Colorado's End Run: Clever, Coercive, and Unconstitutional

by Stephen P. Kranz, Diann L. Smith, and Beth Freeman

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Venturing into new territory in the states' quest to circumvent *Quill v. North Dakota*,[1] Colorado Gov. Bill Ritter (D) signed legislation on February 24, 2010, imposing a set of potentially unconstitutional use tax notice and reporting requirements on retailers with no physical presence in Colorado. The law's reporting regime is tantamount to requiring sales tax collection, because it includes tax collection features such as audits and penalties for failure to comply. Although information reporting from out-of-state retailers may not be as burdensome as enforcing tax collection responsibilities, Colorado's law goes too far. Colorado's information reporting requirement is excessive — and perhaps results in a reporting regime that is ironically more burdensome than the tax collection obligation struck down in *Quill*. Colorado, while crafty, cannot escape the Constitution.

HB 1193 was originally drafted and introduced as click-through nexus legislation, but in response to opposition from in-state associates, the bill morphed into a set of mandatory reporting requirements applicable to all out-of-state retailers selling to Colorado customers. Because the new law does not directly impose a collection requirement on out-of-state retailers, some may presume that it escapes scrutiny under the *Quill* commerce clause regime. Not only does the new law create commerce clause problems, but it also may run afoul of other constitutional protections as well. This article evaluates HB 1193's reporting requirements under the U.S. Constitution as a tax collection and reporting scheme, a regulation of interstate commerce, and a regulation of commercial speech. It concludes that this new law, while admittedly unique, is unconstitutional under the dormant commerce clause and the First Amendment.

I. Colorado HB 1193 — What Does It Do?

HB 1193 amends the Colorado sales tax law to impose new notification and reporting requirements on each "retailer that does not collect Colorado sales tax" and is designed to aid the state in collecting use tax revenues from Colorado residents who purchase taxable items from remote retailers.[2] This far-reaching law attempts, at its essence, to commandeer private out-of-state retailers to do the collection work for which the state does not devote its own resources.

The Reporting Requirements

The new law requires that each retailer that does not collect Colorado sales tax must "notify Colorado purchasers that sales or use tax is due on purchases made from the retailer and that the State of Colorado requires the purchaser to file a sales or use tax return."[3] Emergency Regulation 39-21-112.3.5 explains the information that the retailer must provide to the purchaser at the time of purchase:

- the noncollecting retailer is not obligated to collect, and does not collect, Colorado sales tax;
- the purchase is subject to Colorado sales tax unless it is specifically exempt from taxation;
- the purchase is not exempt merely because it is made over the Internet or by other remote means;
- the state requires that the taxpayer file a sales and use tax return at the end of the year

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[1]*Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

[2]C.R.S. section 39-21-112.

[3]C.R.S. section 39-21-112(3.5)(c)(I).

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reporting all of the purchases that were not taxed, and pay tax on those purchases;
- the retailers that do not collect Colorado sales tax are obligated to provide purchasers an end-of-year summary of purchases; and
- retailers that do not collect Colorado sales tax are required by law to provide the Colorado Department of Revenue with a report of the total amount of all of a purchaser's purchases at the end of the year.[4]

The law also requires that a noncollecting retailer mail a notice to each purchaser by January 31 of each year that includes the following information:
- the total amount paid by the purchaser for Colorado purchases from the retailer during the previous calendar year;
- dates of purchases;
- amounts of each purchase;
- the category of each purchase, including, if known by the retailer, whether the purchase is exempt from taxation;
- notice that Colorado requires a sales or use tax return to be filed by the Colorado purchaser; and
- any other information required by rule of the DOR.[5]

This information must be sent separately to all Colorado purchasers by first-class mail and cannot be included with any other shipments. The mailing must include the words "Important Tax Document Information" on the exterior of the mailing.[6]

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Finally, the law requires that the out-of-state retailer file a separate end-of-year statement with the DOR for each purchaser reporting the total amount of purchases made by that person during the previous year.[7]

Noncompliance Penalties

If the noncollecting retailer fails to meet those multiple requirements, it is subject to significant penalties. Failure to provide the required disclosure at the time of purchase will result in a penalty of $5 *per failure*.[8] Similarly, failure to provide the proper end-of-year statements to the purchaser or the DOR will result in penalties of $10 *per failure*.[9] The choice faced by retailers is clear: meet these strict procedures or face tremendous financial risk.

What's the Big Deal?

The burden of this law on interstate commerce is substantial. The law's disclosure requirement imposes an obligation on retailers to comply with Colorado's sales and use tax laws to ensure accurate reporting. For instance, a retailer must know whether Colorado taxes any specific product by requiring that the end-of-year statement to purchasers identify whether the purchase is exempt if known by the retailer.[10] The meaning of "if known by" is not understood at this time, but it presumably places an obligation on the retailer to determine if the transaction is taxable. That obligation makes the burden of Colorado's law almost indistinguishable from the obligation to collect tax. Also, the notice requirement is such that it cannot be met by the existing billing systems of most retailers without significant and costly reprogramming.

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Under the traditional Colorado collection and remittal scheme, a seller must file one monthly return with the DOR for all sales made during the month.[11] Under the new Colorado reporting scheme, the retailer must file a separate statement per Colorado purchaser, *and* an end-of-year report to each purchaser. Thus, if the retailer has more than 12 customers in Colorado, the filing requirements easily exceed the compliance requirements afforded in-state retailers.

II. The Dormant Commerce Clause Challenges — Let's Get Physical!

Article I, section 8 of the Constitution grants to Congress the power to regulate commerce "among the several states."[12] The degree of regulation that is forbidden under the dormant commerce clause has been the subject of much litigation as states regularly seek to expand their taxing powers. However, one area that is relatively certain is the U.S. Supreme Court's application of the dormant commerce clause to sales and use taxation. In a string of cases

[4]Colo. Emerg. Regs. 39-21-112.3.5.
[5]C.R.S. section 39-21-112(3.5)(d)(I)(A).
[6]C.R.S. section 39-21-112(3.5)(d)(I)(B).
[7]C.R.S. section 39-21-112(3.5)(d)(II)(A).
[8]C.R.S. section 39-21-112(3.5)(c)(II).
[9]C.R.S. sections 39-21-112(3.5)(d)(III)(A), 39-21-112(3.5)(d)(III)(B).
[10]C.R.S. section 39-21-112(3.5)(d)(I)(A).
[11]C.R.S. section 39-21-105(1)(a).
[12]U.S. Const. Art. I, section 8(3).

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decided by the Court, culminating in the substantial nexus standard of *Quill Corp. v. North Dakota*,[13] the Court has applied a physical presence standard when addressing the constitutionality of a state's imposition of a sales or use tax collection obligation.

HB 1193 regulates the conduct of out-of-state retailers, but it is also imposes a sales and use tax collection and reporting regime on those retailers. Hence, an initial question arises in this constitutional analysis: Can this law survive an attack that it is unconstitutional under *Quill*? The following sections will discuss why the *Quill* standard is appropriately applied to the new Colorado law and alternatively will evaluate the law as a general regulation of interstate commerce.

A. *Quill*'s Standard Should Apply to Any Burdensome Tax Regime and Renders HB 1193 Unconstitutional

At first glance, *Quill* appears to apply only to the imposition of a tax collection obligation on out-of-state retailers. The Court in *Quill* considered whether a mail-order retailer had substantial nexus with North Dakota.[14] The *Quill* Court held that a bright-line test requiring a physical presence to establish substantial nexus remained the appropriate standard.[15] In reaching its holding, the Court noted that a purpose of the substantial nexus requirement is to "limit the reach of *state taxing authority* so as to ensure that state taxation does not unduly burden interstate commerce."[16] The Court expressed concern that "similar obligations might be imposed by the Nation's 6000-plus taxing jurisdictions" and, quoting a prior case, noted that "many variations in rates of tax, in allowable exemptions, and in administrative and record-keeping requirements could entangle [a mail-order house] in a virtual welter of complicated obligations."[17] The physical presence standard established in *Quill* was invoked not to prevent the state from requiring the collection of the tax, but to prevent the state from imposing the *burden* of collecting the tax. Thus, the focus was not on the tax itself, but rather the efforts required to comply with the specific sales and use tax laws.

As described above, compliance with the new Colorado tax reporting scheme imposes a significant burden on a retailer. The fact that Colorado gives an out-of-state retailer the "option" to not collect the tax does nothing to render this tax collection and reporting regime less onerous. In fact, the option to report may be worse than the actual collection obligation. The retailer will be required to know and prove what it knows regarding what goods and services are taxable and must accurately report the identity and amounts purchased by each Colorado purchaser separately. The option to report also requires an interference with customer relations, as it requires heavy-handed notice requirements. Imagine the effect if every state imposed similar obligations: Such a burden would make the situation untenable for online and remote retailers selling goods and services in all 50 states.

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Although this new law applies only to the Colorado state sales tax, nothing prevents Colorado's local taxing authorities from imposing the same reporting requirements, meaning that out-of-state retailers would then be required to file the end-of-year statements to those local jurisdictions in addition to the statements filed with the DOR. Because of Colorado's home rule provision, it is particularly difficult for companies to accurately administer Colorado's state and local sales tax obligations, in part because the sales and use tax rules for home rule cities may differ from the state rules.

The Colorado Constitution grants home rule authority to each city or town of the state "having a population of two thousand inhabitants."[18] Those towns or cities may enact a charter that supersedes any conflicting law of the state.[19] That home rule authority, which over 20 cities exert, allows those cities to establish which goods and services are taxable independently from the state.[20] Thus, if home rule cities enact laws similar to HB 1193, the

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[13] *Quill Corp. v. North Dakota*, *supra* note 1.

[14] *See Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977) (holding that a state tax will be sustained under the commerce clause "when 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").

[15] *Quill*, *supra* note 1, 314-315.

[16] *Id*. at 313 (emphasis added).

[17] *Id*. at 313 n.6 (quoting *National Bellas Hess, Inc. v. Dep't of Rev. of Ill.*, 386 U.S. 753, 759-760 (1967) (alteration in original)).

[18] Colo. Const. Art. XX, section 6.

[19] *Id*.

[20] For example, Colorado defines taxable standardized software to include "standardized software that is modified or enhanced even if such modification or enhancement is designed and developed to the specifications of a specific purchaser, unless such standardized software is a de minimis component of such software." C.R.S. section 39-21-102(13.5)(a)(II)(A). The city of Thornton provides a different delineation between prewritten and customized software: "If there are significant modifications to prewritten software to customize it to a specific user, charges for labor which are included in the

(Footnote continued on next page.)

impact on out-of-state retailers would be especially significant. If this law is found to be constitutional and other states follow suit, a quagmire of reporting requirements will result.

The *Quill* standard was established as a means of ensuring that state taxing authority does not unduly burden interstate commerce. Colorado is seeking to circumvent *Quill* by imposing oppressive reporting requirements on retailers that are not obligated to collect Colorado tax. The underlying reasoning of *Quill* applies equally to a tax reporting scheme as it does to a tax collection obligation. Any dormant commerce clause challenge to HB 1193 is properly placed under the *Quill* standard, and because the burdens of HB 1193 on interstate commerce are potentially even greater than the burdens imposed by North Dakota in *Quill*, HB 1193 should be found unconstitutional.

B. Colorado's Reporting Requirements Discriminate Against Interstate Commerce

1. Invalid as a Facially Discriminatory Law?

The clearest prohibition under the dormant commerce clause is against state regulations that discriminate against out-of-state business for the purpose of protecting in-state interests.[21] "Discriminatory laws motivated by 'simple economic protectionism' are subject to a 'virtually *per se* rule of invalidity,'"[22] which can be overcome only by a showing that the state has no other means to advance a legitimate local purpose.[23] That is a difficult standard to meet, and states rarely survive a challenge when the regulation is facially discriminatory.

HB 1193 was enacted for the purpose of collecting the sales and use taxes imposed on taxable sales in Colorado — in other words, revenue generation. It also serves, however, to even the playing field between the local businesses required to collect Colorado sales tax and the remote sellers constitutionally protected from collecting those same taxes. The reporting requirements target out-of-state retailers and impose on them a burden (including penalties) that is not imposed on in-state retailers. The state could have imposed those same requirements on in-state retailers (and give the in-state retailers the option to report or collect tax) if its true purpose was to ensure accurate collection of use taxes, thus avoiding the revenue lost through improper exemption certificates and other lapses or abuses of the system by in-state purchasers. That Colorado chose to impose these requirements only on out-of-state retailers is evidence of its protectionist intent. Retailers will be treated differently under this law based solely on whether they are constitutionally protected from tax collection. Thus, this law can reasonably be subjected to the strict scrutiny applied to a facially discriminatory regulation of interstate commerce.

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Colorado would have little defense to a finding that the law facially discriminates against interstate commerce. Revenue generation is not a legitimate purpose sufficient to overcome a facially discriminatory statute. Colorado also has other means of collecting this revenue, such as educating its own citizens and providing forms and compliance support.

The U.S. Supreme Court has recognized an exception to the per se rule in that a facially discriminatory tax may "survive Commerce Clause scrutiny if it is a truly 'compensatory tax designed simply to make interstate commerce bear a burden already borne by intrastate commerce.'"[24] For example, the imposition of the use tax to goods not subject to a sales tax survived dormant commerce clause scrutiny under this principle.[25] The Court has established three conditions for a valid compensatory tax:

- "a State must, as a threshold matter, identify the intrastate burden for which the State is attempting to compensate";
- "the tax on interstate commerce must be shown roughly to approximate — but not exceed — the amount of the tax on intrastate commerce"; and

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modification are not taxable, but only if such charges are separately billed on the invoice." T.M.C. section 26-389(a)(4).

[21] *Gen. Motors Co. v. Tracy*, 519 U.S. 278, 307 n.15 (1997) (noting that "if a State discriminates against out-of-state interests by drawing geographical distinctions between entities that are otherwise similarly situated, such facial discrimination will be subject to a high level of judicial scrutiny even if it is directed toward a legitimate health and safety goal") (citing *Philadelphia v. New Jersey*, 437 U.S. 617, 626-28 (1978); *Dean Milk Co. v. Madison*, 340 U.S. 349, 353-54 (1951)).

[22] *United Haulers Assoc., Inc. v. Oneida-Herkimer Solid Waste Mgmt. Auth.*, 550 U.S. 330, 338 (2007) (quoting *Philadelphia*, 437 U.S. at 624).

[23] *United Haulers*, 550 U.S. at 338-339 (citing *Maine v. Taylor*, 477 U.S. 131, 138 (1986)).

[24] *Fulton Corp. v. Faulkner*, 516 U.S. 325, 330 (1996) (quoting *Associated Industries of Mo. V. Lohman*, 511 U.S. 641, 647 (1994)).

[25] *See Henneford v. Silas Mason Co.*, 300 U.S. 577, 584 (1936) (holding that Washington use tax exemption on goods that had already been subjected to a sales tax was constitutional because the total effect of the exemption was to subject in-state and out-of-state businesses to equal impositions).

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- "the events on which the interstate and intrastate taxes are imposed must be 'substantially equivalent'; that is, they must be sufficiently similar in substance to serve as mutually exclusive 'proxies' for each other."[26]

Colorado may argue that the unique burden placed on out-of-state companies by HB 1193 helps the state collect the compensating use tax. Although a use tax has been held to be a constitutionally valid compensating tax, this new burden is not a use tax. Instead, it is an elaborate tax collection and reporting regime that is designed, in part, to assist the state in enforcing its use tax on others — that is, purchasers of goods from out-of-state sellers.

To the extent a court evaluates this law as a compensating measure, however, the regime fails two of the three prongs of the compensating tax analysis. Under the second prong, the compliance costs of this new law cannot be quantitatively compared with the burden of collecting sales tax. Further, the penalties for noncompliance are severe and not based on the amount of tax due. There is no way to know if the burden of this law "roughly approximates" the burden of collecting sales tax, but as discussed above, the burden is arguably much greater.

Also, the compensatory tax doctrine's third requirement is not met. The sales tax collection requirement is not "substantially equivalent" or "sufficiently similar in substance" to the compliance burden of multiple notification and reporting requirements and the corresponding penalties for noncompliance.

2. The Reporting Requirements Create an Excessive Burden in Relation to Local Benefits

To the extent that HB 1193 is characterized as a nondiscriminatory regulation of commerce (that is, a nontax regulation of interstate commerce), a judicial decision-maker will rely on the balancing test described in *Pike v. Bruce Church, Inc.* to determine its constitutionality.[27] When a law is not facially discriminatory or aimed at economic protectionism, but instead "regulates even-handedly to effectuate a legitimate local public interest, and its effects on interstate commerce are only incidental, it will be upheld unless the burden imposed on such commerce is clearly excessive in relation to the putative local benefits."[28] The first consideration under the *Pike* test is whether the regulation serves a legitimate local public interest. That assessment is followed by a balancing of the burden imposed on commerce and the putative local benefits.

Revenue generation is a "cognizable benefit for purposes of the *Pike* test."[29] Thus, a regulation designed to increase state revenues may be upheld under the *Pike* test if the burden on interstate commerce does not clearly exceed the benefits of this purpose. A court taking up that exercise will be faced with this question: Does a state's effort to collect the tax it is owed outweigh the substantial burden described in *Quill*? In *Quill* the Court was willing to consider the effect of not just the offending state's action, but the effect if many other taxing jurisdictions took similar actions. Under such an analysis, a court may find HB 1193 unconstitutional because of this potential aggregated impact.[30]

III. A Word About Speech

HB 1193 compels an out-of-state retailer to make a choice: either collect sales tax on goods and services it sells to Colorado purchasers, or include a statement to its customers regarding its obligations under the law on every invoice sent to a Colorado customer. Compelling a person or corporation to say something they otherwise would not say invokes a question as to whether a violation occurs under the First Amendment of the U.S. Constitution. As the U.S. Supreme Court has noted, "There is certainly some difference between compelled speech and compelled silence, but in the context of protected speech, the difference is without constitutional significance, for the First Amendment guarantees 'freedom of speech,' a term necessarily comprising the decision of both what to say and what *not* to say."[31] Courts have recognized this protection against compelled speech in both political and commercial speech.[32]

The Court articulated a four-part analysis to determine whether a government regulation of commercial speech is permissible:

- whether the expression concerns lawful activity and is not misleading;

[26]*Fulton Corp.*, 516 U.S. at 333-334 (quoting *Oregon Waste Systems, Inc. v. Dep't of Environmental Quality of Oregon*, 511 U.S. 93, 103 (1994); *Armco Inc. v. Hardesty*, 467 U.S. 638, 643 (1984)).

[27]*Pike v. Bruce Church, Inc.*, 397 U.S. 137 (1970).

[28]*Id*. at 142.

[29]*United Haulers*, 550 U.S. at 346 (quoting *C & A Carbonne, Inc. v. Clarkstown*, 511 U.S. 383, 393 (1994)).

[30]It should be noted that such a cost benefit analysis has proven difficult for courts, and recent decisions by the U.S. Supreme Court indicate a discomfort with engaging in such analysis. *See Kentucky v. Davis*, 128 S.Ct. 1801, 1818 (2008). The recent decisions by the U.S. Supreme Court involved traditional government functions. Parts of the separate opinions of the justices emphasize this point, but the Court's reticence to engage in an economic analysis may carry over to other types of regulations.

[31]*Riley v. National Federation of the Blind of North Carolina, Inc.*, 487 U.S. 781, 796-797 (1988).

[32]*See Int'l Dairy Foods Assoc. v. Amestoy*, 92 F.3d 67, 71 (2nd Cir. 1996). ("The right not to speak inheres in political and commercial speech alike and extends to statements of fact as well as statements of opinion.")

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- whether the government's interest is substantial;
- whether the labeling law directly serves the asserted interest; and
- whether the labeling law is no more extensive than necessary.[33]

Colorado's HB 1193 requirement to include specific information on the purchaser's invoice is challengeable under the Court's precedent.

Compelling a person or corporation to say something they otherwise would not could cause a violation of the First Amendment.

The information required in the disclosure statement is certainly lawful and not misleading. The state's interest in collecting taxes from its residents who purchase goods from out-of-state retailers may be characterized as substantial, and the disclosure requirement directly serves that interest. However, the fourth prong of this test — whether the disclosure requirement is no more extensive than necessary — will prove most interesting. For instance, is it really necessary for the disclosure to include a statement that the retailer is not obligated to, and does not, collect Colorado sales tax?[34] For that matter, why is it the retailer's responsibility to inform the Colorado resident of the obligation to "file a sales/use tax return at the end of the year reporting all of the purchases that were not taxed and pay tax on those purchases"?[35] Commercial speech is afforded less protection than political speech under the Constitution. But commercial speech *is* afforded protection, and because the notice requirements in HB 1193 are excessive, the law could be struck down as a violation of a retailer's freedom of speech.

[33]*Id*. at 72 (citing *Central Hudson Gas & Elec. Corp. v. Public Serv. Comm'n*, 447 U.S. 557, 562-563 (1980)).
[34]Colo. Emerg. Regs. 39-21-112.3.5.
[35]*Id*.

IV. Conclusion

Colorado's tax collection and reporting regime is a coercive attempt to require constitutionally protected taxpayers to collect Colorado sales and use tax. It is nothing more than an attempt to create a loophole to the *Quill* physical presence standard — a charge levied by states at some taxpayers.

A dormant commerce clause challenge to HB 1193 may be successful if the provisions of the law are viewed as a tax collection and reporting scheme that is subjected to scrutiny under the four-prong commerce clause test. If it is characterized as a facially discriminatory law, it will likely be judged as lacking a legitimate local purpose sufficient to survive strict scrutiny because revenue generation is not a sufficient purpose under this analysis. Further, there are other means of achieving that state purpose, such as by placing the burden on the in-state Colorado purchasers who owe the tax rather than the out-of-state businesses. Any attempt by Colorado to save this tax as an otherwise discriminatory tax by claiming it is a compensating tax will fail as well. The outcome of a challenge under the *Pike* balancing test (if applicable) is uncertain. Finally, because the law compels speech in a manner that is excessive to achieve the state's interest, HB 1193 could be struck down as a violation of a remote retailer's right to freedom of speech.

The design of HB 1193 places all of the use tax collection burden — except for the actual exchange of money — on out-of-state companies that the state otherwise is constitutionally barred from so encumbering. That circumvention of a long-standing constitutional standard should not be allowed to exist for long. ✰

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