may include both taxable and nontaxable sales in determining whether the state's economic thresholds have been exceeded.

Review of out-of-state activities and nexus

While the *Wayfair* decision may have resolved some issues, it has certainly raised others. All taxpayers engaged in remote sales need to review their specific facts and consult their tax advisors. Depending on the facts and circumstances, taxpayers may have stronger positions to challenge states whose statutes fall short of the *Wayfair* standards than before the *Wayfair* case was decided.

Future state legislation

Justice Kennedy's majority opinion emphasized the three elements of the South Dakota law and suggested strongly that South Dakota's law would pass constitutional muster. As a result, states have already announced their intention to introduce legislation similar to or mirroring South Dakota's provisions. Other states with economic nexus provisions already enacted may decide to modify their rules to match South Dakota's rules or establish sales thresholds greater than \$100,000 and/or a number of transactions greater than 200.

Retroactivity

South Dakota's economic nexus does not apply retroactively. While other states could interpret their laws to provide an avenue for retroactive collection, doing so could raise double taxation and due process concerns. Since use tax was already due and payable from customers on purchases from remote sellers prior to the issuance of the *Wayfair* decision, retroactive collection would make both the seller and the buyer legally liable for collecting and remitting the tax on a transaction intended to be taxed only once. States have begun issuing guidance related to their economic nexus rules and whether they intend to enforce their provisions retroactively. A careful review of each state's rules and guidance should be made when evaluating any related exposures.

SSUTA Membership

The Court cited South Dakota's membership with the SSUTA as a factor that could reduce the potential compliance burden of the economic nexus provisions. It is not clear whether membership with the SSUTA, or lack thereof, would impact the constitutionality of a state's economic nexus standard. There may be legal challenges to a state's assertion of economic nexus by arguing that the burden of compliance in a non-SSUTA state is too high. States that are not members may now



find themselves either battling these legal challenges or considering becoming full members in the SSUTA and changing their laws accordingly.

Currently twenty states have an economic nexus model in place: Alabama, Connecticut, Georgia, Illinois, Indiana, Illinois, Iowa, Kentucky, Louisiana, Maine, Minnesota, Mississippi, North Dakota, Oklahoma, Pennsylvania, Rhode Island, South Dakota, Tennessee, Vermont, Washington, and Wyoming. Of these states, seven are not full members of SSUTA: Alabama, Connecticut, Illinois, Louisiana, Maine, Mississippi, and Pennsylvania.

Notice and Reporting Requirements

Some states have enacted complex use tax notice and reporting requirements for remote sellers not required to collect and remit sales tax. Under these laws, remote sellers must provide information to customers about potential use tax liability and report transaction data to the state. These complex and administratively burdensome requirements are primarily intended to induce the remote sellers to register, collect, and remit sales tax in the states. Noncompliance by taxpayers may result in per-occurrence penalties. These laws were recently upheld by the 10th Circuit Court of Appeals, and the U.S. Supreme Court denied certiorari. It is plausible that states that are not part of the SSUTA may look to enact these reporting provisions to encourage remote sellers to favor collecting and remitting the tax instead of attempting to comply with the law's reporting requirements.

Foreign-based sellers

Sellers based outside the United States may also be affected by the *Wayfair* ruling. States are not automatically bound by U.S. bilateral tax treaties. Therefore, a seller that is not subject to federal income tax may nonetheless have sales and use tax collection and reporting obligations at the state level. However, enforcement of such provisions could be problematic. While a state may issue a judgement against another jurisdiction when sales tax goes uncollected, this is not the case when a foreign entity is involved. There currently is no treaty between any foreign country and the U.S. providing for collection of sales tax based on a state judgment. For the U.S. to put pressure on a foreign country to collect this tax would be difficult.

States Response and Enforcement Date

The *Wayfair* case has been remanded to the South Dakota Supreme Court. In order for the state of South Dakota to enforce the provision, the existing injunction will need to be lifted by the lower level South Dakota courts. It may take several weeks or more for the South Dakota courts to accept and deal with the remand and to permit the state to enforce its provisions. Other states currently having either economic nexus rules like South Dakota or other economic nexus provisions have been announcing dates by which they will begin to enforce their requirements on remote sellers. Taxpayers should closely monitor the activities in any states in which they have nexus to determine the state's intended enforcement date.



Income Taxes Impact

Although the *Wayfair* case is a sales tax nexus decision, there may be a future impact on income taxes. The Court's decision to remove the physical presence requirement and approve economic nexus thresholds for sales taxes may encourage states to impose economic nexus for income taxes as well. While Public Law 86-272 currently remains in effect for sellers of tangible property, sellers of services or intangibles may quickly find themselves subject to income tax under a bright-line nexus standard. It is also possible that we may see a state challenge to the physical presence provisions of Public Law 86-272 under arguments similar to those made in *Wayfair*.

For more information on the *Wayfair* case or any other state and local tax matters, please contact:

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