

U.S. Supreme Court Ruling Expands States' Capacity to Require Out-of-State Sellers to Collect and Remit Sales Tax

Overview

On Wednesday June 21, 2018, the U.S. Supreme Court released its decision in *South Dakota v. Wayfair, Inc., et. al.*, (585 U.S. ___ (2018)) holding that South Dakota's sales tax statute does not violate the Commerce Clause of the U.S. Constitution. The decision opens up the door for states to tax out-of-state sellers including sales over the internet. The Court's ruling overruled the "physical presence" test under *Quill Corp. v. North Dakota* (504 U.S. 298 (1992)) that generally required out-of-state sellers to have a physical presence in a state in order to be subject to that state's sales tax collection and remittance rules.

Quill was decided in an era when out-of-state sales originated primarily from mail-order and direct marketing. Since then the internet has transformed the way consumers make purchases as well as the ability of businesses to reach a larger marketplace more economically than ever before. Accordingly, many businesses desiring a national marketplace no longer needed a physical presence outside of their own home state. As Justice Kennedy notes in the *Wayfair* decision, "[m]odern e-commerce does not align analytically with a test that relies on the sort of physical presence defined in *Quill*."

In *Wayfair*, the Court noted that the inability for many states to tax internet sales causes estimated revenue losses of between \$8 billion and \$33 billion to the states. Local businesses complained that they were being placed at a competitive disadvantage since consumers could purchase items online and not have to pay the sales tax that local stores were charging for the same goods. States began enacting laws to chip away at the *Quill* physical presence rule.

South Dakota Law

In 2016, South Dakota enacted a sales tax law with the specific aim of having the U.S. Supreme Court overrule *Quill*. South Dakota's law moved away from a physical presence requirement and towards an "economic nexus" requirement. Under the law, a sufficient economic connection to South Dakota would be enough to subject an out-of-state seller to South Dakota's sales tax rules even if the seller had no physical location in South Dakota.

The South Dakota law required out-of-state sellers to collect and remit sales tax if the seller either delivered more than \$100,000 of goods or services into the state or engaged in 200 or more separate transactions for the delivery of goods or services in the state.

After the law was enacted, South Dakota filed a declaratory action against out-of-state retailers Wayfair, Inc., Overstock.com, Inc., and Newegg, Inc., seeking a judgment that the law was valid and requesting an injunction requiring the three companies to register to collect and remit sales tax. The South Dakota Supreme Court held that the law was invalid under the Commerce Clause, but the U.S. Supreme Court reversed, remitting the case back to the state courts.

The Court, in reversing the state court decision, noted that "[e]ach year, the physical presence rule becomes further removed from economic reality and results in significant revenue losses to the States." For instance, a Company's website could create a physical presence in a state by "leav[ing] cookies saved to the customers' hard drives" or allowing a customer to "download the company's app onto their phones." The Court noted that "a virtual showroom can show far more inventory, in far more detail, and with greater opportunities for

consumer and seller interaction than might be possible for local stores.” According to the Court, the “pervasive virtual presence” of retailers on the web should not be ignored when determining if a company has a presence in a state.

The Court ultimately held that the physical presence rule “intrudes on States’ reasonable choices in enacting their tax systems,” going so far as stating that *Quill* was wrong on its own terms even when decided in 1992. After the *Wayfair* decision, the physical presence test is no longer a requirement for states to impose sales tax.

What does this mean for your business?

Despite the ruling, there is still great uncertainty regarding sales tax and remote sellers. The Court did not give states carte blanche to require every company to collect sales tax in every state in which it makes a sale. Rather, the Court gave states wider discretion to enact laws and regulations to broaden the states’ sales tax base. The Court noted that a state can still only apply a tax to an activity “with a substantial nexus with the taxing state.” However, there is no longer a bright line standard such as requiring physical presence in determining whether there is a substantial nexus.

One likely outcome of the decision is that the sales tax landscape will become more fragmented, with different states adopting different rules potentially limiting consistency among the states. In fact, some states have already enacted legislation in anticipation of *Quill* being overturned.

Companies with sales across state lines should review their sales tax collection policies and procedures and prepare for a potential increase in tax collecting responsibilities.

Open questions

The Court ruling is not the end of the discussion and possibly just a starting point for determining whether a company must collect and remit sales taxes in various jurisdictions. Among some initial open questions regarding the case and sales taxes are:

- What constitutes “substantial nexus” now?
- Can a state subject companies to retroactive sales tax collection?
- What are the implications for third-party sellers on marketplace platforms (such as Amazon)?
- Will states continue to try to expand their tax base by changing laws to tax service providers?
- Will Congress intervene and implement rules governing when states can subject out-of-state sellers to sales tax collections and remittance requirements?
- Could income tax nexus be the next area to be changed?

As we roll into the summer months, we can expect more states to weigh in on this issue. Since 41 states signed onto briefs urging the Supreme Court to overrule *Quill*, it may be safe to say that many companies’ sales tax exposures may be increasing in the near future. Stay tuned!

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