THE *WAYFAIR* DECISION AND ITS EFFECT ON RETAILERS

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In the landmark decision of *South Dakota v. Wayfair*, the U.S. Supreme Court overturned the long-standing physical presence test which was utilized in establishing nexus for sales and use tax.

In *Wayfair*, the Court upheld a South Dakota law that required certain out-of-state sellers to collect and remit sales tax regardless of whether the business had a physical presence in South Dakota.

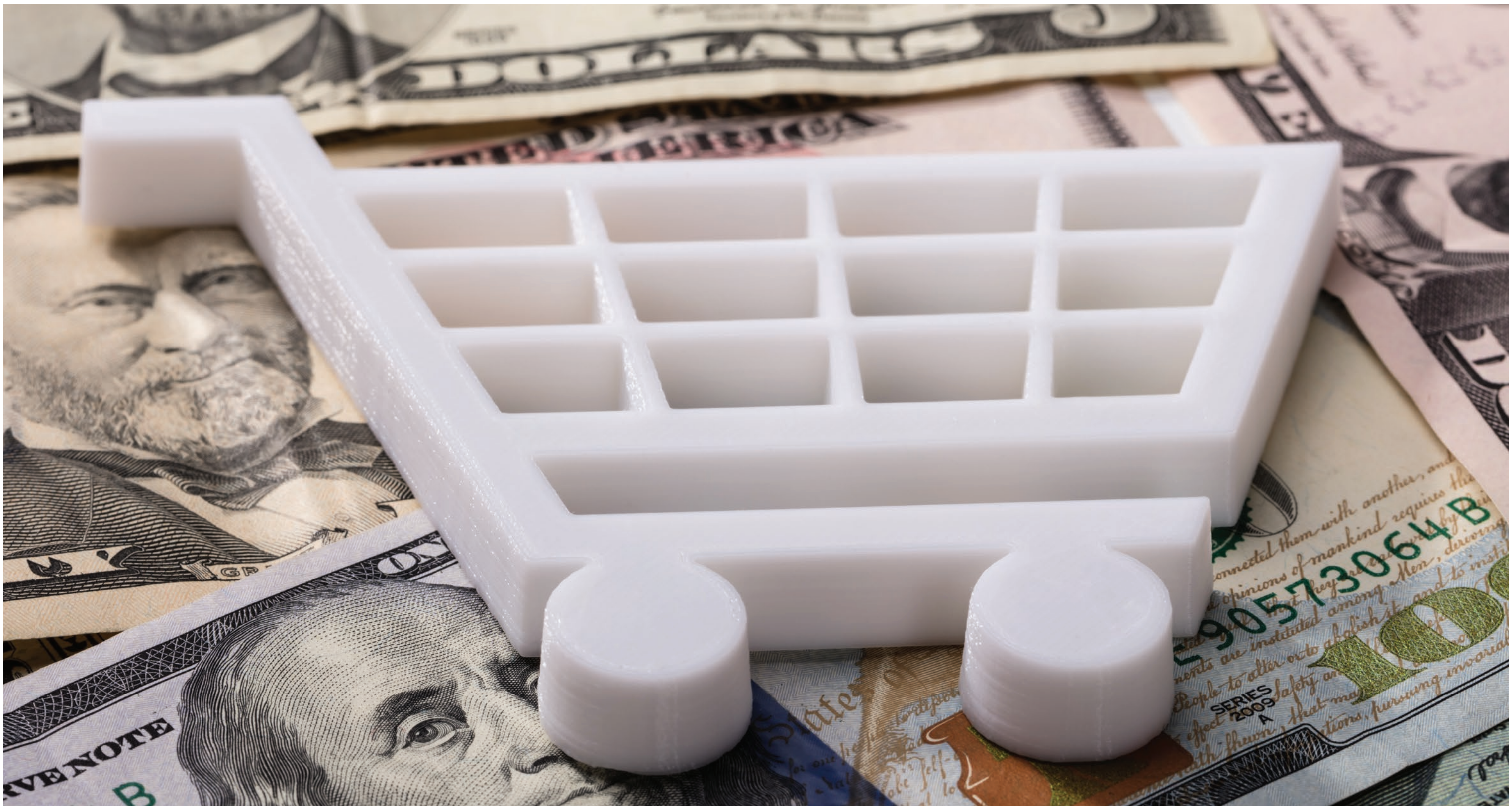
For over 50 years, since the Supreme Court's decision in *National Bellas Hess v. Department of Revenue of Illinois*, the standard for whether an out-of-state retailer could collect and remit sales tax was based upon whether a seller had property, people or some other physical connection within the taxing state. This standard was later upheld by the Supreme Court in *Quill v. North Dakota. Quill* established that a state government could only tax businesses that had a "physical presence" in the state. If the seller did not have a physical presence in the state, the seller was generally not required to collect any sales tax. The burden was on the buyer to report and pay the sales or use tax to the respective state.

TIME FOR A CHANGE

Since 1992, *Quill* was the accepted practice for sales tax collection. Yet, over the years, new technology and the substantial growth of e-commerce made it increasingly difficult for local retailers to compete with online retailers who could sell their products to customers without the imposition of a sales tax, which local retailers were required to collect. A customer in one state could purchase goods online via the seller's website, regardless of where the seller was located. If the seller did not have a physical presence in the customer's state, then sales tax could be avoided since the seller was not required to collect and remit the sales tax to the state. As a result, states, such as South Dakota, lost billions of dollars of revenue each year. In 2016, South Dakota enacted S.B. 106, which directly contradicted the physical presence standard established by the Court in *National Bellas* and *Quill*. The law required out-of-state sellers to collect sales tax as if they had a physical presence in South Dakota if the seller either 1) delivered more than $100,000 of goods or services into South Dakota or 2) engaged in 200 or more separate transactions for the delivery of goods or services into South Dakota. Additionally, S.B. 106 did not apply retroactively. Following the enactment of the law, South Dakota then sued three online remote companies, Wayfair, Overstock.com, Inc. and Newegg (each of which had over $1 billion in annual sales) seeking a declaration that such companies were required to comply with the statute.

IMPACT ON RETAILERS AND STATES

In *Wayfair*, the Supreme Court sought to level the playing field among retailers. The Court reversed earlier precedent and



permitted states to require out-of-state businesses to collect sales tax based solely on the connection created by selling goods to state residents. The Court noted that the physical presence rule created market distortions because it discouraged out-of-state sellers from having an in-state physical presence and encouraged customers to buy from out-of-state vendors.

In their decision, the Court analyzed the U.S. Constitution's Commerce Clause and found that the Court's prior decision in *Quill* was flawed. Specifically, the Court stated that physical presence in a state is no longer required before a state can force a remote seller to collect sales tax. Nevertheless, the Court also said that states could not require a remote seller to collect sales tax unless the seller has "substantial nexus" with the state and the tax collection does not place "undue burdens" on the remote seller. In *Wayfair*, the Court set a new standard known as an "economic nexus" which expanded the reach of states across the country and permitted states to impose sales and use taxes on retail and other businesses, regardless of the physical location of the business.

In overturning the Court's precedent in *Quill* and *National Bellas Hess*, the Court concluded that "the physical presence rule of *Quill* is unsound and incorrect." This fundamental change in the sales tax nexus standard represents an opportunity for states to now determine how they will collect and enforce the collection of sales tax. The Court determined that states now had the authority to require out-of-state retailers to collect and remit sales tax on sales to in-state residents. The Court also noted that its decision "should not prevent states from collecting lawful taxes through a physical presence rule that can be satisfied only if there is an employee or building in the state."

Following the *Wayfair* decision, it is abundantly clear that the physical presence requirement has been overturned. While the Court did not clearly articulate nor define "substantial nexus" or "undue burdens," the Supreme Court held that South Dakota's law was permissible because it had several distinct features which prevented it from violating the Commerce Clause:

1. A safe harbor provision for retailers that transact a limited amount of business in the state (e.g., annual in-state sales that exceed $100,000 or 200 or more transactions into the state).
2. The law was not retroactive.
3. South Dakota was one of more than 20 states that had adopted the Streamlined Sales and Use Tax Agreement, which reduces administrative and compliance costs for taxpayers.

Nevertheless, the Court did not articulate any specific guidelines with respect to whether lower thresholds would be sufficient, or if $100,000 in sales or 200 in transactions would be an adequate threshold in a more populous state.

Post-*Wayfair*, every retailer, including brick and mortar stores, must now consider how they handle sales across state lines. The economic nexus standards are applied broadly to all remote sellers. As a result, each retailer must keep records pertaining to every state in which their business transacts sales.

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