2018

Wayfair: Substantial Nexus and Undue Burden

David Gamage
Indiana University Maurer School of Law, dgamage@indiana.edu

Darien Shanske
University of California, Davis

Adam Thimmesch
University of Nebraska - Lincoln

Wayfair: Substantial Nexus and Undue Burden

by Adam Thimmesch, Darien Shanske, and David Gamage

Adam Thimmesch

Darien Shanske

David Gamage

Adam Thimmesch is a professor at the University of Nebraska College of Law; Darien Shanske is a professor at the University of California, Davis, School of Law (King Hall); and David Gamage is a professor of law at Indiana University Maurer School of Law.

In this edition of Academic Perspectives on SALT, the authors begin a series of articles aimed at evaluating the U.S. Supreme Court's opinion in *South Dakota v. Wayfair*. The first article in this series tackles some of the more immediate interpretive questions raised by the *Wayfair* opinion, such as how a state should approach substantial nexus.

The U.S. Supreme Court decided *South Dakota v. Wayfair* and overruled its physical presence rule in a 5-4 decision.[1] The Court's ruling was very narrow, though, holding only that the physical presence rule is no longer the governing standard for purposes of determining when a taxpayer has the substantial nexus required under the Court's *Complete Auto Transit Inc. v. Brady* formulation.[2] That limited holding leaves many questions unanswered.

This is the first in a series of planned articles that will evaluate the Court's opinion and discuss some of the questions raised by that opinion. In this article, we tackle some of the more immediate interpretive questions raised by the *Wayfair* opinion, such as how a state should approach substantial nexus. In future articles, we will consider additional unsettled issues, such as what *Wayfair* says about the Court's perspective on federalism.

As part of our analysis of the *Wayfair* opinion, we offer advice to state governments. In this article, we recommend that states take note of the features of South Dakota's law that appealed to the Court and replicate or improve on these to the extent possible. We advise states to consider simplifying their sales tax systems (and potentially joining the Streamlined Sales and Use Tax Agreement if they have not already done so), offering full and adequate reimbursement for compliance costs (especially for smaller vendors), and offering free compliance software and immunity for vendors who properly rely on such software.

The Opinion

The majority opinion in *Wayfair* was written by Justice Anthony M. Kennedy, who invited the case three years earlier in his concurring opinion in *DMA v. Brohl*.[3] Kennedy started the majority opinion with a review of the development of the

[1] No. 17-494, 2018 WL 3058015 (2018).

[2] 430 U.S. 274 (1977).

[3] 135 S. Ct. 1124, 1134-35 (2015) (Kennedy, J. concurring).

Court's dormant commerce clause doctrine since the 1800s and noted that the Court's tax-specific precedents had been animated by its approach in its regulatory cases. The opinion started with a clear statement regarding the majority's view of the merit of the physical presence rule, calling the rule "flawed on its own terms."[4] The opinion further stated that it was not a "necessary interpretation" of the substantial nexus requirement, created market distortions rather than preventing them, and was "the sort of arbitrary, formalistic [rule] that the Court's modern commerce clause precedents disavow."[5]

The Court recognized that the nexus requirement was akin to the due process minimum contacts requirement and said that although the two "may not be identical or coterminous . . . there are significant parallels."[6] Incorporating the Court's due process analysis in *Quill Corp. v. North Dakota*, the Court plainly stated that "physical presence is not necessary to create a substantial nexus."[7] With that, *Quill* was dead.

The remainder of the Court's opinion focused on justifying the decision. The Court discussed the distortionary impact of the physical presence rule, its move away from formalism in dormant commerce clause jurisprudence, the poor fit of a physical presence rule in the modern economy, the rule's impact on states and our federal structure, and why *stare decisis* did not compel upholding *Quill*.

The Court addressed the concern that removing the physical presence rule would result in the imposition of undue compliance burdens on vendors engaging in interstate commerce, calling them "legitimate concerns."[8] The Court did not think that those concerns merited retaining the physical presence rule, though, pointing to the availability of software and congressional intervention "if it deems it necessary and fit to do so."[9] The Court noted that South Dakota's law provided a "reasonable degree of protection" for smaller vendors,[10] pointing to the law's sales and transaction thresholds, prospective application, and the state's membership in the SSUTA. It also referenced other potential avenues for smaller vendors to get relief from state laws that overreach using "other theories," including the potential application of its balancing test established in *Pike v. Bruce Church Inc.* — something two of us have argued for in other forums.[11]

The concluding section of the majority opinion gave some insight into the future of the nexus requirement, but not much. The Court seems to have offered a new standard for nexus, or at least formulation of the standard, stating, "Nexus is established when the taxpayer [or collector] 'avails itself of the substantial privilege of carrying on business' in that jurisdiction."[12] The Court cited *Polar Tankers Inc. v. City of Valdez*[13] for that proposition. However, *Polar Tankers* involved a local personal property tax that was struck down as violating the tonnage clause, and does not provide much guidance, especially because the case involved ships that were undeniably present in the taxing jurisdiction.

The Court's application of its nexus standard, whatever the formulation, was terse. The Court simply stated that "here, the nexus is clearly sufficient based on both the economic and virtual contacts respondents have with the State."[14] The Court found that South Dakota's economic thresholds ensured that affected vendors had the requisite economic contacts, and it noted that respondents were "large, national companies that undoubtedly maintain an extensive virtual presence."[15] Those conclusions were enough for the majority to determine the substantial nexus requirement was met on the facts presented.

[4] *Wayfair*, 2018 WL 3058015 at *2.

[5] *Id.*

[6] *Id.* at 10.

[7] *Id. See also* 504 U.S. 298 (1992).

[8] *Id.* at 16.

[9] *Id.*

[10] *Id.*

[11] 397 U.S. 137 (1970). *See also* Adam Thimmesch, "A Unifying Approach to Nexus Under the Dormant Commerce Clause," *Mich. L. Rev. Online* (2018), at 101; and brief of four senators in support of petitioner, *South Dakota v. Wayfair*, 2018 WL 3058015 (2018).

[12] *Wayfair*, 2018 WL 3058015 at *17.

[13] 557 U.S. 1 (2009).

[14] *Wayfair*, 2018 WL 3058015 at *17.

[15] *Id.*

The Court took care to point out that "some other principle in the Court's commerce clause doctrine might invalidate" the South Dakota law, but it declined to opine on that issue because it had "not been litigated or briefed."[16] The Court did, however, again note that South Dakota's law had "several features that appear designed to prevent discrimination against or undue burdens upon interstate commerce."[17] Those features included (1) de minimis safe harbor; (2) prospectivity; and (3) South Dakota's adoption of the SSUTA, which brings with it reduced administrative and compliance costs for vendors.

Other Opinions

Kennedy's majority opinion was joined by Justices Clarence Thomas, Ruth Bader Ginsburg, Samuel A. Alito Jr., and Neil M. Gorsuch. Both Thomas and Gorsuch penned concurring opinions, with Thomas repeating his standard objection to the Court's entire dormant commerce clause doctrine[18] and Gorsuch expressing reservation with it but noting that his broader concerns were "questions for another day."[19]

Chief Justice John G. Roberts Jr. wrote a dissent, which Justices Stephen G. Breyer, Sonia Sotomayor, and Elena Kagan joined.[20] That opinion did not defend the physical presence rule — indeed, it called *National Bellas Hess Inc. v. Department of Revenue* "wrongly decided" — but reasoned that any change to that rule should be done by Congress given the potentially immense economic consequences.[21] The chief justice argued that the principle of *stare decisis* should apply forcefully in the case, and the Court should retain *Quill* on that basis.

Unresolved Questions

The majority opinion in *Wayfair* did one thing very clearly — it eliminated the physical presence rule as the relevant test for determining when a taxpayer (or tax collector) has a substantial nexus within the *Complete Auto* framework. Beyond that limited holding, the Court's opinion did little else, which leaves a lot of questions for states, vendors, and those interested in state tax policy.

Question 1: What Constitutes Substantial Nexus?

The first major question, from both doctrinal and practical perspectives, is what nexus standard applies post-*Wayfair*. The Court offered two threads from which to draw guidance. The first was its citation to *Polar Tankers* and its statement that nexus is created when one "avails itself of the substantial privilege of carrying on business" in a jurisdiction. That standard, though, does not appear to require much, and could be construed as coterminous with a due process, purposeful availment standard.

The second hint of a nexus standard was the Court's reference to "economic and virtual contacts." The key paragraph is as follows:

> Here, the nexus is clearly sufficient based on both the economic and virtual contacts respondents have with the State. The Act applies only to sellers that deliver more than $100,000 of goods or services into South Dakota or engage in 200 or more separate transactions for the delivery of goods and services into the State on an annual basis. S.B. 106, section 1. This quantity of business could not have occurred unless the seller availed itself of the substantial privilege of carrying on business in South Dakota. And respondents are large, national companies that undoubtedly maintain an extensive virtual presence. Thus, the substantial nexus requirement of Complete Auto is satisfied in this case.

The first sentence of this paragraph suggests that two inquiries are relevant to nexus: (1) a taxpayer's economic returns from a state; and (2) its activities directed toward a state.[22] The second and third sentences of this paragraph suggest that the South Dakota thresholds require sufficient

[16] *Id.*

[17] *Id.*

[18] *Wayfair*, 2018 WL 3058015 at *18 (Thomas, J., concurring).

[19] *Id.* (Gorsuch, J., concurring).

[20] *Id.* at 18 (Roberts, C.J., dissenting).

[21] *Id.* at 19-23. *See also* 386 U.S. 753 (1967).

[22] Evaluating nexus by reference to those two factors is how state courts and legislatures have evaluated economic nexus for purposes of state corporate income taxes. *See* Thimmesch, "The Illusory Promise of Economic Nexus," 13 *Fla. Tax Rev.* 157, 176-84 (2012).

"economic contacts" for substantial nexus. The fourth sentence, emphasizing the size of respondents, focused on the so-called virtual contacts that large, national e-commerce vendors create through their extensive marketing and web presences.

What this paragraph does not do is address precisely when small sellers have substantial nexus. What if a small seller has exactly 200 sales, worth $20,000? Given this uncertainty, our advice for states as to nexus now would be, at a minimum, to put in place thresholds similar to South Dakota's. Indeed, for states that want to be better insulated from challenges from small sellers, and likely at minimal revenue loss, we would suggest adopting higher thresholds (that is, thresholds more deferential to small sellers) than South Dakota's. This goes especially for non-SSUTA states.

Question 2: When Do State Statutes Unduly Burden Interstate Commerce?

The Court's opinion seems to leave more room for vendors to challenge state impositions as unduly burdening interstate commerce, as opposed to challenging whether they have nexus with a state. Such a challenge would presumably be evaluated based on the *Pike* balancing test. Several passages from the majority opinion imply this, although these passages are perplexing. After all, *Pike* balancing has been previously understood as the backup test for economic regulations — not for taxes. By contrast, the substantial nexus test has been the first prong of the *Complete Auto* test for taxes. Of course, there is lots of overlap between these two tests, and, indeed, the *Quill* decision used bits of *Pike* balancing language.[23] But the two tests have been understood as being different, and many of the amici who argued for *Pike* balancing did so specifically as an alternative to the *Quill* framework.[24]

In short, the Court could have applied a balancing test in the context of substantial nexus. Instead, the implication of the majority's reasoning is that *Pike* balancing will be applied as an additional test. We do not know of a precedent for this. In any event, the majority opinion clearly left open the possibility for a *Pike* balancing type of challenge. The opinion even (helpfully) explained the features of South Dakota's law that, if duplicated by other states, would make those challenges less likely to succeed. Recall that the Court twice referred to the fact that (1) South Dakota thresholds provided a small seller safe harbor; (2) South Dakota's imposition applied prospectively only; and (3) South Dakota was an SSUTA state and had thus simplified its system in ways to reduce compliance costs for vendors. States that can replicate those factors should take comfort that their statutes are permissible. States that fail them might need to be more concerned.

Some discussion of the *Wayfair* decision seems to suggest that states must conform to these features of South Dakota's statute before they can require remote vendors to collect tax. We think that reads far too much into the opinion. The Court did not make these features into requirements. Instead, the *Wayfair* decision held these features sufficient to insulate states from judicial rebuke. Furthermore, even in "nonconforming" states, it seems highly unlikely that a state statute would be overturned on *Pike* balancing absent low thresholds or retroactive application.[25] Nevertheless, *Pike* is difficult to apply, and we think states should be wary of pressing the issue. Better to avoid costly litigation, especially when the revenue to be gained from smaller vendors is likely also small.

Therefore, as to *Pike* balancing, our advice is that non-SSUTA states seek to reduce compliance costs for out-of-state vendors the best they can. These states should find ways to simplify their sales tax systems within local constraints, offer vendor reimbursement for compliance costs,[26] and consider offering free compliance software and immunizing vendors who rely on it.[27] Again, we

[23] 504 U.S. 298, 313 n.6 (1992).

[24] *See, e.g.*, brief of four U.S. senators, *supra* note 11.

[25] We have previously written that retroactively imposed liabilities could violate the dormant commerce clause. *See* Thimmesch, Darien Shanske, and David Gamage, "Wayfair and the Retroactivity of Constitutional Holdings," *State Tax Notes*, May 7, 2018, p. 511.

[26] One of us discussed this first approach in a prior article: Gamage and Devin J. Heckman, "A Better Way Forward for State Taxation of E-Commerce," 92 *B.U. L. Rev.* 483 (2012).

[27] Two of us discussed this approach in a prior article: Andrew J. Haile, Gamage, and Shanske, "A Potential Game Changer in E-Commerce Taxation," *State Tax Notes*, Mar. 11, 2013, p. 747.

do not think that the Court's opinion requires these actions, just that these actions would be legally advisable and sensible in any event, from a policy perspective.

Conclusion

The Court's decision in *Wayfair* represents a substantial modernization of the Court's approach to regulating state taxing jurisdiction. The much-maligned physical presence rule is no more. What now stands in its place is unclear, but the Court did give states several points of guidance. We will consider additional aspects of the *Wayfair* decision in future articles. ■