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# Closing the Use Tax Loophole: Why Consumer Self-Assessment Is a Viable Solution

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# CLOSING THE USE TAX LOOPHOLE: WHY CONSUMER SELF-ASSESSMENT IS A VIABLE SOLUTION


ABSTRACT

*With the surge in online shopping, use tax has become an increasingly elusive source of tax revenue for states. The constitutional constraints of due process and the Commerce Clause establish limits that often frustrate states' attempts to impose tax collection obligations on remote retailers. Due process is largely uncontroversial. It requires only that a retailer have minimum contacts with a state as to fairly fall under its taxing authority. The Commerce Clause has proven far more contentious, particularly after the Supreme Court's decision in* Quill v. North Dakota*. In* Quill*, the Court held that a state could only impose a collection obligation on a retailer that was physically present in the taxing state. The* Quill *decision has been chastised for grounding taxation on the seemingly arbitrary line of physical presence, particularly in an era where online transactions have largely obscured state lines.*

*This Comment analyzes post-*Quill *cases that exemplify the absurdity of treating local retailers differently from remote retailers that economically exploit the same market. The cases also demonstrate how physical presence is readily susceptible to manipulation from states and retailers alike, making it a wholly unsuitable mechanism for governing which retailers are susceptible to tax collection and which are not. The Comment then considers, and ultimately rejects, four alternative mechanisms that have been proposed by scholars. The Comment concludes by proposing a novel solution, which shifts the burden of use tax collection away from remote retailers and onto the consumer, allowing states to circumvent the Commerce Clause obstacle altogether.*

## INTRODUCTION

The tax gap—defined as the disparity between what taxpayers *should* pay and what they *do* pay[1]—has perpetually plagued state and federal governments alike. For states, one vital source of tax revenue, the use tax, has remained elusive since it was first enacted in the 1930s.[2] The use tax was intended to act as a corollary to the sales tax. While sales made *within* a state's borders are generally subject to a sales tax, the use tax purports to tax goods purchased by a state's residents *outside* state lines that are consumed within the state.[3] The frustration for states in collecting use tax revenue lies in the constitutional constraints of the Due Process and Commerce clauses that limit a state's ability to exercise its taxing authority over an out-of-state retailer.[4]

The states' frustrations were heightened after the 1992 Supreme Court case of *Quill v. North Dakota*.[5] In *Quill*, the Court created two formalistic nexus tests for due process and the Commerce Clause—the minimum contacts test and physical presence test.[6] Both tests must be satisfied before a retailer can come under a state's use tax jurisdiction.[7] This bifurcated analysis has led to considerable confusion among the lower courts over what constitutes physical presence.[8] Moreover, scholars have criticized basing tax collection obligations on the arbitrary distinction of whether a retailer is physically present in a state.[9] Such a test relieves high volume remote retailers who exploit a state's economic market from any tax liability while conferring no such benefit on brick-and-mortar stores located within state lines.

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1 DAVID M. RICHARDSON, JEROME BORISON & STEVE JOHNSON, CIVIL TAX PROCEDURE 94 (Paul L. Caron et al. eds., 2d ed. 2008).

2 Kathleen P. Lundy, Note, *The Taxation of E-Commerce: The Inapplicability of Physical Presence Necessitates an Economic Presence Standard*, 8 RICH. J.L. & TECH. ¶ 3 n.13 (2001).

3 Alexandrea Rose Finch, Note, *Slow Connections for E-Tailer Nexus: Bringing Sales and Use Taxes Up to Speed in an E-Commerce Economy*, 42 STETSON L. REV. 293, 299 (2012); *see also infra* Part I.

4 *See infra* text accompanying note 36.

5 504 U.S. 298 (1992).

6 *See id.* at 312–15.

7 *See id.* at 305–06.

8 *See infra* Part II.B.

9 *See, e.g.*, John A. Swain, *State Income Tax Jurisdiction: A Jurisprudential and Policy Perspective*, 45 WM. & MARY L. REV. 319, 325 (2003) ("[A]s technological advances permit more businesses to provide goods and services from remote locations, . . . jurisdictional rules based on an anachronistic physical presence test threaten the tax base and provide inappropriate tax avoidance opportunities."); Natasha Varyani, *Taxing Electronic Commerce: The Efforts of Sales and Use Tax to Evolve with Technology*, 39 OKLA. CITY U. L. REV. 151, 153 (2014) (characterizing the physical presence test as "a standard that is increasingly outdated as time passes").

Despite calls to overturn *Quill*, the Supreme Court has refused to hear a use tax case since its landmark decision. However, recently in *Direct Marketing v. Brohl*,[10] Justice Kennedy, in a concurring opinion, articulated concerns about the continuing validity of the physical presence test, and suggested that the Supreme Court may be willing to reconsider the issue.[11] According to Justice Kennedy, "[t]he Internet has caused far-reaching systemic and structural changes in the economy" and, "[a]s a result, a business may be present in a State in a meaningful way without that presence being physical in the traditional sense of the term."[12] As a result, Justice Kennedy denounced *Quill* for "inflicting extreme harm and unfairness on the States"[13] and urged the "legal system [to] find an appropriate case for this Court to reexamine [its holding]."[14]

This Comment identifies the shortcomings of the physical presence test and proposes a novel solution that obviates the need for a Commerce Clause analysis by shifting the burden of use tax collection away from remote retailers and onto the consumer. This Comment proceeds in four Parts. Part I distinguishes the use tax from the sales tax and explains why it has historically been an untapped source of tax revenue for the states. Part II provides an in-depth analysis of the *Quill* decision and evaluates post-*Quill* cases that exemplify the level of confusion created by the Court's physical presence test. Part III evaluates the merits of various solutions that have been proposed, as well as their inadequacies and shortcomings. Finally, Part IV proposes an alternative solution that would facilitate states' collection efforts without unduly hindering interstate commerce.

## I. DIFFERENTIATING THE USE TAX FROM THE SALES TAX

Most consumers are familiar with the sales tax. A consumer who goes to a store and picks up an item priced at $9.99 expects to pay more than that at the register. This excess cost is the sales tax, a consumption tax imposed on consumers by the state in which the sale occurs.[15] Today, forty-five states

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10 135 S. Ct. 1124 (2015).

11 *Id.* at 1134–35 (Kennedy, J., concurring).

12 *Id.* at 1135.

13 *Id.* at 1134.

14 *Id.* at 1135.

15 *See, e.g.*, GA. CODE ANN. § 48-8-30(b)(1) (2016) ("Every purchaser of tangible personal property at retail in this state shall be liable for a tax on the purchase at the rate of 4 percent of the sales price of the purchase.").

impose a sales tax on the sale of goods and services within their jurisdictions.[16] For these states, sales tax is a vital source of revenue, accounting on average for approximately 12% of the states' total revenues.[17] Economists have noted that the sales tax has proven more stable than state income taxes during economic downturns.[18] Moreover, sales tax is often a more immediate source of state revenue than the income tax or property tax because it can be "hidden" in prices and collected incrementally, rather than in an annual lump sum.[19] Notably, although sales tax is a tax imposed on *consumers*, it is *retailers* who often bear the burden of collection.[20] For administrative efficiency, states generally compel retailers to collect the tax on their consumers' behalf at the point of sale, and subsequently remit the payments to the state.[21]

With the advent of Internet technology, mail-order and e-commerce sales have taken a large chunk of market share from traditional brick-and-mortar stores.[22] Consumers are no longer limited to making purchases in the state in which they reside.[23] With the click of a mouse, a consumer in New York can purchase an item from a California retailer. Given the proliferation of online ordering, states have attempted to ensure that such purchases do not escape taxation.[24] However, in *McLeod v. J.E. Dilworth Co.*, the Supreme Court held that a state may not impose a sales tax on an out-of-state purchase made by one of its residents.[25] By implication, this meant that a state's residents could purchase goods from a state with a lower sales tax rate (or no sales tax at all), thus putting in-state retailers at a competitive disadvantage.[26] To sidestep such

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16 Finch, *supra* note 3, at 299. Only Alaska, Delaware, Montana, New Hampshire, and Oregon have not enacted sales tax legislation. *Id.* at 299 n.35.

17 *State and Local General Revenue, Percentage Distribution*, TAX POL'Y CTR. (June 20, 2016), http://www.taxpolicycenter.org/taxfacts/displayafact.cfm?Docid=508 (reporting statistics from 2013).

18 Timothy R. Hurley, *Curing the Structural Defect in State Tax Systems: Expanding the Tax Base to Include Services*, 61 MERCER L. REV. 491, 500 n.73 (2009) (explaining that sales tax is more revenue inelastic than income tax, partly because of the progressive income tax system that most states use, which leads to income tax revenues surging during boom times and declining rapidly during downturns).

19 Finch, *supra* note 3, at 298–99.

20 *See* H. Beau Baez III, *The Rush to the Goblin Market: The Blurring of* Quill*'s Two Nexus Tests*, 29 SEATTLE U. L. REV. 581, 588–89 (2006).

21 *Id.* at 589.

22 *See* Ricky Hutchens, Note, *Desperate Times Call for Desperate Measures: States Lead Misguided Offensive to Enforce Sales Tax Against Online Retailers*, 68 VAND. L. REV. 575, 578–79 (2015).

23 *See id.* at 578.

24 *Id.* at 580.

25 322 U.S. 327, 330 (1944) (explaining that such a sales tax would "involve[] an assumption of power by a State which the Commerce Clause was meant to end").

26 Baez, *supra* note 20, at 590–91. Such a scenario would also violate the tax policy of horizontal equity, which requires taxpayers with the same ability to pay to bear the same tax burden. *See* John A. Swain, *State*

concerns, states crafted an innovative solution: the use tax.[27] Instead of taxing the sale, the use tax purports to tax items that are purchased out of state but that are used or consumed in the taxing state.[28]

Because the use tax is a tax imposed on the consumer, states have two options for collection: (1) requiring consumers to self-assess and pay the tax directly to the state; or (2) requiring the out-of-state retailer to collect the use tax on the state's behalf at the point of sale.[29] The first option, self-assessment, is impracticable because consumers would have no incentive to report the tax.[30] To enforce the use tax, states would be required to audit out-of-state purchases made by their residents to assess whether the tax had been paid.[31] As one commentator noted, "[t]he costs associated with hiring auditors, selecting individuals for audit, conducting the actual audit . . . , and collecting the purportedly due amounts," would likely exceed the amount to be collected.[32] Thus, enforcement would be impracticable and essentially render the tax voluntary.[33] However, to impose the collection duty on out-of-state retailers—the second solution—the retailer must fall under the taxing state's jurisdiction so as not to violate principles of due process or the Commerce Clause.[34] Exactly what it takes to meet these two constitutional constraints in the context of use tax has been the subject of much debate,[35] and is discussed in the next Part.

## II. CONSTITUTIONAL LIMITATIONS ON IMPOSING USE TAX COLLECTION ON OUT-OF-STATE RETAILERS

Before a state can impose a use tax collection obligation on an out-of-state retailer, both substantive due process and the Commerce Clause require the retailer to have a "nexus" with the taxing state.[36] Thus, out-of-state retailers opposing the imposition of a collection obligation usually bring forth challenges

*Sales and Use Tax Jurisdiction: An Economic Nexus Standard for the Twenty-First Century*, 38 GA. L. REV. 343, 349 (2003).

27 All states that have a sales tax have enacted a complementary use tax. Baez, *supra* note 20, at 590.

28 Finch, *supra* note 3, at 299.

29 *Id.* at 300.

30 *Id.*

31 Timothy A. Hart, Note, *Taxing E-Commerce: The Sales and Use Tax Question*, 37 TULSA L. REV. 397, 400 (2001).

32 *Id.* at 400–01.

33 Finch, *supra* note 3, at 300.

34 Baez, *supra* note 20, at 582–83.

35 *See infra* Part II.

36 James L. Kronenberg, *A New Commerce Clause Nexus Requirement: The Analysis of Nexus in* Quill Corp. v. North Dakota, 1994 ANN. SURV. AM. L. 1, 2.

under both constitutional provisions.[37] Prior to 1992, courts held that the nexus requirements for the Due Process and Commerce Clauses were equivalent.[38] Accordingly, if a retailer had sufficient nexus with a state to satisfy due process, it was presumed to also satisfy the Commerce Clause nexus requirement.[39] However, in the landmark case *Quill v. North Dakota*, the Supreme Court overturned this presumption by essentially dividing the nexus analysis into two distinct tests.[40] This section first analyzes the reasoning behind the *Quill* decision. Next, it analyzes subsequent cases, exemplifying the level of confusion and controversy in the use tax arena that has erupted in *Quill*'s aftermath.

### *A. The* Quill *Decision*

In *Quill*, North Dakota tried to compel an out-of-state mail-order retailer to collect and remit use tax on sales made to North Dakota residents.[41] The retailer had economic presence in North Dakota; it solicited business by making telephone calls to North Dakota residents, mailing catalogues and flyers into the state, and conducting a national advertising campaign.[42] However, the retailer lacked a physical presence in North Dakota; it owned no real property and had no employees or agents in the state.[43] Thus, the retailer argued it lacked sufficient nexus with North Dakota under both due process and the Commerce Clause to be required to collect use tax on goods shipped into the state.[44]

For the first time, the Supreme Court distinguished the due process and Commerce Clause nexus requirements.[45] Although both constrained a state's taxing authority over out-of-state businesses, the two clauses implicated

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37 *See, e.g.*, Nat'l Geographic Soc'y v. Cal. Bd. of Equalization, 430 U.S. 551, 552–54 (1977) (involving a mail-order retailer challenging a use tax collection liability imposed by a foreign state under both Due Process Clause and Commerce Clause grounds); Town Crier, Inc. v. Dep't of Revenue, 733 N.E.2d 780, 782 (Ill. App. Ct. 2000) (involving a Wisconsin retailer opposing an assessed use tax liability on sales made to Illinois residents on both due process and commerce clause grounds).

38 *See, e.g.*, Nat'l Bellas Hess, Inv. v. Dep't of Revenue of Ill., 386 U.S. 753, 756, 765 (1967) (characterizing the nexus requirements for due process and the Commerce Clause as "closely related" and explaining that a retailer must be physically present in the taxing state to satisfy both provisions); Scripto, Inc. v. Carson, 362 U.S. 207, 210–11 (1960) (holding that an out-of-state retailer did have sufficient nexus with a state, without distinguishing between the constitutional clauses).

39 Kronenberg, *supra* note 36, at 2–3.

40 504 U.S. 298 (1992).

41 *Id.* at 301.

42 *Id.* at 302.

43 *Id.*

44 *Id.* at 303.

45 *Id.* at 305.

different policy concerns: fairness and hindrance of interstate commerce.[46] Accordingly, the Court made clear that each clause should be analyzed separately through its own distinct test.[47]

Due process is fundamentally concerned with notions of fairness.[48] Thus, the Court reasoned that the issue is whether an out-of-state business has sufficient contacts with the taxing state as to have "purposefully avail[ed] itself of the benefits of an economic market" in that state.[49] In this case, the Court held that the retailer's purposeful and continuous solicitation of business in North Dakota met the due process nexus requirement.[50]

In contrast, the Commerce Clause is concerned not with notions of fairness, but rather with whether "state taxes . . . hindered and suppressed interstate commerce."[51] To meet the Commerce Clause nexus requirement, the Court stated that a retailer must be physically present in the taxing state before any collection obligation could be imposed.[52] In this case, the Court held that the Commerce Clause nexus requirement had not been met because the retailer did not have a physical presence in North Dakota.[53]

*Quill* has been criticized for the lack of a logical connection between the physical presence nexus test and the policy justifications behind the Commerce Clause that purportedly justify the test.[54] For example, it is unclear how a warehouse owned by an out-of-state retailer within the taxing state somehow makes tax collection less burdensome on interstate commerce than if the retailer did not own the warehouse. The implication behind ownership of the warehouse

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46 *Id.*

47 *Id.* at 306.

48 *Id.* at 312.

49 *Id.* at 307. The Court equated the due process nexus requirement with the "minimum contacts" test for determining whether a state has in personam jurisdiction over a defendant. *Id.*

50 *Id.* at 308.

51 *Id.* at 312.

52 *Id.* at 315. The physical presence test had first been articulated in *National Bellas Hess v. Department of Revenue of Illinois*. 386 U.S. 753, 756 (1967). Because the facts in *Quill* were virtually indistinguishable from those in *National Bellas*, several commentators have opined that upholding precedent was one of the main motivations behind the *Quill* decision. *See, e.g.*, Swain, *supra* note 26, at 358 (characterizing "stare decisis [as] the crux of the *Quill* decision"). In fact, the *Quill* Court itself conceded that, "contemporary Commerce Clause jurisprudence might not dictate the same result were the issue to arise for the first time today." 504 U.S. at 311.

53 *Id.* at 319.

54 *See, e.g.*, Kronenberg, *supra* note 36, at 27 ("[T]he separate policy concerns underlying the two clauses are irrelevant because the nexus requirement triggers only the policy concerns of due process."). Justice White echoed this concern in his concurring opinion in *Quill*, explaining the lack of connection between the physical presence nexus rule and the Commerce Clause policy considerations that justified it. 504 U.S. at 327 (White, J., concurring).

is that the retailer should be presumed to be familiar with the state tax laws of the jurisdiction where the warehouse is located. However, this reasoning seems to address notions of fairness and notice under the Due Process Clause rather than the economic policy concerns behind the Commerce Clause. The true concern with burdening interstate commerce seems to arise from requiring remote retailers to comply with nonuniform substantive and administrative rules of a multitude of taxing jurisdictions.[55] Use tax rates and tax bases vary among the states.[56] For example, an item may be subject to sales and use tax in one state and exempt from tax in another.[57] Compounding the problem is the fact that states do not have one uniform tax rate.[58] Local jurisdictions within a state often impose taxes too, many with their own bases and procedural rules, adding to the complexity of compliance.[59]

The cornerstone of the physical presence test under *Quill* was to bring certainty and predictability in an area of the law that had previously been plagued by confusion and inconsistency.[60] The Court expressly considered and subsequently rejected a more flexible balancing test for determining nexus, instead preferring the benefits that came with adopting a bright-line rule.[61]

Although not expressly stated in *Quill*, many scholars have also opined that the Court's reasoning in rejecting a purely economic presence test for establishing nexus may reflect a desire to protect small retailers.[62] If economic nexus was sufficient, a small retailer that conducts low-volume sales in a state would be subject to high compliance costs that may exceed the amount of revenue it generates from the state or the taxes to be collected.[63] Thus, imposing a collection duty on small retailers may deter them from doing business in a

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[55] Swain, *supra* note 26, at 353–54.

[56] *Id.* at 353.

[57] Hart, *supra* note 31, at 418.

[58] *Id.*

[59] Currently 9646 jurisdictions impose a sales and use tax in the United States. Hutchens, *supra* note 22, at 579.

[60] 504 U.S. at 315. The Court reasoned that lack of precise guidelines for states regarding the reach of their taxing authority had led to this area of the law being "something of a 'quagmire'" and left "much room for controversy and confusion . . . to the States in the exercise of their indispensable power of taxation." *Id.* (quoting Nw. States Portland Cement Co. v. Minnesota, 358 U.S. 450, 457–59 (1959)).

[61] *Id.* at 316–17. These benefits included "reduc[ing] litigation," "encourag[ing] settled expectations," and "foster[ing] investment by businesses and individuals." *Id.* at 315–16.

[62] *See, e.g.*, Swain, *supra* note 26, at 363. The desire to enforce a tax collection obligation on only large vendors, who have the resources to comply with the procedures of multiple tax jurisdictions, conforms to the tax principle of vertical equity, which allows entities with a greater ability to pay to bear more of the tax burden. *See id.* at 349.

[63] *Id.* at 363.

foreign state and stilt economic growth. One scholar has criticized this rationale, noting that while the physical presence test may indeed protect these small retailers, it is over-inclusive because it also shields large remote vendors who conduct high-volume sales in a state from being subject to a tax collection liability.[64]

The Court concluded its analysis in *Quill* by conceding that Congress, not the courts, may be better suited for evaluating the burdens use tax collection imposes on interstate commerce.[65] By separating the nexus requirements for due process and the Commerce Clause, the Court essentially punted the issue to Congress.[66] However, to date, the lack of congressional action in this area has led to a litany of confusion and inconsistent outcomes in the cases following *Quill*, as discussed in the next section.

### *B. Repercussions of* Quill

Following *Quill*, the physical presence test has been the subject of much debate among legal commentators. Some commentators have argued in favor of keeping the bright-line rule, reasoning that a state's taxing authority needs to be constrained so as not to impede economic growth.[67] "[A] bright-line rule requiring physical presence cuts down on litigation costs, allows companies to reasonably forecast and plan for their state tax liabilities, and helps foster economic growth by reducing the tax burdens on businesses transacting across state lines."[68] Other commentators have characterized the rule as a "relic," reasoning that the growth of e-commerce has largely muddied state lines and rendered geography irrelevant in ways that the *Quill* Court could not have foreseen.[69] The artificiality of the test results in tax inequality; high-volume,

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64 *Id.* ("The physical presence test is not an effective tool for sorting out relative burdens among taxpayers.").

65 504 U.S. at 318.

66 Although Congress is prohibited from legislating around the Due Process Clause, it is free to regulate commerce, and thus could readily overturn the physical presence test articulated by the *Quill* court. Kronenberg, *supra* note 36, at 27.

67 *See, e.g.*, James F. Murtha, *Taxing Colonel Sanders: Re-Examining Constitutional Nexus Through the Lens of* KFC Corp. v. Iowa, 35 W. NEW ENG. L. REV. 55, 75 (2013). Murtha argues that the physical presence test should extend beyond the sales and use tax context and apply to all state-imposed taxes. *Id.* at 56. State courts are split on this issue. *Compare* Guardian Indus. Corp. v. Dep't of Treasury, 499 N.W.2d 349, 356 (Mich. Ct. App. 1993) (holding that the physical presence requirement is applicable to all taxes, not just sales and use tax), *with* Lanco, Inc. v. Div. of Taxation, 908 A.2d 176, 177 (N.J. 2006) (holding that the physical presence test is limited to sales and use tax, and does not extend to income taxes).

68 Murtha, *supra* note 67, at 75.

69 *See* Swain, *supra* note 26, at 392. Swain noted that "[i]n today's world, the notion that physical presence is a reasonable proxy for determining the level of a seller's compliance burdens is absurd . . . ." Paul L. Caron,

remote retailers are able to target a state's residents without being subject to a corresponding use tax collection obligation, leaving local businesses at a competitive disadvantage.[70]

Cases following *Quill* reveal many states' attempts to recover lost use tax revenue by stretching the concept of physical presence to bring as many out-of-state retailers under their jurisdiction as possible. The result has led to a watered-down physical presence test, which is a far cry from the bright-line rule and accompanying certainty that the *Quill* Court intended. The remainder of this section uses post-*Quill* cases to illustrate the uncertainty and divide between state courts as to what constitutes physical presence.

### 1. *Establishing Nexus for a Subsidiary Based on the Physical Presence of Its Parent Company*

With the growth in online shopping,[71] many retailers now have both brick-and-mortar stores and online platforms through which consumers can purchase merchandise.[72] These retailers often try to escape use tax liability by forming subsidiaries to operate their websites,[73] which are separate and distinct legal entities from the parent companies that do have physical presence in states through operation of retail stores.[74] This method of tax evasion is often characterized as "entity isolation."[75] Courts are split on whether states can transpose the physical presence of the parent companies onto its subsidiaries.

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*Pepperdine Hosts Symposium on the Most Maligned Supreme Court Decisions*, TAX PROF. BLOG (Apr. 1, 2011), http://taxprof.typepad.com/taxprof_blog/2011/04/supreme-mistakes.html (nominating *Quill* for being one of the most maligned Supreme Court tax decisions).

70 Swain, *supra* note 26, at 354.

71 *See* Laura Stevens, *Survey Shows Rapid Growth in Online Shopping*, WALL ST. J. (June 8, 2016, 12:03 AM), http://www.wsj.com/articles/survey-shows-rapid-growth-in-online-shopping-1465358582 (noting that consumers made 51% of their purchases online in 2016 compared with 48% in 2015 and 47% in 2014).

72 *See* Natasha Varyani, *Taxing Electronic Commerce: The Efforts of Sales and Use Tax to Evolve with Technology*, 39 OKLA. CITY U. L. REV. 151, 178 (2014) (characterizing retailers that have both a large number of physical stores and an online presence as "click-and-mortar retailers").

73 H. Beau Baez III, *Taxing Internet Sales: Trying to Make A Two-Thousand-Year-Old Jurisdiction Test Work in the Dot-Com Economy*, 64 TAX LAW. 807, 839–40 (2011).

74 *See Subsidiary*, INVESTOPEDIA, http://www.investopedia.com/terms/s/subsidiary.asp (last visited Jan. 24, 2017) (defining a subsidiary as "a company with voting stock that is more than 50% controlled by another company, usually referred to as the parent company" and noting that for taxation purposes a subsidiary is treated as a distinct legal entities from its parent).

75 Finch, *supra* note 3, at 294. Entity isolation has been criticized as "exalt[ing] form over substance, and . . . threaten[ing] the integrity of the state tax system." Swain, *supra* note 26, at 382. If courts allow entity isolation, it would permit savvy retailers to easily structure their organizations to avoid use tax liability on remote sales. *See* Finch, *supra* note 3, at 294.

For example, in *Borders Online v. State Board of Equalization*,[76] Borders operated traditional retail stores in California that sold books and music.[77] It also owned a subsidiary that ran a website, which sold the same products.[78] The activities of the two entities were integrated.[79] For example, customers who bought products online could return them at the retail store, and the retail store had a practice of referring customers to the website for further retail options.[80] The California Appellate Division upheld California's attempt to collect use tax on the online purchases, reasoning that the physical presence of the parent company in California could be imputed to the subsidiary for purposes of establishing a Commerce Clause nexus.[81]

However, in *St. Tammany Parish Tax Collector v. Barnesandnoble.com*,[82] the Eastern District of Louisiana reached a different result on facts similar to those in *Borders Online*. In this case, the court held that the physical presence of Barnes and Noble stores in Louisiana could not be imputed to the online sister company.[83] The Barnes and Noble stores accepted returned merchandise purchased from the sister company's website, but limited the returns to products that were also sold in its stores.[84] Despite the close corporate relationship between the two entities, the court refused to impute physical presence onto the online retailer.[85] The contrary holdings of the California and Louisiana courts leave little predictability about whether other state courts will sanction entity isolation as a viable loophole for escaping use tax collection.

### 2. *The Degree of Physical Presence Needed to Satisfy the* Quill *Test*

The *Quill* decision can also be criticized over its seemingly inconsistent stance on whether "any" or "some" physical presence is needed to satisfy the Commerce Clause nexus. On the one hand, the Court's intent to provide certainty and clear expectations for out-of-state retailers through a bright-line rule suggests that "any" physical presence should suffice.[86] However, the

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76 29 Cal. Rptr. 3d 176 (Cal. Ct. App. 2005).
77 *Id.* at 179.
78 *Id.*
79 *See id.*
80 *Id.* at 178.
81 *Id.* at 192.
82 481 F. Supp. 2d 575 (E.D. La. 2007).
83 *Id.* at 581–82.
84 *Id.* at 580.
85 *Id.* at 582.
86 *See* Quill Corp. v. North Dakota, 504 U.S. 298, 315–16 (1992).

Court's commentary in footnote eight of the decision suggests otherwise.[87] In the footnote, the Court addressed the presence of a few floppy disks in the taxing state that were owned by the remote retailer.[88] Although the disks were clearly tangible personal property, the Court rejected a "slightest presence" standard of constitutional nexus and stated that the disks were insufficient to meet the physical presence test.[89] The implication behind the Court's dicta[90] was that a retailer could maintain *some* physical presence in a state without falling under the state's taxing authority. This interpretation would essentially obliterate the bright-line rule that the Court intended and turn subsequent nexus analysis into a facts-and-circumstances test of how much physical property a retailer could own in a state before being subject to a collection obligation.

### 3. *The Use of Intangible Personal Property to Satisfy the Physical Presence Test*

The Supreme Court has not yet decided whether intangible property in a taxing state is enough to meet the physical presence test.[91] State courts have addressed the issue in contexts outside of sales and use tax. For example, in *KFC Corp. v. Iowa Department of Revenue*, KFC licensed trademarks to restaurant franchisees in Iowa.[92] Subsequently, Iowa tried to collect corporate income tax on revenue derived from the use of the trademarks in the state.[93] Because the tax was an income tax, and not a use tax, the Iowa Supreme Court could have disregarded the *Quill* physical presence test as inapplicable to the case at hand.[94] Instead, the court held that the licensing of intellectual property to resident franchisees gave KFC the functional equivalent of a physical presence in the state.[95] Thus, Iowa was free to impose a tax obligation on KFC without violating the Commerce Clause.[96]

This reasoning has been the subject of stark criticism—one commentator labeled the court's rationale as "semantic nonsense" and the suggestion that

87 *See id.* at 315 n.8.
88 *Id.*
89 *Id.*
90 North Dakota had not relied on the disks to establish the retailer's physical presence in the state, acknowledging that this would be a "slender thread upon which to base nexus." *Id.*
91 Baez, *supra* note 20, at 605.
92 792 N.W.2d 308, 310 (Iowa 2010).
93 *Id.*
94 *See supra* note 67.
95 *KFC Corp.*, 792 N.W. 2d at 324.
96 *Id.*

intellectual property can create the functional equivalent of physical presence as "oxymoronic."[97] What other states will do following *KFC Corp.* remains to be seen, but the case leaves open the possibility that some states will test the boundaries of physical presence even further in an attempt to bring more remote retailers under their taxing jurisdiction.

#### 4. *Whether Temporary Physical Presence Satisfies the Commerce Clause Nexus*

In *Quill*, the Court stated that physical presence in a taxing state can be established through "a small sales force, plant, or office."[98] However, it did not make clear whether such presence needs to be continuous before a company falls under a state's taxing authority. State courts are currently divided over this issue. For example, *Department of Revenue v. Share International*,[99] involved a Texas corporation that sent two of its officers to Florida for three days each year to sell merchandise at a trade show.[100] The Florida Supreme Court held that the three-day annual trade show visit was insufficient to create the requisite nexus required by the Commerce Clause.[101] In contrast, in *Orvis v. Tax Appeals Tribunal of the State of New York*,[102] the New York Court of Appeals held that New York could impose a use tax collection on a remote retailer who made an average of four visits to New York per year.[103] The court reasoned that the temporary presence of the retailer's representatives satisfied the *Quill* test.[104] The number of visits and length of the stay were irrelevant and contrary to the bright-line test that *Quill* sought to keep intact.[105]

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97 Adam B. Thimmesch, *The Fading Bright Line of Physical Presence: Did* KFC Corporation v. Iowa Department of Revenue *Give States the Secret Recipe for Repudiating* Quill*?*, 100 KY. L.J. 339, 379 n.267 (2012).

98 Quill Corp. v. North Dakota, 504 U.S. 298, 315 (1992).

99 676 So. 2d 1362 (Fla. 1996).

100 *Id.* at 1362–63.

101 *Id.* at 1363. The court's reasoning seems at odds with the bright-line rule established by *Quill*, falling instead under the very facts-and-circumstances analysis that the *Quill* Court had expressly rejected. *Quill*, 504 U.S. at 316–17; *see also In re* Appeal of Intercard, Inc., 14 P.3d 1111 (Kan. 2000). In *Intercard*, the Kansas Supreme Court held that eleven state visits by representatives of a Missouri based company over a three-year period did not "constitute a physical presence *sufficient to establish a substantial nexus with* [*Kansas*]." *Id.* at 1122 (emphasis added). The court's use of the word "sufficient" seems to obliterate *Quill*'s bright-line test in favor of a fact-specific analysis centered on how many in-state visits are adequate for a state to impose its taxing authority over a remote retailer. *But see supra* Part II.B.2 (discussing an inherent contradiction in the *Quill* decision, which suggests that a retailer can have "some" physical presence in a state without creating nexus).

102 654 N.E.2d 954 (N.Y. 1995).

103 *Id.* at 961–62.

104 *Id.* at 961.

105 *Id.* at 960–61 ("While a physical presence of the vendor is required, it need not be substantial.").

If temporary or sporadic visits to a taxing state satisfy the Commerce Clause nexus, it raises yet another question: how long does the nexus last?[106] Assume a remote retailer directs a salesperson to solicit sales in the taxing state for three months out of the year. If this constitutes the retailer's only physical presence in the taxing state, does its tax collection obligation end when the salesperson leaves the state, despite continued sales to the state's residents through the retailer's website? Again, states are divided on the issue, leaving retailers with little guidance as to when they may lawfully stop tax collection without incurring state penalties for noncompliance.[107]

## III. PROPOSED SOLUTIONS AND THEIR SHORTCOMINGS

As the above discussion demonstrates, the physical presence test has created a great deal of confusion, inconsistent outcomes, and uncertainty in the use tax arena. With the increase in online sales and ease of corporate restructuring as a tax-avoidance mechanism, the arbitrary line of physical presence seems particularly outdated. As a result, many states, along with several commentators, have called for an overhaul of the current use tax system and for *Quill* to be either legislatively or judicially overturned.

This Part evaluates the merits and shortcomings of four proposed solutions. First, it considers the economic nexus standard. Second, it considers the Streamlined Sales and Use Tax Agreement. Third, it evaluates Colorado's reporting statute. Finally, it considers the click-through nexus approach, first adopted by New York.

### *A. Economic Nexus*

#### *1. Overview*

Many legal commentators have proposed replacing physical presence with an economic nexus standard.[108] The concept of economic nexus first arose in

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[106] Baez, *supra* note 20, at 621.

[107] *Id.* at 622. For example, in Virginia, nexus ends at the same time the physical presence ends. *Id.* at 622 n.260. In contrast, in Indiana nexus can last perpetually. *Id.* at 622. In other states, nexus can continue for fixed time periods ranging from one year to five years after the physical presence that gave rise to the nexus ends. *Id.*

[108] *See, e.g.*, Julie M. Buechler, Note, *Virtual Reality:* Quill*'s "Physical Presence" Requirement Obsolete When Cogitating Use Tax Collection in Cyberspace*, 74 N.D. L. REV. 479, 479 (1998) (urging "Congress to establish a Commerce Clause nexus requirement based on an 'economic presence' rather than a physical presence"); Finch, *supra* note 3, at 320 ("[A] viable solution to the Internet-sales-tax problem requires . . . state

Justice Fortas's dissent in *National Bellas Hess v. Department of Revenue of Illinois*.[109] Justice Fortas reasoned that a state should have authority to impose a tax collection obligation on any retailer that engages in "large-scale, systematic, continuous solicitation and exploitation of the [state's] consumer market."[110] Since then, the scope of economic nexus has been refined. Some formulations require substantial economic exploitation of the taxing state's market,[111] while others require only minimal economic activity in the state.[112]

Intuitively, economic nexus makes sense. It avoids the arbitrary distinction of imposing a tax collection obligation on local merchants while allowing remote retailers who may derive greater economic benefits from the state's market to escape taxation. In theory, it also promotes tax equality. After all, "[i]f consumer purchases are to be taxed, then they all should be taxed to avoid discrimination and keep a level playing field."[113] Economic presence allows all sales to be taxed at the source and makes it administratively easy for states to collect its sales and use tax revenue whether derived inside or outside of state lines. Indeed, many states have applied economic nexus outside the sales and use tax context, asserting that the *Quill* physical presence rule is not applicable to all state taxation.[114]

### 2. *Shortcomings*

Despite academic and state support for adopting economic nexus, the approach has at least three shortcomings. First, economic presence may actually

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autonomy . . . through an economic-nexus approach."); Swain, *supra* note 26, at 393 ("For sales and use taxes . . . jurisdiction to tax should be predicated on economic activity.").

[109] 386 U.S. 753, 761–62, 765–66 (1967) (Fortas, J. dissenting), *overruled by* Quill Corp. v. North Dakota, 504 U.S. 298 (1992).

[110] *Id.* at 761–62.

[111] *See, e.g.*, Christina R. Edson, Quill*'s Constitutional Jurisprudence and Tax Nexus Standards in an Age of Electronic Commerce*, 49 TAX LAW. 893, 945 (1996) (defining substantial economic nexus as "purposeful, direct, and frequent exploitation of a state's market").

[112] *See, e.g.*, Swain, *supra* note 26, at 345 ("[*A*]*nyone* making taxable sales to consumers within the taxing jurisdiction should have a collection obligation, subject to a de minimis threshold." (emphasis added)).

[113] *Id.*

[114] *See, e.g.*, Tax Comm'r v. MBNA Am. Bank, N.A., 640 S.E.2d 226, 232 (W. Va. 2006) ("*Quill*'s physical-presence requirement for showing a substantial Commerce Clause nexus applies only to use and sales taxes and not to business franchise and corporation net income taxes."); *see also supra* note 67. This reasoning has been criticized. *See* R. Todd Ervin, Comment, *State Taxation of Financial Institutions: Will Physical Presence or Economic Presence Win the Day?*, 19 VA. TAX REV. 515, 543–44 (2000) (arguing that a more stringent nexus standard should be imposed on direct taxes, such as income taxes, than for use taxes, not vice versa because direct taxes are directly borne by the remote retailer, as opposed to use taxes, which are borne by the purchaser and merely collected by the retailer).

increase tax inequality instead of leveling the playing field as its proponents contend. By and large, brick-and-mortar stores only conduct sales in the jurisdictions where they are located and thus would only be subject to those jurisdictions' tax laws.[115] In contrast, remote retailers often solicit sales nationwide. Requiring these retailers to comply with the laws of thousands of different taxing jurisdictions would be unduly burdensome and may even deter small retailers from engaging in interstate commerce altogether.[116] Thus, by trying to end tax inequality between remote and local merchants, economic nexus would actually swing the pendulum the other way, leaving the remote merchants with the competitive disadvantage.[117]

Second, adopting economic nexus would blur the distinction between due process and the Commerce Clause. A retailer's systematic economic exploitation of a taxing state is currently sufficient to satisfy due process.[118] Imposing the same standard for the Commerce Clause would essentially result in one test for assessing the constitutionality of a state imposed tax collection duty.[119] However, the *Quill* Court emphasized the need for separate analyses based on the different policy justifications behind the two provisions.[120] In fact, proponents of *Commerce Clause* economic nexus often assert fairness, a *due process* concern, to justify their position.[121] Although it may be "fair" to impose a collection duty on a remote retailer because of the economic benefits it receives from the taxing state, the constitutionality of the tax should not be determined before considering the effect on interstate commerce.[122] Thus, broadening nexus to encompass economic activity without any corresponding attempt to reduce the tax compliance burdens on the out-of-state retailer is an inadequate solution.

Finally, economic nexus would require setting quantitative thresholds, a determination better left to legislators than the courts. Proponents of economic nexus usually agree that a de minimis exception is needed to protect small

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115 *See* Neil V. Birkhoff, *Beyond BATSA: State Taxation Without State Boundaries?*, 67 WASH. & LEE L. REV. 341, 350 (2010).

116 *See id.*

117 *Id.*

118 Quill Corp. v. North Dakota, 504 U.S. 298, 307 (1992).

119 Ervin, *supra* note 114, at 537.

120 *See Quill*, 504 U.S. at 305–06.

121 *See, e.g.*, Buechler, *supra* note 108, at 506 ("[P]rinciples of equity and justice compel[] every foreign merchant to support the economic and environmental stability of the local markets in which it chooses to conduct business.").

122 Ervin, *supra* note 114, at 537.

retailers in situations where the cost of collection exceeds the benefits.[123] Proposed thresholds are normally based on a retailer's gross sales receipts or the percentage of business the retailer does in a jurisdiction.[124] Because courts are ill-equipped to establish such arbitrary thresholds[125] and because of Congress's lack of action in this area, the feasibility of formulating a workable economic nexus standard is questionable.

### *B. Streamlined Sales and Use Tax Agreement*

#### *1. Overview*

With dwindling sales and use tax revenues[126] and lack of any judicial[127] or congressional action in this area, states have joined efforts to enact their own solution to the problem. The Streamlined Sales and Use Tax Agreement (SSUTA) is a multi-state initiative organized by the National Governors Association and the National Council of State Legislatures.[128] The goal of the agreement is to "simplify and modernize sales and use tax administration in the member states to substantially reduce the burden of tax compliance."[129] To achieve this goal, SSUTA requires each member state to have a uniform tax base and tax rate within the state and to administer all collections at the state, not local, level.[130] The result is that remote retailers that comply with SSUTA need only be familiar with one set of tax rules per state and need only file a single tax return for each state in which they operate.[131] SSUTA also seeks to ease

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[123] *See, e.g.*, Swain, *supra* note 26, at 354–55 ("[A] de minimis threshold is needed, below which it is simply too bothersome and expensive to collect the tax.").

[124] Finch, *supra* note 3, at 321 (proposing that remote retailers would be exempt from collecting use tax if they generated less than $500,000 in annual gross national remote sales, and if less than 10% of those sales came from the taxing state).

[125] *See* Swain, *supra* note 26, at 364 ("[C]ourts are usually limited to using qualitative or linguistic distinctions (*e.g.*, physical presence) as surrogates for more finely tuned legislation.").

[126] *See* Jackson Brainerd, *As Consumers Increasingly Shop Online, Many State Lawmakers Say the Sales Tax Is No Longer a Reliable Source of Revenue*, NAT'L CONF. OF ST. LEGISLATURES (June 1, 2016), http://www.ncsl.org/bookstore/state-legislatures-magazine/taxed-spent.aspx.

[127] The Supreme Court has not granted certiorari to a use tax nexus case since its landmark decision in *Quill* over two decades ago.

[128] Jessica Nicole Cory, *The Gap Created by E-Commerce: How States Can Preserve Their Sales and Use Tax Revenue in the Digital Age*, 8 OKLA. J.L. & TECH. 57 (2012).

[129] Finch, *supra* note 3, at 311 (citing STREAMLINED SALES AND USE TAX AGREEMENT § 102 (STREAMLINED SALES TAX GOVERNING BD., INC., amended 2010), http://www.streamlinedsalestax.org/index.php?page=modules).

[130] Swain, *supra* note 26, at 373.

[131] Cory, *supra* note 128.

administrative burdens by providing retailers with sales tax administrative software and reimbursement for other reasonable collection costs.[132]

Because Congress has not approved SSUTA, states cannot mandate a use tax collection obligation on remote retailers without violating the Commerce Clause.[133] Instead, states are limited to providing incentives to these retailers in the hopes they comply with the initiative voluntarily.[134] These incentives include diminished burdens of complying with thousands of tax jurisdictions and amnesty on all previously unremitted use tax.[135] Twenty-four states have currently enacted legislation in conformance with SSUTA.[136] Proponents argue that by reducing the compliance burden of tax collection on remote retailers, SSUTA could "cause the physical presence test 'to die a quiet death' even in the absence of Congressional action."[137]

### 2. *Shortcomings*

Despite the allure of a simplified use tax regime that could obviate existing nexus rules, SSUTA has fallen short of expectations. One of its main flaws is the lack of participation by some of the largest and most populated states.[138] California, Florida, Texas, and New York, along with twenty-two other states, have declined membership.[139] These states likely determined that the costs of altering their tax codes to conform to SSUTA exceed any potential revenue gains.[140] Equally problematic is that SSUTA depends on voluntary compliance by remote retailers.[141] Because *Quill* provides a safe haven from tax collection to remote retailers with no physical presence in a state, compliance runs contrary to their economic interests.[142]

Another critique of SSUTA is that it encroaches on states' rights to design their own use tax regimes, which has traditionally been an area of state law.[143] Although SSUTA does not require one uniform tax rate among all of the states,

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132 *Id.*
133 *See* Finch, *supra* note 3, at 317.
134 *See* Hutchens, *supra* note 22, at 600–01.
135 *See id.* at 601.
136 *Id.* at 593.
137 Swain, *supra* note 26, at 346 (footnote omitted).
138 Hutchens, *supra* note 22, at 601.
139 *Id.* at 601 n.181.
140 *Id.* at 601.
141 *See id.* at 600.
142 *Id.* at 601.
143 *See* Finch, *supra* note 3, at 319.

it imposes other interstate uniformity restrictions that all member states must abide by.[144] These include "uniformity in returns, remittance procedures, bad debt rules, rounding rules, exemption certificates, and seller registration procedures."[145] Because member states must conform their tax laws to comply with these restrictions, SSUTA can be seen as an attempt to diminish state sovereignty.

### *C. Colorado's Reporting Approach*

#### *1. Overview*

Colorado has proposed a novel solution to the use tax problem, which shifts the burden of paying the tax away from the retailer and onto the consumer.[146] The Colorado statute gives remote retailers a choice: either collect and remit use tax directly to the state, or comply with reporting requirements intended to increases tax compliance by the consumer.[147] If the retailers elect the latter, they must comply with three separate reporting obligations.[148] First, at the point of sale, the retailer must notify the consumer that the purchase is not exempt from use tax just because it is made remotely, and that the consumer has a duty to self-report and pay the tax directly to Colorado.[149] Second, the noncollecting retailer must send an annual notice to each Colorado consumer that her purchases are subject to Colorado use tax.[150] Third, each retailer must send a similar annual notice to the Colorado Department of Revenue.[151]

By not imposing a collection duty on remote retailers, the Colorado legislation is intended to circumvent the *Quill* nexus requirement altogether. In *Direct Marketing Association (DMA) v. Huber*,[152] DMA challenged the statute as placing an undue burden on interstate commerce and violating the Commerce Clause.[153] The Colorado District Court ruled in DMA's favor but the Tenth Circuit Court of Appeals reversed, holding that Colorado's use tax reporting

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144 Swain, *supra* note 26, at 372.

145 *Id.* at 378 (footnotes omitted).

146 Joel Griffiths, Comment, *Use It or Lose It: State Approaches to Increasing Use-Tax Revenue*, 60 U. KAN. L. REV. 649, 661 (2012).

147 *Id.*

148 *See* COLO. REV. STAT. § 39-21-112(3.5) (2016).

149 *Id.*

150 *Id.* The notice must be mailed first-class, be prominently labeled "Important Tax Document Enclosed," and include purchase dates and amounts, as well as whether the goods are tax exempt or nonexempt. *Id.*

151 *Id.*

152 No. 10-CV-01546-REB-CBS, 2012 WL 1079175 (D. Colo. Mar. 30, 2012).

153 *Id.* at *2.

regime was constitutional.[154] The Tenth Circuit narrowly interpreted the physical presence requirement in *Quill* to apply only to use tax *collection*, and to impose no such impediment on the *reporting* mandate in Colorado's statute. Having determined that *Quill* was not controlling, the Tenth Circuit went on to hold that the reporting regime did not discriminate against remote retailers and that it did not unduly burden interstate commerce.

### 2. *Shortcomings*

One of the main flaws of Colorado's approach is that imposing such onerous reporting obligations on remote retailers is no less burdensome than actual use tax collection.[155] Indeed, it may be less burdensome to collect the tax at the point of sale and periodically remit payments to the taxing state than to comply with three separate notification requirements with the specificity required by the Colorado statute. Thus, while on its face the legislation purports to give retailers a choice between reporting and collection, it may actually just be a guise to compel collection. This burden would be compounded if other states enacted similar legislation, each with its own distinct notification mandates.[156]

Feasibility is another concern with Colorado's approach. Taxing revenue at the source and collecting it from the retailer is more administratively practical for states than hunting down consumers up to a year after the sale. Colorado must assess whether the revenue it received could justify the cost of collection.[157] Splitting enforcement of the use tax into two distinct procedures

[154] Direct Mktg. Ass'n v. Brohl, 814 F.3d 1129, 1132 (10th Cir. 2016). The Tenth Circuit Court of Appeals initially overturned the district court, holding that the federal Tax Injunction Act (TIA) barred federal court jurisdiction over the case. Direct Mktg. Ass'n v. Brohl, 735 F.3d 904, 920–21 (10th Cir. 2013), *cert. granted*, 134 S. Ct. 2901 (2014), *rev'd*, 135 S. Ct. 1124 (2015). TIA prohibits federal courts from enforcing any law that relates to the "assessment, levy or collection" of a state tax. *Id.* at 910 (citing 28 U.S.C. § 1341). The Supreme Court unanimously overturned the Tenth Circuit's interpretation of the TIA, holding it to be erroneously broad. Direct Mktg. Ass'n v. Brohl, 135 S. Ct. 1124, 1132 (2015). The Court remanded the case back to the Tenth Circuit to decide the case on its merits. *Id.* at 1134.

[155] Finch, *supra* note 3, at 314.

[156] Sara Schoenfeld, *Much Ado About Nexus: The States Struggle to Impose Sales Tax Obligations on Out-of-State Sellers Engaged in E-Commerce*, 24 FORDHAM INTELL. PROP. MEDIA & ENT. L.J. 263, 308 (2013).

[157] *See* Cory, *supra* note 128 ("[J]ust because a state would receive information about remote purchasers under this approach, 'it is not clear how [this receipt] will transfer into revenue,' as 'states may not have the resources to receive and properly analyze such an enormous quantity of reports.'" (quoting Sally P. Schreiber, *Colorado's "Amazon" Law Requiring Out-of-State Retailers to Report Sales Held to Be Unconstitutional*, J. ACCT. (Apr. 5, 2012), http://www.journalofaccountancy.com/Web/20125445.htm)).

conducted by two separate parties—notification by the retailer and collection by the state—also raises issues of economic inefficiency.[158]

### *D. New York's Click-Through Nexus Approach*

#### *1. Overview*

In an attempt to stay within the legal framework of *Quill*, some states have sought to increase tax revenues by broadening the scope of physical presence.[159] Remote retailers routinely enter into marketing arrangements with in-state residents, called marketing affiliates, to gain increased publicity and sales within the state.[160] The affiliates typically use Internet marketing methods to direct traffic to the retailer's website and are paid a commission for all sales that they help generate.[161] In 2008, New York enacted legislation that imputed the affiliate's physical presence in the taxing state to the retailer.[162] The New York law created a rebuttable presumption of Commerce Clause nexus if the remote retailer entered into a marketing agreement with an in-state affiliate that resulted in over $10,000 of annual gross sales.[163]

In *Amazon.com v. New York State Department of Taxation and Finance*,[164] Amazon challenged the statute under the Commerce Clause.[165] In upholding the law, the court distinguished between advertising—which is not sufficient to create nexus—and active solicitation of sales—which is sufficient—holding that the affiliates fell under the latter category.[166] After this decision, several states, including Arkansas, Connecticut, North Carolina, and Rhode Island, enacted similar legislation.[167]

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158 *See* Swain, *supra* note 26, at 349 ("[A]nother goal of good tax policy is to minimize the interference of a tax with the economic decisions that would be made in an otherwise efficient market.").

159 *See supra* Part II.B.2 (discussing other ways that states have tried to expand the concept of physical presence to bring more retailers under their taxing jurisdiction).

160 Finch, *supra* note 3, at 308.

161 *Id.*

162 *See* Schoenfeld, *supra* note 156, at 297–98; *see also supra* Part II.B.1 (discussing the related concept of entity isolation, where a parent can impute its physical presence in a state onto its subsidiary).

163 *See* N.Y. TAX LAW § 1101(b)(8)(vi) (McKinney Supp. 2015).

164 913 N.Y.S.2d 129 (N.Y. App. Div. 2010).

165 *Id.* at 135.

166 *Id.* at 138–39 ("[I]mportan[t] to the requirement that the out-of-state vendor have an in-state presence is that there must be solicitation, not passive advertising.").

167 Schoenfeld, *supra* note 156, at 297–98.

### 2. *Shortcomings*

As with economic nexus, click-through nexus seems to address the due process issue of fairness—whether it is *fair* to tax a retailer that actively solicits sales in a state—instead of tackling the economic concerns underlying the Commerce Clause. The court's reasoning in upholding the New York law in *Amazon.com* also seems suspect.[168] After all, it is incongruous to compel a retailer that *solicits* sales in the taxing state to tax collection, but to relieve a retailer that *advertises* in that state of the same obligation. Drawing such a vague and arbitrary line surely results in the same predicament as *Quill*—with an ad hoc standard that is easily manipulable.[169] For example, to impute nexus on a retailer through its marketing affiliate, the agreement between the two parties must be commission based, rather than being a flat fee.[170] Thus, retailers could easily bypass the collection duty by simply changing their compensation structure.[171] Retailers could also avoid nexus by ending their affiliate relationships in states that decide to adopt the click-through nexus approach. Ultimately, the New York approach succeeds only in stretching the concept of physical presence a little further. It sidesteps the issue of burdens on interstate commerce altogether and brings only those retailers with marketing affiliates in a state under that state's taxing authority. For this reason, it is an unviable and wholly inadequate solution to *Quill*.

## IV. AN ALTERNATIVE SOLUTION

The problems that have arisen with the *Quill* physical presence test and the shortcomings of each proposed alternative underscore the need for a novel solution to the use tax issue. This Part offers such a solution through a three-step procedure. The first step explains why having a Commerce Clause nexus requirement that is distinct from the due process nexus requirement is superfluous. Instead, the nexus analysis should be limited to due process. The second step eliminates Commerce Clause concerns altogether by imposing only minimal reporting requirements on remote retailers. The third step then shifts

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168 *Amazon.com*, 913 N.Y.S.2d at 138–39.

169 *See supra* Part II.B.

170 *Amazon.com*, 913 N.Y.S.2d at 133, 138 (noting that a state may only impose a use tax obligation on an out-of-state retailer who engages in business with an in-state marketing affiliate when that affiliate is paid commission rather than a flat fee).

171 *See* Swain, *supra* note 26, at 350 (explaining that "tax rules that give rise to tax-motivated transactions, as well as tax rules that alter the method by which persons would otherwise do business" violate the tax policy concern of efficiency).

the burden of use tax to the states themselves. The Part concludes by identifying problems that may arise if this proposal is implemented and explains why it remains a viable solution despite these potential pitfalls.

### *A. Step 1: Eliminate the Commerce Clause Nexus Requirement Altogether*

Prior to *Quill*, courts imposed only one nexus requirement for the due process and the Commerce Clause analysis. Although remote retailers often challenged collection of use tax under both clauses, courts analyzed them concurrently.[172] In *Quill*, the Court rejected this notion, explaining that the two standards implicate very different constitutional policies and thus should be analyzed distinctly.[173] Due process is based on the fairness of a state exercising control over each *individual* retailer.[174] Accordingly, due process nexus requires a retailer to have minimum contacts with the taxing state so as not to offend "traditional notions of fair play and substantial justice."[175] In contrast, Commerce Clause concerns center on *broader* economic activity.[176] Under the Commerce Clause, states are prohibited from unduly burdening interstate commerce and the free flow of goods across state lines.[177] The *Quill* Court held that Commerce Clause nexus requires a retailer to have a physical presence in the taxing state.[178]

As explained earlier, the Court's bifurcated nexus approach has led to a great deal of confusion and inconsistent outcomes in the use tax arena.[179] Underpinning this confusion seems to be the lack of logical connection between the physical presence test for Commerce Clause nexus and the economic concerns that the Court used to justify it. For example, suppose two Internet retailers make identical nationwide sales. Each retailer mails marketing materials to each state and benefits from each state's economic market. Such contacts are sufficient to satisfy due process nexus. The first retailer also has a sales agent in all forty-five states that impose sales and use taxes. As a result, under the physical presence Commerce Clause test, it would be subject to a collection obligation in each of those states. Conversely, the second retailer has

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172 *See supra* note 38 and accompanying text.
173 Quill Corp. v. North Dakota, 504 U.S. 298, 312 (1992).
174 *Id.*
175 *See id.* at 307 (citing Int'l Shoe Co. v. Washington, 326 U.S. 310, 316 (1945)).
176 *See id.* at 312.
177 *See id.* at 313 ("[The Commerce Clause requirement] is not, like due process' 'minimum contacts' requirement, a proxy for notice, but rather a means for limiting state burdens on interstate commerce.").
178 *See id.* at 314.
179 *See supra* Part II.

only one sales agent located in one state. Consequently, it would escape its collection obligation in the remaining forty-four states. From an economic standpoint, the disparate treatment between the two retailers is unwarranted. After all, why does the use tax on the former retailer not burden interstate commerce while the tax on the latter does? The only difference between the two retailers is their number of contacts with each state. However, focusing on the level of contacts of each individual retailer erroneously implicates fairness, a due process concern. Fairness is wholly irrelevant to the economic justifications behind the Commerce Clause.

Post-*Quill* cases demonstrate courts' tendencies to mistakenly import fairness considerations into the Commerce Clause inquiry. For example, in *Brown's Furniture v. Wagner*,[180] the Supreme Court of Illinois upheld a statute that required a Missouri retailer to collect use tax on sales made to Illinois residents.[181] In applying the physical presence test, the court looked at the number of contacts the retailer had purposefully made with Illinois residents.[182] By making 942 deliveries into Illinois over a ten-month period, the retailer had "sufficient physical presence . . . to establish a [Commerce Clause] nexus with the State."[183] The court's emphasis on the number and frequency of contacts seems more akin to a fairness due process analysis than to one centered on economic Commerce Clause concerns. Indeed, despite the lip service it paid to the *Quill* decision by stating that the due process and Commerce Clause nexus requirements differed, the court's analysis suggests otherwise.[184] The court used the same facts to analyze due process as it used to analyze the Commerce Clause, explaining that due process nexus was met because the retailer's deliveries into the state had not been "occasional" or "sporadic."[185]

*Brown's Furniture* illustrates the redundancy of having two separate nexus tests.[186] Nexus by definition requires focusing on the degree of contact between an individual retailer and a taxing state. Such a microscopic analysis implicates

180 665 N.E.2d 795 (Ill. 1996).
181 *Id.* at 798.
182 *Id.* at 803.
183 *Id.*
184 *Id.* at 802.
185 *Id.* at 804. The court distinguished the case from *Miller Brothers Co. v. Maryland*, 347 U.S. 340 (1954), which had prohibited Maryland from compelling a remote retailer to collect a use tax on its behalf solely on due process grounds. *Brown's Furniture*, 665 N.E.2d at 803.
186 In *Town Crier Inc. v. Dep't of Revenue*, the court recognized this redundancy by asserting, "[s]ince we have already determined that the use tax assessed against plaintiff passes contemporary commerce clause scrutiny, we could also find that it is a foregone conclusion that the assessment satisfied due process scrutiny as well." 733 N.E.2d 780, 787 (Ill. App. Ct. 2000).

only due process fairness concerns. Due process nexus requires a facts-and-circumstances analysis that centers on whether a particular retailer has purposefully availed itself to the economic benefits of a state, making it fair to subject that retailer to the state's taxing jurisdiction. Once fairness has been established, the notion of nexus loses its utility. Nexus is ill-suited to assess whether imposing a tax collection obligation on remote retailers unduly hinders the national economy. This broader economic concern comes from the complexity of compelling remote retailers to comply with the laws of myriad taxing jurisdictions.[187] If this concern could be eliminated or substantially reduced, the need for a Commerce Clause standard would be eradicated. Step two explains how to diminish the burden on interstate commerce.

### *B. Step 2: Consolidate the Colorado and SSUTA Approaches and Create a Simplified Reporting System for Remote Retailers*

Most proposals that have attempted to reduce the tax compliance burden have focused on simplifying collection and remittance procedures for remote retailers. For example, under the SSUTA approach, participating states must conform to certain uniform substantive and procedural tax rules.[188] SSUTA requires both intrastate and interstate tax uniformity. Examples of intrastate uniformity are a single state-level tax rate[189] and equivalent tax bases at the state and local level.[190] Examples of interstate uniformity include centralized software intended to ease registration and remittance procedures for retailers.[191] Consolidating state tax codes certainly eases the compliance burden on remote retailers. The problem is that it hinders states and local jurisdictions from creating their own tax regimes and therefore is subject to federalism challenges.

This Comment proposes that states only impose minimal *reporting* requirements on remote retailers. As discussed in step three, the burden of use tax *collection* would fall on the states themselves. The benefits of third-party reporting are evident from the analogous requirements of the Internal Revenue Code (IRC), which governs federal income tax. For certain transactions, the IRC imposes information *reporting* obligations on third-parties without imposing a

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187 *See supra* notes 56–59 and accompanying text.

188 *See* STREAMLINED SALES AND USE TAX AGREEMENT § 102 (STREAMLINED SALES TAX GOVERNING BD., INC., 2014) [hereinafter SSUTA], http://www.streamlinedsalestax.org/uploads/downloads/Archive/SSUTA/SSUTA%20as%20Amended%20Through%20October%208,%202014.pdf.

189 *Id.* at § 308.

190 *Id.* at § 302.

191 *See id.* at § 501.

corresponding *withholding* obligation. These transactions include payment of dividends and interest[192] and payment of certain real estate transfers.[193] Third-party information reporting in the federal income tax arena has become a powerful tool for improving voluntary tax compliance and collections. "According to the IRS, . . . [a]mounts subject to third-party reporting but not withholding—such as interest and dividends—have a net misreporting rate of 4.5%. . . . Misreporting skyrockets—up to a 53.9% rate—for items subject to neither information reporting nor withholding."[194]

This proposal essentially mimics the information reporting requirements of the IRC by requiring remote retailers to annually report sales made to out-of-state residents, both to the resident and to the taxing state. Retailers would transmit reports to the taxing states through a centralized reporting software, similar to the streamlined administration software used by SSUTA.[195] The objectives behind the reporting software would match those behind the SSUTA software—reducing costs and administrative burdens—but would center on simplifying reporting procedures in lieu of collection. The reporting software would allow retailers to send consumer information to each state in an identical format, and to be relieved from the burden of complying with a multitude of diverse state reporting requirements. Like the SSUTA software, the states would bear the cost of the software, making compliance simple and inexpensive. Retailers would only be left with the costs of time spent in compiling and submitting the required consumer data to the states, as well as mailing the information returns to consumers.

Unlike the onerous reporting requirements imposed by the Colorado statute, the reporting requirements under this proposal would be minimal. For example, the Colorado statute requires remote retailers to notify the Colorado Department of Revenue of any sales made to Colorado residents.[196] In addition, retailers must notify consumers of their use tax obligations, once at the time of sale and again through an annual written notice.[197] Complicating matters further, retailers must provide micro-level information about each purchase, including whether the

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192 I.R.C. § 6042 (2012).

193 I.R.C. § 6045(e) (2012). In a real estate transaction, the attorney or title company responsible for closing the transaction is required to file a statement with the Internal Revenue Service containing information about the transferor of the property, a description of the property, the date of closing, and the "gross proceeds" received or to be received. *Id.*

194 RICHARDSON, BORISON & JOHNSON, *supra* note 1, at 97.

195 *See supra* note 132 and accompanying text.

196 *See* COLO. REV. STAT. § 39-21-112(3.5) (2016).

197 *Id.*

goods are tax-exempt, which differs depending on each state's and local jurisdiction's tax base.[198] Conversely, creating a SSUTA-like centralized system would allow remote retailers to report sales made to a taxing state's residents only once per year. Further, retailers would be required to provide only information that they should readily have, including the name and address of each customer, and the date and amount of each purchase.

Moreover, this proposal would help restore some of the predictability and consistency that was the impetus behind *Quill*'s bright-line physical presence test. Since *Quill*, retailers have tried to circumvent physical presence through methods such as entity isolation.[199] Conversely, many states have attempted to include more retailers under their taxing jurisdiction by broadening the notion of physical presence. Some states, for example, have argued that minimal or temporary physical presence in the taxing state suffices to meet the test, which has been met with mixed results from the courts.[200] As a result, states and retailers have been left with only vague parameters over the reach of a state's taxing authority, causing the use tax field to be left in the same "quagmire" of uncertainty that the *Quill* Court intended to eliminate.[201] On the contrary, this proposal would require only minimal reporting requirements by remote retailers, obviating the need for a Commerce Clause standard altogether. Accordingly, once a remote retailer has sufficient contacts with the taxing state to satisfy due process,[202] it would be permissible for that state to compel compliance.

### *C. Step 3: Shift the Burden of Collection from the Remote Retailers to the Consumer*

The benefits of shifting the burden of use tax collection from remote retailers to the consumer would be twofold. First, each state could avoid the constraints imposed by the SSUTA approach by constructing substantive tax regimes that are independent from other states. Thus, there would be no requisite uniformity in state and local tax bases and tax rates. States could freely maintain their own bad debt, rounding, and sourcing rules. Moreover, they could specify their own de minimis thresholds to exempt low-dollar amount purchases from their use tax

198 *Id.*

199 *See supra* Part II.B.1.

200 *See supra* Part II.B.2, II.B.4.

201 *See supra* note 60.

202 Due process is satisfied when the retailer has minimum contacts with the taxing state so as not to offend "traditional notions of fair play and substantial justice." Quill Corp. v. North Dakota, 504 U.S. 298, 307 (1992) (citing Int'l Shoe Co. v. Washington, 326 U.S. 310, 316 (1945)).

where the collection costs would otherwise exceed any supplementary revenue. Second, enforcement by states that are familiar with their own laws would be more economical than compelling remote retailers to abide by the complex tax rules of myriad jurisdictions.

Under this proposal, states would rely on self-assessment by their residents to collect outstanding use tax liabilities. Several states have implemented mechanisms allowing their residents to self-assess and pay use tax for items purchased outside of their state. For example, twenty-five states include a use-tax line item on their individual state income tax returns.[203] One of those states, Maine, had the highest participation rate in 2009, collecting use tax from 9.8% of its income tax returns.[204] Other states have generated separate use tax forms for out of state purchases, which consumers can file electronically.[205]

Despite these mechanisms, use tax collections by states relying on self-assessment remain negligible. A University of Tennessee study estimated that state and local governments lost $23.3 billion of use tax revenue in 2012, $11.4 billion of which came from e-commerce sales.[206] Such paltry voluntary participation by consumers has led many scholars to disregard self-assessment as a viable solution. However, by identifying the problems with self-assessment and fashioning corresponding remedies, self-assessment could be made far more effective.

One of the main problems with self-assessment is that most consumers are unaware that they are legally obligated to pay a use tax on out-of-state purchases.[207] To rectify this problem, states would need to implement initiatives to educate consumers on their use tax obligations and provide detailed guidelines on how these obligations are to be calculated. These guidelines would include

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203 Mike Maciag, *Use Tax Revenues: How Much Are States Not Collecting?*, GOVERNING (May 1, 2012), http://www.governing.com/blogs/by-the-numbers/state-use-tax-collection-revenues.html.

204 *Id.* The complexity of the tax code has given rise to more Americans paying someone to do their taxes. For tax year 2012, an estimated 60% of filers paid someone to prepare their returns, while 30% used the assistance of specialized software. Abby Ohlheiser, *Majority of Americans Will Pay Someone Else to Fill Out Tax Returns This Year*, SLATE: THE SLATEST (Jan. 9, 2013, 3:07 PM), http://www.slate.com/blogs/the_slatest/2013/01/09/tax_season_2013_most_americans_won_t_do_their_own_taxes_will_pay_professional.html.
Because calculation of use tax mirrors this complexity, requiring use tax reporting on an income tax return may lead to more accurate self-assessments by consumers.

205 *See, e.g.*, *Tennessee Sales and Use Tax Online Filing*, TENN. DEP'T OF REVENUE, https://apps.tn.gov/sales/ (last visited Feb. 3, 2017).

206 *Estimated Uncollected Use Tax from All Remote Sales in 2012: Estimates from University of Tennessee Study*, NAT'L CONF. OF ST. LEGISLATURES, http://www.ncsl.org/research/telecommunications-and-information-technology/2012-uncollected-use-tax.aspx (last visited Feb. 3, 2017).

207 Baez, *supra* note 20, at 591–92.

intricacies such as varying local and state tax rates, detailing which items are excluded from the tax base, and stating what the de minimis threshold amounts are. Education efforts could include media advertising, mailing letters to individuals and business owners, and encouraging payment of past liabilities by waiving accrued penalties and interest.

Lack of knowledge about the use tax is not the only factor hindering state efforts at collection. Even consumers who are familiar with the tax have little incentive to pay because states have no means of substantiating what out-of-state purchases they have made. However, imposing reporting requirements on remote retailers as described in step two would allow such substantiation to occur. States would be able to compare the information received from remote retailers to the returns filed by its taxpayers. Any discrepancies would highlight which taxpayers were good candidates for an audit.[208] Moreover, education efforts could equate the significance of the use tax obligation with a resident's income tax obligation and impose comparably stringent penalties for noncompliance.[209]

### *D. What Problems Still Remain?*

The use tax issue is a complex one, and the array of solutions that have been proposed illustrates that no perfect solution exists. Even this proposal is not without potential drawbacks. First, requiring consumers to pay use tax long after the time of purchase masks the true cost of an item. Budgeting would become difficult, particularly for low-income individuals for whom it is especially vital. However, because states would shoulder the majority of the collection costs, they would be incentivized to set high de minimis threshold amounts so that costs would not exceed the revenue collected. Thus, use tax would essentially be a tax on the wealthy. Individuals who make large out-of-state purchases would be most affected. This aligns with the progressive income tax system and

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[208] In the federal income tax domain, this process of matching third party information reporting with tax that is self-assessed by taxpayers has greatly improved both the accuracy of tax reporting and the frequency of voluntary compliance. *See supra* note 194 and accompanying text.

[209] The Internal Revenue Service has issued a penalty policy statement, which states:

> In the interest of an effective tax system, the Service uses penalties to encourage voluntary compliance by: (1) helping taxpayers understand that compliant conduct is appropriate and that noncompliant conduct is not; (2) deterring noncompliance by imposing costs on it; and (3) establishing the fairness of the tax system by justly penalizing the noncompliant taxpayer.

RICHARDSON, BORISON & JOHNSON, *supra* note 1, at 287 (citing Penalty Policy Statement P–1–18; IRM 1.2.1-1 (Sept. 4, 2007)).

tax policies of vertical equity that dictate that those with a greater ability to pay shoulder more of the tax burden.

Second, the proposal is subject to the same inefficiency criticism levelled at Colorado's reporting statute.[210] Requiring retailers to collect use tax at the source and remit the payments to the state is more efficient than a bifurcated approach that separates reporting and collection between two parties. However, the de minimis thresholds set by the states would largely dictate when economic benefits exceeded this inefficiency.

Third, the proposal would not render an immediate solution to the use tax issue. It may take considerable time for states to educate consumers about their obligation to pay, to enact stringent penalties for noncompliance, and to work together to create uniform reporting procedures that ease administrative burdens on remote retailers. Nevertheless, the influx of potential use tax revenue would serve as a great incentive for states to quickly overcome these obstacles. Moreover, the proposal would require only implementing *procedural* rules targeted at uniform reporting and monitoring consumer compliance. The proposal would leave intact the *substantive* regimes of each taxing jurisdiction, and thus would likely result in a more seamless transition than would the mass restructuring required by SSUTA.

## CONCLUSION

With the proliferation of online shopping, the failure of states to collect the perpetually elusive use tax has become increasingly consequential.[211] States must sidestep two constitutional quandaries before they can compel remote retailers to collect and remit use tax on their behalf: due process and the Commerce Clause.[212] Due process requires a retailer to have such minimum contacts with the taxing state as to fairly fall under its taxing authority, and is uncontroversial.[213] Far more contentious for states is the Commerce Clause hurdle. In *Quill*, the Supreme Court created a Commerce Clause nexus that precluded a state from imposing a collection obligation on an out-of-state retailer that had no physical presence in the state.[214]

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210 *See supra* note 158 and accompanying text.
211 *See supra* note 206 and accompanying text.
212 Kronenberg, *supra* note 36, at 2–3.
213 Quill Corp. v. North Dakota, 504 U.S. 298, 307 (1992).
214 *Id.* at 315.

This Comment has shown that such a standard is arbitrary and can be easily manipulated through effective tax planning. More problematic is that the physical presence, or lack thereof, of a retailer bears no logical connection with the broad economic justification behind the Commerce Clause, which is to facilitate the free flow of goods across state lines.[215] Accordingly, once it has been established that a retailer fairly falls under a state's taxing authority—thus satisfying due process—the Commerce Clause analysis can be obviated entirely if the burdens imposed on the retailer are minimal.

The challenge lies in implementing a system that permits states to collect use tax from their residents without excessively burdening remote retailers. Imposing only minimal reporting requirements on remote retailers, mandating self-assessment by consumers, and putting the impetus for enforcement on the taxing states strikes this balance. It is the only solution that allows states to collect an untapped source of tax revenue and preserve their state sovereignty, without excessively impeding interstate commerce.

RUBINDER BAL[*]

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[215] *Id.* at 312.

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