The Demise of the Physical Presence Standard for Sales Tax

THE UNITED STATES SUPREME COURT OVERTURNS QUILL

Introduction

On June 21, 2018, the United States Supreme Court ("the Court") reversed over 50 years of legal precedent that required a taxpayer to have a physical presence within a state before that state could impose its sales tax collection regime. In a narrow 5-4 decision, the Court ruled that the long-held physical presence standard is an "unsound and incorrect" interpretation of the U.S. Constitution's Commerce Clause in light of the current economic realities.

Historically, a state's authority to impose a sales tax collection and remittance obligation on out-of-state retailers has been limited to such retailer's physical presence within the state's jurisdiction; a rule born from the Court's 1992 decision in *Quill Corp. v. North Dakota* (1992)[1] upholding the physical presence standard adopted in *National Bellas Hess v. Ill.* (1967).[2]

Citing the incongruence and unfairness created by the physical presence standard (amongst numerous other issues beyond the scope of this alert) the Court changed course in its June decision in *South Dakota v. Wayfair, Inc.* (2018)[3] ruling to overturn the physical presence standard in favor of establishing a substantially broader "economic nexus" standard based on dollar value and volume of transactions within a state; a change that the Court believes will level the playing field between local brick-and-mortar retail operations and the growing e-commerce industry.

As it relates to sales tax collection and remittance, the Court's decision in *Wayfair* establishes a new economic and regulatory landscape for out-of-state retailers, but also creates uncertainty in regard to how states will prospectively adopt, implement, and enforce similar economic nexus laws in the coming months.

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Brief Analysis of South Dakota v. Wayfair

Three online retail merchants (Wayfair, Inc., Overstock.com, Inc., and Newegg, Inc.) challenged a 2016 South Dakota statute requiring a remote seller to collect and remit sales tax if such seller's annual sales to South Dakota customers exceeded $100,000 or 200 individual transactions. The law, targeting out-of-state businesses, was implemented due to concerns arising from the erosion of the state's sales tax base and related revenue loss (exasperated by the fact that South Dakota does not impose a state income tax and relies in large part on sales tax revenues to fund its governmental obligations) and the administrative difficulty of collecting the reciprocal use tax from South Dakota residents.

In its review of the case, the Court found that the physical presence standard allows for a "judicially created tax shelter" in the internet age, favoring out-of-state vendors at the expense of local businesses and creating market advantages with respect to the same or

[1] *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).
[2] *National Bellas Hess v. Department of Revenue of State of Illinois,* 386 U.S. 753 (1967).
[3] *South Dakota v. Wayfair, Inc. et al,* 585 U.S. ___ (2018).

similar goods. Furthermore, the Court found that substantial nexus may be established not only by physical presence, but also through "economic and virtual contacts" through the creation of online marketplaces for sales within a state.

Further, the Court found that any state regulation affecting interstate commerce must comply with the fundamental protections of the Commerce Clause, i.e., the regulation may not discriminate against or impose undue burdens on interstate commerce; must be fairly apportioned; and must be fairly related to the services provided by the states. The Court filtered the South Dakota statute through this rubric and found the following factors satisfied the Commerce Clause:

1. Safe harbor provision. The $100,000/200 transaction threshold does not discriminate but rather protects smaller businesses with limited remote sales into the state, thus avoiding the potential burden of sales tax collection in multiple states.
2. Retroactivity. The South Dakota statute, enacted in 2016, does not apply to sales prior to the date the statute became effective.
3. Streamlined collection. South Dakota, along with approximately 20 other states, adopted the Streamlined Sales and Use Tax Agreement, which provides a simplified, standardized method for collecting and remitting sales tax in multiple jurisdiction through state-provided sales tax software, reducing the time and cost of compliance.

These three deciding factors in the Court's holding create practical implications with respect to a state's enacted, proposed, or potential economic nexus legislation.

Some Anticipated Impact on Current State Economic Nexus Landscape

HCVT's previously released state tax alert[4] discussing *Wayfair* summarized the eight states imposing remote seller reporting and notification regimes, as well as the twelve states imposing some form of sales tax economic nexus. In the aftermath of the repeal of *Quill*, these states may be likely to face civil challenges to the constitutionality of the respective legislation imposed to the extent that it conforms, or fails to conform, with the Court's opinion as it relates to the South Dakota statute. For example, the Washington economic nexus trigger for sales tax filing is only $10,000 in the prior twelve-month period, compared to South Dakota's $100,000; at a tenth of the South Dakota threshold, it is unclear whether, as stated by the Court, the "seller [has] availed itself of the substantial privilege of carrying on business" in Washington such that the state does not burden interstate commerce by imposing a sales tax collection requirement or whether Washington's $10,000 sales threshold constitutes a taxpayer doing "a considerable amount of business in the State."

Recommendations

Because of the Court's decision, it is likely that states without economic nexus rules in effect will move quickly to pass legislation consistent with the standard decided in *Wayfair*. Although the Court attempted to draw some protective lines around taxpayers in its opinion, the attempt may still arguably appear imprecise. Many questions remain unanswered now that states have been unshackled from the restraints of the more stringent physical presence standard, including whether states will implement prospective and fair rules out of intrinsic fairness.

Due to the abrogation of *Quill* and the uncertainty created by this decision, we believe that it is more important now than ever that taxpayers evaluate their sales into all jurisdictions to understand whether the new precedent may create current or prospective requirements to collect and remit sales and use tax and to develop a comprehensive multistate strategy to navigate the new sales and use tax landscape.

If you have any questions on *Wayfair* and prospective strategy, please feel free contact any of the listed HCVT state tax professionals.

[4] No Sales Tax on E-commerce Sales… Guess Again…, https://www.hcvt.com/insights-alerts.html (March 20, 2018).