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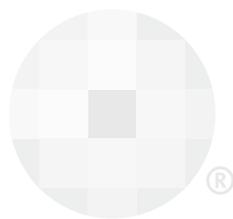
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Did South Dakota Make a Strategic Error in Drafting Its Wayfair Statute?

By Richard D. Pomp*

Richard D. Pomp questions whether South Dakota made a strategic error in drafting its Wayfair statute.



The Issue

Consider a wealthy couple from South Dakota on a shopping spree in New York City. They buy \$1 million of art in a well-known gallery, which packs and ships it back to South Dakota. Does the gallery have to collect the South Dakota sales tax on this transaction?

As is well known to the readers of this JOURNAL, South Dakota in preparation for its attack on *Quill* passed S. 106, “to provide for the collection of *sales* taxes from certain remote sellers ... and to declare an emergency.”¹ It requires out-of-state sellers to collect and remit *sales* tax “as if the seller had a physical presence in the State.”² “Notwithstanding any other provision of the law, any seller selling tangible personal property, products transferred electronically, or services for delivery into South Dakota, who does not have a physical presence in the state ... shall remit the *sales* tax”³ 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.⁴

By drafting its statute in terms of collecting the sales tax, South Dakota is at odds with *Bellas Hess*, which involved the collection of the Illinois *use* tax.⁵ Similarly, it is at odds with *Quill*, which also involved the collection of the *use* tax.⁶ Was this a strategic error?

The 1944 Companion Cases: *Dilworth* and *General Trading*

Under the statute, the gallery’s collection obligation extends only to the South Dakota *sales* tax. It has no obligation to collect the South Dakota *use* tax. Constitutionally, does a South Dakota sale exist in the fact pattern above?

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The start of an answer goes back to 1944 when the U.S. Supreme Court decided a pair of cases: *McLeod v. J.E. Dilworth*⁷ and *General Trading Co. v. State Tax Comm'n.*⁸ *Dilworth* involved the constitutionality of the *imposition* of the Arkansas *sales* tax. *General Trading* involved the constitutionality of the *collection* of the Iowa *use* tax. Arkansas lost *Dilworth*; Iowa won *General Trading*. Justice Frankfurter decided both opinions.

By drafting its statute in terms of collecting the sales tax, South Dakota is at odds with *Bellas Hess*, which involved the collection of the Illinois use tax.

The taxpayers in *Dilworth* were:

Tennessee corporations with home offices and places of business in Memphis where they sell machinery and mill supplies. They are not qualified to do business in Arkansas and have neither sales office, branch plant nor any other place of business in that State. Orders for goods come to Tennessee through solicitation in Arkansas by traveling salesmen domiciled in Tennessee, by mail or telephone. But no matter how an order is placed it requires acceptance by the Memphis office, and on approval the goods are shipped from Tennessee. Title passes upon delivery to the carrier in Memphis, and collection of the sales price is not made in Arkansas. In short, we are here concerned with sales made by Tennessee vendors that are consummated in Tennessee for the delivery of goods in Arkansas.⁹

We would have to destroy both business and legal notions to deny that under these circumstances the sale—the transfer of ownership—was made in Tennessee. For Arkansas to impose a tax on such transaction would be to project its powers beyond its boundaries and to tax an interstate transaction.¹⁰

The gallery would argue that like *Dilworth*, it was not qualified to do business in South Dakota and had no sales office, branch plant, or any other place of business there. It did no solicitation in South Dakota.¹¹ Title passed to

the art in New York, where the sale was consummated for the delivery of goods in South Dakota.

There is, however, another aspect to *Dilworth*. The whole transaction, starting with solicitation in Arkansas and ending with the consumer having possession of the goods in Arkansas, constituted interstate commerce, which, under the jurisprudence of that day, could not be taxed.¹² That part of the opinion was clearly overturned by subsequent cases.¹³ But still left open is the constitutional characterization of where a sale takes place.

The contours on what constitutes a sale might have been expected to have been refined in subsequent litigation. The companion case of *General Trading* made that unnecessary. *General Trading* involved nearly identical facts to *Dilworth*. The constitutional issue, however, was whether the market state (Iowa) could make the out-of-state vendor collect its *use* tax. Iowa was not attempting to make the remote vendor collect its *sales* tax and was not attempting to impose its sales tax on that vendor.¹⁴ Nor was Iowa imposing its use tax on the vendor.

Frankfurter, writing again for the majority, upheld the obligation to collect the use tax, and amazingly did not cite the companion case of *Dilworth*, which he also authored. *Dilworth*, by contrast, did allude to *General Trading*, albeit not by name:

It is suggested, however, that Arkansas could have levied a tax of the same amount on the use of these goods in Arkansas by the Arkansas buyers, and that such a use tax would not exceed the limits upon state power derived from the United States Constitution. Whatever might be the fate of such a tax were it before us,¹⁵ the not too short answer is that Arkansas has chosen not to impose such a use tax, as its Supreme Court so emphatically found. A sales tax and a use tax in many instances may bring about the same result. But they are different in conception, are assessments upon different transactions, and in the interlacings of the two legislative authorities within our federation may have to justify themselves on different constitutional grounds. A sales tax is a tax on the freedom of purchase—a freedom which wartime restrictions serve to emphasize. A use tax is a tax on the enjoyment of that which was purchased. In view of the differences in the basis of these two taxes and the differences in the relation of the taxing state to them, a tax on an interstate sale like the one before us and unlike the tax on the enjoyment of the goods sold, involves an assumption of power by a State which the Commerce Clause was meant to end. The very purpose of the

Commerce Clause was to create an area of free trade among the several States. That clause vested the power of taxing a transaction forming an unbroken process of interstate commerce in the Congress, not in the States.¹⁶

Although paying a sales tax and collecting a use tax may appear to be a formal distinction, Frankfurter obviously disagreed.¹⁷

It may help to understand *Dilworth* by thinking about sales as being arrayed on a continuum. At one end are the sales made by a South Dakota gallery to a customer who leaves with the purchased art. That this constitutes a South Dakota sale is beyond constitutional reproach. At the other end of the continuum is our South Dakota tourist buying art at a New York gallery that ships it to South Dakota. *Dilworth* places this situation at the other end of the continuum and treats it as a New York sale.¹⁸ Under *Dilworth*, no South Dakota sale exists so how can the New York gallery owner be asked to collect the South Dakota sales tax?¹⁹

Did South Dakota Made a Strategic Error?

General Trading presented the market states with a blueprint for avoiding the constitutional issue of when a remote vendor can be made to collect their sales taxes—and that was to require the collection of their use taxes. To be sure, *Dilworth* did not hold that the Tennessee vendor could not be made to collect the Arkansas sales tax provided there was an Arkansas sale; it involved only the imposition of a sales tax on a transaction that did not constitute a sale in the putative taxing state. It could be viewed as having no relevance to determining the constitutionality of a statute requiring a vendor to collect a sales tax rather than a use tax. But if *Dilworth* controls on what constitutes a sale under

the Constitution, it is hard to imagine how a remote vendor like the gallery is making a sale in the market state like South Dakota.

Similarly, it is at odds with Quill, which also involved the collection of the use tax. Was this a strategic error?

Why should South Dakota invite any challenge at all to whether a sale exists in the State when the Court has already blessed the collection of the use tax in *General Trading*? That case sent a clear unambiguous message, which the states clearly understood because their statutes like those in *Bellas Hess* and *Quill* refer to the collection of a use tax and not a sales tax. I have no idea why South Dakota drafted its statute in terms of collecting the sales tax rather than following the tried and true—and safe—pattern of collecting its use tax. Perhaps there are unique South Dakota reasons for doing so. But South Dakota cannot serve as a model that should be mimicked on this point.²⁰ Even if the distinction between a use tax and a sales tax can be described as a “triumph of formalism over substance,”²¹ under *Dilworth* the transaction at the New York gallery is not a South Dakota sale. Drafting a statute in terms of collecting the sales tax rather than the use tax is an invitation to litigation, leaving low-hanging fruit in limbo.

Perhaps South Dakota would win such litigation,²² but why bother when the legislative fix is so easy. Redrafting the statute to impose an obligation to collect the use tax would bring this situation safely under *General Trading*, *Bellas Hess*, and *Quill* and foreclose litigation (at least on this point).

ENDNOTES

* This article is dedicated to John Healy who is stepping down as Editor of the Journal. He is one of the icons of his generation, whose accomplishments are treasured by those of us in the field. He gave so much to all of us and asked so little in return.

¹ *South Dakota v. Wayfair, Inc.*, S Ct, 138 S Ct at 2088 (emphasis added).

² *Id.*, at 2089.

³ S.D. CODIFIED LAWS §10-64-2 (2018) (emphasis added).

⁴ *Wayfair*, 138 S Ct at 2089.

⁵ *Nat'l Bellas Hess, Inc. v. Dep't of Revenue*, S Ct, 386 US 753, 87 S Ct 1389 (1967). “The statute requires [Bellas Hess] to collect and pay to the appellee Department the tax imposed by Illinois upon consumers who purchase the company's goods for use within the State.” *Id.* (emphasis added).

⁶ *Quill v. North Dakota*, S Ct, 504 US 298, 112 S Ct 1904. *Quill*, “like National Bellas Hess, involves a State's attempt to require an out-of-state mail-order house that has neither outlets nor sales

representatives in the State to collect and pay a use tax on goods purchased for use within the State.” *Id.*, at 301 (emphasis added, internal citations omitted). The opinion in *Quill* did not always respect the distinction between sales taxes and use taxes. See, e.g., *id.*, at 314, 316–317, 329.

⁷ *McLeod v. J.E. Dilworth*, S Ct, 322 US 327 (1944).

⁸ *General Trading Co. v. State Tax Comm'n*, S Ct, 322 US 335 (1944).

⁹ *Dilworth*, 322 US at 328. Note that Frankfurter did not distinguish between an Arkansas sales tax

imposed on the transaction and the collection of an Arkansas sales tax. The reason is that the existence of an Arkansas sale is required in either situation.

¹⁰ *Id.*, at 329.

¹¹ *Dilworth* had its employees soliciting sales in Arkansas; the gallery did not. This distinction would be relevant under the Due Process Clause. See *infra* note 19.

¹² *McLeod v. J.E. Dilworth Co.*, SCT, 322 US 327, 328. Jackson, dissenting in *General Trading*, referred to the sale in *Dilworth* as “being clearly interstate commerce, is not taxable.” *Gen. Trading Co. v. State Tax Comm’n*, SCT, 322 US 335, 336 (Jackson J., dissenting).

¹³ *Complete Auto*, SCT, 430 US at 274 (“The issue in this case is whether Mississippi runs afoul of the Commerce Clause ... when it applies the tax it imposes on ‘the privilege of ... doing business within the State to appellant’s activity in interstate commerce’”). See also *Northwestern States Portland Cement Co. v. Minnesota*, SCT, 358 US 450, 79 SCT 357 (1959).

¹⁴ Compare *Gen. Trading Co.*, 322 US at 336, with *Dilworth*, 322 US at 327. “The question now presented is, in short, whether Iowa may collect, in the circumstances of this case, such a use tax from General Trading Company, a Minnesota corporation, on the basis of property bought from Trading Company and sent by it from Minnesota to purchasers in Iowa for use and enjoyment there.” *Gen. Trading Co.*, 322 US at 336.

¹⁵ *Dilworth*, 322 US at 330. This is a bizarre statement because that issue was before the Court in the companion case of *General Trading*, which Frankfurter also authored. See *Gen. Trading Co.*, 322 US at 336. Furthermore, Frankfurter’s phrasing of the issue was somewhat loose. The constitutionality of a use tax was not before the General Trading Court; that issue was resolved in 1937 in

Henneford v. Silas Mason Co., SCT, 300 US 577 (1937). The issue in *General Trading* was the collection of the Iowa use tax by an out-of-state vendor.

¹⁶ *Dilworth*, 322 US at 330.

¹⁷ The distinction between a use tax and a sales tax can be described as a “triumph of formalism over substance,” *Complete Auto Transit Inc. v. Brady*, SCT, 430 US 274, 287, 97 SCT 1076 (1977), and a relic of a bygone naive era when the Commerce Clause was interpreted as protecting an area of tax free trade among the states. *Id.*, at 278. But *Dilworth* would nonetheless not characterize the purchase of art at a New York gallery as a South Dakota sale. See Adam Thimmesch, Darien Shanske, & David Gamage, *Wayfair: Sales Tax Formalism and Income Tax Nexus*, 89 STATE TAX NOTES 975 (2018); Hayes R. Holderness & Matthew C. Boch, *Did South Dakota Neglect Transactional Nexus in Its Bill to Kill Quill?* BLOOMBERG BNA TAX MGMT. WKLY. STATE TAX REPORT (Dec. 6, 2017), available online at www.bna.com/south-dakota-neglect-n73014472885/.

¹⁸ New York does not treat this latter transaction as a New York sale even though it could under *Dilworth*. N.Y. COMP. CODES R. & REGS. tit. 20, §526.7 (2017). A state is obviously free not to exercise its constitutional powers to their fullest. New York may not treat this as a sale for economic development reasons, wishing to encourage tourists to make large purchases at galleries and department stores that must be shipped. It is also possible that pre-*Complete Auto*, *supra* note 17, New York thought it could not tax this situation because it constituted interstate commerce.

¹⁹ It is also possible that the gallery owner cannot be made to collect either the South Dakota sales tax or the use because of its lack of due process connections. *Wayfair* dealt only with the Commerce Clause, eliminating physical

presence as a nexus requirement. In order to concentrate on the sales tax/use tax issue in the text, I have deferred the due process arguments for another day. Admittedly, this is unrealistic, a bit like saying “other than that Mrs. Lincoln, did you enjoy the play?”

²⁰ The majority in *Wayfair* stated that “all concede that taxing the sales in question here is lawful.” *Wayfair*, 138 SCT at 2087 (emphasis added). I make nothing of this overgeneralization. Neither party, nor any of the amici addressed the issue discussed in the text. I cannot believe that the Court was even aware of *Dilworth*, let alone was implicitly overruling it. Accord, Thimmesch, Shanske, & Gamage, *supra* note 17 (“Justice Anthony M. Kennedy’s opinion explicitly noted that the South Dakota statute imposed a sales tax collection obligation, but the reference seems to have been more colloquial than technical.”). See Holderness & Boch, *supra* note 17 (“By limiting the scope of the new economic nexus rule to sales taxes, South Dakota has put up an additional hurdle in the way of the victory it deserves. The state may find that even if it wins on the physical presence issue, it will remain unable to tax the proceeds from sales of products delivered into the state by common carrier, and additional legislation will be necessary.”) Holderness and Boch dissect and eviscerate possible South Dakota statutory arguments defending its drafting. *Id.*

²¹ See *supra* note 17.

²² Winning on a *Dilworth* argument would, of course, only stall the inevitable litigation because of the ease with which a state could cure the defect by redrafting. Also, because the use tax would nonetheless be owed by the purchaser regardless of such litigation, even a winning litigant would not necessarily recover any sales taxes that it might have already paid.

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