Is *Quill* Dead? At Least One State Has Written the Obituary

by Stephen P. Kranz, Lisbeth A. Freeman, and Mark W. Yopp

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State departments of revenue and legislators are becoming increasingly bold in their efforts to raise revenue by forcing remote retailers to collect use tax, despite a clear constitutional barrier against doing so. Some commentators[1] have suggested a "multipronged approach" in which states should pursue legislation aimed at "asserting their taxing powers" through "new legislation to extend their reach to the outer limits of current commerce clause nexus jurisprudence and . . . a constitutional challenge to *Quill*."[2] The four strategies suggested are:

- reporting and notice requirements to improve use tax collection;
- affiliate nexus statutes that create nexus presumptions;
- New York-style Internet affiliate statutes aimed at a specific segment of e-commerce — also known as click-through nexus; and
- state simplification and later declaration by the state that the physical presence nexus standard no longer applies because of lowered burdens on interstate commerce.

The reference to *Quill*, of course, points to the physical presence standard rearticulated by the U.S. Supreme Court in 1992, in which the Court held that a North Dakota use tax statute was unconstitutional because it placed an undue burden on interstate commerce.[3] *Quill* affirmed a bright-line rule that a retailer must have a physical presence in a state for that state to require the out-of-state retailer to collect sales and use taxes from in-state purchasers.[4] The *Quill* Court held that the bright-line test requiring a physical presence to establish substantial nexus remained the appropriate standard for establishing the substantial nexus prong of the four-part test for dormant commerce clause scrutiny of state taxes.[5] The commentators argue that because of technology changes and the simplification efforts some states have taken, this physical presence standard is no longer necessary and states should directly challenge it.

Some states appear to have given serious consideration to the blueprint laid out by the commentators' article and have enacted legislation accordingly. The first strategy has been used by Colorado and Oklahoma, which have enacted reporting and notice requirements; the Multistate Tax Commission is drafting a similar model reporting statute for consideration by other states. The second strategy has been adopted by New York, Rhode Island, and North Carolina, which each enacted click-through nexus legislation. The third strategy has been adopted by many states through the enactment of affiliate nexus statutes. Oklahoma appears to be the first state to pursue the fourth strategy and has adopted several provisions aimed at forcing remote retailers to collect use tax.[6] The unique feature of the Oklahoma legislation is the explicit intent to violate *Quill* through a declaration that Oklahoma's sales and use tax laws no longer burden interstate commerce.

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[1]Robert D. Plattner, Daniel Smirlock, and Mary Ellen Ladouceur, "A New Way Forward for Remote Vendor Sales Tax Collection," *State Tax Notes*, Jan. 18, 2010, p. 187, *Doc 2009-28458*, or *2010 STT 11-2*.

[2]*Id.* at 193.

[3]*Quill*, 504 U.S. 298, 317-319 (1992).

[4]*Id.* at 317-318.

[5]*Id.* at 314-15 (reaffirming *National Bellas Hess, Inc. v. Dep't of Revenue of Ill.*, 386 U.S. 753, 759-760 (1967)). *See Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977).

[6]HB 2359, 52nd Leg. (Okla. 2010).

This article will examine those various legislative options and constitutional infirmities. Ultimately, we conclude that federal legislation, such as the Main Street Fairness Act (MSFA) recently introduced in the House of Representatives, remains the most appropriate avenue to simplify sales and use tax burdens and to simultaneously gain congressional authorization to impose the collection burden on out-of-state vendors.

Reporting Requirements

Unable to force remote vendors to collect use tax, states are pursuing notice requirements that require remote vendors to track and report sales made to customers and/or to notify customers that they owe use tax. With a provision based largely on the notice requirement adopted by Colorado earlier this year, Oklahoma became the second state to pass a notice requirement.[7] The MTC is also advocating a model statute with a notice requirement.[8]

Oklahoma's reporting law requires vendors to notify their in-state customers of use tax obligations at the time of purchase. We note that Colorado's law goes much further — requiring vendors to report remote sales data to the state. The constitutional issues associated with forcing vendors to collect and report those customer data may have dissuaded Oklahoma from following Colorado's full-blown reporting regime.

Colorado's and Oklahoma's notice requirements impose significant burdens on out-of-state retailers.

In broad terms, Colorado's and Oklahoma's notice requirements impose significant burdens on out-of-state retailers. Requiring remote vendors to gather and submit substantial amounts of information to the state is intrusive and time consuming. The burden is imposed only on out-of-state retailers, and because the statutes were motivated by economic protectionism, they are discriminatory and unconstitutional. Further, other states' adoption of notice and reporting requirements will lead to a patchwork of different and inconsistent processes. It will be interesting to monitor Colorado's and Oklahoma's efforts to step up their use tax enforcement efforts. Their notice and reporting requirements are purportedly aimed at assisting use tax enforcement on each state's citizens. If use tax collection is not increased, those notice and reporting regimes will serve no purpose other than to coerce remote vendors into "voluntarily" collecting sales or use tax.

Affiliate Nexus Provision

Oklahoma also adopted an affiliate nexus provision similar to provisions adopted by many other states in recent years, including Alabama, Georgia, Minnesota, New York, and Wisconsin. These affiliate nexus statutes attempt to assert nexus over out-of-state retailers that are related to in-state retailers.

The Oklahoma law includes two specific nexus provisions that appear to add little to the state's current law. First, the legislation asserts nexus over out-of-state retailers that hold a substantial interest in, or are owned in whole or in part by, a retailer maintaining a place of business in Oklahoma. And, either the out-of-state retailer sells the same or a substantially similar line of products as the Oklahoma retailer under a substantially similar business name, or the Oklahoma retailer has facilities or employees that are used to advertise, promote, or facilitate sales for the out-of-state retailer.[9] Second, the law seeks to impose nexus on retailers when "the retailer holds a substantial ownership interest in, or is owned in whole or in substantial part by, a business that maintains a distribution house, sales house, warehouse or similar place of business in Oklahoma that delivers property sold by the retailer to consumers."[10] Oklahoma had previously asserted nexus over out-of-state retailers that had agents operating in the state under the authority of the retailer and also asserted nexus over out-of-state retailers that have or maintain a distribution house in Oklahoma. The new statutory language appears to restate and possibly elaborate on the state's preexisting "doing business" statute.

Nexus by affiliation is not constitutional.

In addition to the two provisions described above, Oklahoma's affiliate nexus statute includes language that seeks to assert nexus based solely on the out-of-state vendor's common ownership with an in-state company — regardless of the type of activities that are taking place in the state. Oklahoma has enacted, and California and Tennessee have proposed, statutory language that creates a presumption that an out-of-state retailer has nexus if the out-of-state retailer is a part of a controlled group of

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[7]The problems with the Colorado-style reporting requirements were examined in depth in a previous edition of A Pinch of SALT. Stephen Kranz, Diann Smith, and Beth Freeman, "Colorado's End Run: Clever, Coercive, and Unconstitutional," *State Tax Notes*, Apr. 5, 2010, p. 55, *Doc 2010-6640*, or *2010 STT 64-9*.

[8]MTC Draft Sales and Use Tax Notice and Reporting Act, July 15, 2010.

[9]Okla. Stat. tit. 68 section 1401(9)(b)(1)(a).

[10]Okla. Stat. tit. 68 section 1401(9)(b)(2).

corporations and that controlled group of corporations has a component member that is a retailer engaged in business in that state.[11] Under those provisions, the simple fact of the relationship between the two companies is sufficient under the statute to give rise to the nexus presumption. Nexus by affiliation is not constitutional. Nowhere does the Constitution, or the cases applying it, give support to the idea that two retailers that are simply members of the same controlled group of corporations create nexus for each other. Oklahoma's nexus by affiliation has no basis in constitutional law and the presumption of nexus should be stricken as unconstitutional.

Click-Through Nexus Provisions

New York, Rhode Island, and North Carolina have each enacted provisions that establish nexus over an out-of-state Internet retailer if it has entered into a relationship with an in-state affiliate.[12] Those laws create a presumption that nexus exists if the out-of-state Internet retailer has an agreement with an in-state resident who is paid a commission for advertising and referring customers to the out-of-state retailer, provided that the referrals generate sufficient sales (for example, $10,000 in New York sales). The MTC has also set out to draft a model click-through nexus statute.[13]

In *Tyler Pipe v. Washington* and *Scripto, Inc. v. Carson*,[14] the U.S. Supreme Court said that the presence of an agent or independent contractor in a state created nexus for an out-of-state retailer if the agent's or independent contractor's activities were directed at making or maintaining a market in that state. The click-through nexus provisions possess a fatal flaw — the in-state affiliate's referral activities are not associated with the in-state market. In fact, in nearly every case the referrals occur without regard to any geographical market. That disassociation between the solicitation activities and the taxing state creates too tenuous a connection to establish a presumption of nexus.

Quill Presumption

The fourth strategy used by states is to enact laws that simply declare the death of *Quill*'s physical presence nexus standard. Oklahoma is the first state to have adopted that approach as part of HB 2359, which states:

> The sales and use tax system established under Oklahoma law does not pose an undue burden on out-of-state retailers and provides sufficient simplification to warrant the collection and remittance of use taxes by out-of-state retailers that are due and owing to the State of Oklahoma and its local jurisdictions.[15]

The legislation lists the steps Oklahoma has taken to simplify its state and local sales and use tax as justification for abandoning *Quill*'s physical presence nexus standard.

> ***Oklahoma's nexus law ignores Supreme Court precedent and usurps the authority reserved for Congress under the commerce clause of the U.S. Constitution.***

The Oklahoma Legislature has unilaterally declared that it has eliminated the burdens on interstate commerce that the U.S. Supreme Court held were too high to require remote sellers to collect sales and use taxes. That tactic ignores Supreme Court precedent and usurps the authority reserved for Congress under the commerce clause of the U.S. Constitution to regulate commerce "among the several States."[16] That bold move will inevitably be subject to constitutional challenge, and according to some commentators, that is exactly its goal: a "test case statute . . . that directly confronts *Quill* and sets the stage for a constitutional challenge to *Quill*."[17] Such a move, according to these commentators, must be supported by the argument that a court should consider only the burden within a state's borders and ignore what other jurisdicition are doing. However, this notion flies in the face of a long history of Supreme Court jurisprudence.

The Supreme Court, in *National Bellas Hess, Inc. v. Department of Revenue, Illinois*, held that the state of Illinois lacked the power to impose a use tax collection obligation on an out-of-state mail-order retailer without a physical presence in the state.[18] The Court extrapolated the effect of the Illinois law if other states were to enact similar legislation:

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[11] Okla. Stat. tit. 68 section 1401(9)(d); California AB 2078.

[12] N.Y. Tax Law section 1101(b)(8)(vi); N.C. Gen. Stat. section 105-164.8(3); R.I. Gen. Laws section 44-18-15(a).

[13] The problems associated with click-through nexus laws were addressed in a previous edition of A Pinch of SALT. Michele Borens and Mark W. Yopp, "Overextending Attributional Nexus: States' Latest Attempts to Tax Internet Sales," *State Tax Notes,* Mar. 2, 2009, p 697, *Doc 2009-3947*, or *2009 STT 39-3*.

[14] *Scripto, Inc. v. Carson*, 362 U.S. 207 (1960); *Tyler Pipe v. Washington*, 483 U.S. 232 (1987).

[15] Okla. Stat. tit. 68 section 1407.5(C).

[16] U.S. Const. Art. I, section 8, cl. 3.

[17] Plattner, et al., *supra* note 1, at 196; *Quill v. North Dakota*, 504 U.S. 298 (1992).

[18] *National Bellas Hess, Inc. v. Dep't of Revenue of Ill.*, 386 U.S. 753, 759-760 (1967).

> If the power of Illinois to impose use tax burdens on National were upheld, the resulting impediments on the free conduct of its interstate business would be neither imaginary nor remote. For if Illinois can impose such burdens, so can every other State, and so, indeed, can every municipality, every school district, and every other political subdivision throughout the Nation with power to impose sales and use taxes. The many variations in rates of tax, in allowable exemptions, and in administrative and record-keeping requirements could entangle National's interstate business in a virtual welter of complicated obligations to local jurisdictions with no legitimate claim to impose "a fair share of the cost of the local government."[19]

The Court reconsidered that limitation in *Quill*, and reached the same conclusion regarding the extent that the commerce clause limits a state's ability to impose a tax collection obligation on out-of-state retailers. In reaching its decision, 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."[20] Notably, in footnote 6, the Court discusses the concept of "undue burden," and expresses concern that "similar obligations might be imposed by the Nation's 6000-plus taxing jurisdictions."[21] The *Quill* Court rejected "a case-by-case evaluation of the actual burdens imposed by particular regulations or taxes," and instead adopted the *Bellas Hess* approach of a "demarcation of a discrete realm of commercial activity that is free from interstate taxation," saying that *Bellas Hess* "created a safe harbor for vendors whose only connection with customers in the [taxing] State is by common carrier or the United States mail."[22] Those concerns are perhaps even more critical in today's economy, which has shifted so heavily toward e-commerce.

The decisions in *Quill* and *Bellas Hess* were both based on the aggregated burden that retailers must contemplate when attempting to comply with all of the state and local sales and use tax impositions. Likewise, the Court has rejected other state regulations of interstate commerce not because of the burden imposed by the one state in isolation, but by the burden imposed because of the differences in regulations among the states. In *Bibb v. Navajo Freight Lines, Inc.*, the Court determined that a nondiscriminatory trucking safety regulation was contrary to the commerce clause because it was different from the regulations in other states and therefore created a "heavy burden" on the interstate movement of trucks and trailers.[23] In another trucking regulation case, the Court also considered the regulations of neighboring states to determine that an inconsistent regulation would impose an undue burden on interstate commerce.[24] Thus, the Court has long considered the effect of a state tax or regulation in the context of other states' regimes, rather than just the effect of that tax or regulation in isolation. The Oklahoma declaration that its simplification efforts have overcome the restrictions of *Quill* taken at face value, without consideration of other states, is an insufficient basis to justify abandoning *Quill's* physical presence nexus standard.

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The *Quill* Court retained the bright-line test and invited Congress to review the appropriateness of this standard, saying that "Congress may be better qualified" and "has the ultimate power to resolve" this issue.[25] But some commentators argue that the "current constitutional sales tax nexus rules are a relic of the last century" and that the changes in the marketplace and technology have caused the "underpinnings [of *Quill*] to crumble."[26] Whether one believes such claims is beside the point; Congress — and not states with self-serving claims and legislation — is the proper body to consider whether the time has come to abandon the physical presence standard.

Streamlined Sales and Use Tax Agreement and the Main Street Fairness Act: A Comprehensive Solution

The effort to simplify state and local sales and use tax laws through the Streamlined Sales and Use Tax

[19]*Id.*

[20]*Quill*, 504 U.S. at 313.

[21]*Id.* at 313 n.6.

[22]*Quill*, 504 U.S. at 315 (internal quotations omitted) (alteration in original).

[23]*Bibb v. Navajo Freight Lines,* 359 U.S. 520, 529-530 (1959).

[24]*See Kassel v. Consolidated Freightways Corp. of Delaware*, 45 U.S. 662, 668 (1981) (noting that, even in the case of safety regulations in which states are granted great deference, regulations that "impair significantly the federal interest in efficient and safe interstate transportation . . . cannot be harmonized with the Commerce Clause," and that the challenged law "is now out of step with all other Midwestern and Western states").

[25]*Quill*, 504 U.S. at 318.

[26]Plattner, et al., *supra* note 1, at 193.

Agreement, which now includes 23 member states, began in 2000. This effort focuses on several critical areas of sales and use tax simplification:

- state-level administration;
- uniformity of tax bases and uniformity of tax base definitions;
- central, electronic registration for all member states; and
- uniform sourcing rules for taxable transactions.

That effort is aimed at simplifying and modernizing sales and use tax administration to reduce the burden of tax compliance. Although the agreement is not all encompassing, its extensive simplification provisions have brought some welcomed relief to increasingly complex sales and use tax compliance requirements.

> ***The MSFA is the only vehicle that provides a comprehensive approach to addressing the states' concerns with the physical presence nexus standard.***

The MSFA is a next step in the collaborative work between states and businesses to further the streamlined sales tax effort.[27] The MSFA is designed to encourage more states to adopt the agreement by offering a reward: Any state that becomes a member state of the agreement and enacts the requirements of the MSFA would be authorized by Congress, as part of this legislation, to require collection of sales and use taxes by remote retailers. Thus, Congress, if it enacts the MSFA, will offer conditional authorization for overcoming the restriction of *Quill*.

The MSFA offers a comprehensive approach. Tying the states' simplification efforts to an expanded sales and use tax collection standard that is authorized by Congress is a fundamentally sound approach. Debate continues as to whether the agreement (and the MSFA) adopts enough simplification to justify abandoning *Quill*'s physical presence nexus standard.[28]

A coordinated simplification effort among the states is required to lower the nexus standard. Although the agreement has been somewhat successful, greater membership among the states is needed to ensure its long-term success. And greater participation by large states (for example, California and New York) is also needed. The approach used by the MSFA offers states continued autonomy over their internal tax policies but offers a carrot for simplifying tax laws in a manner that moves the states toward uniformity.

Conclusion

Oklahoma is the latest state to attempt to circumvent *Quill*'s physical presence nexus standard through a variety of means. Each of the approaches adopted by Oklahoma and other states, and endorsed by some state tax commentators, is constitutionally suspect. The MSFA is the only vehicle that provides a comprehensive approach to addressing the states' concerns with the physical presence nexus standard. Only time will tell whether the states will be able to achieve the requisite level of sales tax simplification to gain sufficient support to alter nexus standards. ✰

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[27]H.R. 5660, 111th Cong. (2010).

[28]For instance, two sections of the bill that address the inclusion of vendor compensation requirements and include communications taxes in the simplification scheme now have placeholder language because agreement regarding the breadth of those protections has not been reached. *See* H.R. 5660, sections 7(a)(14) and 7(b).