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State Sales Tax Collections Finally Move Into the Internet Age.

The Supreme Court's ruling in South Dakota v. Wayfair scraps a precedent that dates back to the heyday of mail order catalogs.

States entered into a new era Thursday when it comes to collecting taxes on internet sales.

The U.S. Supreme Court issued a 5-4 decision in the case of *South Dakota v. Wayfair, Inc.* that overturned two of its own previous rulings, which have blocked states from requiring out-of-state online vendors to pay sales taxes—even as internet commerce has ballooned.

States governments will now have greater authority to capture these taxes from the merchants.

"I think you've got 50 states chomping at the bit to enact collection obligations on out-of-state retailers," said Steve Rosenthal, a senior fellow in the Urban-Brookings Tax Policy Center at the Urban Institute.

"And that will happen," he added. "That will be new."

Justice Anthony Kennedy delivered the majority opinion, which appears to give a nod of approval to elements in the South Dakota statute that triggered the case. But it also leaves questions about how much latitude states have in coming up with new tax laws.

The court decision promises to help raise state and local revenues in the years ahead, particularly in states that depend heavily on sales tax.

Although sales tax collections are already flowing from many sales made by some of the nation's largest online vendors, like Amazon. And online commerce, while growing, is still a fraction of the total retail market. So the near-term effects on government budgets could be relatively limited.

Even so, those involved in state and local budgeting and finance described the high court's decision as a major development. "This is an incredibly big deal," Emily S. Brock, director of the federal liaison center at the Government Finance Officers Association, said by phone.

U.S. Government Accountability Office estimates released last year show that state and local governments could have gained $8 billion to $13 billion in 2017, if states could have required sales tax collections from all out-of-state "remote sellers," like online vendors.

Those gains would be equal to about 2 percent to 4 percent of total 2016 state and local revenues.

E-commerce made up about 9 percent of the nation's overall retail sales last year. But it is expanding rapidly. Internet sales jumped 16 percent last year in the U.S, while total retail sales edged upwards by just 4.4 percent.

"The amount of online sales is only going to grow," said John Hicks, executive director of the

National Association of State Budget Officers.

Thursday's court decision, he added: "Stems the tide of sales tax losses."

Hicks said that based on figures for the last fiscal year, South Dakota, Florida, Tennessee, Texas and Washington all depend on sales taxes for more than half of their general fund revenues. Sales taxes supported at least 40 percent of general fund spending in 15 states, he said.

"If you are a state that is heavily reliant on sales taxes to begin with, you'll see a bigger boost," Chandra Ghosal, vice president and senior analyst at Moody's Investors Service, said by phone.

S&P Global Ratings issued a bulletin that said the court decision "will have a beneficial effect on long-term state credit quality. However, the immediate credit effect may be muted."

"We do not anticipate any immediate rating changes because of the court's decision. It will take time to pass implementing legislation, and the additional revenue will represent a relatively small portion of overall state and local revenues," the ratings agency added.

Kennedy's opinion was a clear death knell for the so-called "physical presence rule," a legal precedent that prevented states from collecting sales tax from companies that don't have an in-state "physical presence"—like offices, warehouses or employees.

The rule was grounded in two previous Supreme Court cases. The more recent was the 1992 case *Quill Corp. v. North Dakota*. The other was a 1967 case known as *National Bellas Hess, Inc. v. Department of Revenue of Illinois*. Both involved mail order catalog sales.

Kennedy wrote that the physical presence mandate was "unsound and incorrect" and said that both cases are overruled.

"The physical presence rule has long been criticized as giving out-of-state sellers an advantage," the court's majority opinion says. "Each year, it becomes further removed from economic reality and results in significant revenue losses to the States."

It goes on to call *Quill* "a judicially created tax shelter for businesses that limit their physical presence in a State but sell their goods and services to the State's consumers, something that has become easier and more prevalent as technology has advanced."

"The Internet revolution has made *Quill's* original error all the more egregious and harmful," the opinion adds.

Forty-one states and the District of Columbia had urged the court to reject the physical presence test cemented by *Quill*.

"The court very, very, very rarely overturns cases," said Lisa Soronen, executive director of the State and Local Legal Center, a group that files amicus briefs in support of state and local governments in the U.S. Supreme Court. "This is a big step."

Kennedy was joined in the majority by Justices Clarence Thomas, Ruth Bader Ginsburg, Samuel Alito and Neil Gorsuch. Chief Justice John Roberts, along with Justices Stephen Breyer, Sonia Sotomayor and Elena Kagan, issued the dissenting opinion.

"We've waited 26 years," state Sen. Deb Peters, the Republican lawmaker who authored South Dakota's tax legislation, and who is the current president of the National Conference of State

Legislatures, said in a statement, reacting to the court tossing out the *Quill* standard.

“State officials look forward to working with all stakeholders in the coming months as we move forward to level the playing field for all of our nation’s retailers,” Peters added.

The court case pitted South Dakota against Wayfair, Inc, Overstock.com, Inc. and Newegg, Inc., three online merchants who have no employees or real estate in the state. The companies challenged a 2016 South Dakota law that required out-of-state retailers to pay sales taxes if they had over $100,000 of sales, or 200 separate transactions, in the state annually.

The Supreme Court decision is not the final step in the case. It actually sends the case back to the South Dakota Supreme Court. But the state court will no longer be able to factor the physical presence rule into its decision, as it did previously in siding against the state.

“The case isn’t necessarily over,” Soronen said. “It’s probably over.”

Soronen said that some in the state and local government arena were hoping or expecting the court to say more about South Dakota’s law and that the guidance it did include in the decision was minimal.

“It’s probably too brief to call it a road map, but there’s some suggestions in here,” she said.

Soronen said policy makers would be wise to look at three elements of the South Dakota law that Kennedy’s opinion suggests do not run afoul of the Constitution’s Commerce Clause.

These include the dollar-amount and transaction thresholds that keep companies that conduct limited business in South Dakota from falling under the law, the fact that the law does not apply retroactively to sales that have happened in the past, and that South Dakota is one of over 20 states that has adopted what’s known as the Streamlined Sales and Use Tax Agreement.

That agreement provides a framework that is designed to reduce the administrative and compliance costs companies face under state sales and use tax laws. It also offers sellers access to sales tax software that is paid for by states.

Hayes Holderness, an assistant professor at the University of Richmond School of Law, explained that he does not think that the court’s decision provided a good “floor” as far as what qualifies as a “substantial nexus” under the Commerce Clause. (Substantial nexus here refers to the connection between the activity being taxed and the state that is taxing it.)

“It’s definitely not physical presence,” Holderness said, referring to what amounts to a “substantial nexus” now that the Quill decision is overturned.

“But I’m not sure that we have a great idea of what it is going forward,” he added.

Holderness said if he were a state policy maker seeking to tax online sales, he’d look to mimic what South Dakota has done with its law. “I think if you’re reading Wayfair, and trying to figure out what to do going forward, you have a safe harbor with the South Dakota model,” he said. “After that, you’re sort of out at sea.”

Hicks, with NASBO, said he was aware of at least 13 states that have already passed legislation like South Dakota’s law, adopting dollar amount or transaction thresholds.

Rosenthal said that, in his view, a key consideration going forward for states crafting tax policy

aimed at internet retailers is that it aligns with certain bedrock principles of the Commerce Clause, namely that the policy is not a burden on interstate commerce and that it is not discriminatory. Even if a law differs from the one South Dakota passed, if it is in sync with those principles, he believes it would be likely to pass legal muster.

He also said he was happy to see the physical presence standard finally scrapped.

“The question really was, ‘What do you do when the Supreme Court makes a mistake? Does it slavishly follow precedent or does it re-articulate the right standard and then apply that going forward,’” Rosenthal said as he discussed the *Wayfair* case.

“They actually went out of their way to say that the physical presence test was just wacky and wrong,” he added, “and we’re going to shift to the right standard.”

Route Fifty

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June 21, 2018

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