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**Constitutional Limitations**

Sales and use tax is an area that should generate large amounts of revenue for a state, but because of the lack of clarity on what constitutes physical presence and therefore nexus, that isn't always the case. In this article, Mark P. Rotatori, Morgan R. Hirst, Yael D. Aufgang and John M. Robinson of Jones Day discuss recent developments at the federal level and the potential for federal sales and use tax legislation.

**The Past and Uncertain Future of 'Quill' and the Physical Presence Requirement**

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**Introduction**

**F**or nearly half a century, states have been increasingly uncertain of their ability to generate revenue from sales and use tax. The issue is not an inability to tax. Most states currently have laws on the books imposing sales tax liabilities directly on their citizens.<sup>1</sup> Rather, the issue is an inability to collect the tax. As a practical matter, time and experience have shown that

<sup>1</sup> Sales Tax Institute, *What States Impose Sales/Use Tax?*, [http://www.salestaxinstitute.com/Sales\\_Tax\\_FAQs/What\\_states\\_impose\\_sales\\_use\\_tax](http://www.salestaxinstitute.com/Sales_Tax_FAQs/What_states_impose_sales_use_tax) (last visited March 31, 2015).

collection of sales taxes is best achieved by requiring retailers to collect and remit sales tax on behalf of their customers.<sup>2</sup> However, under federal law, and most commonly in the area of remote sales, this form of collection may not be permitted. Today, Internet sales are the primary focus of this conversation.

The legal roadblock to states' collection of sales tax on remote sales is a combination of two U.S. Supreme Court cases, *National Bellas Hess, Inc. v. Department of Revenue of Ill.*<sup>3</sup> and *Quill Corp. v. North Dakota*<sup>4</sup>—which stand for the proposition that, under the U.S. Constitution, a state cannot simply compel an out-of-state retailer engaged in remote transactions to collect and remit sales and use taxes owed by in-state customers. Instead, under the dormant commerce clause,<sup>5</sup> one of two preconditions must exist for a state to be permitted to impose such obligations. Either the out-of-state retailer must have a “substantial nexus” with the taxing state, meaning some “physical presence” within the state, to legitimize the collection burden, or the state must be authorized by Congress to enforce its taxing obligation.<sup>6</sup> Without nexus or authorization, states must rely on individual citizens' payment and internal auditing for collection. And as discussed above, historically, citizens rarely comply with individual use tax remittance obligations.<sup>7</sup>

Thus, states have a strong interest in changes to this legal landscape, while consumers and Internet retailers have contrary interests. If one considers sales tax on Internet purchases revenue to which states are entitled, some estimates peg losses at billions of dollars annually.<sup>8</sup> With so much money at stake, federal authorities have also taken notice and some are posturing for change.

After briefly laying out the current state of the law in the area of sales and use tax collection, this article examines recent legal developments at the federal level. Businesses engaged in remote sales to citizens in states other than their own should keep themselves apprised of these developments given that a federal response is likely forthcoming.

## ‘Quill’ Affirms the Physical Presence Test of ‘Bellas Hess’

In 1992, the Supreme Court decided *Quill Corp. v. North Dakota*, which clarified the commerce clause's “substantial nexus” requirement. In that case, Quill

<sup>2</sup> Erika K. Lunder, *Taxation of Internet Sales and Access: Legal Issues*, Congressional Research Service, 1 (2014).

<sup>3</sup> 386 U.S. 753 (1967).

<sup>4</sup> 504 U.S. 298 (1992).

<sup>5</sup> The commerce clause gives Congress the power to regulate commerce “among the several States.” U.S. Const. art. 1, §8, cl. 3. Courts have interpreted that authority to mean that the states cannot pass legislation that will substantially burden interstate commerce. This implied doctrine is commonly referred to as the “dormant commerce clause.” See, e.g., *Comptroller of Treasury of Md. v. Wynne*, No. 13-485, 2015 BL 152755 (U.S. May 18, 2015).

<sup>6</sup> *Quill*, 504 U.S. at 311-14.

<sup>7</sup> See D. Bruce, et al., *State and Local Government Sales Tax Revenue Losses from Electronic Commerce*, 21 (2009), available at <http://cber.bus.utk.edu/ecomm/ecom0409.pdf> (last visited April 22, 2015).

<sup>8</sup> See, e.g., *id.* at ii.

Corporation sought to avoid enforcement of North Dakota's use tax law, which obligated “every person [engaged] in regular or systemic solicitation of” a North Dakota consumer market to collect and remit use taxes owed by in-state customers.<sup>9</sup> Although Quill Corporation had no office or warehouse in North Dakota, it appeared to be subject to the state's use tax law by virtue of its business solicitation efforts in North Dakota (including catalogues, flyers, magazine advertisements, and phone calls).<sup>10</sup> Quill Corporation objected to North Dakota's use tax law on the theory that, under the dormant commerce clause of the Constitution, a state cannot enforce its sales and use tax collection mandates on retailers with no physical presence in the state.<sup>11</sup>

The U.S. Supreme Court used *Quill* to reexamine its 1967 decision in *National Bellas Hess, Inc. v. Department of Revenue of Ill.*, in which the court held that, under the dormant commerce clause, a state may not impose a duty to collect and remit use taxes on a seller “whose only connection with customers in the State is by common carrier or the United States mail.”<sup>12</sup> Rather, the court held, to be subject to a state's tax collection and remittance obligations, the seller's nexus with the state must be “substantial,” meaning the seller must have some “physical presence” within its borders.<sup>13</sup> The court's decision was animated by its reluctance to authorize potentially burdensome regulation on the interstate marketplace. Given the “many variations” that exist “in tax rates, in allowable exemptions, and in administrative and recordkeeping requirements” among every state, “every municipality, every school district, and every other political subdivision[.]” the court declined to impose “a virtual welter of complicated obligations” on businesses throughout the country.<sup>14</sup> Under the commerce clause, imposition of that sort is within the discretion of “Congress alone.”<sup>15</sup> No one in *Quill*'s eight-justice majority reconsidered *Bellas Hess* in light of the rapid growth of mail-order sales by 1992. The court did note, however, that its decision was “made easier” knowing that Congress, at any time, could pass legislation doing away with its “physical presence” test.<sup>16</sup>

## States Attempt to Evade ‘Quill’

Following *Quill*, local consumer product markets continued to be increasingly driven by transactions with out-of-state sellers—likely, in part, due to the frequent lack of sales tax charged on those transactions.<sup>17</sup> At the same time, expansion of the Internet and rise of e-commerce meant citizens were doing a greater

<sup>9</sup> *Quill*, 504 U.S. at 302-03.

<sup>10</sup> *Id.* at 302.

<sup>11</sup> *Id.* at 303. Though Quill Corporation licensed software to some of its North Dakota clients, the court rejected the argument that title to “a few floppy diskettes” is enough of a physical presence to create a “substantial nexus.” *Id.* at 315 n.8.

<sup>12</sup> *Bellas Hess*, 386 U.S. at 758.

<sup>13</sup> *Quill*, 504 U.S. at 311.

<sup>14</sup> *Bellas Hess*, 386 U.S. at 759.

<sup>15</sup> *Id.* at 760.

<sup>16</sup> *Quill*, 504 U.S. at 318.

<sup>17</sup> See, e.g., A. Goolsbee, *In a World Without Borders: The Impact of Taxes on Internet Commerce*, *The Quarterly Journal of Economics* (2000) at 562 (showing that “people who live in high sales tax locations are significantly more likely to buy over the Internet”).

amount of their shopping online, often through retailers with only an online presence within their state. Second, as non-remittance of state taxes continued to climb, states began testing the limits of *Quill*. Three types of laws are currently in effect among the states, designed to either define tenuous in-state connections as a “physical presence” or induce voluntary collection and remittance through costly regulation.

In New York, for example, the state legislature passed a law in 2008 attributing physical presence to out-of-state retailers based on their contractual relationships with in-state affiliates.<sup>18</sup> Typically, an affiliate is an in-state entity that gets paid to refer potential customers to the retailer, often through a link on the affiliate’s website. The theory under this type of law is that the affiliate’s physical presence is attributed to the retailer, a concept that in this context is sometimes referred to as “click-through nexus.” Several states have followed suit.<sup>19</sup>

A similar type of law enacted in some states bases physical presence on associational relationships. In Ohio, for example, an out-of-state vendor is considered to have a physical presence in the state if it is part of an “affiliated group” of two or more entities in which one entity controls the business operations of another.<sup>20</sup> This type of relationship can exist within business associations where an out-of-state corporation directs the operations of an in-state subsidiary.

More recently, states have begun experimenting with information-reporting laws. In Colorado, for example, out-of-state retailers that do not voluntarily collect and remit Colorado state taxes are required to inform in-state customers of their use tax liability, provide each customer with a year-end notice detailing that liability, and submit an annual statement to the Colorado Department of Revenue listing the total amount each citizen paid for its products.<sup>21</sup> For each violation of the law, retailers are liable for between \$5 and \$10 in fines—an amount so great in aggregate that some believe the ultimate purpose of the law is to force out-of-state retailers to simply opt to comply with the state’s collection mandate.<sup>22</sup> Oklahoma, South Dakota, and Vermont have all passed laws of a similar stripe,<sup>23</sup> and Colorado’s law was recently the subject of Supreme Court litigation, discussed below.

## ‘Quill’ Comes Under Fire

On Mar. 3, 2015, the Supreme Court decided *Direct Marketing Association v. Brohl*, unanimously holding that a legal challenge to Colorado’s information reporting law is not barred by the Tax Injunction Act.<sup>24</sup> In a

<sup>18</sup> N.Y. Tax Law §1101(b)(8)(i)(C)(I) (McKinney 2013).

<sup>19</sup> See, e.g., 35 Ill. Comp. Stat. Ann. 105/2 (West Supp. 2011); N.C. Gen. Stat. §105-164.8(b)(3) (2009).

<sup>20</sup> Ohio Rev. Code Ann. §5741.01(I)(5) (LexisNexis 2008).

<sup>21</sup> Colo. Rev. Stat. Ann. §39-21-112(3.5).

<sup>22</sup> Adam B. Thimmesch, *The Fading Bright Line of Physical Presence: Did KFC Corporation v. Iowa Department of Revenue Give States the Secret Recipe for Repudiating Quill?*, 100 Ky. L.J. 339, 358 (2011-2012).

<sup>23</sup> *Id.* at 355.

<sup>24</sup> 135 S. Ct. 1124 (2015). In *Direct Marketing Ass’n v. Huber*, No. 10-CV-01546-REB-CBS, 2012 WL 1079175, at \*7 (D. Colo. Mar. 30, 2012), the District Court enjoined enforcement of the Colorado law discussed above, holding that the law dis-

criminated against out-of-state retailers and, therefore, violated the commerce clause. On appeal, the Tenth Circuit did not reach the merits but remanded the case for dismissal, holding that the district court had no jurisdiction to “enjoin Colorado’s tax collection effort.” *Direct Marketing Ass’n v. Brohl*, 735 F.3d 904, 906 (2013). The Supreme Court held that the district court did have jurisdiction, reversed the Tenth Circuit’s decision, and remanded the case. 135 S. Ct. at \*1134.

<sup>25</sup> *Brohl*, 135 S. Ct. at 1134.

<sup>26</sup> *Id.* at 1134-35.

<sup>27</sup> *Id.* at 1135.

<sup>28</sup> *Id.*

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separate concurrence, Justice Kennedy took the opportunity to attack the taxing conditions created by *Bellas Hess* and *Quill* in our modern economy.

Though *Brohl* did not ask the court to address *Quill* or even the issue of taxation, Justice Kennedy’s concurrence was intended to highlight the “tenuous nature” of *Quill*’s stare decisis underpinnings.<sup>25</sup> In Justice Kennedy’s view, “dramatic technological and social changes” within the national economy have rendered *Quill* a punitive precedent, to the point that it is “now inflicting extreme harm and unfairness on the States.”<sup>26</sup>

As a result, he opined, “[t]here is a powerful case to be made that a retailer doing extensive business within a State has a sufficiently ‘substantial nexus’ to justify imposing some minor tax-collection duty, even if that business is done through mail or the Internet.”<sup>27</sup> After expressing these views, Justice Kennedy capped off his concurrence with a direct appeal to the entire legal system, soliciting it to “find an appropriate case for this Court to reexamine *Quill* and *Bellas Hess*.”<sup>28</sup>

One week later, a bipartisan group of U.S. senators introduced a legislative response to *Quill* with the Marketplace Fairness Act of 2015 (MFA).<sup>29</sup> The MFA represents the latest iteration of a Congressional proposal originally introduced in 2011 and passed by the Senate in 2013 (the 2013 Act died in the House).<sup>30</sup> Simply put, the MFA would authorize states to compel remote sellers to collect and remit sales and use taxes, subject to one condition and one exception.

As a condition, the MFA requires states to simplify their sales tax laws in one of two ways. First, a state can voluntarily adopt the Streamlined Sales and Use Tax Agreement (SSUTA). Any state that achieves full member status under the SSUTA will have collection authority on the first day of the calendar quarter that is at least 180 days after enactment of the MFA. Alternatively, a state can adopt five simplification measures listed in the MFA. Those measures include notifying retailers of rate changes, designating a single state taxing authority, establishing a uniform sales tax base throughout the state, using destination sourcing to determine sales tax rates for out-of-state purchases, and providing free software for use in tax compliance.<sup>31</sup>

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<sup>25</sup> *Brohl*, 135 S. Ct. at 1134.

<sup>26</sup> *Id.* at 1134-35.

<sup>27</sup> *Id.* at 1135.

<sup>28</sup> *Id.*

<sup>29</sup> Marketplace Fairness Act Information, *TaxCloud*, <http://marketplacefairness.org/bill-text/> (last visited March 31, 2015).

<sup>30</sup> S. 1832 (112th); Marketplace Fairness Act, <https://www.govtrack.us/congress/bills/112/s1832> (last visited March 31, 2015); S. 743 – Marketplace Fairness Act of 2013, <https://www.congress.gov/bill/113th-congress/senate-bill/743> (last visited March 31, 2015).

<sup>31</sup> Marketplace Fairness Act Information, *TaxCloud*, <http://marketplacefairness.org/what-is-the-marketplace-fairness-act/> (last visited March 31, 2009).

The one exception to the MFA exempts online retailers with less than \$1 million in annual remote sales from collection obligations.<sup>32</sup>

There is vehement opposition to the MFA from many Internet retailers who warn that the burden created by forced compliance with a multitude of state tax laws, as well as customer information gathering requirements, will create a decidedly uneven playing field in favor of brick-and-mortar retailers.

## What Next?

Internet retailers should keep their eyes peeled for developments in the coming months and, certainly in the next few years. Justice Kennedy's call for a case allowing the court to revisit the *Quill* decision is sure to find a taker soon.<sup>33</sup> And the Marketplace Fairness Act of 2015, though unable to make it out of Congress in

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<sup>32</sup> *Id.*

<sup>33</sup> President and CEO of the National Retailer Federation, Matthew Shay, called Justice Kennedy's statements an invitation that "is far too good to ignore." M. Shay, *An Invitation Too Good to Turn Down*, April 15, 2015, available at [https://](https://nrf.com/news/invitation-too-good-turn-down)

previous iterations, has strong bipartisan support (though still elicits heated debate from opponents of the Act).

Developments in the *Brohl* case may help shed light on the future, particularly if the Marketplace Fairness Act is not enacted. It remains to be seen whether the Tenth Circuit will uphold the district court's decision finding the law unconstitutional.<sup>34</sup> And Justice Kennedy may yet have his chance at reversing or modifying *Quill* with the *Brohl* case.

In any event, states are currently seeking and finding creative ways to evade *Quill*'s physical presence requirement and to capture much-needed sales tax revenue from out-of-state retailers. Soon, it will be up to the Supreme Court and Congress to decide what part, if any, they will play in supporting those efforts.

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[nrf.com/news/invitation-too-good-turn-down](https://nrf.com/news/invitation-too-good-turn-down) (last visited April 22, 2015).

<sup>34</sup> The Tenth Circuit set a supplemental briefing schedule on April 13 ordering the parties to brief the commerce clause claims as well as other issues. Supplemental briefing should be complete by the end of June.