

Insights: Alerts

South Dakota v. Wayfair: Three Open Issues

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Yesterday, in *South Dakota v. Wayfair*, the United States Supreme Court abandoned its longstanding physical presence nexus standard for sales/use tax collection. From May 8, 1967 to June 21, 2018, under the Court's precedents, a seller could not constitutionally be required to collect sales/use tax in a state absent a physical presence in the state. Following the Court's opinion yesterday, remote sellers with no physical presence, but with substantial virtual and economic presence, can be forced to collect sales/use tax without the commerce clause being violated.

This holding was not entirely unexpected. Justice Kennedy, the author of the opinion, had previously broadcasted his view that the Court's sales/use tax nexus precedents were outdated in light of modern technologies and electronic commerce business models.

While the opinion is a big victory for the states, it also acknowledges that there are still some constitutional limits on sales/use tax collection, without detailing what those limits are, other than by saying that sales/use tax collection schemes cannot unduly burden interstate commerce. This alert first briefly summarizes the Court's opinion, and then discusses three issues that the opinion leaves open.

The Opinion

From the start, the Court frames the issue as one of tax collection. No new tax is being imposed by South Dakota – rather the opinion is addressing the circumstances under which South Dakota can force a seller to collect and remit a sales/use tax.

The meat of the Court's opinion is a discussion of *Quill*'s “flaws” (the Court's word). As explained by the Court, the *Quill* physical presence nexus standard is an “artificial” rule that “does not align analytically” with “modern e-commerce.” Physical presence nexus, per the Court, gives an unfair and “arbitrary advantage [to remote sellers that do not collect tax] over their competitors who collect state sales taxes.” Further, physical presence nexus creates economic distortions by providing a disincentive to expand physical operations into new states (because creating a footprint in a new state results in nexus in the new state). For these reasons, the Court conceives of physical presence as inconsistent with principles of federalism and free markets, rather than as a standard that advances those principles.

Explaining *Quill* and *National Bellas Hess*, the Court writes that those opinions were decided in a different time, before electronic commerce exploded. It would be foolhardy, in the Court's opinion, to cling to the reasoning of its prior opinions and try to force them to apply to entirely new business models, such as internet sales, that

implicate different considerations. Therefore, the Court explains that it is abrogating *Quill* and the physical presence nexus standard, vacating the lower court opinion, and remanding the case for “proceedings not inconsistent with this opinion” (at least allowing respondents to offer as-applied challenges on their specific facts).

Open Issue: A New Three Features Test?

Overall, the Court's opinion focuses much more on *Quill*'s flaws and on explaining deficiencies with the physical presence nexus standard than on prescribing an alternative. However, the language in the coda to the opinion highlights three “features” of the “South Dakota tax system” in blessing its constitutionality:

- South Dakota has adopted the Streamlined Sales and Use Tax Agreement (“SSUTA”), meaning that South Dakota uses standardized definitions of products and services and also provides sellers access to software paid for by the state
- South Dakota's economic nexus rule is prospective only
- South Dakota has a small seller exception

Notably, the Court describes these three things as “features” and does not say that it has created a new three-part test to assess the constitutionality of a sales tax economic nexus statute. However, the Court also offers that these features “appear designed to prevent discrimination against or undue burdens upon interstate commerce.” This language leaves room for challenges to state sales/use tax economic nexus statutes in states that do not offer these same three features (or substantially similar safeguards). As the Court explains it, sales/use tax collection schemes cannot produce undue burdens, and a collection scheme that does not alleviate burdens the way the South Dakota statute does would at the very least present a different case than *Wayfair*.

Open Issue: Potential For As-Applied Challenges?

The Court's opinion also leaves the door open for businesses with only “*de minimis*” contacts with a state to show that the state's economic nexus sales/use tax statute, while generally constitutional, operates in an unconstitutional way as applied to the business's specific and individual facts. The Court acknowledges the likelihood of such challenges in future cases, but says that the issues presented by such cases “are not before the Court.”

Interestingly, it should not be difficult for many small sellers to argue that they have *de minimis* contacts with South Dakota, especially compared to the “major internet retailers” (the Court's phrasing) before the Court in *Wayfair*, described as “large, national companies that undoubtedly maintain an extensive [economic and] virtual presence” in South Dakota. Had the Court simply abrogated *Quill* and ruled the South Dakota statute facially constitutional, there would have been less of an opening for small sellers. But by placing some emphasis on the size and national reach of the respondents, and by acknowledging that “complex state tax systems could be a burden on small business,” the Court leaves an opening for small sellers to argue that the South Dakota tax system unconstitutionally burdens them on their specific facts.

Also in connection with as-applied challenges, it is perhaps noteworthy that the Court's opinion does not discuss application of the South Dakota tax scheme to online service providers that, unlike respondents, do not ship goods into South Dakota, and do not compete chiefly with physical retailers. At least arguably such businesses

have different economic and virtual presence in South Dakota than do respondents, and therefore a sales/use tax collection scheme could produce different burdens as applied to their business models.

None of this is to say that as-applied challenges will necessarily be successful– it seems most likely that the devil is in the details and the likelihood of any as-applied challenge will depend on a remote seller's specific and individualized facts. That said, the Court plainly left the door open for challenges by acknowledging that they are likely to arise and by declining to address them.

Open Issue: Economic Nexus Thresholds?

In noting the South Dakota economic nexus thresholds (\$100,000 of goods or services into South Dakota or 200 or more separate transactions for the delivery of goods and services into the State on an annual basis), the Court writes that “this quantity of business could not have occurred unless the seller availed itself of the substantial privilege of carrying on business in South Dakota.” The Court also says in a different part of the opinion that “the law at issue requires a merchant to collect the tax only if it does a considerable amount of business in the State.”

These sentences seem to endorse South Dakota's thresholds, but there is no discussion of how satisfactory the Court thinks these thresholds are. There is also no discussion about how to export the same thresholds to other states. If \$100,000 / 200 are constitutionally sufficient thresholds in South Dakota, does that mean that the same thresholds are constitutionally sufficient in all other states? Consider that South Dakota is not a particularly representative state economically – it typically vies with Montana, Wyoming, Vermont, and Alaska for the lowest State GDP. In contrast, the California GDP was roughly 55 times that of South Dakota's for a recent quarter, according to the Bureau of Productivity Analytics. Does that mean that, to be constitutional, the “small seller” threshold in a larger state like California needs to be many multiples higher than the South Dakota threshold?

The Court, while acknowledging that it is addressing a national nexus issue, does not provide guidelines on how much economic nexus might be satisfactory in other states, or if the South Dakota thresholds are constitutionally sufficient everywhere, instead leaving this issue unaddressed.

Conclusion

In an eagerly-awaited decision, the United States Supreme Court has abrogated *Quill* and upended its longstanding physical presence sales/use tax nexus standard. The states have been calling for the Court to do this for many years. Following the opinion, it is clear that the states now generally possess the ability to force large, national retailers to collect sales/use tax, even if such large, national retailers lack physical presence in a state. However, the Court's opinion also acknowledges that under at least some circumstances forcing remote sellers to collect sales/use tax could unduly burden interstate commerce. Resolving what those circumstances are is a vexing question that the Court's opinion leaves open for another day.

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