

Supreme Court Rules States May Require Some Out-of-State Businesses to Collect Sales Tax

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In a case of major importance to both online and brick-and-mortar retailers, the Supreme Court has overruled the half-century-old “physical presence rule” for imposing sales tax. In *South Dakota v. Wayfair Inc.*, No. 17-494, the Court held that states are *not* prohibited from requiring a retailer to collect sales tax if it does not have a physical presence in the state. Instead, the proper inquiry is “whether the tax applies to an activity with a substantial nexus with the taxing State,” judged by whether the retailer “avails itself of the substantial privilege of carrying on business” in the state. The Court’s opinion leaves the states with more flexibility to compel out-of-state businesses to collect sales taxes, without establishing a clear rule for when they may do so.

The case arose when South Dakota decided to challenge the physical presence rule, which was established in the Supreme Court’s 1967 decision *National Bellas Hess Inc. v. Department of Revenue of Illinois* and was upheld against a previous challenge in the 1992 case *Quill Corp. v. North Dakota*. South Dakota passed a tax law requiring out-of-state sellers to collect a tax on sales in South Dakota if the seller annually delivers more than \$100,000 of goods or services into the state or engages in 200 or more transactions to deliver goods into the state. South Dakota sought a declaratory judgment that the law was constitutional, but a state court rejected the argument. The South Dakota Supreme Court affirmed, noting that *Bellas Hess* and *Quill* were still good law and plainly rendered the tax collection requirement unconstitutional.

The Supreme Court vacated that decision. Although the Court’s decision split 5 to 4, no justice defended *Bellas Hess* or *Quill* as rightly decided. In 1977 the Supreme Court in *Complete Auto Transit Inc. v. Brady* laid out a framework for weighing whether a state tax offended the dormant commerce clause, requiring “a substantial nexus with the taxing State.” *Quill* had acknowledged that *Complete Auto Transit* might not mandate the physical presence rule, but it nonetheless held that a physical presence was required for there to be a substantial nexus, largely on *stare decisis* grounds. The majority opinion this week rejected that analysis, describing the physical presence rule as a judicially created tax shelter that discouraged businesses from opening locations in the same state as their customers. As a result, the Court held that the physical presence rule was disconnected from the purpose of the commerce clause, which is to prevent states from discriminating against or burdening interstate commerce. As *Bellas Hess* and *Quill* “prohibit the States from exercising their lawful sovereign powers in our federal system,” the Court continued, *stare decisis* should not stop it from admitting error.

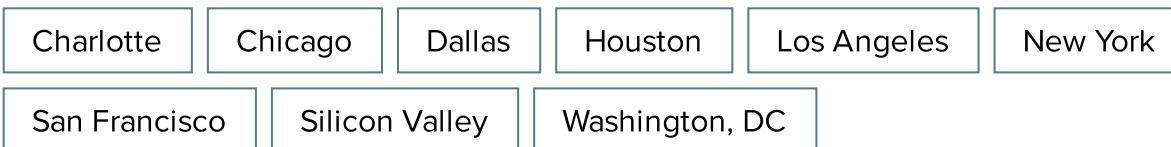
Noting that the South Dakota law applied only to retailers with substantial sales in the state, the Court found that it satisfied the substantial nexus prong of *Complete Auto Transit*. Because the South Dakota Supreme Court had not considered whether other aspects of the dormant commerce clause doctrine might invalidate the law, the Court vacated its decision and remanded the case.

Justices Thomas and Gorsuch wrote separate concurrences to express doubts about the dormant commerce clause in general. Chief Justice Roberts dissented, joined by Justices Breyer, Sotomayor, and Kagan. The dissenters emphasized Congress's ability to overrule the courts on dormant commerce clause issues and would have left it to Congress to decide how best to reconcile the states' need to collect taxes with modern e-commerce.

While the end of the physical presence rule does not leave states free to require every out-of-state retailer to collect sales tax, the Court's decision does not establish how much volume a retailer must deliver into a state before it can be required to collect taxes. Nor does the Court's opinion clarify when a state's collection requirement might impose an undue burden upon interstate commerce, or whether there are any limits upon retroactive application by the states. Absent some action by Congress, states will establish their criteria and courts will assess their effects on interstate commerce on a case-by-case basis under the *Complete Auto Transit* framework.

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