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In the Name of Federalism and Free Markets

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INTRODUCTION

Believe it or not, Justices of the Supreme Court sometimes get confused too. "What's the standard? What's the standard? . . . Huh? Any? What?", asked Justice Breyer during oral arguments in *South Dakota v. Wayfair*.[2] The South Dakota Attorney General answered this question during his last five-minute rebuttal. To summarize his answer? "*Complete Auto*" and "*Pike*".[3] Given his answer, it seems like nothing has changed. *Pike* has been the primary principle that guided courts in adjudicating cases challenging state laws that is not discriminatory on its face under the Commerce Clause; and *Complete Auto* has been the principle framework in addressing the validity of state and local taxations.[4]

Respectfully, this answer is far from satisfying. As this article explains, *Complete Auto* and *Pike*, although sound in theory, are not adequately equipped to address the questions and confusions created by *Wayfair*. For one thing, *Pike* has not been applied in the state tax context in the past and will not likely to be used in the future.[5] With respect to *Complete Auto*, crucial questions still left unanswered: What is the standard? What is "substantial nexus"?

The Supreme Court in the past has restricted states' power to compel out-of-state vendors to collect sales and use taxes based on the physical-presence rule. The Court in *South Dakota v. Wayfair* overruled the physical presence rule of *Quill* and articulated an undefined test for

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[1] *South Dakota v. Wayfair, Inc.*, 138 S. Ct. 2080, 2096 (2018) ("In the name of federalism and free markets, *Quill* does harm to both.")

[2] Transcript of Oral Argument at 15-16, *South Dakota v. Wayfair, Inc.*, 138 S. Ct. 2080 (2018) (No. 17-494).

[3] *Id.* at 56. "Justice Breyer, I owe you an answer to your third question . . . I would tell you the sky isn't falling, that this Court's jurisprudence already in place with respect to a tax assessment is *Complete Auto*. With respect to the collection side and concerns with burden, the balancing that *Pike* has in place provides those constitutional protections."

[4] *See Wayfair*, 138 S. Ct. at 2091.

[5] *See infra* notes 109 - 114 and accompanying texts.

determining whether "substantial nexus" is satisfied under the Dormant Commerce Clause. The Court went on to apply the standard and concluded that such nexus is met when the taxpayer "avails itself of the substantial privilege of carrying on business in that jurisdiction."[6] Instead of trying to articulate what it means to "avail oneself", the Court simply declared that the requirement was satisfied.[7]

In doing so, the *Wayfair* Court had passed up the opportunity to give meaning to its substantial nexus standard and to better explain the relationship between the Due Process nexus requirement and the Dormant Commerce Clause nexus requirement. In short, *Wayfair* failed to provide a clear path forward for the "substantial nexus" doctrine.

Accordingly, this paper raises and tries to offer answers to the important questions that *Wayfair* left open. First, this paper argues for the proposition the Commerce Clause nexus requirement should remain independent of the Due Process nexus requirement. It should stay distinct and further strengthened into a standard that addresses the concerns of the Dormant Commerce Clause. Then, this paper tackles the question the *Wayfair* majority opinion left unanswered: What's the standard? This section starts by checking off *Pike* balancing test as a possible solution, then proceeds to evaluate a particular theory that Professor Holderness proposed in his recent article.

This paper proceeds in three parts. First, Part I provides the necessary background of the two constitutional restrictions on state's power to collect sales and use taxes, and the historical Dormant Commerce Clause nexus case law, with particular reference to *Bellas Hess*[8], *Quill*[9], and the physical presence rule. Part II then turns to a detailed analysis of the Court's recent Commerce

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[6] *Wayfair*, 138 S. Ct. at 2099.
[7] *Id.*
[8] *National Bellas Hess, Inc. v. Department of Revenue*, 386 U.S. 753 (1967).
[9] *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

Clause case, *South Dakota v. Wayfair*, focuses on the litigation, the Court's reasoning for overruling the physical presence rule, and its holding with respect to the Commerce Clause "nexus" requirement. Part III then evaluates and offers answers to two important questions that *Wayfair* left open. Namely, the relationship between the two constitutional restrictions; and the meaning of the Court's Dormant Commerce Clause nexus requirement. This part concludes by summarizing what should the states do in the wake of *Wayfair*, and absent congressional action.

I. BACKGROUND

A. Sales and Use Taxes

There are two main methods that states currently rely on to tax personal consumptions: the sales tax and the use tax. A sales tax is broadly defined as "any tax which includes within its scope all business, sales of tangible personal property at either the retailing, wholesaling or manufacturing stage . . ."[10] Most commonly, a "sales tax" is equated with the "retail sales tax", in which the consumer pays the tax and the retailer remits the tax to the state on a per-item basis.[11] The retailer bears the burden of collecting and remitting the tax, even though the consumer is responsible for paying the tax.[12]

A use tax is defined as a "tax imposed upon the privilege of using, storing, or consuming tangible personal property within the state or local government boundaries" that has avoided being subject to a sales tax.[13] Essentially, a use tax is a complementary tax to a sales tax, imposing the burden of self-assessing and remitting the tax on the individual of the goods or service that were

[10] Jerome R. Hellerstein & Walter Hellerstein, State Taxation: Sales and Use Taxes, PP 19A.01[1], 12.02 (3d ed. 2011).

[11] Hellerstein & Hellerstein, supra, P 12.01. Some states require the vendor to pay the tax as payment for the privilege of engaging in in-state business. *Id*.

[12] *Id*.

[13] Hellerstein & Hellerstein, supra, P 16.01[2]. Typically, the use tax rate is the same as the sales tax rate. *Id.* P 16.01[4].

purchased beyond state boundaries.[14] However, use tax compliance among individual consumers is dismally low and states have struggled to enforce the use tax obligation against individual purchasers.[15]

Thus, states have enacted various laws and attempted to impose a use tax[16] collection obligation on sellers with no in-state physical presence, in a way try to fill the sales and use tax gap.[17] As of last year, however, states faced federal constitutional constraints on their ability to achieve this result. States may not impose a use tax or sales tax collection obligation on an out-of-state vendor, unless the vendor had more than a *de minimims* in-state physical presence. But that all changed with the Court's recent decision in *South Dakota v. Wayfair*.

B. Constitutional Limits on State's Power to Tax

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[14] RICHARD D. POMP, STATE & LOCAL TAXATION 6-39 (8th ed. 2015) (describing the role of use taxes). If sales tax does not apply to a consumer's purchase at the time of sale, as might occur when a good is purchased over the Internet, then the consumer is typically legally obligated to pay a use tax when she first uses the purchased property in the state. *Id.*

[15] *Id*. at 6-40 to 6-42. In theory, the complementary sales and use tax regime creates a seamless web of tax collection that is easy to administer. In practice, however, states often result in significant revenue losses because the use tax is notoriously difficult to collect. *See* e.g., Walter Hellerstein, *Jurisdiction to Tax Income and Consumption in the New Economy: A Theoretical and Comparative Perspective*, 38 GA. L. REV. 1, 23-24 (2003) (discussing administrative problems states face in collecting use taxes from individual consumers); John A. Swain, *State Sales and Use Tax Jurisdiction: An Economic Nexus Standard for the Twenty-First Century*, 38 GA. L. REV. 343, 353 (2004) ("Sales made by remote sellers are subject to a de facto exemption.. .. [T]he Supreme Court has required that a seller be physically present in a state before the state can impose its use tax collection obligation, and it is administratively impractical for a state to directly collect use taxes against individual consumers. Individual consumers seldom self-assess use tax, and so the tax goes unpaid."); Adam B. Thimmesch, *Taxing Honesty*, 118 W. VA. L. REV. 147, 151-60 (2015) (noting difficulties creating the current "use tax gap"). *See also*, Nina Manzi, Use Tax Collection on Income Tax Returns in Other States, House Res. Dep't 10 (April 2015), http://www.house.leg.state.mn.us/hrd/pubs/usetax.pdf (noting that the percentage of taxpayers who report use tax in states where that tax can be reported on income-tax returns is approximately 1.9%).

[16] In *Bellas Hess* and *Quill*, both laws required collection of *use* tax as a means to try to shift the burden of collection and remittance to the vendor.

[17] According to a recent study, the lack of sales taxes and nonpayment of use taxes on online purchases resulted in the non-collection of $ 11.4 billion in sales and use tax revenues in 2012. *See* Donald Bruce, William F. Fox & LeAnn Luna, *State and Local Sales Tax Revenue Losses from E-Commerce*, 52 ST. TAX NOTES 537 (May 18, 2009). The uncollected amount represented 3.8% of total sales tax liabilities for 2012. The researchers expect that such revenue losses "will likely continue to grow rapidly, at least for the next several years." Donald Bruce, William F. Fox & LeAnn Luna, *E-tailer Sales Tax Nexus and State Tax Policies*, 68 NAT'L TAX J. 735, 736 (2015).

The two constitutional limits on a state's power to require out-of-state vendors to collect sales taxes are the Due Process Clause of the Fourteenth Amendment[18] and the Commerce Clause of Article I, Section 8.[19] These provisions, as we will see, have an overlapping and uncertain relationship, but both have been interpreted by the Court to require some minimal connection, as the Court put, a "nexus" between the taxing state and the party on which it attempts to impose tax obligations. This section will consider each of these limitations in turn.

1. Due Process Clause and the Nexus Requirement

In the world of state and local taxation, the Due Process Clause has been held to require "some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax."[20] Essentially, the Due Process Clause nexus requirement is concerned with the fundamental fairness of governmental activity and to ensure that the individual taxpayer has notice of fair warning.[21]

The Court in *Quill v. North Dakota* hold that the nexus requirement of Due Process Clause is met irrespective of a corporation's lack of physical presence in the taxing State.[22] Relying on comparable reasoning to the personal jurisdiction jurisprudence,[23] which also considers whether a person has a minimum connection with a state, the Court hold that the Due Process Clause nexus inquiry is met when the taxpayer "purposefully avail[ed] itself the benefits of an economic market in the forum State . . . [by actively engaging] in continuous and widespread solicitation of business

[18] U.S. CONST. amend. XIV, § 1 ("Nor shall any state deprive any person of life, liberty, or property, without due process of law.")
[19] U.S. CONST. art. I, § 8, cl. 3 (Congress shall have the exclusive power to "regulate commerce . . . among the several states.")
[20] *Miller Bros. Co. v. Maryland*, 347 U.S. 340, 344-45 (1954).
[21] *Quill*, 504 U.S. at 312.
[22] *Id.* at 308.
[23] *Quill*, 504 U.S. at 307-08 (citing *Burger King Corp. v. Rudzewicz*, 471 U.S. 462 (1985)); *see also Tyler Pipe Indus., Inc. v. Wash. State Dep't of Rev.*, 483 U.S. 232, 250 (1987) ("[T]he crucial factor governing nexus is whether the activities performed in this state on behalf of the taxpayer are significantly associated with the taxpayer's ability to establish and maintain a market in this state for the sales.").

within a State."[24] Requiring such purposeful direction ensures that the person has notice or fair warning that she may be subject to the state's jurisdiction.[25]

2. *Commerce Clause and the Nexus Requirement*

Article I, Section 8 of the Constitution grants Congress the exclusive power to regulate interstate commerce. Today, the Court interprets the Commerce Clause as a broad grant of power, according to which Congress has substantial authority to regulate interstate commerce and actively to preempt state laws that run counter to its own measures. The Court has also held that the Commerce Clause by implication, imposes an additional, implied limitation on state or local laws related to interstate commerce, which operates to prohibit the enactment of state and local taxes that unduly interfere with or discriminate against interstate commerce, in the absence of express congressional action. [26] This limitation is often referred to as the Dormant Commerce Clause.[27]

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[24] *Quill*, 504 U.S. at 307-08.

[25] *Id.*

[26] The crucial question in determining whether a state law violates the Dormant Commerce Clause is to ask if the law either facially discriminates against or has an unduly discriminatory impact on interstate commerce. If the law discriminates against interstate commerce, either on its face or in purpose or effect, the burden is on the state to demonstrate that the discriminatory law serves a legitimate local purpose that cannot be achieved through reasonable nondiscriminatory alternatives. *See Granholm v. Heald*, 544 U.S. 460 (2005); If the law does not discriminate on its face, courts often refer to the *Pike* balancing test to determine whether the state can show that the burden is not clearly excessive in relations to the local benefit. *Pike v. Bruce Church, Inc.*, 397 U.S. 137, 142 (1970) (noting that "if a legitimate local purpose is found, then the question becomes one of degree", depending on the interests at stake).

[27] The argument implying that Congress's interstate commerce power can be traced back to a statement made by Chief Justice John Marshall in *Gibbons v. Ogden*, explaining that "when a State proceeds to regulate commerce … among the several States, it is exercising the very power that is granted to Congress, and is doing the very thing which Congress is authorized to do." *Gibbons v. Ogden*, 22 U.S. 1, 199-200 (1824). In *Oklahoma Tax Commission v. Jefferson Lines, Inc.*, Justice Souter provided a succinct summary of the justification and history of the Dormant Commerce Clause: "Despite the express grant to Congress of the power to 'regulate Commerce . . . among the several States,' . . . we have consistently held this language to contain a further, negative command, known as the dormant Commerce Clause, prohibiting certain state taxation even when Congress has failed to legislate on the subject. We have understood this construction to serve the Commerce Clause's purpose of preventing a State from retreating into economic isolation or jeopardizing the welfare of the Nation as a whole, as it would do if it were free to place burdens on the flow of commerce across its borders that commerce wholly within those borders would not bear. The provision thus 'reflect[s] a central concern of the Framers that was an immediate reason for calling the Constitutional Convention: the conviction that in order to succeed, the new Union would have to avoid the tendencies toward economic Balkanization that had plagued relations among the Colonies and later among the States under the Articles of Confederation.'" *Okla. Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175, 179-80 (1995).

In contrast to the Due Process Clause, the Commerce Clause addresses "structural concerns about the effects of state regulation on the national economy" and prohibits state tax actions that "unduly burden interstate commerce."[28] To achieve these goals, the Court has developed a framework for adjudicating cases challenging state tax laws under the Commerce Clause in *Complete Auto Transit, Inc. v. Brady*.[29] Under the four-part test, a tax may be sustained against a Dormant Commerce Clause challenge if it is "[1] is applied to an activity with a 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 provide by the State."[30] The first prong of the test, that is, the "substantial nexus" between the taxing state and the activity being taxed is the primary focus of this paper.

The "substantial nexus" requirement of the Dormant Commerce Clause is not, like Due Process's minimum contacts requirement, a "proxy for notice, but rather a means for limiting state burdens on interstate commerce."[31] Because the two clauses address different concerns, it is possible for a corporation to have the minimum contracts necessary as required by the Due Process Clause but still lack the substantial nexus with the state as required by the Commerce Clause.[32] "Substantial nexus" under the Commerce Clause, therefore, requires something different than minimum contracts.

As the next sections explains, the Court did not fully resolve the precise meaning of "substantial nexus", although it did provide a "physical presence rule" that guided the analysis in the context of sales and use taxes.[33] In 2018, the Court in *South Dakota v. Wayfair* overruled the

[28] *Quill*, 504 U.S. at 312
[29] *Complete Auto Transit Inc. v. Brady*, 430 U.S. 274 (1977).
[30] *Id.* at 279.
[31] *Quill*, 504 U.S. at 313.
[32] *Id.*
[33] *Id.* at 317-18. The *Quill* Court held that the taxpayer must have a physical presence in the taxing state to satisfy the Commerce Clause in the context of use tax collection obligations.

long-standing physical presence rule and articulated a new "substantial nexus" test under the Commerce Clause that turns on whether a taxpayer has availed itself of the substantial privilege of carrying on business in the taxing state.[34] The next section first provide the history of the physical presence rule, then turns to the demise of the rule, which leading to the litigation in Wayfair . a campaign known informally as the "Kill Quill movement", which culminated to the recent case *South Dakota v. Wayfair*.

C. The Physical Presence Rule

The Commerce Clause's substantial nexus requirement used to focus on an out-of-state seller's physical presence in the taxing state to determine whether a tax imposed on the seller is permissible.[35] The physical presence rule, as the next section unfolds, was first articulated in *National Bellas Hess*, reaffirmed by *Quill*, and overruled in *South Dakota v. Wayfair*.

Before *Complete Auto*, the Court had addressed a challenge to an Illinois tax that required out-of-state retailers to collect and remit use taxes on sales made to consumers who purchased goods for use within Illinois in *National Bellas Hess, Inc. v. Department of Revenue*.[36] Bellas Hess was a mail order company incorporated in Delaware with its principal place of business in Missouri and had no physical presence in the state of Illinois.[37] Bellas Hess raised two constitutional objections, respectively grounded in the Due Process and the Dormant Commerce Clauses.[38] The Court held that a mail-order company "whose only connection with customers in the State is by common carrier or the United States mail" lacked the requisite minimum contacts with the State

[34] *Wayfair*, 138 S. Ct. at 2099.
[35] *Quill*, 504 U.S. at 314-318.
[36] *National Bellas Hess.*, 386 U.S. at 753-54.
[37] *Id.*
[38] *Id.* at 756.

required by both the Due Process Clause and the Commerce Clause.[39] Unless the retailer maintained a physical presence such as "retail outlets, solicitors, or property within a State," the State lacked the power to require that retailer to collect a local use tax.[40]

The Court reexamined the physical presence rule in *Quill Corp. v. North Dakota* and reaffirmed it as the means of determining whether a substantial nexus exists between the taxing state and the taxpayer.[41] *Quill* involved North Dakota's attempt to require an out-of-state, mail-order house that had neither outlets nor sales representatives in North Dakota to collect and pay use taxes on goods purchased for use within the state.[42] Quill solicited business in North Dakota through mailed catalogues, advertisements in national periodicals that circulated in the state, and telephone calls; it had over 3,000 North Dakota customers and sales of about $ 1 million annually.[43] Emphasizing these facts detailing Quill's "continuous and widespread solicitation of business" in North Dakota, the Court had no difficulty in concluding that the company had "purposefully directed" its business to the state and that was sufficient for purposes of Due Process, despite the fact that the company lacked physical presence in the jurisdiction.[44]

But the absence of physical presence was dispositive of the Dormant Commerce Clause issue. The Court explained that physical presence was essential to the "substantial nexus" element of the *Complete Auto* test and was necessary to prevent undue burdens on interstate commerce.[45]

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[39] *Id.* at 758. The Supreme Court concluded that the two constitutional doctrines were "closely related" and that the test for whether a state tax on interstate commerce is allowable is similar to the test for a state's compliance with due process.

[40] *Id.*

[41] *Quill*, 504 U.S. at 314-18.

[42] *Id.* at 301.

[43] *Id.* at 302.

[44] *Id.* at 308.

[45] *Id.* at 313 ("Thus, the 'substantial nexus' requirement is not, like due process 'minimum contracts' requirement, a proxy for notice, but rather a means for limiting state burdens on interstate commerce.")

Therefore, it grounded the physical presence rule in *Complete Auto*'s first prong test by means of "substantial nexus".

Since *Quill* was decided in 1992, "physical presence" has undertaken a different meaning than twenty-eight years ago.[46] Thus, although it was initially envisioned to operate as a significant limit on a taxing state's authority to tax, the physical presence rule found itself—thanks largely to a changing technological landscape—authorizing taxation under a broadening set of circumstances. *Wayfair* shows that a large national internet retailer completing thousands of transactions generating millions of dollars in revenue is beyond the reach of physical presence rule, while an out-of-state entity's decision to hire a single in-state employee or rent a single warehouse would subject it to the local tax obligations.

But with the increased breadth of its operation, the physical presence rule was still regarded by many critics as insufficiently protective of states' interests in raising revenue.[47] In the twenty-eight years since *Quill* was decided, the rise and growth of Internet and E-commerce diverted significant business from brick-and-mortar stores to online retailing, much of which remained immune to various states' tax-collection requirements.[48] In light of these difficulties, scholars and

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[46] *Wayfair*, 138 S. Ct. at 2095 ("For example, a company with a website accessible in South Dakota may be said to have a physical presence in the State via the customers' computers. A website may leave cookies saved to the customers' hard drives, or customers may download the company's app onto their phones. Or a company may lease data storage that is permanently, or even occasionally, located in South Dakota.").

[47] *See, e.g.*, Walter Hellerstein, *Deconstructing the Debate Over State Taxation of Electronic Commerce*, 13 Harv. J. Law & Tec 549, 553 (2000); Richard D. Pomp, *Revisiting* Miller Brothers, Bellas Hess, *and* Quill, 65 Am. U. L. Rev. 1115, 1144-48 (2016); Charles Rothfeld, Quill*: Confusing the Commerce Clause*, 3 St. Tax Notes 111 (1992); John A. Swain, *State Income Tax Jurisdiction: A Jurisprudential and Policy Perspective*, 45 Wm. & Mary L. Rev. 319, 337-44 (2003); Recent Case, 131 Harv. L. Rev. 2089, 2093-2094 (2018) ("In the internet economy, physical presence alone is both over- and under inclusive as a legal standard. It is over inclusive of business entities with very limited physical contact within the state and under inclusive of businesses whose models do not happen to require brick-and-mortar presence.").

[48] In 2018, state's inability to tax retailers without physical presence will result in $34 billion in lost state tax revenue, a number projected to reach $52 billion annually by 2022, compared to an estimated loss of up to $3 billion per year when *Quill* was decided. David J. Herzig, Opinion, *States Pay the Price when You Buy Online*, N.Y. TIMES (Jan. 1, 2018), https://www.nytimes.com/2018/01/01/opinion/online-shopping-sales-tax.html?smid=pl-share. These projections may fall short of capturing the total revenue that would be lost to the *Quill* rule, as e-commerce is growing at a rate of "23% year-over-year", a pace expected to accelerate as the digital retail landscape continues to evolve. Tom Popomaronis, *E-Commerce in 2018: Here's What the Experts Are Predicting*, *FORBES* (Dec. 15, 2017, 01:40

state-tax authorities initiated a campaign to persuade the Supreme Court to abandon *Quill*,[49] a campaign known informally as the "Kill Quill movement".[50]

Twenty-three years after *Quill*, the Supreme Court has remained silent on this issue, until 2015, the Court in *Direct Marketing Ass'n v. Brohl*[51] expressed its receptiveness to reconsidering the physical presence rule. *Brohl* involved Colorado's attempt to enhance its collection of use tax derived from sales made by out-of-state vendors lacking in-state physical presence.[52] The most significant aspect about the Court's decision was Justice Kenney's concurrence opinion. Writing separately, Justice Kennedy acknowledged that "[t]he Internet has caused far-reaching systemic and structural changes in the economy" and therefore "*Quill* now harms States to a degree far greater than could have been anticipated earlier."[53] Justice Kennedy concluded that "[t]he legal system should find an appropriate case for this Court to reexamine *Quill* and *Bellas Hess*."[54]

The State of South Dakota seized the opportunity and the Court took on the "appropriate case" soon after. In 2018, the Court issued the opinion in *South Dakota v. Wayfair* and overruled the physical presence rule. The Court was rather very blunt with its attitude towards *Quill*: "In the

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PM), https://www.forbes.com/sites/tompopomaronis/2017/12/15/e-commerce-in-2018-heres-what-the-experts-are-predicting. By 2022, online sales will represent 17% of all U.S. retail sales. Daniel Keyes, *E-Commerce Will Make Up 17% of All US Retail Sales by 2022--And One Company Is the Main Reason*, *BUS. INSIDER* (Aug. 11, 2017, 11:12 AM), http://www.businessinsider.com/e-commerce-retail-sales-2022-amazon-2017-8.

[49] *See, e.g.*, Charles E. McLure, Jr., *Taxation of Electronic Commerce: Economic Objectives, Technological Constraints, and Tax Laws*, 52 TAX L. REV. 269, 394-95 (1997); Pomp, *supra* note 47, at 1120 (noting that "[m]any, many articles have discussed *Quill*" and that "[a]lmost all of these articles...agree" that *Quill* should be overruled); Swain, *supra* note 47, at 337-44 (questioning *Quill* on many grounds).

[50] *See* Hayes Holderness, *The Next Tax Reform: Internet Sales Tax*, THE HILL (Jan. 17, 2018, 11:00 AM), https://thehill.com/opinion/judiciary/369157-the-next-tax-reform-internet-sales-tax

[51] *Direct Marketing Ass'n v. Brohl*, 135 S. Ct. 1124 (2015).

[52] Colorado required these vendors, sometimes referred to as "remote vendors," to provide large dollar consumers with year-end statements as to their purchases, and to provide the state's revenue agency with the purchase information of such large dollar consumers. Remote vendors that would be subject to the Colorado statute sued to enjoin its enforcement. Along the way, a dispute arose as to whether the case belonged in federal or state court, and that specific question ascended to the Supreme Court. The Court's unanimous ruling was that the case could be tried in federal court. The Court did not address the merits of the constitutional claim of the Colorado regulation. *See generally*, *Direct Marketing Ass'n v. Brohl*, 135 S. Ct. 1124.

[53] *Brohl*, 135 S. Ct. at 1134-35 (Kennedy, J., concurring).

[54] *Id.*

name of federalism and free markets, *Quill* does harm to both. The physical presence rule it defines has limited states' ability to seek long-term prosperity and has prevented market participant from competing on an even playing field."[55] The next section turns the focus on the details of *Wayfair* litigation and describes how the physical presence rule went down.

II. SOUTH DAKOTA V. WAYFAIR

A. S.B.106

In 2016, the South Dakota legislature passed a law, 2016 S.D. Senate Bill 106 ("S.B. 106"), requiring out-of-state sellers to collect and remit sales tax "as if the seller had a physical presence in the state."[56] The Act covers only sellers that, on an annual basis, deliver more than $100,000 of goods or services into the State or engage in 200 or more separate transactions for the delivery of goods or services into the State.[57] The text of Senate Bill made clear that it was specifically designed to challenge the *Quill* physical presence doctrine and directly referenced Justice Kennedy's concurring opinion in *Brohl*.[58]

Soon after S.B.106 was signed into law, the South Dakota Department of Revenue began issuing written notices to sellers it believed met the requirements of the law.[59] Wayfair Inc.,

[55] *Wayfair*, 138 S. Ct. at 2096.

[56] S.D. Codified Laws § 10-64-2.

[57] S.B. 106 § 1. The Act provided that: "[A]ny sellers selling tangible personal property, . . . or services for delivery into South Dakota, who does not have a physical presence in the state . . . shall remit the sales tax and shall follow all applicable procedures and requirements of the law as if the seller had a physical presence in the state, provided the seller meets either of the following criteria in the previous calendar year or the current calendar year: (1) The seller's gross revenue from the sale of tangible personal property, any product transferred electronically, or services delivered into South Dakota exceeds one hundred thousand dollars; or (2) The seller sold tangible personal property, any product transferred electronically, or services for delivery into South Dakota in two hundred or more separate transactions."

[58] *See* S.B. 106 § 8 (7). "As Justice Kennedy recently recognized in his concurrence in *Direct Marketing Association v. Brohl*, the Supreme Court of the United States should reconsider its doctrine that prevents states from requiring remote sellers to collect sales tax, and as the foregoing findings make clear, this argument has grown stronger, and the cause more urgent, with time;"

[59] *State v. Wayfair Inc.*, 901 N.W.2d 754, 759 (S.D. 2017). The notices informed the sellers of the passage of the law; explained its requirements; advised the sellers to register for South Dakota sales tax licenses by a date certain; and warned that the failure to register could result in a declaratory judgment action as authorized by the law.

Overstock.com, Inc., and Newegg, Inc. received the notices but failed to register for sales tax licenses.[60] South Dakota filed a declaratory judgment action in state court against these vendors pursuant to the Bill.[61] The online retailers moved for summary judgment, admitting that they each met S.B. 106's economic-nexus threshold but raising the affirmative defense on the grounds that the taxing regulation was unconstitutional under *Quill* and *Bellas Hess*.[62] The trail court granted their motion.[63] The South Dakota Supreme Court unanimously affirmed and ruled in favor of Wayfair, recognizing that "*Quill* remains the controlling precedent."[64] The State promptly filed a petition for *certiorari* in the Supreme Court of the United States, which was granted without delay.[65]

B. *Wayfair* Holding and Reasoning

South Dakota v. Wayfair involved the constitutionality of the South Dakota statue that requires out-of-state vendors with no physical presence in the state to collect and remit sales tax. In a 5-4 decision, the Court upheld the South Dakota statue, thus overruling *Quill* and the physical presence rule.

The majority opinion began by explaining the history of the Court's Dormant Commerce Clause jurisprudence and concluded that modern precedents rest on two primary principles that mark the boundaries of a state authority to regulate interstate commerce.[66] After articulating the

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[60] *Id.*

[61] *See* S.B. 106 § 2. The Act authorized the state to bring "declaratory judgment actions in any circuit court against any person that the state believes to meet the criteria . . . to establish that the obligation to remit sales tax is applicable and valid under state and federal law."

[62] *State v. Wayfair*, 901 N.W.2d at 759-60.

[63] *Id.* at 761.

[64] *Id.*

[65] The Act was designed to "permitting the most expeditious possible review of the constitutionality of this law." S.B. 106. § 8 (8). And it achieved this goal: The South Dakota Supreme Court issued its decision on September 13, 2017; the State filed its petition for certiorari on October 2, 2017; and the U.S. Supreme Court granted the petition on January 12, 2018, barely three weeks after the state's reply brief was submitted.

[66] *Wayfair*, 138 S. Ct. at 2090 ("First, State regulations may not discriminate against interstate commerce; and second, States may not impose undue burdens on interstate commerce. State laws that discriminates against interstate commerce face 'a virtually *per se* rule of invalidity.' State laws that regulat[e] evenhandedly to effectuate a legitimate

guiding principles of the commerce clause analysis, the majority then explained the history of the Court's state tax Dormant Commerce Clause jurisprudence in *Bellas Hess*, *Complete Auto*, *Quill*, and the physical presence standard.[67] The majority then noted that economic changes had occurred since *Quill* and stated that the physical presence rule, both as first formulated and as applied today, was an incorrect interpretation of the commerce clause.[68] The majority then explained why the physical presence rule was incorrect.[69]

The Court reasoned that Quill and its physical presence rule was flawed for three reasons: First, the physical presence rule is not a necessary interpretation of Complete Auto's nexus requirement; Second, the physical presence rule creates rather than resolves market distortions; Third, the physical presence rule imposed arbitrary and formalistic distinctions in contravention of modern Commerce Clause jurisprudence.[70]

First, the Court explained that the substantial nexus requirement is closely related to the 14th Amendment due process minimum contacts requirement, and it is well settled that a business need not have a physical presence to satisfy that requirement.[71] Thus, even though the Due Process and the Commerce Clause standards may not be identical or coterminous, when considering whether a state may levy a tax, there are "significant parallels" between the two standards.[72] Therefore, physical presence is not necessary to create a substantial nexus.[73]

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local interest . . . will be upheld unless the burden imposed on interstate commerce is clearly excessive in relation to the putative local benefits.") (internal quotation omitted).

[67] *Id.* at 2091-92.

[68] *Id.* at 2092.

[69] *Id.* at 2092-99.

[70] *Id.* at 2092.

[71] *Id.*

[72] *Id.* at 2093 ("The reasons given in Quill for rejecting the physical presence rule for due process purposes also apply to the question of whether physical presence is required to force an out-of-state seller to collect and remit use taxes.").

[73] *Id.*

The Court then explained that the physical presence rule creates rather than resolves market distortions and that these distortions were in direct conflict with the purpose of the Commerce Clause, that is, to prevent states from engaging in economic discrimination.[74] Local businesses and businesses with a physical presence are at an economic disadvantage because a remote seller can offer "*de facto* lower prices," since states have difficulty enforcing their own use tax laws directly against the in-state purchasers.[75] Thus, the physical presence rule served as a "judicially created tax shelter" and guaranteed a competitive benefit to some businesses based solely on the organizational form they chose.[76]

The Court next addressed the role of the physical presence requirement in the modern E-commerce economy and concluded that the rule was "artificial in its entirety."[77] The Court recognized that "[t]he continuous and pervasive virtual presence of retailers today is, under *Quill*, simply irrelevant," and the "Court should not maintain a rule that ignores these substantial virtual connections to the State."[78]

The Court also addressed the rule of *stare decisis*, with the majority concluding that *stare decisis* "can no longer support the Court's prohibition of a valid exercise of the State's sovereign power."[79] The Court then noted that it was inappropriate to ask Congress to resolve the matter because, although Congress could change the physical presence rule, it was not proper for the Court to ask Congress to "address a false constitutional premise of the Court's own creation."[80]

The Court thus concluded that the physical presence rule of *Quill* was "unsound and incorrect" and that *Quill* and *Bellas Hess* are overruled. After abandoning *Quill* and the physical

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[74] *Id.*
[75] *Id.* at 2094.
[76] *Id.*
[77] *Id.* at 2095-96.
[78] *Id.* at 2096.
[79] *Id.* at 2096-97.
[80] *Id.*

presence rule, the Court went on to note several features of the South Dakota tax system that appear designed to prevent discrimination against or undue burdens upon interstate commerce,[81] and hold that the South Dakota statue satisfied *Complete Auto*'s substantial nexus requirement.[82]

C. Creation of a New "Substantial Nexus" Test

Narrowly read, *Wayfair* made one thing clear: a business's physical presence in the taxing state is not essential to the "substantial nexus" prong of the *Complete Auto* test.[83] Therefore, post-*Wayfair*, in the absence of the "physical presence" requirement, the first prong of the *Complete Auto* test simply asks whether the tax applies to an activity with a "substantial nexus" with the taxing state.[84] And such a nexus is established when "the taxpayer [or collector] 'avails itself of the substantial privilege of carrying on business' in that jurisdiction."[85]

The Court had essentially created a new test to determine whether substantial nexus exists under the Commerce Clause. It went on to apply the new nexus standard to the case at issue, referred to the "economic and virtual contracts" that Wayfair, Inc. and other respondents had with South Dakota and hold that the nexus is "clearly sufficient."[86] The Court offered some explanation:

> 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. 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,

[81] *Id.* 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 a member of the Streamlined Sales and Use Tax Agreement ("SSUTA")and had thus simplified its system in ways to reduce compliance costs for vendors.

[82] The South Dakota tax regulation was only challenged on the interpretation of the Commerce Clause and the validity of the physical presence rule. *See Id.* at 2087 ("All concede that taxing the sales in question here is lawful. The question is whether the out-of-state seller can be held responsible for its payment, and this turns on a proper interpretation of the Commerce Clause, U. S. Const., Art. I, §8, cl. 3.").

[83] *Wayfair*, 138 S. Ct. at 2093; *See* Adam Thimmesch, Darien Shanske, & David Gamage, Wayfair: *Substantial Nexus and Undue Burden*, 89 ST. TAX NOTES 447, 447 (2018) ("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.").

[84] *Wayfair*, 138 S. Ct. at 2099.

[85] *Id.*

[86] *Id.*

> national companies that undoubtedly maintain an extensive virtual presence. Thus, the substantial nexus requirement of *Complete Auto* is satisfied in this case.[87]

The first sentence laid out the South Dakota statutory thresholds of 200 transactions or $100,000 in sales revenue annually. The second sentence simply concluded that the threshold require was sufficient "economic contacts" for substantial nexus, because the quantity of business occurred in the taxing state and the fact that the sellers had availed themselves of the substantial privilege of carrying on business in the state. The Court did not, however, continue to explain to what extent a business has availed oneself of "the substantial privilege of carrying on business." Rather, it emphasized the company's size and business scope of the respondents and focused on the "virtual presence" that large, national companies maintained. Then, the Court simply declared that the substantial nexus requirement is satisfied.

The *Wayfair* decision leaves many uncertainties. For one thing, it left the minimum threshold of the new nexus test undefined, for lower courts to determine. It further muddied the distinction between the Due Process Clause and Commerce Clause analysis articulated in *Quill* by suggesting a due-process-type substantial nexus under the Commerce Clause doctrine. The next section addresses some of the uncertainties, focusing primarily on the relationship between the Due Process Clause and the Dormant Commerce Clause; and how to define the new "substantial nexus" standard with the physical-presence rule now no longer in effect.

III. QUESTIONS WAYFAIR LEFT OPEN

A. Should the Two Constitutional Limits Merge into One?

The *Wayfair* Court failed to address the relationship between the Due Process Clause and the Dormant Commerce Clause restraints in state and local tax field. Moving forward, should the

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[87] *Wayfair*, 138 S. Ct. at 2099-2100.

"nexus" concept continue to play a role in Dormant Commerce Clause restrictions, or should the nexus requirement only matter in the Due Process personal jurisdiction context? The *Wayfair* Court seemed to suggest that the "substantial nexus" requirement of the Dormant Commerce Clause is now a Due Process nexus concern. This paper disagrees with this proposition. The Dormant Commerce Clause's substantial nexus requirement should remain distinct and independent of the Due Process Clause's nexus requirement.

Before *Quill*, the Supreme Court had treated the Due Process Clause and the Commerce Clause nexus requirements on state and local taxes as closely related.[88] In *Quill*, the Court split the two doctrines and hold that each nexus requirement was analytically distinct.[89]

Wayfair seems to take a step back in the direction of *Bellas Hass* and collapse the two constitutional restrictions back into one. The Court recognized that that nexus requirement of the Commerce Clause was akin to the Due Process minimum contacts requirement, stating that the requirements of the two "may not be identical or coterminous . . . there are significant parallels."[90]

What is more, the Court in *Wayfair* further muddied the water by suggesting a new nexus standard under the Commerce Clause and stating that the Commerce Clause nexus is established when "the taxpayer [or collector] 'avails itself of the substantial privilege of carrying on business' in that jurisdiction."[91] The Court only cited to dicta from *Polar Tankers*[92] for that proposition. However, *Polar Tankers* was an odd case to rely on, particular because it was a case about personal

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[88] *Bellas Hess*, 386 U.S. at 756 ("[Appellant] argues that the liabilities which Illinois has thus imposed violate the Due Process Clause of the Fourteenth Amendment and create an unconstitutional burden upon interstate commerce. These two claims are closely related. For the test whether a particular state exaction is such as to invade the exclusive authority of Congress to regulate trade between the States, and the test for a State's compliance with the requirements of due process in this area are similar.")

[89] *Quill*, 504 U.S at 313 ("Thus, the 'substantial nexus' requirement is not, like due process 'minimum contracts' requirement, a proxy for notice, but rather a means for limiting state burdens on interstate commerce.").

[90] *Wayfair*, 138 S. Ct. at 2093.

[91] *Id.* at 2099.

[92] *Polar Tankers, Inc., v. City of Valdez*, 558 U.S. 1 (2009). It involves a local personal property tax imposed upon the values of large ships traveling to and from the city and was stuck down as violating the Tonnage Clause.

property tax imposed upon a company that had physical presence in the taxing jurisdiction.[93] *Polar Tankers* provided little guidance to the analysis of the Commerce Clause nexus requirement, since the court explicitly declined to address the Commerce Clause arguments[94] and the "availment" language came straight from the Due Process Clause analysis of another case cited within.[95]

The reference to *Polar Tanker* and the use of "availment" language may further strengthen the conclusion that the Court in *Wayfair* was relying on the due-process version of nexus for purposes of fashioning its new Dormant Commerce Clause rule.[96] Post-*Wayfair*, some commentators have suggested that the Due Process Clause will assume a greater role in state tax litigations.[97] Others are highly critical of this trend. Professor Holderness in his recent paper suggests that "if the substantial nexus standard were to collapse into the Due Process jurisdiction standard, many taxpayers would face uncertain and potentially burdensome state tax obligations, which may chill their willingness to engage in interstate commerce."[98]

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[93] *See* Michael T. Fatale, Wayfair*, What's Fair, and Undue Burden*, 90 ST. TAX NOTES 857 (2018) ("It might seem odd at first blush that the Court's important re-affirmation of the purposeful availament principle relies on language in a somewhat aberrational case focused on one of the Constitution's least-known provision, the so-called Tonnage Clause."); Richard D. Pomp, *Wayfair and the Myth of Substantial Nexus*, 36 J. ST. TAXATION 27 (2018) ("*Polar Tankers*, a case interpreting the Tonnage Clause of the Constitution had an ironic similarity with *Complete Auto*. Neither case had anything to do with nexus. *Polar Tankers* has played no dispositive role in any state or local tax case and is infrequently cited, nor was it cited by any of the parties in *Wayfair*, including the 40 or so amici. Even *Polar Tankers*, a 2009 case, made no mention of *Complete Auto*.").

[94] *Polar Tankers*, 558 U.S. at 6.

[95] *Id.* at 11 (citing *Mobil Oil Corp. v. Comm'r of Taxes of Vt*., 445 U.S. 425, 437 (1980)). The analysis in *Mobil Oil*, in turn, derived from the Court's Due Process holding in *Wisconsin v. J.C. Penney*, 311 U.S. 435, 444–45 (1940) (stating that when evaluating Due Process as applied to the imposition of a state tax "[t]he simple but controlling question is whether the state has given anything for which it can ask return");

[96] *See* Thimmesch, Shanske, & Gamage, *supra* note 83 (noting that the nexus standard articulated in *Wayfair* could be construed as coterminous with a due process, purposeful availment standard); Jonathan L. Entin, *Another Superseded* Quill*: The End of the Physical-Presence Rule for Requiring Out-of-State Businesses to Collect Use Taxes*, 36 J. Tax'n Inv. 15 ("Or perhaps the quotation from *Polar Tankers* is a subtle hint that the parallels are very strong indeed.").

[97] *See* Jaye Calhoun & William J. Kolarik II, *Implications of the Supreme Court's Historic Decision in Wayfair*, 89 ST. TAX NOTES 125 (2018) ("Among other things, the authors expect future due process litigation to explore whether a taxpayer must target some states or markets before the due process minimum contact test is satisfied.").

[98] Hayes Holderness, *Navigating 21st Century Tax Jurisdiction* (January 11, 2019), Md. L. Rev. (Forthcoming), http://dx.doi.org/10.2139/ssrn.3314272 ("[B]y allowing the substantial nexus standard to completely collapse into the due process personal jurisdiction standard would open the door to unprincipled expansion of state tax power and uncertain tax obligations that may burden interstate commerce, particularly the activities of small businesses and of

This paper aligns with Professor Holderness and argues that the Commerce Clause nexus requirement, while equated with Due Process minimum contacts prior to *Quill*, is independent of the Due Process nexus requirement, should remain distinct and further strengthened into a standard that addresses the concerns of the Dormant Commerce Clause.

The Due Process Clause and Commerce Clauses are not identical because the two standards are animated by different constitutional concerns. Due Process Clause centrally concerns fundamental fairness to the individual taxpayer, while the Commerce Clause and its nexus requirement is designed to protect the national economy from the adverse effects of state regulation.[99] Thus, the Court in *Quill* was correct to conclude that the "[Commerce] Clauses pose distinct limits on the taxing powers of the States," and a state regulation that comports with the Due Process Clause nonetheless violates the Commerce Clause.[100]

It is also conceptually possible to conclude the other way around. A small vendor that has not purposefully directed its business into a particular state may be subjected to the state's taxing regulation, if for some reason a handful sales ended up occurring in the state. The regulation may be fully conforming with the four-part *Complete Auto* test, but nonetheless violate the Due Process fundamental fairness requirement for lacking "purposeful availment".

Policy reasons further justify the split of the Due Process and Dormant Commerce Clause requirements.[101] The Dormant Commerce Clause is distinct from Due Process Clause because it

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entities that facilitate the commerce of others, such as online marketplaces similar to Amazon Marketplace, payment intermediaries like MasterCard, and common carriers such as FedEx.").

[99] *See supra* Part I-B.

[100] *Quill.* 504 U.S. at 305.

[101] *See* Shane D. Buntrock, Quill Corporation v. North Dakota*: Spawning the Physical Presence "Nexus" Requirement Under the Commerce Clause*, 38 S.D. L. Rev. 130, 142-46 (1992) (stating that the two clauses are driven by separate policy considerations and, therefore, warrant two distinct nexus requirements); James L. Kronenberg, *A New Commerce Clause Nexus Requirement: The Analysis of Nexus in* Quill Corp. v. North Dakota, *1994* Ann. Surv. Am. L.1, 25-28 (distinguishing the due process policy of preventing a state from using illegitimate taxing power on external entities from the Commerce Clause policy of preventing unwarranted state regulation of the national economy).

has the "congressional override" feature: An action deemed to violate the Commerce Clause by the court might be subsequently validated by Congress.[102] The same thing, however, cannot be said of the Due Process Clause. Only through amendments to the Constitution may Congress overturn a decision based on the Due Process Clause.

Congressional override thus presents an opportunity for experimentation that the Due Process Clause does not present. Moving forward, lower courts could be more "aggressive" in applying the Dormant Commerce Clause nexus requirement on the theory that Congress can step in to change the decisions it disapproves. The same rational can be used to justify state's actions as well. If a state taxing regulation goes too far and burdens interstate commerce, Congress can validate that regulation, if so choose, even though it is deemed as violating the Dormant Commerce Clause by the court.[103] However, Congress has no such power to authorize actions that violate the Due Process Clause, absent constitutional amendment. Therefore, it is important to keep the two restraints separate, based on their distinct features.

That said, the *Wayfair* Court has still left the matter largely unsettle. Moving forward, the substantial nexus standard might merge into the Due Process personal jurisdiction standard, or it could be strengthened into a distinct standard that better addresses the concerns of the Dormant Commerce Clause. Because this paper proposes for the later approach, another question follows: post-*Wayfair*, what is this independently-defined "nexus" requirement under the Dormant Commerce Clause? As noted above, the Court in *Wayfair* has not defined the new substantial nexus test by reference to anything other than its observation that South Dakota's statutory threshold of 200 transactions or $100,000 sales revenue seems to meet it.[104]

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[102] *Quill.* 504 U.S. at 318 ("Congress remains free to disagree with our conclusion.")

[103] *Id.* ("Accordingly, Congress is now free to decide whether, when, and to what extent the States may burden interstate mail-order concerns with a duty to collect use taxes.")

[104] *See supra* Part II-C.

B. What is "Substantial Nexus"?

The second question is largely motivated by the answer to the first question. Because this paper answers to the first question in negative, that is, the substantial nexus standard of the Dormant Commerce Clause should remain distinct and independent of the Due Process Clause requirement. Then the second question follows: post-*Wayfair*, how should lower courts decide to what extend does an online vendor have substantial nexus with the taxing jurisdiction? To put it simply, what is "substantial nexus"?

The *Wayfair* Court hold that a "substantial nexus" with the taxing state is established when "the taxpayer [or collector] 'avails itself of the substantial privilege of carrying on business' in that jurisdiction."[105] It is not entirely clear how the Court intents lower courts to apply the new nexus test. Because the Court did not articulate what it means to "avail oneself of the substantial privilege of carrying on business", it also passed the opportunity to address the question of "substantial nexus" in terms of small sellers that make a small volume of sales to customers in many states.[106]

Essentially, the *Wayfair* Court has left the question that was raised by Justice Sotomayor during oral argument unanswered: "How many sales does it take [for the state to tax an out-of-state vendor and for the vendor to have a constitutionally-sufficient connection with the state]? . . . What's the minimum everywhere else?"[107]

[105] *Wayfair*, 138 S. Ct. at 2099.

[106] *See* Holderness, *supra* note 98 ("The Court may be correct, but how should smaller vendors read this opinion? What if Wayfair sold only one $150,000 piece of furniture to a South Dakotan? Or what if Wayfair sold $1.00 trinkets to 200 separate South Dakotans? The Wayfair opinion did not adequately answer these questions because it failed to articulate a meaning behind the "substantial privilege of carrying on business" phrase in the dormant Commerce Clause context."); Thimmesch, Shanske, & Gamage, *supra* note 83 ("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?").

[107] Justice Sotomayor asked South Dakota's Attorney General during oral arguments in *South Dakota v. Wayfair Inc*., Transcript of Oral Argument at 6, *South Dakota v. Wayfair, Inc.*, 138 S. Ct. 2080 (2018) (No. 17-494). The *Wayfair* majority opinion did not answer this question.

The Court in *Wayfair* seems to suggest that in the future, online vendors could presumably rely on the *Pike* balancing test to challenge state taxing regulations that unduly burdens interstate commerce.[108]

In general, since *Quill*, state tax cases do not rely on or even evaluate the application of the *Pike* balancing test.[109] When courts do engage in such balancing, it rarely struck down any state tax laws using the test.[110] One possible reason is the difficulty in quantifying the necessary interest and burden in cases involving tax obligations.[111] The state's interest in its fair share of revenue is

[108] *Wayfair*, 138 S. Ct. at 2099 ("Finally, other aspects of the Court's Commerce Clause doctrine can protect against any undue burden on interstate commerce, . . . For example, the United States argues that tax-collection requirements should be analyzed under the balancing framework of *Pike v. Bruce Church, Inc*."). *See also* Thimmesch, Shanske, & Gamage, *supra* note 83 ("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."); Jeffery S. Reed, *What Is the New Constitutional Test After* Wayfair*?*, 89 ST. TAX NOTES 335 (2018) ("The Court in *Wayfair* declined to adopt any new bright-line rule to replace physical presence, but rather implicitly endorsed something like the balancing test from *Pike v. Bruce Church Inc*., while providing some criteria for applying the balancing test in future cases."); Fatale, *supra* note 93 ("The *Wayfair* majority invoked the undue burden standard in a peculiar way. The Court stated that 'the United States argues that tax-collection requirements should be analyzed under the balancing framework of *Pike v. Bruce Church*, *Inc*.' The United States did in fact argue in favor of applying the undue burden test to the states' use tax collection laws in both its *Wayfair* amicus brief and at oral argument. But the Court's lukewarm endorsement of this point—attributing it not to its own legal conclusions but to the thoughts of one of the amici—suggests ambivalence.").

[109] *See* Holderness, *supra* note 98 ("However, the Pike balancing test has not found a clear home in the state tax jurisprudence despite the Court's recognition that a tax levied on interstate commerce has the potential to unduly burden that commerce."); Michael T. Fatale, *Common Sense: Implicit Constitutional Limitations on Congressional Preemptions of State Tax*, 2012 MICH. ST. L. REV. 41, 60–62 (2012) (describing the Court's general concerns with *Pike* balancing dating back to the time of Quill).

[110] The last time the U.S. Supreme Court struck down a state law based on a *Pike* balancing analysis was over 35 years ago, and not due to lack of opportunity. For a comprehensive analysis of *Pike* balancing test in light of *Wayfair*, see Walter Hellerstein and Andrew Appleby, *Substantive and Enforcement Jurisdiction in a Post-*Wayfair *World*, 90 ST. TAX NOTES 283 (Oct. 22, 2018).

[111] *See* Thimmesch, Shanske, & Gamage, *supra* note 83 ("Nevertheless, *Pike* is difficult to apply, and we think states should be wary of pressing the issue."); Holderness, *supra* note 98 ("The *Pike* balancing test's absence from the state tax cases likely is a result of the difficulties in quantifying a state's significant interest in exercising the tax power, a power that often has been described as fundamental.").

significant and fundamental.[112] The burden imposed on interstate commerce is not easily calculable, and it varies between states and over time.[113]

Despite the *Wayfair* Court's lukewarm endorsement of the *Pike* balancing test, it seems unlikely that courts would actually apply the test moving forward.[114] But if courts were to apply the test, the *Wayfair* Court has directed its focus to some features of South Dakota's law that "appear designed to prevent discrimination against or undue burdens upon interstate commerce."[115] The Court seems to suggest that those features are sufficient to insulate states from the *Pike* balancing type of challenge. That said, if the South Dakota tax regime was adopted by other states, challenging the constitutionality of such taxing regulations would less likely to succeed.

Another possible reading into the *Wayfair* Court's reference to *Pike* is that small vendors may have a stronger argument under the balancing test moving forward.[116] The Court expressed

[112] Chief Justice John Marshall famously described the power to tax as the power to destroy; *see also Commonwealth Edison Co. v. Montana*, 453 U.S. 609, 616 (1981) ("[T]his Court has acknowledged that 'a State has a significant interest in exacting from interstate commerce its fair share of the cost of state government.'") (internal citations omitted); *Arkansas v. Farm Credit Services of Central Arkansas*, 520 U.S. 821, 826 (1997) ("The power to tax is basic to the power of the State to exist."); *Wisconsin v. J.C. Penney*, 311 U.S. 435, 444 (1940) (referring to taxation as "the most basic power of government").

[113] See Adam B. Thimmesch, *A Unifying Approach to Nexus Under The Dormant Commerce Clause*, 116 MICH. L. REV. ONLINE 101, 109-10 (2018) (articulating the difficulty of measuring a state's interest in imposing taxes); Fatale, *supra* note 93, at 873-74 (detailing the difficulty of applying the Pike balancing test to tax matters).

[114] *See, e.g.*, Hellerstein & Appleby, *supra* note 110 ("Despite the *Wayfair* Court's tantalizing suggestion *Pike* could potentially protect remote sellers from overreaching sales and use tax collection obligations, *Pike* is not likely to be the panacea that some have envisaged."); Fatale, *supra* note 93 ("Given the above analysis, it seems unlikely that the Court itself would actually apply the undue burden standard to a use tax collection duty.").

[115] *Wayfair*, 138 S. Ct. at 2099. The Court 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.

[116] *See* Hellerstein & Appleby, *supra* note 110 ("It may be difficult for large, sophisticated remote sellers to avoid a sales and use tax collection obligation under the Pike balancing test. The Court has recognized that imposing such obligations on sellers is a 'familiar and sanctioned device,' and that the 'sole burden imposed upon the out-of-state seller . . . is the administrative one of collecting [the tax].'") (quoting Gen. Trading Co. v. State Tax Comm'n, 322 U.S. 335, 338 (1944) and Nat'l Geographic Soc'y v. Cal. Bd. of Equalization, 430 U.S. 551, 558 (1977)); Fatale, *supra* note 93 ("Wayfair implied that the only vendors that could logically bring an undue burden claim would be small remote vendors, as they would have the greatest difficulty with the tax implications resulting from the case.").

concerns and sympathy for small vendors throughout the opinion[117] and noted that those small businesses with only "*de minimis* contacts" may bring potential claims using the *Pike* undue burden standard and seek relief in the future.[118] It follows that, the Court seems to suggest the "burden" a taxing regulation imposed on interstate commerce may depends on a business's size and sophistication level. A large, more sophisticated firm should have the infrastructure to incur the costs of tax compliance obligations less expensively than a small firm, at least as a percentage of the firm's total revenue.

Now that we've made some progress,[119] we've demonstrated that the nexus requirement of the Dormant Commerce Clause should stay independent from that of the Due Process Clause going forward, and the need to protect interstate commerce from undue burdens of state actions cannot be adequately addressed by the *Pike* balancing test, we still need a robust theory of the substantial nexus requirement to guide the doctrine post-*Wayfair*.

Professor Holderness recently proposed such a theory–the "compliance burden theory"–as well as the substantial nexus standard that follows from that theory, to address the concerns and questions raised by *Wayfair*.[120]

Professor Holderness explained:

> The substantial nexus standard that follows from the compliance burden theory provides that substantial nexus exists when the benefits the taxpayer receives from conducting interstate commerce in the state exceed the tax compliance costs imposed on the taxpayer. Simply put, if the interstate commerce is profitable despite the tax compliance costs, then the substantial nexus standard should be satisfied. If not, substantial nexus should not be found. This standard can be expressed formulaically as:

[117] Fatale, *supra* note 93 ("*Wayfair* referred sympathetically to such smaller vendors nine times.").
[118] *Wayfair*, 138 S. Ct. at 2099.
[119] Hopefully.
[120] *See generally*, Holderness, *supra* note 98.

Substantial Nexus ⇔ Benefit to Taxpayer of Activity in State > Taxpayer Compliance Costs

Put it differently, substantial nexus is found when the state ultimately benefits more in the way of increased tax revenue than the taxpayer loses in the way of compliance costs.

Professor Holderness listed several benefits of the proposed substantial nexus standard.[121] First, it can appropriately adapt to changing economies, business practices, and tax systems. As one thing changes, the burden of tax compliance costs changes. Second, the proposed standard gives the states opportunity to expand their jurisdiction to tax by lowering or fully absorbing the compliance costs of their tax systems. Third, because the proposed standard is also balancing in nature, it helps to bring tax jurisprudence in line with other areas of the Dormant Commerce Clause jurisprudence and promoting conformity between different areas of laws.

Professor Holderness also acknowledged the challenges and difficulties in applying the balance test. First, the proposed standard requires "intensive evidence gathering and complicated calculations to determine when tax compliance costs become too burdensome." To address this issue, Professor Holderness proposed that lawmakers and taxpayers may resort to proxies such as the average profit margin of the particular activity taxed to simplify the analysis. Or, to complete avoid such controversies, states can always lower the compliance costs and simplify the tax system on their end. Second, the standard might be criticized by tax payers because its pro-state nature. From the look of it, states now have more power to tax than before. To address this concern, Professor Holderness pointed out that the state's authority should have been broader all along, and the laws prior to *Wayfair* was inappropriately anti-state.[122]

[121] *See generally*, Holderness, *supra* note 98.
[122] I actually don't have a problem with this proposition.

The "Holderness theory" is theoretically-sound, in a sense that it is uniquely situated to protect interstate commerce from the burden of tax compliance costs. However, this paper is still skeptical about this theory would apply in practice and therefore raise two concerns in the remainder of this section.

First, as a not so bright-line rule, the proposed standard still lacks clarity in practice. It requires extensive and complicated calculations to determine the appropriate tax compliance costs. Professor Holderness's solution to this criticism is for states to lower the compliance costs and simplify the tax system on their end. Take this argument to the extreme, however, say if a state decides to fully absorb the tax compliance costs, or offers vendor reimbursement for compliances costs, under the Holderness equation, the taxpayer compliance costs would become "zero". And the standard can be expressed formulaically as:

Substantial Nexus $\Leftrightarrow$ Benefit of Taxpayer > \$0.00 (Compliance Costs)

Now, "substantial nexus" is found as soon as the taxpayer gains some benefit in the taxing state, regardless of the monetary amount of that gain or the number of transactions involved. Therefore, the answer to Justice Sotomayor's question would in fact be, "one sale".[123] However, are we really comfortable saying that one sale into the state, or one dollar gained from a single transaction into the state constitutes as a "substantial nexus" under the operative Dormant Commerce Clause doctrine?

At least this is not the way how the *Wayfair* Court phrased it. Recall the Court's references to the South Dakota law's several features, specially the fact that South Dakota's high statutory nexus thresholds and the fact that South Dakota is a member of the SSUTA which offers simple tax system and free software to taxpayers. The Court encouraged, though did not require, other

[123] Indeed, the South Dakota Attorney General's answer to that question, during oral argument, was "[O]ne sale." Transcript of Oral Argument at 6, South Dakota v. Wayfair, Inc., 138 S. Ct. 2080 (2018) (No. 17-494).

states to adopt similar measures. But pushing too far and making the threshold as low as one sale or one dollar might run afoul with the Court's intention.

Secondly, Professor Holderness did not discuss or even mention Congress's role in developing the theory. This is a little confusing considering that all justices in *Wayfair* agreed that the ultimate solution to the underlying problem should come from Congress.[124] In addition, Professor Holderness laid out the ground work of a strong and robust Dormant Commerce Clause jurisprudence before dive into the substantial nexus standard in the article. As an important distinction between the Dormant Commerce Clause and the Due Process Clause, the possibility of congressional override should be taken into consideration. In light of *Wayfair*, one possible solution for congressional action is to adopt this theoretically-sound substantial nexus standard and fully incorporate it or codify into laws, which would promote uniformity and consistency in multistate transactions, and provide guidance for states and their newly enacted taxing regulations.

While we are on the subject of congressional action, although several bills have been introduced to Congress in the past, none has made it out of the House or Senate.[125] However

[124] *Wayfair*, 138 S. Ct. at 2098 (making clear that Congress may address the subject "if it deems it necessary and fit to do so"); *Id.* at 2101, Roberts, C.J., dissenting (emphasizing that Congress has the power to act and is better qualified than the judiciary to address the problem); *see also Quill*, 504 U.S. at 318 ("The underlying issue is not only one that Congress may be better qualified to resolve, but also one that Congress has the ultimate power to resolve . . . Congress is now free to decide whether, when, and to what extent the States may burden interstate mail-order concerns with a duty to collect use taxes.").

[125] Three proposed bills have also been introduced in Congress: Main Street Fairness Act of 2011, Marketplace Equity Act of 2011 and the Marketplace Fairness Act of 2011. Each bill, if passed, would authorize states to collect from out-of-state sellers, however, with different requirements that state must satisfy before becoming authorized to collect from out-of-state sellers. The Main Street Fairness Act of 2011 attempts to create consistency and to level the competition for all businesses. It requires states to "adhere to uniform product definitions, adopt uniform requirements for filing sales tax returns, administer both state and local sales tax collection through a single state office, and allow retailers to register through a centralized, one-stop multistate registration system." The Act would impose a national tax standard but allow states abiding by the SSUTA to force internet sellers to collect tax based on their own state's legislation. *See generally*, The Main Street Fairness Act, The New Rules Project (Nov. 15, 2011), http://www.newrules.org/retail/rules/internet-sales-tax-fairness/main-street-fairness-act. Traditional retailers such as Target, Wal-Mart, Best Buy, Home Depot, and Sears all support the Main Street Fairness Act. Most large retailers support the passage of a national tax, arguing that it would level the playing field between them and large internet retailers. *See* Wall Street Journal: Retailers Support the Main Street Fairness Act, Blog.FedTax.Net (Nov. 28, 2011), http://blog.fedtax.net/2011/03/17/wall-street-journal-retailers-support-main-street-fairness-act/. The Marketplace Fairness Act of 2011 authorizes states that fully comply with the SSUTA to require remote vendors who do not qualify

theoretically sound a proposal for congressional legislation may be, it is only valuable if the proposed legislation is actually enacted. As a matter of history, "Congress has not proven to be an effective forum for state tax reform."[126]

Over two decades after *Quill* was decided, Congress has not acted, and is not likely to do so any time soon. Therefore, the next question follows: Post-*Wayfair*, while we are waiting for such congressional action, what should the states do?

C. What Should the States Do?

For states looking to enact their own online sales tax statues, the *Wayfair* Court did not provide a single standard for cities and states to follow for online tax collection. Although it did create a clear safe harbor. The Court highlighted twice key features of the South Dakota law that minimized discrimination or undue burden on interstate commerce, including its application only to business that meet or surpass certain thresholds, a prohibition on retroactive application, and the fact that South Dakota is a member of the SSUTA, which reduces administrative and compliance costs.[127]

Some commentators have recommended that states take note of the features of the South Dakota law that appealed to the Court and replicate or improve on these to the extent possible.[128]

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for the small seller exception to collect and remit sales taxes. *See generally*, Marketplace Fairness Act, S. 1832, 112th Cong. § 3(a) (2011).

[126] John A. Swain, *State Sales and Use Tax Jurisdiction: An Economic Nexus Standard for the Twenty-First Century*, 38 Ga. L. Rev. 343, 370 (2003). At least one empirical academic study predicts that Congress is unlikely ever to enact legislation mandating uniformity in state and local taxation. *See* Kathryn L. Moore, *State and Local Taxation: When Will Congress Intervene?*, 23 J. Legis. 171, 173 (1997).

[127] *Wayfair*, 138 S. Ct. at 2099-2100. Soon after the decision in *Wayfair*, states have quickly passed laws similar to S.B. 106. Generally speaking, roughly twenty states have followed the South Dakota approach and complys with the following features: (1) Safe harbor provision, which exclude "those who transact only limited business" in the state; (2) No retroactive collection; (3) Single state-level administration of all sales taxes in the state; Uniform definitions of products and services; (5) Simplified tax rate structures (same tax base between state and local sales tax and no partial tax rates for items); (6) Free access to sales tax administration software provided by the state; (7) Immunity, sellers who use the software are not liable for errors derived from relying on it; others have followed the approach but limit the transaction threshold.

[128] *See*, e.g., Thimmesch, Shanske, & Gamage, *supra* note 83 ("States that can replicate those factors should take comfort that their statutes are permissible. States that fail them might need to be more concerned.").

While others encourage states to be fair in their implementation of the decision and to otherwise simplify their tax laws if appropriate.[129]

CONCLUSION

South Dakota v. Wayfair is one of the most impactful case in the field of state and local taxation since *Quill* was decided in 1992. This paper has raised and tried to offer answers to the confusions and questions that *Wayfair* created. Specially, this paper has argued for keeping the Dormant Commerce Clause nexus requirement distinct and independent from the Due Process Clause nexus requirement, and then analyzed one particular theory raised by Professor Holderness that addressed the question, "what is substantial nexus?"

Outside of the specific parameters set forth by *Wayfair*, it is unclear what other laws would be constitutional. Must a state's law be prospective only? What if a state is not a member of the Streamlined Sales and Use Tax Agreement? What happens if a state requires a much lower threshold to begin collecting taxes, say $10,000 in annual sales revenue? It remains to be seen whether other state laws imposing collection obligations on out-of-state sellers that do not have sufficient safe harbor provisions or are otherwise burdensome on interstate commerce will pass constitutional muster.[130]

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[129] Fatale, *supra* note 93 ("The *Wayfair* Court's references to the undue burden test seem intended to encourage the states to be fair in their implementation of that decision and to otherwise simplify their use tax collection laws, if appropriate."); Holderness, *supra* note 98 ("Finally, states that wish to avoid substantial nexus controversies can always simplify their taxes and assume the compliance costs associated with them.").

[130] Professor Coenen's amazing lectures on "constitutional muster" animated this paper.