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SCOTUS Rejects Physical Presence Rule in *Wayfair*

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In a narrow 5-4 decision, the Court in *South Dakota v. Wayfair, Inc.* overruled its long-held precedent and held that under the Commerce Clause physical presence is no longer the touchstone for sales tax nexus. Dating back to its decision in *National Bellas Hess* in 1967, the Court had been clear that a state sales tax passes scrutiny under the Commerce Clause only if the out-of-state business had a physical presence in the taxing state. The holding in *National Bellas Hess* was affirmed by the Court most recently in 1992 in *Quill*. Since *Quill*, the e-commerce marketplace has exploded and, in many ways, is now the sole channel through which consumers shop for purchases of tangible personal property.

The Court premised its holding by citing to the market distortions caused by the physical presence rule. In the view of the Court, the physical presence rule created a "tax shelter" for businesses that limit their physical presence to only a handful of states. Further, the Court reasoned, the rule created distortions by deterring out-of-state businesses from creating a physical presence in state. There are obvious economic benefits to having a physical presence in a state – i.e., through an office or distribution location – and the benefits of the physical presence rule artificially alters these business decisions.

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In addition, the Court further noted that the physical presence rule perpetuated formalistic distinctions that it has long-sought to avoid in its Commerce Clause jurisprudence. A retailer located just over a state border can permeate the market just as effectively as an in-state brick-and-mortar retailer. Yet, the in-state retailer is obligated to charge sales tax on sales to residents of the state. The out-of-state retailer would not. Over the past many decades, the Court has been vigilant in avoiding these types of formalistic distinctions under the Commerce Clause.

Another important foundation for the Court's ruling related to the undeniable impact on state budgets stemming from the operation of the physical presence rule. Specifically, in the context of the *Wayfair* decision, the South Dakota legislature noted that state sales tax revenues had dramatically fallen resulting in a "state of emergency." The Court referred to the physical presence rule as creating an inequitable exception to state sales tax laws. By allowing out-of-state businesses to avoid collecting and remitting sales tax, the Court continued, the financial health of many states has been jeopardized.

The Court takes great care not to overrule its prior precedent. The sensitivity to this concern is heightened when Congress has the constitutional authority to address the issue. As *Wayfair* dealt squarely with the Commerce Clause, our founders were clear that only Congress can define how and when a state may tax interstate commerce. In overruling the physical presence rule, the Court explained that it was merely addressing a "false constitutional premise" of its own creation. Advancements in e-commerce, in the Court's view, served to highlight the Court's error in affirming *Quill* in 1992.

While the Court's holding was to make unequivocal that physical presence is no longer required for purposes of sales tax nexus under the Commerce Clause, there remain many unanswered questions. The Court only addressed the narrow question of physical presence. It readily acknowledged that certain other aspects of the Court's Commerce Clause jurisprudence may need to be considered in order to confirm the constitutionality of the South Dakota law. The decision of the South Dakota Supreme Court was ultimately vacated and remanded to develop and consider further argument under the Commerce Clause. While it may be said that South Dakota has won the battle, the war is likely far from over as it relates to sales tax nexus.

For a look at what steps businesses should consider in light of *Wayfair*, please click here.