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Supreme Court Overrules Quill, States May Require Vendors Without Physical Presence to Collect Sales Tax

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Introduction

The U.S. Supreme Court, in *South Dakota v. Wayfair, Inc.*, reversed the long-standing rule that physical presence by a vendor is necessary for a state to require the vendor to collect sales tax on taxable goods and services purchased by consumers in the state. Although the Court's opinion in *Wayfair* clearly provides new opportunities for states to require out-of-state vendors to collect sales tax, the Court did not delineate a new standard for sales tax nexus, potentially opening up uncertainties in an area that has long had a black-and-white rule.

Background

In 1962, in *National Bellas Hess, Inc. v. Department of Revenue of Ill.*, 386 U.S. 753 (1967), the Supreme Court, relying on the Due Process Clause of the Constitution, decided that a state could require only vendors with a physical presence in the state to collect sales tax from sales to customers in that state. Thirty years later, when given the opportunity to reconsider *National Bellas Hess* in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), the Court declined to do so and, relying on the Dormant Commerce Clause of the Constitution, again held that the vendor's physical presence in the state was necessary for that state to require the vendor to collect sales tax.

By relying on the Dormant Commerce Clause, and because Congress has the power to regulate commerce, *Quill* seemed to be an open invitation by the Court to Congress to establish a clear statutory standard for sales tax nexus. Congress, however, declined that invitation, leaving *Quill* as the nexus standard for another 26 years.

Since *Quill*, physical presence in a state by a vendor has been a necessary and sufficient condition for the state to require a vendor to collect sales tax. As a result, many remote sellers (particularly internet vendors) have been able to deliver goods and services without collecting sales taxes. Although, in virtually all such situations, the purchaser technically is required to pay corresponding use tax on the purchase of the goods or services, use tax is very difficult for states to police and collect. As a result, states regularly lose revenue because of unpaid use tax.

Wayfair Case and Opinions

In 2016, accepting the invitation of Justice Anthony Kennedy in his concurring opinion in *Direct Marketing Association v. Brohl*, 135 S. Ct. 1124 (2016), South Dakota set up a test case by enacting a law requiring remote sellers with (i) annual gross revenue from sales to South Dakota consumers of more than $100,000, or (ii) 200 or more separate sales transactions delivered to South Dakota in a year, to collect sales tax when making sales delivered to that state's residents. South Dakota's new law was effective prospectively. Several remote sellers, including Wayfair, challenged the new law. The South Dakota state courts, including the South Dakota Supreme Court, were bound by *Quill* and struck down the new statute.

When the Supreme Court granted certiorari in January 2018, many state and local tax practitioners believed that the Court would seize the opportunity to overrule *Quill*. However, following oral arguments in April 2018, some Justices seemed to express reluctance to step in when Congress had declined to do so. Notwithstanding that skepticism, the Court, in a 5-4 opinion authored by Justice Kennedy and joined by Justices Clarence Thomas, Ruth Bader Ginsburg, Samuel Alito, and Neil Gorsuch, not only expressly overruled *Quill* and *National Bellas Hess*, but concluded that both decisions were wrong when they had been decided.

The Court stated that requiring physical presence in the state as a condition for sales tax collection unfairly advantaged companies without a physical presence in the state and had become largely unworkable, particularly in the internet economy. Although Wayfair and the other taxpayers argued that broad sales tax collection requirements would unfairly burden smaller businesses, the Court noted that software would be available to assist small businesses to comply with their sales tax collection obligations. Additionally, the Court mentioned that Wayfair specifically advertised that it was not required to collect sales tax on South Dakota sales—and seemed annoyed by this.

Chief Justice John Roberts authored the dissent—joined by Justices Stephen Breyer, Sonia Sotomayor, and Elena Kagan—stating that, although *Quill* and *National Bellas Hess* were decided incorrectly, the Court should be bound by *stare decisis* and should defer to those decisions in part, the dissenting Justices said, because they believed Congress would be better at considering the competing interests at stake. Thus, although *Wayfair* was a 5-4 decision, all nine Justices agreed that *Quill* and *National*

Bellas Hess were wrongly decided, and the difference between the majority and the dissent solely concerned whether the error was better corrected by Congress or the Court.

The opinions leave open some very important questions, including:

1. Since physical presence is not necessary to require a vendor to collect sales tax, what is the new standard? Is there any minimum number or dollar amount of sales that is necessary before a state may require a vendor to collect the tax or is one sale for $0.01 enough to create nexus for sales tax?

2. Can states apply the *Wayfair* decision retroactively and seek to collect tax from vendors if their customers did not pay the tax on purchases in prior years?

The Court implied that rules like those in South Dakota, including the lack of retroactive application, may be necessary elements to pass muster, but did not announce a standard that could be used to review state rules.

The Court also noted that South Dakota is a signatory of the Streamlined Sales and Use Tax Agreement (SSUTA), an agreement among states designed to reduce administrative and compliance costs for sales and use taxes. The SSUTA requires a single, state-level tax administration, uniform definitions of products and services, simplified tax rate structures, and other uniform rules among the participating states. The SSUTA also provides sellers with access to sales tax administration software paid for by the state and gives immunity from audit liability to sellers who choose to use such software.

That the Court seemed to give South Dakota's participation in the SSUTA such significance begs the question of whether a state that is not a signatory to the SSUTA would bear a greater burden in arguing that its rules are fair to remote vendors because vendors in such a state would need to learn a separate set of state-specific rules in order to comply with sales tax obligations.

What Comes Next?

Currently, all but five states have sales and use taxes and almost certainly will be affected by *Wayfair*. These states likely will act quickly to seize the opportunity to collect additional revenue, but the approaches may vary. Some states may try to enact new legislation or promulgate new regulations—perhaps incorporating rules similar to South Dakota's in an effort to ensure constitutionality. Other states may be far more aggressive and may enact laws requiring out-of-state vendors to collect sales tax with no minimum thresholds.

Although it is clear that the *National Bellas Hess/Quill* physical presence requirement is dead, it is not clear what standard will fill the void. Taxpayers may be inclined to challenge new state rules that impose collection requirements on businesses based solely on economic connections in the state. However, unless states pursue vendors retroactively, taxpayers with the greatest incentive to challenge new rules (*i.e.*, businesses with only a handful of sales in a particular state) likely will be those that lack sufficient resources to mount a lengthy challenge like *Wayfair*. As a result, it may be some time before a high-level court is forced to rule on new standards

imposed by states.

Finally, *Wayfair* likely will have an impact in the realm of state and local income taxes in addition to sales and use taxes. Many states and cities have long believed that the physical presence requirement of *Quill* was limited to sales taxes and that they could impose income taxes on taxpayers without a physical presence based on so-called "economic nexus"—*i.e.*, sufficient business connection in the taxing state. *Quill*, however, had left the door open—at least a bit—for taxpayers to push back against economic nexus by arguing that the Court's interpretation of the Dormant Commerce Clause should apply equally to income taxes. However, in a world without *Quill*, that line of defense no longer exists. Although, as is now the case for sales tax, the question remains open as to the level of activity that can give rise to economic nexus, physical presence in the taxing state seems not to be a necessary condition for income tax to be imposed.

Christopher Jones co-authored this post.