U.S. Supreme Court: States may require remote online retailers to collect sales tax

David M. Kall | Thursday, June 21, 2018

The U.S. Supreme Court today overturned over 50 years of its own precedent regarding state authority to collect sales tax from online merchants. In a divided 5-4 decision, the court in *South Dakota v. Wayfair* held that South Dakota may require remote sellers to collect sales tax from their consumers whether or not they have a physical presence in the state. As the court ruled, "physical presence is not necessary to create a substantial nexus."

The decision is expected to embolden states to ramp up sales and use tax enforcement efforts. In our alert "What the biggest sales tax case in 25 years means for your business," we discuss strategies for sales tax compliance in light of the *Wayfair* case. Businesses should be more mindful than ever to identify sales and use tax exposure, manage audit risk, and consider tax planning considerations in connection with business transactions.

THE EVOLVING LANDSCAPE

As tax experts parse the majority opinion in *Wayfair*, the question becomes: If not physical presence, then what? The legal boundaries of state taxation are somewhat uncertain now that the court has overruled the physical presence rule set forth in the 1967 case *Nat'l Bellas Hess v. Illinois* and reaffirmed in 1992 through *Quill Corp. v. North Dakota.*

The court offered little guidance in this regard. We know that states may use the threshold set forth in the South Dakota law to establish substantial nexus for taxing purposes. That law applies to sellers that, on an annual basis, deliver more than $100,000 of goods or services into South Dakota or engage in 200 or more separate transactions for the delivery of goods or services in the state. The South Dakota law also does not apply retroactively to transactions occurring prior to its enactment. States may follow this South Dakota model for establishing nexus standards on a prospective basis.

But states must be mindful that there are other components of the court's case law that could invalidate a state tax even where a state establishes substantial nexus. The court's doctrine is designed to limit state burdens on interstate commerce even where a taxing state has established a sufficient connection to impose a tax. The court in *Wayfair* noted that any remaining claims against the South Dakota law may now be resolved in South Dakota courts on remand.

THE LEGAL RATIONALE

There are a number of state laws with different thresholds, rules, and reporting requirements designed to promote tax compliance for internet or mail-order sales. For states with more aggressive laws, presently or at some time in the future, we must look for guidance in the court's *Wayfair* decision to determine whether there is substantial nexus to tax.

The court overturned *Nat'l Bellas Hess* and *Quill* for at least three major reasons. First, the court described the physical presence rules as "unfair and unjust." The court held that, in effect, the rule is a "judicially created tax shelter for businesses that limit their physical presence in a state but sell their goods and services to the state's consumers," something that has become easier in the internet age. The court was clearly concerned with leveling the playing field among internet and mail-order firms relative to in-state brick and mortar rivals.

Second, the court expressed concerns with state sovereignty and their ability to raise tax revenue to provide for essential government services. The court relied upon a report from the Government Accountability Office to find that the physical presence rules cause states to lose between $8 and $33 billion every year in tax revenue.

Thirdly, the court described the physical presence rule as an "artificial, anachronistic rule" that arbitrarily determines whether a business has nexus with a taxing state. What may have once been a clear or easily applicable standard is no more following the rise of e-commerce. The court raised serious concerns as to whether aspects of computerized technology and e-commerce actually create a physical presence in a taxing state. In the court's view, these are "technical and arbitrary disputes about what counts as physical presence" that bear little or no relation to whether a business has availed itself to a taxing state and exploited its marketplace.

With these considerations in mind, the court's majority declared that "In the name of federalism and free markets, *Quill* does harm to both."

POTENTIAL CONGRESSIONAL ACTION

The *Wayfair* decision may not be the end of the story. The court's majority opinion left the door open for Congress to step in if they disagree with the court's ruling in *Wayfair*. In fact, the court's dissenting justices would have deferred to Congress to decide whether to depart from the court's pre-*Wayfair* case law. In their view, the court's decision threatens small businesses now charged with costly sales tax compliance burdens and, further, has potential to detrimentally affect the U.S. market writ large. The dissent argued that Congress, not the judiciary, has the resources and expertise to investigate these matters and weigh competing concerns.

Despite recognizing that Congress may act in this area, the majority opinion also discussed competing concerns with state sovereignty and the state power to tax. "Congress cannot change the constitutional default rule," wrote Justice Kennedy, in discussing to what extent Congress may "limit[] the lawful prerogatives of the states."
How these competing concerns interact may be a question for another day. For now, the focus should be on business compliance as tax experts keep a watchful eye on developments in Congress and state legislatures across the country.

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