The Franchise Valuations Reporter

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Publisher's Note

Welcome to a special edition of ***The Franchise Valuations Reporter*** devoted to just one topic: The U.S. Supreme Court's decision in *South Dakota v Wayfair.*

As a reminder, we report on damages, valuations, expert testimony and tax issues as they relate to franchising. As always, we are happy to provide readers with a consultation on any of these topics.

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SCOTUS Overturns "Physical Presence" Requirement for Sales Tax Nexus

How Wayfair Will Have an Impact on Franchising

Background

South Dakota enacted a sales tax statute which went into effect on May 1, 2016, to overturn the "physical presence" requirement for sales tax nexus. South Dakota has no income tax and the legislative history of the bill noted that sales tax avoidance was epidemic in the state. While South Dakota knew the statute was unconstitutional they passed it with the express purpose of convincing the United State Supreme Court to hear a challenge, and overrule the *National Bellas Hess*[1]and *Quill*[2] physical presence requirement. South Dakota's statute specifically provided an expedited appeals process for any challenges to the constitutionality of the law.

On March 6, 2017, the law was challenged by online giant Wayfair. The South Dakota Sixth Judicial Court ruled the new sales tax nexus law was unconstitutional and the South Dakota Supreme Court agreed with the lower court. The state filed a petition with the United States Supreme Court, which granted *certiorari*.

Issue

At issue in *South Dakota v Wayfair*[3], in what is clearly the most significant sales tax nexus case in 25 years, was whether or not the so-called "bright line" test of *Bellas Hess* and *Quill* requiring a taxpayer to have a "physical presence" within the taxing jurisdiction as a pre-requisite for the obligation of a seller to collect and pay over sales taxes should continue to be the law of the land.[4]

Holding
The Court concluded that because the "physical presence rule of *Quill* is unsound and incorrect" *Quill* and *National Bellas Hess* "should be and are now overruled." Justice Kennedy delivered the opinion of the Court, in which Thomas, Ginsburg, Alito and Gorsuch joined. Thomas and Gorsuch filed concurring opinions. Roberts filed a dissenting opinion in which Breyer, Sotomayor and Kagan joined.

Analysis
Having decided in many previous cases that the Due Process Clause of the Constitution was not offended by States taxing the income of out-of-jurisdiction sellers, the prior SCOTUS decisions restricting sales tax nexus rested on the Commerce Clause. But in *Wayfair* the Court decided:

(1) Two primary principles mark Commerce Clause restrictions on States: first, they may not **discriminate** against interstate commerce; and second, they may not **impose undue burdens** on interstate commerce.

(2) Otherwise, state taxes will be sustained so long as they (1) apply to an activity with a substantial nexus with the taxing State, (2) are fairly apportioned, (3) do not discriminate against interstate commerce, and (4) are fairly related to the services the State provides.[5]

Problems With the Physical Presence Rule
The Court noted that the physical presence rule has long been criticized because it gives out-of-state sellers an advantage and results in significant revenue losses to the States. Accordingly precedent was reversed because:

(1) *Quill* was flawed on its own terms. First, the physical presence rule was not a necessary interpretation of *Complete Auto*'s nexus requirements listed above - a business need not have a physical presence in a State to satisfy the demands of due process.

In addition, *Quill* created rather than resolved market distortions. The majority felt that the rule was, in effect, 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 rule also produced an incentive to avoid physical presence in multiple States, affecting development that might be efficient or desirable.

Furthermore, *Quill* imposed the sort of arbitrary, formalistic distinction that the Court's modern Commerce Clause precedents disavow in favor of "a sensitive, case-by-case analysis of purposes and effects." It treated economically identical actors differently for arbitrary reasons. For example, a business that maintained a few items of inventory in a small warehouse in a State was required to collect and remit a tax on all of its sales in the State, while a seller with a pervasive Internet presence could not be subject to the same tax for the sales of the same items.

(2) When the day-to-day functions of marketing and distribution in the modern economy were considered, it became evident that *Quill*'s physical presence rule was "artificial in its entirety". Modern e-commerce does not align analytically with a test that relies on the sort of physical presence defined in *Quill*. And the Court should not

maintain a rule that ignores substantial virtual connections to the State.

(3) The physical presence rule of *Bellas Hess* and *Quill* was also an extraordinary imposition by the Judiciary on States' authority to collect taxes and perform critical public functions. Forty-one States, two Territories, and the District of Columbia asked the Court to reject *Quill*'s test.

(4) The longest section of the 24-page majority decision focuses on *stare decisis*, its importance to jurisprudence and why the Court had to overturn precedent in this instance. The entire opinion sounds like an apology for a foolish rule that had been invented by this very Court and now had to be overturned to account for historical and computer-driven progress. The high Court held that *stare decisis* can no longer support the Court's prohibition of a valid exercise of the States' sovereign power. Because the physical presence rule as defined by *Quill* is no longer a clear or easily applicable standard, arguments for reliance based on its clarity are misplaced. As the Court said, "*Stare decisis* may accommodate 'legitimate reliance interest[s]', *United States v. Ross*, 456 U. S. 798, 824, but a business 'is in no position to found a constitutional right ... on the practical opportunities for tax avoidance' *Nelson v. Sears, Roebuck & Co.*, 312 U. S. 359, 366."

The Dissent
In a poorly reasoned dissent, four justices conceded that the physical presence rule was wrong but said it was up to Congress - not the Court - to fix it. The majority opinion disputed that reasoning noting that the physical presence rule was made by the Court and should be corrected by the Court - Congress had nothing to do with it.

A Concurrence
There is a certain ironic apology in Justice Clarence Thomas' concurrence. Justice Byron White had been part of the majority finding a bright line test in *Bellas Hess* in 1967 and then 25 years later was in the dissent in *Quill*. In his concurring opinion in *Wayfair* Thomas noted that although he had been among the majority in *Quill* in 1992 he should have listened to White in his *Quill* dissent.

Conclusion: Planning for Probable Impact on Franchising
The Court noted that the South Dakota law at issue in *Wayfair* did not (by its express terms) apply retroactively. But it left unanswered whether another statute from another state would be unconstitutional if it was retroactive. Nonetheless, this decision should not be such a big deal for the franchise community for two reasons: it is not a tax on operators directly - they are only required to collect and pay over the tax - it is not assessed against their income; and it may not be of broad application in the franchise context except to mail order franchisees.

Clearly, the decision opens the door for states to enact laws that require remote sellers to collect and remit sales or use tax regardless of whether they have a physical presence in the taxing jurisdiction. This will undoubtedly lead to a free-for-all of new state and local sales taxation. It may also lead to additional reporting requirements imposed on franchisors to report their in-state franchisees (and their sales) to tax authorities such as already exists in New York.

Suggestions for Franchisors

- Franchisors that provide goods or services to franchisees should be sure they obtain re-sale certificates or they will be subject to sales tax on such transactions.

- Be wary of the potential for states to allege that the payment of royalties is subject to sales tax. This would be economically painful.

- Amend or clarify franchise agreements to be sure franchisees indemnify franchisors for any sales tax liability they may incur because of franchisee operations.

- Franchisor lobbying groups should do all they can to make sure no sales tax nexus provisions are passed that are retroactive.

As pointed out by CCH:

Any retailer or service provider will likely have to implement or change internal systems to respond to new state statutes. In many cases, these entities may already have systems set up for any jurisdiction where they already have a physical presence and were collecting tax under the Quill *standard, but it is feasible that some entities may only have a physical presence in a jurisdiction without a sales tax, and will now have to implement such a system to enable sales out of state.*

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[1] *National Bellas Hess v Dept of Revenue*, 386 US 753 (1967)
[2] 504 US 298 (1992)
[3] US Supreme Court No 17-494 (Decided June 21, 2018
[4] There was and is no legitimate argument that "physical presence" was a pre-requisite for income tax nexus.
[5] Citing *Complete Auto Transit, Inc. v. Brady*, 430 U. S. 274, 279.