Sellers

In part one, I discussed the U.S. Supreme Court's big decision and touched on physical presence. In part two, I'll go a step further and break down the physical presence sales tax nexus standard, as well as South Dakota's nexus standard, as it relates...

Michael T. Dillon • Jul. 31, 2018

In part one, I discussed the U.S. Supreme Court's big decision and touched on physical presence. In part two, I'll go a step further and break down the physical presence sales tax nexus standard, as well as South Dakota's nexus standard, as it relates to Wayfair Court.

[Read Part 1 — Read Part 3]

WAYFAIR COURT'S CONSIDERATION OF THE PHYSICAL PRESENCE SALES TAX NEXUS STANDARD

In *Direct Marketing Association v. Brohl*, Justice Kennedy called for states to enact legislation that would enable the Court to reconsider its 1992 decision in *Quill*. The majority opinion notes that "[e]ach year, the physical presence rule becomes further removed from economic reality and results in significant revenue losses to States." Chief Justice Roberts wrote a dissenting opinion, in which he was joined by Justices Breyer, Sotomayor and Kagan.

The Commerce Clause Doctrine Applied by the Court: Justice Kennedy began the Court's analysis with a historical summary of the Court's Commerce Clause jurisprudence, noting that "Two primary principles mark the boundaries of a State's authority to regulate interstate commerce: State regulations may not discriminate against interstate commerce; and States may not impose undue burdens on interstate commerce." He then noted that the validity of state taxes under Commerce Clause precedents require that state taxes "will be sustained so long as they (1) apply to an

Court first stated that "*Quill* is flawed on its own terms," providing that "[t]he reasons given in *Quill* for rejecting the physical presence rule for due process purposes apply as well to the question whether physical presence is a requisite for an out-of-state seller's liability to remit sales taxes. Physical presence is not necessary to create a substantial nexus."

Physical Presence Creates Market Distortions: Second, the Court focused on the market distortions created by the physical presence standard, noting that "Q*uill* puts both local businesses and many interstate businesses with physical presence at a competitive disadvantage, relative to remote sellers. Remote sellers can avoid the regulatory burdens of tax and can offer *de facto* lower prices caused by the widespread failure of consumers to pay the tax on their own," in effect producing "an incentive to avoid physical presence" and investment in multiple states. To this, the Court's opinion states that "it is certainly not the purpose of the Commerce Clause to permit the Judiciary to create market distortions" or "judicially created tax shelter[s]."

Physical Presence is an Arbitrary Standard: The Court next considered the Court's Commerce Clause jurisprudence, providing that it avoids formal standards in favor of "a sensitive, case-by-case analysis of purposes and effects." The Court concluded that "*Quill*, in contrast, treats economically identical actors differently," and for arbitrary reasons, cited an example of similarly situated sellers, one with inventory in a state and one without. Noting that the former seller would be required to collect sales tax under the physical presence rule, the Court stated that courts should not invalidate laws based on outdated or anachronistic formalisms, but should consider "functional, marketplace dynamics, on which states can rely in enacting and enforcing their laws."

The Court provided that "[m]odern e-commerce does not align analytically with a test that relies on the sort of physical presence defined in *Quill*," stating that "it is not clear why a single employee or a single warehouse should create a substantial nexus,

Court's opinion continues that not only is the physical presence standard legally wrong, but that it also creates an extraordinary imposition on state authority to raise revenue and carry out critical public functions. In a direct attack on Wayfair itself, the Court stated that: "What Wayfair ignores in its subtle offer to assist in tax evasion is that creating a dream home assumes solvent state and local governments. State taxes fund the police and fire departments that protect the homes containing their customers' furniture and ensure goods are safely delivered; maintain the public roads and municipal services that allow communication with and access to customers; support the 'sound local banking institutions to support credit transactions [and] courts to ensure collection of the purchase price' … and help create the 'climate of consumer confidence' that facilitates sales."

In terms of fairness, the Court's opinion provides that "there is nothing unfair about requiring companies that avail themselves of the States' benefits to bear an equal share of the burden of tax collection." According to the Court, "it is essential to public confidence in the tax system that the Court avoid creating inequitable exceptions. This is also essential to the confidence placed in this Court's Commerce Clause decisions. Yet, the physical presence rule undermines that necessary confidence by giving some online retailers an arbitrary advantage over their competitors who collect state sales taxes."

"Stare Decisis" Cannot Protect the Court's Prior Error: Considering the issue of *stare decisis* (the notion that cases must be decided the same way when their material facts are the same), the Court found ample distinguishing facts to overturn *Quill*, regardless of the principle of *stare decisis* for these five reasons:

1. The Court concluded that *stare decisis* "can no longer support the Court's prohibition of a valid exercise of the States' sovereign power."

2. It stated that when the Court is wrong, it "should be vigilant in correcting the

interests," calling the tax distortion created by Quill an opportunity for tax avoidance "in large part because consumers regularly fail to comply with lawful use taxes," a fact exploited by remote sellers who advertise sales as tax free.
5. As for concerns regarding the complexity of multistate sales tax compliance, the Court noted that "eventually, software that is available at a reasonable cost may make it easier for small businesses to cope with these problems ... and, in all events, Congress may legislate to address these problems if it deems it necessary and fit to do so."

WAYFAIR COURT'S CONSIDERATION OF THE SOUTH DAKOTA NEXUS STANDARD

While the Court declined to adopt a new sales tax nexus standard, in considering the South Dakota law at issue, the Court summarized that the South Dakota nexus standard:

- requires businesses whose sales exceed the safe harbor threshold of $100,000 in annual sales or 200 separate transactions to collect sales tax,
- does not apply retroactively, and
- is effective in a state that is party to the Streamlined Sales Tax Agreement.

The Court also stated that its "Commerce Clause doctrine can protect against any undue burden on interstate commerce." For example, the risk of discrimination can be avoided because the in-state sellers collect and remit the same taxes as remote sellers, and while the Court noted that some small businesses with only *de minimis* contacts may seek to challenge the constitutionality of state tax collections thought to be a burden, "[t]hese issues are not before the Court in the instant case, and their potential to arise in some later case cannot justify retaining this artificial, anachronistic rule that deprives States of vast revenues from major businesses."

In considering the constitutionality of the South Dakota nexus standard under the

nexus standards that include three features designed to prevent discrimination against, or undue burdens upon, interstate commerce:

1. The Act applies a safe harbor to those who transact only limited business in South Dakota.
2. The Act ensures that no obligation to remit the sales tax may be applied retroactively.
3. South Dakota is one of more than 20 states that adopted the Streamlined Sales and Use Tax Agreement. This system standardizes taxes to reduce administrative and compliance costs. It requires a single, state level tax administration, uniform definitions of products and services, simplified tax rate structures, and other uniform rules. It also provides sellers access to sales tax administration software paid for by the state. Sellers who choose to use such software are immune from audit liability.

The Court then vacated the judgment of the Supreme Court of South Dakota and noted that any such claims may be asserted on remand, consistent with its over ruling of the physical presence standard.

What’s Next: Part 3

As you can see in part two, Wayfair consideration of the physical presence sales tax nexus standard is complex, but how exactly does it affect remote sellers and what is their impact in particular states? Stay tuned for part three of this series.

Go to Part 3.

===========

Michael T. Dillon, Esq. is president of Dillon Tax Consulting LLC. Contact him at