The U.S. Supreme Court Invalidates the Physical Presence Standard It Previously Upheld in *Quill v. North Dakota*: Remote Sellers Beware!

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In what can only be described as a remarkable turn of events, the U.S. Supreme Court, in *South Dakota v. Wayfair, Inc.,* 585 U.S. ___ (2018), overruled the long-standing physical presence test for establishing nexus for sales and use tax under the U.S. Commerce Clause, which it previously upheld in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992). Reading the Court's opinion, it is difficult to comprehend that the same Court issued both decisions. The implications of this decision for remote sellers (*i.e*. out-of-state sellers) will likely be immediate and significant.

Physical Presence Has Been the Nexus Standard Since 1967

For over 50 years, following the Supreme Court's holding in *National Bellas Hess, Inc. v. Dep't of Revenue of Ill*., 386 U.S. 753 (1967), the applicable standard for determining whether sufficient nexus exists under the U.S. Commerce Clause to require a taxpayer to collect a state's sales or use tax has been one of physical presence. In addition to establishing a certain degree of certainty, this standard has also enabled remote sellers to make sales into a state without having to collect the host state's sales or use tax. In what may be a windfall for the States, the Supreme Court overruled that standard.

South Dakota's Law Directly Challenged the Validity of the Physical Presence Test

In 2016, South Dakota became the first state to enact a law that directly contradicts the physical presence standard established by the Court in *National Bellas Hess* and later upheld by the Court in *Quill*. The South Dakota law, S.B. 106, requires out-of-state sellers to collect South Dakota sales tax as if the seller had a physical presence in the state if the seller either (1) delivers more than $100,000 of goods or services into the state or (2) engages in 200 or more separate transactions for the delivery of goods or services into the state. The South Dakota law also precludes retroactive application of the new law. Following enactment of the new law, the State then sued Wayfair, Overstock.com, Inc. and Newegg ("Respondents"), seeking a declaration that the requirements of the law were valid and applicable to Respondents, as well as injunctive relief requiring Respondents to register for licenses to collect and remit sales tax.

The *Wayfair* Court Found the Physical Presence Test to Be Inherently "Flawed"

After an extensive review of its Commerce Clause jurisprudence, the Court concluded that modern precedents focus on two primary principles that mark the boundaries of a state's authority to regulate interstate commerce. First, a state may not discriminate against interstate commerce. Second, states may not impose undue burdens on interstate commerce. These general concepts, stated the Court, also led to its four-part test in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), which permits a state to tax interstate commerce as long as the taxing law: (1) applies to an activity with a substantial nexus with the taxing state; (2) is fairly apportioned; (3) does not discriminate against interstate commerce; and (4) is fairly related to the services the state provides.

In *Quill*, the Court noted, when it was asked to consider the continuing validity of the *National Bellas Hess* physical presence standard, that *Complete Auto* might have dictated a different result if the issue was being decided for the first time. Nevertheless, the Court in *Quill* upheld the physical presence test to prevent undue burdens on interstate commerce.

Exploring its prior holdings in *Quill* and *National Bellas Hess* and the implications of those holdings, the Court essentially found the physical presence test inherently flawed. First, stated the Court, the physical presence test is not required to establish substantial nexus under *Complete Auto*. Second, "*Quill* creates rather than resolves market distortions." Third, the Court found that *Quill* "imposes the sort of arbitrary, formalistic distinctions that the Court's modern Commerce Clause precedents disavow." According to the Court, *Quill* creates an inefficient "'online sales tax loophole' that gives out-of-state businesses an advantage." In effect, continued the Court, "*Quill* has come to serve as a judicially created tax shelter for businesses that decide to limit their physical presence and still sell their goods and services to a state's consumers, something that has become easier and more prevalent as technology has advanced."

The Administrative Cost of Compliance Is Unrelated to Physical Presence According to *Wayfair*

The Court also disavowed the basis for upholding the physical presence standard in *Quill*, namely the undue burden of subjecting retailers to tax collection obligations in thousands of different taxing jurisdictions. The Court found that the administrative costs of compliance are largely unrelated to whether a company happens to have a physical presence in a state. For example, stated the Court, a small company with a single sales person in each state would have a larger tax compliance burden than a large company with 500 salespersons in a single state.

The Court also questioned why a single employee or a single warehouse should create a substantial nexus while "'physical' aspects of pervasive modern technology should not." For example, stated the Court, a company with a website accessible in South Dakota may be said to have a physical presence in the state via the customers' computers. The Court noted that a website may leave cookies on a customer's hard drive, or a customer may download an app onto their phone, or a company may lease data storage that is permanently or occasionally located in the state. The Court also acknowledged difficulties the States are confronting in defining physical presence in the "Cyber Age," noting that some states have defined physical presence to include making apps available to in-state residents and placing cookies on in-state resident's computers; other states have enacted "click-through" legislation; and yet other states have imposed notice and reporting requirements on out-of-state sellers.

***Quill* Could Not Be Upheld on the Basis of Taxpayer Reliance or *Stare Decisis* Either**

The Court also addressed the concern of reliance, namely the argument that taxpayers have relied on the physical presence test to establish and grow companies without being exposed to the daunting complexity and obstacles of nationwide sales tax collection. The Court held that because *Quill* is no longer clear or easily applicable, arguments for reliance were misplaced. Furthermore, stated the Court, arguments for *stare decisis* must be founded on "legitimate

reliance concerns." In this case, stated the Court, a business "is in no position to found a constitutional right… on the practical opportunities for tax avoidance."

Small Businesses With Only *De Minimis* Contacts May Seek Relief Under Other Theories

Additionally, the Court noted that undue burden concerns may be legitimate in some instances, particularly for small businesses that make a small volume of sales to customers in many states. But the Court also noted that eventually software may be available at a reasonable cost to make it easier for small businesses to cope with these problems. The Court also stated that, "if some small businesses with only *de minimis* contacts seek relief from collection systems thought to be a burden, those entities may still do so under other theories." But the potential for this issue to arise did not warrant keeping the "artificial, anachronistic rule" that has been costing the States significant revenues from major businesses.

The Substantial Nexus Requirement Was Satisfied Under South Dakota's Law

Applying its holding to the South Dakota law, the Court summarily found that nexus was clearly established through both economic and virtual contacts Respondents have with the state. The Court declined to decide, however, whether some other principle of the Court's Commerce Clause jurisprudence might invalidate the South Dakota law, noting that those issues had not been litigated or briefed. Nevertheless, the Court observed that several features of the law appeared designed to prevent discrimination, including: (i) the law includes a safe harbor based on limited business activity in South Dakota; (ii) the law does not apply retroactively; and (iii) South Dakota has adopted the Streamlined Sales and Use Tax Agreement. The Court stated that any remaining arguments relating to the Commerce Clause may be addressed by the parties on remand.

There Are Many Remaining Questions Following *Wayfair*

There is much to be said about the Court's holding that will be written and discussed in the months and years to come. And the boundaries of the Court's holding will no doubt be the subject of much debate and litigation. Questions that remain to be answered include, in part, how much activity or business generated within a state will suffice to establish substantial nexus? While the Court found South Dakota's threshold standards to satisfy the substantial nexus requirement of *Complete Auto*, states will no doubt seek to lower those thresholds in their never-ending quest for generating tax revenues. Additionally, to what extent does the burden of complying with thousands of jurisdictions to collect and remit sales tax violate the U.S. Constitution, particularly with respect to smaller sellers? And perhaps equally if not more significantly, to what extent can or will *Wayfair* be applied retroactively?

For now, taxpayers can expect states to be aggressive in asserting nexus on the basis of the *Wayfair* decision with respect to remote sellers regardless of physical presence. If that alone were not a sufficient concern for these taxpayers, the extent to which a state will seek to apply this decision retroactively remains to be determined. Many states, including Texas, have enacted statutory provisions which provide that no statute of limitations applies for making an assessment against a taxpayer where the taxpayer has not filed returns. If a state seeks to apply

this decision retroactively, how far back will or could it attempt to go? And will retroactive application violate the U.S. Constitution under *Wayfair*?

As noted by the Court, Congress can certainly step in to legislate in this area. But should it choose to do so, to what extent could or would it apply any such federal law retroactively to potentially avoid huge assessments against taxpayers? All of these issues, and many more, remain to be determined, possibly through future litigation.

Remote sellers should be especially vigilant in the coming weeks and months as states announce how they will apply the Court's decision in *Wayfair*. In some instances, remote sellers may want to consider participating in an amnesty or voluntary disclosure program offered by the host state.