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US Supreme Court overturns physical presence standard

South Dakota v. Wayfair, Inc.[1], US Supreme Court, judgment of 21 June 2018

On 21 June 2018, the Supreme Court of the US issued its highly anticipated decision in a case that has been referred to as the US state tax case of the millennium. At issue in this landmark case was a law enacted in 2016 by the State of South Dakota, which imposed sales tax registration, collection and remittance obligations on out-of-state retailers with no physical presence in South Dakota. By overturning the 'physical presence' requirement, the Supreme Court was in fact overturning a 51-year-old standard - which dramatically changed the state tax landscape in the US.

In 1992, 26 years prior to *South Dakota v. Wayfair, Inc.* ('*Wayfair*'), the US Supreme Court affirmed in *Quill Corp. v. North Dakota*[2] ('*Quill*') that states could not impose their sales tax obligations on out-of-state businesses that lacked a 'physical presence' in their state. In *Quill*, the Supreme Court was asked to reconsider its 1967 decision in *National Bellas Hess v. Department of Revenue of Illinois*[3] ('*Bellas Hess*'), a decision that similarly held that a physical presence was required before sales tax obligations could be imposed on out-of-state retailers.

The US system of federalism

Prior to commencing discussion of the *Wayfair* decision, it is important briefly to review the US governmental system of federalism, which is a system of government in which power is divided between a national (federal) government and various state governments. Under the US federalist system, the US Constitution gives certain powers to the Federal Government, other powers to the state governments, and yet others to both. A distinctive feature of federalism is a relationship of parity between the two levels of government in which there is a division of powers between two levels of equal status. The US Constitution grants certain enumerated powers solely to the Federal Government, such as the powers to declare war, enter into treaties and regulate interstate and international trade. Certain other powers are reserved for the individual state governments. These 'reserved powers' include the power to establish local governments. Concurrent powers are shared by federal and state governments, and include the powers to tax and to maintain courts. Finally, certain powers are not specifically delegated in the US Constitution, but are understood to be necessary or permitted to be employed by the Federal Government, such as the 'necessary and proper clause' of the US Constitution[4]. This brief overview is important, as the state's 'authority to tax' and the Federal Government's enumerated authority 'to regulate commerce with foreign nations, and among the several states, and with the Indian tribes[5]' under the commerce clause of the US Constitution are significant themes in the *Wayfair* opinion, as is discussed further below.

South Dakota's economic nexus law

At issue in the *Wayfair* case was a law enacted on 22 March 2016[6] by the State of South Dakota - SB 106 - which imposes sales tax collection, reporting and remittance duties on out-of-state ('remote') retailers whose South Dakota activity meets certain economic thresholds. The South Dakota law requires certain remote sellers that sell tangible personal property, products transferred electronically or services for delivery into South Dakota, and that meet one of two economic thresholds in either the previous or current calendar year, to collect and remit South Dakota sales tax as if they had a physical presence in the state. Remote retailers subject to South Dakota's collection and remittance duties are those that, during the previous or current calendar year: had more than $100,000 in gross revenue from the sale of tangible personal property, any product transferred electronically or services delivered into South Dakota; or sold tangible personal property, any product transferred electronically or services for delivery into South Dakota in 200 or more separate transactions[7].

By enacting a law imposing sales tax obligations absent any physical presence, the South Dakota law clearly violated *Quill*. Also notable were the numerous justifications cited in SB 2016 for enacting an economic nexus law, and anticipating a legal challenge, language addressing judicial concepts and procedures should a legal challenge be presented[8].

South Dakota's economic nexus law invites a legal challenge

While one might question why a state would enact legislation that clearly violated *Quill*, the intent of South Dakota's economic nexus was also to invite a legal challenge. In addition to citing its justifications for enacting a law that clearly violated *Quill*, SB 106 specifically referenced Supreme Court Justice Kennedy's concurring opinion in *Direct Marketing Association v. Brohl*[9], in which he expressed his strong view that the time had come to reconsider *Quill*, urging that the Supreme Court of the United States should reconsider its doctrine that prevents states from requiring remote sellers to collect sales tax, and as the foregoing findings make clear, this argument has grown stronger, and the cause more urgent, with time." Thus, incorporated into the law were several 'fast-track' provisions

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permitting South Dakota to bring a declaratory judgment action in a circuit court against any person it believed met the 'economic nexus' criteria, and directions to the circuit court to act on the declaratory judgment 'expeditiously' and to presume that the matter could be resolved through a motion to dismiss or a motion for summary judgment[10]. SB 106 also provided that the filing of a declaratory judgment action by the State would operate as an injunction while a case was pending, thus prohibiting the state from enforcing the sales tax remittance obligations against any taxpayer who did not comply[11]. Another provision in SB 106 would also allow any appeal to go directly to the South Dakota Supreme Court[12].

Legal actions commence

Prior to the 1 May 2016 effective date for its economic nexus law, South Dakota filed a suit in the Sixth Circuit Court of South Dakota seeking a declaratory judgment against several large remote online retailers: Wayfair LLC, Newegg Inc. and Overstock.com Inc[13]. The South Dakota Department of Revenue ('the Department') had sent notices to these retailers informing them of their requirement to register by 25 April 2016, based simply on the State's assumption that they met the economic nexus sales and transaction requirements. The retailers filed a motion for summary judgment, admitting that they each met SB 106's economic nexus threshold but raising the affirmative defence that the South Dakota economic nexus law was unconstitutional under *Quill*. The Sixth Circuit Court agreed, holding that SB 106 "fails as a matter of law to satisfy the physical presence requirement that remains applicable to state sales and use taxes under *Quill* and its application of the Commerce Clause[14]." A motion for summary judgment was granted to the retailers and, under the 'fast-track provisions' in the law, the State appealed directly to the South Dakota Supreme Court.

Despite South Dakota's persuasive arguments that the US Supreme Court should reconsider *Bellas Hess* and *Quill* because changes in circumstances and technology had made these decisions outdated, the South Dakota Supreme Court affirmed the 6th Circuit Court's decision, stating that "[h]owever persuasive the State's arguments on the merits of revisiting the issue, *Quill* has not been overruled [and] remains the controlling precedent on the issue of Commerce Clause limitations on interstate collection of sales and use taxes[15]." South Dakota then appealed to the US Supreme Court, which granted *certiorari* on 23 January 2018. Oral arguments were presented before the US Supreme Court on 17 April 2018.

The dormant commerce clause

As discussed above, under the US federalist system, the US Constitution grants certain enumerated powers to the Federal Government. The Commerce Clause of the Constitution affirmatively grants Congress the power 'to regulate commerce with foreign nations, and among the several states[16].' Historically, the Commerce Clause has been viewed as both a grant of congressional authority and a restriction on states' regulatory authority. Thus, the Supreme Court has consistently held that the Commerce Clause contains a further, negative command, known as the 'dormant' Commerce Clause, which refers to the prohibition, implicit in the Commerce Clause, against states passing legislation that discriminates against or excessively burdens interstate commerce. The US Supreme Court has "long held that in some instances it imposes limitations on the States absent congressional action." In *Wayfair*, the Supreme Court considered this limitation on state taxation, noting two key principles: (1) a state may not discriminate against interstate commerce; and (2) a state may not impose undue burdens on interstate commerce.

The *Wayfair* decision reviewed the Commerce Clause principles and their application to state taxes. In a 1977 landmark case involving a Missouri transaction privilege tax, the US Supreme Court provided standards for applying the commerce clause to state taxes. In its analysis in *Complete Auto Transit, Inc. v. Brady*[17] ('*Complete Auto Transit*'), the Supreme Court presented a four-prong test that requires that: (1) there must be a substantial nexus between the taxpayer and the state; (2) the tax must be fairly apportioned; (3) the tax must not discriminate against interstate commerce; and (4) the tax must be fairly related to the services provided by the state.

Ten years prior to *Complete Auto Transit*, the Supreme Court found, in *National Bellas Hess*, that the State of Illinois lacked the power under the due process clause and commerce clause to require a retailer to collect sales tax unless the retailer maintained a physical presence in the state. In 1992, the Supreme Court considered the physical presence standard again, in *Quill*. It overruled the due process clause holding, however, and applying the doctrine of *stare decisis*, reaffirmed the physical presence requirement as it applied to sales tax under the commerce clause. While *Quill*

acknowledged that intervening cases such as *Complete Auto Transit* might dictate a different result if the issue were being considered for the first time, adhering to the physical presence requirement was necessary to prevent undue burdens on interstate commerce.

Findings in *Wayfair* admit *Quill* decision was flawed; physical presence is not the correct interpretation of the Commerce Clause

In *Wayfair*, the Supreme Court noted the 'physical presence' rule that "has long been criticized as giving out-of-state sellers an advantage" becomes "further removed from economic reality" each year. The Supreme Court held that the 'physical presence' rule is an "incorrect interpretation of the Commerce Clause," both as first formulated by the *Bellas Hess* and *Quill* courts as well as it is applied today. Calling *Quill* flawed on its own terms, the Supreme Court in *Wayfair* provided three key points supporting its position:

1. the 'physical presence' rule is not a necessary interpretation of the 'substantial nexus' requirement;
2. *Quill* creates, rather than resolves, market distortions; and
3. *Quill* imposes the sort of arbitrary, formalistic distinction that the Court's modern commerce clause precedents disavow.

Substantial nexus can be achieved without a physical presence

The Supreme Court in *Wayfair* reasoned that physical presence is a "poor proxy" for measuring a company's compliance burden when doing business in multiple states. Although physical presence can frequently enhance a business's connection with a state, "it is an inescapable fact of modern commercial life that a substantial amount of business is transacted [with no] need for physical presence within a State in which business is conducted." The Court noted that although the *Quill* majority expressed concern that without the 'physical presence' rule "a state tax might unduly burden interstate commerce by subjecting retailers to tax collection obligations in thousands of different taxing jurisdictions[18]," the administrative costs of compliance, especially in the modern economy with its internet technology, are largely unrelated to whether a company happens to have a physical presence in a state. For instance, a small company with a single employee in every state would meet each state's physical presence nexus and be significantly burdened with compliance costs. Yet, a large business with 500 employees located in one single state and a webstore accessible by customers throughout the country might bear significantly lesser compliance costs. Despite acknowledging that due process and Commerce Clause standards may not be identical, *Wayfair* states that the reasons for rejecting physical presence for due process purposes apply as well to whether physical presence is a requisite for an out-of-state seller's liability to remit sales taxes.

The physical presence rule creates market distortions

The Supreme Court reasoned that *Quill* places businesses with an in-state presence at a competitive disadvantage relative to remote sellers. Calling *Quill* 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[19]," the Supreme Court added that *Quill* "produces an incentive to avoid physical presence in multiple States, affecting development that might be efficient or desirable[20]." Furthermore, by "giving some online retailers an arbitrary advantage over their competitors who collect state sales taxes, *Quill*'s physical presence rule has limited States' ability to seek long-term prosperity and has prevented market participants from competing on an even playing field[21]." The Supreme Court rejected the 'physical presence' rule to "ensure that artificial competitive advantages are not created by this Court."

The 'physical presence' rule arbitrarily treats identical actors differently

To emphasise the arbitrary treatment created by the 'physical presence' rule, the Supreme Court in *Wayfair* presented a scenario in which a remote business stocks a few items of inventory in a small warehouse in South Dakota. Just across the border, in North Dakota, a second business stores inventory in a major warehouse and maintains a sophisticated website with a virtual showroom accessible in every state. By reason of physical presence, the business whose South Dakota presence is limited to the few items of inventory stored in the state must collect South Dakota sales tax on all orders shipped to South Dakota customers. However, the second business, lacking any physical presence in South Dakota, cannot be subject to the same tax for the sales of the same items made through a pervasive internet presence. This distinction simply makes no sense. The Supreme Court in *Quill* itself acknowledged that the 'physical presence' rule is "artificial at its edges[22]." That was an understatement when *Quill* was decided; and when the day-to-day functions of marketing and

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distribution in the modern economy are considered, it is all the more evident that the 'physical presence' rule is artificial in its entirety. Modern e-commerce does not align analytically with a test that relies on the sort of physical presence defined in *Quill*. Thus, the *Wayfair* court questioned why, if a single employee or warehouse can create substantial nexus, aspects of "pervasive modern technology" - such as in-state customer computers, downloaded apps and website cookies - cannot create substantial nexus. A remote business can very well be "present in a meaningful way without that presence being physical in the traditional sense of the term."

Adding to this argument, the Supreme Court in *Wayfair* noted that the 'physical presence' standard renders irrelevant a retailer's "continuous and pervasive virtual presence"; accordingly, the Supreme Court declined to follow a 'physical presence' rule that ignores "substantial virtual connections" to a state.

But, more than just being a technical legal problem, the Supreme Court in *Wayfair* argued that the 'physical presence' rule is an "extraordinary imposition by the Judiciary on States' authority to collect taxes and perform critical public functions[23]." Thus, allowing remote sellers to "escape an obligation to remit a lawful state tax is unfair and unjust[24]" to competitors that remit the tax, to consumers who pay the tax, and to states that seek to "create and secure the active market" that remote sellers supply with goods and services. The Supreme Court reasoned that companies that avail themselves of state benefits "bear an equal share of the burden of tax collection[25]." Adding further to its argument that the physical presence standard is arbitrary and unjust, the Supreme Court concluded that it "has limited States' ability to seek long-term prosperity and has prevented market participants from competing on an even playing field[26]."

Stare decisis does not warrant retaining the 'physical presence' standard

The Supreme Court gives great weight to the doctrine of *stare decisis*: that what been decided should be retained. In effect, in order to say that *stare decisis* should not apply, the Supreme Court is overturning its own prior rulings. On this point, in *Wayfair* it held that the doctrine of "*stare decisis* can no longer support the Court's prohibition of a valid exercise of the States' sovereign power[27]." Recognising that reliance on *stare decisis* is a legitimate consideration when determining whether to follow an earlier case, the Supreme Court concluded that, in this case, *Quill*'s physical presence standard is "no longer a clear or easily applicable standard, so arguments for reliance based on its clarity are misplaced[28]." Even though Congress has the authority to change the 'physical presence' rule, it should be vigilant in correcting a judicially created error. It is not the Supreme Court's role to "ask Congress to address a false constitutional premise of this Court's own creation[29]." It is currently the Supreme Court, and not Congress, that is limiting the lawful prerogatives of the states.

The Supreme Court in *Wayfair* further cited numerous 'unworkable' state attempts to apply the physical presence standard to online retail sales, such as defining 'physical presence' to include the availability of downloadable apps and presence of digital cookies, 'click-through' nexus statutes, and notice and reporting requirements[30]. Such statutes are "likely to embroil courts in technical and arbitrary disputes about what counts as physical presence."

The Supreme Court stated that "real world implementation" of commerce clause doctrines require that physical presence must give way to the "far-reaching systemic and structural changes in the economy[31]." E-commerce has exploded since the time that *Quill* was decided. For the states, this has translated into estimated revenue shortages ranging from $8 to $33 billion as a result of lost sales tax revenue.

Finally, the Supreme Court in *Wayfair* addressed the argument that the 'physical presence' standard allowed online companies to grow without being subject to the complexity of obstacles of nationwide sales tax collection. Although compliance burdens may be legitimate concerns in some instances, and particularly for small businesses, software 'eventually' will be available at a reasonable cost, which 'may' make it easier for small businesses to cope with such problems. Additionally, Congress is still free to enact federal legislation to address issues such as the additional burden on small retailers.

Majority opinion

In an opinion written by Justice Anthony Kennedy, who was joined by four other justices - Thomas, Ginsburg, Alito and Gorsuch - the Supreme Court held that because the 'physical presence' rule of *Quill* is unsound and incorrect, *Quill* and *National Bellas Hess* were overruled. The South Dakota Supreme Court decision was vacated, and the case was remanded for further proceedings not inconsistent with the Supreme Court's opinion[32].

Dissenting opinion

In a dissent written by Chief Justice John Roberts, who was joined by three other justices - Breyer, Sotomayor and Kagan - the dissenting opinion held that, while agreeing with the majority's opinion that *Quill*'s 'physical presence' rule was wrongfully decided, the dissenting justices opposed discarding the 'physical presence' rule, as doing so has the potential to disrupt the development of e-commerce that has relied on the standard. The dissent argued that such an action should be undertaken by Congress, not the Supreme Court, and that a heightened form of *stare decisis* should be applied due to Congress's 'superior authority' in the realm of interstate commerce.

The dissenting justices also took issue with the majority's sense of urgency to address the states' significant loss of sales tax revenue, noting that states have recently been able to collect more remote seller sales tax revenue and that harm to states has been "receding with time." Further, the dissent argued that the majority 'breezily discards' the costs that its decision will impose on retailers, that the added burden will fall disproportionately on small businesses, that the majority opinion "will surely have the effect of dampening opportunities for commerce in a broad range of new markets"[33] and that the dissenting justices were concerned that the "troubling question" of retroactive application could remain under state laws.

Conclusion

The Supreme Court decision is significant for many reasons - most importantly because *Wayfair* overturned the 'physical presence' standard that had previously been established in the decision in *National Bellas Hess*[34] and affirmed in *Quill Corp v. North Dakota*[35], which, for the previous 51

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years, had prohibited states from imposing their sales tax obligations on out-of-state businesses that lacked a 'physical presence' in their states.
The decision has already had a dramatic impact in the US, as states have rushed to adopt an economic nexus standard for sales tax. As of 1 August 2018, more than 25 states had adopted economic nexus as their standard for imposing sales tax obligations on remote sellers[36] either through enacted state legislation or regulation, or through administrative policy statements. Many of these states' economic nexus laws are modelled on the South Dakota law and use the same 'more than $100,000 in sales' or '200 or more transactions' economic nexus standards. Several states that had enacted economic nexus laws in previous years were met with similar legal suits challenging the constitutionality of those states' economic nexus laws and were prohibited from enforcing their laws due to their pending litigation. Other states enacted laws that were contingent on the Supreme Court abrogating the 'physical presence' standard. Now that the Supreme Court has rendered its opinion reversing *Quill*, states are free to enforce their economic nexus law or adopt economic nexus if they have not already done so.

For non-US entities who engage in business in the US, this decision has significant implications. As noted previously, only the federal government has the power to enter into treaties. Therefore the states are not a 'party to' or 'bound by' any bilateral tax treaty into which the Government enters. Thus, although a non-US business may have treaty protection from US federal taxation, this protection does not extend to state taxation. States can therefore impose their economic laws on non-US entities whose sales, transactions or other activities meet the economic nexus standards established by that state.

The state tax decision of the millennium has already had a dramatic impact on the US state tax landscape and will undoubtedly have significant implications not only for US-based companies, but for non-US businesses as well.

1. US Supreme Court Docket 17-494; argued April 17, 2018; opinion issued 21 June 2018.
2. 504 U.S. 298 (1992). In *Quill*, the US Supreme Court re-examined the 'physical presence' rule in a case that presented a challenge to North Dakota's "attempt to require an out-of-state mail-order house that has neither outlets nor sales representatives in the State to collect and pay a use tax on goods purchased for use within the State." The Court affirmed its holding in *National Bellas Hess* primarily on the principle of *stare decisis* and affirmed its prior decision in *National Bellas Hess*, which required a physical presence in the state before it could impose its sales tax obligations.
3. 386 U.S. 753 (1967). In *National Bellas Hess v. Department of Revenue* (of the State of Illinois), the appellant, a mail order house with a principal place of business in the State of Missouri, challenged an Illinois tax that required out-of-state retailers to collect and remit taxes on sales made to consumers who purchased goods for use within Illinois. In *Bellas Hess*, the Supreme Court held that a mail-order company "whose only connection with customers in the State is by common carrier or the United States mail" lacked the requisite minimum contacts with the state required by both the due process clause and the commerce clause and unless the retailer maintained a physical presence such as "retail outlets, solicitors, or property within a State," Illinois lacked the power to require the retailer to collect its tax.
4. Article I, Section 8, Clause 18, US Constitution. The 'Necessary and Proper' clause permits the Federal Government to 'make all laws which shall be necessary and proper for carrying into execution the foregoing powers, and all other powers vested by this constitution.'
5. Article 1, Section 8, Clause 3, US Constitution.
6. SB 106 had an effective date of 1 May 2016 (SB 106, Laws 2016, § 9). The law states that the 'Act shall be in full force and effect on the first day of the first month that is at least fifteen calendar days from the date of this Act.' As the law was signed into effect on 22 March 2016, the first day of the first month that fell at least 15 days after enactment was 1 May 2016. However, due to legal action initiated prior to the effective date and the enforcement of the South Dakota law, it was stayed.
7. SB 106, Laws 2016, § 1.
8. A mong the South Dakota's legislature's justifications for enacting its economic nexus law were its finding that the state's ability effectively to collect tax from remote sellers was leading to significant revenue shortages and imminent harm due to critical funding shortages for state and local government services (SB 106, Laws 2016, § 8(1)); that the loss of revenue from remote sales is particularly significant for South Dakota, which is a state with no state income tax, and which relies heavily on sales and use tax revenues (SB 106, Laws 2016, § 8(2)); that remote sellers who make a substantial number of deliveries into or have large gross revenues from South Dakota benefit extensively from the state's market as well as infrastructure, yet many remote sellers 'actively market sales as tax free or no sales tax transactions' (SB 106, Laws 2016, § 8(5),(3)); and that modern computing and software options have lessened the difficulty and burden on remote sellers to comply with collection and remittance duties (SB 106, Laws 2016, § 8(6)).
9. *Direct Marketing Association v. Brohl*, 135 S. Ct. 1124 (2015). Although the *Direct Marketing* case dealt with Colorado's 2010 notification and reporting law, which imposed administrative obligations and punitive sanctions on 'non-collecting' retailers.
10. SB 106, Laws 2016, § 2. South Dakota's economic nexus legislation, SB 106, was signed into law on 22 March 2016 by Governor Daugaard. The new law is set to go into effect on 1 May 2016.
11. SB 106, Laws 2016, § 3.
12. Ibid, § 4.
13. All three retailers had no physical presence in South Dakota. A fourth online retailer, Systemax Inc., was also served a notification to register and opted to comply with the law's requirements.
14. *State v. Wayfair Inc.*, No. 32CIV16-000092, 2017 WL 4358293, (S.D. Cir. Ct. Mar. 6, 2017).
15. 901 N.W.2d 754 (S.D. 2017).
16. Article 1, Section 8, Clause 3 of the US Constitution.
17. 430 U.S. 274 (1977).
18. 17-494, pgs. 16-17.
19. Ibid, pg. 18.
20. Ibid.
21. Ibid, pg. 3.
22. 504 US at 315.
23. 17-494, pg. 3.
24. Ibid, pg. 21.
25. Ibid, pg. 22.
26. Ibid.
27. Ibid.
28. Ibid, pg. 25.
29. Ibid, pg. 4.
30. For several years, states have enacted laws that expand what constitutes a physical presence in order to comply with *Quill*. This has been included in increasingly aggressive laws and ever-expanding definitions of what constitutes a physical presence.
31. 17-494, pg. 23.
32. Although the Supreme Court overturned the 'physical presence' standard in its majority opinion, the case was sent back, or remanded, to the South Dakota Supreme Court to address whether there might be any other valid grounds under which the law could be challenged. It is unlikely, however, that a new and valid challenge will be presented.
33. 17-494, pg. 38.
34. 386 US 753 (1967).
35. 504 US 298 (1992).
36. As of 1 August 2018, the following states have adopted economic nexus for sales tax: Alabama, Connecticut, Georgia, Hawaii, Illinois, Indiana, Iowa, Kentucky, Louisiana, Maine, Massachusetts, Minnesota, Mississippi, Nebraska, North Dakota, Ohio, Oklahoma, Pennsylvania, Rhode Island, South Dakota, Tennessee, Utah, Vermont, Washington, Wisconsin and Wyoming.