

U.S. Supreme Court Hands Down Two Significant Tax Decisions

by Katina M. Peterson and Christopher R. Duggan

Yesterday, the Supreme Court handed down two tax decisions, one of which is set to immediately impact internet and other remote retailers nationwide. In *South Dakota v. Wayfair*, No. 17-494, the Court overruled *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), and *National Bellas Hess Inc. v. Department of Revenue of Illinois*, 386 U.S. 753 (1967), which held that a state may not require an out-of-state seller to collect and remit sales tax on goods the seller ships to the state unless the seller has a physical presence in the state. In *Wis. Cent. Ltd. v. United States*, 17-530, the Court held that employee stock options are not taxable compensation under the Railroad Retirement Tax Act. Although both are significant tax decisions, *Wayfair* will have the further-reaching impact.

Principally, the *Wayfair* decision opens the door for states to require internet and other remote retailers to collect and remit state sales tax on items they ship to those states. Until now, under the Supreme Court's 1967 *National Bellas Hess* and 1992 *Quill* decisions, a seller's mere shipment of goods into a state was not a sufficient reason for that state to force the seller to collect and remit tax from the purchasing consumer. Instead, a seller needed some physical presence in the state before a state could require it to collect and remit tax. Justice Anthony Kennedy authored the majority opinion, and he was joined by Justices Thomas, Gorsuch, Ginsburg, and Alito, with both Thomas and Gorsuch authoring separate, brief concurring opinions. Chief Justice Roberts, joined by Justices Breyer, Sotomayor, and Kagan, wrote a dissent.

South Dakota was a particularly interesting party because the state has no state income tax and relies on sales and use tax for much of its revenue. When South Dakota passed a law creating sales tax liability for out of state retailers, it set up a conflict with three internet retailers (Wayfair, Overstock.com, and Newegg.com) that eventually led to the Supreme Court. Earlier in the case, the state trial court granted summary judgment for the retailers and the South Dakota Supreme Court affirmed, noting, "However persuasive the State's arguments on the merits of revisiting the issue, *Quill* has not been overruled. . . ." Forty-one states, two U.S. territories, and the District of Columbia joined an amicus brief supporting South Dakota's position before the Supreme Court.

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The majority made a harsh assessment of *Quill*'s impact on states under the Commerce Clause, calling *Quill* "an extraordinary imposition by the judiciary on States' authority to collect taxes and perform critical public functions." The majority further viewed *Quill* as effectively creating a "tax shelter for businesses that decide to limit their physical presence and still sell their goods and services to a state's consumers, something that has become easier and more prevalent as technology has advanced." Justice Kennedy illustrated the "arbitrary" nature of the physical nexus requirement by pointing out that even a company with "a few items of inventory in a small warehouse" in a state would be obligated to collect and remit tax on every sale it made in that state, while a company with "a sophisticated website with a virtual showroom accessible in every State," but no physical presence in that individual state, would not. The Court vacated the Supreme Court of South Dakota's opinion, which had followed the *Quill* precedent.

Stating that the majority "proceeds with an inexplicable sense of urgency," Chief Justice Roberts argued in his dissent that this was a matter best left to Congress, noting that "this Court in *Quill* 'tossed [the ball] into Congress's court, for acceptance or not as that branch elects,'" and that "[t]hree bills addressing the issue are currently pending." The dissenters were also concerned that "[t]he burden will fall disproportionately on small businesses," like those "small, even 'micro' businesses" selling "embroidered pillowcases or carved decoys" The dissent also described the varied state tax schemes that would create inevitable complications for internet retailers, noting that Texas levies a tax on "plain deodorant at 6.25% but imposes no tax on deodorant with antiperspirant," Illinois taxes Twix and Snickers "as food and candy, respectively (Twix have flour; Snickers don't)," and "New Jersey knitters pay sales tax on yarn purchased for art projects, but not on yarn earmarked for sweaters."

As a result of the Court's decision, the substantial nexus test from *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1974), becomes the law of the land. Under *Complete Auto*, "[t]he Court will sustain a tax so long as it (1) applies to an activity with substantial nexus with the taxing State, (2) is fairly apportioned, (3) does not discriminate against interstate commerce, and (4) is fairly related to the services the State provides." The *Wayfair* holding notes that a "substantial nexus" is established when a seller "avails itself of the substantial privilege of carrying on business" in the state. Although this isn't as precise a test as *Quill*'s physical presence test, the Supreme Court noted that South Dakota's law, which applies only to sellers that deliver more than \$100,000 in goods or services into the state or that engage in 200 or more separate transactions for the delivery of goods or services into the state, would be a sufficient "quantity of business" that it "could not have occurred unless the seller availed itself of the substantial privilege of carrying on business in South Dakota." The Court also noted that the South Dakota law would not discriminate against interstate commerce because it created a safe harbor for sellers that fell below \$100,000 or 200 separate transactions, because it was not retroactive, and because South Dakota has adopted the Streamlined Sales and Use Tax Agreement, which requires certain simplifications and standardization to the state's sales tax act to reduce administrative burden, including access to state software for calculating taxes.

The Court's decision is available [here](#). We expect to supplement this e-Update as subsequent developments occur in state legislatures and in Congress, which may result in new state definitions or a new uniform national definition of “substantial nexus” for state sales and use tax purposes.

In *Wis. Cent. Ltd. v. United States*, the Court held that railroad employees’ stock-based compensation is exempt from federal employment taxes. In another 5-4 ruling, Justice Gorsuch authored the majority opinion and he was joined by Chief Justice Roberts and Justices Kennedy, Thomas, and Alito. Justice Breyer wrote the dissent, joined by Justices Ginsburg, Sotomayor, and Kagan. The Court examined whether the Railroad Retirement Tax Act of 1937 (the “RRTA”), which creates a number of taxes for both railroad employers and employees, applied to the same taxable base as other federal employment taxes. Stock-based compensation is generally subject to federal tax. Justice Gorsuch wrote that the RRTA’s taxes on “money remuneration” did not apply to stock options because “money” is a “medium of exchange” or a “circulating medium” and “few of us buy groceries or pay rent or value goods and services in terms of stock.” Gorsuch continued “Good luck, too, trying to convince the IRS to treat your stock options as a medium of exchange at tax time.” The Court concluded that, under the RRTA, “Pretty obviously, stock options do not fall within that definition.”

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