South Dakota v. Wayfair, Inc.: Supreme Court Overturns Physical Presence Test for Online Retailers

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The U.S. Supreme Court upended 51 years of precedent on Thursday, June 21, 2018, when it held in a 5-4 decision that a state can require an online retailer with no in-state property or personnel to collect and remit sales tax on sales made to the state's residents.[1] The Court overturned the *Quill Corp. v. North Dakota* "physical presence" rule, arguing it was wrong when decided and has become unworkable in the age of e-commerce. Although *Wayfair* approved South Dakota's "economic nexus" statute, questions remain as to the limits of Commerce Clause nexus and whether statutes like South Dakota's can apply retroactively.

Quill Physical Presence Test

All but five states currently require in-state retailers to collect and remit sales tax on purchases by customers in their states. These states also impose tax at the same rate on purchases by in-state customers from out-of-state retailers when such retailers do not collect sales tax.

Until *Wayfair*, the Supreme Court had imposed a bright-line nexus standard for sales tax collection. In 1967, the Court in *National Bellas Hess, Inc. v. Dep't of Rev.* determined that both the due process clause and the dormant Commerce Clause enjoined enforcement of use tax collection when the retailer lacked a physical presence in the state.[2] *Quill*, decided 25 years later, overturned the *Bellas Hess* due process holding but maintained the physical presence requirement as "a means of limiting state burdens on interstate commerce."[3]

After 26 years, Congress has not accepted the *Quill* Court's invitation to address the physical presence rule through legislation. In 2013, the Senate approved the Marketplace Fairness Act, which would have authorized states to require most remote retailers to collect sales tax.[4] This and similar recent proposals have not reached a vote in the House, largely because of the efforts of Rep. Bob Goodlatte, R-Va., the outgoing Judiciary Committee chairman and a fervent *Quill* supporter.[5]

State Responses to the Growth of Online Retail

South Dakota and 41 states joining as *amici* argued that *Quill* has drained state coffers and put brick-and-mortar retailers at a competitive disadvantage. According to one academic study cited in South Dakota's brief, the physical presence rule cost state and local governments $23 billion of uncollected tax in 2012 alone.[6]

Wayfair and the other named respondents questioned the study's accuracy, arguing that a handful of large retailers that collect sales tax control the vast majority of the online retail marketplace, and that uncollected sales tax is rapidly declining due to market forces.[7]

[1] Justice Kennedy delivered the opinion of the Court, in which Justices Thomas, Ginsburg, Alito and Gorsuch joined. Justices Thomas and Gorsuch filed concurring opinions. Chief Justice Roberts filed a dissenting opinion, in which Justices Breyer, Sotomayor and Kagan joined.

[2] 386 U.S. 753 (1967).

[3] 504 U.S. 298 (1992).

[4] *See* Henry J. Reske, "U.S. Senate Approves Marketplace Fairness Act," State Tax Today (May 7, 2013).

[5] Amy Hamilton, "Why Goodlatte Blocks Remote Seller Proposals," State Tax Today (April 26, 2018).

[6] Petitioner's Brief at 34–35, *South Dakota v. Wayfair, Inc.*, No. 17-494 (U.S. Feb. 26, 2018).

[7] *See* Respondent's Brief at 47–53, *South Dakota v. Wayfair, Inc.*, No. 17-494 (U.S. March 28, 2018).

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In the years since *Quill*, states have sought to shore up sales tax compliance in ways that test the physical presence rule.[8] By the time *Wayfair* reached the Supreme Court, 22 states had adopted "click-through" nexus statutes whereby an out-of-state retailer must collect a state's sales tax if it receives substantial customer referrals through links on an in-state organization's website.[9] *Wayfair* itself noted that Ohio has adopted a "cookie nexus" statute, which defines physical presence to include making apps available to be downloaded by in-state residents and placing cookies on in-state residents' web browsers. Another 10 states have adopted Colorado-style reporting statutes, which require online retailers to inform both in-state customers and state taxing authorities of each customer's tax liability.[10]

Wayfair is a challenge to one of several state nexus statutes and regulations that discard the physical presence test in favor of "economic nexus." South Dakota's statute requires collection by any retailer transacting more than $100,000 of business or conducting more than 200 transactions annually with state residents. Several states enacted similar laws following Justice Anthony M. Kennedy's request in a 2015 concurrence that the legal system find an appropriate case for the Supreme Court to re-examine the physical presence test, which "now harms states to a degree far greater than could have been anticipated earlier."[11]

Physical Presence Rule Struck Down

The majority opinion found that the *Quill* physical presence rule is "flawed on its own terms," for three reasons. First, physical presence is not a necessary interpretation of the Commerce Clause nexus requirement. The opinion stops short of equating due process nexus limitations with Commerce Clause nexus limitations, but it notes that the standards have "significant parallels" and that a retailer could not be required to collect tax under the South Dakota statute "unless the seller availed itself of the substantial privilege of carrying on business in South Dakota."

Second, the Court found that the physical presence rule creates rather than resolves market distortions. It puts businesses with physical presence at a competitive disadvantage to remote sellers and discourages the development of physical presence that might be efficient or desirable.

Third, the Court found that the rule treats economically identical actors differently for arbitrary reasons. Modern Commerce Clause jurisprudence eschews formalistic distinctions like physical presence in favor of a sensitive, case-by-case analysis of purposes and effects.

The Court also reasoned that *Quill* makes even less sense in light of the subsequent expansion of e-commerce, which does not align analytically with the physical presence rule. A retailer without an in-state brick-and-mortar store or sales representatives might still be physically present if in-state customers access the retailer's website on their computers or download the retailer's app onto their phones, or if the company leases in-state data storage. States' inability to collect tax from these kinds of retailers places severe constraints on the states' ability to perform critical public functions. It is also unfair to the consumers and retailers that pay the tax and undermines public confidence in the tax system and the Court's Commerce Clause decisions.

Wayfair explains that *stare decisis*, which formed part of the basis of the *Quill* decision, can no longer support retention of the physical presence rule. Although the Court noted that Congress could overturn the rule by statute, it is not the Supreme Court's role "to ask Congress to address a false constitutional premise of this Court's own creation." The *Quill* Court did not have before it the present realities of the interstate marketplace, and the proliferation of state statutes designed to address the revenue shortfalls *Quill* has wrought would likely continue to "embroil courts in technical and arbitrary disputes about what counts as physical presence." Whereas *Quill* emphasized the reliance interest of remote retailers, *Wayfair* argues *stare decisis* accommodates only legitimate reliance interests. Everyone agrees that customers owe, but regularly fail to pay, sales tax on purchases from out-of-state retailers, and a business is in no position to found a constitutional right on the practical opportunities for tax avoidance.

[8] *See generally* Brief of Tax Foundation as *Amicus Curiae* in Support of Neither Party at 19–31, *South Dakota v. Wayfair, Inc.*, No. 17-494 (U.S. March 5, 2018).

[9] The New York State Court of Appeals upheld the first such statute in *Overstock.com, Inc. v. N.Y. State Dep't of Taxation & Fin.*, 20 N.Y.3d 586 (N.Y. 2013).

[10] The U.S. Court of Appeals for the Tenth Circuit approved Colorado's statute in *Direct Mktg. Ass'n v. Brohl*, 814 F.3d 1129 (10th Cir. 2016). In addition to the nexus question, these statutes raise privacy concerns because they require retailers to disclose what customers purchase online.

[11] *Direct Mktg. Ass'n v. Brohl*, 135 S. Ct. 1124, 1135 (2015) (Kennedy, J., concurring).

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Remaining Questions

The *Wayfair* decision is certainly groundbreaking but by no means completely unexpected.

Moreover, it leaves as many questions as it answers:

- If physical presence is no longer required for Commerce Clause nexus, what practical limit does the Commerce Clause present to imposition of the collection obligation?
- South Dakota's rule of $100,000 of business or 200 transactions passes muster since it is "a considerable amount of business," but what of the click-through nexus and cookie nexus statutes adopted in many other states without such thresholds?
- If the *Wayfair* decision makes the South Dakota rule a de facto safe harbor, are click-through and cookie nexus statutes, or Colorado-style reporting statutes, now obsolete?
- *Wayfair* also remarks approvingly that the South Dakota statute "is not retroactive," but it does not explicitly address whether due process forbids states to enforce collection obligations that accrued under this kind of statute when *Quill* was still the governing law.

Like *Quill*, *Wayfair* is certain to result in continued controversy until Congress acts.

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