ROPES & GRAY

ALERT

Tax Controversy

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The Bell Tolls for *Quill*'s Physical Presence Standard

On June 21, 2018, the Supreme Court ruled 5-4 in *South Dakota v. Wayfair et al.* that the Constitution does not prevent the State of South Dakota from requiring large online retailers without actual physical presence in the state to collect and remit sales tax. Its decision, written by Justice Kennedy and joined by Justices Thomas, Ginsburg, Alito, and Gorsuch, was foreshadowed by Justice Kennedy's 2015 call for the Court to review its prior precedent to the contrary.

The Supreme Court has long held that, although the Constitution grants Congress authority to regulate interstate commerce, the states may also do so, as long as they do not discriminate against or impose an undue burden on interstate commerce. Under this requirement—the "dormant" Commerce Clause—the Supreme Court has upheld any state tax that [1] is "applied to an activity with a substantial nexus with the taxing State, [2] is fairly apportioned, [3] does not discriminate against interstate commerce, and [4] is fairly related to the services provided by the State." The Court held in *Quill v. North Dakota* in 1992 that North Dakota's attempt to impose sales tax on an out-of-state retailer with no physical locations or staff in a state did not meet the substantial nexus requirement, upholding its 1967 decision in *Bellas Helas v. Dep't of Rev. of Ill*.

The majority in *Wayfair* reconsidered these precedents in light of the dramatic growth of the internet over the past several decades. It held first that *Quill* was incorrectly decided from its onset since physical presence was never required for "substantial nexus" and the bright-line physical presence test both caused significant economic distortion and eschewed case-by-case analysis contrary to dormant Commerce Clause jurisprudence. It next reasoned that the realities of modern e-commerce allowed retailers to use websites, cookies, and apps to establish comparably more nexus than under prior physical presence requirements, particularly where 89% of Americans had internet access at home. Finally, it found that the increasing unworkability of *Quill*, recent technological improvements that reduced the cost of compliance, and the protective features of the South Dakota law, including non-retroactivity and the state's participation in a multi-state tax compact, justified overturning its past precedents despite their long provenance.

The dissent, written by Chief Justice Roberts, would have upheld *Quill* and left the issue to Congress to resolve. It disagreed with the majority's decision to reverse prior Court precedent, particularly because Congress could, if it so wanted, legislate to override *Quill*. The dissent questioned the Court's "inexplicable urgency" and disputed the Court's assessment of the importance of changing the law, because tax collection from online retailers had been increasing and Congress had been considering passing legislation in the area. The dissent noted that "over 10,000 jurisdictions levy sales taxes" and thus the majority's decision could impose heavy costs and burdens on out-of-state sellers.

While this decision is likely to put to rest certain state tax disputes by large online retailers, this decision is unlikely to end dormant Commerce Clause litigation challenging sales and other taxes levied by states and other jurisdictions. In particular, the Court left open the question of whether other state sales tax laws that imposed a greater burden on taxpayers could pass constitutional muster, such as state sales taxes in states that have unique or multiple sales tax regimes or attempt to apply tax retroactively. The Court's ruling also invites challenges by particular taxpayers whose nexus with a taxing state is less extensive due to the nature of their business and sales practices. By settling the question of states' rights to impose sales tax on internet sales, the Court's decision relieves the pressure on Congress to legislate in this area. It is unlikely that Congress will legislate in this sphere for years to come.