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Landmark Decision in South Dakota v. Wayfair, Inc. et al

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Practice Area: Business and Corporate Law & Tax & Retail Real Estate

On June 21, 2018, the U.S. Supreme Court overturned fifty years of long-standing precedent in a landmark decision, *South Dakota v. Wayfair, Inc., et al.* (No.17-494, 06/21/2018). The Court in *Wayfair* rejected the "physical presence test" for determining when remote (out-of-state) businesses must collect state and local sales tax. The decision is a win for brick-and-mortar retailers, states and localities, but it presents new challenges for online retailers as they consider how to handle increased administrative burdens and compliance challenges. This *Legal Update* addresses *Wayfair*'s background, the Court's decision, and what we can expect looking forward.

Background
Previously, under the physical presence test, states and localities could assert nexus (sufficient contact with a state to allow the state to tax a business) for sales and use tax purposes only when a business had a physical presence—stores, warehouses, property, employees—in the state. This test was established in the Supreme Court's 1967 decision, *National Bellas Hess, Inc. v. Department of Revenue of Ill.*, 386 U.S. 753 (1967), and reaffirmed in the 1992 decision, *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992). Both cases involved mail order catalogs and were decided prior to the internet commerce boom that accompanied the proliferation of online retailers.

The physical presence test favored remote retailers, who were able to do business without having to navigate the complex patchwork of state and local tax codes. Brick-and-mortar retailers, on the other hand, saw the physical presence test as providing an unfair advantage to remote sellers.

Significant increases in online sales led several states to create workarounds that tested the physical presence test. States enacted tax laws with nexus provisions by which out-of-state retailers with no physical presence in the state were considered to have substantial nexus (connections with the state) on the basis of "cookie nexus," "click through nexus," "affiliate nexus" or "economic nexus."

In 2016, South Dakota enacted S.B. 106 (the "South Dakota Act"), a remote seller statue imposing sales tax obligations on retailers with an economic nexus to the state. Specifically, the South Dakota Act imposes a sales tax obligation on sellers that, on an annual basis, deliver more than $100,000 of goods or services into the state or engage in 200 or more separate transactions for the delivery of goods into the state. The South Dakota Act is not applied retroactively.

Shortly after the South Dakota Act was enacted, South Dakota brought a declaratory judgment action against several large remote sellers, including Wayfair Inc., Overstock.com Inc., and Newegg Inc. The retailers challenged the constitutionality of the South Dakota Act, and the case ended up before the Supreme Court in *Wayfair*.

Court's Decision
The Supreme Court found in favor of South Dakota. In a 5-4 ruling, the Supreme Court overturned the physical presence test from *Quill* and *Bellas Hess*. Justice Kennedy, who had previously expressed disapproval of *Quill*, authored the Court's majority opinion. The Court ruled that the physical presence rule of *Quill* was "unsound and incorrect." The Court went on to say that the decision in *Quill* created market distortions and served as a "judicially created tax shelter."

The majority opinion engaged in a lengthy review of constitutional principles under the Commerce Clause, and ultimately concluded that the physical presence rule was an incorrect interpretation of the Commerce Clause. The Court emphasized two overarching principles related to states' authority to regulate interstate commerce: (1) a state tax system should not discriminate against out-of-state business and (2) it should not place an "undue burden" on interstate commerce. The Court acknowledged that small businesses and startups would bear the impact of the Court's decision, but decided that reliance interests—the notion that businesses had been relying on the physical presence test for decades—were not enough to permit "tax avoidance" and further stated that these concerns could be better addressed under "other" aspects of the Commerce Clause.

Moving forward, the correct standard in deciding the constitutionality of a state tax law is whether the tax applies to an activity that has "substantial nexus" with the taxing state. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977). Substantial nexus exists when a taxpayer "avails itself of the substantial privilege of carrying on a business in that jurisdiction [state]" and can be established based on economic and virtual contacts. In *Wayfair*, the Court noted that targeted advertising and electronic sales may allow a business to have substantial virtual connections without traditional physical presence.

The Court ultimately concluded that the South Dakota Act satisfied the substantial nexus prong of *Complex Auto*. Because the South Dakota Act limits its application to sellers who engage in a "significant quantity of business" with the taxing state and the sellers in the case were all "large national companies that undoubtedly maintain an extensive virtual presence" the Commerce Clause did not prevent South Dakota from requiring collection.

The Court decided that the South Dakota Act was designed to minimize the burden on interstate commerce and provided small businesses a reasonable degree of protection. The Court noted, with approval, three protective features of the South Dakota Act:

1. **Thresholds** – The South Dakota Act only applies to merchants who do a considerable amount of business in the state, at least $100,000 in sales or at least 200 individual transactions.
2. **Streamlined Sales and Use Tax Agreement (SSUTA)** – South Dakota is a member of the SSUTA, a sales tax simplification agreement that 24 states currently participate in.
3. **Not retroactive** – The South Dakota Act is not applied retroactively.

The Court's opinion does not bind other states to use the South Dakota Act as a model, nor does it clearly establish thresholds or limits for considering whether "substantial nexus" exists in other fact patterns. These issues, along with many others, will be played out in litigation, in Congress, and on the state level.

Looking Forward
The Court's opinion in *Wayfair* will likely have a broad and lasting impact on the sales and use tax landscape. It is important to recognize that the Court's opinion is not a blank check and did not give states carte blanche. Pending additional developments from a litigation or congressional standpoint, states will establish their own nexus statutes.

Litigation. The Supreme Court remanded the case back to the South Dakota Supreme Court to determine if any other parts of the South Dakota Act impede interstate commerce. This means we might see additional litigation regarding the administrative burden or compliance costs for remote businesses.

Congressional Action. The majority and the dissent agreed that Congress could step in and enact legislation. Congressional action could establish a uniform sales tax rate and standard, which would apply to all states that impose the sales tax.

State Statutes. This decision has already prompted actions by state tax administrators and legislatures, a trend that will continue moving forward. As previously discussed, many states already have laws on the books that expand the traditional physical presence test. A number of states have "economic nexus" laws (similar to the South Dakota Act) and others have economic nexus bills pending in the state legislature. In these states, we can expect to see additional guidance published with additional information regarding enforcement. Because the Supreme Court did not provide clear guidance on the appropriate limits and thresholds, states' statutes may differ significantly with respect to: (1) tax rates, (2) rules governing tax-exempt goods and services, (3) product category definitions, and (4) standards for determining out-of-state presence.

State nexus issues may involve income, franchise, sales and use taxes. Here is a non-exhaustive list of factors to consider regarding whether you may have a state nexus issue:

- Whether business formalities exist with the state (e.g., incorporation);
- Physical presence in the state (e.g., salespeople, training, offices, answering services);
- Nexus types of activities, including:
  1. Non-resident employees visiting the state
  2. Shipping products to third party distributors in the state
  3. Filing tax returns in the state
  4. Leasing equipment

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