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STATE+LOCAL TAX INSIGHTS

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STAND YOUR GROUND! SUBSTANTIAL NEXUS LIVES AFTER *WAYFAIR*

By Craig B. Fields, Mitchell A. Newmark, and Eugene J. Gibilaro

The U.S. Supreme Court decided in *South Dakota v. Wayfair, Inc.* that the U.S. Constitution does not require a physical presence in a taxing state in order for the state to impose a sales and use tax collection obligation on an out-of-state seller.[1] It is time to decipher what remains of the substantial nexus standard. The good news is that the Court made clear in *Wayfair* that a substantial nexus between the taxing state and the business that it seeks to tax is required, albeit not a physical presence bright-line.[2] The Court framed its overruling of *National Bellas Hess, Inc. v. Department of Revenue*[3] and *Quill Corp. v. North Dakota*[4] as a natural progression in its Commerce Clause jurisprudence away from "arbitrary, formalistic distinction(s)" and toward "a sensitive, case-by-case analysis of purposes and effects."[5] Therefore, in the absence of a bright-line, formalistic substantial nexus rule, the key will be to understand the relevant factors to consider when performing a substantial nexus analysis and how these factors relate to whether a state can successfully assert a taxable nexus.

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  Nicole L. Johnson and Rebecca M. Balinskas

September 19

Wisconsin State and Local Tax Club
Milwaukee, Wisconsin

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  Craig B. Fields

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  Craig B. Fields
- **"Look (and Think) Before You Leap – State Tax Issues in Mergers and Acquisitions"**
  Mitchell A. Newmark
- **"Top Ten Income Tax Cases"**
  Holly L. Hyans

October 24 – 26

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  Mitchell A. Newmark
- **"Market Sourcing: The Audits Are Coming"**
  William H. Gorrod
- **"Happy 10 Year Anniversary, *MeadWestvaco*!"**
  Nicole L. Johnson
- **"The Great 'Discussion'"**
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December 6

Bar Association of San Francisco Tax Section Meeting
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- **"State and Local Tax – 2018 Year in Review"**
  William H. Gorrod

SUBSTANTIAL NEXUS BEFORE *WAYFAIR*

The U.S. Supreme Court framed its 1977 decision in *Complete Auto Transit, Inc. v. Brady* as a rejection of formalism.[6] There, the Court overruled a long line of cases that had held that any state tax imposed on the "privilege of doing business" was *per se* unconstitutional if the tax applied to interstate commerce.[7] In overruling this formalistic, bright-line rule, the Court stated that a proper constitutional analysis of a state tax considers "not the formal language of the tax statute but rather its practical effect."[8] In determining the practical effect of a state tax, the *Complete Auto Court* reminded us that it has considered whether "the tax is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State."[9] In doing so, the Court pulled together threads of state tax analysis that, until then, had been separate.

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In *Quill,* the Court explained that the substantial nexus prong of *Complete Auto* has both a Due Process Clause and a Commerce Clause component and, although the two components are closely related, the two Clauses "pose distinct limits on the taxing powers of the States."[10] The Due Process component of the analysis "concerns the fundamental fairness of governmental activity" with respect to the specific taxpayer whereas the Commerce Clause component is "a means for limiting state burdens on interstate commerce."[11] The Court concluded that the Due Process Clause did not require a physical presence and that Quill "purposefully directed its activities" to North Dakota and "the magnitude of those contacts is more than sufficient for due process purposes."[12] However, the Court ruled that the Commerce Clause required physical presence inasmuch as a bright-line rule avoids undue burdens on interstate commerce and "encourages

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settled expectations and, in doing so, fosters investment by businesses and individuals."[13]

After *Quill*, the U.S. Supreme Court never confirmed whether the physical presence requirement for substantial nexus under the Commerce Clause applied only in the context of sales and use taxes or applied to all state tax types (*e.g.*, income tax and franchise tax). State courts split on this issue and the U.S. Supreme Court did not grant review in any of these cases.[14] However, as we know, certiorari denied means nothing as to the merits of the case.[15]

THE *WAYFAIR* DECISION

In *Wayfair*, the Court did not reject *Quill*'s conclusion that there was both a Due Process and Commerce Clause component to the substantial nexus test. Rather, the *Wayfair* Court stated that the two components have "significant parallels" and "[t]he reasons given in *Quill* for rejecting the physical presence rule for due process purposes apply as well to the question whether physical presence is a requisite" under the Commerce Clause.[16] In stating the substantial nexus standard under *Complete Auto*, the Court cited to the due process standard that "nexus is established when the taxpayer [or collector] 'avails itself of the substantial privilege of carrying on business' in *that* jurisdiction."[17] However, the Court also explained that one of the primary principles of its modern precedents is that "States may not impose undue burdens on interstate commerce."[18]

The Court concluded that Wayfair had a substantial nexus with South Dakota "based on both the economic and virtual contacts" that it had with South Dakota.[19] Applying its due process standard, the Court concluded that the quantity of business done by Wayfair in South Dakota (*i.e.*, on an annual basis, over $100,000 of sales of goods and services delivered into South Dakota or 200 or more separate transactions for the delivery of goods and services into South Dakota) "could not have occurred unless the seller availed itself of the substantial privilege of carrying on business in South Dakota."[20] The Court did not resolve whether the South Dakota law violated the Commerce Clause prohibition against undue burdens upon interstate commerce, but presaged its likely constitutionality because: (1) the law provides a safe harbor to those who transact only limited business in South Dakota; (2) the law expressly does not apply retroactively; and (3) South Dakota has addressed uniformity with other states by adopting the Streamlined Sales and Use Tax Agreement.[21]

WHAT NOW?

Wayfair has dimmed the line that *Quill* had made bright between substantial nexus standards under the Due Process Clause and the Commerce Clause. However, two distinct requirements remain that a state must pass before imposing a tax (or a tax collection obligation) on an out-of-state business. The Court's due process precedents have focused on the issue of whether a person is subject to the jurisdiction of the state's courts. In a 2011 decision, a six-justice majority agreed that New Jersey could not assert jurisdiction over a non-U.S. business whose only activities in the U.S. were the following: (1) the business sold products to an independent company that agreed to sell the products within the U.S.; (2) the business' officials attended annual conventions in the U.S. to advertise its products, but none of the conventions took place in New Jersey; and (3) four of the business' products ended up in New Jersey.[22] The Court's plurality stated that "transmission of goods permits the exercise of jurisdiction only where the defendant can be said to have targeted the forum; as a general rule, it is not enough that the defendant might have predicted that its goods will reach the forum State."[23] Moreover, the Court rejected the idea that purposeful availment of the *U.S.* market generally conferred jurisdiction to an individual state. Rather, the defendant must have directed its activities to the *specific state* seeking to assert jurisdiction.[24] This due process analysis applies in equal force with respect to a state's jurisdiction to tax.[25] The taxpayer must direct activity to the state seeking to impose the tax.

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For the Commerce Clause, *Wayfair* identified three factors that made it unlikely that the South Dakota law imposes an undue burden on interstate commerce: (1) the law has a safe harbor provision for those conducting limited business in the state; (2) the law is not retroactive; and (3) South Dakota has sought uniformity with other states by adopting the Streamlined Sales and Use Tax Agreement.[26] While it remains to be seen whether other state tax imposition statutes pass constitutional muster under *Wayfair*, these three prophylactic features of the South Dakota law may set the bar for what will pass Commerce Clause muster in the future. To the extent other state imposition statutes assert new jurisdictional standards retroactively, do not have sufficient safe harbor provisions or are otherwise burdensome on interstate commerce, those assertions of substantial nexus will be constitutionally suspect under *Wayfair*. Two of these lines of inquiry can also apply to the due process analysis as we have seen with retroactivity[27] and minimum contacts.[28]

Further, *Wayfair* does not eliminate the additional constitutional requirements of the Foreign Commerce Clause for states asserting substantial nexus with respect to non-U.S. businesses. The Foreign Commerce Clause will invalidate the imposition of a state tax when the tax: (1) "creates a substantial risk of international multiple taxation"; and (2) "prevents the Federal Government from 'speaking with one voice when regulating commercial relations with foreign governments.'"[29] The imposition of sales and use tax collection obligations by "[o]ver 10,000 jurisdictions,"[30] each with its own unique rules (and safe harbor thresholds), arguably prevents the Federal Government from "speaking with one voice" with respect to regulating commerce with foreign governments.

The U.S. Supreme Court has not eliminated the substantial nexus requirement.

Moreover, to the extent that states have taken the position that *Quill* created different substantial nexus standards for sales and use tax as compared with other kinds of taxes, *Wayfair* has potentially reunified the substantial nexus standards. Under *Wayfair*, for all state taxes, the question becomes whether the purported taxpayer has purposefully directed activities towards the state that is asserting nexus and whether the state's tax imposition statute imposes an undue burden on interstate commerce.

Finally, *Wayfair* only concludes that the imposition of a sales and use tax collection obligation on an out-of-state seller without a physical presence in the taxing state is not an undue burden on interstate commerce under the Commerce Clause. By overruling *Quill*'s bright-line physical presence rule, the U.S. Supreme Court has not eliminated the substantial nexus requirement, but has instead endorsed a case-by-case analysis of the issue that looks to the relevant purposes and effects of the tax. The substantial nexus requirement and its constitutional bases shine through. States cannot tax everybody everywhere. Unfair overreaching and economic protectionism must still yield to the Due Process and Commerce Clauses of the U.S. Constitution.

1 585 U.S. ___, ___ (2018) (slip op. at 22).
2 *Id.* at ___ (slip op. at 22-23).
3 386 U.S. 753 (1967).
4 504 U.S. 298 (1992).
5 585 U.S. at ___ (slip op. at 10, 13) (citation omitted).
6 430 U.S. 274, 279 (1977).
7 *See, e.g.*, *Spector Motor Serv., Inc. v. O'Connor*, 340 U.S. 602 (1951).
8 *Complete Auto*, 430 U.S. at 279.
9 *Id.*
10 *Quill*, 504 U.S. at 305.
11 *Id.* at 312-13.
12 *Id.* at 308.
13 *Id.* at 314-16.
14 *See, e.g.*, *Geoffrey, Inc. v. S.C. Tax Comm'n*, 437 S.E.2d 13 (S.C. 1993); *Tax Comm'r v. MBNA Am. Bank, N.A.*, 640 S.E.2d 226 (W. Va. 2006). *But see J.C. Penney Nat'l Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999), *appeal denied*, No. M1998-00497-SC-R11-CV (Tenn. May 8, 2000); *Rylander v. Bandag Licensing Corp.*, 18 S.W.3d 296 (Tex. App. 2000), *review denied* No. 00-0646 (Tex. Jan. 11, 2001).
15 *See, e.g.*, *Robertson v. United States ex rel. Watson*, 560 U.S. 272, 282 (2010) (Roberts, J., dissenting) (quoting the *Baltimore Radio Show* rule with respect to denial of certiorari); *Maryland v. Balt. Radio Show, Inc.*, 338 U.S. 912, 919 (1950) (opinion of Frankfurter, J., dissenting from the denial of certiorari) ("[D]enial carries with it no implication whatever regarding the Court's views on the merits of a case which it has declined to review.").
16 *Wayfair*, 585 U.S. at ___ (slip op. at 11).
17 *Id.* at ___ (slip op. at 22) (alteration in original) (emphasis added) (quoting *Polar Tankers, Inc. v. City of Valdez*, 557 U.S. 1, 11 (2009)).
18 *Id.* at ___ (slip op. at 7).
19 *Id.* at ___ (slip op. at 22).
20 *Id.* at ___ (slip op. at 22-23).
21 *Id.* at 23.
22 *J. McIntyre Mach., Ltd. v. Nicastro*, 564 U.S. 873 (2011).
23 *Id.* at 882.
24 *Id.* at 884-85.
25 *Allied-Signal, Inc. v. Dir., Div. of Taxation*, 504 U.S. 768, 778 (1992).
26 *Wayfair*, 585 U.S. at ___ (slip op. at 23).
27 *United States v. Carlton*, 512 U.S. 26 (1994).
28 *Allied-Signal*, 504 U.S. at 778.
29 *Japan Line, Limited v. County of Los Angeles*, 441 U.S. 434, 451 (1979).
30 *Wayfair*, 585 U.S. at ___ (Roberts, J., dissenting) (slip op. at 6).

This newsletter addresses recent state and local tax developments. Because of its generality, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations. If you wish to change an address, add a subscriber, or comment on this newsletter, please write to Rebecca M. Balinskas at Morrison & Foerster LLP, 250 West 55th St., New York, New York 10019, or email her at rbalinskas@mofo.com., or write to Matthew F. Cammarata at Morrison & Foerster LLP, 250 West 55th St., New York, New York 10019, or email him at mcammarata@mofo.com.

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