Updates
June 22, 2018
South Dakota v. Wayfair: Practical Answers to Tax Questions Raised by Supreme Court Decision

Yesterday, the U.S. Supreme Court overruled more than 50 years of Commerce Clause precedent to hold that a state may require an out-of-state retailer with no physical presence in the taxing state to collect sales and use taxes on sales of goods and services delivered in the state. *South Dakota v. Wayfair, Inc.*, 585 U.S. ___ (2018). In a 5-4 decision, the Court concluded that its physical presence rule articulated in *National Bellas Hess, Inc. v. Dep't of Revenue of Ill.*, 386 U.S. 753 (1967) and reaffirmed in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), is "unsound and incorrect."

While much will be written on the merits of the decision, we wanted to share initial thoughts on some key practical questions.

What Is the Nexus Standard for Out-of-State Retailers After *Wayfair*?

After *Wayfair*, it is likely that a retailer will have substantial nexus under the Commerce Clause by virtue of making a single sale of goods or services for delivery into the taxing state. While not all states will require collection of sales and use taxes on such a weak basis, the *constitutional* nexus limitation after *Wayfair* is exceedingly low.

Wayfair provides that, in the absence of *Quill* and *Bellas Hess*, "nexus is established when the taxpayer [or collector] 'avails itself of the substantial privilege of carrying on business' in that jurisdiction." *Wayfair*, Slip Op. at 22 (citing *Polar Tankers, Inc. v. City of Valdez*, 557 U. S. 1, 11 (2009)). Although the Court noted that "Due Process and Commerce Clause [nexus] standards may not be identical or coterminous," there appears to be little practical difference between the standards. In most cases, a retailer that delivers goods or services into a state will be "availing" themselves of the privilege of carrying on business in that jurisdiction.

Wayfair addressed a South Dakota statute that was carefully crafted as a vehicle to overturn *Quill* and *Bellas Hess*. South Dakota's statute requires tax collection from retailers that deliver more than $100,000 per year in goods or services into the state or engage in 200 or more separate transactions for the delivery of goods or services into the state. While the Court favorably discussed South Dakota's small seller exemption, there is nothing in the decision to suggest that a small seller exemption is required for Commerce Clause nexus. E.g., Slip Op. at 21 ("South Dakota affords small merchants a reasonable degree of protections"). On the contrary, the Court suggests that "small businesses with only de minimis contacts" will need to rely on "other theories" to seek relief from burdensome tax collection systems. Slip Op. at 22. For example, a retailer may be able to establish that its sales/use tax collection system discriminates against or creates an undue burden on interstate commerce. Slip Op. at 22.

Although the constitutional nexus standard has been gutted, many states may have statutory protections that exceed the nexus requirements of the constitution. For example, South Dakota protects some small retailers by limiting sales/use tax collection to retailers with 200 or more South Dakota transactions or more than $100,000 in South Dakota sales during the previous or current calendar year.

It is also possible that Congress could enact a higher nexus standard through federal legislation as the Supreme Court has repeatedly invited Congress to do.

Does Wayfair Allow States to Retroactively Assess Out-of-State Retailers With No Physical Presence?

Technically, *Wayfair* is likely to operate retroactively. In some states, including South Dakota, retailers will be protected against retroactive application by state law. In practice, few states are likely to retroactively assess out-of-state retailers with no physical presence in the taxing state.

In briefing before the Supreme Court, 41 states jointly filed an amicus curiae brief to reassure the Supreme Court that retroactive application of any new decision would be unlikely and limited. The states asserted that states rules and administrative guidance "would limit retroactive enforcement of a new 'post-Quill' rule" in many states. Further, the states assured the Court that "amici States generally provide, as a matter of course, advance notice of significant regulatory changes, announcing both the nature of the change and its effective date." According to the states, "there is no reason to suspect that the amici States will deviate from their normal administrative procedures—including advance notice—when implementing this Court's new post-Quill precedent." Time will tell if states adhere to this optimistic view of their own self-restraint.

Although outright retroactive application of *Wayfair* may be unlikely, *Wayfair* may embolden states to pursue out-of-state retailers for past periods based on dubious "physical presence." In describing the challenges in applying the physical presence test, the Supreme Court noted that an out-of-state retailer "***may be said*** to have a ***physical presence*** in the State via the customers' computers" because "[a] website may leave cookies saved to the customers' hard drives, or customers may download the company's app onto their phones." Slip Op. at 15 (emphasis added). The Court specifically noted the "complexities of defining physical presence in the Cyber Age" and cited Massachusetts' "cookie" regulation and various state "click through" nexus statutes. While the Court did not explicitly endorse any of these expansive views of physical presence, *Wayfair* gives little comfort to retailers fighting expansive state views of physical presence.

Does *Wayfair* Impact Nexus for Income or Other Business Activity Taxes?

Wayfair addressed the physical presence nexus standard for sales and use tax collection. To the extent there was any doubt, *Wayfair* put to rest any arguments that the Commerce Clause requires physical presence for the state income or other business activity taxes. "[N]exus is established when the taxpayer [or collector] 'avails itself of the substantial privilege of carrying on business' in that jurisdiction" without regard to physical presence. *Wayfair*, Slip Op. at 22

Public Law 86-272, 15 U.S.C. § 381(a), however, still prohibits states from imposing a ***net income tax*** (but not other taxes) on sellers of tangible personal property that have no physical presence in the state or that limit their in-state activities to the solicitation of orders and ancillary activities.

What About Congress?

As *Wayfair* makes clear, Congress is free to regulate interstate commerce, including adopting a federal standard for the collection of sales and use taxes. Although Congress has the power, it will be politically difficult to enact any meaningful limitation on the states' newly won taxing power. To borrow a phrase from a former U.S. president, "there are no red states or blue states" with respect to protecting state taxing power. The threat of Congressional action, however, may restrain the states' more aggressive inclinations on questions like retroactivity and application to small businesses. For more information about *Wayfair* or to address issues triggered by the decision, please contact experienced counsel.

Authors

Explore more in

Tax Law Retail & Consumer Products

Related insights

Update

February Tip of the Month: Federal Court Issues Nationwide Injunction Against Trump Executive Orders on DEI Initiatives

Update

New US Commerce Prohibitions on Chinese and Russian Connected Vehicle Technology