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A Way Forward for State Taxation of E-Commerce

By David Gamage¹ & Devin Heckman²

Electronic commerce (or, “e-commerce”) has exploded in magnitude and importance over the past two decades.³ While e-commerce revenues have skyrocketed, U.S. state governments have suffered severe budget shortfalls due to the financial crisis and ongoing recession.⁴ Yet following the 1992 Supreme Court decision of *Quill Corp. v. North Dakota*, major interstate e-commerce vendors have been effectively exempt from state-level sales and use taxes.⁵ The rapid growth of e-commerce has thus eroded the states’ sales and use tax bases, depriving the states of much needed revenue.⁶

The *Quill* decision held that states can only impose the burden of collecting sales and use taxes on vendors that have a “physical presence” within the taxing state.⁷ *Quill* was decided with respect to a mail-order catalog vendor, but the holding applies equally to interstate e-commerce.⁸ Recently, a number of states have passed legislation aggressively interpreting *Quill*’s physical

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³ E-commerce constituted seven percent of all retail sales in 2010, and this share is expected to grow rapidly over the coming years. See, e.g., National Retail Foundation, *Online Retail Sales*, tbl. 1, available at http://www.nrf.com/modules.php?name=Pages&sp_id=1240 (last visited August 13, 2011).

⁴ See, e.g., Center on Budget and Policy Priorities, *States Continue to Feel Recession’s Impact*, June 17, 2011, available at <http://www.cbpp.org/files/9-8-08sfp.pdf> (estimating the states’ total budget shortfall to be \$103 billion).

⁵ *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

⁶ Annual national state and local sales tax losses on e-commerce are predicted to total \$11.4 billion in 2012 and to continue growing rapidly thereafter. Donald Bruce, William Fox & LeAnn Luna, *State and Local Sales Tax Revenue Losses from E-Commerce*, 52 STATE TAX NOTES 537, 537 (2009).

⁷ *Quill*, 504 U.S. at 317-18.

⁸ Walter Hellerstein, *State Taxation of Electronic Commerce*, 52 TAX L. REV. 425, 437 (1997).

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presence requirement in an attempt to reach out-of-state e-commerce vendors.⁹ Commonly referred to as “Amazon laws,”¹⁰ these statutes have taken a number of forms, such as imputing physical presence when a remote vendor has sales affiliates within a state,¹¹ or attributing physical presence whenever a remote vendor licenses trademarks to an in-state firm.¹²

Although litigation remains ongoing, many commentators have concluded that the recent state Amazon laws are unconstitutional, ineffective, or both.¹³ Even if courts allow the states to stretch the definition of physical presence to include affiliations with in-state firms, major e-commerce vendors like Amazon can respond by simply terminating those relationships in order to retain their sales and use tax exemption.¹⁴ Being exempt from state sales and use taxes is sufficiently important to major e-commerce vendors like Amazon that these vendors can be expected to end any affiliations that would deem them to have a physical presence within key customer states.¹⁵

At the same time, the *Quill* decision has been widely criticized. The case was recently nominated for “the most maligned Supreme Court tax decision.”¹⁶ Numerous commentators have called for the Supreme Court to revisit the decision,¹⁷ or for Congress to pass legislation

⁹ For further discussion, see *infra* Part III.A.

¹⁰ Amazon.com is both the leading internet retailer and has been among the most aggressive in combatting the states’ attempts to tax interstate e-commerce. Dale Kasler, *Amazon Takes on California Over Sales Tax*, SACRAMENTO BEE, Jul. 17, 2011, available at <http://www.sacbee.com/2011/07/17/v-print/3774593/amazon-takes-on-california-over.html>.

¹¹ E.g., New York Chapter of Laws of 2008, ch. 57; N.Y. Tax Law § 1101(b)(8)(vi) (2011). See also N.Y. TSB-M-08(3)S (May 8, 2008); Michael R. Gordon, *Up the Amazon Without a Paddle: Examining Sales Taxes, Entity Isolation, and the “Affiliate Tax”*, 11 N.C. J.L. & TECH. 299, 309 (2010).

¹² E.g., Ala. Code Ann. 40-23-190(a)(2) (2011); 2009 ILL H.B. 3659, 95th Gen. Assem. (Ill. 2011). See also Edward Zelinsky, *Lobbying Congress, Amazon Laws in the Lands of Lincoln and Mt. Rushmore*, 60 STATE TAX NOTES 557, 559 (2011).

¹³ See, e.g., Edward A. Zelinsky, *New York’s “Amazon Law”: Constitutional But Unwise*, 54 STATE TAX NOTES 715 (Dec. 7, 2009) (ineffective); Edward A. Zelinsky, *The Siren’s Song of “Amazon” Laws: The Colorado Example*, 59 STATE TAX NOTES 695 (Mar. 7 2011) (unconstitutional); Stephen P. Kranz, Diann L. Smith, & Beth Freeman, *Colorado’s End Run: Clever, Coercive, and Unconstitutional*, 56 STATE TAX NOTES 55 (Apr. 5, 2010) (unconstitutional).

¹⁴ Major e-commerce vendors have already ended many of their relationships with affiliates in states that have passed Amazon laws, and they can be expected to terminate their remaining affiliations if they lose in litigation over the definition of physical presence. E.g., Dale Kasler, *California Affiliates Hurt by Tax Bill Targeting Amazon.com*, SACRAMENTO BEE, Jul. 7, 2011, at 1A, available at <http://www.sacbee.com/2011/07/07/3752677/california-affiliates-hurt-by.html> (“Hoping to exempt itself from the law, Amazon has fired its 10,000 California affiliates, cutting off their commissions. Scores of other e-commerce companies affected by the law, including Overstock.com and a slew of smaller firms, have done the same.”).

¹⁵ *Id.* As an alternative to terminating relationships, e-commerce vendors might demand that their affiliates move out of major customer states. For further discussion, see *infra* Part III.A.

¹⁶ Paul L. Caron, Pepperdine Hosts Symposium on The Most Maligned Supreme Court Decisions, TAX PROF LAW BLOG, Apr. 1, 2011, http://taxprof.typepad.com/taxprof_blog/2011/04/supreme-mistakes.html.

¹⁷ See, e.g., Arthur R. Rosen and Matthew P. Hedstrom, *Quill – Stare at the Decision*, 60 STATE TAX NOTES 931, 931 (2011) (“Indeed, many commentators have expressed and continue to express an interest in ‘overturning’ *Quill*.”); David Brunori, *It’s Time to Overturn Quill*, 55 STATE TAX NOTES 497 (Feb. 15, 2010).

enabling the states to tax out-of-state e-commerce vendors.¹⁸ A near scholarly consensus has developed against the *Quill* framework for governing when state sales and use taxes can reach interstate e-commerce.¹⁹

In this Article, we dispute the conventional wisdom on the merits of the *Quill* decision and on how the case has been understood. We argue that – properly interpreted – the *Quill* decision provides an ideal framework for determining when states should be allowed to subject remote e-commerce vendors to sales and use taxation. Crucially, we argue that the *Quill* decision should only prevent states from taxing remote e-commerce vendors to the extent that doing so would burden interstate commerce. The *Quill* decision is not entirely clear as to what constitutes a burden on interstate commerce. Yet we contend that both the text of *Quill* and the policy rationales underlying the decision best support an interpretation that the burden on interstate commerce of concern in *Quill* only results when a state imposes tax collection costs on out-of-state vendors.

In other words, we argue that interstate commerce is not burdened under *Quill* merely because a sales transaction between a state resident and an out-of-state vendor bears the economic incidence of a state tax.²⁰ Instead, interstate commerce is only burdened when an out-of-state vendor bears reporting or compliance costs as a result of a state imposing tax collection duties on the out-of-state vendor.²¹ Although this distinction has not previously been analyzed in

¹⁸ E.g., Edward Zelinsky, *New York Appellate Division Upholds ‘Amazon’ Law: Analysis*, 59 STATE TAX NOTES 93, 104 (2010). Because the *Quill* decision was decided on dormant commerce clause grounds, states are only barred from taxing out-of-state vendors in the absence of Congressional action authorizing such taxation.

¹⁹ See Walter Hellerstein, *Deconstructing the Debate Over State Taxation of Electronic Commerce*, 13 HARV. J.L. & TECH. 549, 549-50 (2000) (“there is a broad consensus among academic tax specialists regarding the general principles that should guide any effort to deal with sales and use taxation of electronic commerce . . . Remote sales, including electronic commerce, should, to the extent possible, be taxed by the state of destination of sales, regardless of whether the vendor has a physical presence in the state.”).

Indeed, even those who praise *Quill* do so primarily on the grounds that Congress, not the courts, is the proper actor for specifying how the states should be able to tax interstate. Hence, even most “praise” for the case does not necessarily support the continuation of the physical presence rule for governing when states should be able to subject remote vendors to their sales and use taxes. E.g., Arthur R. Rosen & Matthew P. Hedstrom, *Quill – Stare at the Decision*, 60 STATE TAX NOTES 931, 936 (2011).

²⁰ The term “economic incidence” refers to when . . . The term “economic incidence” refers to the ultimate effect of a tax or subsidy on the cost or price of a good. Who bears a tax or subsidy is a function of the relative price elasticities of supply and demand, and is not fixed by who has a legal obligation to pay the tax. See Don Fullerton & Gilbert E. Metcalf, *Tax Incidence*, 4 HANDBOOK OF PUB. ECON, 1787-1788 (Alan J. Auerbach & Martin Feldstein eds., 2002).

²¹ As we will discuss in more depth *infra* notes 112-14 and accompanying text, sales transactions between in-state residents and out-of-state vendors already bear the economic incidence of many state taxes, and this has not been viewed as constitutionally problematic. Most notably, many states already impose use taxes on purchases their residents make from out-of-state vendors that are not subject to sales taxation. Compliance with these use taxes is notoriously low, but the existence of use taxes highlights that the *Quill* decision only prevents states from subjecting remote vendors to tax collection costs. States can and do levy taxes for which the economic incidence falls on sales transactions between their residents and remote e-commerce vendors.

any depth, our interpretation of *Quill* is consistent with most of what has been written about the decision.²²

However, what previous commentators have failed to recognize is that this distinction may offer the states a constitutionally permissible approach for partially subjecting remote vendors to use taxes. Moreover, our proposed approach should require neither the Supreme Court to revisit *Quill* nor Congress to pass enabling legislation. Rather, we argue that a state desiring to subject remote vendors to its use tax should need only to adequately compensate the remote vendors for the compliance and reporting costs thereby imposed.

Because we conclude that the source of the burden on interstate commerce in *Quill* results from imposing reporting and compliance costs on out-of-state vendors, adequately compensating those vendors for these costs would completely alleviate the burden on interstate commerce. The states would benefit from our approach as adequately compensating for tax collection costs should result in each state losing only a small fraction of the potential revenue available from taxing interstate e-commerce.²³ Yet as the Court noted in *Quill*, without adequate compensation for tax collection costs, a remote vendor selling across the U.S. might face a substantial burden from the aggregate costs of complying with the “virtual welter of complicated obligations” imposed by the “[n]ation’s 6,000-plus taxing jurisdictions.”²⁴ Our proposed approach of adequately compensating remote vendors for all tax collection costs would thus allow the states to capture most of the potential revenue available from taxing interstate e-commerce while still not burdening interstate e-commerce with excess tax collection costs.

Previous scholarship has viewed the courts as facing a dilemma between either: (a) denying states the right to tax interstate e-commerce and thus effectively granting remote e-commerce vendors an unjustified tax advantage over their in-state competitors,²⁵ or (b) allowing states the right to tax interstate e-commerce and thus potentially disadvantaging multistate e-commerce vendors – as multistate e-commerce vendors might then be burdened by tax compliance costs from each of the “[n]ation’s 6,000-plus taxing jurisdictions”²⁶ whereas their

²² E.g., Bradley Joondeph, *Rethinking the Role of the Dormant Commerce Clause in State Tax Jurisdiction*, 24 VA. TAX REV. 109, 119 (2004) (“Although North Dakota clearly had jurisdiction over the value it sought to tax—the use of furniture in North Dakota—imposing a compliance obligation on Quill violated the dormant Commerce Clause.”); John A. Swain, *State Income Tax Jurisdiction: A Jurisprudential and Policy Perspective*, 45 WM. & MARY L. REV. 319, 334 & 341 (2003) (“ . . . [W]e now turn to *Quill*. Here, the Court is not concerned with the economic impact of the tax liability, but with the compliance burden of reporting tax to multiple jurisdictions with non-uniform rules.”); Walter Hellerstein, *State Taxation of Electronic Commerce*, 52 TAX L. REV. 425, 438 (1997) (summarizing *Quill* as focusing “on the burdens the tax collection obligation imposed on interstate commerce”).

²³ See *infra* Part II.B.

²⁴ *Quill*, 504 U.S. at 313 n.6 (“[S]imilar obligations might be imposed by the Nation’s 6,000-plus taxing jurisdictions. See *National Bellas Hess, Inc. v. Department of Revenue of Ill.*, 386 U.S. 753, 759-760 . . . (noting that the “many variations in rates of tax, in allowable exemptions, and in administrative and recordkeeping requirements could entangle [a mail-order house] in a virtual welter of complicated obligations”).”).

²⁵ See, e.g., David Brunori, *It’s Time to Overturn Quill*, 55 STATE TAX NOTES 497 (2010).

²⁶ *Nat’l Bellas Hess, Inc. v. Dep’t of Revenue of Ill.*, 386 U.S. 753, 759-760.

local competitors would only face compliance costs wherever they have a physical presence. Our proposed approach navigates between these two undesirable extremes. In contrast to the alternatives, by permitting states and local taxing jurisdictions to tax remote vendors if and only if the remote vendors are adequately compensated for all tax compliance costs, our approach would place remote vendors and their in-state competitors on a far more level playing field.

Moreover, our proposed approach would incentivize states and local taxing jurisdictions to simplify their sales and use tax regimes, as the states and local jurisdictions would be forced to internalize the remote vendors' costs of complying with those regimes.²⁷ Our approach thus avoids the concern that permitting states to tax interstate e-commerce might allow the states to create complicated sales and use tax regimes as protectionist bulwarks against out-of-state competitors.

The remainder of this Article develops our argument in greater depth. Part I evaluates the *Quill* decision and the constitutional restrictions on applying state sales and use taxes to e-commerce. Part I is largely intended to provide background; readers who are already well-versed in the constitutional issues surrounding state taxation of e-commerce may wish to skip Part I and begin reading with Part II.

Part II presents the heart of our argument – that our proposed approach of adequate vendor compensation would allow the states to raise most of the revenue available from taxing transactions between a state's residents and remote vendors without burdening interstate commerce. We argue that our proposed approach is compatible with the *Quill* framework and we explain how states might implement our proposed approach.

Part III analyzes the implications of our argument for the states, for the courts, and for Congress. We discuss the recent state Amazon laws and proposals for Congress to authorize the states to tax interstate e-commerce, and argue that our proposed approach of adequate vendor compensation offers a better way forward.

I. *Quill* and the Constitutional Limitations on State Taxation of E-Commerce

²⁷ See *infra* Part III.B.²⁸ John Mikesell, *State Sales Taxes in 2010: Collections Still in Recession*, 60 STATE TAX NOTES 709, 711 (2011); WALTER HELLERSTEIN, KIRK J. STARK, JOHN A. SWAIN & JOAN M. YOUNGMAN, STATE AND LOCAL TAXATION: CASES AND MATERIALS 607 (9th ed. 2009) (“[T]he general sales tax is in force in 45 states and the District of Columbia.”); RICHARD D. POMP & OLIVER OLDMAN, 1 STATE AND LOCAL TAXATION (5th ed. 2005) 6-2 (“The only states still without a sales tax are Delaware, New Hampshire, Montana, Oregon, and Alaska . . .”).

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Forty-five states and the District of Columbia levy sales taxes.²⁸ As corollaries to these sales taxes, the states also employ use taxes.²⁹ Use taxes apply when a state resident purchases non-exempt goods or services for use within the state for which sales taxes have not been paid.³⁰

In most states, individuals are responsible for paying use taxes on any e-commerce goods they purchase for which the e-commerce vendor did not previously remit sales or use taxes.³¹ Hence, if state residents generally paid the use taxes they owed on e-commerce purchases, there would be no problem with state taxation of e-commerce, as the states' inability to levy sales or use taxes on e-commerce vendors would be remedied by the state residents instead paying use taxes on these purchases. But states have found it nearly impossible to collect use taxes from individual residents.³² Indeed, most state residents appear to be unaware that they even owe use taxes on goods purchased from out-of-state e-commerce vendors.³³ Hence, when states are unable to impose use tax reporting or collection duties on vendors, use tax compliance is very low.³⁴

The Supreme Court decided two cases in 1944 that created divergent constitutional rules for sales taxes and use taxes.³⁵ In *McLeod v. J.E. Dilworth Co.*,³⁶ the Court ruled that an Arkansas sales tax could not be applied to goods sold by travelling salespersons residing in Tennessee who solicited orders in Arkansas in person, by mail, or by telephone. On the same day, the Court held in *General Trading Co. v. State Tax Commission* that an Iowa use tax could be levied on orders solicited through travelling salespersons residing in Minnesota.³⁷ The facts of these two cases were nearly identical, with the different outcomes turning on that Arkansas imposed a sales tax and Iowa a use tax.³⁸ Together, these two cases established a dichotomy

²⁹ Edward A. Zelinsky, *Lobbying Congress: Amazon Laws in the Lands of Lincoln and Mt. Rushmore*, 60 STATE TAX NOTES 557, 662 (2011) (“To backstop their sales taxes, the states and localities imposing them also levy use taxes if a resident makes a retail purchase but fails to pay sales tax on such purchase.”).

³⁰ *Id.* See also Washington State Department of Revenue, Use Tax (Aug. 10, 2011), <http://dor.wa.gov/content/findtaxesandrates/usetax/>.

³¹ *Id.*

³² Charles McLure, *Sales and Use Taxes on Electronic Commerce: Legal, Economic, Administrative, and Political Issues*, 34 URB. LAW. 487, 489 (2002) (“Use taxes are the legal liability of purchasers. With two exceptions—for automobiles and other products that must be registered to be used in the state and for purchases by business that can be audited—tax is likely to be paid only if vendors collect it.”).

³³ The Economist, *The Amazon War: More Complicated Than the Boston Tea Party, But Potentially as Colorful*, July 23, 2011, at 28 (“[I]n theory, consumers are supposed to keep receipts and pay so-called ‘use taxes’. But few people have ever heard of them.”).

³⁴ John A. Swain, *Cybertaxation and the Commerce Clause: Entity Isolation or Affiliate Nexus?*, 75 S. CAL. L. REV. 419, 428 n.53 (2002).

³⁵ The discussion in this paragraph follows John Swain, *id.* at 427-29.

³⁶ 322 U.S. 327 (1944).

³⁷ 322 U.S. 335 (1944).

³⁸ John A. Swain, *Cybertaxation and the Commerce Clause: Entity Isolation or Affiliate Nexus?*, 75 S. CAL. L. REV. 419, 428 (2002).

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between sales and use taxes that remains in effect to this day – purchases that occur within a state are subject to sales taxation while purchases from remote vendors are subject to use taxation.³⁹

The remainder of this Part analyzes the constitutional limitations on a state’s ability to impose use tax compliance duties on remote vendors. These limitations arise from the due process clause of the Fourteenth Amendment and from the dormant commerce clause. In brief, the due process clause requires only “some definite link, some minimum connection, between a state and the person, property or transaction” that the state seeks to tax or regulate.⁴⁰ In contrast, the dormant commerce clause broadly invalidates state legislation that has a “burdening effect upon [interstate] commerce.”⁴¹ State regulation and taxation of interstate commerce must satisfy both of these clauses in order to be constitutionally permissible, but typically it is the dormant commerce clause that invalidates such regulations and taxes.

A. The Due Process Clause

The due process clause of the Fourteenth Amendment provides the baseline restriction on a state’s ability to subject out-of-state vendors to sales and use taxation. More generally, the due process clause places a floor on the amount of connection that is required between a state and an out-of-state entity before the state may tax or regulate its conduct. This floor cannot be modified by a state or by Congress.⁴² This test has been formulated in a variety of ways, but the touchstone is generally accepted to be “whether a defendant’s contacts with the forum made it reasonable, in the context of our federal system of Government, to require it to defend [] suit in that State.”⁴³

As this test is rather opaque as worded, the Supreme Court has taken several opportunities to clarify the amount of contacts required by the due process clause. For instance, the Court has ruled that soliciting sales from a state’s residents through independent contractors is contact sufficient to satisfy due process.⁴⁴ More broadly, the Court’s modern due process jurisprudence allows states to reach out-of-state actors who “purposefully avail” themselves of the state’s economic market.⁴⁵

³⁹ *Id.*

⁴⁰ *Quill Corp. v. North Dakota*, 504 U.S. at 306 (quoting *Miller Bros. Co. v. Maryland*, 347 U.S. 340, 344–45 (1954)).

⁴¹ *Id.* (quoting *Int’l Harvester Co. v. Dep’t of Treasury*, 322 U.S. 340, 353 (1944) (Rutledge, J., concurring in part and dissenting in part)).

⁴² *Quill*, 504 U.S. at 305. As such, even if Congress passed legislation permitting states to require e-tailers to collect a use tax for sales to in-state residents, the states’ exercise of that authority must be consistent with the due process clause.

⁴³ *Quill*, 504 U.S. at 307.

⁴⁴ *Scripto, Inc. v. Carson*, 362 U.S. 207 (1960).

⁴⁵ *See Burger King Corp. v. Rudzewicz*, 471 U.S. 462, 474–75 (1985) (“[I]t is essential in each case that there be some act by which the defendant purposefully avails itself of the privilege of conducting activities within the forum

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Modern due process clause jurisprudence thus imposes a very low bar on a state's exercise of its jurisdiction over out-of-staters that do business within a state. In contrast, for some time, it was unclear whether a state could, consistent with the due process clause, exercise power over mail-order retailers that had *no* physical presence in that state. Previous due process case law had focused on the requirement that persons subjected to a state's power had a "presence" in that state; the shift to testing based on "minimum contacts" and "purposeful availment" thus created uncertainty that was ultimately resolved by the *Quill* decision.

In *Quill*, the Court decisively ruled that physical presence is not necessary under the due process clause and that the due process clause does not bar states from subjecting vendors who conduct a significant amount of sales within a state to the state's use tax. The *Quill* case involved North Dakota suing a remote mail-order vendor for unpaid use taxes on its sales to North Dakota residents.⁴⁶ The vendor in *Quill* owned no tangible property in the state and had no employees there, but it did sell almost \$1 million worth of merchandise to about 3,000 North Dakotans.⁴⁷ The Court upheld the tax, concluding, "[T]here is no question that Quill has purposefully directed its activities at North Dakota residents, that the magnitude of those contacts is more than sufficient for due process purposes, and that the use tax is related to the benefits that Quill receives from access to the state."⁴⁸

The *Quill* decision thus resolved any doubt about whether the due process clause prevents the exercise of a state's regulatory or taxing powers over out-of-state retailers who sell to a significant number of in-state residents. It is yet to be determined exactly what magnitude of sales to in-state residents is required to satisfy the due process clause. Nevertheless, it seems clear that the due process clause does not block states from subjecting major e-commerce vendors to use taxes, even when the vendors do not have a physical presence within the state.⁴⁹ To comply with the due process clause, a state or local taxing jurisdiction need only exempt from its use tax those remote vendors whose sales within the jurisdiction fall below some minimal threshold.⁵⁰

State, thus invoking the benefits and protections of its laws." (quoting *Hanson v. Denckla*, 357 U.S. 235, 253 (1958))).

⁴⁶ *Quill*, 504 U.S. at 303.

⁴⁷ *Id.* at 302.

⁴⁸ *Id.* at 308.

⁴⁹ *Quill*, 504 U.S. at 308 ("The requirements of due process are met irrespective of a corporation's lack of physical presence in the taxing State. Thus, to the extent that our decisions have indicated that the Due Process Clause requires physical presence in a State for the imposition of duty to collect a use tax, we overrule those holdings as superseded by developments in the law of due process.").

⁵⁰ State Amazon laws thus generally only apply to out-of-state vendors that conduct more than some threshold level of sales to in-state residents. *E.g.*, N.Y. Tax Law § 1101(b)(8)(iv) (2011) ("[A] person shall be presumed to be regularly or systematically soliciting business in this state if . . . the cumulative total of such person's gross receipts from sales of property delivered in this state exceeds three hundred thousand dollars and such person made more than one hundred sales of property delivered in this state."); Colo. Reg. 39-21-112.3.5(1)(a)(iii) (2010) ("A 'retailer that does not collect Colorado sales tax' does not include a retailer

B. The Dormant Commerce Clause

Just as *Quill* removed a potential limitation to state taxing power based on the due process clause, it fortified another restriction based on the dormant commerce clause. The Court has long held that the power granted to Congress to “regulate Commerce with foreign Nations, and among the several States”⁵¹ can prevent the states from interfering with interstate commerce even in the absence of congressional action.⁵² This “negative” or “dormant commerce clause,” first recognized by Justice Johnson in *Gibbons v. Ogden*,⁵³ imposes special restrictions on the states’ taxing powers.

The Court’s dormant commerce clause jurisprudence has evolved over time to become more permissive with respect to state taxation. In 1888, the Court held that “no State has the right to lay a tax on interstate commerce in any form.”⁵⁴ The Court later narrowed this holding to prohibit only “direct burdens on interstate commerce.”⁵⁵ Finally, in *Complete Auto Transit, Inc. v. Brady*,⁵⁶ the Court jettisoned the direct/indirect distinction and shifted the question to whether a state tax, in substance, “produces a forbidden effect”⁵⁷ by “discriminat[ing] against interstate commerce.”⁵⁸

The *Complete Auto* decision established a four-part test that continues to govern the applicability of the dormant commerce clause to state taxation.⁵⁹ The Court has relied on this four-part test in virtually every dormant commerce clause challenge to a state or local tax since *Complete Auto* was decided in 1977.⁶⁰ Under the *Complete Auto* test, a state tax survives a dormant commerce clause challenge if the tax: “[1] is applied to an activity with a substantial nexus with the taxing state, [2] is fairly apportioned, [3] does not discriminate against interstate commerce, and [4] is fairly related to the services provided by the State.”⁶¹

The first prong of the *Complete Auto* test requires that a tax be “applied to an activity with a substantial nexus with the taxing state.”⁶² This first prong is by far the most important component of the *Complete Auto* test. The *Quill* decision ruled that vendors without a physical

whose sales in Colorado are de minimis.” which is presumed when the retailer makes “less than \$100,000 in total gross sales in Colorado in the prior calendar year.”)

⁵¹ U.S. CONST. art. I, § 8.

⁵² *Quill*, 504 U.S. at 309.

⁵³ 9 Wheat. 1, 231–232, 239 (1824) (Johnson, J., concurring).

⁵⁴ *Leloup v. Port of Mobile*, 127 U.S. 640, 748 (1888).

⁵⁵ *Quill*, 504 U.S. at 309 (citing *Sanford v. Poe*, 69 F. 546 (6th Cir. 1895), *aff’d sub nom. Adams Express Co. v. Ohio State Auditor*, 165 U.S. 194, 220 (1897)).

⁵⁶ 430 U.S. 274 (1977).

⁵⁷ *Id.* at 288.

⁵⁸ *Id.* at 287.

⁵⁹ *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977).

⁶⁰ Bradley Joondeph, *Rethinking the Role of the Dormant Commerce Clause in State Tax Jurisdiction*, 24 VA. TAX REV. 109, 117 (2004).

⁶¹ *Quill*, 504 U.S. at 311.

⁶² *Id.*

presence in the taxing state do not have the substantial nexus required by this first prong.⁶³ In the Court's words, "a vendor whose only contacts with the taxing state are by mail or common carrier lacks the 'substantial nexus' required by the Commerce Clause."⁶⁴ It is this first prong that prevents states from imposing use tax compliance obligations on remote e-commerce vendors.

The majority in *Quill* justified the physical presence test for nexus based on *stare decisis* and on the concern that allowing states to impose use tax compliance obligations on remote vendors could burden interstate commerce by entangling remote vendors in a "virtual welter of complicated obligations" imposed by the "[n]ation's 6,000-plus taxing jurisdictions."⁶⁵ The *stare decisis* justification arose because the Court had previously articulated the physical presence requirement in the case of *National Bellas Hess v. Department of Illinois*.⁶⁶ *Bellas Hess* also justified the physical presence requirement based on the burden on interstate commerce that might arise if multiple jurisdictions were allowed to impose "a virtual welter of complicated obligations."⁶⁷ The *Bellas Hess* Court worried that if one state "can impose such burdens, so can every other State, and so, indeed, can every municipality, every school district, and every other political subdivision throughout the Nation with power to impose sales and use taxes."⁶⁸

The *Quill* Court's invocation of *stare decisis* was important because the North Dakota State Supreme Court had previously determined that *Bellas Hess*'s physical presence rule no longer applied due to the evolution of the Supreme Court's commerce clause jurisprudence.⁶⁹ *Quill*'s reaffirmation of the physical presence requirement for nexus thus resolved any ambiguity about whether the permissive trend in modern commerce clauses jurisprudence might have made the physical presence requirement obsolete. The *Quill* majority argued that the physical presence requirement appropriately functions as a bright-line rule capable of avoiding the "quagmire" that might otherwise result from the need to evaluate on a case-by-case basis whether the exercise of the states' taxing power would unduly burden interstate commerce.⁷⁰

In Part II of this Article, we argue that *Quill*'s physical presence requirement should not prevent states from imposing use tax compliance obligations on remote vendors when the states adequately compensate the remote vendors for all compliance costs imposed. However, before

⁶³ *Id.*

⁶⁴ *Id.*

⁶⁵ *Id.* at n.6; *id.* at 317 ("The interest in stability and orderly development of the law' that undergirds the doctrine of *stare decisis* therefore counsels adherence to settled precedent.") (internal citations omitted).

⁶⁶ 386 U.S. 753 (1967).

⁶⁷ *Id.* at 759.

⁶⁸ *Id.*

⁶⁹ *Quill*, 504 U.S. at 314.

⁷⁰ *Id.* at 315.

proceeding to that discussion, it is useful to first briefly describe the remaining three prongs of the *Complete Auto* test.

The second prong of the *Complete Auto* test requires that a tax be “fairly apportioned.”⁷¹ The idea behind fair apportionment is to insure that multi-state economic activity does not become doubly taxed by being subject to the full taxing regimes of multiple states.⁷² For instance, state corporate income taxes are considered to be fairly apportioned when a state taxes only a portion of a multi-state corporation’s national income based on what percentage of the corporation’s total sales, payroll, and/or property occurs within the state.⁷³ For state sales and use taxes, fair apportionment is achieved when either the state in which the vendor resides or the state in which the customer resides taxes the transaction; fair apportionment would be violated if both states taxed the transaction.⁷⁴ Hence, the Court has held that use taxes are fairly apportioned when they provide “a credit . . . for sales that have been paid in other States.”⁷⁵ More generally, a use tax should only fail the fair apportionment test if it is levied on transactions that were already subject to a sales or use tax in another state and if the use tax does not offer a credit for taxes paid in other states.⁷⁶

The third prong of the *Complete Auto* test requires that a tax “not discriminate against interstate commerce.”⁷⁷ A use tax should generally satisfy this prong as long as the rate of the use tax does not exceed the sales or use tax rate that would apply to an intra-state sale. Indeed, the Court held that a Louisiana use tax satisfied the non-discrimination test because the tax “was designed to compensate the state for revenue lost when residents purchase out-of-state goods for use within the state” and the rate of the tax was “equal to the sales tax applicable to the same

⁷¹ *Id.* at 311.

⁷² Bradley W. Joondeph, *The Meaning of Fair Apportionment and the Prohibition on Extraterritorial State Taxation*, 71 *FORDHAM L. REV.* 149, 158 (2002). *See also* Okla. Tax Comm’n v. Jefferson Lines, Inc., 514 U.S. 175 (1995) (“A properly apportioned tax must be both internally and externally consistent. Internal consistency looks to whether a tax’s identical application by every State would place interstate commerce at a disadvantage as compared with intrastate commerce. . . . External consistency, on the other hand, looks to the economic justification for the State’s claim upon the value taxed, to discover whether the tax reaches beyond the portion of value that is fairly attributable to economic activity within the taxing State.”).

⁷³ Elliot Dubin, *Changes in State Corporate Tax Apportionment Formulas and Tax Bases*, 55 *STATE TAX NOTES* 563, 563 (2010); Bradley Joondeph, *Rethinking the Role of the Dormant Commerce Clause in State Tax Jurisdiction*, 24 *VA. TAX REV.* 109, 117 (2004).

⁷⁴ John A. Swain, *CyberTaxation and the Commerce Clause: Entity Isolation or Affiliate Nexus?*, 75 *S. CAL. L. REV.* 419, 438 (2002); Charles McLure, *Sales and Use Taxes on Electronic Commerce: Legal, Economic, Administrative, and Political Issues*, 34 *URB. LAW.* 487, 493 (2002); *Jefferson Lines*, 514 U.S. at 176.

⁷⁵ *D.H. Holmes Co. Lt. v. McNamara*, 486 U.S. 24, 31 (1988).

⁷⁶ The most typical approach for insuring that use taxes are fairly apportioned is to levy the use tax only on transactions that were not subject to sales or use taxes in other states. The State of Washington’s use tax, for example, only applies when goods “are purchased in another state that does not have a sales tax or a state with a sales tax lower than Washington’s.” Washington State Department of Revenue, *Use Tax* (Aug. 10, 2011), <http://dor.wa.gov/content/findtaxesandrates/usetax/>.

⁷⁷ *Quill*, 504 U.S. at 311.

tangible personal property purchased in-state.”⁷⁸ A properly designed use tax should thus have no trouble fulfilling the non-discrimination requirement.

The fourth prong of the *Complete Auto* test requires that a tax be “fairly related to the services provided by the State.”⁷⁹ This fourth prong “is closely connected to the first prong of the *Complete Auto Transit* test.”⁸⁰ Beyond the substantial nexus requirement of the first prong, the fourth prong “imposes the additional limitation that the *measure* of the tax must be reasonably related to the extent of the” taxpayer’s contact with the state.⁸¹ The Court has repeatedly interpreted this fourth prong as being met when a tax is measured as a percentage of some proxy for the value of the taxpayer’s economic activity occurring within the state.⁸² However, as long as a tax is measured based on some proxy for the value of the services a taxpayer receives from a state, the Court has declined to inquire into the appropriate level or rate of the tax based on that proxy, ruling that determinations about the appropriate levels of taxation must be made by the political process.⁸³ With respect to use taxes, an interstate sale jointly benefits from the services provided by the state in which the vendor resides and the state in which the customer resides.⁸⁴ Consequently, a use tax should meet the fourth prong of the *Complete Auto* test as long as the tax applies only to transactions that were not subject to a sales or use tax in another state or if the tax allows a credit for sales or use taxes paid to another state.⁸⁵

In sum, only the physical presence requirement of the first prong of the *Complete Auto* test prevents states from imposing use tax compliance obligations on the major e-commerce vendors. A properly designed use tax can avoid any due process clause concerns as long as it exempts remote vendors who conduct less than some minimal amount of sales within the state. Likewise, a properly designed use tax can avoid any other commerce clause concerns – beyond

⁷⁸ *D.H. Holmes*, 486 U.S. at 31.

⁷⁹ *Quill*, 504 U.S. at 311.

⁸⁰ *Commonwealth Edison Co. v. Montana*, 453 U.S. 609, at 625-26 (1981).

⁸¹ *Id.* at 626.

⁸² *E.g. Jefferson Lines*, 514 U.S. at 177; *Commonwealth Edison*, 453 U.S. at 626; *Exxon Corp. v. Wis. Dept. of Revenue*, 447 U.S. 207, at 228 (“When a tax is assessed in proportion to a taxpayer’s activities or presence in a State, the taxpayer is shouldering its fair share of supporting the State’s provision of ‘police and fire protection, the benefit of a trained work force, and ‘the advantages of a civilized society.’”).

⁸³ *Commonwealth Edison*, 453 U.S. at 626.

⁸⁴ See John A. Swain, *State Income Tax Jurisdiction: A Jurisprudential and Policy Perspective*, 45 WM. & MARY L. REV. 319, 344-45 (2003) (“It is well-settled that state power to tax can arise both from residence and source. . . . The fundamental rationale for allowing states to tax income with an in-state source is that the state provides benefits and protections that allow the income to arise in the first instance.”).

⁸⁵ See *D.H. Holmes*, 486 U.S. at 31 (ruling that a use tax is fairly related to the benefits provided by the State because it is related to the advantages provided by the state such as the state’s provision of mass transit and public roads for the benefit of the vendor’s customers). Arguably, a use tax that fails the substantial nexus requirement of the first prong of the *Complete Auto* test might also fail the fourth prong. But there can be no doubt that an interstate sales benefit from services provided by the state in which the customer resides, as the various benefits provided by that state provide the framework within which the customer was able to earn funds with which to make the purchase and . . .

those arising from the nexus requirement – as long it (1) applies a tax rate to interstate transactions no higher than the sales or use tax rate that applies to intrastate transactions, and (2) either exempts transactions that were already subject to a sales or use tax in another state or else offers a credit for any sales or use taxes paid to another state.

The key to enabling state taxation of e-commerce thus resides in the nexus requirement – the first prong of the *Complete Auto* test. The *Quill* decision affirmed the physical presence rule in order to prevent mail-order vendors from being burdened by a multitude of complicated compliance obligations imposed by the nation’s thousands of taxing jurisdictions. In the next Part, we argue that states could alleviate this concern by adequately compensating remote vendors for all compliance costs imposed, thus enabling the states to constitutionally tax e-commerce transactions.

II. Our Proposed Solution of Adequate Vendor Compensation

Numerous commentators have argued that *Quill* is inappropriate for the Internet age and that the decision should be overturned.⁸⁶ Yet we see no indication that the Supreme Court intends or even has reason to revisit *Quill*.⁸⁷ Accordingly, the states have generally attempted to work within the *Quill* framework when designing their sales and use taxes.

In this Part, we explain our proposed approach of adequate vendor compensation and argue that our approach should allow the states to capture most of the potential revenue available from taxing interstate e-commerce in a manner consistent with the *Quill* framework. We also explain how the states might implement our proposed approach of adequate vendor compensation.

There are two justifications for *Quill*’s physical presence rule – preventing burdens on interstate commerce and *stare decisis*.⁸⁸ We argue that the burden on interstate commerce that troubled the Court in *Quill* arises solely from the potential for remote vendors to be subject to excess tax compliance costs. Hence, properly implemented, our proposed solution of adequate vendor compensation can completely alleviate any potential for burdening interstate commerce. We further argue that our proposed approach should survive any constitutional challenge based on *stare decisis*, because the lack of any potential for burdening interstate commerce makes our proposed approach different in kind from the tax statutes that the *Quill* decision ruled unconstitutional.

⁸⁶ See Arthur R. Rosen and Matthew Hedstrom, *Quill – Stare at the Decision*, 60 STATE TAX NOTES 931, 931 & n.6 (2011).

⁸⁷ See *id.* at 935 (“From the Court’s perspective its job is done; it has already spoken.”).

⁸⁸ See *supra* notes 65–69 and accompanying text.

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A. The Burden on Interstate Commerce in *Quill*

In moving beyond its old formalistic dormant commerce clause jurisprudence, the Court has repeatedly emphasized “the importance of looking past ‘the formal language of the tax statute [to] its practical effect.’”⁸⁹ As the Court explained in *Commonwealth Edison*, “the Court has rejected the notion that state taxes levied on interstate commerce are per se invalid In reviewing Commerce Clause challenges to state taxes, our goal has instead been to ‘establish a consistent and rational method of inquiry’ focusing on ‘the practical effect of a challenged tax.’”⁹⁰

In evaluating whether the dormant commerce clause bars any state action then, the threshold question must be whether the state action would actually burden interstate commerce. The commerce clause should not bar a state from taking action that would not burden interstate commerce. As the Court explained in *Quill*:⁹¹

[T]he Commerce Clause and its nexus requirement are informed not so much by concerns about fairness for the individual defendant as by structural concerns about the effects of state regulation on the national economy. Under the Articles of Confederation, state taxes and duties hindered and suppressed interstate commerce; the Framers intended the Commerce Clause as a cure for these structural ills It is in this light that we have interpreted the negative implication of the Commerce Clause. Accordingly, we have ruled that that Clause . . . bars state regulations that unduly burden interstate commerce.”

Crucially, the Court has “recognized that, with certain restrictions, interstate commerce may be required to pay its fair share of state taxes.”⁹² Or, in other words, the “Court has acknowledged that ‘a State has a significant interest in exacting from interstate commerce its fair share of the cost of state government’”⁹³ Perhaps most to the point, the Court proclaimed in *Commonwealth Edison* that:⁹⁴

To accept appellants' apparent suggestion that the Commerce Clause prohibits the States from requiring an activity connected to interstate commerce to contribute to the general cost of providing governmental services . . . would place such commerce in a privileged position. But as we recently reiterated, “ [i]t was not the purpose of the commerce clause to relieve those engaged in interstate commerce from their just share of state tax burden even though it increases the cost of doing business.”

As these cases indicate, the Court’s modern commerce clause jurisprudence is not designed to place interstate commerce in a tax-advantaged position with respect to intrastate commerce.⁹⁵ “Even interstate business must pay its way.”⁹⁶ A state tax that equally burdens

⁸⁹ *Quill*, 504 U.S. at 309.

⁹⁰ *Commonwealth Edison*, 453 U.S. at 615.

⁹¹ *Quill*, 504 U.S. at 312.

⁹² *D.H. Holmes Co. Lt. v. McNamara*, 486 U.S. 24, 32 (1988).

⁹³ *Commonwealth Edison*, 453 U.S. at 617.

⁹⁴ *Id.* at 624.

⁹⁵ *Id.*

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both interstate and intrastate transactions should not run afoul of the commerce clause, as such a tax would not burden interstate commerce as compared to intrastate commerce.

Why then did the *Quill* decision hold that a state cannot apply its use tax to remote vendors lacking a physical presence within the state, when the tax rate levied on interstate transactions would have been the same as that levied on intrastate transactions? The Court's reason cannot have been that the commerce clause shields remote vendors from paying the same taxes or bearing the same compliance obligations as do in-state vendors. Such a reason would be in direct contradiction to the Court's repeated proclamations that the purpose of the commerce clause is not "to relieve those engaged in interstate commerce from their just share of state tax burden even though it increases the cost of doing business."⁹⁷ Instead, the only justification for the *Quill* decision consistent with the Court's articulation of modern commerce clause jurisprudence must be that allowing the states to apply their use taxes to remote vendors lacking physical presence would result in those vendors bearing *greater* costs than do in-state vendors.

As we have already noted,⁹⁸ the *Quill* decision does indeed explain how allowing states to impose use tax compliance obligations on remote vendors could result in those vendors bearing greater costs as compared to vendors that operate solely within a single state.⁹⁹ Quoting *Bellas Hess*, the *Quill* decision's entire discussion of how allowing states to impose use tax obligations on remote vendors might burden interstate commerce revolved around the "virtual welter of complicated obligations" that a vendor operating in multiple taxing jurisdictions might face.¹⁰⁰ Because the *Quill* decision's articulation of the potential burden on interstate commerce is key to our argument, it is worth quoting the relevant discussion from *Quill* in full:¹⁰¹

North Dakota's use tax illustrates well how a state tax might unduly burden interstate commerce. On its face, North Dakota law imposes a collection duty on every vendor who advertises in the State three times in a single year. Thus, absent the *Bellas Hess* rule, a publisher who included a subscription card in three issues of its magazine, a vendor whose radio advertisements were heard in North Dakota on three occasions, and a corporation whose telephone sales force made three calls into the State, all would be subject to the collection duty. What is more significant, similar obligations might be imposed by the Nation's 6,000-plus taxing jurisdictions. See *National Bellas Hess, Inc. v. Department of Revenue of Ill.*, 386 U.S. 753, 759-760 . . . (noting that the "many variations in rates of tax, in allowable exemptions, and in administrative and recordkeeping requirements could entangle [a mail-order house] in a virtual welter of complicated obligations").

To repeat ourselves for emphasis, the above paragraph is the entirety of the *Quill* decision's analysis for how allowing states to apply their use taxes to remote vendors might burden interstate commerce. As the quoted paragraph makes clear, the Court was concerned with the imposition of a "collection duty" on remote vendors and in particular with the fear that a remote

⁹⁶ *W. Live Stock v. Bureau of Revenue*, 303 U.S. 250, 254 (1938).

⁹⁷ *Commonwealth Edison*, 453 U.S. at 624.

⁹⁸ *Supra* note 65 and accompanying text.

⁹⁹ *Quill*, 504 U.S. at 310 n.6.

¹⁰⁰ *Id.*

¹⁰¹ *Id.*

vendor might be entangled in a “virtual welter of complicated obligations” imposed by the “[n]ation’s 6,000-plus taxing jurisdictions.”¹⁰² Consistent with the Court’s modern commerce clause jurisprudence, the *Quill* decision was thus justified based on the fear that overlapping compliance burdens from multiple jurisdictions could result in multistate vendors bearing greater costs than single-state vendors. The *Quill* decision was not based on any notion that remote vendors ought to be placed in a tax-advantaged position as compared to single-state vendors.

Moreover, the *Quill* decision was correct in concluding that allowing states to impose use tax compliance obligations on remote vendors could burden interstate commerce as compared to intrastate commerce. Whereas a vendor operating exclusively within a single state must only bear the tax collection costs imposed by that state’s sales or use tax, in the absence of a physical presence rule, an e-commerce vendor operating in many states could bear tax collection costs from the use tax of each state to which the vendor ships goods. The combined costs of coping with multiple states’ use tax regimes could greatly exceed the costs of dealing with only a single state’s regime, thus forcing vendors wishing to sell to multiple states to face higher aggregate compliance costs than would vendors selling only within a single state.¹⁰³

As in *Quill*, the only discussion in the *Bellas Hess* decision about how allowing states to impose use tax compliance obligations on remote vendors might burden interstate commerce relies on the overlapping compliance duties that could be imposed by multiple jurisdictions.¹⁰⁴ Again, it is worth quoting that discussion in full:¹⁰⁵

And if the power of Illinois to impose use tax burdens upon National were upheld, the resulting impediments upon the free conduct of its interstate business would be neither imaginary nor remote. For if Illinois can impose such burdens, so can every other State, and so, indeed, can every municipality, every school district, and every other political subdivision throughout the Nation with power to impose sales and use taxes. The 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 with no legitimate claim to impose ‘a fair share of the cost of the local government.’ The very purpose of the Commerce Clause was to ensure a national economy free from such unjustifiable local entanglements.

Both *Quill* and *Bellas Hess* thus justify the physical presence requirement based on the fear that a mail-order vendor (or e-commerce vendor) selling across the United States could face high aggregate compliance costs due to the nation’s many taxing jurisdictions. This fear appears to have been magnified by the concern that there is no necessary connection between the compliance costs imposed by a state or local jurisdiction’s use tax regime and the magnitude of

¹⁰² *Id.*

¹⁰³ We provide an extended example in support of this point *infra* Part II.B.

¹⁰⁴ *Bellas Hess*, 386 U.S. at 759-60.

¹⁰⁵ *Id.*

sales a vendor conducts within that state or local jurisdiction.¹⁰⁶ A small state or jurisdiction could potentially impose compliance costs larger than the actual amount of sales made into the jurisdiction, if the level of sales were sufficiently small and the jurisdiction's use tax regime sufficiently complicated.

The physical presence rule of the nexus requirement might thus be viewed as a mechanism for creating a fair apportionment test for tax compliance costs analogous to the fair apportionment test for direct tax costs in the second prong of the *Complete Auto* test.¹⁰⁷ Rather than attempting to devise a rule for what minimum amount of sales – beyond that required by the due process clause – would justify a jurisdiction's imposing compliance burdens on remote vendors, the Court instead adopted the bright-line physical presence rule.¹⁰⁸ Again, the Court's motive appears to have been the desire to prevent jurisdictions from disproportionately burdening remote vendors with excess compliance costs. But for the concern about excess tax compliance costs, there would be no need to insure fair apportionment of tax compliance costs, and there would consequently be no need for *Quill*'s physical presence rule.

Even Amazon.com – “the No. 1 Internet retailer” and “lead dog when it comes to fighting the online tax issue”¹⁰⁹ – publically defends its opposition to the states' extending their use tax regimes to e-commerce based on the same concern about excess compliance costs as relied on by the *Quill* and *Bellas Hess* decisions. As the Sacramento Bee reports, “Amazon says it isn't opposed to an Internet sales tax. It just doesn't want to deal with the complexity of 7,500 different tax jurisdictions in the United States. Founder and Chief Executive Jeff Bezos has said he supports a unified approach that simplifies tax collection across the country.”¹¹⁰ Of course, skeptics argue that Amazon's public statements are hypocritical, and that Amazon really desires to maintain for as long as possible its tax advantage as compared to competing retailers that must maintain a physical presence within major customer states.¹¹¹ Nevertheless, Amazon's public position supports our argument that the only justifiable reason for barring states from applying their use taxes to remote vendors comes from the excess compliance costs that could be generated by numerous taxing jurisdictions imposing non-uniform compliance obligations; even Amazon.com does not argue that remote e-commerce vendors deserve a tax advantage as compared to their in-state competitors.

¹⁰⁶ *Quill*, 504 U.S. at 310 n.6; *Bellas Hess*, 386 U.S. at 760.

¹⁰⁷ For a discussion of the fair apportionment rule for direct tax costs, see *supra* notes 71-76 and accompanying text.

¹⁰⁸ *Quill*, 504 U.S. at 314-16.

¹⁰⁹ Dale Kasler, *Amazon Takes on California Over Sales Tax*, SACRAMENTO BEE, Jul. 17, 2011, available at <http://www.sacbee.com/2011/07/17/v-print/3774593/amazon-takes-on-california-over.html>.

¹¹⁰ *Id.*

¹¹¹ *Id.*; John Moe, *You May Soon Be Paying Sales Tax on Your Amazon Purchases*, MARKETPLACE, July 19, 2011, at <http://marketplace.publicradio.org/display/web/2011/07/19/tech-report-you-may-soon-be-paying-sales-tax-on-amazon/?refid=0>.

Finally, that states have long been able to levy use tax liabilities on their residents who purchase from remote vendors is perhaps the strongest argument in favor of interpreting *Quill*'s physical presence requirement as applying only when the states impose use tax compliance obligations on remote vendors that might burden interstate commerce. In most states, when individuals purchase e-commerce goods for which the vendor did not remit sales or use tax, the individual state residents legally owe use taxes to their state.¹¹² That state residents appear to be unaware of their use tax liabilities, and that compliance is very low, does not change the fact that the commerce clause has never been interpreted as preventing states from making their individual residents liable for use taxes on purchases from remote vendors.¹¹³ If the purpose of *Quill*'s physical presence requirement was to shield remote vendors from the economic incidence of state sales and use taxation, then the commerce clause should also block states from imposing use tax liabilities on their own residents for goods purchased from remote vendors.

The economic incidence of the tax burden generally remains the same even if the statutory incidence changes; that is, the economic incidence is not affected by whether a state resident is liable for a use tax on purchases from remote vendors or whether the remote vendors are liable for remitting the use tax.¹¹⁴ In either case, the same amount of tax is paid – raising the cost of the sales transaction between the state resident and the remote vendor by the same amount. The only major differences between these two approaches for taxing interstate transactions are: (1) states find it much easier to enforce compliance when vendors are required to remit use taxes as compared to when individual residents are required to remit the taxes, and (2) requiring vendors to remit use taxes imposes reporting and compliance costs on those vendors whereas requiring individual residents to remit use taxes imposes the reporting and compliance costs on the individual residents. As no one has argued that enforcement difficulties make a tax less constitutionally suspect, it is only the second of these factors that can justify the commerce clause's barring states from imposing use tax compliance obligations on remote vendors while allowing states to impose such obligations on the state's individual residents. Again, the only plausible way to reconcile *Quill*'s physical presence requirement with the Court's other commerce clause holdings is to view the physical presence requirement as only applying when states impose compliance costs on remote vendors that might burden interstate commerce.

B. The Solution of Adequate Vendor Compensation

If – as we have argued – the burden on interstate commerce in *Quill* results from multistate vendors potentially facing higher use tax compliance costs as compared to single-state

¹¹² *Supra* notes 31–34 and accompanying text.

¹¹³ *Id.* See also Nina Manzi, *Use Tax Collection on Income Tax Returns in Other States*, available at <http://www.house.leg.state.mn.us/hrd/pubs/usetax.pdf> (last visited Aug. 14, 2011).

¹¹⁴ JONATHAN GRUBER, *PUBLIC FINANCE & PUBLIC POLICY* 521 (2004). There are exceptions to this rule, i.e., circumstances that can lead to economic incidence varying with statutory incidence. But these exceptions are not important for our purposes here.

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vendors, then a remedy is available that would allow states to collect use tax revenues from remote vendors without burdening interstate commerce. We propose that *Quill* be interpreted such that states would only be barred from imposing use tax compliance burdens on remote vendors when the states fail to adequately compensate the remote vendors for all such compliance costs imposed.

Imagine two fictional states – Taxachusetts and New Pork – each of which wishes to levy a sales and use tax with a rate of ten percent. Each state’s tax regime would impose compliance costs on vendors charged with remitting the state’s tax. These compliance costs are unlikely to be directly proportional to the amount of tax revenues collected, as there are fixed costs associated with complying with a tax that arise due to the need to research the tax regime and design systems to remit the tax.¹¹⁵ Hence, imagine that a typical small vendor with total sales of \$500,000 would bear compliance costs for each state’s tax it is charged with remitting equal to fixed costs of \$2,500 plus additional variable costs equal to 0.02 percent of the amount sold into the state.¹¹⁶

A small vendor selling only to the residents of the state in which the vendor resides would thus bear compliance costs of \$3,500 (the \$2,500 of fixed costs plus variable costs of \$1,000 – or, variable costs equal to 0.02 percent of the \$500,000 of sales). These compliance costs would be in addition to the \$50,000 of tax revenues that the vendor would be charged with remitting (from the ten percent tax rate). In total, the state’s tax would thus impose a burden of \$53,500 on sales between the single-state vendor and the state’s residents.

Now imagine that a vendor selling exclusively to residents of Taxachusetts moves its operations to New Pork, such that the vendor no longer has a physical presence in Taxachusetts and conducts all of its sales through e-commerce. If *Quill*’s physical presence rule exempts the vendor from Taxachusetts’s sales and use tax, the vendor would now have a tax cost advantage over competitors that remain in Taxachusetts. Using the numbers above, the vendor would enjoy a tax cost advantage of \$53,500 – or 10.7 percent of sales – from the combination of avoiding both direct tax costs and tax compliance costs due to moving to New Pork.

¹¹⁵ See Robert J. Cline & Thomas S. Neubig, *Masters of Complexity and Bearers of Great Burden: The Sales Tax System and Compliance Costs for Multistate Retailers*, ENRST & YOUNG ECONOMIC CONSULTING AND QUANTITATIVE ANALYSIS, at ii, September 8, 1999, available at <http://plaza.ufl.edu/chriske2/masters.pdf> (“Small in-state retailers (\$250,000 of annual taxable sales in Washington) bear unacceptably high compliance costs – 7 percent of sales taxes collected – that put them at a competitive disadvantage to larger firms in the state. This high level of compliance costs suggests that, for smaller firms, the sales tax may be reaching the point where it cannot be collected at a reasonable cost. Medium (\$750,000 of sales) and large retailers (\$10 million in sales) have lower compliance cost burdens because fixed compliance costs are spread over larger sales tax collections and they generally use automated collection and reporting systems. The compliance cost for the medium-size retailer is still very high at almost 4 percent of sales taxes collected, or one-quarter of its profits.”).

¹¹⁶ The numbers in these examples are very roughly extrapolated from Cline and Neubig’s study of compliance costs, *id.*

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This example might seem to suggest that the goal of treating interstate commerce and intrastate commerce equally would require allowing Taxachusetts to subject remote vendors to its sales and use tax without compensating for compliance costs. But imagine another small vendor residing in New Pork that makes half of its sales (\$250,000) to individual residents of Taxachusetts and the other half (\$250,000) to individual residents of New Pork. If this vendor was subject the sales and use tax regimes of both Taxachusetts and New Pork, the vendor would face compliance costs from both tax regimes. In total, the vendor would face compliance costs of \$6,000 (the vendor would be subject to the fixed costs of \$2,500 twice, due to the need to comply with both Taxachusetts's and New Pork's tax regimes, plus the variable costs of 0.02 percent of the \$500,000 of aggregate sales). When combined with the direct tax costs of \$50,000 from the ten percent tax rate levied on sales into either state, the vendor's sales would be subject to an aggregate burden of \$56,000.

In the absence of *Quill's* physical presence rule, the multistate vendor could thus face higher aggregate costs than would a vendor operating solely within a single state. This tax disadvantage results from the fixed costs associated with complying with each separate tax regime.¹¹⁷ In our example above, the multistate vendor only faced a tax disadvantage of \$2,500 (from aggregate costs of \$56,000 as compared to the single-state vendor's aggregate costs of \$53,500). But our example above only involved two taxing jurisdictions. With fifty states and several thousand local taxing jurisdictions, a multistate vendor might well face a significant disadvantage from aggregate use tax compliance costs in the absence of *Quill's* physical presence rule or an equivalent protection.¹¹⁸

In the extreme, imagine if the \$2,500 of additional tax burden resulting from the fixed costs of complying with each jurisdiction's separate use tax was multiplied by several thousand separate taxing jurisdictions. Although it is unlikely that real-world tax compliance burdens would ever reach these levels,¹¹⁹ we should be wary of even the theoretical possibility of a multistate vendor with sales of only \$500,000 facing use tax compliance costs in the range of

¹¹⁷ See, e.g., Cara Griffeth, *Streamlining Versus "Amazon" Laws: The Remote Seller Dilemma*, 55 STATE TAX NOTES 351, 354 (2010) ("Determining how to handle tax-exempt sales, sales tax holidays, and product taxability coding can be a daunting task, particularly for small and midsize businesses. It has been estimated that sales tax exemptions account for 60 percent of the cost of compliance for small businesses.").

¹¹⁸ This disadvantage would burden small and medium vendors far more than it would large vendors, and the disadvantage could be alleviated to some extent by exempting small vendors from use taxation. But the burden does not completely disappear for large vendors, and even the burden facing large vendors could be significant if thousands of taxing jurisdictions are allowed to impose different use tax regimes and the differences in these regimes are sufficiently complicated.

¹¹⁹ If compliance burdens ever did start to reach extremely high levels, there would likely be significant political pressure to simplify and unify use tax regimes.

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multiple millions of dollars.¹²⁰ Even if burdens reached only a small fraction of that level, use tax compliance costs could still significantly burden interstate commerce.

We thus have a dilemma in developing a commerce clause rule for state taxation of transactions between the state's residents and remote vendors. Exempting remote vendors from state sales and use taxation grants those vendors a significant tax advantage, which is not the purpose of the commerce clause. But allowing states to impose the same compliance burdens on remote vendors as they do on in-state vendors could impose a substantial tax cost disadvantage on remote vendors which could burden interstate commerce.

Fortunately, a middle course is available. Because the burden on interstate commerce that justifies *Quill's* physical presence rule results from tax compliance costs – rather than from the direct costs of taxation – the burden can be alleviated by permitting states to impose use tax compliance obligations on remote vendors if and only if the states adequately compensate the remote vendors for all such compliance costs imposed. Returning to our example above where a vendor residing in New Pork sold to both Taxachusetts and New Pork residents, imagine that Taxachusetts levied its use tax on the vendor while compensating for the tax compliance costs thereby imposed. The vendor would still bear \$6,000 in gross compliance costs (the vendor would still be subject to the fixed costs of \$2,500 twice, due to the need to comply with both Taxachusetts's and New Pork's tax regimes, plus the variable costs of 0.02 percent of \$500,000). But Taxachusetts would then reimburse the vendor for \$3,000 of those compliance costs (the \$2,500 fixed costs of complying with Taxachusetts's use tax plus the variable costs of 0.02 percent of the \$250,000 of sales made to Taxachusetts's residents). The vendor would thus face net compliance costs of only \$3,000 after the reimbursement. When combined with the direct tax costs of \$50,000 from the ten percent tax rate levied on sales into either state, the vendor's sales would be subject to an aggregate burden of \$53,000.

Consequently, permitting states to impose use tax compliance obligations on remote vendors only when the states adequately compensate the remote vendors for those costs would completely alleviate the burden on interstate commerce. Indeed, our proposal of adequate vendor compensation would result in remote vendors' maintaining a small tax cost advantage as compared to in-state vendors. In our numerical examples, the multi-state vendor would face costs of \$53,000 as compared to the in-state vendor's costs of \$53,500. The reason for this tax cost advantage is that states would be required to compensate for the variable costs of use tax

¹²⁰ An aggregate use tax compliance burden in the millions of dollars could only result if the vendor sold into numerous taxing jurisdictions, and some of these jurisdictions might be prevented from levying use taxes on the vendor due to the minimum contacts requirement of the due process clause, even if the jurisdictions were not prevented from imposing burdens due to the commerce clause. Nevertheless, although the example of a vendor making \$500,000 in total sales being subject to millions of dollars in aggregate use tax compliance costs is unrealistically extreme, it still illustrates the general result whereby a multistate vendor could face a significant tax disadvantage from being subject to multiple use tax compliance regimes in the absence of a compensation requirement or some other protection for the vendor.

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compliance in addition to the fixed costs. It would not be administratively practical to require states to compensate only for fixed costs, as there is no simple and straightforward mechanism for perfectly distinguishing between direct and indirect costs.¹²¹ Nevertheless, our proposal would considerably level the playing field as compared to completely exempting remote vendors from use taxation.

Moreover, our proposal would allow states to garner most of the potential revenue available from taxing e-commerce transactions with out-of-state vendors. In our example above, Taxachusetts would raise \$25,000 of revenue from levying its ten percent sales and use tax rate on the \$250,000 of sales the remote vendor makes to Taxachusetts residents. As compensation for the compliance costs imposed by subjecting the remote vendor to its use tax, Taxachusetts would need to compensate the remote vendor only \$3,000, thus producing a net revenue gain of \$22,000 for Taxachusetts. This \$22,000 net revenue gain amounts to 88 percent of the revenue that could have been raised from imposing the use tax on the remote vendor without compensating for compliance costs.

More generally, use tax compliance costs are estimated to be around 1-3 percent of tax revenues, with the costs being much higher as a percent of sales for small vendors than for large vendors.¹²² Hence, requiring states to compensate for compliance costs should result in the states being able to raise nearly all of the revenue available from taxing e-commerce, while still avoiding burdening interstate commerce. If the requirement that states compensate remote vendors for compliance costs incentivizes the states to simplify and unify their use tax regimes, then the revenue loss from compensating remote vendors could end up being an even smaller percentage of the revenues states could raise without vendor compensation.

Some small states and taxing jurisdictions might find that compensating vendors for compliance costs could result in significant revenue loss, but only if the jurisdictions impose complicated use tax compliance obligations on vendors that sell only minimal amounts into the jurisdictions. If a jurisdiction exempts from its use tax vendors whose sales into the jurisdiction fall below some minimal threshold amount, the jurisdiction can insure that vendor compensation results in only small revenue loss. In any case, requiring adequate vendor compensation results in the states and jurisdictions bearing the costs when compliance burdens are imposed on small vendors. Requiring vendor compensation would protect small vendors from bearing these costs, and taxing jurisdictions would be incentivized to impose use tax compliance obligations only to the extent that the potential revenue gain sufficiently exceeds the resulting compliance costs.

¹²¹ However, as we discuss *infra* Part II.C, a state could set the default compensation rates much higher for small vendors than for large vendors.

¹²² PriceWaterhouseCoopers, *Retail Sales Tax Compliance Costs: A National Estimate, Volume One: Main Report*, at E-1, April 7, 2006, available at <http://www.bacssuta.org/Cost%20of%20Collection%20Study%20-%20SSTP.pdf>; Mary Welsh, *Retailers Cost of Collecting and Remitting Sales Tax*, Washington State Department of Revenue, December 1998, at 4, available at http://dor.wa.gov/content/aboutus/statisticsandreports/retailers_cost_study/default.aspx.

In sum, permitting the states to impose use tax compliance burdens on remote vendors if and only if the states adequately compensate for all compliance costs thereby imposed would effectively navigate between the harms that result either from completely blocking the states from taxing remote vendors or from allowing the states to tax remote vendors without restriction. As compared to a rule completely exempting remote vendors from sales and use taxation, our proposal would considerably level the playing field between remote vendors and their in-state competitors. No longer would remote vendors be advantaged over their in-state competitors by being shielded from both direct tax costs and compliance costs. Instead, the remote vendors would enjoy only the much smaller advantage of being compensated for compliance costs. Plus, the states would mostly be protected from the revenue loss that currently results from their inability to tax e-commerce transactions between their residents and remote vendors.

Conversely, as compared to overturning *Quill* and allowing the states unrestricted ability to tax e-commerce transactions with remote vendors, our proposal eliminates any potential for burdening interstate commerce. Because remote vendors would be more than compensated for any excess compliance costs that would result from their being subject to multiple jurisdictions' use taxes, remote vendors would never face a tax disadvantage as compared to in-state vendors. Moreover, the states would have incentives to simplify and unify their use tax regimes and would be prevented from using complicated use tax compliance obligations as a back-door form of protectionism. Consequently, our proposal of adequate vendor compensation would alleviate nearly all of the harms that result from the previous, strict interpretation of *Quill*'s physical presence rule and would do so without creating any potential for burdening interstate commerce.

C. Implementing our Proposal for Adequate Vendor Compensation

The implementation mechanics of our proposal are not without precedent. Twenty-eight states compensate vendors to some degree for the costs of complying with sales and use taxes in at least certain contexts.¹²³ For instance, in 2006, Utah passed a law that reimbursed certain vendors for some of their costs in complying with a reduced sales and use tax rate imposed on food and food ingredients.¹²⁴ The law reimbursed vendors who remitted between \$15,000 and \$500,000 in sales or use taxes for their “verifiable amounts . . . actually expended . . . to purchase computer hardware, software, and programming to account for sales under the reduced sales and use tax.”¹²⁵

¹²³ Tripp Baltz, *Wyoming Governor Signs Bill Providing Vendor Compensation for State Sales Tax*, BNA WEEKLY STATE TAX REPORT, Mar. 18, 2011 (on file with authors); Robert J. Cline & Thomas S. Neubig, *Masters of Complexity and Bearers of Great Burden: The Sales Tax System and Compliance Costs for Multistate Retailers*, ENRST & YOUNG ECONOMIC CONSULTING AND QUANTITATIVE ANALYSIS, at 22, September 8, 1999, available at <http://plaza.ufl.edu/chriske2/masters.pdf> (noting that 27 states offered vendor discounts in 1999, which makes 28 states including Wyoming which recently initiated a vendor compensation system as noted above).

¹²⁴ Utah H.B. 3004 (2006).

¹²⁵ See Utah H.B. 3004 § 3(4), (5).

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As an alternative to the Utah approach of compensating for “verifiable amounts” expended, some states allow vendors to keep a specified portion of the sales and use taxes they collect as compensation for the compliance costs of remitting the remainder to the state. For instance, Wyoming passed a law in 2011 “allowing retailers and other vendors to take up to a 1.95 percent discount from the sales taxes they collect and remit to the state.”¹²⁶ The Wyoming approach of using specified percentages thus achieves greater administrability at the expense of being less finely tuned in measuring actual compliance costs. Another similar example of a mechanism for reimbursing vendors’ compliance costs was the proposed administration and compliance equipment cost credit in the failed National Retail Sales Tax Act of 1996, which would have allowed vendors to withhold a percentage of taxes due to be remitted in compensation for certain compliance-related expenses.¹²⁷

We suggest that states use a combination of these two approaches in order to insure that they adequately compensate remote vendors for all compliance costs. As a default, and without need to show verification, vendors should be allowed to opt to keep a specified percentage of the use tax amounts they collect from transactions with a state’s residents. The percentage of use tax collections that a vendor should be allowed to keep could be set based on the size of the vendor or other easily demonstrable characteristics of the vendor. Regardless, the percentage amount should be set significantly higher than the state’s estimate for the average collection costs the state’s use tax compliance burdens impose on the category of vendors. In addition, vendors should be allowed to demonstrate if their actual verifiable compliance costs are in excess of the percentage allowed. Vendors whose actual verifiable compliance costs exceed the allowed percentage should be permitted to keep a portion of the use tax revenues collected equal to the vendor’s actual verifiable compliance costs plus the costs incurred in reporting and demonstrating those compliance costs. Finally, if the compliance costs for any vendor exceed the amount of use tax revenues the vendor collects from transactions with individual residents in a state or local taxing jurisdiction, the state or jurisdiction should establish a process for the vendor to apply for reimbursement for those costs.¹²⁸

According to a 1998 study by the Research Division of the Washington State Department of Revenue, vendors’ total costs of collecting and remitting state and local sales taxes amounted to 6.47 percent of revenues for small vendors, 3.35 percent of revenues for medium vendors, and 0.97 percent of revenues for large vendors – for a total weighted average of 1.42 percent of total revenues across all vendors.¹²⁹ According to another study by PriceWaterhouseCoopers in 2006,

¹²⁶ Tripp Baltz, *Wyoming Governor Signs Bill Providing Vendor Compensation for State Sales Tax*, BNA WEEKLY STATE TAX REPORT, Mar. 18, 2011 (on file with authors).

¹²⁷ H.R. No. 3039 § 11(e), (f), 104th Congress, 2d Sess. (1996).

¹²⁸ This condition is necessary to insure that small taxing jurisdictions do not impose excess compliance costs on remote vendors.

¹²⁹ Mary Welsh, *Retailers Cost of Collecting and Remitting Sales Tax*, Washington State Department of Revenue, December 1998, at 4, available at http://dor.wa.gov/content/aboutus/statisticsandreports/retailers_cost_study/default.aspx.

the national average for annual sales tax compliance costs amounted to 3.09 percent of total revenues – with small retailers costs amounting to 13.47 percent of revenues, medium-sized retailers costs amounting to 5.2 percent of revenues, and large retailers costs amounting to 2.17 percent of revenues.¹³⁰

Hence, a jurisdiction might set the default compensation rates at 15 percent of revenues for small vendors, 7 percent of revenues for medium-sized vendors, and 3 percent of revenues for large vendors. These generous compensation rates should exceed actual compliance costs for almost all vendors. Indeed, a jurisdiction wishing to be more aggressive might opt to set the compensation rates well below these levels. In any case, vendors would need to be allowed to demonstrate if their actual compliance burdens exceeded the default percentages. Again, the vendors should be allowed to keep as compensation a percentage of the use tax revenues collected equal to the greater of the amount calculated using the relevant default compensation percentage or the amount the vendor verifiably demonstrates as the vendor’s actual compliance costs.

D. Overcoming *Stare Decisis* and *Quill*’s Bright-Line Rule

There are two major justifications for the *Quill* decision’s physical presence rule.¹³¹ So far, we have focused our discussion on analyzing the first justification – the potential burden on interstate commerce that could result from excess tax compliance costs. The second justification is based on *stare decisis*. Because the physical presence rule had previously been adopted by the *Bellas Hess* decision, the *Quill* majority concluded that “the interest in stability and orderly development of the law that undergirds the doctrine of *stare decisis* . . . counsels adherence to settled precedent.”¹³²

The *Quill* decision articulated the physical presence rule as a bright-line test.¹³³ As Arthur Rosen and Matthew Hedstrom explain, “[u]nder *Quill*, an assessment of the actual burdens is not required; physical presence is a bright-line rule and the law of the land.”¹³⁴ Even a miniscule potential burden on interstate commerce thus suffices to prevent states from imposing use tax compliance obligations on remote vendors that lack physical presence within the state. Although the *Quill* decision acknowledged that the physical presence rule “[l]ike other bright-line tests . . . appears artificial at its edges,”¹³⁵ the *Quill* majority nonetheless concluded

¹³⁰ PriceWaterhouseCoopers, *Retail Sales Tax Compliance Costs: A National Estimate, Volume One: Main Report*, at E-1, April 7, 2006, available at <http://www.bacssuta.org/Cost%20of%20Collection%20Study%20-%20SSTP.pdf>.

¹³¹ Edward Zelinsky, *The Siren Song of ‘Amazon’ Laws: The Colorado Example*, 59 STATE TAX NOTES 695, 698 (2011.); *supra* notes 65–69 and accompanying text.

¹³² *Quill*, 504 U.S. at 317.

¹³³ *Id.* at 314.

¹³⁴ Arthur R. Rosen & Matthew Hedstrom, *Quill – Stare at the Decision*, 60 STATE TAX NOTES 931, 931 (2011).

¹³⁵ *Quill*, 504 U.S. at 315.

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that this artificiality “is more than offset by the benefits of a clear rule.”¹³⁶ By adopting the clear, bright-line physical presence rule, the *Quill* majority hoped to reduce litigation and to avoid the “quagmire” and “confusion” that might otherwise arise in the absence of “precise guides to the States in the exercise of their indispensable power of taxation.”¹³⁷

Nevertheless, although *Quill*'s physical presence rule applies even when the potential burden on interstate commerce is small, the physical presence rule should not prevent state action unless that action has some actual potential for burdening interstate commerce. The *Quill* majority adopted the physical presence rule in order to avoid the potential confusion and quagmire that could result from a balancing test.¹³⁸ It would be difficult to balance potential harms to interstate commerce against the states' valid interest in levying an appropriate amount of revenue from transactions between the states' residents and remote vendors; such a comparison would be like comparing apples to aardvarks, as there is no common metric for evaluating the two competing concerns. But in the absence of any potential burden on interstate commerce, this balancing act becomes simple. When there is zero weight placed on one side of a scale, any amount of weight on the other side of the scale makes the scale tip in that direction, even if the amount of that weight is indeterminable.

Zero potential burden is thus different in kind from minimal potential burden. Both balancing tests and bright-line tests are designed for when there are competing burdens that must be weighed. Neither test is appropriate when evaluating state action that has zero potential for burdening interstate commerce. Before any commerce clause test should be applied, the threshold condition must be met of there being some potential for the state action to actually burden interstate commerce.

Some commentators have attempted to justify *Quill*'s physical presence rule apart from any potential burden on interstate commerce.¹³⁹ Such arguments might have validity based only on *Bellas Hess*, as the *Bellas Hess* decision was unclear as to whether the physical presence requirement was justified by the commerce clause, by the due process clause, or by both.¹⁴⁰ But the *Quill* decision clarified that the due process clause does not block states from imposing use tax compliance obligations on remote vendors as long as the remote vendors conduct some threshold level of sales within the state.¹⁴¹ Only the commerce clause prevents states from imposing use tax compliance obligations on the major e-commerce vendors. And the *Quill* decision repeatedly clarified that the nexus requirement of the commerce clause is not about

¹³⁶ *Id.*

¹³⁷ *Id.* at 315-16.

¹³⁸ *Id.*

¹³⁹ *E.g.*, Arthur R. Rosen & Matthew Hedstrom, *Quill – Stare at the Decision*, 60 STATE TAX NOTES 931, 932 (2011).

¹⁴⁰ *See Quill*, 504 U.S. at 305 (“[A]lthough we have not always been precise in distinguishing between the two, the Due Process Clause and the Commerce Clause are analytically distinct.”).

¹⁴¹ *Supra* Part I.A.

“fairness for the individual defendant”¹⁴² but rather is justified as “a means for limiting state burdens on interstate commerce.”¹⁴³ In the absence of any potential for burdens on interstate commerce, the physical presence rule should not apply.

In other words, we argue that imposing use tax compliance burdens while adequately compensating remote vendors for all compliance costs is substantially different with respect to the commerce clause as compared to imposing use tax compliance burdens on remote vendors without adequately compensating for compliance costs. Although the *Quill* decision never discusses whether it’s holding would apply were states to adequately compensate for compliance costs, the logic of the *Quill* decision suggests that the physical presence rule should not block states from imposing use tax compliance burdens when they adequately compensate remote vendors for all compliance costs. *Stare decisis* does not justify extending a holding to fact patterns that substantially differ from the facts based on which the original holding was decided.

Although many states have established systems for compensating certain vendors for compliance costs to at least some degree, existing compensation levels are “relatively small compared to the estimated retailer’s costs of collecting sales and use taxes.”¹⁴⁴ To our knowledge, no state or local taxing jurisdiction has ever fully compensated for vendors’ compliance costs.¹⁴⁵ Hence, that some states implemented partial vendor compensation schemes prior to the *Quill* decision does not imply that the *Quill* majority considered and rejected the possibility for a full and adequate vendor compensation system to alleviate any potential for states to impose use tax compliance obligations without burdening interstate commerce. Only by fully and adequately compensating remote vendors for all use tax compliance costs¹⁴⁶ can a state impose use tax compliance burdens on remote vendors without creating any potential for burdening interstate commerce, thus satisfying *Quill*.

A number of commentators have suggested that the *Quill* majority was partially motivated by the concern that state use taxes would be applied retroactively to remote vendors if the Court fully overturned *Bellas Hess*.¹⁴⁷ As the *Quill* majority explained, an “overruling of *Bellas Hess* might raise thorny questions concerning the retroactive application of those taxes and might trigger substantial unanticipated liability for mail-order houses.”¹⁴⁸ At least one witness to the *Quill* oral argument thought that the Justices were “very concerned about

¹⁴² *Quill*, 504 U.S. at 312.

¹⁴³ *Id.* at 313.

¹⁴⁴ Robert J. Cline & Thomas S. Neubig, *Masters of Complexity and Bearers of Great Burden: The Sales Tax System and Compliance Costs for Multistate Retailers*, ENRST & YOUNG ECONOMIC CONSULTING AND QUANTITATIVE ANALYSIS, at 22, September 8, 1999, available at <http://plaza.ufl.edu/chriske2/masters.pdf>.

¹⁴⁵ See *id.* (discussing existing compensation regimes).

¹⁴⁶ For instance, by employing the implementation mechanisms we discuss in Part II.C *supra*.

¹⁴⁷ E.g., Arthur R. Rosen & Matthew Hedstrom, *Quill – Stare at the Decision*, 60 STATE TAX NOTES 931, 935-36 (2011); Charles Rothfield, *Quill: Confusing the Commerce Clause*, 3 STATE TAX NOTES 111, 115 & n.47 (1992).

¹⁴⁸ *Quill*, 504 U.S. at 318 n.10.

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retroactivity” and that the retroactivity issue might have tipped the “case against the states.”¹⁴⁹ The *Quill* majority may have even been thinking of the retroactivity issue when they wrote that “a bright-line rule in the area of sales and use taxes encourages settled expectations and, in doing so, fosters investment by businesses and individuals.”¹⁵⁰ Regardless, because the states do not currently reimburse vendors for all use tax compliance costs, there would be no retroactivity concern in a court ruling that states can impose use tax compliance obligations on remote vendors if and only if the states adequately compensate for all tax compliance costs thereby imposed.

Note that we do not mean to suggest that states could impose use tax compliance burdens on remote vendors and have no fear of these burdens being ruled unconstitutional as long as the states adequately compensate for all compliance costs. There remains uncertainty as to how courts would respond to our proposal. We have argued that both the language and the logic of the *Quill* decision strongly imply that states should be permitted to impose use tax compliance obligations as long as they adequately compensate remote vendors so as to remove any potential for burdening interstate commerce. But formalist judges might still hold that *Quill*'s physical presence rule applies even to our proposal.

Remember, however, that the Court has repeatedly cautioned against formalism in its commerce clause holdings.¹⁵¹ The Court has emphasized that its commerce clause jurisprudence is grounded in “pragmatism,”¹⁵² “economic realities,”¹⁵³ and “practical effect[s],”¹⁵⁴ and is disdainful of “formalism,”¹⁵⁵ “magic words,”¹⁵⁶ and “labels.”¹⁵⁷ It is thus hard to imagine a court justifying the extension of *Quill*'s physical presence test to circumstances in which there is no potential for burdening interstate commerce. Such an extension could only be justified on formalistic grounds, and extending the physical presence rule to apply even when there is no potential for burdening interstate commerce would thus be directly contrary to the Court's pronouncements about the purposes of the commerce clause.

We take the *Quill* decision seriously in its statements that the purpose of the physical presence rule is to prevent burdens on interstate commerce,¹⁵⁸ that the potential burden on

¹⁴⁹ Billy Hamilton, *Remembrance of Things Not So Past: The Story Behind the Quill Decision*, 59 STATE TAX NOTES 807, 810 (2011).

¹⁵⁰ *Quill*, 504 U.S. at 316.

¹⁵¹ John Swain, *Cybertaxation and the Commerce Clause: Entity Isolation or Affiliate Nexus*, 75 S. CAL. L. REV. 419, 427 (2002).

¹⁵² *D.H. Holmes Co. v. McNamara*, 486 U.S. 24, 30 (1988).

¹⁵³ *Complete Auto*, 430 U.S. at 279.

¹⁵⁴ *Id.* at 279.

¹⁵⁵ *Quill*, 504 U.S. at 310.

¹⁵⁶ *Complete Auto*, 430 U.S. at 279.

¹⁵⁷ *Trinova Corp. v. Mich. Dep't of Treasury*, 498 U.S. 358, 373 (1991).

¹⁵⁸ *Quill*, 504 U.S. at 313.

interstate commerce arises from excess compliance costs,¹⁵⁹ and that the commerce clause should be applied based on economic realities and practical effects¹⁶⁰ rather than formalistically.¹⁶¹ It consequently seems clear to us that *Quill*'s physical presence rule should not apply when a state adequately compensates remote vendors for all compliance costs and thereby alleviates any possibility of burdening interstate commerce. Although we cannot guarantee that courts will agree with our analysis, we think that the arguments supporting the constitutionality of our proposed approach are more than persuasive enough to make our approach the best way forward for states that wish to raise revenue by taxing e-commerce.

III. Implications for the States, for the Courts, and for Congress

As of August 2011, ten states have passed “Amazon laws” designed to collect use taxes from remote vendors.¹⁶² These laws have been described as unconstitutional, ineffective, or both,¹⁶³ and have been the subject of litigation across the nation.¹⁶⁴ At the same time, Congress has considered and rejected federal legislative solutions on numerous occasions.¹⁶⁵ Nevertheless, the states have continued to lobby Congress in the hope that it will reconsider.

We predict that our proposed approach will dramatically change the use tax landscape and eliminate the states' need to rely on more questionable strategies for circumventing *Quill*'s physical presence rule. However, because our approach would mostly eliminate the use tax exemption for remote vendors, it is likely to be subject to the same level of criticism that has been directed at the current state legislation. Nevertheless, we are confident that our approach is superior to the alternatives both as a matter of constitutional law and of efficacy.

To illustrate why our proposed approach is the best way forward for state taxation of e-commerce, our approach must be compared to the alternatives currently working their way through state legislatures and the courts. Below, we analyze and reject these other approaches either on constitutional or prudential grounds. We then outline the implications of our proposed approach for the states, for the courts, and for Congress.

¹⁵⁹ *Id.* at 313 n.6.

¹⁶⁰ *Id.* at 309.

¹⁶¹ *Id.* at 310.

¹⁶² See *infra* note **Error! Bookmark not defined.** and accompanying text.

¹⁶³ See, e.g., Edward A. Zelinsky, *New York's "Amazon Law": Constitutional But Unwise*, 54 STATE TAX NOTES 715 (Dec. 7, 2009) (ineffective); Edward A. Zelinsky, *The Siren's Song of "Amazon" Laws: The Colorado Example*, 59 STATE TAX NOTES 695 (Mar. 7 2011) (unconstitutional); Stephen P. Kranz, Diann L. Smith, & Beth Freeman, *Colorado's End Run: Clever, Coercive, and Unconstitutional*, 56 STATE TAX NOTES 55 (Apr. 5, 2010) (unconstitutional).

¹⁶⁴ See, e.g., *Amazon.com, LLC v. New York State Dept. of Tax'n & Fin.*, 2010 NY Slip Op. 07823 (Nov. 4, 2010); *Direct Marketing Association v. Huber*, 2011 U.S. Dist. Lexis 9589 (D. Colo.).

¹⁶⁵ See *infra* note 238 and accompanying text.

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A. State “Amazon” Laws

Frustrated by the *Quill* decision, and desperate for revenues, the states have become increasingly aggressive in attempting to tax interstate e-commerce. New York passed the first so-called “Amazon” law in 2008.¹⁶⁶ Nine additional states have since followed New York’s lead.¹⁶⁷ And the action has become particularly intense during the summer of 2011, with both California¹⁶⁸ and Texas¹⁶⁹ passing new Amazon legislation. A number of other state legislatures have also been debating their own Amazon laws.¹⁷⁰ As the remaining states watch to see how the courts and e-commerce vendors will react, we expect to see more states passing Amazon laws in the near future. Even if the states conclude that these laws are unlikely to be successful, passing such laws can help the states muddle through their current-year budget crises, as long as the laws can be scored as generating additional revenues.¹⁷¹

Previous scholars have analyzed the recent state Amazon laws with laudable thoroughness and depth.¹⁷² We will not repeat their efforts here. Instead, we aim only to briefly outline some of the major features of these laws in order to demonstrate why the laws are unlikely to succeed in enabling the states to tax interstate e-commerce. Ultimately, we believe that only our proposed solution of adequate vendor compensation offers the states an effective way forward in their attempts to preserve their sales and use tax bases against the erosion caused by the growth of e-commerce.¹⁷³

¹⁶⁶ New York Chapter of Laws of 2008, ch. 57; N.Y. Tax Law § 1101(b)(8)(vi) (2011); N.Y. TSB-M-08(3)S (May 8, 2008).

¹⁶⁷ Billy Hamilton, *The Empire Strikes Back: Amazon Fights Against Online Tax Efforts*, 60 STATE TAX NOTES 959, 960 (2011) (listing as states that have passed Amazon laws: Arkansas, Colorado, Connecticut, Illinois, New York, North Carolina, Rhode Island, and South Dakota). California and Texas subsequently also passed Amazon laws, bringing the total to ten states.

¹⁶⁸ Karen Setze & John Buhl, *California Governor Signs ‘Amazon’ Law*, 61 STATE TAX NOTES 7, 7 (2011).

¹⁶⁹ Billy Hamilton, *How Amazon’s Texas Deal Unraveled*, 61 STATE TAX NOTES 191, 191 (2011).

¹⁷⁰ Billy Hamilton, *The Empire Strikes Back: Amazon Fights Against Online Tax Efforts*, 60 STATE TAX NOTES 959, 960 (2011) (“Another 10 states are considering or have recently considered similar legislation – Arizona, California, Hawaii, Louisiana, Minnesota, Mississippi, Nevada, New Mexico, Texas, and Vermont.”). See also Dolores W. Gregory & Nancy J. Moore, *As States Crank Up Efforts to Force Use Tax Collection, Amazon Threatens to Shutter Operations in Texas and California*, BNA DAILY TAX REPORT, March 22nd, 2011 (describing proposed and actual legislation by Arizona, Arkansas, California, Colorado, Connecticut, Hawaii, Illinois, Maine, Massachusetts, Minnesota, Mississippi, New Mexico, Oklahoma, Rhode Island, South Dakota, Tennessee, Texas, and Vermont).

¹⁷¹ For a general discussion of how states muddle through budget crises, see David Gamage, *Preventing State Budget Crises, Managing the Fiscal Volatility Problem*, 98 CALIF. L. REV. 749, 754-68 (2010).

¹⁷² E.g., Edward A. Zelinsky, *Lobbying Congress: Amazon Laws in the Lands of Lincoln and Mt. Rushmore*, 60 STATE TAX NOTES 557 (2011); Michael Mazerov, *Amazon’s Arguments Against Collecting Sales Taxes Do Not Withstand Scrutiny*, CENTER ON BUDGET AND POLICY PRIORITIES, November 29, 2010; Andrew Haile, *Defending Colorado’s Use Tax Reporting Requirement*, 57 STATE TAX NOTES 761 (2010).

¹⁷³ See, e.g., Edward A. Zelinsky, *Lobbying Congress: Amazon Laws in the Lands of Lincoln and Mt. Rushmore*, 60 STATE TAX NOTES 557, 578 (2011) (“Why are Amazon laws suddenly proliferating as they are now? At one level, that proliferation seems particularly quixotic, given the unconstitutionality and futility of these state laws.”).

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Although there is considerable variation in the content of the states' Amazon laws, current legislation can be roughly categorized into three approaches: referrer nexus, related-entity nexus, and information-reporting requirements.

The “referrer nexus” approach presumes that a vendor has physical presence within a state whenever the vendor makes sales and marketing arrangements with in-state residents. Referrer nexus statutes typically trigger use tax liability for a remote vendor if two conditions are satisfied. First, the remote vendor must have some agreement with in-state residents pursuant to which the in-state residents directly or indirectly refer potential customers – “whether by a link on an internet website or otherwise” – to the vendor for some consideration.¹⁷⁴ Second, the “cumulative gross receipts” from sales to in-state residents made by all such referrals must exceed some amount (ten thousand dollars, in the case of New York’s statute) in the previous year.¹⁷⁵ These statutes provide that remote vendors who have such agreements are presumed to be soliciting sales through in-state residents,¹⁷⁶ and as such are subject to the state’s use tax.

The referrer nexus approach is sometimes called the “affiliate tax” approach¹⁷⁷ or the “click-through nexus”¹⁷⁸ approach. The first state Amazon law – passed by New York in 2008 – relied on this approach,¹⁷⁹ and many of the subsequent state Amazon laws have also employed the approach.¹⁸⁰ New York’s referrer-nexus statute provides that a vendor can rebut the presumption of physical presence if it can prove that “the resident with whom the seller has an agreement did not engage in any solicitation in the state on behalf of the seller that would satisfy the nexus requirement of the United States constitution.”¹⁸¹ The litigation surrounding New York’s statute has consequently centered around the statute’s application – in particular, whether a remote vendor may be subject to use taxation if the vendor’s only solicitation activities within the state are compensating in-state residents for linking to the vendor on the residents’ webpages.¹⁸²

¹⁷⁴ N.Y. Tax Law § 1101(b)(8)(vi). It appears that the state may chain such connections back to the remote vendor, even if the remote vendor contracts solely with another out-of-state business, which in turn contracts with an in-state business. See N.Y. TSB-M-08(3)S, p. 2.

¹⁷⁵ N.Y. Tax Law § 1101(b)(8)(vi).

¹⁷⁶ New York’s sales tax law provides that out-of-state businesses who solicit sales through an in-state independent contractor or other representative must collect sales tax. Section 1101(b)(8)(vi) creates a “presumption” that out-of-staters are doing so if its requirements are met. However, the presumption appears definitional and is likely difficult to rebut unless the out-of-state business can prove that it should fit within the statutory exclusion.

¹⁷⁷ See, e.g., Michael R. Gordon, *Up the Amazon Without a Paddle: Examining Sales Taxes, Entity Isolation, and the “Affiliate Tax”*, 11 N.C. J.L. & TECH. 299, 309 (2010).

¹⁷⁸ See, e.g., Stephen P. Kranz, Lisbeth A. Freeman, & Mark W. Yopp, *Is Quill Dead? At Least One State Has Written the Obituary*, 57 STATE TAX NOTES 307, 309 (2010).

¹⁷⁹ See New York Chapter of Laws of 2008, ch. 57; N.Y. Tax Law § 1101(b)(8)(vi) (2011). See also N.Y. TSB-M-08(3)S (May 8, 2008).

¹⁸⁰ E.g., R.I. Gen. Laws § 44-18-15(a)(2); N.C. Gen. Stat. § 105-164.8(b)(3).

¹⁸¹ *Id.*

¹⁸² Guidance by New York’s Department of Taxation and Finance indicates that an in-state resident’s linking to the remote vendor’s website without any other “solicitation activity in the state targeted at potential New York State

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The New York Court of Appeals recently upheld New York's statute as facially constitutional.¹⁸³ However, the question remains to be decided on remand as to whether the statute can constitutionally be applied to major e-commerce vendors like Amazon.¹⁸⁴ And Amazon will undoubtedly appeal if it loses the as-applied challenge. "Ultimately, this controversy is likely to play out before the U.S. Supreme Court."¹⁸⁵

Moreover, even if Amazon loses its constitutional challenges to New York's statute, the referrer-nexus approach will still prove ineffective. Overtok.com has already suspended its relationships with marketing associates in New York in order to avoid being subject to New York's use tax.¹⁸⁶ Amazon has similarly suspended relationships with marketing associates in other states that have passed referrer-nexus laws.¹⁸⁷ Presumably, the only reason that Amazon has not also done so in New York is in order to maintain standing to challenge New York's statute.¹⁸⁸ There seems little doubt that if Amazon loses the litigation it will respond by terminating all click-through marketing relationships with New York residents so as to remain exempt from New York's use tax.¹⁸⁹ The referrer-nexus approach ultimately fails as a way forward for the states to tax e-commerce for the simple reason that e-commerce vendors can easily end all referral relationships with in-state residents.

Similar in many ways to the referrer-nexus approach, the "related-entity nexus" approach attempts to satisfy the commerce clause's nexus requirement by attributing physical presence to remote vendors that have specific business relationships with in-state firms. The approach is sometimes called the "affiliate nexus" approach.¹⁹⁰ Under either name, the approach involves

customers on behalf of the seller" does not on its own trigger the vendor being subject to use taxation. N.Y. TSB-M-08(3)S, p. 4. However, this language appears inconsistent with one of the accompanying examples, which describes a remote vendor that enters into an agreement with a service provider, who in turn contracts with New York State residents to refer potential customers back to the remote vendor. The referrals take the form of "placing [the vendor's] product links on their Web sites," with commissions paid by the service provider for sales made through such links. The example concludes that the remote vendor is presumed to be soliciting sales through in-state residents. *Id.* Later guidance provided another safe harbor, under which remote vendors could rebut the nexus presumption by including in their referral agreements a provision prohibiting their in-state representatives from "engaging in solicitation activities in New York." N.Y. TSB-M-08(3.1)S (June 30, 2008). This safe harbor requires the in-state residents to certify annually that they have not engaged in any such prohibited solicitation during the prior year.

¹⁸³ Amazon.com, LLC v. New York State Dept. of Tax'n & Fin., 2010 NY Slip Op. 07823 (Nov. 4, 2010).

¹⁸⁴ Edward A. Zelinsky, *New York Appellate Division Upholds 'Amazon' Law: Analysis*, 59 STATE TAX NOTES 93, 104 (2011).

¹⁸⁵ *Id.* at 93.

¹⁸⁶ *Id.* at 102.

¹⁸⁷ E.g., Joe Hanel, *Amazon Drops Colorado Affiliates In Response to Law*, 55 STATE TAX NOTES 735 (March 15, 2010); Geoffrey A. Fowler, *Amazon Cuts North Carolina Affiliates to Avoid Tax*, WALL ST. J., June 27, 2009, available at <http://online.wsj.com/article/SB124603593605261787.html> (last visited Feb. 16, 2011).

¹⁸⁸ Edward A. Zelinsky, *New York Appellate Division Upholds 'Amazon' Law: Analysis*, 59 STATE TAX NOTES 93, 102 (2011).

¹⁸⁹ *Id.*

¹⁹⁰ John Swain, *Cybertaxation and the Commerce Clause: Entity Isolation or Affiliate Nexus?*, 75 S. CAL. L. REV. 419, 419 (2002).

triggering a remote vendor's use tax liability under one of two circumstances: (1) if the remote vendor controls or is controlled by an in-state business, or is under common control with an in-state business,¹⁹¹ or (2) if the remote vendor and an in-state business "use an identical or substantially similar name, tradename, trademark, or goodwill, to develop, promote, or maintain sales,"¹⁹² or otherwise substantially coordinate their business practices. In effect, the related-entity nexus approach attempts to circumvent the commerce clause's prohibitions by disregarding corporate structure and treating related business entities as though they were a single unitary business. States that have passed legislation based on the related-entity-nexus approach include Alabama, Arkansas, California, Georgia, Idaho, Indiana, Kansas, Minnesota, New York, Oklahoma, Texas, and Wisconsin.¹⁹³

Like the referrer-nexus approach, the related-entity nexus approach may be "constitutionally suspect."¹⁹⁴ Stephen Kranz, Lisbeth Freeman, and Mark Yopp argue that "[n]owhere does the Constitution, or the cases applying it, give support to the idea that two retailers that are simply members of the same controlled group of corporations create nexus for each other."¹⁹⁵ In contrast, however, John Swain argues that although "no Supreme Court decision has addressed directly the issue of affiliate nexus, the Court has [addressed related concepts] which serve as building blocks for a theory of affiliate nexus."¹⁹⁶ He thus concludes that "states should feel unconstrained in enforcing sales tax collection obligations against companies currently attempting to avoid taxation through entity isolation techniques."¹⁹⁷ As these competing views indicate, there is no consensus about the constitutionality of the related-entity-nexus approach and litigation remains ongoing.¹⁹⁸

Regardless of its constitutionality, we do not believe that the related-entity nexus approach offers the states an effective means for taxing interstate e-commerce. Maintaining their sales and use tax exemption is sufficiently important to major e-commerce vendors like Amazon that they can be expected to terminate any relationships that would cause them to lose that exemption. Alternatively, e-commerce vendors can move their subsidiaries or other related

¹⁹¹ See, e.g., Ala. Code Ann. § 40-23-190(a)(1), (b)(1) (2011).

¹⁹² See, e.g., *id.* § 40-23-190(a)(2).

¹⁹³ Stephen P. Kranz, Lisbeth A. Freeman, & Mark W. Yopp, *Is Quill Dead? At Least One State Has Written the Obituary*, 57 STATE TAX NOTES 307, 308 (2010); Robert D. Plattner, Daniel Smirlock, & Mary Ellen Ladouceur, *A New Way Forward for Remote Vendor Sales Tax Collection*, 55 STATE TAX NOTES 187, 194 (2010).

¹⁹⁴ Stephen P. Kranz, Lisbeth A. Freeman, & Mark W. Yopp, *Is Quill Dead? At Least One State Has Written the Obituary*, 57 STATE TAX NOTES 307, 311 (2010).

¹⁹⁵ *Id.* at 309.

¹⁹⁶ John Swain, *Cybertaxation and the Commerce Clause: Entity Isolation or Affiliate Nexus?*, 75 S. CAL. L. REV. 419, 424 (2002).

¹⁹⁷ *Id.*

¹⁹⁸ Dolores W. Gregory & Nancy J. Moore, *As States Crank Up Efforts to Force Use Tax Collection, Amazon Threatens to Shutter Operations in Texas and California*, BNA DAILY TAX REPORT, March 22, 2011 ("Whether Amazon's position will be upheld in court is an open question.").

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entities out of the states that pass related-entity nexus statutes. As evidence of this willingness, Amazon has already threatened to close warehouses and other facilities in a number of states.¹⁹⁹

Some e-commerce vendors may place sufficient importance on maintaining their related operations within the states in which they currently operate so as to remain subject to related-entity nexus statutes. But we predict that Amazon and other major e-commerce vendors will go to nearly any lengths to reorganize their operations in order to maintain their sales and use tax exemption, once the vendors have exhausted litigation and alternative options for challenging such statutes. For instance, the Wall Street Journal has reported that Amazon originally located in Washington State, rather than in California, in order to avoid being subject to California's sales tax.²⁰⁰ And Amazon has continued to aggressively manage its business operations so as to avoid being subject to the sales and use taxes of major customer states.²⁰¹

California's recently passed Amazon law attempts to subject Amazon to use taxation based on the related-entity-nexus strategy because Amazon maintains a subsidiary in California responsible for developing the Kindle e-book reader.²⁰² Consequently, Amazon is challenging California's Amazon law both through litigation and by sponsoring a referendum to overturn the law.²⁰³ But despite the importance of its California subsidiary to Amazon's business, we predict that Amazon will ultimately move the subsidiary's operations to Washington State if Amazon fails in its other attempts to overturn California's Amazon law. As Amazon's previous actions indicate, maintaining a roughly ten percent tax cost advantage on sales to California customers is sufficiently important to Amazon's business model to be worth moving even important subsidiaries out of state.²⁰⁴ And the related-entity nexus approach is even less likely to succeed for states other than California, as most states lack unique regions like Silicon Valley that might deter the major e-commerce vendors from moving all of their operations out of state.²⁰⁵

¹⁹⁹ E.g., Bill Kidd, *Amazon Closing Texas Facility Amid Sales Tax Dispute*, STATE TAX TODAY, Feb. 14, 2011, available at <http://services.taxanalysts.com/taxbase/tbnews.nsf/Go?OpenAgent&2011+STT+30-22> (last visited Aug. 15, 2011).

²⁰⁰ Stu Woo, *Amazon Battles States Over Sales Tax*, WALL ST. J., Aug. 3, 2011 ("Amazon's Mr. Bezos has said he established the company in Washington partly because it has a tech-savvy but relatively small population, so state taxes wouldn't affect many potential customers.").

²⁰¹ *Id.* ("Former Amazon staffers say the tactic is typical of its aggressive approach to minimizing sales tax. Early employees recall requirements to consult lawyers before arranging trips to states including California. Former staffers say they got grilled about the purpose of trips and warned to avoid soliciting new customers, promoting products and doing similar activities in certain states because of tax concerns.").

²⁰² Laura Mahoney, *Retailers, Lawyers, Regulators, Scramble to Interpret 'Amazon' Law*, BNA DAILY TAX REPORT, July 6, 2011.

²⁰³ Karen Setze, *Amazon Wants Repeal of California's Click-Through Law*, STATE TAX NOTES, July 18, 2011.

²⁰⁴ See, e.g., Stu Woo, *Amazon Battles States Over Sales Tax*, WALL ST. J., Aug. 3, 2011 (quoting California assemblywoman Nancy Skinner as saying, "Amazon has been quite clear . . . that they designed this business model to not have to collect sales tax" . . .).

²⁰⁵ Amazon and other major e-commerce vendors probably need to maintain warehouses and other related facilities in at least some states, but as long as a few geographically dispersed states do not pass affiliate-nexus statutes, Amazon should be able to cease operations in those states that do pass such statutes. The states face a hold out

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The final method by which states have attempted to tax sales by remote vendors to in-state residents – the “information-reporting requirements” approach – does not involve taxing the remote vendors at all. Rather, the approach involves requiring remote vendors to divulge the information about the vendors’ sales to in-state residents necessary for the state to effectively collect use taxes from the state’s residents.²⁰⁶

Notice and reporting requirements facilitate the collection of use taxes in a manner similar to how W-2s facilitate income tax collections. The information reported need only contain the total amount of a resident’s purchases and some information capable of uniquely identifying the resident (such as an address). The most-well known state attempt to impose notice and reporting requirements is Colorado’s HB 1193, which imposes three separate requirements on remote vendors that do not voluntarily collect use taxes on sales to Colorado residents.²⁰⁷ First, these vendors must include a notice on invoices sent to Colorado purchasers informing them that use tax may be due to Colorado’s Department of Revenue.²⁰⁸ Second, the vendors must provide a year-end summary of all sales to Colorado residents who purchased \$500 or more of taxable items in the previous year.²⁰⁹ Finally, and most crucially, the vendors must provide the Colorado Department of Revenue with an annual summary of purchases made by Colorado residents and the aggregate amount that each resident purchased.²¹⁰ Failure to satisfy any of these requirements results in a fine, which ranges from \$5 to \$100,000.

Unlike the referrer-nexus and related-entity-nexus approaches, we expect that the information-reporting requirements approach would be largely successful were it constitutional. However, of the three major approaches, we conclude that the information-reporting requirements approach most clearly violates the commerce clause and *Quill*’s physical presence requirement. As Edward Zelinsky argues, “[s]ix thousand different state and local reporting requirements would constitute the same ‘welter of complicated obligations’ as an equivalent number of conflicting tax collection responsibilities.”²¹¹ If we take the *Quill* decision seriously that the purpose of the physical presence requirement is to prevent the excess burden on remote vendors that might result from numerous taxing jurisdictions imposing tax compliance

problem in attempting to cooperate to prevent Amazon from moving operations to states that do not attempt to enforce affiliate-nexus laws. We expect that a sufficient number of states will be willing to continue granting Amazon and other major e-commerce vendors use tax exemptions in order to lure warehousing and other business operations. For small states, the benefit of having these operations moved to within the state can easily exceed the revenues lost due to granting use tax exemptions.

²⁰⁶ E.g., Colo. Rev. Stat. § 39-21-112(3.5) (2011); Cal. A.B. 155 § 3 (2011).

²⁰⁷ The vendor must first be considered a “retailer” “doing business” within the state in order to be subject to notice and reporting requirements. See Colo. Rev. Stat. § 39-26-102(8) (2011) (defining retailer as a person “doing business in [Colorado]”); *id.* 39-21-112(3.5)(c), (d) (requiring “retailers” that do not collect Colorado sales tax to satisfy notice and reporting regime).

²⁰⁸ See Colo. Reg. 39-21-112.3.5(2) (2010).

²⁰⁹ *Id.* 39-21-112.3.5(3)(c).

²¹⁰ *Id.* 39-21-112.3.5(4).

²¹¹ Edward Zelinsky, *The Siren Song of ‘Amazon’ Laws: The Colorado Example*, 59 STATE TAX NOTES 695, 698 (2011).

obligations, then the physical presence rule should also apply to information-reporting requirements.

Andy Haile has argued that information-reporting requirements are “significantly less onerous than the burden of actually collecting use taxes.”²¹² This may be so,²¹³ but *Quill*’s bright-line rule was designed so that courts would not need to inquire into the magnitude of the burden on interstate commerce.²¹⁴ Unless the information-reporting requirements approach is combined with our proposed solution of adequate vendor compensation, imposing information-reporting requirements would seem to clearly fail *Quill*’s physical presence test. Information-reporting requirements can only really be distinguished from tax collection obligations based on pure formalism, and the Court has repeatedly rejected formalism in its dormant commerce clause jurisprudence.²¹⁵

For these reasons, the U.S. District Court for the District of Colorado has preliminarily enjoined the enforcement of Colorado’s information-reporting requirements.²¹⁶ In finding the law unconstitutional, the court held that “the information reporting obligations of the Colorado Amazon statute are indistinguishable from the responsibility to collect tax.”²¹⁷ Although litigation remains ongoing, we think there is little chance that the courts will allow states to tax interstate e-commerce using the information-reporting requirements approach,²¹⁸ unless that approach is combined with our proposed solution of adequate vendor compensation.

B. Implications for the States

We propose that the states adopt our approach of requiring remote vendors to remit use taxes while compensating the remote vendors for all tax compliance costs thereby imposed. Our approach should have obvious attractiveness for the states that are currently contemplating Amazon laws. We have argued that the current strategies underlying the states’ Amazon laws

²¹² Andrew J. Haile, *Defending Colorado’s Use Tax Reporting Requirement*, 57 STATE TAX NOTES 761, 764 (2011). But see Edward Zelinsky, *The Siren Song of ‘Amazon’ Laws: The Colorado Example*, 59 STATE TAX NOTES 695, 698 (2011) (questioning Haile’s argument).

²¹³ Or it may not be so. In order to comply with information-reporting requirements, a remote vendor must know each taxing jurisdiction’s rules for tax-exempt sales, sales tax holidays, and product coding. And “[d]etermining how to handle tax-exempt sales, sales tax holidays, and product taxability coding can be a daunting task, particularly for small and midsize businesses. It has been estimated that sales tax exemptions account for 60 percent of the cost of compliance for small businesses.” Cara Griffeth, *Streamlining Versus “Amazon” Laws: The Remote Seller Dilemma*, 55 STATE TAX NOTES 351, 354 (2010).

²¹⁴ *Supra* Part II.D.

²¹⁵ *Id.*

²¹⁶ *Direct Marketing Ass’n v. Huber*, 2011 U.S. Dist. Lexis 9589 (D. Colo. Jan. 26, 2011).

²¹⁷ Edward Zelinsky, *The Siren Song of ‘Amazon’ Laws: The Colorado Example*, 59 STATE TAX NOTES 695, 698 (2011).

²¹⁸ Further analysis can be found in Stephen P. Kranz, Diann L. Smith, & Beth Freeman, *Colorado’s End Run: Clever, Coercive, and Unconstitutional*, 56 STATE TAX NOTES 55 (2010).

will be ineffective, are likely to be held unconstitutional, or both.²¹⁹ In contrast, we have argued that our approach should be both effective and constitutional.²²⁰

Granted, to the extent the states can actually reach remote vendors with the existing Amazon-law strategies, our approach might generate slightly less revenue due to the need to compensate for compliance costs. But even if the need to compensate for compliance costs reduces the revenue-generating potential of our approach, this disadvantage should be more than offset because our approach would not incentivize e-commerce vendors to move their operations out of state.²²¹

Moreover, our proposed approach could be combined with the other Amazon-law strategies. By combining our vendor-compensation approach with the referrer-nexus or related-entity nexus strategies, a state could impose use tax compliance obligations on all e-commerce vendors who conduct more than some minimal amount of business with in-state residents. To the extent the courts determine that remote vendors can be imputed to have physical presence based on the referrer-nexus or related-entity-nexus principles, the states would not need to compensate the remote vendors for tax compliance costs. Plus, our approach would also allow the states to impose use tax compliance obligations on remote vendors that the courts determine to lack physical presence, as long as the states compensate those remote vendors for all tax compliance costs.

By using our approach as a backstop to other strategies, the states could thus greatly reduce remote vendors' incentives to move their operations out of state. The most remote vendors could gain from reorganizing their operations would be compensation for tax compliance costs, which is much less lucrative for the remote vendors than the possibility of being made completely exempt from both direct tax costs and tax compliance costs.

Similarly, by combining our approach with the information-reporting requirements strategy, states could greatly improve the likelihood of the information-reporting requirements being held constitutional. We expect other courts to follow the lead of the U.S. District Court for the District of Colorado in determining that information-reporting requirements violate the commerce clause, at least when not combined with adequate vendor compensation.²²² But we conclude that all commerce clause concerns would be completely alleviated were a state to

²¹⁹ *Supra* Part III.A.

²²⁰ *Supra* Part II.

²²¹ See, e.g., Eric Anderson, Nathan Fong, Duncan Simester, Catherine Tucker, *How Does an Obligation to Collect Sales Tax Affect Consumer and Firm Behavior?*, 47 *J. of Marketing Research* 229 (2010) ("We find that retailers who earn a large proportion of their revenue from direct channels (such as the Internet) avoid opening stores in high-tax states. We conclude that current United States sales tax laws have significant effects on both customer and firm behavior.").

²²² *Supra* Part III.A.

impose information-reporting requirements while adequately compensating remote vendors for all of the compliance costs they thereby incur.²²³

Furthermore, we suggest that even states not currently contemplating Amazon laws should adopt our approach. Because our approach eliminates any potential for burdening interstate commerce while generating revenues for the states, there is no reason for the states to continue offering remote e-commerce vendors a tax cost advantage over in-state competitors. In order to level the playing field, every state that levies a sales tax should adopt our approach so that in-state consumers would decide whether to purchase from in-state vendors or from remote e-commerce vendors based on market factors rather than on differential tax treatment.²²⁴ States that do not want to raise additional tax revenues could use the revenues generated by adopting our approach to reduce the general sales tax rate affecting all vendors.²²⁵

Finally, our approach is fully compatible with multistate efforts to simplify and unify sales and use taxation. Indeed, our approach would incentivize the states to reduce compliance costs to the extent possible, as our approach would lead to the states bearing those costs rather than remote vendors. We applaud current multistate efforts to simplify and unify sales and use tax administration – such as the Streamlined Sales and Use Tax Agreement.²²⁶ However, we also recognize that there may be valid reasons why states may wish to avoid completely unifying their sales and use taxes.²²⁷ For example, centralization potentially interferes with the states’ customizing their tax laws to meet local needs and from their experimenting with new approaches so as to foster a laboratory of democracy.²²⁸ Our approach balances the competing goals of unification and of maintaining local discretion by causing states to internalize the costs of complexity and non-unification. Except where local needs overpower the cost-saving advantages of unifying a state’s sales and use tax laws with those of the other states, our

²²³ *Id.*

²²⁴ See, e.g., John Swain, *State Sales and Use Tax Jurisdiction: An Economic Nexus Standard for the Twenty-First Century*, 38 GA. L. REV. 343, 345 (2003) (arguing that from “a normative tax policy perspective” all consumer purchases should be taxed “to avoid discrimination” and to “keep a level playing field” and that “it is more administratively practical to collect the tax from the seller.”).

²²⁵ Or the state could reduce other state taxes.

²²⁶ For discussion of these efforts, we recommend: Frank Shafroth, *Has the SSTP Become Overburdened?* 55 STATE TAX NOTES 355 (2010); Brian Galle, *Designing Interstate Institutions: The Example of SSUTA*, 40 U.C. DAVIS L. REV. 1381 (2007); John Swain & Walter Hellerstein, *The Political Economy of the Streamlined Sales Tax Agreement*, 58 NAT’L TAX J. 605 (2005).

²²⁷ See, e.g., Robert Plattner, Daniel Smirlock, & Mary Ladouceur, *A New Way Forward for Remote Vendor Sales Tax Collection*, 55 STATE TAX NOTES 187, 187 (2010) (“Moreover, for legitimate reasons, approximately half the states imposing a sales tax, including California, Texas, Florida, New York, Illinois, and Pennsylvania, have not chosen to join SSUTA.”); John Swain & Walter Hellerstein, *The Political Economy of the Streamlined Sales Tax Agreement*, 58 NAT’L TAX J. 605, 612-16 (2005) (describing potentially divergent local interests).

²²⁸ Justice Brandeis famously praised the states as laboratories of democracy in his dissent in *New Ice Co. v. Lieberman*, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting).

approach should lead the states to pursue simplification and unification based on their own self-interest in minimizing the costs of compensating remote vendors.

C. Implications for the Courts

The primary implication of our analysis is that the courts should bless state attempts to place use tax compliance obligations on remote vendors as long as the states compensate the remote vendors for all tax compliance costs thereby imposed. If states adopt our approach, the courts should uphold those states' laws against any commerce clause challenges. Furthermore, in reviewing commerce clause challenges to the existing state Amazon laws, we would advise the courts to note that our approach is available as a more constitutionally sound (and effective) alternative.

Indeed, realizing that our approach is available ought to make the courts feel more comfortable in ruling that the existing Amazon-law strategies violate the commerce clause. We take no stance on how the courts should actually rule on evaluating the referrer-nexus or related-entity-nexus strategies.²²⁹ But judges uncertain about the constitutionality of these strategies might appropriately be influenced by our proposal being available as a superior alternative.

If the Supreme Court accepts a case challenging any of the existing Amazon laws, many scholars hope that the Court will overturn the *Quill* decision.²³⁰ Even with our proposed approach available as a means for states to tax remote e-commerce vendors, these scholars might still argue that the physical presence rule grants remote e-commerce vendors an unjustified advantage over multistate retailers that need to maintain a physical presence within their customer states.²³¹ If subject to use taxation, both a multistate retailer with physical presence and a multistate e-commerce retailer without physical presence would bear tax compliance costs. Yet our proposal would only require states to reimburse the multistate e-commerce vendor for those costs.

A good case can be made that the states should also provide adequate vendor compensation for multistate retailers that maintain a physical presence within the state.²³² But we think the case for requiring states to compensate remote e-commerce vendors for tax

²²⁹ Evaluating the constitutionality of these approaches is beyond the scope of this Article. For our purposes, it suffices to note that these strategies are constitutionally questionable and that they are in any case unlikely to be effective. In contrast, as we have already mentioned, we agree with the District Court for the District of Colorado that the information-reporting-requirements approach is unconstitutional (unless combined with providing adequate vendor compensation). See *supra* Part III.A.

²³⁰ *Supra* notes 16-19 and accompanying text.

²³¹ See, e.g., John Swain, *State Sales and Use Tax Jurisdiction: An Economic Nexus Standard for the Twenty-First Century*, 38 GA. L. REV. 343, 362 (2003) ("The physical presence test is not an effective tool for sorting out relative burdens among taxpayers.").

²³² We would urge states to reimburse all multistate vendors for tax compliance costs based on the interests of sound tax policy, but we do think that the commerce clause should be interpreted so as to require states to compensate for the compliance costs incurred by multistate vendors who maintain physical presence within the state.

compliance costs is much stronger. A vendor acquires physical presence within a taxing jurisdiction by purposefully choosing to locate operations within that jurisdiction. By doing so, the vendor knowingly becomes subject to a wide variety of local laws and regulations. A vendor should thus only choose to maintain physical presence within a jurisdiction if selling to customers within that jurisdiction is of more than incidental importance to the vendor's business. In contrast, a remote e-commerce vendor may end up selling within a taxing jurisdiction due to customers within that jurisdiction finding the vendor's website – without the e-commerce vendor making any purposeful decision to sell to that jurisdiction.

That a vendor has physical presence within a jurisdiction is thus suggestive of the vendor deriving significant value from selling to that jurisdiction.²³³ Undoubtedly, evaluating the magnitude of a vendor's sales into a jurisdiction would be a better proxy than physical presence for the importance of selling into that jurisdiction for the vendor's business. But courts are poorly equipped to design quantitative tests such as evaluating the magnitude of sales.²³⁴

We recognize that our argument here blurs commerce clause considerations with due process clause considerations. But the commerce clause is properly concerned with preventing states and local taxing jurisdictions from disproportionately burdening multistate vendors with tax compliance costs. By creating a permissive due process clause test for when states can tax remote vendors, *Quill* left the commerce clause as the primary deterrent to states' imposing excess compliance costs on multistate vendors conducting only a small magnitude of sales within a state or local taxing jurisdiction. Again, because courts have no ready means for evaluating what magnitude of sales is significant, physical presence can function as a very rough proxy for the importance a vendor places on selling into a jurisdiction.

Hence, we would oppose the Supreme Court overturning *Quill*, as long as *Quill* is interpreted to permit our proposed approach for the states to tax interstate e-commerce while providing adequate vendor compensation. We admit that our proposed approach would grant multistate e-commerce vendors a small tax cost advantage over multistate physical retailers (with the advantage being equal to the magnitude of tax compliance costs). But we find this weakness of our approach considerably less troubling than would be overturning *Quill* and allowing the states to burden interstate commerce by imposing excess tax compliance costs on multistate e-commerce vendors lacking physical presence. Whereas a retailer with physical presence must necessarily be rather large in order to make sales within thousands of taxing jurisdictions, even a small e-commerce retailer may end up selling across the entire United States. Moreover, the tax cost advantage that our proposed approach would grant to remote e-commerce vendors is much

²³³ This connection is far from perfect, and the absence of physical presence does not imply that a vendor does not gain significant value from selling into a jurisdiction. Still, the maintenance of physical presence is not meaningless.

²³⁴ John Swain, *State Sales and Use Tax Jurisdiction: An Economic Nexus Standard for the Twenty-First Century*, 38 GA. L. REV. 343, 364 (2003).

smaller than the tax cost advantage these vendors currently enjoy due to their being shielded from both direct tax costs and tax compliance costs.

D. Implications for Congress

By holding that only the commerce clause prevents states from imposing use tax compliance obligations on the major e-commerce vendors – and that the due process clause does not – the *Quill* decision opened the door for Congress to regulate state taxation of interstate e-commerce.²³⁵ There have since been repeated calls by scholars and state tax officials for Congress to authorize the states to subject remote vendors to use taxation.²³⁶ Many of these commentators have suggested that Congress should require the states to unify and simplify their sales and use taxes along specified dimensions as a precondition for allowing the states to tax interstate e-commerce.²³⁷

Congress has so far shown little inclination to expand the states' ability to tax interstate commerce.²³⁸ When Congress has acted, it has generally adopted even greater nexus protections rather than facilitating state taxation of remote vendors.²³⁹ Nevertheless, many commentators continue to hope that Congress will eventually resolve the problems created by the *Quill* decision.²⁴⁰ The most noteworthy recent action along these lines is the “Main Street Fairness Act” sponsored by Senator Richard Durbin (D-IL) and Congressman Richard Conyers (D-MI).²⁴¹ The Main Street Fairness Act would authorize the states to extend their use taxes to reach remote vendors, but would only do so for states that agree to the Streamlined Sales and Use Tax Agreement – a multistate compact for simplifying and unifying sales and use taxes.²⁴²

We have argued that congressional action is unnecessary for the states to reach remote vendors with their use taxes as long as the states are willing to compensate the remote vendors

²³⁵ *Id.* at 346.

²³⁶ *E.g., Id.*; Edward Zelinsky, *New York Appellate Division Upholds ‘Amazon’ Law: Analysis*, 59 STATE TAX NOTES 93, 104 (2010).

²³⁷ See Walter Hellerstein, *Deconstructing the Debate Over State Taxation of Electronic Commerce*, 13 HARV. J.L. & TECH. 549, 550 (2000) (describing a “broad consensus among academic tax specialists regarding general principles” including the need for simplification to make destination-based taxation of sales feasible).

²³⁸ See, e.g., Cara Griffeth, *Streamlining Versus “Amazon” Laws: The Remote Seller Dilemma*, 55 STATE TAX NOTES 351, 352 (2010) (“Congress has historically been reluctant to address state revenue issues, preferring instead to leave tax administration to the states.”); John Swain & Walter Hellerstein, *The Political Economy of the Streamlined Sales and Use Tax Agreement*, 58 NAT’L TAX J. 605, 615 (2005).

²³⁹ John Swain, *State Sales and Use Tax Jurisdiction: An Economic Nexus Standard for the Twenty-First Century*, 38 GA. L. REV. 343, 370 (2003).

²⁴⁰ *E.g., Id.*; Edward Zelinsky, *New York Appellate Division Upholds ‘Amazon’ Law: Analysis*, 59 STATE TAX NOTES 93, 104 (2010).

²⁴¹ National Taxpayers Union, *Beware of Fiscal Potholes in Congress’s Latest “Mainstreet Fairness Act,” Taxpayer Group Warns*, PRESS RELEASE, July 29, 2011.

²⁴² *Id.* For discussion of the Streamlined Sales and Use Tax Agreement, we recommend: Frank Shafroth, *Has the SSTP Become Overburdened?* 55 STATE TAX NOTES 355 (2010); Brian Galle, *Designing Interstate Institutions: The Example of SSUTA*, 40 U.C. DAVIS L. REV. 1381 (2007); John Swain & Walter Hellerstein, *The Political Economy of the Streamlined Sales Tax Agreement*, 58 NAT’L TAX J. 605 (2005).

for all tax compliance costs thereby imposed. But if Congress does decide to pass legislation enabling the states to tax remote vendors – or if the courts rule against our proposed solution, making such action necessary – we would urge Congress to only allow the states to impose use tax compliance obligations on remote vendors if the states compensate the remote vendors for all tax compliance costs. Further, we would exhort Congress not to place any additional simplification or unification requirements on the states beyond conditioning the states’ ability to impose use tax compliance obligations on remote vendors on the states’ also compensating the remote vendors for all use tax compliance costs. Rather than forcing the states to adopt a specific form of simplification and unification as a precondition for taxing remote vendors, Congress should incentivize the states toward unification and simplification while maintaining flexibility for each state to decide how to balance the goals of simplification and unification against local interests that might call for divergent tax design.²⁴³ Hence, even if Congress decides to clarify the scope of the commerce clause, we would urge Congress to adopt our proposed approach as the best way forward for state taxation of e-commerce.

IV. Conclusion

We hope that our proposed solution of adequate vendor compensation will resolve the two decades of controversy over the scope of *Quill*. Yet it is worth pondering why no commentator has advocated for our proposed solution before now. Although previous vendor compensation schemes have been incomplete and inadequate, vendor compensation is not a new component of sales and use tax design.²⁴⁴ Why then has no one proposed full and adequate vendor compensation as a means for states to impose use tax compliance obligations on remote vendors without burdening interstate commerce? Indeed, when we have discussed our arguments with state tax practitioners, some have responded to our analysis with disbelief.²⁴⁵

Because the *Quill* majority partially justified *Quill*’s commerce clause holding based on *stare decisis*, some commentators appear to have concluded that *Quill* affirmed the entirety of the *Bellas Hess* physical presence rule.²⁴⁶ But the *Quill* decision very clearly overturned *Bellas*

²⁴³ See, e.g., Robert Plattner, Daniel Smirlock, & Mary Ladouceur, *A New Way Forward for Remote Vendor Sales Tax Collection*, 55 STATE TAX NOTES 187, 191 (2010) (“A major problem with the streamlined approach is that it offers a ‘one size fits all’ solution to states whose circumstances widely differ.”).

²⁴⁴ *Supra* notes 144-45 and accompanying text.

²⁴⁵ Other state tax practitioners have told us they find our analysis compelling. All have been surprised by our arguments.

²⁴⁶ E.g., Arthur R. Rosen & Matthew Hedstrom, *Quill – Stare at the Decision*, 60 STATE TAX NOTES 931, 932 (2011).

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Hess's physical presence rule with respect to the due process clause.²⁴⁷ Justice White, concurring in part and dissenting in part, criticized the majority's creating separate rules for the due process clause and the commerce clause as "an uncharted and treacherous foray,"²⁴⁸ noting that the Court had "never before found, as we do in this case, sufficient contacts for due process purposes but an insufficient nexus under the Commerce Clause."²⁴⁹

From the beginning, it has been understood that *Quill*'s separate holdings for the due process clause and the commerce clause means that Congress can authorize the states to tax remote vendors.²⁵⁰ Nevertheless, in light of Congress's failure to act, state tax practitioners have come to see *Quill* as a limitation on states' taxing powers. That *Quill* actually expanded states' taxing powers with respect to the due process clause has received comparatively little attention. Because *Quill* has come to stand so firmly in practitioners' minds as a victory for remote vendors, there has been little inquiry into the implications of *Quill*'s overturning of the physical presence rule with respect to the due process clause. Even those who argue that states should be able to tax remote vendors have focused their rhetoric on criticizing *Quill*'s commerce clause holding.²⁵¹

In contrast, we believe that *Quill*'s due process clause holding is potentially far more important than its commerce clause holding. The *Quill* majority made clear that they were upholding *Bellas Hess*'s physical presence rule with respect to the commerce clause because "it is not inconsistent with *Complete Auto* and our recent cases."²⁵² The *Quill* majority further explained that upholding the physical presence rule based on the commerce clause is compatible with *Complete Auto* because the physical presence rule serves to "limit the reach of state taxing authority so as to ensure that state taxation does not unduly burden interstate commerce."²⁵³ The *Quill* majority then cited *Bellas Hess* to explain that the potential burden on interstate commerce that justified the upholding of the physical presence rule results from the excess tax compliance costs that "might be imposed by the Nation's 6,000-plus taxing jurisdictions."²⁵⁴ By basing the potential burden on interstate commerce on excess tax compliance costs – rather than on direct tax costs – the *Quill* majority reconciled the physical presence rule with *Complete Auto*'s affirmation that it is "not the purpose of the commerce clause to relieve those engaged in

²⁴⁷ *Quill*, 504 U.S. at 308 ("Thus, to the extent that our decisions have indicated that the Due Process Clause requires physical presence in a State for the imposition of duty to collect a use tax, we overrule those holdings as superseded by developments in the law of due process.").

²⁴⁸ *Id.* at 325.

²⁴⁹ *Id.*

²⁵⁰ *Id.* at 318-19.

²⁵¹ *E.g.*, John Swain, *State Sales and Use Tax Jurisdiction: An Economic Nexus Standard for the Twenty-First Century*, 38 GA. L. REV. 343, 334-36 (2003).

²⁵² *Quill*, 504 U.S. at 311.

²⁵³ *Id.*

²⁵⁴ *Id.* at 313 n.6.

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interstate commerce from their just share of state tax burden even though it increases the cost of doing business.”²⁵⁵

As we have argued, the very steps the *Quill* majority took to demonstrate that upholding the physical presence rule under the commerce clause is compatible with *Complete Auto* necessarily limit the scope of the physical presence rule to applying only when remote vendors might be burdened by excess tax compliance costs. As a result, the physical presence rule should not apply if states fully and adequately compensate remote vendors for all tax compliance costs such that there is no potential for burdening interstate commerce. Any other interpretation of *Quill* would be incompatible with *Complete Auto* and would thus contradict the *Quill* majority’s justification for upholding the physical presence rule under the commerce clause because “it is not inconsistent with *Complete Auto* and our recent cases.”²⁵⁶

Quill’s expansion of state taxing powers with respect to the due process clause thus paves the way for our proposed solution of adequate vendor compensation as an effective and constitutional means for states to tax interstate e-commerce. We urge the states to adopt our proposed approach – either on its own, or in combination with the existing state Amazon-law strategies.²⁵⁷ Once the states begin to do so, we predict a rapid end to the sales and use tax exemption currently enjoyed by Amazon and the other major e-commerce vendors, moving us toward a more fair and efficient multistate sales and use tax regime.

²⁵⁵ *Complete Auto*, 430 U.S. at 279.

²⁵⁶ *Quill*, 504 U.S. at 311.

²⁵⁷ See *supra* Part III.B.