Losing the Forest for the Trees: Is it Really All About Physical Presence?

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This new attack is different, and it:

- began with the now famous concurrence in Direct Marketing Association,1 in which Justice Kennedy wrote that “it is unwise to delay any longer a reconsideration” of Quill;
- was advanced when Alabama promulgated a clearly unconstitutional regulation, with the Department of Revenue literally inviting a lawsuit by out-of-state retailers, which it recently received;2 and
- further ripened into a full-fledged dispute in South Dakota when South Dakota sued Newegg Inc., Overstock.com Inc., Systemax Inc. and Wayfair LLC in a circuit court in Hughes County to enforce the state’s newly enacted (also plainly unconstitutional under Quill) economic nexus standard.

Yet despite all the focus on “physical presence” and the states’ aggressive attacks on that standard as set forth in Quill, the states may have lost the forest for the trees, so to speak, with the overall concept of constitutional “nexus” playing the role of the forest and “physical presence” playing the trees. Fundamental principles of federal constitutional law require that a taxpayer have “nexus” with the taxing state before a sales or use tax collection obligation or income or business activity tax may be imposed on the taxpayer, which includes satisfying the requirements of both the Due Process and Commerce Clauses of the United States Constitution. This article will explore why we believe that the states, in their urgency to overturn Quill, have failed to consider whether the standards they are proposing would satisfy all relevant constitutional restrictions, including the “substantial nexus” prong under the Complete Auto analysis, along with the other prongs of such analysis, as well as the Due Process Clause. In other words, is it really all about Quill?

“Substantial Nexus” Must Mean Something

South Dakota has the distinct privilege of having enacted the most aggressive sales and use tax nexus standard to date, and one that blurs the line between Due Process and Commerce Clause nexus insofar as it seeks to assert Commerce Clause nexus over out-of-state retailers solely as a result of having made sales to customers in the state. Specifically, South Dakota’s statute asserts nexus over such retailers in the following circumstances: (1) “gross revenue from the sale of tangible personal property, any product transferred electronically, or services delivered into South Dakota” exceeds $100,000; or (2) the retailer “sold tangible personal property, any product transferred electronically, or services for delivery into South Dakota in [200] or more separate transactions.”2

While it can certainly be argued that a company would likely have sufficient Due Process Clause nexus with any state where it has customers (the U.S. Supreme Court has held that it is not necessary for a taxpayer to be physically present in a taxing state for the Due Process Clause nexus requirement to be satisfied), the same should not be true for Commerce Clause purposes. The Supreme Court, in Quill, concluded that a corporation “may have the ‘minimum contacts’ with a taxing State as required by the Due Process Clause, and yet lack the ‘substantial nexus’ with that State as required by the Commerce Clause,” thereby specifically bifurcating the two tests.5 This makes sense given that they are animated by different concerns.6 In contrast to the Due Process Clause, which mandates fair notice to persons,7 the Commerce Clause (or more specifically, the dormant Commerce Clause) is “a means for limiting state burdens on interstate commerce.”8

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3 Ala. Admin. Code 810-6-2-.90.03. Newegg Inc. filed a notice of appeal with the Alabama Tax Tribunal on June 9, 2016, contending that an assessment issued by the Department of Revenue based on the new rule was unconstitutional and conflicted with Alabama’s own sales/use tax statutes. See Newegg Inc. v. Dep’t of Rev., Ala. Tax. Trib. Dkt. No. S. 16-613.
4 S.B. 106 § 1(1)-(2).
5 Quill Corp., 504 U.S. at 299.
6 Id. at 312.
7 Id. at 307.
8 Id. at 313 (emphasis added).
A decision upholding South Dakota’s nexus statute would not only drastically lower the Commerce Clause nexus bar, but would have the effect of practically reuniting the Due Process and Commerce Clause nexus standards. Indeed, Professor John Swain has said that if South Dakota prevails in its direct challenge to *Quill*, states would go back to a test that looks an awful lot like due process. “I think the answer would be that most everybody is taxable. And it’s a very rare case, a very de minimis situation, where you could argue a violation of the due process or commerce clause once the physical presence test is removed,” he said. “Everybody would be in, basically, except for the little guys; and I think there would be concern expressed by taxpayers and then a real chance at congressional legislation if the Court ruled that way.”

Simply put, South Dakota has enacted an extremely low bar to Commerce Clause nexus and one that raises questions in light of the Court’s recent language on Due Process generally. Perhaps the states want it this way, but if you are the states, is South Dakota’s statute the best test case to present to the Supreme Court? It is a fair question to ask given how low the bar truly is, as made clear by Professor Swain’s comments. The Supreme Court has concluded in numerous cases that the Commerce Clause imposes certain restrictions on the states’ jurisdiction to tax, including recently in *Comptroller of the Treasury of Maryland v. Wynne*. If we assume, for argument’s sake, that the Supreme Court is inclined to overturn *Quill*, is it reasonable to assume that it will replace that standard with a 200 transactions or $100,000 standard? We question whether the Supreme Court is willing to essentially obliterate the substantial nexus prong of *Complete Auto* in the manner sought by South Dakota. Why not simply abandon the substantial nexus prong altogether? It is one thing to argue that *Quill’s* physical presence nexus standard is tired (we do not agree), but it is entirely another to suggest that the right answer is to walk back the Commerce Clause nexus to essentially a Due Process Clause standard, as South Dakota is seeking to do.

Even if that is the case, states have to contend with due process. One could argue that due process could be satisfied with less activity than 200 transactions or $100,000 of receipts, for example, through targeted advertising. On the other hand, in light of recent decisions, that argument may fail. In two recent cases, the Supreme Court confirmed that the actions of a taxpayer, not the eventual results of its participation in interstate commerce, create jurisdiction. Applying the Court’s reasoning from these recent due process cases to a *Quill* challenge, a court may conclude that the out-of-state retailer would have to specifically “target the forum” in order for the state to exert jurisdiction over the retailer. The threshold for targeting a forum is, of course, fact-specific; for example, a nationwide advertising campaign is not sufficient evidence that a particular state has been targeted. Moreover, the Court in *J. McIntyre* clearly held that a single, isolated sale does not suffice. In January of 2014, the Court reiterated its holding in *Goodyear*, stating that the test for general jurisdiction remains whether an entity’s “affiliations with the State are so continuous and systematic as to render [the entity] essentially at home in the forum state.”

The point is that for “substantial nexus” to mean something, it must be a standard higher than what the Due Process Clause requires, which is not an insignificant standard generally. That requirement is also not insignificant in the specific context of the imposition of tax nexus either—according to at least one state court. In particular, we are flagging for consideration the Oklahoma Supreme Court’s holding in *Scioto Ins. Co. v. Okla. Tax Comm’n*, in which the court denied, on due process grounds, Oklahoma’s attempt to tax an out-of-state corporation that has no contact with the state other than receiving payments from an Oklahoma company. These recent due process cases demonstrate that the overturning of *Quill’s* physical presence standard for Commerce Clause nexus purposes would not necessarily be fatal to an out-of-state retailer’s argument that it cannot constitutionally be subject to a state’s taxing jurisdiction, though such an argument would clearly be subject to the facts and circumstances of the case rather than a bright-line standard.

Substantial Nexus is Only One Prong

In addition to a discussion of the Due Process Clause, what is often ignored in the “overturn *Quill*” hysteria is that the Supreme Court has enumerated four requirements that must be met for a tax to pass muster under the dormant Commerce Clause: (1) there must be “substantial nexus” between the transaction, the income or the property being taxed and the state, (2) the tax must be fairly apportioned, (3) the tax must not discriminate against interstate commerce and (4) the tax must be fairly related to the benefits provided to the taxpayer.

In a recent article, we explored the fourth prong of *Complete Auto* and argued that even under facts where it is difficult to win on the substantial nexus prong, it does not necessarily follow that a taxpayer should concede the fairly-related

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12. 279 P.3d 782, 784 (Okla. 2012).

prong. Specifically, we argued that where the basis for nexus is not physical presence (e.g., where a taxpayer’s only connection with a state is the fact that its sales to the state have exceeded a certain threshold or where its contacts are virtual or non-existent), it is more likely to be the case that the taxpayer can argue that the state has not provided it any discernible benefit. As we noted in that article, the fairly-related prong analysis is related to considerations invoked when considering Due Process clause restrictions on state taxation.

In particular, our article focused on the N.C. Supreme Court’s decision in *The Kimberley Rice Kaestner 1992 Family Trust v. N.C. Dept of Revenue*, which addressed whether North Carolina could tax the income accumulated by a trust based primarily on the fact that the trust’s current beneficiaries were North Carolina residents. In its decision, the court explained that the fairly-related prong ensures that “a State’s tax burden is not placed upon persons who do not benefit from services provided by the State” and that, relatedly, the ‘beneficiaries’ residence in North Carolina, standing alone, is not a sufficient contact by the Trust with this State to support the imposition of the tax at issue under the Due Process clause. That is, the trust “has not done anything to seek out the protection, opportunities, and benefits conferred by North Carolina, and North Carolina has not provided anything to the Trust for which it can ask in return.”

In situations where states are asserting economic nexus over an out-of-state retailer whose primary (or sole) presence in the state is the delivery of goods via common carrier, we think such a retailer would be wise to consider how this assertion may, depending on the facts, fail the Commerce Clause and Due Process Clause protections under this fairly related “benefits” analysis.

Again, as noted above, it has been argued and perhaps assumed by states that an out-of-state retailer making sales to in-state residents would necessarily satisfy the Due Process Clause, since that retailer has purposefully availed itself of the benefits of the state’s economic market by making those sales. Even if that were true, the Due Process Clause should still prevent a state from asserting jurisdiction over the out-of-state retailer if the state confers benefits “for which it can ask in return” within the framework of the Constitution. In the words of the Supreme Court:

Constitutional provisions are often so glossed over with commentary that imperceptibly we tend to construe the commentary, rather than the text. We cannot, however, be too often reminded that the limits on the otherwise autonomous powers of the states are those in the Constitution, and not verbal weapons imported into it. “Taxable event,” “jurisdiction to tax,” “business situs,” “extraterritoriality,” are all compendious ways of implying the impotence of state power because state power has nothing on which to operate. These tags are not instruments of adjudication, but statements of result in applying the sole constitutional test for a case like the present one. That test is whether property was taken without due process of law, or, if paraphrase we must, whether the taxing power exerted by the state bears fiscal relation to protection, opportunities, and benefits given by the state. The simple but controlling question is whether the state has given anything for which it can ask return.

An out-of-state retailer with no physical presence in the state and whose contacts with the state are limited to solicitation of sales over the Internet and through general advertising may be able to convince a court that the state is truly providing no benefits to the taxpayer, especially if a taxpayer conducts its business solely online without taking advantage of any in-state actor/benefit, which could theoretically include any in-state service provider. While it is possible that a court could, in any instance, argue that the use of a common carrier and by extension, the roadways, is sufficient to attribute a benefit to the out-of-state retailer, we believe that such an argument would be subject to challenge on the grounds that the benefit conferred is really to the common carrier, since that carrier is not an agent of the out-of-state retailer.

Conclusion

While the resolution in any/some of the attacks on *Quill*'s physical presence nexus standard will undoubtedly provide some clarity on the sales and use tax collection requirements on out-of-state retailers, physical presence is only one side of a two- (or even three-) sided coin.

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16 Id. at ¶ 46.
17 *Kaestner Trust*, ¶ 37.
18 Id. at ¶ 45.

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20 Id. at 444 (emphasis added).

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