What Will Happen With Tenn. Rule 129 In Light Of Wayfair

By **David Mittelstadt and David Hunter** (July 6, 2018)

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For over 50 years, interstate vendors have relied on a bright-line standard establishing that they did not have to collect destination-state sales taxes in respect of interstate sales unless they had a physical presence there. The physical presence standard was initially established back in 1967 by the United States Supreme Court's decision in National Bellas Hess Inc. v. Department of Revenue of Illinois.[1] That case was decided both on due process and commerce clause grounds. The physical presence standard endured through the court's decision in Quill Corp. v. North Dakota,[2] decided in 1992, and all the way to June 21, 2018. During that period, the constitutional basis for the establishment of the physical presence standard morphed somewhat, but as a standard it remained intact. (By the time Quill came around, the court decided that due process did not mandate physical presence, but still maintained that standard largely on dormant commerce clause grounds).

Ever since (and even before) National Bellas Hess, various states have enacted laws inconsistent with the physical presence standard as a precondition to requiring out-of-state sellers to collect sales or use taxes. Indeed, the Illinois statute challenged in National Bellas Hess stated that a business would be considered a “[r]etailer maintaining a place of business in this state” if it engaged “in soliciting orders within this state from users by means of catalogues or other advertising, whether such orders are received or accepted within or without this State." Such attempts were typically based on a concept of “economic nexus” and an argument that if a vendor has sufficient activity and sales in a state, that should be a good proxy for physical presence, especially in the modern economy.

These attempts to establish an economic nexus standard continued after Quill. In part, perhaps states were emboldened by Justice Anthony Stevens' acknowledgement in Quill of transformational changes in the economy, of an evolving history to commerce clause jurisprudence, and by his comment that "[c]ontemporary commerce clause jurisprudence might not dictate the same result were the issue to arise for the first time today."[3]

The U.S. economy continued to evolve with the internet revolution commencing after Quill. States continued to try for economic nexus, and private parties continued to litigate against them. Following Justice Anthony Kennedy's opinion in Direct Marketing Association v. Brohl[4] inviting "kill Quill" forces to bring a case challenging the Quill physical presence standard, Tennessee jumped into the fray. In 2016, Tennessee devised, by regulation, its own nonphysical presence economic nexus test. “Rule 129”[5] was aimed at out-of-state sellers having a substantial economic nexus with the state (i.e., a minimum of $500,000 in sales to Tennessee customers in a 12-month period). It required them to register with the Tennessee Department of Revenue by March 1, 2017, and start collecting Tennessee sales or use tax on sales made to Tennessee customers beginning July 1, 2017.

Rule 129 was challenged before it became effective, in American Catalog Mailers Association v. Tennessee Department of Revenue.[6] The plaintiffs sued for a declaration that rule 129 is unconstitutional because it violates Quill's physical presence standard. After the lawsuit was filed, an agreed order was entered by the court on April 10, 2017, preventing the department from enforcing rule 129 pending a final judgment in the case. The basis for the agreement to the order was the marketplace uncertainty created by rule 129, which presented "a substantial legal issue under the U.S. Constitution."[7] The Tennessee Legislature itself also was concerned about the likelihood of rule 129 being invalidated and it inserted provisions in 2017 omnibus legislation to legislatively suspend rule 129, pending further legislative review after the outcome of the case.[8]

Fast forward to June 21, 2018, and the same institution that seemed to so revere the doctrine of precedent in Quill — the United States Supreme Court — has swept away the physical presence standard in its entirety.[9] The South Dakota Legislature had enacted a law requiring out-of-state sellers to collect and remit sales tax "as if the seller had a physical presence in the State." The South Dakota act in question covered only sellers that, on an annual basis, delivered more than $100,000 of goods or services into the state or engaged in 200 or more separate transactions for the delivery of goods or services into the state. The taxpayers in the suit were established online retailers with large sales that met these requirements but did not collect and remit South Dakota's sales tax, relying on established U.S. Supreme Court precedent. The taxpayers won the case in the lower courts, including the South Dakota Supreme Court, which ruled that it was bound by the U.S. Supreme Court decision in Quill and its predecessors. The U.S. Supreme Court overturned the state court rulings and overruled Quill, finding the physical presence test to be invalid from its inception as well as ill-suited to transformations in the U.S. economy. Note the similarity of the South Dakota law to Tennessee's suspended rule 129. Both have at their core a minimum sales threshold to establish economic nexus.

In writing the opinion for the court in Wayfair, Justice Kennedy was clearly unimpressed with the notion that commerce clause doctrine should be influenced by compliance complexity and cost. Justice Potter Stewart's statement in National Bellas Hess is almost haunting, where he said that "[t]he many variations in rates of tax, in allowable exemptions, and in administrative and record-keeping requirements could entangle National's interstate business in a virtual welter of complicated obligations to local jurisdictions."[10] Small online retailers run by entrepreneurs wearing many hats and working long hours will surely find this comment to resonate even today. In contrast to Justice Stewart's above statement in National Bellas Hess, Justice Kennedy dismissed the issue by stating that "the administrative costs of compliance, especially in the modern economy with its internet technology, are largely unrelated to whether a company happens to have a physical presence in a state."[11]

The U.S. Supreme Court has recognized that there must be a substantial nexus between the state and the "person, property, or transaction it seeks to tax."[12] By overruling the bright-line physical presence standard for nexus established in Quill in relation to state sales and use taxes, significantly all taxpayers that have a web presence, or sell, deliver or provide services are now exposed to sales tax collection obligations in multiple jurisdictions. Although the South Dakota act would impose a collection obligation on out-of-state sellers having 200 transactions or $100,000 in in-state sales, other states have a much lower threshold. For example, without the certainty provided by Quill's physical presence standard for nexus, although a small retailer that sells high-end equipment at a cost of $11,000 might have to sell several pieces of equipment before being subject to sales tax liability in South Dakota, the same retailer must worry that the sale of even one piece of equipment per year to customers in Oklahoma,[13] Pennsylvania[14] or Washington[15] subjects the retailer to sales tax liability in these states.

So where does all of this leave Tennessee?

Rule 129 closely parallels the South Dakota law analyzed in Wayfair, but with a sales threshold more generous to vendors and without the 200-transaction test, so it appears likely that the court will rule in favor of the department. But will the Tennessee legislature, upon review of rule 129, simply reinstate it? With the physical presence standard gone and economic nexus given the green light, we have yet to plumb the depths of commerce clause nexus. In one light, rule 129, the South Dakota statute and similar provisions in other states can be seen as enactments in frustration with the physical presence standard, designed to test the same. Now the standard is gone, do those state legal measures set an appropriate balance or are states free to go even further? Why have a sales threshold at all? While in Wayfair Justice Kennedy acknowledged that there could be situations where vendors — especially small ones — could be unduly burdened, he merely acknowledged that this could be addressed by challenges based on "other theories" under the commerce clause.[16] It was unnecessary to resolve such issues in Wayfair because the statute in question had sufficient safeguards such as the 200 transaction and $100,000 sales threshold.

Another unknown is the possibility of retroactive application of sales taxes, an issue that did not arise in Wayfair because the state statute was written to prohibit it. To the extent that in the absence of rule 129, Tennessee sales tax laws subject vendors to sales tax collection if they have sufficient nexus within the state and nothing has been promulgated nor enacted to specifically prohibit retroactivity; should this be a concern? It is impossible to read the proverbial tea leaves here, but retroactivity opens up a host of negative arguments (some of which were discussed in concurrent briefs filed in Wayfair). Furthermore, one would think that the legislative intervention in Tennessee's rule 129 matter sufficiently muddies that waters that retroactivity would be unlikely. But right now this still has to play out.[17]

Tennessee is a state with no broad-based income tax,[18] heavily reliant on sales tax revenues and according to administration calculations, stands to gain $450 million in revenues annually by shifting to an economic nexus standard. While it almost certainly will do so, it is not clear that it will do so by simply restoring rule 129. The Tennessee legislature may choose to act differently. Furthermore, Congress will undoubtedly be the object of fierce lobbying on the subject and (especially if it listens to small business), may intervene to enact unifying standards under its commerce clause power. For the moment, it is "wait and see" in Tennesee.

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[1] 386 U.S. 753 (1967).

[2] 504 U.S. 298 (1992).

[3] Id. at 311.

[4] 135 S. Ct. 1124, 1134-35 (2015).

[5] Tenn. Comp. R. & Regs. 1320-05-01-.129(2)

[6] No. 17-307-IV (Davidson Co. Ch. Ct. Mar. 30, 2017).

[7] Agreed Order Granting Joint Mot. for Entry of Agreed Order Preventing Enforcement of Rule 129, supra note 5, at Paragraph 4.

[8] 2017 Tenn. Pub. Acts 452.

[9] South Dakota v. Wayfair, Inc., et al., No. 17-494 (U.S. Jun. 21, 2018).

[10] Supra note 1, at 759.

[11] Supra note 8, slip op. at 12.

[12] Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 279 (1977).

[13] 68 Okl. St. § 1392.

[14] 72 Pa. Stat. Ann. § 7213.1.

[15] Wash. Rev. Code § 82.08.053.

[16] Supra note 8, at 22.

[17] Informal conversations we have had with the Department indicate that the Department will not apply economic nexus retroactively.

[18] Tennessee's Hall income tax is imposed on annual interest and dividend income from investments exceeding $1,250 per person ($2,500 for married couples filing jointly) but is scheduled for repeal for tax years beginning January 1, 2021.