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IN FOCUS

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State Sales and Use Tax Nexus After *South Dakota v. Wayfair*

In its 2018 decision in *South Dakota v. Wayfair, Inc.*, the Supreme Court upheld a South Dakota law requiring out-of-state sellers, or "remote sellers," to collect and remit sales taxes on goods and services delivered into South Dakota. For decades prior to *Wayfair*, the Court had construed the Commerce Clause's substantial nexus requirement only to permit state sales and use tax collection duties on sellers with a physical presence in the taxing state. As a result, states could not impose sales and use tax collection duties on remote sellers that competed with in-state sellers. In *Wayfair*, the Court overturned its physical presence rule on the ground that the rule produced market distortions and treated "economically identical actors differently for arbitrary reasons."

Nearly every state has now enacted laws modeled after the South Dakota act upheld in *Wayfair* in order to facilitate sales and use tax collection, stop the erosion of the sales tax base, prevent revenue losses, and increase funding for state and local services. However, it remains possible that courts might rule that laws that do not resemble the South Dakota law violate Commerce Clause principles. In *Wayfair*, the Supreme Court only addressed the Commerce Clause's substantial nexus requirement and concluded that several features of the South Dakota tax system "appear[ed] designed to prevent discrimination against or undue burdens upon interstate commerce." The Court stated that it did not consider whether other Commerce Clause principles might have compelled it to invalidate the South Dakota law.

This In Focus covers sales and use taxes, the Commerce Clause, and the Commerce Clause's substantial nexus requirement for state sales and use taxes before and after *Wayfair*.

Sales and Use Taxes

Most states impose a sales tax on the retail sale of goods in their states, and many states impose a sales tax on the retail sale of specified services. In general, sellers collect sales taxes from consumers at the time of purchase and remit the amount collected to the taxing state. When sellers do not collect and remit sales taxes, consumers in the taxing state are usually responsible for paying a use tax at the same rate. Use taxes are taxes on goods or services for the use, storage, or consumption of goods or services in the taxing state. As the Supreme Court observed in *Wayfair*, consumer compliance with state use tax laws is "notoriously low," and the shift from in-person sales to online sales has led to reductions in state revenues.

Commerce Clause

The U.S. Constitution's Commerce Clause is an affirmative grant of authority to Congress to regulate interstate commerce. The Supreme Court has interpreted the Commerce Clause to include an implicit restriction, the "Dormant" Commerce Clause, which limits state regulation of interstate commerce even absent congressional action. Thus, states may require participants in interstate commerce to pay their fair share of state taxes so long as these taxes do not produce an effect forbidden by the Commerce Clause.

As explained in *Wayfair*, two general principles guide courts adjudicating Commerce Clause challenges to state regulations of interstate commerce and "mark the boundaries" of those regulations: (1) "state regulations may not discriminate against interstate commerce;" and, (2) "[s]tates may not impose undue burdens on interstate commerce." In *Wayfair*, the Court reaffirmed:

> State laws that discriminate against interstate commerce face "a virtually per se rule of invalidity." State laws that "regulat[e] even-handedly to effectuate a legitimate local public interest … will be upheld unless the burden imposed on such commerce is clearly excessive in relation to the putative local benefits."

Congress has generally left it to the courts to determine whether a state action has discriminated against or unduly burdened interstate commerce.

The Supreme Court set out the framework for determining whether a state tax law violates the Commerce Clause in *Complete Auto Transit, Inc. v. Brady*. In *Complete Auto*, the Court stated it would sustain a state tax law against a Commerce Clause challenge

> when the tax is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State.

The "substantial nexus" prong of this test is often the center of cases in which states have imposed sales and use tax collection duties on out-of-state sellers.

Sales and Use Tax Nexus Before *South Dakota v. Wayfair*

The Supreme Court has frequently stated that the Commerce Clause's substantial nexus requirement is "closely related" to the Fourteenth Amendment's Due Process Clause nexus requirement that there must be "some definite link, some minimum connection, between a state and the person, property or transaction it seeks" to subject to a tax or a tax obligation. Until the Supreme Court's 1992 decision in *Quill Corp. v. North Dakota*, courts generally regarded state laws imposing sales and use tax obligations on sellers without a physical presence in the taxing state as barred by the Due Process Clause *and* the Commerce Clause. Before *Quill*, the Supreme Court had not explained precisely how the Due Process Clause is analytically distinct from the Commerce Clause in sales and use tax cases. Then, in *Quill*, the Court explained that Due Process Clause challenges require courts to ask if the out-of-state seller has the minimum contacts with the taxing state necessary to legitimate the state's exercise of power over the seller. The primary concern is whether the imposition of the tax on the out-of-state seller satisfies the "traditional notions of fair play and substantial justice." Thus, the Due Process Clause's minimum contacts requirement serves as a proxy for "notice" or "fair warning" to out-of-state sellers.

Even though the remote seller in *Quill* was a mail-order business, the Court ruled that the Due Process Clause did not bar enforcement of North Dakota's use tax collection obligations. The Court reasoned that "modern commercial life" warranted a different outcome. At the time of *Quill*, businesses no longer needed to have a physical presence in the taxing state in order to conduct business across state lines. The Court explained that out-of-state sellers operating exclusively through mail and wire communications should have fair warning that they might be subject to a taxing state's jurisdiction when they are "engaged in continuous and widespread solicitation within" the taxing state. The Court held that the Due Process Clause did not bar enforcement because the seller had "purposefully directed its activities" at the state's residents, "the magnitude of [the seller's] contacts" were "more than sufficient" for due process, and the state's use tax was "related to the benefits" the seller received from state access.

The Court then examined the Commerce Clause, explaining that the Commerce Clause's substantial nexus requirement is concerned with the effects of a state sales or use tax on the national economy. It is a means to limit state interference with interstate commerce. For Commerce Clause purposes, the Court expressed support for the bright-line physical presence rule because it "firmly establishe[d] the boundaries of legitimate state authority to impose a duty to collect sales and use taxes and reduce[d] litigation concerning those taxes." The Court reasoned that the bright-line rule fostered business and individual investment by providing clarity and settling expectations.

South Dakota v. Wayfair

In *South Dakota v. Wayfair, Inc.*, the Supreme Court overruled the physical presence rule set forth in *Quill*. Thus, a business need not have a physical presence in a taxing state in order for the state to impose a duty on the business to collect and remit sales and use taxes. The Court determined

> [t]he reasons given in *Quill* for rejecting the physical presence rule for due process purposes apply as well to the question whether physical presence is a requisite for an out-of-state seller's liability to remit sales taxes. Other aspects of the Court's doctrine can better and more accurately address potential burdens on interstate commerce, whether or not *Quill's* physical presence rule is satisfied.

The Court concluded that the physical presence rule was an "unsound and incorrect" interpretation of the Commerce Clause and that physical presence was unnecessary to satisfy *Complete Auto's* substantial nexus prong.

The Court explained in *Wayfair* that the purpose of the Commerce Clause is to prevent economic discrimination, not create "market distortions," and that the effect of *Quill* was "a judicially created tax shelter for businesses that limit their physical presence." Remote businesses were at a competitive advantage because they could avoid regulatory burdens and sell goods and services at lower prices. The Court observed that modern e-commerce and the ability of out-of-state sellers to maintain a "continuous and pervasive virtual presence" in a taxing state only exacerbated the problem. In *Quill*, the Court focused on the benefits of bright-line rules and was concerned about the administrative costs arising from nationwide sales tax compliance. Nearly 30 years later, the Court reasoned in *Wayfair* that the physical presence rule was a "poor proxy for compliance costs" faced by interstate businesses and predicted that the burden of nationwide sales tax collection could be reduced by software available at a reasonable cost.

Thus, for purposes of the sales and use tax substantial nexus analysis under the Commerce Clause, the Court in *Wayfair* replaced the physical presence rule with an economic nexus rule. It held that substantial nexus is established when a remote seller has "availed itself of the substantial privilege of carrying on business" in the taxing state. The Court held that the South Dakota law at issue satisfied this test because (1) the law only applied to sellers who, on an annual basis, "deliver more than $100,000 of goods or services into South Dakota or engage in 200 or more separate transactions for the delivery of goods and services into" South Dakota; and (2) the remote sellers were large national online retailers that maintained an "extensive virtual presence."

The Court acknowledged in *Wayfair* that the burden of nationwide sales tax collection "may pose legitimate concerns," particularly for small businesses making a few sales across many states. It noted that "Congress may legislate to address these problems." However, the Court also concluded that the South Dakota law provided these small businesses with a "reasonable degree of protection" as (1) the law included a safe harbor limiting its application to businesses that did considerable business in South Dakota; (2) the law was not retroactive; and (3) South Dakota was a party to the Streamlined Sales and Use Tax Agreement that more than 20 states had joined, which "standardizes taxes to reduce administrative and compliance costs." The Court stated that these features of the South Dakota tax system "appear[ed] designed to prevent discrimination against or undue burdens upon interstate commerce." Still, because the Commerce Clause's substantial nexus requirement was the only Commerce Clause issue before the Court in *Wayfair*, the Court underscored that another "principle in the Court's Commerce Clause doctrine might invalidate" the law.

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