ALSTON & BIRD

WWW.ALSTON.COM

State & Local Tax Advisory ■

JUNE 22, 2018

Thanks for the Memories, *Quill*: The Supreme Court Adopts a New Nexus Standard for Use Tax Collection

The Supreme Court decided *South Dakota v. Wayfair Inc.* yesterday. In a 24-page decision, the Court held that (1) a seller is not required under the Commerce Clause to have a physical presence in a state before the state may require the seller to collect its use tax; and (2) because of their "economic and virtual contacts" with South Dakota, the retailers in the case (Wayfair, Overstock, and Newegg) had sufficient substantial nexus with South Dakota under the Commerce-Clause test for state taxation established in *Complete Auto Transit Inc. v. Brady*, 430 U.S. 274 (1977). The Court left open, however, the possibility that factors other than a lack of physical presence could place an impermissible Commerce-Clause burden on remote sales tax collection.

The decision puts a rather unceremonious end to the bright-line physical-presence substantial-nexus standard set forth 26 years ago in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992). While the Court's decision explicitly overturns the physical-presence standard as "unsound and incorrect," a number of questions remain.

Brief Background

South Dakota passed legislation (S.B. 26) in 2016 to challenge the physical-presence standard affirmed in *Quill* and to replace it with an "economic nexus" standard under which out-of-state sellers with either $100,000 in sales into the state or 200 sales to South Dakota customers are required to collect and remit South Dakota use tax on those sales. South Dakota's direct challenge to *Quill* in turn invited an immediate challenge by Wayfair and other remote sellers, and the fast-track appeal mechanism included in South Dakota's bill allowed the case to reach the Supreme Court quickly.

Many observers predicted that the Court would overrule *Quill* when it granted certiorari at the beginning of the year, surmising that the Court would take the case for no other reason. However, oral argument demonstrated clear divisions among the Justices regarding the proper nexus standard and how the Court should view its role in creating—and resolving—the tax collection issues that the Court's physical-presence rule had created. And while it was difficult to draw conclusions from oral argument, the divisions expressed among the Justices had many wondering if *Quill* would remain the law of the land after all.

Quill Is Gone, But What Took Its Place?

The Court completed its takedown of prior precedent by holding that *Quill*'s physical-presence rule for substantial-nexus purposes is "unsound and incorrect," and that *Quill* (in addition to *National Bellas Hess*) "should be, and now are, overruled."

In the wake of its disposal of *Quill*, the Court had little difficulty in confirming that South Dakota's statutory standard "clearly satisfied" the substantial-nexus requirement given the respondents' "economic and virtual contacts" with South Dakota. Specifically, the Court found that "the seller" could not have satisfied the economic-nexus thresholds (i.e., $100,000 in sales or 200 transactions) unless the seller "availed itself of the substantial privilege of carrying on business" in the state. The Court also stated that the respondents "are large, national companies that undoubtedly maintain an extensive virtual presence." Accordingly, the Court concluded that the South Dakota law satisfied the substantial-nexus prong of the four-part *Complete Auto* test that governs the constitutional validity of a state tax, notwithstanding a taxpayer's lack of physical presence in the state.

However, it is not clear how the Court intends its decision to apply more broadly, both in the context of other fact patterns and under the laws of states with standards that deviate from South Dakota's. At a fundamental level, the majority's decision establishes that the post-*Quill* substantial-nexus standard is satisfied when a retailer avails itself of the substantial privilege of carrying on business in a state. This standard can be further broken into two distinct (yet related) prongs: (1) whether the retailer has sufficient economic contacts with a state; and (2) whether the retailer has substantial virtual connections to the state. Prong one seems somewhat more straightforward than prong two. Under prong one, the Court held that a $100,000 sales receipt or 200 transaction threshold establishes sufficient economic contact to satisfy substantial nexus, though the Court did *not* hold that the South Dakota thresholds are new constitutional minimums. States could therefore contend that a lower threshold—possibly as low as a single sale—is sufficient economic contact to constitute substantial nexus for purposes of the *Complete Auto* test. The constitutionality of a lower standard could be subject to further litigation, either as a facial or an as-applied challenge.

In contrast, prong two would appear to be highly subjective. The majority explained that a retailer that maintained a "sophisticated website with a virtual showroom accessible in every State" would satisfy this "substantial virtual connections" standard, and it highlighted Wayfair's "targeted advertising and instant access to most consumers via any internet-enabled device" as a factor supporting its virtual connections to the state. But the majority did not explicitly hold that an economic-nexus standard is always constitutional, nor did it mention whether South Dakota's threshold might be too low on certain fact patterns (e.g., service providers with lesser connections to the state than a seller of tangible personal property that ships orders to a South Dakota address). And it is possible that a taxpayer could succeed on due process grounds in challenging that due process is not satisfied on its facts, even where it otherwise satisfies an economic-nexus standard that satisfies the substantial-nexus prong for Commerce Clause purposes. Given the Court's expressed concern with the supposedly "unworkable" nature of the bright-line rule, it is ironic that the Court overruled *Quill* without a replacement standard.

The Supreme Court's Take on *Quill* and Stare Decisis

The majority in *Wayfair* did not find stare decisis a compelling reason to uphold *Quill*. While the Court recited the well-settled principle that a break from its prior decisions should be approached with "utmost

caution," it ultimately concluded that stare decisis alone cannot support the prohibition of a valid exercise of the states' sovereign power, particularly when the harm caused by the physical-presence standard was significantly exacerbated in the years since *Quill* due to "far-reaching systemic and structural changes in the economy" (i.e., Internet sales). In addition, the majority found that the proliferation of the Internet had caused an erosion of the bright-line test that *Quill* intended to provide. The Court cited state physical-presence workarounds—such as New York's "click-through nexus" provisions and Massachusetts's proposed regulation defining a physical presence to include Internet cookies—as evidence that the physical-presence standard has become unclear and "unworkable," predicting that if *Quill* were upheld, it would "embroil courts in technical and arbitrary disputes about what counts as physical presence." Yet this same result may be inevitable in light of the nebulous new substantial-nexus standard.

Sharply Divided on Stare Decisis

The dissenting opinion, written by Chief Justice Roberts, reveals a sharp division in the Court regarding the weight of stare decisis. While the dissenting Justices agreed with the majority that *National Bellas Hess* was wrongly decided, they firmly rejected the majority's conclusion that overturning the physical-presence standard would fix the perceived harms caused by *Quill* and *National Bellas Hess*. Specifically, the dissent concluded that "E-Commerce has grown into a significant and vibrant part of our national economy against the backdrop of established rules, including the physical-presence rule." The dissent concluded that any alteration to the established rules that has the potential to disrupt the development of such a critical segment of the economy should be undertaken by Congress, not the Court, explaining that "legislators may more directly consider the competing interests at stake" and "focus directly on current policy concerns rather than past legal mistakes."

Further Observations and Takeaways

Is there any daylight?

A hallmark of *Quill* was its separation of the Due Process Clause and the Commerce Clause into distinct constitutional limitations. Although "closely related," according to the *Quill* court, the two clauses "reflect different constitutional concerns." The Due Process Clause is about fairness and thus requires a minimum link between a state and the person, property, or transaction that a state seeks to tax. The Commerce Clause, on the other hand, prevents discrimination and undue burdens on interstate commerce. *Quill* was able to hold that a mail-order retailer satisfied due process concerns by intentionally directing its activities toward North Dakota while failing to satisfy Commerce Clause concerns based on the bright-line physical-presence standard affirmed in that case.

Wayfair's holding undoes some of *Quill*'s precision and again blurs the distinction between the Due Process Clause and the Commerce Clause as they apply to interstate taxation. Under the Court's holding, a retailer need only to offer its wares on the Internet and make a certain number of sales to satisfy substantial nexus. But under the right circumstances, that level of presence might fail the due process standard articulated in *Quill*. Cloud service providers—who may not direct their activities to any particular state or even have much awareness of the location of their customers, who are often on the move—are a particularly notable example of a fact pattern that is not well-addressed by yesterday's decision.

In sum, *Wayfair* acknowledges that there are "significant parallels" between the Due Process Clause and the Commerce Clause but continues to insist that they "may not be identical or coterminous." Based on the *Wayfair* decision alone, though, it is somewhat difficult to identify the space between the two.

Economic and virtual presence

Although noting that the due process "minimum contacts" test and Commerce Clause substantial-nexus standards have "parallels," the Court stopped short of reuniting the two clauses that it pulled apart in *Quill*. In other words, substantial nexus under the Commerce Clause remains something distinct from the due process requirement. In removing the physical-presence standard, it appears that the Court has replaced it with an "economic and virtual contacts" standard. Specifically, the Court concluded that "[substantial] nexus is clearly sufficient based on both the economic and virtual contacts respondents have with the State." In articulating this new, fact-based standard, it is interesting to note that the Court did not stop at "economic" but added "virtual" to what is the clearest articulation of a bright-line rule in the decision. The holding invites the question: what is a virtual presence? The Court provides some examples of what could constitute a virtual presence:

> [I]t is not clear why a single employee or a single warehouse should create a substantial nexus while "physical" aspects of pervasive modern technology should not. For example, a company with a website accessible in South Dakota may be said to have a physical presence in the State via the customers' computers. A website may leave cookies saved to the customers' hard drives, or customers may download the company's app onto their phones. Or a company may lease data storage that is permanently, or even occasionally, located in South Dakota .... Yet the continuous and pervasive virtual presence of retailers today is, under *Quill*, simply irrelevant. This Court should not maintain a rule that ignores these substantial virtual connections to the State.

It seems that questions will remain about what constitutes a virtual presence.

What constitutes an "undue burden"?

Although *Wayfair* overruled *Quill*, it did not articulate a clear alternative—nor did it actually hold that South Dakota's use tax collection scheme as a whole is constitutional. Instead, the Court outlined its economic and virtual-presence standard and specified that there is a backstop provided by other aspects of the Commerce Clause doctrine. The Court was careful to caution that the application of a standard like South Dakota's standard could be unconstitutional *as applied* to certain emerging companies without the necessary protections, writing that "[t]hese burdens may pose legitimate concerns in some instances, particularly for small businesses that make a small volume of sales to customers in many States. State taxes differ, not only in the rate imposed but also in the categories of goods that are taxed and, sometimes, the relevant date of purchase."

The Court pointed to the balancing framework analysis of *Pike v. Bruce Church Inc.*, 397 U.S. 137, and past apportionment jurisprudence that would serve as constitutional limitations under the new standard created by overturning *Quill*. The Court expressly contemplates that "complex state tax systems could have the effect of discriminating against interstate commerce" if those systems impose undue burdens or have the effect of discrimination against interstate commerce.

The Court goes on to suggest that South Dakota's tax system is likely constitutional because it includes three features that appear designed to prevent discrimination against or undue burdens upon interstate commerce:

1. A safe harbor threshold for those that transact only limited business in the state.
2. A guarantee that the law will not be applied retroactively.
3. South Dakota's membership in the Streamlined Sales and Use Tax Agreement, which reduced compliance burdens through uniform definitions and centralized administration of state and local taxes.

Perhaps most importantly for the states, these three features of the South Dakota law, which the Court twice outlines and emphasizes in its opinion, present a likely roadmap toward satisfaction of the Commerce Clause applied to both sales and use tax as well as state income taxes. Conversely, the Court's analysis provides remote sellers with a roadmap for how to argue that certain states' statutes/regimes should be invalidated.

The Court found it necessary to remand the appeal back to the South Dakota Supreme Court for further proceedings on other possible Commerce Clause aspects that could invalidate the state's nexus standard because these issues were not litigated or briefed.

If there is any salutary effect of the *Wayfair* decision for taxpayers, it is that the Court's emphasis on the easing of administration and compliance burdens as a means of ensuring constitutionality may induce states to take steps that make it easier—and cheaper—for all businesses to comply with applicable sales and use tax collection obligations (e.g., centralized administration, uniform state-wide rates, uniform definitions of relevant terms across states).

Retroactive application of the repeal of the physical-presence standard

Although retroactive application of the dramatic change in constitutional nexus standards is not an issue in South Dakota – the South Dakota statute expressly provides for prospective only application – how the decision will be applied to prior periods in other states remains a potentially significant issue for remote sellers affected by the decision. Though the majority decision did not focus on retroactivity, the decision strongly suggests retroactive application would raise considerable constitutional concerns in this context. That said, it remains to be seen how other states interpret the Court's decision on this very important issue.

Business activity tax nexus

The prevailing consensus among states is that physical presence is *not* required for income and other business activity tax purposes. In several instances, parties have asked the Court to resolve this debate; however, the Court has declined to hear any of the cases on this topic. The question of whether physical presence is required in the context of an income or other business activity tax has yet to be addressed by the Supreme Court. However, the *Wayfair* decision seems to put this debate to rest: physical presence is not a limit on state taxation. Taxpayers will want to pay attention to what states might do with income tax nexus.

Stay tuned. We will be having conversations about nexus long after the impact of this case is felt by vast numbers of businesses and consumers across the country.

You can subscribe to future ***State & Local Tax*** advisories and other Alston & Bird publications by completing our **publications subscription form**.

Click **here** for Alston & Bird's Tax Blog.

If you have any questions or would like additional information, please contact your Alston & Bird attorney or any of the following:

Mary T. Benton
404.881.7255
mary.benton@alston.com

Clark R. Calhoun
404.881.7553
clark.calhoun@alston.com

John L. Coalson, Jr.
404.881.7482
john.coalson@alston.com

Kathleen Cornett
404.881.4445
kathleen.cornett@alston.com

Michael M. Giovannini
404.881.7957
michael.giovannini@alston.com

Zachry T. Gladney
212.210.9423
zach.gladney@alston.com

Matthew P. Hedstrom
212.210.9533
matt.hedstrom@alston.com

Kendall L. Houghton
202.239.3673
kendall.houghton@alston.com

Richard C. Kariss
212.210.9452
richard.kariss@alston.com

Ethan D. Millar
213.576.1025
ethan.millar@alston.com

Michael T. Petrik
404.881.7479
mike.petrik@alston.com

Charles D. Wakefield
212.210.1281
charles.wakefield@alston.com

Andrew W. Yates
404.881.7677
andy.yates@alston.com

ALSTON & BIRD

WWW.ALSTON.COM

ATLANTA: One Atlantic Center ■ 1201 West Peachtree Street ■ Atlanta, Georgia, USA, 30309-3424 ■ 404.881.7000 ■ Fax: 404.881.7777
BEIJING: Hanwei Plaza West Wing ■ Suite 21B2 ■ No. 7 Guanghua Road ■ Chaoyang District ■ Beijing, 100004 CN ■ +86 10 8592 7500
BRUSSELS: Level 20 Bastion Tower ■ Place du Champ de Mars ■ B-1050 Brussels, BE ■ +32 2 550 3700 ■ Fax: +32 2 550 3719
CHARLOTTE: Bank of America Plaza ■ 101 South Tryon Street ■ Suite 4000 ■ Charlotte, North Carolina, USA, 28280-4000 ■ 704.444.1000 ■ Fax: 704.444.1111
DALLAS: 2828 North Harwood Street ■ 18th Floor ■ Dallas, Texas, USA, 75201 ■ 214.922.3400 ■ Fax: 214.922.3899
LOS ANGELES: 333 South Hope Street ■ 16th Floor ■ Los Angeles, California, USA, 90071-3004 ■ 213.576.1000 ■ Fax: 213.576.1100
NEW YORK: 90 Park Avenue ■ 15th Floor ■ New York, New York, USA, 10016-1387 ■ 212.210.9400 ■ Fax: 212.210.9444
RALEIGH: 555 Fayetteville Street ■ Suite 600 ■ Raleigh, North Carolina, USA, 27601-3034 ■ 919.862.2200 ■ Fax: 919.862.2260
SAN FRANCISCO: 560 Mission Street ■ 5th Floor ■ San Francisco, California, USA, 94105-0912 ■ 415.243.1000 ■ Fax: 415.243.1001
SILICON VALLEY: 1950 University Avenue ■ Suite 2100 ■ East Palo Alto, California, USA, 94303-2282 ■ 650.838.2000 ■ Fax: 650.838.2001
WASHINGTON, DC: The Atlantic Building ■ 950 F Street, NW ■ Washington, DC, USA, 20004-1404 ■ 202.239.3300 ■ Fax: 202.239.3333