No. 17-494

IN THE

Supreme Court of the United States

SOUTH DAKOTA,

PETITIONER,

V.

WAYFAIR, INC., ET AL.,

RESPONDENTS.

On Writ of Certiorari to the Supreme Court of South Dakota

BRIEF FOR THE CATO INSTITUTE AS *AMICUS CURIAE* IN SUPPORT OF RESPONDENTS

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QUESTION PRESENTED

Can a state compel all businesses engaged in interstate commerce to monitor their sales in that state and collect that state's sales tax, or can such a mandate only be applied to businesses with a physical presence in the state, as this Court held in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992)?

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INTEREST OF THE *AMICUS CURIAE*[1]

The Cato Institute is a nonpartisan public-policy research foundation dedicated to advancing the principles of individual liberty, free markets, and limited government. Cato's Robert A. Levy Center for Constitutional Studies was established to restore the principles of constitutional government that are the foundation of liberty. Toward those ends, Cato publishes books and studies, conducts conferences, and produces the annual *Cato Supreme Court Review*. This case interests Cato because it concerns the regulation and taxation of interstate commerce in our federal system.

SUMMARY OF ARGUMENT

South Dakota's Senate Bill 106 directly targets this Court's decision in *Quill Corp. v. North Dakota*, which made some physical presence in a state a prerequisite to the attachment of tax liability. 504 U.S. 298 (1992). The statute provides, in pertinent part, that "any seller selling . . . into South Dakota, shall be subject to chapters 10-45 and 10-52, and the seller shall collect and remit the sales tax." S.B. 106, 2016 Leg., 91st Sess. (S.D. 2016). If the remote seller either receives gross revenue from delivery into the state exceeding $100,000, or makes 200 separate transactions into the state, "[t]he seller shall follow all applicable procedures and requirements of law as if the seller had a physical presence in the state." *Id.*

South Dakota's law is at odds with the Constitution. The Commerce Clause exists to prevent penalties on interstate transactions and foster a robust national

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[1] Rule 37 statement: All parties filed blanket consents. No counsel for any party authored any part of this brief; only *amicus* funded its preparation or submission.

market. The Framers would not recognize the concern South Dakota poses: that interstate commerce is thriving to such an extent that collection of a particular type of tax has become difficult.

South Dakota and its *amici* fail to give weight to the substantial constitutional underpinnings of *Quill*'s physical-presence requirement. *Quill* followed decades of tax-law developments that struck an important balance under the Due Process Clause and the Commerce Clause. Due process requires some definite link—some minimum contacts—between the state and any person, property, or transaction that a state seeks to tax or regulate. Wayfair does not own property in South Dakota, elects no representatives in South Dakota, and was afforded no protection by South Dakota's police. South Dakota's only justification for binding a foreign entity to its law is that some of Wayfair's many customers happen to live there. To allow South Dakota to compel Wayfair's collection of its state taxes raises serious concerns of taxation without representation. If states can directly compel people who live outside their boundaries to adhere to their standards—standards Wayfair had no chance to influence—the concept of statehood itself is undermined.

South Dakota's law also violates the Commerce Clause principle of territoriality. That the burden kicks in at either the 200th transaction or $100,000 mark does not cure the discrimination against interstate commerce and raises longstanding concerns of the evils of "economic isolation and protectionism" which has long colored Commerce Clause cases. *See, e.g.*, *City of Philadelphia v. New Jersey*, 437 U.S. 617, 623 (1978) (internal quotation marks omitted).

A federal constitutional structure inevitably poses such difficulties, particularly if goods flow freely interstate. South Dakota may have to use other means to generate revenue or invest in raising awareness of its use tax, but that's not a justification for abridging the Due Process and Commerce Clauses. Governments around the world are prone to complain about the difficulties of collecting taxes, but our Constitution was not written to bend to states' desire to raise revenue.

ARGUMENT

I. SOUTH DAKOTA'S EXTRATERRITORIAL REGULATION UNDERSCORES WHY THE COMMERCE CLAUSE REQUIRES PHYSICAL PRESENCE AS A PREREQUISITE TO THE COLLECTION OF STATE SALES TAX

James Madison believed that "the regulation of Commerce was in its nature indivisible and ought to be wholly under one authority." 2 The Records of the Federal Convention of 1787, at 625 (Max Farrand ed., rev. ed. 1937 (1911)). Under the Articles of Confederation, "[s]tate taxes and duties hindered and suppressed interstate commerce." *Quill Corp. v. North Dakota*, 504 U.S. 298, 312 (1992). Those failures are what motivated the inclusion of the Commerce Clause in our Constitution.

This Court's state-taxation precedents supply ample reason to stop South Dakota's scheme to shift its revenue burdens onto the national market. Predictably, many sister states have filed briefs supporting South Dakota, seeking to overcome a series of well-founded decisions that make some kinds of revenue generation a bit more difficult. But for the constraints of the Commerce Clause, it would certainly be easier for states to raise money from citizens of other states, but *Quill* and the decisions that undergird it, reflect

> 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.

Granholm v. Heald, 544 U.S. 460, 472 (2005) (quoting *Hughes v. Oklahoma*, 441 U.S. 322, 325–26 (1979)). *See also Wardair Canada, Inc. v. Fla. Dep't of Revenue*, 477 U.S. 1 (1986).

To curb the balkanization that rendered the Articles a failure—and which South Dakota seeks to revive—the Commerce Clause invalidates laws that have the effect of discriminating against interstate commerce and regulating extraterritorially. *See*, *e.g.*, *West Lynn Creamery v. Healy*, 512 U.S. 186 (1994).

A. South Dakota's Law Violates the Commerce Clause Principle of Territoriality

By forcing Wayfair to collect South Dakota's taxes "as if [they] had a physical presence in the state," Joint App. 19, South Dakota is clearly and openly "projecting" its legislation into other states, something the circuits have persistently found to violate the Commerce Clause's territoriality principle. *See e.g., Midwest Title Loans, Inc. v. Mills*, 593 F.3d 660, 668–69 (7th Cir. 2010) (invalidating state application of consumer credit code to out-of-state title lender making loans to people within state); *Experience Hendrix, LLC v. Hendrixlicensing.com, Ltd.*, 766 F. Supp. 2d 1122, 1142

(W.D. Wash. 2011) (right-of-publicity statute that regulated "a variety of transactions occurring 'wholly outside' Washington's borders" violated the territoriality principle); *In re Nat'l Century Fin. Enters., Inc., Inv. Litig.*, 755 F. Supp. 2d 857, 887 (S.D. Ohio 2010) (application of "blue sky" laws to transaction occurring outside the state violated the territoriality principle).

That a state's regulatory reach must be limited to its own borders is a bedrock principle of federalism woven deeply into our legal and societal fabric. As Justice Story wrote in his 1834 *Commentaries on the Conflict of Laws*, "no state or nation can, by its laws, directly affect or bind . . . persons not resident therein." Justice Waite observed in 1881 that "[n]o State can legislate except with reference to its own jurisdiction," *Bonaparte v. Tax Court*, 104 U.S. 592, 594 (1881). The fact that the internet has facilitated interstate commerce does nothing to change the "principle of universal application, recognized in all civilized states, that the statutes of one state have . . . no force or effect in another." *Marshall v. Sherman*, 148 N.Y. 9, 24 (1895).

In *Healy v. Beer Institute*, the Court correctly held that the Commerce Clause "precludes the application of a state statute to commerce that takes place wholly outside of the State's borders, whether or not the commerce has effects within the State." 491 U.S. 324, 336 (1989). Although the presumption against extraterritorial regulation has been muddled since *Healy*, South Dakota's law still fails to alleviate the concerns underlying the rule that have colored more recent Commerce Clause cases.

Allowing South Dakota to act as if foreign entities "had a physical presence in the state" does not alleviate the constitutional considerations that the territoriality principle protects. Holding otherwise would allow states to effectively extend their sovereignty by statute. *See Baldwin v. G.A.F. Seelig, Inc.*, 294 U.S. 511, 521 (1935) ("New York has no power to project its legislation into Vermont by regulating the price to be paid in that state for milk acquired there."); *Edgar v. MITE Corp.*, 457 U.S. 624, 642–43 (1982) (The Commerce Clause "precludes the application of a state statute to commerce that takes place wholly outside of the State's borders, whether or not the commerce has effects within the State."); *Healy*, 491 U.S. at 332 ("[A] state law that has the 'practical effect' of regulating commerce occurring wholly outside that State's borders is invalid under the Commerce Clause.").

B. South Dakota's Law Discriminates against Interstate Commercial Activity

Whether couched as "dormant" or "negative" for analytical convenience, the clear purpose of the Commerce Clause as it relates to state law is to ensure free trade across state lines. *See*, *e.g.*, *Wyoming v. Oklahoma*, 502 U.S. 437, 469 (1992) (Scalia, J., dissenting) ("Our negative Commerce Clause jurisprudence grew out of the notion that the Constitution implicitly established a national free market."). The Commerce Clause invalidates laws that have the "inevitable effect" of "threaten[ing] the free movement of commerce by placing a financial barrier around the State." *Am. Trucking Ass'ns v. Scheiner*, 483 U.S. 266, 284 (1987). When commerce is so burdened, it "jeopardizes the welfare of the Nation as a whole" by "plac[ing] burdens on the flow of commerce across its borders that commerce wholly within those borders would not bear." *Okla. Tax Comm'n v. Jefferson Lines*, 514 U.S. 175, 180

(1995). By forcing businesses to specifically monitor their customers in South Dakota—or even choose to refrain from selling in the state altogether—South Dakota discriminates against interstate commerce and transgresses the Commerce Clause.

The state attempts to misdirect the Court by framing the Commerce Clause question of discrimination exclusively in terms of cases that discriminate by favoring in-state economic actors. Pet. Brief at 6. In actuality, the question is whether the tax "discriminate[s] against interstate commerce" *and* "is fairly related to the services provided by the state." *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977). South Dakota runs afoul of each of those prongs of *Complete Auto*'s test.

South Dakota does not seek to benefit in-state actors at the expense of those out-of-state, as was the concern in *Granholm*. Instead, South Dakota's law directly burdens commerce because of its interstate character—and no state can burden the privilege of doing interstate business. *Cf. Western Live Stock v. Bureau of Rev.*, 303 U.S. 250, 255–56 (1938) (explaining that courts typically strike down local taxes that could be placed by every state the commerce touches). In a world where South Dakota's law is permissible, a business would be impelled to collect and remit the taxes of foreign jurisdictions based on the localities of its customers, not its own relationship with the taxing state.

It is this lack of regard for the foreign business's availment of South Dakota's law that poses not only due-process concerns, as discussed below, but have no "relat[ion] to the services of the taxing state." *Complete Auto*, 470 U.S. at 279. If South Dakota prevails, all businesses engaged in interstate commerce will be forced to monitor their customers' locations rather than their own actions. In *Scripto, Inc v. Carson*, 362 U.S. 207 (1960), the Court recognized "use taxes" as constitutional under the Commerce Clause. There, however, the regulated entity directed activities into the taxing state. *Id.* at 209 ("Each salesman . . . is actively engaged in Florida as a representative 'of Scripto for the purpose of attracting, soliciting and obtaining Florida customers' for its mechanical advertising specialties.") South Dakota's law works in very differently: instead of placing a taxing burden on entities that knowingly direct activity towards a state, every single business shipping goods in interstate commerce will have to keep tabs on its customers to remain compliant. It's the customers' behavior, not the businesses', that triggers compliance.

The only firms not subject to South Dakota's law would be those that either refuse to do business with South Dakota at all or cap sales volume. This has no "relationship with the services" South Dakota affords the business, *Complete Auto*, 470 U.S. at 279, but instead forces foreign firms to comply with state law due to the firm's popularity with South Dakotans. It forces the following decision: "This would be my 200th sale to South Dakota. . . . Should I deny it, or accept it and begin collecting and remitting their sales tax?" That Morton's Fork is a clear impediment to engaging in interstate commerce, and an example of the evils of "economic isolation and protectionism" that have animated Commerce Clause jurisprudence for years. *City of Philadelphia v. New Jersey*, 437 U.S. 617, 623 (1978) (internal quotation marks omitted).

II. THE PHYSICAL-PRESENCE REQUIREMENT IS AN ESSENTIAL DUE-PROCESS SAFEGUARD

The Fourteenth Amendment's Due Process Clause requires some definite link—some minimum contacts—between a state and the person, property, or transaction it seeks to tax or regulate. *Miller Bros. Co. v. Maryland*, 347 U.S. 340, 344–45 (1954). "In a Union of 50 States, to permit each State to tax activities outside its borders would have drastic consequences for the national economy, as businesses could be subjected to severe multiple taxation." *Allied-Signal, Inc. v. Dir., Div. of Taxation*, 504 U.S. 768, 778 (1992).

The fact that South Dakota's law is not directly taxing entities like Wayfair does not cure its constitutional shortcomings. The same concerns of multiple taxation, due process, and taxation-without-representation are not alleviated by gamesmanship enabling a state to get the same revenue benefits as direct taxation through the back door.

A. South Dakota Seeks to Impose Obligations on Entities to Whom It Offers No Services

South Dakota's law predicates collection and remittance of a state sales tax upon either the receipt of "gross revenue . . . exceed[ing] one hundred thousand dollars," or "two hundred . . . separate transactions[.]" Joint App. at 20. There is no regard for any due process quid-pro-quo—that, in exchange for availing itself of South Dakota's government services, a business could reasonably expect to be taxed by the state. The obligation hinges entirely on the choices of third-party customers, not on the "protection, opportunities, and benefits" South Dakota confers. *Allied-Signal*, 504 U.S. at

778. A customer's decision—the 200th customer, specifically—to entangle Wayfair in South Dakota's sales-tax regime is insufficient to satisfy due process. A holding to the contrary would be inconsistent with longstanding principles developed in the due-process-informed Commerce Clause cases discussed above.

The basic idea that legitimizes state regulation of an activity is the "protection, opportunities and benefits" the state confers on those activities. *Allied-Signal*, 504 U.S. at 778; *Wisconsin v. J. C. Penney Co.*, 311 U.S. 435, 444 (1940). Here, South Dakota engages in sleight-of-hand by complaining of uncollected revenue, Pet. Brief at 35, while distracting the Court from the fact that the state seeks to compel compliance from entities who have no representation in the state.

Although modern due-process jurisprudence rejects a rigid, formalistic definition of minimum contacts, the Court has not abandoned the requirement of a substantial connection between the regulating state and the activity it seeks to touch—rather than a connection only to the peculiar actor the state seeks to tax. *Allied-Signal, Inc.*, 504 U.S. at 778; *Quill Corp. v. North Dakota*, 504 U.S. at 306–08. South Dakota's law does only the latter; its concern is not with the transaction but with revenue from the transaction.

B. Due Process Requires That Businesses Not Be Subject to Onerous Requirements from Jurisdictions Where They Have No Representation and No Intent to Enter

South Dakota claims that the burden of simultaneous compliance with all of America's tax jurisdictions is "marginal." Pet. Brief at 44. This is misleading. A molehill can't be made out of a mountain by referring to a mass of paid tax-compliance services that everyone engaged in e-commerce could subscribe to should South Dakota get its way. *Id.* at 46. While advanced accounting software may be something most large interstate operations should already have, South Dakota's statute applies not only to e-commerce giants like Wayfair, but also to businesses and individuals who cannot affair a compliance department. Tax software may solve a business's regulatory-compliance issues, but it doesn't remedy a constitutional failing.

Individuals and small shops could be subject to lawsuits based on information they never even considered keeping. Imagine someone selling stickers online for a dollar each. If South Dakota can apply its law to anyone who ships into the state, that person must now keep a log of how many stickers are mailed to which states or be subject to legal action in South Dakota should the number reach 200 in a given year. The small business thus has an obligation not only to manage, but to recalculate and remit every year.

If this Court upholds this tax, states across the country will likely follow South Dakota's example. This patchwork of regulations will require businesses of all sort—from Walmart to a grandma in Poughkeepsie selling handmade doilies on the website Etsy—to monitor whether their sales have exceeded a given state's idiosyncratic thresholds. Those onerous requirements, coupled with "triggering" events that are entirely out of a seller's control—maybe the grandma's doilies become suddenly popular with a sorority in Boulder, thus passing the threshold in Colorado's hypothetical law—create substantial due-process concerns.

III. A DECISION IN SOUTH DAKOTA'S FAVOR WOULD OBVIATE USE TAXES, WHICH ARE A CONSTITUTIONAL SOLUTION TO SOUTH DAKOTA'S PROBLEM

As recognized in *Scripto, Inc. v. Carson*, a use tax is a tax on the privilege of using property that has come to rest in and become a part of the mass of property within the taxing state. 362 U.S. 207, 210. Use taxes are so-named because they focus not on the sale of goods but on the use, storage, or other consumption of tangible personal property within the taxing state. The use tax "was developed as a device to complement [sales tax] in order to prevent evasion . . . by the completion of purchases in a non-taxing state and shipment by interstate commerce into a taxing forum." *Id.*

Use taxes have existed for a long time, and they came about to solve the very problems of which South Dakota complains. If states could simply compel out-of-state businesses to collect and remit their taxes, the use tax would never have come to exist as a logical "complement" to sales taxes, as recognized in *Scripto*. *Id.* The key difference between sales and use taxes is that use taxes are generally self-assessed. Where a sales tax happens at the point of sale, a use tax becomes due when non-taxed or undertaxed property moves into the taxing state. *Are your online purchases subject to use tax?*, S.D. Dep't of Revenue, https://bit.ly/2GVru7k (last visited Apr. 3, 2018).

The levying, collection, and remittance of use taxes have their own distinct history, from which due process and Commerce Clause concerns have required the burden of collecting such taxes to be limited to the state's jurisdiction. *See Miller Bros. Co.*, 347 U.S. at 342 (holding that the burden of collecting tax cannot fall on a foreign corporation in the absence of a jurisdictional basis because "[i]t is a venerable if trite observation that seizure of property by the State under pretext of taxation when there is no jurisdiction or power to tax is simple confiscation and a denial of due process of law").

The constitutionality of use taxes were first tested in *Henneford v. Silas Mason Co.*, where the Court held Washington's use tax to be a permissible means of protecting both its sales tax base and its in-state businesses. 300 U.S. 577, 587–88 (1937). In *Henneford*, the Court concluded that use taxes did not violate the Commerce Clause so long as they were nondiscriminatory and "compensating"—designed to equalize the tax burden on locally sourced and imported goods. *Id.* at 579–80; *cf. Molloy v. Gov't of the V.I.*, 594 F. Supp. 2d 595, 597 (D.V.I. 2007) (invalidating the Virgin Islands' use tax, under which locally sourced goods were tax free, but imported goods subject to a 4 percent tax, regardless of whether they had already been taxed); *see also D.H. Holmes Co. v. McNamara*, 486 U.S. 24, 30 (1988) (use tax on catalogs printed out-of-state and subsequently shipped to prospective in-state customers did not violate the Commerce Clause).

South Dakota is no stranger to the use tax, as it implemented one shortly after its sales tax upon "discover[y] that consumers were leaving the state to make tax-free purchases." *Use Tax Form: Everyone's Responsibility*, S.D. Dep't of Revenue (Jun. 2016), https://bit.ly/2GsYMvr. According to the South Dakota Department of Revenue, "[t]he use tax makes it impossible to avoid taxes by purchasing from an out-of-state vendor." *Use Tax Fact Sheet*, S.D. Dep't of Revenue (Feb. 2018), https://bit.ly/2pW8wEc.

South Dakota claims that "[c]onditions in South Dakota vividly illustrate [the physical presence requirement's] harm." Pet. Brief at 35. It further asserts that the state "is dependent on its sales tax," and would necessarily need to increase this tax to make up for the shortfall in being unable to compel entities over which it has no jurisdiction to collect the tax for them. *Id*. at 35–36. This is wrong. The state is simply experiencing the pervasive problem of compliance with self-assessed taxes. *See* U.S. Gov't Accountability Off., GAO-12-651T, *Tax Gap: Sources of Noncompliance and Strategies to Reduce It* (2012) (estimating noncompliance at 56 percent for taxes without third-party reporting).

Instead of petitioning the Court to stretch the limits of due process and the Commerce Clause, South Dakota could instead attempt to increase compliance with their existing use tax regime, as many other states have done. As of 2015, 27 states have placed a line item on their state tax forms for the use tax along with instructions and seen increases in compliance as a result. *See*, Nina Manzi, "Use Tax Collection on Income Tax Returns in Other States," Minn. House of Representatives Research Dep't Policy Brief (2015), https://bit.ly/2p97kg3. South Dakota could also work with other states to share information on use tax collection, and of course, pursue their collection efforts through the court system. *See, e.g.*, *Borders Online v. State Bd. of Equalization*, 129 Cal. App. 4th 1179, 1201 (2005) (holding that California's assessment of their use tax against a nonconforming business "does not violate the Commerce Clause of the United States Constitution.")

Moreover, while it may come as a surprise to South Dakota, sales taxes are not the only way for a state to generate revenue. If they were, Delaware, Montana, New Hampshire, and Oregon—which have no statewide sales tax—would be inexplicable anomalies. Jared Walczack & Scott Drenkard, State and Local Sales Tax Rates 2018, The Tax Foundation (Feb. 12, 2018), http://bit.ly/2uBcmXO. The simple fact is that there are multiple mechanisms the state can use to collect revenue, the enforcement of which ranges from easy to hard. Point-of-sale transactions are easy to tax, yes, and user-reported use taxes can be more difficult. However, the fact that a state has chosen a difficult way to generate revenue should not result in the erosion of constitutional safeguards this Court has long recognized in the tax context just to ease its burden, especially where less constitutionally dubious alternatives exist, as they clearly do here.

The Constitution restricts what measures states might take in order to raise revenue, and the fact that South Dakota's conception of revenue generation is struggling in a robust and thriving national economy should counsel the state to restructure its ideas on revenue generation, not direct the Court to abandon decades of constitutionally grounded precedent to ease a self-imposed burden.

CONCLUSION

The decision below should be affirmed.

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