by Gerald J. Donnini II

Reasonable Answer Done the Wrong Way: Supreme Court Overturns *Quill* in *South Dakota v. Wayfair, Inc.*

The U.S. Supreme Court gave states a reason to celebrate and online retailers with shoppers alike, a reason to mourn the days of avoiding sales tax. Although often incorrectly pegged as a new "internet tax" in the media, the U.S. Supreme Court decided *South Dakota v. Wayfair, Inc., et al.*, Case No. 17-494 (2018), on June 21, 2018. Rather than creating a "new tax" on internet sales, the Supreme Court examined whether a state could force a retailer with no in-state physical presence to collect and remit its tax. In the past, if a retailer lacked physical presence in a state, the state was previously left with no choice but to rely on its residents to pay the proper tax to the state directly. Studies on the issue suggest that only about 4 percent of consumers actually report tax, which results in lost revenue to the states of approximately $33 billion annually.[1]

By way of brief background, for the imposition of a state tax to be constitutional, there must be a "substantial nexus" between the activity being taxed and the taxing state.[2] Despite the shifting economy from predominantly *intrastate* activity to the *interstate* nature of the mail order sales marketplace of the 1990s, the Supreme Court affirmed its then 25-year-old case.[3] Specifically, the Court's holding in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), required a company to be physically present in the state to meet the substantial nexus requirement for sales tax collection purposes.[4] Since the Supreme Court's punt and explicit plea in *Quill* for Congress to resolve the physical presence dilemma through legislation in 1992, e-commerce sales have grown to an estimated $453.5 billion, while Congress has failed to address the issue.[5] Given the growing online sales marketplace, the lack of consumer compliance, the inaction by Congress, and the alleged lost revenue, what is a state to do?

Apparently, one solution is to enact emergency and admittedly unconstitutional legislation to force remote sellers without a physical presence to collect sales tax.[6] Despite being in direct conflict with roughly 50 years of Supreme Court precedent, the South Dakota law (the act) was necessary because *Quill* was "causing revenue losses and imminent harm" and was "necessary for the support of the state government."[7] Specifically, the act provided that if a remote seller delivered more than $100,000 of sales into South Dakota or 200 or more separate transactions within a one year period, the remote seller had sufficient nexus "as if the seller had a physical presence."[8]

South Dakota followed the act's enactment by filing a declaratory judgment action against Wayfair, Inc., Overstock.com, Inc., and Newegg, Inc. (collectively "Wayfair"), all of which conducted far more than 200 transactions in South Dakota and had annual sales ranging from $1.7 billion to $4.7 billion.[9] Interestingly, South Dakota agreed the act was unlawful and to further its goal of "expeditious judicial review," it agreed to an order of summary judgment in favor of Wayfair.[10] The South Dakota Supreme Court moved almost as efficiently and quickly in ruling in favor of Wayfair as well.[11] In its opinion, the South Dakota Supreme Court stated, "[h]owever persuasive the state's arguments on the merits of revisiting the issue, *Quill* has not been overruled and remains the controlling precedent on the issue of Commerce Clause limitations on interstate collections of sales and use taxes."[12]

Seemingly due to the direct request in *Quill* by the Supreme Court to Congress to address sales tax collection issues through national legislation, the Supreme Court has not considered a sales tax collection case since 1992. After denying certiorari in *Amazon.com LLC, et al. v. New York Dep't of Tax.*, 97 N.E.2d 821 (N.Y. 2013), it seemed highly unlikely that the Supreme Court would entertain an intentionally defective statute from South Dakota.[13] Unexpectedly, for the first time in more than 25 years, the Supreme Court decided to hear a sales tax collection case by granting certiorari earlier this year.

The fate of *Quill* and the taxpayers in *Wayfair* was obvious when the June 21, 2018, opinion contained Justice Kennedy's name on the top of the page.[14] After laying out the procedural background of the case and providing a recap of Commerce Clause jurisprudence, Justice Kennedy wrote that there are three main reasons "*Quill* is flawed on its own terms."[15] Despite ruling for the similarly situated taxpayer in *Quill* nearly three decades ago, he wrote that the decision was wrong because physical presence was not the necessary test for substantial nexus, it

created market distortions, and was too formalistic for the modern-day economy.[16] Although it took some work to bury *Quill* for good, Justice Kennedy seemed to take exception with the minimal costs of compliance in the modern economy and unjust loss of revenue to the states.[17]

Fairness issues aside, it seemed troubling for the Supreme Court to overturn 50 years of precedent. The Court brushed away stare decisis concerns by stating that "[a]lthough we approach the reconsideration of our decisions with the utmost caution, stare decisis is not an inexorable command. Here, stare decisis can no longer support the Court's prohibition of a valid exercise of the [s]tates' sovereign power."[18] Justice Kennedy carefully relied on his own dissent in *Direct Marketing Assn. v. Brohl*, 135 S. Ct. 1124 (2015), and pointed to the significant change in the economy since *Quill* in 1992.[19] Although an analogous argument could be made about the mail-order industry at the time of *Quill*, internet access has grown from 2 percent to 89 percent over the last 25 years.[20] He also dismissed the 50 years of taxpayer reliance on precedent as minimal because numerous courts have unpredictably interpreted what constitutes physical presence in the digital world.[21] Finally, it is noteworthy that Justice Kennedy also deemed the South Dakota law permissible because it allowed an exemption for small business and did not apply retroactively.[22]

Conversely, four justices dissented for predictable reasons and highlighted several flaws with the opinion.[23] Chief Justice Roberts spoke for the dissent and argued that a shift in the economy was not a reason for the Court to overturn five decades of precedent, but rather Congress was more equipped for such a national problem.[24] He pointed to the heightened scrutiny of overturning prior decisions in fields in which Congress has plenary power, like the Commerce Clause, and stated:

> This is neither the first, nor the second, but the third time this Court has been asked whether a [s]tate may obligate sellers with no physical presence within its borders to collect tax on sales to residents. Whatever salience the adage "third time's a charm" has in daily life, it is a poor guide to Supreme Court decision making. If stare decisis applied with special force in *Quill*, it should be an even greater impediment to overruling precedent now, particularly since this Court in *Quill* "tossed [the ball] into Congress's court, for acceptance or not as that branch elects.[25]

In the dissent's view, the Court did nothing but compound "its past error by trying to fix it in a totally different era" and "would let Congress decide whether to depart from the physical-presence rule."

The dissent went in depth as to how Congress can better weigh the competing concerns of state revenue loss against the disproportionate burdens of small businesses.[26] In the dissent's view, the Court did nothing but compound "its past error by trying to fix it in a totally different era" and "would let Congress decide whether to depart from the physical-presence rule."[27]

By putting an end to *Quill*, the Supreme Court has invited states to enact similar legislation. In fact, the following states have enacted similar legislation set to take effect pending *Wayfair* or within the next year: Alabama, Georgia, Hawaii, Illinois, Indiana, Iowa, Kentucky, Louisiana, Maine, Massachusetts, Mississippi, North Dakota, Ohio, Pennsylvania, Rhode Island, South Dakota, Tennessee, Vermont, Washington, Wyoming.[28] It is only logical that many, if not all of the states, will be quick to follow with similar legislation of their own.

Undoubtedly, the economy and internet have changed since *Quill*. However, the same argument was true in the days of *Quill*, as the mail-order sales marketplace had heavily evolved at the time. The opinion was not a surprising one for the state tax world; however, it is puzzling that the Supreme Court would overturn such a long history of state tax jurisprudence and ultimately undermine Congress' role in issues of national and interstate commerce. If a shift in the economy is a reason to depart from long-standing precedent, then few long-standing tax principles are safe.

A national issue of interstate commerce is obviously better suited for the expertise of Congress. It is hard to envision a direct case on a national issue of interstate commerce. Even though the Court created the physical-presence standard, if Congress did not approve, it could have taken the Court's invitation in *Quill* and enacted legislation to resolve the "problem." Congress' inaction could be a result of a feared reaction to a perceived "new" internet tax from which the federal government receives little or no benefit, or it could be that it believed the standing rule of physical presence was acceptable. Now that the U.S. Supreme Court has taken matters into its own hands, we will never know exactly what caused Congress' failure to act.

Throughout the opinion, the Supreme Court's frustration with Congress is apparent. Numerous times, the Court seemed to indicate remorse of its decision in *Quill* and ruled in favor of South Dakota to remedy its past mistakes. While the result of the case may be reasonable, it is far-fetched for the Court, without any factual record, to overturn such a long history of precedent and undertake a balancing of the cost of compliance against its impact on the national economy. In the words of Chief Justice Roberts, "Congress has the final say over interstate commerce," and it "has the capacity to investigate and analyze facts beyond anything the judiciary could match."[29]

The prospective effects of *Wayfair* are largely uncertain. For example,

Florida has not enacted an economic nexus standard to date. Further, in *Dep't of Revenue v. Share Int'l, Inc.*, 676 So. 2d 1362 (Fla. 1996), the Florida Supreme Court held that substantial nexus was lacking even when the company was physically present in Florida for three days a year. The Florida Supreme Court, however, principally relied on *Quill* and *National Bellas Hess, Inc. v. Ill. Dep't of Revenue*, 386 U.S. 753 (1967), which were just overruled by *Wayfair*. While it seems *Share Int'l* remains the law of the land in Florida until economic legislation is enacted, it is uncertain how the courts will view nexus in light of *Wayfair*.

There are many questions and concerns for our clients that do business on a national level. From a tax lawyer's perspective and among others, the following issues should be analyzed:

- *Nexus Legislation* — If your client sells across state lines it should be evaluated as to whether the destination state has expanded nexus legislation. If your client has a physical presence in a state, has exceeded the legislative nexus thresholds, and the good or service being sold is taxable, your client should likely begin collecting and remitting tax in that state.
- *Digital Goods* — While some states, like Florida, do not tax digital goods, many states do. Among the states that tax digital goods, many have different rules as to where the sale occurs.
- *Voluntary Disclosures* — It seems as though the lack of retroactivity played a role in the Court's decision. However, it is possible that states may enact retroactive nexus legislation. Consider voluntary disclosures in states with high sales volume.
- *Future Legislation* — While $100,000 per year or 200 transactions was held to be permissible, states may enact statutes with lower thresholds like $25,000, $50,000, or 100 transactions.
- *Other Defenses* — If your client has been audited and relied on the lack of physical presence as a defense, it is likely worthwhile to carefully review a due process defense (*i.e.*, purposeful availment).

While it seems *Share Int'l* remains the law of the land in Florida until economic legislation is enacted, it is uncertain how the courts will view nexus in light of *Wayfair*.

Conclusion

It is debatable as to whether the conclusion in *Wayfair* was the correct answer to a difficult problem. In effect, the U.S. Supreme Court rewarded a state for enacting legislation in direct conflict with decades of prior precedent. Decades of inaction by Congress also considerably contributed to the *Wayfair* result. Despite being more suited to handle an issue on the national economy, Congress' inaction will likely significantly harm small and medium businesses across the country. Companies that sell more than $100,000 or conduct more than 200 transactions in a state will now be subject to complicated compliance burdens, expensive audits, and possibly even criminal issues in many more jurisdictions. It would be an understatement to say that the Court "breezily disregard[ed] the costs that its decision will impose on retailers."[30] The only thing certain from *Wayfair* is more uncertainty in the state and local tax world.❑

[1] GAO, *Report to Congressional Requesters: Sales Taxes, States Could Gain Revenue from Expanded Authority, but Businesses Are Likely to Experience Compliance Costs* 5 (GAO–18–114, Nov. 2017).

[2] *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977).

[3] *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992) (affirming *National Bellas Hess, Inc. v. Ill. Dep't of Revenue*, 386 U.S. 753 (1967)).

[4] *Id.*

[5] *South Dakota v. Wayfair, Inc., et al.*, 585 U.S. ___, 2018 WL 3058015, Case No. 17-494 at 14 (2018).

[6] S. 106, 2016 Leg. Assembly, 91st Sess. (S.D. 2016) (S.B. 106).

[7] *Id.* at §8-9.

[8] *Id.* at §1.

[9] *Wayfair*, 2018 WL 3058015, at *5.

[10] *Id.* at *6.

[11] *South Dakota v. Wayfair, Inc.*, 901 N.W. 2d 754, 761 (S.D. 2017).

[12] *Wayfair*, 2018 WL 3058015, at *6.

[13] *Amazon.com LLC, et al. v. New York Dep't of Tax.*, 97 N.E.2d 821 (N.Y. 2013).

[14] *See Direct Marketing Assn. v. Brohl*, 135 S. Ct. 1124, 1135 (2015) (Kennedy, J., concurring) ("Given these changes in technology and consumer sophistication, it is unwise to delay any longer a reconsideration of the Court's holding in *Quill*. A case questionable even when decided.").

[15] *Wayfair*, 2018 WL 3058015, at *10.

[16] *Id.*

[17] *Id.* at *10-16.

[18] *Id.* at *14 (internal citations omitted). Justice Thomas also ruled in favor of *Quill* and switched camps in *Wayfair* by explaining "Although I adhered to that jurisprudence in *Quill*, it is never too late to 'surrende[r] former views to a better considered position.'"

[19] *Id.* at *12.

[20] *Wayfair*, 2018 WL 3058015, at *18.

[21] *Id.* at *20.

[22] *Id.* at *16.

[23] *Id.* at *19 (Roberts, C.J., dissenting).

[24] *Id.* at **20-22 (Roberts, C.J., dissenting).

[25] *Id.* at *20 (Roberts, C.J., dissenting).

[26] *Id.* at **21-23.

[27] *Id.* at *23.

[28] Sales Tax Institute, Remote Seller Nexus Chart, https://www.salestaxinstitute.com/resources/remote-seller-nexus-chart.

[29] *Wayfair,* 2018 WL 3058015, at *22 (Roberts, C.J. dissenting).

[30] *Id.* at *20 (Roberts, C.J., dissenting).

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