States and Local Governments Win Online Sales Tax Case

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The State and Local Legal Center (SLLC) files Supreme Court amicus curiae *briefs on behalf of the Big Seven national organizations representing state and local governments.*

In *South Dakota v. Wayfair* the Supreme Court ruled that states and local governments can require vendors with no physical presence in the state to collect sales tax in some circumstances. In a 5-4 decision, the Court concluded that Wayfair's "economic and virtual contacts" with South Dakota are enough to create a "substantial nexus" with the state allowing it to require collection.

As the Court pointed out in its majority opinion, it is estimated states and local governments lose between $8-$33 billion annually because they haven't been able to collect sales tax owed on purchases from out-of-state sellers.

As a result of this decision, state legislatures are likely to pass laws like South Dakota's, if they haven't already.

In the 1967 case *National Bellas Hess v. Department of Revenue of Illinois*, the Supreme Court held that per its Commerce Clause jurisprudence, states and local governments cannot require businesses to collect sales tax unless the business has a physical presence in the state.

Twenty-five years later in *Quill v. North Dakota* (1992), the Supreme Court reaffirmed the physical presence requirement but admitted that "contemporary Commerce Clause jurisprudence might not dictate the same result" as the Court had reached in *Bellas Hess*.

Customers buying from remote sellers still owe sales tax, but they rarely pay it when the remote seller does not collect it. Congress had the authority to create solution that would overrule *Bellas Hess* and *Quill* but never did so.

In March 2015 Justice Kennedy wrote a concurring opinion stating that the "legal system should find an appropriate case for this Court to reexamine *Quill*." Justice Kennedy criticized *Quill* in *Direct Marketing Association v. Brohl* for many of the same reasons the State and Local Legal Center (SLLC) stated in its *amicus* brief in that case. Specifically, internet sales have risen

astronomically since 1992 and states and local governments had been unable to collect most taxes due on sales from out-of-state vendors.

Following the 2015 Kennedy opinion a number of state legislatures passed laws requiring remote vendors to collect sales tax in order to challenge *Quill*. South Dakota's law was the first ready for Supreme Court review. It requires out-of-state retailers to collect sales tax if they annually conduct $100,000 worth of business or 200 separate transactions in South Dakota.

South Dakota v. Wayfair was a nail biter. After oral argument it looked like South Dakota had four votes: Justices Kennedy, Ginsburg, Gorsuch, and Thomas (who has long since disavowed dormant Commerce Clause jurisprudence). Justice Alito provided the fifth vote to overturn *Quill*—perhaps in part because he was going to write an opinion overturning union dues precedent a week later.

In an opinion written by Justice Kennedy the Court offered three reasons for why it was overruling *Quill* and abandoning the physical presence rule. "First, the physical presence rule is not a necessary interpretation of the requirement that a state tax must be 'applied to an activity with a substantial nexus with the taxing State.' Second, *Quill* creates rather than resolves market distortions. And third, *Quill* imposes the sort of arbitrary, formalistic distinction that the Court's modern Commerce Clause precedents disavow."

Overturning precedent isn't something the Supreme Court does often or lightly. But the Court noted the Internet's "prevalence and power" have dramatically changed the national economy since 1992. The Court pointed out that in 1992, less than 2 percent of Americans had Internet access. Today that number is about 89 percent. In 1992, mail-order sales in the United States totaled $180 billion. Last year, internet retail sales were estimated at $453.5 billion. In 1992, it was estimated that the states were losing between $694 million and $3 billion per year in sales tax revenues as a result of the physical presence rule. Now estimates range from $8 to $33 billion.

Justice Kennedy noted that forty-one States, two Territories, and the District of Columbia joined an *amicus* brief asking the Court to overturn *Quill*. It is remarkable to get so many state attorneys general (from different political parties) to agree to the same position on any issue.

While the dissenting Justices, in an opinion written by Chief Justice Roberts, would have left it to Congress to act, Justice Kennedy opined the Court should be "vigilant" in correcting its error. "Courts have acted as the front line of review in this limited sphere; and hence it is important that their principles be accurate and logical, whether or not Congress can or will act in response."

The dissent also questioned whether the Court needed to act urgently given the fact that states and local governments are currently collecting approximately 80 percent of the tax revenue that would be available if there were no physical-presence rule. The dissent also criticized the majority opinion for "breezily" disregarding the costs that the decision will impose on small businesses. It noted that "[o]ver 10,000 jurisdictions levy sales taxes, each with 'different tax rates, different rules governing tax-exempt goods and services, different product category

definitions, and different standards for determining whether an out-of-state seller has a substantial presence' in the jurisdiction."

Although *Wayfair* overturned precedent, it is not without limitations. In 1977 in *Complete Auto Transit v. Brady* the Supreme Court held that interstate taxes may only apply to an activity with a "substantial nexus" with the taxing State. *Quill*'s physical presence test was seen as an addition to the "substantial nexus" requirement. Post-*Quill*, the "substantial nexus" requirement remains.

The Court found a "substantial nexus" in this case based on the "economic and virtual contacts" Wayfair has with South Dakota. A business could not do $100,000 worth of sales or 200 separate transactions in South Dakota "unless the seller availed itself of the substantial privilege of carrying on business in South Dakota." "And [Wayfair, etc.] are large, national companies that undoubtedly maintain an extensive virtual presence."

Finally, the Court acknowledged that questions remain whether "some other principle in the Court's Commerce Clause doctrine might invalidate" South Dakota's law. The Court could have (but didn't) say that South Dakota's law (including its small seller exception of $100,000 worth of business or 200 separate transactions) is constitutional in every respect and that if every state passes a law exactly like South Dakota's they will be in the clear. Instead, the Court cited to three features of South Dakota's tax system that "appear designed to prevent discrimination against or undue burdens upon interstate commerce. First, the Act applies a safe harbor to those who transact only limited business in South Dakota. Second, the Act ensures that no obligation to remit the sales tax may be applied retroactively. Third, South Dakota is one of more than 20 States that have adopted the Streamlined Sales and Use Tax Agreement."

In conclusion the opinion highlighted several aspects of the South Dakota tax system that may outline a successful legislative or regulatory roadmap for other states to follow including: not requiring small businesses to collect; not collecting online sales tax retroactivity; and adopting a standardized tax system that reduces administrative and compliance costs.