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Tax Alert
News Concerning Recent Developments in Tax Law

COZEN O'CONNOR

Wayfair Decided – E-commerce Subject to Use Tax Collection

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In a 5-4 decision, the U.S. Supreme Court ruled that out-of-state online retailers can be held responsible for collecting use tax from their customers without having a physical presence in the state. *South Dakota v. Wayfair, Inc.*, No. 17-494 (U.S. June 21, 2018). The decision overturned more than 50 years of jurisprudence requiring retailers to have a physical presence in a state before they can be required to collect and remit any sales and use taxes on purchases. *See National Bellas Hess v. Department of Revenue of Ill.*, 386 U.S. 753 (1967) and *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992). Justice Kennedy wrote the opinion for the Court and was joined by Justices Thomas, Ginsburg, Alito, and Gorsuch. A strong dissent was authored by Chief Justice Roberts, joined in by Justices Breyer, Sotomayor, and Kagan. The Court remanded the case to the South Dakota Supreme Court to consider whether the specific provisions in the South Dakota Act met the otherwise applicable Commerce Clause requirements for taxing interstate commerce.

In 2016, South Dakota enacted S.B. 106 (the Act) that required remote out-of-state e-commerce sellers to collect and remit use tax on sales to South Dakota residents. The legislature intended to apply the South Dakota sale and use tax obligations to the limit of the federal and state constitutions. Act § 8(11), (8). In order for the remote seller to be responsible for the collection and remittance of use tax, it had to meet one of the following conditions: (1) On an annual basis deliver more than $100,000 of goods or services into South Dakota; or (2) engage in 200 or more separate transactions for the delivery of goods or services into the state. The Act further foreclosed any retroactive application of the requirement and provided means for the Act to be stayed until the constitutionality of the Act was established. South Dakota filed a declaratory judgment against three national retailers with no physical presence within South Dakota but otherwise met the requirements for the collection of use tax under the Act. Because both *Bellas Hess* and *Quill* were controlling precedent on the limitations of the Commerce Clause, the courts in South Dakota found in favor of the national online retailers. The Supreme Court then granted certiorari.

The Constitution grants Congress the power "[t]o regulate Commerce … among the several States." Art. I, §8. The Court noted that two principles guide the courts in adjudicating challenges to state laws under the Commerce Clause: (1) State regulations may not discriminate against interstate commerce; and (2) States may not impose undue burdens in interstate commerce. In *Complete Auto Transit, Inc., v. Brady*, 430 U.S. 274 (1977), the Court held that a "Court will sustain a tax so long as it (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." *Id.* at 279. In *Bellas Hess*, (decided before *Complete Auto Transit*), the Court concluded that a "seller whose only connection to the state was by common carrier or mail, did not have the requisite minimum contacts" required by the Due Process and the Commerce clauses to be forced to collect and remit use tax on those sales. *Bellas Hess*, 368 U.S. at 758. Subsequently, *Quill* overruled the due process holding of *Bellas Hess* but upheld the Commerce Clause requirement that physical presence was needed to prevent undue burdens on interstate commerce. 504 U.S. at 313. *Quill* grounded the physical presence rule as part of the substantial nexus requirement stated in *Complete Auto Transit. Id.* at 311.

The Court stated that the physical presence test has been the target of criticism for many years. See *Direct Marketing Assoc. v. Brohl*, 814 F.3d 1129, 1148, 1150-1151 (CA10 2016) (Gorsuch, J. concurring). The Court indicated that the physical presence test noted in *Quill* was flawed for three reasons. First, substantial nexus under *Complete Auto* does not necessarily need a physical presence. Second, the test set out in *Quill* creates market distortions rather than eliminates them. Finally, the physical presence test imposes an arbitrary formalistic distinction inconsistent with modern Commerce Clause precedents.

The Court further stated that the e-commerce remote sellers without a physical presence in a state could avoid the regulatory burdens of tax collection and offer de facto lower prices caused by the widespread failure of consumers to pay these taxes on their own. “In effect, *Quill* has come to serve as a judicially created tax shelter for businesses that decide to limit their physical presence and still sell their goods and services to a State’s consumers — something that has become easier and more prevalent as technology has advanced.” Slip. Op. at 13. The Court concluded that rejecting the physical presence rule was necessary to ensure that artificial competitive advantages were not created by the Court’s prior precedents of *Bellas Hess* and *Quill*.

The Court indicated that Commerce Clause analysis must be based on functional, marketplace dynamics and states need to consider those realities in enacting and enforcing their tax laws. At the time of *Quill* less than 2 percent of Americans had internet access; today, access to the internet is about 89 percent and has changed the dynamics of the national economy. As a result, physical presence is no longer a workable standard.

Nonetheless, although *Quill* is overruled, the remaining Commerce Clause analysis was not repealed. Substantial nexus is still required and the Commerce Clause still forbids a state from imposing an undue burden on interstate commerce. The Court noted that other states have used various approaches to define the degree of presence that will survive a Commerce Clause challenge. The Court noted the following examples:

> A Massachusetts regulation states a taxable presence includes making apps available to be downloaded by in-state residents and placing cookies on in-state residents’ web browsers. 830 Code Mass Regs. 64H.1.7 (2017);
>
> New York enacted a “click-through” nexus statute which defines nexus to include out-of-state sellers that contract with in-state residents who refer customers for payment. N.Y. Tax Law Ann. §1101(b)(8)(iv); and
>
> Colorado enacted notice and reporting requirements on out-of-state retailers that fall just short of requiring collecting and remitting the tax. Colo. Rev. Stat. 39-21-112(3.5). (Pennsylvania used this approach in Act 43 of 2017 which requires either collecting tax or notice and reporting.)

The Court noted several features in South Dakota’s Act that may avoid a finding of an undue Commerce Clause burden. First, the Act applies a safe harbor to those entities that transact only limited business in South Dakota. Second, there was no obligation to remit sales tax retroactively. Third, South Dakota was one of 20 states that has adopted the Streamlined Sales and Use Tax Agreement (Streamlined Agreement) with uniform definitions of products and services, standardized tax rate structures, and other uniform rules to reduce administrative and compliance costs. The Court intimated that these features should be considered on remand.

Thus, with the physical presence test eliminated, states can force out-of-state e-commerce retailers to collect and remit use tax for sales made in their respective states to their residents without a physical presence of the retailers in the state. However, whatever approach the states take in imposing collection duties on retailers will need to be analyzed in light of the Commerce Clause to see if the imposition impinges on interstate commerce. The states cannot require collection if the seller has no substantial nexus with the state and they cannot unduly burden or discriminate against interstate commerce. Because the specific provisions in South Dakota’s law were not litigated, we will need to see what happens when they are. South Dakota, and indeed all states, will need to consider what weight is to be given to whether the taxing state is a member of the Streamlined Agreement. The Court specifically noted the membership as a factor favorable to South Dakota. Only 20 states are currently a part of the Streamlined Agreement. How those rules will apply in the states will depend on further litigation and perhaps federal legislation.

To discuss any questions you may have regarding this Alert, or how it may apply to your particular circumstances, please contact a member of Cozen O'Connor's Tax Team.