

U.S. Supreme Court Overrules “Physical Presence” Standard - Potentially Opening the Door for States to Collect Sales Tax on Online Sales

by Jeffrey A. Rossman

A FREEBORN & PETERS LLP CLIENT ALERT

ABOUT THIS CLIENT ALERT:

This Client Alert addresses the U.S. Supreme Court’s decision in *South Dakota v. Wayfair*, which overturned the physical presence nexus rule established in 1992 in *Quill Corp. v. North Dakota*. This is a significant decision which will likely open the door for states to tax online retailers who have no physical presence in the state.



On June 21, 2018, in a 5-4 decision, the U.S. Supreme Court overruled its prior decision in *Quill Corp. v. North Dakota*, disposing of the “physical presence” rule that had long served as a bright-line test for whether a state could require out-of-state retailers to collect state sales tax.

BACKGROUND

In *South Dakota v. Wayfair*, the U.S. Supreme Court expanded a state’s right to tax out-of-state retailers or, more appropriately, to require out-of-state retailers to collect state sales tax for sales into the state. Through a series of prior decisions, the U.S. Supreme Court had developed a regulatory framework limiting the states’ ability to tax out-of-state retailers based on the Commerce Clause. In 1977, the U.S. Supreme Court issued one of the first decisions in this series, *Complete Auto Transit, Inc. v. Brady*, which held that a state’s tax on an out-of-state retailer’s activities will meet the requirements of the Commerce Clause so long as the tax (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 1992, the U.S. Supreme Court issued another important decision regarding taxation of out-of-state retailers, *Quill Corp. v. North Dakota*, which addressed the first prong of the *Complete Auto* test. In *Quill*, the Court held that, in order for there to be substantial nexus, the out-of-state retailer had to have a physical presence (like stores, warehouses, or employees) in the state.

PHYSICAL PRESENCE NOT NECESSARY FOR “SUBSTANTIAL NEXUS”

For the next two-and-a-half decades, *Quill* remained the last word on the issue. Then, in 2016, in a direct assault on *Quill* the South Dakota legislature passed a law which created a sales tax collection obligation for taxpayers with sales into South Dakota in excess of \$100,000 or 200 discrete transactions annually, even if those sellers had no physical presence in the state. The online home-goods store Wayfair challenged the tax, and the resulting case eventually reached the U.S. Supreme Court. In a 5-4 decision, the U.S. Supreme Court overturned the physical presence standard in *South Dakota v. Wayfair*, finding it “unsound” and “incorrect.” Instead, the Court found that a state has a “substantial nexus” with a taxpayer if that taxpayer (or collector) avails itself of the substantial privilege of carrying out business in that jurisdiction. Given the minimum quantity standards set forth in the South Dakota law, the Court found “[t]his quantity of business could not have occurred unless the seller availed itself of the substantial privilege of carrying on business in South Dakota.”

The 5-4 opinion was written by Justice Kennedy with concurrences from Justice Thomas and Justice Gorsuch. The dissent authored by Chief Justice Roberts, while critical of the physical presence rule in *Quill*, would have upheld the 1992 decision based on precedential grounds and concerns over the administrative burden on taxpayers.

The Court’s holding was limited to the physical presence issue and specifically noted that the “question remains whether some other principle in the Court’s Commerce Clause doctrine might invalidate the Act,” such as the so-called “Dormant Commerce Clause,” which is the doctrine that prevents states from discriminating against out-of-state businesses in favor of in-state ones. The Court said that those issues may be addressed on remand, but noted three aspects of the South Dakota law that “appear designed to prevent discrimination against or undue burdens upon interstate commerce.” First, the law had a threshold requirement and exempted sellers who only had limited sales in the state. Second, the law was not retroactive in application. Third, South Dakota was one of more than 20 States that have adopted the Streamlined Sales and Use Tax Agreement, which helps reduce the administrative and compliance costs by creating uniform rules and definitions.

IMPLICATIONS

The decision is significant as it does away with the physical presence requirement. States now have more flexibility in taxing the sales of online and out-of-state retailers, and retailers who lack a physical presence in a state may soon be required to collect state sales tax. However, the decision left open a number of issues that almost certainly will lead to further

ABOUT THE AUTHOR



Jeffrey A. Rossman

Partner

Chicago Office
(312) 360-6784

jrossman@freeborn.com

Jeff is a Partner in the Litigation Practice Group. In addition to his extensive trial and appellate experience, he regularly counsels clients on state and local tax matters across the country.

litigation. Also, while the Court indicated that it found aspects of the South Dakota law reasonable and likely to survive Commerce Clause scrutiny, the same may not be true for other states' laws that differ from South Dakota's law.

In the wake of *South Dakota v. Wayfair*, we can expect that states will ramp up their enforcement efforts against out-of-state retailers. Over 30 states have laws that purport to tax out-of-state sales, and it is very likely more states will follow suit by revamping their laws in light of this decision.

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CHICAGO

311 South Wacker Drive
Suite 3000
Chicago, IL 60606
(312) 360-6000
(312) 360-6520 fax

NEW YORK

230 Park Avenue
Suite 630
New York, NY 10169
(212) 218-8760
(212) 218-8761 fax

SPRINGFIELD

217 East Monroe Street
Suite 202
Springfield, IL 62701
(217) 535-1060
(217) 535-1069 fax

RICHMOND

411 East Franklin Street
Suite 200
Richmond, VA 23219
(804) 644-1300
(804) 644-1354 fax

TAMPA

1 Tampa City Center
201 North Franklin Street
Suite 3550
Tampa, FL 33602
(813) 488-2920

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