

Supreme Court decides internet sales tax case in favor of South Dakota

June 21, 2018 – Today, the Supreme Court announced in a 5-4 opinion that the “physical presence rule” for the purpose of requiring out of state sellers to collect and remit sales tax is “unsound and incorrect,” has limited States’ and local governments’ “ability to seek long-term prosperity,” and that *Quill Corp. v. North Dakota*, 504 U. S. 298 (1992), and *National Bellas Hess, Inc. v. Department of Revenue of Ill.*, 386 U. S. 753 (1967) are therefore overruled.

Amanda Kellar, Director of Legal Advocacy at IMLA (International Municipal Lawyers Association), sent out to IMLA members the following report on today’s SCOTUS decision. It is republished below with permission of IMLA:

It is estimated that states and local governments lose between \$8 and \$33 billion dollars each year as a result of the Supreme Court’s “physical presence” requirement. In a huge win for state and local governments, today, the Supreme Court announced in a 5-4 opinion that the “physical presence rule” for the purpose of requiring out of state sellers to collect and remit sales tax is “unsound and incorrect,” has limited States’ and local governments’ “ability to seek long-term prosperity,” and that *Quill Corp. v. North Dakota*, 504 U. S. 298 (1992), and *National Bellas Hess, Inc. v. Department of Revenue of Ill.*, 386 U. S. 753 (1967) are therefore overruled.

In 1967, in *Bellas Hess*, the Supreme Court held that an out-of-state seller’s requirement to collect and remit sales tax depended on whether that seller had a “physical presence” in the State. In 1992, the Court was asked to revisit its ruling in *Bellas Hess*, and in *Quill v. North Dakota*, the Supreme Court upheld the rule, largely on *stare decisis* grounds.

The physical presence rule has long been criticized and in 2015, Justice Kennedy called its validity into question in a concurring opinion in *Direct Marketing Assn v. Brohl*. South Dakota’s legislature acted quickly to pass a law that directly challenged *Quill*. Specifically, the Act applied to require out-of-state sellers to collect and remit sales tax if they delivered more than \$100,000 worth of goods or services into the State or engaged in more than 200 separate transactions in the State. The Act specifically forecloses retroactive liability for taxation and stayed its application until the constitutionality of the law had been established.

South Dakota then sought declaratory judgment that its law was constitutional. Unsurprisingly, the law was held to be unconstitutional under *Quill* by the South Dakota Supreme Court.

In a 5-4 opinion authored by Justice Kennedy, the Supreme Court reversed, concluding that *Quill* and *Bellas Hess* were not only wrong in their interpretations of the Commerce Clause at the time they were decided, but that “[e]ach year, the physical presence rule becomes further removed from economic reality”, particularly given the boom of e-commerce, “and results in significant revenue losses to the

States.” After recounting the history of the Court’s Commerce Clause jurisprudence as well as the decisions in *Quill* and *Bellas Hess*, the Court explained that under the Commerce Clause, the correct inquiry is not physical presence, but whether the tax applies to “an activity with a substantial nexus with the taxing state” under *Complete Auto*. The Court explained that *Quill* was flawed because: (1) “physical presence” is not required for an activity to have a “substantial nexus” with the taxing state under *Complete Auto*; (2) *Quill* “creates rather than resolves market distortions; and (3) *Quill* imposes the sort of “arbitrary, formalistic distinction that the Court’s modern Commerce Clause precedents disavow.”

The Court also noted the serious federalism concerns with its prior holdings in *Bellas Hess* and *Quill* and that it was “an extraordinary imposition by the Judiciary on States’ authority to collect taxes and perform critical public functions.” The Court explained that the purpose of the Commerce Clause is to “prevent States from engaging in economic discrimination” not to “permit the Judiciary to create market distortions.” According to the Court, *Quill* did exactly the latter by allowing remote sellers to avoid the regulatory burdens of tax collection and therefore offer lower prices (and even advertise that their goods are being sold “tax free”). This “judicially created tax shelter” has been exploited as technology has advanced.

The Court concluded that the doctrine of *stare decisis* “can no longer support the Court’s prohibition of a valid exercise of the State’s sovereign power.” The majority explained that although *Quill* was wrongly decided in 1992, the drastic change in circumstances with the way companies utilize Internet sales made the Court’s “earlier error all the more egregious and harmful.” In terms of reliance principles, which sometimes countenance against overruling precedent, the Court noted that the physical presence rule is not clear or easy to apply. Further, reliance principles only apply for “legitimate reliance interests,” and here, the tax problems States face is largely due to consumers failing to comply with lawful use taxes and so the companies should not be allowed to argue that they are relying on “opportunities for tax avoidance” as a legitimate constitutional concern.

And while the Court noted that some small remote sellers might be burdened by the abolishment of the physical presence requirement, the Court indicated that South Dakota’s law at least seemed to take these concerns into consideration and that nothing would preclude Congress from enacting legislation to address those concerns.

Finally, in terms of the facts of this case the Court explained, the nexus was clearly sufficient under *Complete Auto* “based on both the economic and virtual contacts” Overstock and Wayfair have with the State. The Court remanded the case for the lower courts to decide whether some other principle might invalidate the Act, but noted that the tax system the State had enacted included “several features that appear designed to prevent discrimination against or undue burdens upon interstate commerce.”

In an interesting lineup, Chief Justice Roberts authored a dissent, joined by Justices Kagan, Breyer, and Sotomayor. The dissents primary argument is that principles of *stare decisis* weigh against overruling precedent and that Congress is in a better position to enact a law to weigh all of the policy considerations at play with e-commerce.

IMLA joined an amicus brief filed by the SLLC at both the petition and merits stage of this case, arguing to overturn *Quill*. This is a great decision for state and local governments that can now require internet retailers to collect and remit sales taxes and can even the playing field for businesses on main street. As an added bonus, the decision also underscores state sovereignty principles.

To read the Court's opinion, click here:

https://www.supremecourt.gov/opinions/17pdf/17-494_j4el.pdf

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