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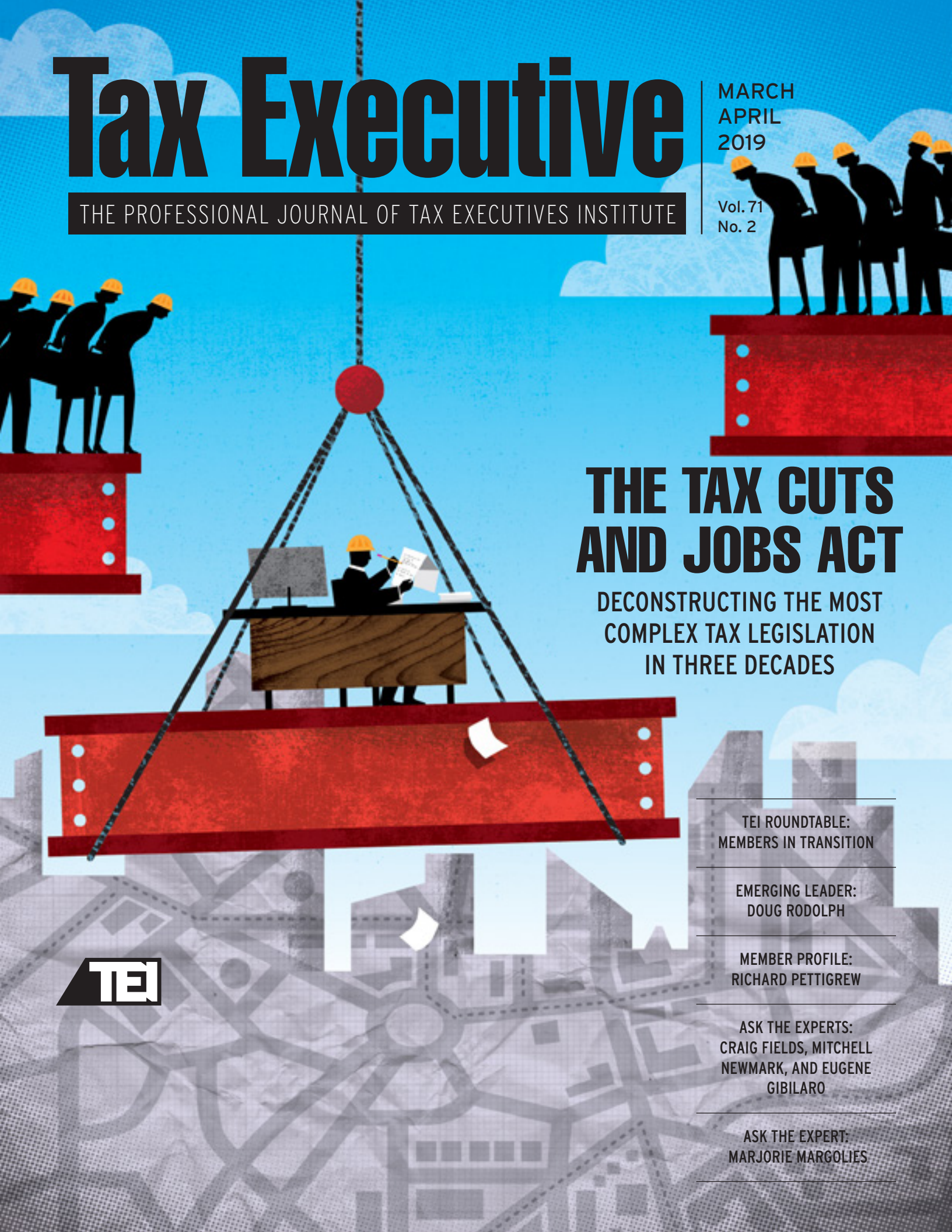

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Practical Application of Constitutional Limitations: A Road Map to Future Success

The Experts: Craig B. Fields, Mitchell A. Newmark, and Eugene J. Gibilaro

In the wake of the U.S. Supreme Court's decision in *South Dakota v. Wayfair, Inc.*, taxpayers have sought practical approaches to challenges under the significant remaining constitutional limitations on the authority of states to tax interstate commerce. In *Wayfair*, the U.S. Supreme Court put two large stakes in the ground. First, it held that the U.S. Constitution does not require a physical presence in a taxing state as a prerequisite to the state's imposition of a sales and use tax collection obligation on an out-of-state seller.[1] Second, the Court *reaffirmed* each of the constitutional limitations on the authority of states to tax interstate commerce under the Due Process Clause and the Commerce Clause.[2] This article examines these limits and provides practical considerations with respect to state and local tax controversy and litigation.

Question: What constitutional challenges remain for taxpayers to battle overreaching state taxing schemes post-*Wayfair*?

In addressing the constitutional limitations on state taxation, the *Wayfair* Court reaffirmed the "now-accepted framework for state taxation" that the Court previously explained in *Complete Auto Transit, Inc. v. Brady*.[3] Under the *Complete Auto* framework, a state tax will be sustained only if "the tax is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State."[4] These four independent constitutional requirements provide the goalposts for taxpayers seeking to challenge a state's taxing scheme on constitutional grounds.

The Substantial Nexus Limitation Post-*Wayfair*

The substantial nexus requirement is the only prong of the *Complete Auto* framework affected by the *Wayfair* decision, and that effect is muted. In *Wayfair*, the Court overruled its prior embrace of a bright-line physical presence rule and framed its decision as a natural progression away from "arbitrary, formalistic distinction(s)" and toward "a sensitive, case-by-case analysis of purposes and effects."[5] In stating the proper substantial nexus standard under the *Complete Auto* framework, the Court applied its due process standard that "nexus is established when the taxpayer [or collector] 'avails itself of the substantial privilege of carrying on business' in *that* jurisdiction."[6]

The *Wayfair* Court's application of that due process standard for the substantial nexus prong of the *Complete Auto* framework magnifies the importance of the Court's due process precedents in identifying the post-*Wayfair* limitations that the substantial nexus requirement imposes on states. The Court's due process precedents have focused on the issue of whether a person is subject to the jurisdiction of a state's courts. In this context, the Court has explained:

> [The seller's] transmission of goods permits the exercise of jurisdiction only where the [seller] can be said to have targeted the forum; as a general rule, it is not enough that the [seller]

> might have predicted that its goods will reach the forum State. . . . The question is whether a [seller] has followed a course of conduct directed at the society or economy existing within the jurisdiction of a given sovereign. . . .[7]

Therefore, the substantial nexus requirement will not be satisfied when an out-of-state person simply targets the U.S. economic market generally or when it is merely foreseeable that the person's goods will end up in the state seeking to impose the tax. Instead, the U.S. Constitution requires that the out-of-state person's activities be specifically targeted to the state seeking to impose the tax.

The Court has also explained that a state may assert jurisdiction over an out-of-state person based only on that person's "own affiliation with the State" and not based on "'random, fortuitous, or attenuated' contacts he makes by interacting with other persons affiliated with the State."[8] Under that standard, the substantial nexus requirement will not be satisfied when an out-of-state person's only connection with a state seeking to assert jurisdiction is its interactions with third parties who have connections with the state. Rather, only the activities of the out-of-state person itself may create a substantial nexus with the state seeking to impose the tax.

Moreover, existing thresholds under the substantial nexus prong of the *Complete Auto* framework continue to apply. The Court has expressly declined to adopt a "slightest presence" standard for substantial nexus.[9] The Court has also made clear that when a state seeks to tax an activity, the substantial nexus prong requires a sufficient connection between the state and both the out-of-state person conducting the activity and the activity itself.[10]

Finally, *Wayfair* does not contravene the additional constitutional limitations placed on states under the Foreign Commerce Clause. The Court has stated that the Foreign Commerce Clause will invalidate the imposition of a state tax when the tax 1) "creates a substantial risk of international multiple taxation" and 2) "prevents the Federal Government from 'speaking with one voice when regulating commercial relations with foreign governments.'"[11]

By overruling only the bright-line physical presence rule, *Wayfair* did not eliminate the substantial nexus requirement, but instead endorsed an approach that considers the specific facts and circumstances in each case. Under this approach, state overreach in connection with state attempts to assert jurisdiction to tax out-of-state persons remains a ripe area for constitutional challenges.

Other Constitutional Limitations Post-*Wayfair*

The *Wayfair* Court remanded the case to the lower courts inasmuch as "[t]he question remains whether some other principle in the Court's Commerce Clause doctrine might invalidate the [South Dakota law]."[12] Therefore, the Court made clear that the other constitutional limitations in the *Complete Auto* framework still apply and still can provide the basis for a successful constitutional challenge to a state's tax scheme.

Constitutional fair apportionment retains its power and might. With respect to the limitation of fair apportionment, a state tax must be "internally consistent" and "externally consistent."[13] The internal consistency test looks to the overall structure of the tax at issue and asks whether the tax would necessarily disadvantage interstate commerce in comparison with intrastate commerce if every state enacted an identical taxing scheme.[14] The external consistency test will strike down a tax when it is "out of all appropriate proportion to the business transacted" in the taxing state or when the apportionment formula yields "a grossly distorted result."[15]

Constitutional nondiscrimination is the mate to the one-two punch of fair apportionment/nondiscrimination. The Court has defined "discrimination" to mean "differential treatment of in-state and out-of-state economic interests that benefits the former and burdens the latter. If a restriction on commerce is discriminatory, it is virtually *per se* invalid."[16]

Moreover, even if a state tax is not discriminatory on its face and has "only incidental effects on interstate commerce," the tax will nonetheless be unconstitutional if "the burden imposed on such [interstate] commerce is clearly excessive in relation to the putative local benefits."[17] In *Wayfair*, the Court identified three factors that made it unlikely that the South Dakota law at issue imposed an undue burden on interstate commerce: 1) the law had a safe-harbor provision for those conducting limited business in the state (i.e., $100,000 or less of in-state sales and fewer than 200 separate in-state transactions); 2) the law was not retroactive; and 3) South Dakota had sought uniformity with other states by adopting the Streamlined Sales and Use Tax Agreement.[18] These three protective features may set the bar in the future for whether a facially evenhanded state tax scheme passes constitutional muster or constitutes an undue burden on interstate commerce. To the extent that other state tax schemes do not have these protective features, such tax schemes will be constitutionally suspect

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under *Wayfair*. Further, retroactively applied taxes raise additional bases for constitutional due process challenges, and more than fourteen months of retroactivity may fail under the U.S. Supreme Court's precedents.[19]

Finally, the fourth prong of the *Complete Auto* framework requires that any state tax imposed must be "fairly related to the services provided by the State." The Court has explained that "[the] test is . . . whether the taxing power exerted by the state bears fiscal relation to protection, opportunities and benefits given by the state. The simple but controlling question is whether the state has given anything for which it can ask return."[20]

Each of these other constitutional limitations is unaffected by the Court's *Wayfair* decision, and state tax schemes that do not adhere to these additional limitations are likewise ripe for constitutional challenges.

Practical Example

Consider a large multinational corporation that forms a subsidiary corporation, and that subsidiary corporation engages in a new startup venture that involves selling tangible property through a website. Concerning the new venture, the number of receipts and amount of sales volume in State A are relatively low (e.g., $101,000 to $150,000 of in-state sales and 201 to 250 separate in-state transactions). Moreover, State A has a jurisdictional statute similar to the statute at issue in *Wayfair* that asserts that an out-of-state seller has a substantial nexus with State A and is required to collect use tax from State A's residents if the seller "delivers more than $100,000 of goods or services into State A" or "engages in 200 or more separate transactions in State A."

The first consideration should be whether the subsidiary corporation has nexus with State A under existing substantial nexus theories predating *Wayfair*. For example, does the subsidiary have a physical presence in State A (i.e., property or employees in State A)?[21] Does the subsidiary engage independent contractors or agents who perform solicitation activities for the subsidiary in State A?[22] Do any of the subsidiary's affiliates maintain a physical presence in State A and assist the subsidiary in maintaining a market for its goods in State A?[23]

Next, does the subsidiary satisfy the substantial nexus standard as articulated in *Wayfair*? Although the subsidiary has narrowly exceeded the safe-harbor threshold amounts, has the subsidiary purposefully availed itself of the benefits of doing business in State A? Further, assume that the subsidiary is a non-U.S. entity that maintains a website outside the United States and ships tangible property from overseas to purchasers in the United States. Has that subsidiary actually targeted the United States with its activities at all and, if so, has the subsidiary specifically targeted customers in State A? Does the potential imposition of sales and use tax collection obligations by "[o]ver 10,000 jurisdictions [in the U.S.],"[24] each with its own unique sales and use tax rules, arguably prevent the federal government from "speaking with one voice" with respect to regulating commerce with foreign governments in violation of the Foreign Commerce Clause?

If the substantial nexus prong of the *Complete Auto* framework is satisfied and State A has jurisdiction under the U.S. Constitution to impose the tax or the tax collection obligation, are the other prongs of the *Complete Auto* framework satisfied? Although every prong of the *Complete Auto* framework is not implicated in this example, different taxes and different tax schemes will implicate different prongs and be susceptible to different types of constitutional challenges.

The Bottom Line

The U.S. Supreme Court's decision in *Complete Auto* rejected formalism in favor of a more practical case-by-case approach for determining the constitutionality of a state taxing scheme. Since *Complete Auto* was decided, state taxation has steadily progressed away from formalism and toward the principles articulated in *Complete Auto*. The Court's *Wayfair* decision is the most recent case in this steady progression. However, the Court has continuously made clear that its rejection of formalism is not a rejection of meaningful constitutional limitations on the authority of states to tax. Unfair state overreach and economic protectionism will continue to be struck down under the *Complete Auto* framework. It is up to taxpayers to raise all arguments and make their cases.

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Endnotes

1 138 S. Ct. 2080, 2099 (2018).
2 *Id.* at 2090-91.
3 *Id.* at 2091.
4 *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977).
5 138 S. Ct. at 2092-94 (citation omitted).
6 *Id.* at 2099 (alteration in original) (emphasis added) (quoting *Polar Tankers, Inc. v. City of Valdez*, 557 U.S. 1, 11 (2009)).

7 *J. McIntyre Mach., Ltd. v. Nicastro*, 564 U.S. 873, 882-84 (2011).
8 *Walden v. Fiore*, 571 U.S. 277, 286 (2014) (citation omitted).
9 *Nat'l Geographic Soc'y v. Cal. Bd. of Equalization*, 430 U.S. 551, 556 (1977).
10 *Allied-Signal, Inc. v. Dir., Div. of Taxation*, 504 U.S. 768, 778 (1992).
11 *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 451 (1979).
12 138 S. Ct. at 2099.
13 *Okla. Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175, 185 (1995), *superseded by statute on other grounds*, ICC Termination Act of 1995, Pub. L. No. 104-88, 109 Stat. 803.
14 *Id.*
15 *Hans Rees' Sons, Inc. v. North Carolina ex rel. Maxwell*, 283 U.S. 123, 135 (1931); *Norfolk & W. Ry. Co. v. Mo. State Tax Comm'n*, 390 U.S. 317, 329 (1968).
16 *Or. Waste Sys., Inc. v. Dep't of Envtl. Quality*, 511 U.S. 93, 99 (1994).
17 *Id.* (quoting *Pike v. Bruce Church, Inc.*, 397 U.S. 137, 142 (1970)).
18 138 S. Ct. at 2099-2100.
19 *United States v. Carlton*, 512 U.S. 26, 32-33 (1994).
20 *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 444 (1940).
21 *Standard Pressed Steel Co. v. Dep't of Revenue*, 419 U.S. 560 (1975).
22 *Scripto, Inc. v. Carson*, 362 U.S. 207 (1960).
23 *N.M. Taxation & Revenue Dep't v. Barnesandnoble.com LLC*, 303 P.3d 824 (N.M. 2013).
24 *Wayfair*, 138 S. Ct. at 2103 (Roberts, J., dissenting).