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Digital Economy: Supreme Court Overturns Physical Presence Requirement for State Sales Tax

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In a landmark decision changing course on decades of precedent, the United States Supreme Court decided on June 21, 2018 *South Dakota v. Wayfair, Inc., et al*. Justice Kennedy, writing for the Court's 5-4 majority, expressly overruled the physical presence rule established over fifty years ago in *Bellas Hess*[1] and affirmed over twenty-five years ago in *Quill*,[2] which prohibited states from collecting sales tax from online vendors lacking an in-state physical presence. While the Court stopped short of formally declaring the South Dakota tax statute constitutional, instead remanding the case to the South Dakota Supreme Court to resolve any other potential arguments under the Court's "dormant Commerce Clause"[3] jurisprudence and under other existing case law,[4] the case strongly supports the view that the physical presence rule in *Quill* inadequately addressed the realities of the digital economy and its effects on interstate competition and state tax revenues.

Even under *Quill,* many states had passed a variety of measures aimed at recouping tax revenue from the expanding digital economy. These measures intended to capture sales and use tax revenue that had been lost from declining sales at brick-and-mortar retailers—where the right of a state to impose sales tax (regardless of the residence of the purchaser) is in no doubt. *Wayfair* is widely expected to be taken as a go-ahead for other states to adopt laws based on South Dakota's model statute (likely with an eye to the details noted in the Court's opinion). As a result, many internet-trade companies, especially smaller retailers, may face significant burdens in complying with the differing tax regimes of thousands of state and local jurisdictions.

The Majority Opinion's Reasoning

The Court's majority opinion declared that Quill was "unsound and incorrect."[5] The physical presence rule was 1) not a necessary interpretation of the *Complete Auto* substantial nexus requirement; 2) created rather than resolved market distortions; and 3) imposed an "arbitrary, formalistic distinction" of the type rejected by the Court's modern dormant Commerce Clause precedents. In addition, the Court noted that the physical presence rule was "an extraordinary imposition by the Judiciary on States' authority to collect taxes and perform critical public functions."

Throughout its opinion, the Court explained how the expansion of e-commerce had changed economic realities. *Quill* was decided prior to the Internet revolution, which exacerbated its shortcomings. As a result, the Court said, *Quill* "increased the revenue shortfall faced by States seeking to collect their sales and use taxes" and "put both local businesses and many interstate businesses with physical presence at a competitive disadvantage."

The Future of Taxation of Interstate E-Commerce

As noted, though the *Wayfair* decision overturned *Quill*'s physical presence standard, it left open the possibility of challenging state taxes on other grounds under existing general dormant Commerce Clause jurisprudence. As a result, the statute, upon remand (and any similar tax statutes passed by other states) generally will be subject to the four-pronged test from *Complete Auto*[6]. According to *Complete Auto*, state taxes are valid under the Court's dormant Commerce Clause jurisprudence so long as they 1) apply to an activity with a substantial nexus with the taxing state; 2) are fairly apportioned; 3) do not discriminate against interstate commerce; and 4) are fairly related to the services the state provides.

Applying the first element to South Dakota's statute, the Court stated that the nexus was "clearly sufficient" because the sellers' significant quantity of business could not have occurred unless they had availed themselves of "the substantial privilege of carrying on business in South Dakota."

The Court suggested, without deciding, that several limitations in South Dakota's statute would satisfy the second and third elements of the *Complete Auto* test. First, the law protected small retailers by setting a threshold requiring tax collection only from online vendors who conducted more than 200 separate in-state transactions or had annual in-state sales exceeding $100,000. Second, the obligation to collect tax did not apply retroactively. Third, South Dakota is one of more than 20 states that has adopted the Streamlined Sales and Use Tax Agreement, which reduces the administrative costs of compliance for retailers.

While states are widely expected to model legislation on the South Dakota statute, it remains to be seen just what modifications they will make, especially given the wide disparities between existing state tax regimes. States may attempt to lower the economic thresholds, even though they already provide scant protection in large states, such as California. Nor did the Court provide a clear answer on whether a retroactive statute would be unconstitutional. Finally, as acknowledged in the majority opinion, Congress may choose to resolve these remaining issues by taking action.

Please contact any of the authors listed here or any other Proskauer tax attorney with whom you normally consult to discuss the implications of *Wayfair* in your particular circumstances.

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[1] *National Bellas Hess, Inc. v. Department of Revenue of Ill.*, 386 U.S. 753 (1967).

[2] *Quill Corp. v. North Dakota,* 504 U.S. 298 (1992).

[3] U.S. Const. Article 1, Section 8, Clause 3.

[4] Specifically, the opinion remanded for consideration of the other prongs of the four-pronged test of*Complete Auto Transit, Inc. v Brady,* 430 U.S. 274 (1977). The first prong, requiring a substantial nexus, was the prong at issue in *Quill* and *Wayfair*.

[5] As noted, the Opinion of the Court was written by Justice Kennedy and joined by Justices Thomas, Ginsburg, Alito and Gorsuch. Importantly, Chief Justice Roberts's dissent (joined by Justices Breyer, Kagan and Sotomayor) takes little to no issue with the majority view that *Bellas Hass* and *Quill* were likely wrongly decided, but disagrees with the decision of the majority to overrule those decisions and would instead have put the issue squarely on Congress, where a number of bills to reach this result have been proposed over the years with no success.

[6] *Complete Auto Transit, Inc. v Brady* 430 U.S. 274 (1977).

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