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**A BETTER WAY FORWARD FOR STATE TAXATION  
OF E-COMMERCE**

**DAVID GAMAGE\* & DEVIN J. HECKMAN\*\***

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\* Assistant Professor, University of California, Berkeley, School of Law (Boalt Hall). As this Article goes to press, Professor Gamage is on teaching leave while serving as Special Counsel and Senior Stanley S. Surrey Fellow to the U.S. Department of the Treasury, Office of Tax Policy. This Article was begun prior to the start of Professor Gamage’s Treasury position; nothing discussed herein reflects the views of the Treasury Department, the Obama Administration, or anyone other than the authors of this Article.

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## INTRODUCTION

Electronic commerce (or, “e-commerce”) has exploded in magnitude and importance over the past two decades.<sup>1</sup> Yet while e-commerce revenues have skyrocketed, U.S. state governments have suffered severe budget shortfalls due to the financial crisis and ongoing recession.<sup>2</sup> Since the 1992 Supreme Court decision in *Quill Corp. v. North Dakota*, major interstate e-commerce vendors have been effectively exempt from state sales and use taxes.<sup>3</sup> The rapid growth of e-commerce has thus eroded the states’ sales and use tax bases, depriving the states of much needed revenue.<sup>4</sup>

*Quill* held that states can only impose the burden of collecting sales and use taxes on vendors that have a “physical presence” within the taxing state.<sup>5</sup> *Quill* was decided with respect to a mail-order catalog vendor, but the holding applies equally to interstate e-commerce.<sup>6</sup> Recently, a number of states have passed legislation aggressively interpreting *Quill*’s physical presence requirement in an attempt to reach out-of-state e-commerce vendors.<sup>7</sup> Commonly referred to as “Amazon laws,”<sup>8</sup> these statutes have taken a number of forms, such as imputing physical presence when a remote vendor has sales

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<sup>1</sup> E-commerce constituted seven percent of all retail sales in 2010, and this share is expected to grow rapidly over the coming years. See, e.g., *Online Retail Sales*, NAT’L RETAIL FOUND., [http://www.nrf.com/modules.php?name=Pages&sp\\_id=1240](http://www.nrf.com/modules.php?name=Pages&sp_id=1240) (last visited Feb. 20, 2012).

<sup>2</sup> See, e.g., ELIZABETH McNICHOL, PHIL OLIFF & NICHOLAS JOHNSON, CTR. ON BUDGET AND POLICY PRIORITIES, STATES CONTINUE TO FEEL RECESSION’S IMPACT 1 (2011), available at <http://www.cbpp.org/files/9-8-08sfp.pdf> (estimating the states’ total budget shortfall to be \$103 billion).

<sup>3</sup> *Quill Corp. v. North Dakota*, 504 U.S. 298, 309-19 (1992).

<sup>4</sup> Annual national state and local sales tax losses on e-commerce are predicted to total \$11.4 billion in 2012 and to continue growing rapidly thereafter. Donald Bruce, William Fox & LeAnn Luna, *State and Local Sales Tax Revenue Losses from E-Commerce*, 52 ST. TAX NOTES 537, 537 (2009).

<sup>5</sup> *Quill*, 504 U.S. at 317-18.

<sup>6</sup> Walter Hellerstein, *State Taxation of Electronic Commerce*, 52 TAX L. REV. 425, 437 (1997).

<sup>7</sup> For further discussion, see *infra* Part III.A.

<sup>8</sup> Amazon is both the leading internet retailer and has been among the most aggressive in combating the states’ attempts to tax interstate e-commerce. Dale Kasler, *Amazon Takes on California over Sales Tax*, SACRAMENTO BEE, July 17, 2011, at 1A, available at <http://www.sacbee.com/2011/07/17/v-print/3774593/amazon-takes-on-california-over.html>.

affiliates within a state<sup>9</sup> or attributing physical presence whenever a remote vendor licenses trademarks to an in-state firm.<sup>10</sup>

Although litigation remains ongoing, many commentators have concluded that the recent state Amazon laws are unconstitutional, ineffective, or both.<sup>11</sup> Even if courts allow the states to stretch the definition of physical presence to include affiliations with in-state firms, major e-commerce vendors like Amazon can respond by simply terminating those relationships in order to retain their sales and use tax exemption.<sup>12</sup> Being exempt from state sales and use taxes is sufficiently important to major e-commerce vendors such as Amazon that these vendors can be expected to end most affiliations that would deem them to have a physical presence within key customer states.<sup>13</sup>

At the same time, the *Quill* decision has been widely criticized. The case was recently nominated for “the most maligned Supreme Court tax decision.”<sup>14</sup> Numerous commentators have called for the Court to revisit the decision<sup>15</sup> or

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<sup>9</sup> E.g., N.Y. TAX LAW § 1101(b)(8)(vi) (McKinney Supp. 2011); see also N.Y. STATE DEP’T OF TAXATION AND FIN., NEW PRESUMPTION APPLICABLE TO DEFINITION OF SALES TAX VENDOR, TSB-M-08(3)S (May 8, 2008); Michael R. Gordon, *Up the Amazon Without a Paddle: Examining Sales Taxes, Entity Isolation, and the “Affiliate Tax,”* 11 N.C. J.L. & TECH. 299, 309 (2010).

<sup>10</sup> E.g., ALA. CODE 40-23-190(a)(2) (2003); H.B. 3659, 95th Gen. Assemb. (Ill. 2011); see also Edward A. Zelinsky, *Lobbying Congress: “Amazon” Laws in the Lands of Lincoln and Mt. Rushmore*, 60 ST. TAX NOTES 557, 559 (2011).

<sup>11</sup> See, e.g., Stephen P. Kranz, Diann L. Smith & Beth Freeman, *Colorado’s End Run: Clever, Coercive, and Unconstitutional*, 56 ST. TAX NOTES 55 (2010) (maintaining that Colorado’s Amazon law is unconstitutional); Edward A. Zelinsky, *New York’s “Amazon” Law: Constitutional but Unwise*, 54 ST. TAX NOTES 715 (2009) [hereinafter Zelinsky, *New York’s “Amazon” Law*] (arguing that New York’s Amazon law is ineffective); Edward A. Zelinsky, *The Siren Song of “Amazon” Laws: The Colorado Example*, 59 ST. TAX NOTES 695 (2011) [hereinafter Zelinsky, *The Siren Song*] (claiming that Colorado’s Amazon law is unconstitutional).

<sup>12</sup> Major e-commerce vendors have already ended many of their relationships with affiliates in states that have passed Amazon laws, and they can be expected to terminate their remaining affiliations if they lose in litigation over the definition of physical presence. E.g., Dale Kasler, *California Affiliates Hurt by Tax Bill Targeting Amazon.com*, SACRAMENTO BEE, July 7, 2011, at 1A, available at <http://www.sacbee.com/2011/07/07/3752677/california-affiliates-hurt-by.html> (“Hoping to exempt itself from the law, Amazon has fired its 10,000 California affiliates, cutting off their commissions. Scores of other e-commerce companies affected by the law, including Overstock.com and a slew of smaller firms, have done the same.”).

<sup>13</sup> *Id.* As an alternative to terminating relationships, e-commerce vendors might demand that their affiliates move out of major customer states. For further discussion, see *infra* Part III.A.

<sup>14</sup> Paul L. Caron, *Pepperdine Hosts Symposium on the Most Maligned Supreme Court Decisions*, TAX PROF. L. BLOG (Apr. 1, 2011), [http://taxprof.typepad.com/taxprof\\_blog/2011/04/supreme-mistakes.html](http://taxprof.typepad.com/taxprof_blog/2011/04/supreme-mistakes.html).

<sup>15</sup> See, e.g., David Brunori, *It’s Time to Overturn Quill*, 55 ST. TAX NOTES 497 (2010);

for Congress to pass legislation enabling the states to tax out-of-state e-commerce vendors.<sup>16</sup> A near scholarly consensus has developed against the *Quill* framework for governing when state sales and use taxes can reach interstate e-commerce.<sup>17</sup>

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

In other words, we argue that interstate commerce is not burdened under *Quill* merely because a sales transaction between a state resident and an out-of-state vendor bears the economic incidence of a state tax.<sup>18</sup> Instead, interstate commerce is only burdened when an out-of-state vendor bears reporting or compliance costs as a result of a state's imposing tax collection duties on the

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Arthur R. Rosen & Matthew P. Hedstrom, *Quill – Stare at the Decision*, 60 ST. TAX NOTES 931, 931 (2011) (“Indeed, many have expressed and continue to express an interest in ‘overturning’ *Quill* . . . .” (footnote omitted)).

<sup>16</sup> E.g., Edward A. Zelinsky, *New York Appellate Division Upholds “Amazon” Law: Analysis*, 59 ST. TAX NOTES 93, 104 (2010). Because the *Quill* decision was decided on dormant Commerce Clause grounds, states are only barred from taxing out-of-state vendors in the absence of congressional action authorizing such taxation.

<sup>17</sup> Walter Hellerstein, *Deconstructing the Debate over State Taxation of Electronic Commerce*, 13 HARV. J.L. & TECH. 549, 549-50 (2000) (“[T]here is a broad consensus among academic tax specialists regarding the general principles that should guide any effort to deal with sales and use taxation of electronic commerce . . . . Remote sales, including electronic commerce, should, to the extent possible, be taxed by the state of destination of sales, regardless of whether the vendor has a physical presence in the state.”).

Indeed, even those who praise *Quill* do so primarily on the grounds that Congress, not the courts, is the proper actor for specifying how the states should be able to tax interstate. Hence, even most of the “praise” for the case does not necessarily support the continuation of the physical presence rule for governing when states should be able to subject remote vendors to their sales and use taxes. E.g., Rosen & Hedstrom, *supra* note 15, at 936.

<sup>18</sup> The term “economic incidence” refers to the ultimate effect of a tax or subsidy on the cost or price of a good. Who bears a tax or subsidy is a function of the relative price elasticities of supply and demand and is not fixed by who has a legal obligation to pay the tax. See Don Fullerton & Gilbert E. Metcalf, *Tax Incidence*, in 4 HANDBOOK OF PUB. ECON. 1787, 1791 (Alan J. Auerbach & Martin Feldstein eds., 2002).

out-of-state vendor.<sup>19</sup> Although this distinction has not previously been analyzed in any depth, our interpretation of *Quill* is consistent with most of what has been written about the decision.<sup>20</sup>

What previous commentators have failed to recognize, however, is that this distinction potentially offers the states a constitutionally permissible approach for partially subjecting remote vendors to use taxes. Moreover, our proposed approach should not require the Supreme Court to revisit *Quill* or Congress to pass enabling legislation. Rather, we argue that a state desiring to subject remote vendors to its use tax should need only to adequately compensate the remote vendors for the compliance and reporting costs thereby imposed.

Because we conclude that the burden on interstate commerce at issue in *Quill* results from imposing reporting and compliance costs on out-of-state vendors, adequately compensating those vendors for these costs would completely alleviate the burden on interstate commerce. The states would benefit from our approach, as adequately compensating for tax collection costs should result in each state losing only a small fraction of the potential revenue available from taxing interstate e-commerce.<sup>21</sup> Yet as the Court observed in *Quill*, without adequate compensation for tax collection costs, a remote vendor selling across the United States might face a substantial burden from the aggregate costs of complying with the “virtual welter of complicated obligations” imposed by the “[n]ation’s 6,000-plus taxing jurisdictions.”<sup>22</sup> Our

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<sup>19</sup> As we will discuss in more depth *infra* in notes 113-115 and accompanying text, sales transactions between in-state residents and out-of-state vendors already bear the economic incidence of many state taxes, and this has not been viewed as constitutionally problematic. Most notably, many states already impose use taxes on purchases their residents make from out-of-state vendors that are not subject to sales taxation. Compliance with these use taxes is notoriously low, but the constitutionality of these use taxes highlights that the *Quill* decision only prevents states from subjecting remote vendors to tax collection costs. States can and do levy taxes for which the economic incidence falls on sales transactions between their residents and remote e-commerce vendors.

<sup>20</sup> *E.g.*, Hellerstein, *supra* note 6, at 439 (summarizing *Quill* as focusing “on the burdens the tax collection obligation imposed on interstate commerce”); Bradley Joondeph, *Rethinking the Role of the Dormant Commerce Clause in State Tax Jurisdiction*, 24 VA. TAX REV. 109, 120 (2004) (“Although North Dakota clearly had jurisdiction over the value it sought to tax – the use of furniture in North Dakota – imposing a compliance obligation on *Quill* violated the dormant Commerce Clause.”); John A. Swain, *State Income Tax Jurisdiction: A Jurisprudential and Policy Perspective*, 45 WM. & MARY L. REV. 319, 341 (2003) (“[W]e now turn to *Quill*. Here, the Court is not concerned with the economic impact of the tax liability, but with the compliance burden of reporting tax to multiple jurisdictions with non-uniform tax rules.”).

<sup>21</sup> See *infra* Part II.B.

<sup>22</sup> *Quill Corp. v. North Dakota*, 504 U.S. 298, 313 n.6 (1992) (“[S]imilar obligations might be imposed by the Nation’s 6,000-plus taxing jurisdictions.”); see also *Nat’l Bellas Hess, Inc. v. Dep’t of Revenue of Ill.*, 386 U.S. 753, 759-60 (1967) (“[M]any variations in rates of tax, in allowable exemptions, and in administrative and record-keeping

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proposed approach of adequately compensating remote vendors for all tax collection costs would thus allow the states to capture most of the potential revenue available from taxing interstate e-commerce while still not burdening interstate e-commerce with excess tax collection costs.

Previous scholarship has viewed the courts as facing a dilemma between either (a) denying states the right to tax interstate e-commerce and thus effectively granting remote e-commerce vendors an unjustified tax advantage over their in-state competitors<sup>23</sup> or (b) allowing states the right to tax interstate e-commerce and thus potentially disadvantaging multistate e-commerce vendors – who might then be burdened by tax compliance costs from each of the “Nation’s 6,000-plus taxing jurisdictions”<sup>24</sup> whereas their local competitors would only face compliance costs wherever they have a physical presence. Our proposed approach navigates between these two undesirable extremes. By permitting states and local taxing jurisdictions to tax remote vendors if and only if the remote vendors are adequately compensated for all tax compliance costs, our approach would place remote vendors and their in-state competitors on a far more level playing field.

Moreover, our proposed approach would incentivize state and local taxing jurisdictions to simplify their sales and use tax regimes, as the state and local jurisdictions would be forced to internalize the remote vendors’ costs of complying with those regimes.<sup>25</sup> Our approach thus avoids the concern that permitting states to tax interstate e-commerce might allow the states to create complicated sales and use tax regimes as protectionist bulwarks against out-of-state competitors.

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

Part II presents the heart of our argument – that our proposed approach of adequate vendor compensation would allow the states to raise most of the revenue available from taxing transactions between a state’s residents and remote vendors without burdening interstate commerce. It argues that our

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requirements could entangle [a mail-order house] in a virtual welter of complicated obligations.”).

<sup>23</sup> See, e.g., Brunori, *supra* note 15, at 2.

<sup>24</sup> *Nat’l Bellas Hess, Inc.*, 386 U.S. at 759-60.

<sup>25</sup> See *infra* Part III.B. For discussions of the theory behind causing economic actors to “internalize” the effects of “externalities,” see, for example, David Gamage, *Taxing Political Donations: The Case for Corrective Taxes in Campaign Finance*, 113 YALE L.J. 1283, 1292-94 (2004), and David Gamage & Darien Shanske, *Three Essays on Tax Salience: Market Salience and Political Salience*, 65 Tax L. Rev. (forthcoming 2012) (manuscript at 47-48), available at <http://ssrn.com/abstract=1779382>.

proposed approach is compatible with the *Quill* framework and explains how states might implement our proposed approach.

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

#### I. *QUILL* AND THE CONSTITUTIONAL LIMITATIONS ON STATE TAXATION OF E-COMMERCE

Forty-five states and the District of Columbia levy sales taxes.<sup>26</sup> As corollaries to these sales taxes, the states also employ use taxes.<sup>27</sup> Use taxes apply when a state resident purchases non-exempt goods or services for use within the state for which sales taxes have not been paid.<sup>28</sup>

In most states, individuals are responsible for paying use taxes on any e-commerce goods they purchase for which the e-commerce vendor did not previously remit sales or use taxes.<sup>29</sup> Hence, if state residents generally paid the use taxes they owed on e-commerce purchases, there would be no problem with state taxation of e-commerce, as the states' inability to levy sales or use taxes on e-commerce vendors would be remedied by the state residents instead paying use taxes on these purchases. But states have found it nearly impossible to collect use taxes from individual residents.<sup>30</sup> Indeed, most state residents appear to be unaware that they even owe use taxes on goods purchased from out-of-state e-commerce vendors.<sup>31</sup> Accordingly, when states

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<sup>26</sup> WALTER HELLERSTEIN, KIRK J. STARK, JOHN A. SWAIN & JOAN M. YOUNGMAN, *STATE AND LOCAL TAXATION: CASES AND MATERIALS* 607 (9th ed. 2009); 1 RICHARD D. POMP & OLIVER OLDMAN, *STATE AND LOCAL TAXATION* § 6-2 (5th ed. 2005) (“The only states still without a sales tax are Delaware, New Hampshire, Montana, Oregon, and Alaska . . .”); John Mikesell, *State Sales Taxes in 2010: Collections Still in Recession*, 60 *ST. TAX NOTES* 709, 711 (2011).

<sup>27</sup> Zelinsky, *supra* note 10, at 665 (“To backstop their sales taxes, the states and localities imposing them also levy use taxes if a resident makes a retail purchase but fails to pay sales tax on the purchase.”).

<sup>28</sup> *Id.*; see also *Use Tax*, WASH. ST. DEPARTMENT OF REVENUE, <http://dor.wa.gov/content/findtaxesandrates/usetax/> (last visited Feb. 20, 2012).

<sup>29</sup> *Use Tax*, *supra* note 28.

<sup>30</sup> Charles E. McLure, Jr., *Sales and Use Taxes on Electronic Commerce: Legal, Economic, Administrative, and Political Issues*, 34 *URB. LAW.* 487, 489 (2002) (“Use taxes are the legal liability of purchasers. With two exceptions – for automobiles and other products that must be registered to be used in the state and for purchases by business that can be audited – tax is likely to be paid only if vendors collect it.”).

<sup>31</sup> *The Amazon War: More Complicated than the Boston Tea Party, but Potentially as Colorful*, *ECONOMIST*, July 23rd-29th 2011, at 28 (“[I]n theory, consumers are supposed to keep receipts and pay so-called ‘use taxes’, but few people have ever heard of them.”).

are unable to impose use tax reporting or collection duties on vendors, use tax compliance is very low.<sup>32</sup>

The Supreme Court decided two cases in 1944 that created divergent constitutional rules for sales taxes and use taxes.<sup>33</sup> In *McLeod v. J.E. Dilworth Co.*,<sup>34</sup> the Court ruled that an Arkansas sales tax could not be applied to goods sold by travelling salespersons residing in Tennessee who solicited orders in Arkansas in person, by mail, or by telephone.<sup>35</sup> On the same day, the Court held in *General Trading Co. v. State Tax Commission* that an Iowa use tax could be levied on orders solicited through travelling salespersons residing in Minnesota.<sup>36</sup> The facts of these two cases were nearly identical, with the different outcomes turning solely on whether the retailer or the purchaser was obligated to collect and remit the tax.<sup>37</sup> Together, these two cases established a dichotomy between sales and use taxes that remains in effect to this day: purchases that occur within a state may be subject to sales taxation while purchases from remote vendors may only be subject to use taxation.<sup>38</sup>

The remainder of this Part analyzes the constitutional limitations on a state's ability to impose use tax compliance duties on remote vendors. These limitations arise from the Due Process Clause of the Fourteenth Amendment and from the dormant Commerce Clause. In brief, the Due Process Clause requires only "some definite link, some minimum connection, between a state and the person, property or transaction" that the state seeks to tax or regulate.<sup>39</sup> In contrast, the dormant Commerce Clause broadly invalidates state legislation that has a "burdening effect upon [interstate] commerce."<sup>40</sup> State regulation and taxation of interstate commerce must satisfy both of these clauses to be constitutionally permissible, but typically it is the dormant Commerce Clause that invalidates such regulations and taxes.

#### A. *The Due Process Clause*

The Due Process Clause of the Fourteenth Amendment provides the baseline restriction on a state's ability to subject out-of-state vendors to sales and use taxation. More generally, the Due Process Clause places a floor on the amount of connection that is required between a state and an out-of-state entity

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<sup>32</sup> John A. Swain, *Cybertaxation and the Commerce Clause: Entity Isolation or Affiliate Nexus?*, 75 S. CAL. L. REV. 419, 428 n.53 (2002).

<sup>33</sup> The discussion in this paragraph follows prior work by John Swain. *Id.* at 427-29.

<sup>34</sup> 322 U.S. 327 (1944).

<sup>35</sup> *Id.* at 331.

<sup>36</sup> 322 U.S. 335 (1944).

<sup>37</sup> Swain, *supra* note 32, at 428.

<sup>38</sup> *Id.*

<sup>39</sup> *Quill Corp. v. North Dakota*, 504 U.S. 298, 306 (1991) (quoting *Miller Bros. Co. v. Maryland*, 347 U.S. 340, 344-45 (1954)).

<sup>40</sup> *Id.* (quoting *Int'l Harvester Co. v. Dep't of Treasury*, 322 U.S. 340, 353 (1944) (Rutledge, J., concurring in part and dissenting in part)).

before the state may tax or regulate its conduct. This floor cannot be modified by a state or by Congress.<sup>41</sup> This test has been formulated in a variety of ways, but the touchstone is generally accepted to be “whether a defendant’s contacts with the forum made it reasonable, in the context of our federal system of Government, to require it to defend [a] suit in that State.”<sup>42</sup>

As this test is rather opaque as worded, the Supreme Court has taken several opportunities to clarify the amount of contact required by the Due Process Clause. For instance, the Court has ruled that soliciting sales from a state’s residents through independent contractors is sufficient contact to satisfy due process.<sup>43</sup> More broadly, the Court’s modern due process jurisprudence allows states to reach out-of-state actors who “purposefully avail” themselves of the state’s economic market.<sup>44</sup>

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

In *Quill*, the Court decisively ruled that physical presence is not necessary under the Due Process Clause and that the Due Process Clause does not bar states from subjecting vendors who conduct a significant amount of sales within a state to the state’s use tax. The *Quill* case involved North Dakota suing a remote mail-order vendor for unpaid use taxes on its sales to North Dakota residents.<sup>45</sup> The vendor in *Quill* owned no tangible property in the state and had no employees there, but it did sell almost \$1 million worth of merchandise to about 3,000 North Dakotans.<sup>46</sup> The Court upheld the tax, concluding, “[T]here is no question that Quill has purposefully directed its activities at North Dakota residents, that the magnitude of those contacts is

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<sup>41</sup> *Id.* at 305. Thus, even if Congress passed legislation permitting states to require “e-tailers” to collect a use tax for sales to in-state residents, the states’ exercise of that authority must be consistent with the Due Process Clause.

<sup>42</sup> *Id.* at 307.

<sup>43</sup> *Scripto, Inc. v. Carson*, 362 U.S. 207, 211 (1960).

<sup>44</sup> See *Burger King Corp. v. Rudzewicz*, 471 U.S. 462, 475 (1985) (“[I]t is essential in each case that there be some act by which the defendant purposefully avails itself of the privilege of conducting activities within the forum State, thus invoking the benefits and protections of its laws.” (citing *Hanson v. Denckla*, 357 U.S. 235, 253 (1958))).

<sup>45</sup> *Quill*, 504 U.S. at 303.

<sup>46</sup> *Id.* at 302.

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more than sufficient for due process purposes, and that the use tax is related to the benefits Quill receives from access to the state.”<sup>47</sup>

The *Quill* decision thus resolved any doubt about whether the Due Process Clause prevents the exercise of a state’s regulatory or taxing powers over out-of-state retailers who sell to a significant number of in-state residents. It is yet to be determined exactly what magnitude of sales to in-state residents is required to satisfy the Due Process Clause. Nevertheless, it seems clear that the Due Process Clause does not prevent states from subjecting major e-commerce vendors to use taxes, even when the vendors do not have a physical presence within the state.<sup>48</sup> To comply with the Due Process Clause, a state or local taxing jurisdiction need only exempt from its use tax those remote vendors whose sales within the jurisdiction fall below some minimal threshold.<sup>49</sup>

#### B. *The Dormant Commerce Clause*

Just as *Quill* removed a potential limitation to state taxing power based on the Due Process Clause, it fortified another restriction based on the dormant Commerce Clause. The Court has long held that the power granted to Congress to “regulate Commerce with foreign Nations, and among the several States”<sup>50</sup> can prevent the states from interfering with interstate commerce even in the absence of congressional action.<sup>51</sup> This “dormant” or “negative” Commerce Clause, first recognized by Justice Johnson in *Gibbons v. Ogden*,<sup>52</sup> imposes special restrictions on the states’ taxing powers.

The Court’s dormant Commerce Clause jurisprudence has evolved over time to become more permissive with respect to state taxation. In 1888, the Court

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<sup>47</sup> *Id.* at 308.

<sup>48</sup> *Id.* (“The requirements of due process are met irrespective of a corporation’s lack of physical presence in the taxing State. Thus, to the extent that our decisions have indicated that the Due Process Clause requires physical presence in a State for the imposition of duty to collect a use tax, we overrule those holdings as superseded by developments in the law of due process.”).

<sup>49</sup> State Amazon laws thus generally only apply to out-of-state vendors that conduct more than some threshold level of sales to in-state residents. *E.g.*, N.Y. TAX LAW § 1101(b)(8)(iv) (McKinney Supp. 2011) (“[A] person shall be presumed to be regularly or systematically soliciting business in this state if . . . the cumulative total of such person’s gross receipts from sales of property delivered in this state exceeds three hundred thousand dollars and such person made more than one hundred sales of property delivered in this state . . . .”); COLO. CODE REGS. § 39-21-112.3.5(1)(a)(iii) (2010) (providing that “[a] ‘retailer that does not collect Colorado sales tax’ does not include a retailer whose sales in Colorado are de minimis,” and that de minimis sales are presumed when the retailer makes “less than \$100,000 in total gross sales in Colorado in the prior calendar year”).

<sup>50</sup> U.S. CONST. art. I, § 8, cl. 3.

<sup>51</sup> *Quill*, 504 U.S. at 309.

<sup>52</sup> 22 U.S. 1, 231-32, 239 (1824) (Johnson, J., concurring).

held that “no State has the right to lay a tax on interstate commerce in any form.”<sup>53</sup> The Court later narrowed this holding to prohibit only “direct burdens on interstate commerce.”<sup>54</sup> Finally, in *Complete Auto Transit, Inc. v. Brady*,<sup>55</sup> the Court jettisoned the direct/indirect distinction and shifted the question to whether a state tax, in substance, “produces a forbidden effect”<sup>56</sup> by “discriminat[ing] against interstate commerce.”<sup>57</sup>

The *Complete Auto* decision established a four-part test that continues to govern the applicability of the dormant Commerce Clause to state taxation.<sup>58</sup> The Court has relied on this four-part test in virtually every dormant Commerce Clause challenge to a state or local tax since *Complete Auto* was decided in 1977.<sup>59</sup> Under the *Complete Auto* test, a state tax survives a dormant Commerce Clause challenge if the tax “[1] is applied to an activity with a substantial nexus with the taxing state, [2] is fairly apportioned, [3] does not discriminate against interstate commerce, and [4] is fairly related to the services provided by the State.”<sup>60</sup>

The first prong of the *Complete Auto* test requires that a tax be “‘applied to an activity with a substantial nexus with the taxing state.’”<sup>61</sup> For our purposes, this first prong is by far the most important component of the *Complete Auto* test. The *Quill* decision ruled that vendors without a physical presence in the taxing state do not have the substantial nexus required by this first prong.<sup>62</sup> In the Court’s words, “a vendor whose only contacts with the taxing state are by mail or common carrier lacks the ‘substantial nexus’ required by the Commerce Clause.”<sup>63</sup> It is this first prong that prevents states from imposing sales or use tax compliance obligations on remote e-commerce vendors.

The majority in *Quill* justified the physical presence test for nexus based on stare decisis and on the concern that allowing states to impose use tax compliance obligations on remote vendors could burden interstate commerce by entangling remote vendors in a “‘virtual welter of complicated obligations’” imposed by the “‘Nation’s 6,000-plus taxing jurisdictions.’”<sup>64</sup> The stare

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<sup>53</sup> *Leloup v. Port of Mobile*, 127 U.S. 640, 648 (1888).

<sup>54</sup> *Quill*, 504 U.S. at 309 (citing, among other cases, *Sanford v. Poe*, 69 F. 546 (6th Cir. 1895), *aff’d sub nom. Adams Express Co. v. Ohio State Auditor*, 165 U.S. 194 (1897)).

<sup>55</sup> 430 U.S. 274 (1977).

<sup>56</sup> *Id.* at 288.

<sup>57</sup> *Id.* at 287.

<sup>58</sup> *Id.* at 297.

<sup>59</sup> *Joodeph*, *supra* note 20, at 117.

<sup>60</sup> *Quill Corp. v. North Dakota*, 504 U.S. 298, 311 (1992) (quoting *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977)).

<sup>61</sup> *Id.*

<sup>62</sup> *Id.*

<sup>63</sup> *Id.*

<sup>64</sup> *Id.* at 313 n.6 (quoting *Nat’l Bellas Hess, Inc. v. Dep’t of Revenue of Ill.*, 386 U.S. 753, 759-60 (1967)).

decisis justification arose because the Court had previously articulated the physical presence requirement in *National Bellas Hess, Inc. v. Department of Revenue of Illinois*.<sup>65</sup> *Bellas Hess* also justified the physical presence requirement based on the burden on interstate commerce that might arise if multiple jurisdictions were allowed to impose “a virtual welter of complicated obligations.”<sup>66</sup> The *Bellas Hess* Court worried that if one state “can impose such burdens, so can every other State, and so, indeed, can every municipality, every school district, and every other political subdivision throughout the Nation with power to impose sales and use taxes.”<sup>67</sup>

The *Quill* Court’s invocation of stare decisis was important because the North Dakota State Supreme Court had previously determined that *Bellas Hess*’s physical presence rule no longer applied due to the evolution of the U.S. Supreme Court’s Commerce Clause jurisprudence.<sup>68</sup> *Quill*’s reaffirmation of the physical presence requirement for nexus thus resolved any ambiguity about whether the permissive trend in modern Commerce Clause jurisprudence might have made the physical presence requirement obsolete. The *Quill* majority argued that the physical presence requirement appropriately functions as a bright-line rule capable of avoiding the “quagmire” that might otherwise result from the need to evaluate on a case-by-case basis whether the exercise of the states’ taxing power would unduly burden interstate commerce.<sup>69</sup>

In Part II of this Article, we argue that *Quill*’s physical presence requirement should not prevent states from imposing use tax compliance obligations on remote vendors when the states adequately compensate the remote vendors for all compliance costs imposed. Before proceeding to that discussion, however, we will briefly describe the remaining three prongs of the *Complete Auto* test.

The second prong of the *Complete Auto* test requires that a tax be “fairly apportioned.”<sup>70</sup> Fair apportionment ensures that multi-state economic activity does not become doubly taxed by being subject to the full taxing regimes of multiple states.<sup>71</sup> For instance, state corporate income taxes are considered

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<sup>65</sup> 386 U.S. at 758.

<sup>66</sup> *Id.* at 760.

<sup>67</sup> *Id.* at 759.

<sup>68</sup> *Quill*, 504 U.S. at 314.

<sup>69</sup> *Id.* at 315.

<sup>70</sup> *Id.* at 311.

<sup>71</sup> Bradley W. Joondeph, *The Meaning of Fair Apportionment and the Prohibition on Extraterritorial State Taxation*, 71 *FORDHAM L. REV.* 149, 158 (2002); see also *Okla. Tax Comm’n v. Jefferson Lines, Inc.*, 514 U.S. 175, 186 (1995) (“[W]e have assessed any threat of malapportionment by asking whether the tax is internally consistent and, if so, whether it is externally consistent as well. . . . Internal consistency is preserved when the imposition of a tax identical to the one in question by every other State would add no burden to interstate commerce that intrastate commerce would not also bear. . . . External consistency, on the other hand, looks not to the logical consequences of cloning, but to the economic

fairly apportioned when a state taxes only a portion of a multi-state corporation's national income based on what percentage of the corporation's total sales, payroll, and property occurs within the state.<sup>72</sup> For state sales and use taxes, fair apportionment is achieved when either the state in which the vendor resides or the state in which the customer resides taxes the transaction; fair apportionment would be violated if both states taxed the transaction.<sup>73</sup> Hence, the Court has held that use taxes are fairly apportioned when they provide "a credit . . . for sales taxes that have been paid in other States."<sup>74</sup> More generally, a use tax should only fail the fair apportionment test if it is levied on transactions that were already subject to a sales or use tax in another state and does not offer a credit for sales taxes paid in other states.<sup>75</sup>

The third prong of the *Complete Auto* test requires that a tax "not discriminate against interstate commerce."<sup>76</sup> A use tax should generally satisfy this prong as long as the rate of the use tax does not exceed the sales or use tax rate that would apply to an intrastate sale.<sup>77</sup> Indeed, the Court held that a Louisiana use tax satisfied the non-discrimination test because the tax "was designed to compensate the State for revenue lost when residents purchase out-of-state goods for use within the state" and the rate of the tax was "equal to the sales tax applicable to the same tangible personal property purchased in-state."<sup>78</sup> A properly designed use tax should thus have no trouble satisfying the non-discrimination requirement.

The fourth prong of the *Complete Auto* test requires that a tax be "fairly related to the services provided by the State."<sup>79</sup> This fourth prong "is closely connected to the first prong of the *Complete Auto Transit* test."<sup>80</sup> Beyond the substantial nexus requirement of the first prong, the fourth prong "imposes the additional limitation that the *measure* of the tax must be reasonably related to

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justification for the State's claim upon the value taxed, to discover whether a State's tax reaches beyond that portion of value that is fairly attributable to economic activity within the taxing State." (internal quotation marks omitted)).

<sup>72</sup> Elliot Dubin, *Changes in State Corporate Tax Apportionment Formulas and Tax Bases*, 55 ST. TAX NOTES 563, 563 (2010); Joondeph, *supra* note 20, at 117.

<sup>73</sup> *Jefferson Lines*, 514 U.S. at 190; Charles E. McLure, Jr., *supra* note 30, at 492-93; Swain, *supra* note 32, at 438.

<sup>74</sup> *D.H. Holmes Co. v. McNamara*, 486 U.S. 24, 31 (1988).

<sup>75</sup> The typical approach for ensuring that use taxes are fairly apportioned is to levy the use tax only on transactions that were not subject to sales or use taxes in other states. The State of Washington's use tax, for example, only applies when goods "are purchased in another state that does not have a sales tax or a state with a sales tax lower than Washington's." *Use Tax*, *supra* note 28.

<sup>76</sup> *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977).

<sup>77</sup> *Id.* at 313.

<sup>78</sup> *D.H. Holmes*, 486 U.S. at 32.

<sup>79</sup> *Complete Auto*, 430 U.S. at 279.

<sup>80</sup> *Commonwealth Edison Co. v. Montana*, 453 U.S. 609, 625-26 (1981).

the extent of the [taxpayer's] contact" with the state.<sup>81</sup> The Court has repeatedly interpreted this fourth prong as being met when a tax is measured as a percentage of some proxy for the value of the taxpayer's economic activity occurring within the state.<sup>82</sup> However, as long as a tax is measured based on some proxy for the value of the services a taxpayer receives from a state, the Court has declined to inquire into the appropriate level or rate of the tax based on that proxy, ruling that determinations about the appropriate levels of taxation must be made by the political process.<sup>83</sup> With respect to use taxes, an interstate sale jointly benefits from the services provided by the state in which the vendor resides and the state in which the customer resides.<sup>84</sup> Consequently, a use tax should meet the fourth prong of the *Complete Auto* test as long as the tax applies only to transactions that were not subject to a sales or use tax in another state or if the tax allows a credit for sales or use taxes paid to another state.<sup>85</sup>

In sum, only the physical presence requirement of the first prong of the *Complete Auto* test prevents states from imposing use tax compliance obligations on the major e-commerce vendors. A properly designed use tax can avoid any due process concerns so long as it exempts remote vendors who conduct less than some minimal amount of sales within the state. Likewise, a properly designed use tax can avoid any other Commerce Clause concerns – beyond those arising from the nexus requirement – as long as it (1) applies a tax rate to interstate transactions no higher than the sales or use tax rate that applies to intrastate transactions and (2) either exempts transactions that were

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<sup>81</sup> *Id.* at 626.

<sup>82</sup> *E.g.*, *Okla. Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175, 198-99 (1995); *Exxon Corp. v. Wis. Dep't of Revenue*, 447 U.S. 207, 228 (1989) (finding that Wisconsin demonstrated fair apportionment of a tax and that the tax was fairly related to state services such as "police and fire protection, the benefit of a trained work force, and 'the advantages of a civilized society'" (quoting *Japan Line Ltd. v. Cnty. of Los Angeles*, 441 U.S. 434, 445 (1979))); *Commonwealth Edison Co.*, 453 U.S. at 626.

<sup>83</sup> *Commonwealth Edison Co.*, 453 U.S. at 626.

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

<sup>85</sup> *See* *D.H. Holmes Co. Ltd. v. McNamara*, 486 U.S. 24, 32 (1988) (ruling that a use tax is fairly related to the benefits provided by the state because it is related to the services provided by the state, such as the state's provision of mass transit and public roads for the benefit of the vendor's customers). Arguably, a use tax that fails the substantial nexus requirement of the first prong of the *Complete Auto* test might also fail the fourth prong. But there can be no doubt that interstate sales benefit from services provided by the state in which the customer resides, as the various benefits provided by that state create the framework within which the customer was able to earn funds to make the purchase.

already subject to a sales or use tax in another state or else offers a credit for any sales or use taxes paid to another state.

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

## II. OUR PROPOSED SOLUTION: ADEQUATE VENDOR COMPENSATION

Numerous commentators have argued that *Quill* is inappropriate for the Internet age and that the decision should be overturned.<sup>86</sup> Yet we see no indication that the Supreme Court intends or even has reason to revisit *Quill*.<sup>87</sup> Accordingly, the states have generally attempted to work within the *Quill* framework when designing their sales and use taxes.<sup>88</sup>

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

There are two justifications for *Quill*’s physical presence rule – preventing burdens on interstate commerce and stare decisis.<sup>89</sup> We argue that the burden on interstate commerce that troubled the Court in *Quill* arises solely from the potential for remote vendors to be subject to excess tax compliance costs. Hence, properly implemented, our proposed solution of adequate vendor compensation can completely alleviate any potential for burdening interstate commerce. We further argue that our proposed approach should survive any constitutional challenge based on stare decisis, because the lack of any potential for burdening interstate commerce makes our proposed approach different in kind from the tax statutes that the *Quill* decision ruled unconstitutional.

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<sup>86</sup> See Rosen & Hedstrom, *supra* note 15, at 931 n.6.

<sup>87</sup> See *id.* at 935 (“From the Court’s perspective its job is done; it has already spoken.”). Note, however, that we are not Court watchers and that we do not intend anything in this Article to be understood as predicting how the Supreme Court might rule if it actually takes a case evaluating any of the new state Amazon laws. Our doctrinal analysis in this Article is directed toward lower courts that must interpret cases like *Quill* and that do not have the option of overturning these cases. In Part III.C., *infra*, we argue that the Supreme Court should not overturn *Quill* as long as the case is interpreted to permit our proposed approach of adequate vendor compensation, but we base this argument on policy considerations.

<sup>88</sup> See *id.* at 931.

<sup>89</sup> See *supra* notes 64-68 and accompanying text.

A. *The Burden on Interstate Commerce in Quill*

In moving beyond its old formalistic dormant Commerce Clause jurisprudence, the Court has repeatedly emphasized “the importance of looking past ‘the formal language of the tax statute [to] its practical effect.’”<sup>90</sup> As the Court explained in *Commonwealth Edison*,

[T]he Court has rejected the notion that state taxes levied on interstate commerce are per se invalid . . . . In reviewing commerce clause challenges to state taxes, our goal has instead been to “establish a consistent and rational method of inquiry” focusing on “the practical effect of a challenged tax.”<sup>91</sup>

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

[T]he Commerce Clause and its nexus requirement are informed not so much by concerns about fairness for the individual defendant as by structural concerns about the effects of state regulation on the national economy. Under the Articles of Confederation, state taxes and duties hindered and suppressed interstate commerce; the Framers intended the Commerce Clause as a cure for these structural ills. It is in this light that we have interpreted the negative implication of the Commerce Clause. Accordingly, we have ruled that that Clause . . . bars state regulations that unduly burden interstate commerce.<sup>92</sup>

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

To accept appellants’ apparent suggestion that the Commerce Clause prohibits the States from requiring an activity connected to interstate commerce to contribute to the general cost of providing governmental services . . . would place such commerce in a privileged position. But as

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<sup>90</sup> *Quill Corp. v. North Dakota*, 504 U.S. 298, 310 (1992) (quoting *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977)).

<sup>91</sup> *Commonwealth Edison Co. v. Montana*, 453 U.S. 609, 615 (1981) (citations omitted) (quoting *Mobil Oil Corp. v. Comm’r of Taxes of Vt.*, 445 U.S. 425, 443 (1980)).

<sup>92</sup> *Quill*, 504 U.S. at 312 (citation omitted).

<sup>93</sup> *D.H. Holmes Co. v. McNamara*, 486 U.S. 24, 31 (1988).

<sup>94</sup> *Commonwealth Edison*, 453 U.S. at 616 (quoting *Wash. Revenue Dep’t v. Ass’n of Wash. Stevedoring Cos.*, 435 U.S. 734, 748 (1978)).

we recently reiterated, “[i]t was not the purpose of the commerce clause to relieve those engaged in interstate commerce from their just share of state tax burden even though it increases the cost of doing business.”<sup>95</sup>

As these cases indicate, the Court’s modern Commerce Clause jurisprudence is not designed to place interstate commerce in a tax-advantaged position with respect to intrastate commerce<sup>96</sup> – “[e]ven interstate business must pay its way.”<sup>97</sup> A state tax that equally burdens both interstate and intrastate transactions should not run afoul of the Commerce Clause, as such a tax would not burden interstate commerce as compared to intrastate commerce.

Why then did the *Quill* decision hold that a state may not apply its use tax to remote vendors lacking a physical presence within the state, when the tax rate levied on interstate transactions would have been the same as that levied on intrastate transactions? The Court’s reason cannot have been that the Commerce Clause shields remote vendors from paying the same taxes or bearing the same compliance obligations as do in-state vendors. Such a reason would be in direct contradiction to the Court’s repeated proclamations that the purpose of the Commerce Clause is not “to relieve those engaged in interstate commerce from their just share of state tax burden even though it increases the cost of doing business.”<sup>98</sup> Importantly, the *Quill* majority specified that they were upholding the physical presence rule because “it is not inconsistent with *Complete Auto*” and the other modern Commerce Clause cases.<sup>99</sup> And the only justification for the *Quill* decision that would be consistent with *Complete Auto* and with the Court’s other articulations of modern Commerce Clause jurisprudence must be that allowing the states to apply their use taxes to remote vendors lacking physical presence would result in those vendors bearing *greater* costs than do in-state vendors.

As noted,<sup>100</sup> the *Quill* decision did indeed explain how allowing states to impose use tax compliance obligations on remote vendors could result in those vendors bearing greater costs as compared to vendors that operate solely within a single state.<sup>101</sup> Quoting *Bellas Hess*, the *Quill* decision’s entire discussion of how allowing states to impose use tax obligations on remote vendors might burden interstate commerce revolved around the “virtual welter of complicated obligations” that a vendor operating in multiple taxing jurisdictions might face.<sup>102</sup> Because the *Quill* decision’s articulation of the potential burden on

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<sup>95</sup> *Id.* at 623-24.

<sup>96</sup> *Id.*

<sup>97</sup> *Postal Tel.-Cable Co. v. Richmond*, 249 U.S. 252, 259 (1919); *see also* *W. Live Stock v. Bureau of Revenue*, 303 U.S. 250, 254 (1938).

<sup>98</sup> *Colonial Pipeline Co. v. Traigle*, 421 U.S. 100, 108 (1975); *see also* *Commonwealth Edison*, 453 U.S. at 624-25.

<sup>99</sup> *Quill Corp. v. North Dakota*, 504 U.S. 298, 311(1992).

<sup>100</sup> *See supra* note 64 and accompanying text.

<sup>101</sup> *Quill*, 504 U.S. at 313 n.6.

<sup>102</sup> *Id.*

interstate commerce is key to our argument, it is worth quoting the relevant discussion from *Quill* in full:

North Dakota's use tax illustrates well how a state tax might unduly burden interstate commerce. On its face, North Dakota law imposes a collection duty on every vendor who advertises in the State three times in a single year. Thus, absent the *Bellas Hess* rule, a publisher who included a subscription card in three issues of its magazine, a vendor whose radio advertisements were heard in North Dakota on three occasions, and a corporation whose telephone sales force made three calls into the State, all would be subject to the collection duty. What is more significant, similar obligations might be imposed by the Nation's 6,000-plus taxing jurisdictions. See *National Bellas Hess, Inc. v. Department of Revenue of Ill.*, 386 U.S. 753, 759-760 . . . (noting that the "many variations in rates of tax, in allowable exemptions, and in administrative and recordkeeping requirements could entangle [a mail-order house] in a virtual welter of complicated obligations").<sup>103</sup>

To repeat ourselves for emphasis, the above paragraph is the entirety of the *Quill* decision's analysis as to how allowing states to apply their use taxes to remote vendors might burden interstate commerce. As the quoted paragraph makes clear, the Court was concerned with the imposition of a "collection duty" on remote vendors and in particular with the fear that a remote vendor might be entangled in a "virtual welter of complicated obligations" imposed by the "[n]ation's 6,000-plus taxing jurisdictions."<sup>104</sup> Consistent with the Court's modern Commerce Clause jurisprudence, the *Quill* decision was thus justified based on the fear that overlapping compliance burdens from multiple jurisdictions could result in multistate vendors bearing greater costs than single-state vendors. The *Quill* decision was not based on any notion that remote vendors ought to be placed in a tax-advantaged position as compared to single-state vendors.

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

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<sup>103</sup> *Id.*

<sup>104</sup> *Id.* (quoting *Nat'l Bellas Hess, Inc. v. Dep't of Revenue of Ill.*, 386 U. S. 753, 760 (1967)).

forcing vendors wishing to sell to multiple states to face higher aggregate compliance costs than would vendors selling only within a single state.<sup>105</sup>

As in *Quill*, the only discussion in the *Bellas Hess* decision about how allowing states to impose use tax compliance obligations on remote vendors might burden interstate commerce relies on the overlapping compliance duties that could be imposed by multiple jurisdictions.<sup>106</sup> Again, it is worth quoting that discussion in full:

And if the power of Illinois to impose use tax burdens upon National were upheld, the resulting impediments upon the free conduct of its interstate business would be neither imaginary nor remote. For if Illinois can impose such burdens, so can every other State, and so, indeed, can every municipality, every school district, and every other political subdivision throughout the Nation with power to impose sales and use taxes. The many variations in rates of tax, in allowable exemptions, and in administrative and record-keeping requirements could entangle National's interstate business in a virtual welter of complicated obligations to local jurisdictions with no legitimate claim to impose "a fair share of the cost of the local government." The very purpose of the Commerce Clause was to ensure a national economy free from such unjustifiable local entanglements.<sup>107</sup>

Both *Quill* and *Bellas Hess* thus justify the physical presence requirement based on the fear that a mail-order vendor (or e-commerce vendor) selling across the United States could face high aggregate compliance costs due to the nation's many taxing jurisdictions. This fear appears to have been magnified by the concern that there is no necessary connection between the compliance costs imposed by a state or local jurisdiction's use tax regime and the magnitude of sales a vendor conducts within that state or local jurisdiction.<sup>108</sup> A small state or local jurisdiction could potentially impose compliance costs larger than the actual amount of sales made into the jurisdiction, if the level of sales were sufficiently small and the jurisdiction's use tax regime sufficiently complicated.

The physical presence rule of the nexus requirement might thus be viewed as a mechanism for creating a fair apportionment test for tax compliance costs analogous to the fair apportionment test for direct tax costs in the second prong of the *Complete Auto* test.<sup>109</sup> Rather than attempting to devise a rule for what minimum amount of sales – beyond that required by the Due Process Clause – would justify a jurisdiction's imposing compliance burdens on remote vendors,

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<sup>105</sup> We provide an extended example in support of this point *infra* in Part II.B.

<sup>106</sup> *Nat'l Bellas Hess, Inc.*, 386 U.S. at 759-60.

<sup>107</sup> *Id.* (footnotes omitted) (quoting *Freeman v. Hewit*, 329 U.S. 249, 253 (1946)).

<sup>108</sup> *Quill*, 504 U.S. at 313 n.6; *Nat'l Bellas Hess, Inc.*, 386 U.S. at 760.

<sup>109</sup> For a discussion of the fair apportionment rule for direct tax costs, see *supra* notes 70-75 and accompanying text.

the Court instead adopted the bright-line physical presence rule.<sup>110</sup> Again, the Court's motive appears to have been the desire to prevent jurisdictions from disproportionately burdening remote vendors with excess compliance costs. But for the concern about excess tax compliance costs, there would be no need to ensure fair apportionment of tax compliance costs, and there would consequently be no need for *Quill's* physical presence rule.

Even Amazon – “the No. 1 Internet retailer” and “lead dog when it comes to fighting the online tax issue”<sup>111</sup> – publicly defends its opposition to the states' extending their use tax regimes to e-commerce based on the same concern about excess compliance costs as relied on by the *Quill* and *Bellas Hess* decisions. As the *Sacramento Bee* reports, “Amazon says it isn't opposed to an Internet sales tax. It just doesn't want to deal with the complexity of 7,500 different tax jurisdictions in the United States. Founder and Chief Executive Jeff Bezos has said he supports a unified approach that simplifies tax collection across the country.”<sup>112</sup> Of course, skeptics argue that Amazon's public statements are hypocritical and that Amazon's true motives are to maintain for as long as possible its tax advantage as compared to competing retailers that must maintain a physical presence within major customer states.<sup>113</sup> Nevertheless, Amazon's public position supports our argument that the only justifiable reason for barring states from applying their use taxes to remote vendors comes from the excess compliance costs that could be generated by numerous taxing jurisdictions imposing non-uniform compliance obligations; even Amazon does not argue that remote e-commerce vendors deserve a tax advantage as compared to their in-state competitors.

Finally, that states have long been able to levy use tax liabilities on their residents who purchase from remote vendors is perhaps the strongest argument in favor of interpreting *Quill's* physical presence requirement as applying only when the states impose use tax compliance obligations on remote vendors that might burden interstate commerce. In most states, when individuals purchase e-commerce goods for which the vendor did not remit sales or use tax, the individual state residents legally owe use taxes to their state.<sup>114</sup> That state residents appear to be unaware of their use tax liabilities, and that compliance is very low, does not change the fact that the Commerce Clause has never been interpreted as preventing states from making their individual residents liable for use taxes on purchases from remote vendors.<sup>115</sup> If the purpose of *Quill's*

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<sup>110</sup> *Quill*, 504 U.S. at 314-16.

<sup>111</sup> Kasler, *supra* note 8, at 1A.

<sup>112</sup> *Id.*

<sup>113</sup> *Id.*; John Moe, *You May Soon Be Paying Sales Tax on Your Amazon Purchases*, MARKETPLACE (July 19, 2011), <http://marketplace.publicradio.org/display/web/2011/07/19/tech-report-you-may-soon-be-paying-sales-tax-on-amazon/?refid=0>.

<sup>114</sup> *Supra* notes 29-32 and accompanying text.

<sup>115</sup> *Supra* notes 29-32; see also NINA MANZI, MINN. HOUSE OF REPRESENTATIVES RESEARCH DEP'T, USE TAX COLLECTION ON INCOME TAX RETURNS IN OTHER STATES 3-4

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physical presence requirement was to shield remote vendors from the economic incidence of state sales and use taxation, then the Commerce Clause should also block states from imposing use tax liabilities on their own residents for goods purchased from remote vendors.

The economic incidence of the tax burden generally remains the same even if the statutory incidence changes; that is, the economic incidence is not affected by whether a state resident is liable for a use tax on purchases from remote vendors or whether the remote vendors are liable for remitting the use tax.<sup>116</sup> In either case, the same amount of tax is paid – raising the cost of the sales transaction between the state resident and the remote vendor by the same amount. The only major differences between these two approaches for taxing interstate transactions are that (1) states find it much easier to enforce compliance when vendors are required to remit use taxes as compared to when individual residents are required to remit the taxes and (2) requiring vendors to remit use taxes imposes reporting and compliance costs on those vendors whereas requiring individual residents to remit use taxes imposes the reporting and compliance costs on the individual residents. As no one has argued that enforcement difficulties make a tax less constitutionally suspect, only the second of these factors can justify the Commerce Clause's barring states from imposing use tax compliance obligations on remote vendors while allowing states to impose such obligations on the state's individual residents. Again, the only plausible way to reconcile *Quill*'s physical presence requirement with the Court's other Commerce Clause holdings is to view the physical presence requirement as only applying when states impose compliance costs on remote vendors in a manner that burdens interstate commerce. Any other interpretation of *Quill* would contradict the majority's claim that upholding the physical presence requirement is consistent with the Court's other modern Commerce Clause holdings.<sup>117</sup>

#### B. *The Solution of Adequate Vendor Compensation*

If – as we have argued – the burden on interstate commerce in *Quill* results from multistate vendors potentially facing higher use tax compliance costs as compared to single-state vendors, then a remedy is available that would allow states to collect use tax revenues from remote vendors without burdening interstate commerce. We propose that *Quill* be interpreted in such a way that states would only be barred from imposing use tax compliance burdens on remote vendors when the states fail to adequately compensate the remote vendors for all such compliance costs imposed.

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(2010), available at <http://www.house.leg.state.mn.us/hrd/pubs/usetax.pdf>.

<sup>116</sup> JONATHAN GRUBER, PUBLIC FINANCE & PUBLIC POLICY 521 (2004). There are exceptions to this rule – i.e., circumstances that can lead to economic incidence varying with statutory incidence. But these exceptions are not important for our purposes here.

<sup>117</sup> *Quill Corp. v. North Dakota*, 504 U.S. 298, 311 (1992).

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Imagine two fictional states – Taxachusetts and New Pork – each of which wishes to levy a sales and use tax with a rate of ten percent. Each state’s tax regime would impose compliance costs on vendors charged with remitting the state’s tax. These compliance costs are unlikely to be directly proportional to the amount of tax revenues collected, as there are fixed costs associated with complying with a tax that arises from the need to research the tax regime and design systems to remit the tax.<sup>118</sup> Imagine that a typical small vendor with total sales of \$500,000 would bear compliance costs for each state’s tax it is charged with remitting equal to fixed costs of \$2,500 plus additional variable costs equal to 0.02 percent of the amount sold into the state.<sup>119</sup>

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

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

This example might seem to suggest that the goal of treating interstate commerce and intrastate commerce equally would require allowing Taxachusetts to subject remote vendors to its sales and use tax without

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<sup>118</sup> See ROBERT J. CLINE & THOMAS S. NEUBIG, ERNST & YOUNG LLP, MASTERS OF COMPLEXITY AND BEARERS OF GREAT BURDEN: THE SALES TAX SYSTEM AND COMPLIANCE COSTS FOR MULTISTATE RETAILERS, at ii (1999), available at <http://plaza.ufl.edu/chriske2/masters.pdf> (“Small in-state retailers (\$250,000 of annual taxable sales in Washington) bear unacceptably high compliance costs – 7 percent of sales taxes collected – that put them at a competitive disadvantage to larger firms in the state. This high level of compliance costs suggests that, for smaller firms, the sales tax may be reaching the point where it cannot be collected at a reasonable cost. Medium (\$750,000 of sales) and large retailers (\$10 million in sales) have lower compliance cost burdens because fixed compliance costs are spread over larger sales tax collections and they generally use automated collection and reporting systems. The compliance cost for the medium-size retailer is still very high at almost 4 percent of sales taxes collected, or one-quarter of its profits.”).

<sup>119</sup> The numbers in these examples are very roughly extrapolated from Cline and Neubig’s study of compliance costs. *Id.* These costs, however, might be somewhat lower today than they were in 1999.

compensating for compliance costs. But imagine another small vendor residing in New York that makes half of its sales (\$250,000) to individual residents of Massachusetts and the other half (\$250,000) to individual residents of New York. If this vendor were subject to the sales and use tax regimes of both Massachusetts and New York, the vendor would face compliance costs from both tax regimes. In total, the vendor would face compliance costs of \$6,000 (the vendor would be subject to the fixed costs of \$2,500 twice, due to the need to comply with both Massachusetts's and New York's tax regimes, plus the variable costs of 0.02 percent of the \$500,000 of aggregate sales). When combined with the direct tax costs of \$50,000 from the ten percent tax rate levied on sales into either state, the vendor's sales would be subject to an aggregate burden of \$56,000.

In the absence of *Quill's* physical presence rule, the multistate vendor could thus face higher aggregate costs than would a vendor operating solely within a single state. This tax disadvantage results from the fixed costs associated with complying with each separate tax regime.<sup>120</sup> In our example above, the multistate vendor only faced a tax disadvantage of \$2,500 (from aggregate costs of \$56,000 as compared to the single-state vendor's aggregate costs of \$53,500). But our example above only involved two taxing jurisdictions. With fifty states and several thousand local taxing jurisdictions, a multistate vendor might well face a significant disadvantage from aggregate use tax compliance costs in the absence of *Quill's* physical presence rule or an equivalent protection.<sup>121</sup>

In the extreme, imagine if the \$2,500 of additional tax burden resulting from the fixed costs of complying with each jurisdiction's separate use tax was multiplied by several thousand separate taxing jurisdictions. Although it is unlikely that real-world tax compliance burdens would ever reach these levels,<sup>122</sup> we should be wary of even the theoretical possibility of a multistate vendor with sales of only \$500,000 facing use tax compliance costs in the range of multiple millions of dollars.<sup>123</sup> Even if burdens reached only a small

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<sup>120</sup> See, e.g., Cara Griffeth, *Streamlining Versus "Amazon" Laws: The Remote Seller Dilemma*, 55 ST. TAX NOTES 351, 354 (2010) ("Determining how to handle tax-exempt sales, sales tax holidays, and product taxability coding can be a daunting task, particularly for small and midsize businesses. It has been estimated that sales tax exemptions account for 60 percent of the cost of compliance for small businesses.").

<sup>121</sup> This disadvantage would burden small and medium vendors far more than it would large vendors, and the disadvantage could be alleviated to some extent by exempting small vendors from use taxation. But the burden does not completely disappear for large vendors, and even the burden facing large vendors could be significant if thousands of taxing jurisdictions are allowed to impose different use tax regimes and the differences in these regimes are sufficiently complicated.

<sup>122</sup> If compliance burdens began to reach extremely high levels, there would likely be significant political pressure to simplify and unify use tax regimes.

<sup>123</sup> An aggregate use tax compliance burden in the millions of dollars could only result if the vendor sold into numerous taxing jurisdictions, and some of these jurisdictions might be

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fraction of that level, use tax compliance costs could still significantly burden interstate commerce. And remember that without some rule preventing the imposition of compliance burdens on remote vendors, states might be tempted to impose burdensome compliance obligations as a back-door form of protectionism in order to advantage in-state retailers.

We thus have a dilemma in developing a Commerce Clause rule for state taxation of transactions between the state's residents and remote vendors. Exempting remote vendors from state sales and use taxation grants those vendors a significant tax advantage, which is not the purpose of the Commerce Clause. But allowing states to impose the same compliance burdens on remote vendors as they do on in-state vendors could impose a substantial tax cost disadvantage on remote vendors which could in turn burden interstate commerce. And if a state attempted to chart a middle course by imposing compliance burdens on larger remote vendors while exempting smaller remote vendors, then this approach would provide the smaller remote vendors with an unjustified tax advantage as compared to both larger remote vendors and in-state vendors of all sizes.

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

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prevented from levying use taxes on the vendor due to the minimum contacts requirement of the Due Process Clause, even if the jurisdictions were not prevented from imposing burdens due to the Commerce Clause. Nevertheless, although the example of a vendor making \$500,000 in total sales being subject to millions of dollars in aggregate use tax compliance costs is unrealistically extreme, it still illustrates the general result whereby a multistate vendor could face a significant tax disadvantage from being subject to multiple use tax compliance regimes in the absence of a compensation requirement or some other protection for the vendor.

levied on sales into either state, the vendor's sales would be subject to an aggregate burden of \$53,000.

Consequently, permitting states to impose use tax compliance obligations on remote vendors only when the states adequately compensate the remote vendors for those costs would completely alleviate the burden on interstate commerce. Indeed, our proposal of adequate vendor compensation would likely result in remote vendors' maintaining a small tax cost advantage as compared to in-state vendors.<sup>124</sup> In our numerical examples, the multi-state vendor would face costs of \$53,000 as compared to the in-state vendor's costs of \$53,500. The reason for this tax cost advantage is that our examples require the states to compensate for the variable costs of use tax compliance in addition to the fixed costs. We suspect that it would prove administratively impractical to require states to compensate only for fixed costs, as there is no simple and straightforward mechanism for perfectly distinguishing between direct and indirect costs.<sup>125</sup> Nevertheless, our proposal would still considerably level the playing field as compared to completely exempting remote vendors from use taxation.<sup>126</sup>

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

More generally, use tax compliance costs are estimated to be around one to three percent of tax revenues, with the costs being much higher as a percentage

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<sup>124</sup> This advantage results because we propose that states implement vendor compensation so as to ensure that remote vendors are fully and adequately compensated; in order for states to meet their constitutional obligations, we suggest that states err in the direction of overcompensating remote vendors. Were states able to compensate only for the incremental compliance costs that a remote vendor incurs from doing business in the state, then states could avoid either overcompensating or undercompensating remote vendors such that neither remote vendors nor in-state vendors would enjoy any tax cost advantages. For further discussion, see Part II.C *infra*.

<sup>125</sup> As we discuss *infra* in Part II.C., however, a state could set the default compensation rates much higher for small vendors than for large vendors.

<sup>126</sup> And a state wishing to completely level the playing field would need only to compensate in-state vendors for compliance costs in addition to compensating remote vendors.

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of sales for small vendors than for large vendors.<sup>127</sup> Hence, requiring states to compensate for compliance costs should result in the states being able to raise nearly all of the revenue available from taxing e-commerce, while still avoiding burdening interstate commerce. If the requirement that states compensate remote vendors for compliance costs incentivizes the states to simplify and unify their use tax regimes, then the revenue loss from compensating remote vendors could end up being an even smaller percentage of the revenues states could raise without vendor compensation.

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

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

Conversely, as compared to overturning *Quill* and allowing the states unrestricted ability to tax e-commerce transactions with remote vendors, our proposal eliminates any potential for burdening interstate commerce. Because remote vendors would be more than compensated for any excess compliance

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<sup>127</sup> PRICEWATERHOUSECOOPERS, RETAIL SALES TAX COMPLIANCE COSTS: A NATIONAL ESTIMATE, VOLUME ONE: MAIN REPORT, at E-1 (2006), available at <http://www.bacssuta.org/Cost%20of%20Collection%20Study%20-%20SSTP.pdf>; WASH. STATE DEP'T OF REVENUE, RETAILERS' COST OF COLLECTING AND REMITTING SALES TAX 4 (1998), available at [http://dor.wa.gov/content/aboutus/statisticsandreports/retailers\\_cost\\_study/default.aspx](http://dor.wa.gov/content/aboutus/statisticsandreports/retailers_cost_study/default.aspx).

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

C. *Implementing Our Proposal for Adequate Vendor Compensation*

The implementation mechanics of our proposal are not without precedent. Twenty-eight states compensate vendors to some degree for the costs of complying with sales and use taxes in at least certain contexts.<sup>128</sup> For instance, in 2006, Utah passed a law that reimbursed certain vendors for some of their costs of complying with a reduced sales and use tax rate imposed on food and food ingredients.<sup>129</sup> The law reimbursed vendors who remitted between \$15,000 and \$500,000 in sales or use taxes for their “verifiable amounts . . . actually expended . . . to purchase computer hardware, software, or programming to account for sales under the reduced sales and use tax.”<sup>130</sup>

As an alternative to the Utah approach of compensating for “verifiable amounts” expended, some states allow vendors to keep a specified portion of the sales and use taxes they collect as compensation for the compliance costs of remitting the remainder to the state. For instance, Wyoming passed a law in 2011 “allowing retailers and other vendors to take up to a 1.95 percent discount from the sales taxes they collect and remit to the state.”<sup>131</sup> The Wyoming approach of using specified percentages thus achieves greater administrability at the expense of being less finely tuned in measuring actual compliance costs. Another similar example of a mechanism for reimbursing vendors' compliance costs was the proposed administration and compliance equipment cost credit in the failed National Retail Sales Tax Act of 1996,

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<sup>128</sup> ROBERT J. CLINE & THOMAS S. NEUBIG, *supra* note 118, at 22 (recognizing that twenty-seven states offered vendor discounts in 1999, which has increased to twenty-eight states after Wyoming recently initiated a vendor compensation system); Tripp Baltz, *Wyoming Governor Signs Bill Providing Vendor Compensation for State Sales Tax*, BNA TAX MGMT. WKLY. ST. TAX REP., Mar. 18, 2011 (on file with authors); *see also* Philip MATTERA WITH LEIGH McILVAINE, SKIMMING THE SALES TAX: HOW WAL-MART AND OTHER BIG RETAILERS (LEGALLY) KEEP A CUT OF THE TAXES WE PAY ON EVERYDAY PURCHASES (2008), available at <http://www.goodjobsfirst.org/sites/default/files/docs/pdf/skimming.pdf>.

<sup>129</sup> Sales and Use Tax Relating to Food § 3, 2006 Utah Laws 2023-24.

<sup>130</sup> *Id.* § 3(4)-(5).

<sup>131</sup> Baltz, *supra* note 128.

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which would have allowed vendors to withhold a percentage of taxes due to be remitted as compensation for certain compliance-related expenses.<sup>132</sup>

We suggest that states use a combination of these two approaches to ensure that they adequately compensate remote vendors for all compliance costs. As a default, and without need to show verification, vendors should be allowed to opt to keep a specified percentage of the use tax amounts they collect from transactions with a state's residents. The percentage of use tax collections that a vendor should be allowed to keep could be set based on the size of the vendor or other easily demonstrable characteristics of the vendor. Regardless, the percentage amount should be set significantly higher than the state's estimate for the average collection costs imposed on the category of vendors. In addition, vendors should be allowed to demonstrate that their actual verifiable compliance costs are in excess of the percentage allowed. Vendors whose actual verifiable compliance costs exceed the allowed percentage should be permitted to keep a portion of the use tax revenues collected equal to the vendor's actual verifiable compliance costs plus the costs incurred in reporting and demonstrating those compliance costs. Finally, if the compliance costs for any vendor exceed the amount of use tax revenues the vendor collects from transactions with individual residents in a state or local taxing jurisdiction, the state or local jurisdiction should establish a process for the vendor to apply for reimbursement for those costs.<sup>133</sup>

Importantly, compensation for compliance costs must include compensation for intangible costs such as executives' time and the risk of being subject to penalties for inadvertent noncompliance.<sup>134</sup> The default compensation rates should be set based on outside experts' estimates for aggregate compliance costs – including both tangible and intangible costs. Remote vendors who wish to demonstrate that their actual compliance costs exceed the default amounts should be permitted to submit expert testimony substantiating the vendor's aggregate compliance costs – both tangible and intangible. And the states should also compensate remote vendors for amounts expended to

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<sup>132</sup> H.R. 3039, 104th Cong. § 11(f) (1996).

<sup>133</sup> This condition is necessary to ensure that small taxing jurisdictions do not impose excess compliance costs on remote vendors.

<sup>134</sup> It is not possible to reimburse for the actual penalties imposed for noncompliance (inadvertent or otherwise), but it is possible to reimburse for the risk premium created by the possibility of being subject to sanctions for inadvertent noncompliance. A properly designed vendor compensation system should be able to compensate fully and adequately for all of the expected costs created by imposing use tax compliance obligations on remote vendors, and this should satisfy the standard of not imposing any burden on interstate e-commerce. Even if some small number of remote vendor firms ended up bearing larger sanctions from inadvertent noncompliance than the allowed reimbursement amounts, this would not burden interstate commerce as long as remote vendors could anticipate receiving reimbursement amounts equal to or greater than the aggregate of all of their expected costs – i.e., compensation amounts would be full and adequate in expectation. We thank Mark Gergen and Andy Haile for their helpful comments on this point.

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document their compliance costs and to dispute the amounts of the compliance costs with the states.

As a matter of policy, it might arguably be excessive to compensate for all intangible compliance costs of this sort. Were Congress to pass legislation enabling the states to tax remote vendors as long as the states adequately compensated for all compliance costs, we might favor a less strict compensation regime. But to comply with the *Quill* framework, the states must create procedures so that vendors can expect to be fully and adequately compensated for all compliance costs, both tangible and intangible. Such procedures will likely result in many vendors being overcompensated. Nevertheless, the states should prefer to overcompensate vendors while levying use taxes rather than to be blocked from levying use taxes all together.

According to a 1998 study by the Research Division of the Washington State Department of Revenue, vendors' total costs of collecting and remitting Washington's state and local sales taxes amounted to 6.47% of tax collections for small vendors, 3.35% of tax collections for medium-sized vendors, and 0.97% percent of tax collections for large vendors – for a total weighted average of 1.42% of total revenues across all vendors.<sup>135</sup> According to another study by PricewaterhouseCoopers in 2006, the national average for annual sales tax compliance costs amounted to 3.09% of total tax collections in 2003 – with small retailers' costs amounting to 13.47% of tax collections, medium-sized retailers' costs amounting to 5.2% of tax collections, and large retailers' costs amounting to 2.17% of tax collections.<sup>136</sup>

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

Our proposal in this section is intended as an example of a mechanism for ensuring full and adequate vendor compensation. Other approaches to vendor compensation are certainly possible. For instance, on policy grounds it might arguably be preferable for a state to compensate only for the estimated incremental compliance costs generated by doing business in the state.<sup>137</sup> Our proposed approach is designed with the goal of minimizing constitutional

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<sup>135</sup> WELSH, *supra* note 127, at 4.

<sup>136</sup> PRICEWATERHOUSECOOPERS, *supra* note 127, at E-1.

<sup>137</sup> We thank Eric Rakowski and Susie Morse for their helpful suggestions on this point.

tensions, even at the expense of overcompensating many remote vendors from a policy perspective.

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

There are two major justifications for *Quill's* physical presence rule.<sup>138</sup> So far, we have focused on analyzing the first justification – the potential burden on interstate commerce that could result from excess tax compliance costs. The second justification is based on stare decisis. Because the physical presence rule had previously been adopted by the *Bellas Hess* decision, the *Quill* majority concluded that “[t]he ‘interest in stability and orderly development of the law’ that undergirds the doctrine of *stare decisis* . . . counsel[ed] adherence to settled precedent.”<sup>139</sup>

The *Quill* decision articulated the physical presence rule as a bright-line test.<sup>140</sup> As Arthur Rosen and Matthew Hedstrom explain, “Under *Quill*, an assessment of the actual burdens is not required; physical presence is a bright-line rule and the law of the land.”<sup>141</sup> Even a small potential burden on interstate commerce thus suffices to prevent states from imposing use tax compliance obligations on remote vendors that lack physical presence within the state. Although the *Quill* decision acknowledged that the physical presence rule, “[l]ike other bright-line tests[,] . . . appears artificial at its edges,”<sup>142</sup> the *Quill* majority nonetheless concluded that “this artificiality . . . is more than offset by the benefits of a clear rule.”<sup>143</sup> By adopting the clear, bright-line physical presence rule, the *Quill* majority hoped to reduce litigation and to avoid the “quagmire” and “confusion” that might otherwise arise in the absence of “precise guides to the States in the exercise of their indispensable power of taxation.”<sup>144</sup>

Nevertheless, although *Quill's* physical presence rule applies even when the potential burden on interstate commerce is small, the physical presence rule should not prevent state action unless that action has some actual potential for burdening interstate commerce. The *Quill* majority adopted the physical presence rule in order to avoid the potential confusion and quagmire that could result from a balancing test.<sup>145</sup> It would be difficult to balance potential harms to interstate commerce against the states' valid interest in levying an

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<sup>138</sup> For a discussion of the two major justifications, see Zelinsky, *The Siren Song*, *supra* note 11, at 698, and *supra* notes 64-68 and accompanying text.

<sup>139</sup> *Quill Corp. v. North Dakota*, 504 U.S. 298, 317 (1992) (quoting *Runyon v. McCrary*, 427 U.S. 160, 190-91 (1976) (Stevens, J., concurring)).

<sup>140</sup> *Id.* at 314.

<sup>141</sup> Rosen & Hedstrom, *supra* note 15, at 931.

<sup>142</sup> *Quill*, 504 U.S. at 315.

<sup>143</sup> *Id.*

<sup>144</sup> *Id.* at 315-16 (quoting *Nw. States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 457-58 (1959)).

<sup>145</sup> *Id.* at 314-16.

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appropriate amount of revenue from transactions between the states' residents and remote vendors; such a comparison would be like comparing apples to aardvarks, as there is no common metric for evaluating the two competing concerns. But in the absence of any potential burden on interstate commerce, this balancing act becomes simple. When there is zero weight placed on one side of a scale, any amount of weight on the other side of the scale makes the scale tip in that direction, even if the amount of that weight is indeterminable.

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

Some commentators have attempted to justify *Quill*'s physical presence rule apart from any potential burden on interstate commerce.<sup>146</sup> Such arguments might have validity based only on *Bellas Hess*, as the *Bellas Hess* decision was unclear as to whether the physical presence requirement was justified by the Commerce Clause, the Due Process Clause, or both.<sup>147</sup> But the *Quill* decision clarified that the Due Process Clause does not prevent states from imposing use tax compliance obligations on remote vendors as long as the remote vendors conduct some threshold level of sales within the state.<sup>148</sup> Only the Commerce Clause prevents states from imposing use tax compliance obligations on the major e-commerce vendors. And the *Quill* decision repeatedly clarified that the nexus requirement of the Commerce Clause is not about "fairness for the individual defendant"<sup>149</sup> but rather is justified as "a means for limiting state burdens on interstate commerce."<sup>150</sup> In the absence of any potential for burdens on interstate commerce, the physical presence rule should not apply.

In other words, we argue that imposing use tax compliance burdens while adequately compensating remote vendors for all compliance costs is substantially different with respect to the Commerce Clause from imposing use tax compliance burdens on remote vendors without adequately compensating for compliance costs. Although the *Quill* Court never discusses whether its holding would apply were states to adequately compensate for compliance costs, the logic of the *Quill* decision suggests that the physical presence rule should not block states from imposing use tax compliance burdens when they adequately compensate remote vendors for all compliance costs. *Stare decisis*

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<sup>146</sup> *E.g.*, Rosen & Hedstrom, *supra* note 15, at 932.

<sup>147</sup> *See Quill*, 504 U.S. at 305 ("[A]lthough we have not always been precise in distinguishing between the two, the Due Process Clause and the Commerce Clause are analytically distinct.").

<sup>148</sup> *See supra* Part I.A.

<sup>149</sup> *Quill*, 504 U.S. at 312.

<sup>150</sup> *Id.* at 313.

does not justify extending a holding to fact patterns that substantially differ from the facts on which the original holding was based.

Although many states have established systems for compensating certain vendors for compliance costs to at least some degree, existing compensation levels are “relatively small compared to the estimated retailer’s costs of collecting sales and use taxes.”<sup>151</sup> To our knowledge, no state or local taxing jurisdiction has ever fully compensated vendors for their compliance costs.<sup>152</sup> Hence, that some states implemented partial vendor compensation schemes prior to the *Quill* decision does not imply that the *Quill* majority considered and rejected the possibility that a full and adequate vendor compensation system could enable the states to impose use tax compliance obligations without burdening interstate commerce. Only by fully and adequately compensating remote vendors for all use tax compliance costs<sup>153</sup> can a state impose use tax compliance burdens on remote vendors without creating any potential for burdening interstate commerce – thus satisfying *Quill*.

Along these lines, it is worth noting that the North Dakota statute evaluated by the *Quill* decision contained a provision for partial vendor compensation.<sup>154</sup> This provision was not discussed by any of the U.S. Supreme Court opinions, but the North Dakota Supreme Court noted that the vendor compensation provision served to “alleviate[] any burdens created by requiring Quill to collect and remit the tax.”<sup>155</sup> Because the vendor compensation provision was inadequate, however, the provision did not eliminate the North Dakota Supreme Court’s concern that allowing states to impose collection costs on remote vendors could burden interstate commerce through excess tax collection costs.<sup>156</sup> Unlike our proposal for full and adequate vendor compensation, to merely “alleviate” burdens on remote vendors does not suffice to prevent the potential for burdening interstate commerce. That the U.S. Supreme Court did not discuss the partial vendor compensation provision in the North Dakota statute thus provides no indication as to the constitutionality of a full and adequate system of vendor compensation.<sup>157</sup>

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<sup>151</sup> CLINE & NEUBIG, *supra* note 118, at 22.

<sup>152</sup> *See id.* (discussing existing compensation regimes).

<sup>153</sup> For instance, by employing the implementation mechanisms we discuss in Part II.C, *supra*.

<sup>154</sup> We thank Kirk Stark for bringing this to our attention and for his helpful comments on this point.

<sup>155</sup> *State v. Quill Corp.*, 470 N.W.2d 203, 215 (N.D. 1991).

<sup>156</sup> *See Quill Corp. v. North Dakota*, 504 U.S. 298, 313 n.6 (1992).

<sup>157</sup> The statutes evaluated in some of the earlier cases, such as the statute at issue in *Bellas Hess*, also contained partial vendor compensation provisions. *E.g.*, *Nat’l Bellas Hess, Inc. v. Dep’t of Revenue of Ill.*, 386 U.S. 753, 764 n.7 (1967) (Fortas, J., dissenting). These provisions are irrelevant to our discussion because there is no indication that the statutes offered full and adequate vendor compensation, and because *Bellas Hess* and the other earlier cases concerned the Due Process Clause in addition to the Commerce Clause. We do

There is no suggestion in *Quill* or in any of the related cases that any court considered the possibility that a state might devise a system for fully and adequately compensating remote vendors.

Somewhat relatedly, a number of commentators have suggested that the *Quill* majority was partially motivated by the concern that state use taxes would be applied retroactively to remote vendors if the Court fully overturned *Bellas Hess*.<sup>158</sup> As the *Quill* majority explained, “An overruling of *Bellas Hess* might raise thorny questions concerning the retroactive application of those taxes and might trigger substantial unanticipated liability for mail-order houses.”<sup>159</sup> At least one witness to the *Quill* oral argument thought that the Justices were “very concerned about retroactivity” and that the retroactivity issue might have “tip[ped] the case against the states.”<sup>160</sup> The *Quill* majority may have even been thinking of the retroactivity issue when they wrote that “a bright-line rule in the area of sales and use taxes . . . encourages settled expectations and, in doing so, fosters investment by businesses and individuals.”<sup>161</sup> Regardless, because the states do not currently reimburse vendors for all use tax compliance costs, there would be no retroactivity concern in a court ruling that states can impose use tax compliance obligations on remote vendors, if and only if the states adequately compensate for all tax compliance costs thereby imposed.

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

Remember, however, that the Court has repeatedly cautioned against formalism in its Commerce Clause holdings.<sup>162</sup> The Court has emphasized that its Commerce Clause jurisprudence is grounded in “pragmatism,”<sup>163</sup>

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not argue that full and adequate vendor compensation would resolve potential Due Process Clause violations, but *Quill* held that states can impose compliance burdens on remote vendors without violating the Due Process Clause.

<sup>158</sup> E.g., Rosen & Hedstrom, *supra* note 15, at 935-36; Charles Rothfield, *Quill: Confusing the Commerce Clause*, 3 ST. TAX NOTES 111, 115 & n.47 (1992).

<sup>159</sup> *Quill*, 504 U.S. at 318 n.10.

<sup>160</sup> Billy Hamilton, *Remembrance of Things Not so Past: The Story Behind the Quill Decision*, 59 ST. TAX NOTES 807, 810 (2011).

<sup>161</sup> *Quill*, 504 U.S. at 316.

<sup>162</sup> Swain, *supra* note 32, at 427.

<sup>163</sup> D.H. Holmes Co. v. McNamara, 486 U.S. 24, 30 (1988).

“economic realities,”<sup>164</sup> and “practical effect[s]”<sup>165</sup> and is disdainful of “formalism,”<sup>166</sup> “magic words,”<sup>167</sup> and “labels.”<sup>168</sup> Lower courts should thus have difficulty justifying the extension of *Quill*’s physical presence test to circumstances in which there is no potential for burdening interstate commerce. Such an extension could only be justified on formalistic grounds, and extending the physical presence rule to apply even when there is no potential for burdening interstate commerce would thus directly contradict the Court’s pronouncements about the purposes of the Commerce Clause.

We take the *Quill* decision seriously in its statements that the purpose of the physical presence rule is to prevent burdens on interstate commerce,<sup>169</sup> that the potential burden on interstate commerce arises from excess compliance costs,<sup>170</sup> and that the Commerce Clause should be applied based on economic realities and practical effects rather than formalistically.<sup>171</sup> It consequently seems clear to us that *Quill*’s physical presence rule should not apply when a state adequately compensates remote vendors for all compliance costs and thereby alleviates any possibility of burdening interstate commerce. Although we cannot guarantee that courts will agree with our analysis, we think that the arguments supporting the constitutionality of our proposed approach are more than persuasive enough to make our approach the best way forward for states that wish to raise revenue by taxing interstate e-commerce.

### III. IMPLICATIONS FOR THE STATES, FOR THE COURTS, AND FOR CONGRESS

As of August 2011, at least twelve states have passed “Amazon laws” designed to collect use taxes from remote vendors.<sup>172</sup> These laws have been described as unconstitutional, ineffective, or both,<sup>173</sup> and they have been the subject of litigation across the nation.<sup>174</sup> At the same time, Congress has considered and rejected federal legislative solutions on numerous occasions.<sup>175</sup>

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<sup>164</sup> *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977).

<sup>165</sup> *Id.* at 279.

<sup>166</sup> *Quill*, 504 U.S. at 310.

<sup>167</sup> *Complete Auto*, 430 U.S. at 279.

<sup>168</sup> *Id.*

<sup>169</sup> *Quill*, 504 U.S. at 313.

<sup>170</sup> *Id.* at 313 n.6.

<sup>171</sup> *Id.* at 310.

<sup>172</sup> See *infra* note 177 and accompanying text.

<sup>173</sup> See, e.g., Kranz, Smith & Freeman, *supra* note 11, at 55 (unconstitutional); Zelinsky, *New York’s “Amazon” Law*, *supra* note 11, at 715 (ineffective); Zelinsky, *The Siren Song*, *supra* note 11, at 695 (unconstitutional).

<sup>174</sup> See, e.g., *Direct Mktg. Ass’n v. Huber*, No. 10-cv-01546-REB-CBS, 2011 U.S. Dist. LEXIS 9589 (D. Colo. Jan. 26, 2011); *Amazon.com, LLC v. New York State Dep’t of Tax’n & Fin.*, 13 N.Y.S.2d 129 (N.Y. App. Div. 2010).

<sup>175</sup> See *infra* note 258 and accompanying text.

Nevertheless, the states have continued to lobby Congress on the chance that it might reconsider.

We hope that our proposed approach will dramatically change the use tax landscape and eliminate the states' need to rely on more questionable strategies for circumventing *Quill's* physical presence rule. We are confident that our approach is superior to the alternatives, both as a matter of constitutional law and of efficacy.

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

#### A. *The States' "Amazon" Laws*

Frustrated by the *Quill* decision and desperate for revenues, the states have become increasingly aggressive in attempting to tax interstate e-commerce. New York passed the first so-called "Amazon" law in 2008.<sup>176</sup> At least eleven additional states have since followed New York's lead.<sup>177</sup> The action became particularly intense during the summer of 2011 with both California<sup>178</sup> and Texas<sup>179</sup> passing new Amazon legislation. A number of other state legislatures have also been debating their own Amazon laws.<sup>180</sup> As the remaining states

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<sup>176</sup> Act of April 23, 2008, ch. 57 pt. OO-1, 2008 N.Y. Laws 2844 (codified at N.Y. TAX LAW § 1101(b)(8)(vi) (McKinney 2011)); N.Y. STATE DEP'T OF TAXATION AND FIN., *supra* note 9, at 2.

<sup>177</sup> Harley Duncan & Sarah McGahan, *An Overview of Recent Sales and Use Tax Legislation*, 61 ST. TAX NOTES 483, 488 (2011) (listing the states that have passed Amazon laws: Arkansas, California, Colorado, Connecticut, Illinois, New York, North Carolina, Oklahoma, Rhode Island, South Dakota, Texas, and Vermont); *see also* Stephen P. Kranz, Lisbeth A. Freeman & Mark W. Yopp, *Is Quill Dead? At Least One State Has Written the Obituary*, 57 ST. TAX NOTES 307, 308 (2010) (listing Alabama, Georgia, Minnesota, and Wisconsin as states that have passed Amazon laws); Robert D. Plattner, Daniel Smirlock & Mary Ellen Ladouceur, *A New Way Forward for Remote Vendor Sales Tax Collection*, 55 ST. TAX NOTES 187, 194 (2010) (listing Alabama, Idaho, Indiana, Kansas, Minnesota, and Wisconsin as states that have passed Amazon laws).

Our preliminary research suggests that as many as sixteen states may have passed Amazon laws as of August 2011, including Alabama, Arkansas, California, Colorado, Connecticut, Georgia, Illinois, Minnesota, New York, North Carolina, Oklahoma, Rhode Island, South Dakota, Texas, Vermont, and Wisconsin. However, one might question whether the actions taken by some of these states should be counted as Amazon laws.

<sup>178</sup> Karen Setze & John Buhl, *California Governor Signs 'Amazon' Law*, 61 ST. TAX NOTES 7, 7 (2011).

<sup>179</sup> Billy Hamilton, *How Amazon's Texas Deal Unraveled*, 61 ST. TAX NOTES 191, 191 (2011).

<sup>180</sup> Billy Hamilton, *The Empire Strikes Back: Amazon Fights Against Online Tax Efforts*,

watch to see how the courts and e-commerce vendors will react, we expect to see more states passing Amazon laws in the near future. Even if the states conclude that these laws are unlikely to be successful, passing such laws can help the states muddle through their current-year budget crises as long as the laws can be scored as generating additional revenues.<sup>181</sup>

Previous scholars have analyzed the recent state Amazon laws with laudable thoroughness and depth.<sup>182</sup> We will not repeat their efforts here. Instead, we aim only to outline briefly some of the major features of these laws to demonstrate why the laws are unlikely to succeed in enabling the states to tax interstate e-commerce. Ultimately, we believe that only our proposed solution of adequate vendor compensation offers the states an effective way forward in their attempts to preserve their sales and use tax bases against the erosion caused by the growth of e-commerce.<sup>183</sup>

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

The "referrer-nexus" approach presumes that a vendor has a physical presence within a state whenever the vendor makes sales and marketing arrangements with in-state residents. Referrer-nexus statutes typically trigger use tax liability for a remote vendor if two conditions are satisfied. First, the remote vendor must have some agreement with in-state residents pursuant to which the in-state residents directly or indirectly refer potential customers – "whether by a link on an internet website or otherwise" – to the vendor for

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60 ST. TAX NOTES 959, 960 (2011) ("Another 10 states are considering or have recently considered similar legislation – Arizona, California, Hawaii, Louisiana, Minnesota, Mississippi, Nevada, New Mexico, Texas, and Vermont."); *see also* Dolores W. Gregory & Nancy J. Moore, *As States Crank Up Efforts to Force Use Tax Collection, Amazon Threatens to Shutter Operations in Texas and California*, BNA DAILY TAX REPORT, March 22, 2011, No. 55, at J-1 (describing proposed and actual legislation by Arizona, Arkansas, California, Colorado, Connecticut, Hawaii, Illinois, Maine, Massachusetts, Minnesota, Mississippi, New Mexico, Oklahoma, Rhode Island, South Dakota, Tennessee, Texas, and Vermont).

<sup>181</sup> For a general discussion of how states muddle through budget crises, see David Gamage, *Preventing State Budget Crises, Managing the Fiscal Volatility Problem*, 98 CALIF. L. REV. 749, 754-68 (2010).

<sup>182</sup> *E.g.*, MICHAEL MAZEROV, CTR. ON BUDGET AND POLICY PRIORITIES, AMAZON'S ARGUMENTS AGAINST COLLECTING SALES TAXES DO NOT WITHSTAND SCRUTINY (2010), available at <http://www.cbpp.org/files/11-16-09sfp.pdf>; Andrew Haile, *Defending Colorado's Use Tax Reporting Requirement*, 57 ST. TAX NOTES 761 (2010); Zelinsky, *supra* note 10, at 557.

<sup>183</sup> *See, e.g.*, Zelinsky, *supra* note 10, at 578 ("Why are Amazon laws suddenly proliferating as they are now? At one level, that proliferation seems particularly quixotic, given the unconstitutionality and futility of these state laws.").

some consideration.<sup>184</sup> Second, the “cumulative gross receipts” from sales to in-state residents made by all such referrals must exceed some amount in the previous year – \$10,000, in the case of New York’s statute.<sup>185</sup> These statutes provide that remote vendors who have such agreements are presumed to be soliciting sales through in-state residents<sup>186</sup> and therefore are subject to the state’s use tax.

The referrer-nexus approach is sometimes called the “affiliate tax” approach<sup>187</sup> or the “click-through nexus”<sup>188</sup> approach. The first state Amazon law – passed by New York in 2008 – relied on this approach,<sup>189</sup> and many of the subsequent state Amazon laws have also employed the approach.<sup>190</sup> New York’s referrer-nexus statute provides that a vendor can rebut the presumption of physical presence if it can prove that “the resident with whom the seller has an agreement did not engage in any solicitation in the state on behalf of the seller that would satisfy the nexus requirement of the United States constitution.”<sup>191</sup> The litigation surrounding New York’s statute has consequently centered on the statute’s application – in particular, whether a remote vendor may be subject to use taxation if the vendor’s only solicitation activities within the state are compensating in-state residents for linking to the vendor on the residents’ websites.<sup>192</sup>

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<sup>184</sup> N.Y. TAX LAW § 1101(b)(8)(vi) (McKinney 2011). It appears that the state may chain such connections back to the remote vendor, even if the remote vendor contracts solely with another out-of-state business that in turn contracts with an in-state business. See N.Y. STATE DEP’T OF TAXATION AND FIN., *supra* note 9, at 2.

<sup>185</sup> N.Y. TAX LAW § 1101(b)(8)(vi).

<sup>186</sup> Section 1101(b)(8)(vi) creates a “presumption” that out-of-staters are soliciting sales through in-state residents if its requirements are met. See *id.* The presumption appears definitional, however, and is likely difficult to rebut unless the out-of-state business can prove that it should fit within the statutory exclusion.

<sup>187</sup> See, e.g., Gordon, *supra* note 9, at 309.

<sup>188</sup> See, e.g., Kranz, Freeman & Yopp, *supra* note 177, at 309.

<sup>189</sup> See *supra* note 176.

<sup>190</sup> See, e.g., R.I. GEN. LAWS § 44-18-15(a)(2) (2010); N.C. GEN. STAT. § 105-164.8(b)(3) (2009).

<sup>191</sup> N.Y. TAX LAW § 1101(b)(8)(vi) (McKinney 2011).

<sup>192</sup> Guidance by New York’s Department of Taxation and Finance indicates that an in-state resident’s linking to the remote vendor’s website without any other “solicitation activity in the state targeted at potential New York State customers on behalf of the seller” does not on its own trigger the vendor’s being subject to use taxation. N.Y. STATE DEP’T OF TAXATION AND FIN., *supra* note 9, at 4. This language, however, appears inconsistent with one of the accompanying examples, which describes a remote vendor that enters into an agreement with a service provider, who in turn contracts with New York State residents to refer potential customers back to the remote vendor. The referrals take the form of “placing [the vendor’s] product links on their Web sites,” with commissions paid by the service provider for sales made through such links. *Id.* at 3. The example concludes that the remote vendor is presumed to be soliciting sales through in-state residents. *Id.* at 4. Later guidance

The New York Appellate Division recently upheld New York's statute as facially constitutional.<sup>193</sup> However, the question remains to be decided on remand as to whether the statute can constitutionally be applied to major e-commerce vendors like Amazon.<sup>194</sup> And Amazon will undoubtedly appeal if it loses the as-applied challenge. According to Edward Zelinsky, "Ultimately, this controversy is likely to play out before the U.S. Supreme Court."<sup>195</sup>

Even if Amazon loses its constitutional challenge to New York's statute, we expect that the referrer-nexus approach will still prove ineffective. Overstock.com has already suspended its relationships with marketing associates in New York in order to avoid being subject to New York's use tax.<sup>196</sup> Amazon has similarly suspended relationships with marketing associates in other states that have passed referrer-nexus laws.<sup>197</sup> Presumably, the only reason that Amazon has not also done so in New York is to maintain standing to challenge New York's statute.<sup>198</sup> If Amazon loses the litigation it likely will respond by terminating all click-through marketing relationships with New York residents so as to remain exempt from New York's use tax.<sup>199</sup> The referrer-nexus approach ultimately fails as a way forward for the states to tax e-commerce for the simple reason that e-commerce vendors can easily end all referral relationships with in-state residents.

Similar in many ways to the referrer-nexus approach, the "related-entity-nexus" approach attempts to satisfy the Commerce Clause's nexus requirement by attributing physical presence to remote vendors that have specific business relationships with in-state firms. The approach is sometimes called the "affiliate-nexus" approach.<sup>200</sup> Under either name, the approach involves triggering a remote vendor's use tax liability under one of two circumstances:

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provided another safe harbor, under which remote vendors could rebut the nexus presumption by including in their referral agreements a provision prohibiting their in-state representatives from "engaging in solicitation activities in New York." N.Y. STATE DEP'T OF TAXATION AND FIN., ADDITIONAL INFORMATION ON HOW SELLERS MAY REBUT THE NEW PRESUMPTION APPLICABLE TO THE DEFINITION OF SALES TAX VENDOR AS DESCRIBED IN TSB-M-08(3)S, TSB-M-08(3.1)S, at 1 (2008). This safe harbor requires the in-state residents to certify annually that they have not engaged in any such prohibited solicitation during the prior year. *Id.*

<sup>193</sup> Amazon.com, LLC v. N.Y. State Dep't of Tax'n & Fin., 913 N.Y.S.2d 129 (N.Y. App. Div. 2010).

<sup>194</sup> Zelinsky, *supra* note 16, at 104.

<sup>195</sup> *Id.* at 93.

<sup>196</sup> *Id.* at 102.

<sup>197</sup> E.g., Joe Hanel, *Amazon Drops Colorado Affiliates in Response to Law*, 55 ST. TAX NOTES 735 (2010); Geoffrey A. Fowler, *Corporate News: Amazon Cuts North Carolina Affiliates to Avoid Tax*, WALL ST. J., June 27, 2009, <http://online.wsj.com/article/SB124603593605261787.html>.

<sup>198</sup> Zelinsky, *supra* note 16, at 102.

<sup>199</sup> *Id.*

<sup>200</sup> Swain, *supra* note 32, at 419.

(1) if the remote vendor controls or is controlled by an in-state business or is under common control with an in-state business,<sup>201</sup> or (2) if the remote vendor and an in-state business “use an identical or substantially similar name, tradename, trademark, or goodwill, to develop, promote, or maintain sales”<sup>202</sup> or otherwise substantially coordinate their business practices. In effect, the related-entity-nexus approach attempts to circumvent the Commerce Clause’s prohibitions by disregarding corporate structure and treating related business entities as though they were a single unitary business. States that have passed legislation based on the related-entity-nexus approach include Alabama, Arkansas, California, Georgia, Idaho, Indiana, Kansas, Minnesota, New York, Oklahoma, Texas, and Wisconsin.<sup>203</sup>

Like the referrer-nexus approach, the related-entity-nexus approach may be “constitutionally suspect.”<sup>204</sup> Stephen Kranz, Lisbeth Freeman, and Mark Yopp argue, “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.”<sup>205</sup> In contrast, John Swain argues, “Although no Supreme Court decision has addressed directly the issue of affiliate nexus, the Court has [addressed related concepts] which serve as building blocks for a theory of affiliate nexus.”<sup>206</sup> He thus concludes that “states should feel unconstrained in enforcing sales tax collection obligations against companies currently attempting to avoid taxation through entity isolation techniques.”<sup>207</sup> As these competing views indicate, there is no consensus about the constitutionality of the related-entity-nexus approach, and litigation remains ongoing.<sup>208</sup>

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

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<sup>201</sup> See, e.g., ALA. CODE § 40-23-190(a)(1)-(3), (b)(1) (2003).

<sup>202</sup> *Id.* § 40-23-190(a)(2).

<sup>203</sup> Kranz, Freeman & Yopp, *supra* note 177, at 311; Plattner, Smirlock & Ladouceur, *supra* note 177, at 194

<sup>204</sup> Kranz, Freeman & Yopp, *supra* note 177, at 311.

<sup>205</sup> *Id.* at 309; see also Edward Zelinsky, *California’s Once and Future Amazon Law*, 62 ST. TAX NOTES 83, 94 (2011) (“As a constitutional matter, common ownership is not a substitute for physical presence in the taxing state.”).

<sup>206</sup> Swain, *supra* note 32, at 424.

<sup>207</sup> *Id.*

<sup>208</sup> Gregory & Moore, *supra* note 180 (“Whether Amazon’s position will be upheld in court is an open question.”).

evidence of this willingness, Amazon has already threatened to close warehouses and other facilities in a number of states.<sup>209</sup>

Some e-commerce vendors may place sufficient importance on maintaining their related operations within the states in which they currently operate so as to remain subject to related-entity-nexus statutes. But we predict that Amazon and other major e-commerce vendors will go to nearly any lengths to reorganize their operations in order to maintain their sales and use tax exemption, once the vendors have exhausted litigation and alternative options for challenging such statutes. For instance, the *Wall Street Journal* has reported that Amazon originally located in Washington State, rather than in California, in order to avoid being subject to California's sales tax.<sup>210</sup> And Amazon has continued to aggressively manage its business operations so as to avoid being subject to the sales and use taxes of major customer states.<sup>211</sup>

California's recently passed Amazon law attempted to subject Amazon to use taxation based on the related-entity-nexus strategy because Amazon maintains a subsidiary in California responsible for developing the Kindle e-book reader.<sup>212</sup> Consequently, Amazon challenged California's Amazon law both through litigation and by sponsoring a referendum to overturn the law.<sup>213</sup> Amazon recently indicated that it might voluntarily collect sales tax on its California sales after a year-long exemption period as part of a deal with the State of California.<sup>214</sup> Exactly what Amazon has committed itself to as part of

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<sup>209</sup> E.g., Bill Kidd, *Amazon Closing Texas Facility Amid Sales Tax Dispute*, ST. TAX TODAY, Feb. 14, 2011, available at <http://services.taxanalysts.com/taxbase/tbnews.nsf/Go?OpenAgent&2011+STT+30-22>.

<sup>210</sup> Stu Woo, *Amazon Battles States Over Sales Tax*, WALL ST. J., Aug. 3, 2011, at A1 ("Amazon's Mr. Bezos has said he established the company in Washington partly because it has a tech-savvy but relatively small population, so state taxes wouldn't affect many potential customers.").

<sup>211</sup> *Id.* ("Former Amazon staffers say the tactic is typical of its aggressive approach to minimizing sales tax. Early employees recall requirements to consult lawyers before arranging trips to states including California. Former staffers say they got grilled about the purpose of trips and warned to avoid soliciting new customers, promoting products and doing similar activities in certain states because of tax concerns."); see also MAZEROV, *supra* note 182, at 6-7 (discussing Amazon's history of aggressive tax planning).

<sup>212</sup> Laura Mahoney, *Retailers, Lawyers, Regulators, Scramble to Interpret 'Amazon' Law*, DAILY TAX REP. (Bureau of Nat'l Affairs, Arlington, Va.), July 6, 2011, No. 83, at H-2. Amazon actually has two subsidiaries in California – A9.com, Inc. and Lab126. Zelinsky, *supra* note 205, at 83.

<sup>213</sup> Karen Setze, *Amazon Wants Repeal of California's Click-Through Law*, 61 ST. TAX NOTES 151, 151 (2011). There have been important developments in the dispute between Amazon and California since this Article was written. Unfortunately, our publishing schedule prevents us from chronicling these developments as they unfold. For more recent analysis, see, for example, Zelinsky, *supra* note 205, at 83.

<sup>214</sup> See Stu Woo, *Amazon to Collect California Sales Tax by 2013*, WALL ST. J., Sept. 28, 2011, <http://online.wsj.com/article/SB10001424052970204138204576598883358407422.ht>

this deal is unclear; Amazon has withdrawn its referendum, but Amazon may still have the option of challenging the California statute in court or moving its operations out of state after the end of the year-long exemption period. Yet even if Amazon does eventually comply with California's related-entity-nexus statute, the related-entity-nexus approach seems less likely to succeed for states other than California, which lack unique regions like Silicon Valley that might deter the major e-commerce vendors from moving all of their operations out of state.<sup>215</sup>

The final method by which states have attempted to tax sales by remote vendors to in-state residents – the “information-reporting requirements” approach – does not involve taxing the remote vendors at all. Rather, the approach involves requiring remote vendors to divulge information about the vendors' sales to in-state residents necessary for the state to effectively collect use taxes from the state's residents.<sup>216</sup>

Notice and reporting requirements facilitate the collection of use taxes in a manner similar to how W-2s facilitate income tax collection. The information reported need only contain the total amount of a resident's purchases and some information capable of uniquely identifying the resident (such as an address). The most well-known state attempt to impose notice and reporting requirements is Colorado's House Bill 10-1193, which imposes three separate requirements on remote vendors that do not voluntarily collect use taxes on sales to Colorado residents.<sup>217</sup> First, these vendors must include a notice on invoices sent to Colorado purchasers informing them that use tax may be due to Colorado's Department of Revenue.<sup>218</sup> Second, the vendors must provide a year-end summary of all sales to Colorado residents who purchased \$500 or more of taxable items in the previous year.<sup>219</sup> Finally, and most crucially, the

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<sup>215</sup> Amazon and other major e-commerce vendors probably need to maintain warehouses and other related facilities in at least some states, but as long as a few geographically dispersed states do not pass affiliate-nexus statutes, Amazon should be able to cease operations in those states that do pass such statutes. The states face a holdout problem in attempting to cooperate to prevent Amazon from moving operations to states that do not attempt to enforce affiliate-nexus laws. We expect that a sufficient number of states will be willing to continue granting Amazon and other major e-commerce vendors use tax exemptions in order to lure warehousing and other business operations. For small states, the benefit of having these operations moved to within the state can easily exceed the revenues lost due to granting use tax exemptions.

<sup>216</sup> *E.g.*, Colo. Rev. Stat. § 39-21-112(3.5) (2011); Assem. B. 155 § 3, 2011-2012 Reg. Sess. (Cal. 2011).

<sup>217</sup> The vendor must first be considered a “retailer” “doing business” within the state in order to be subject to notice and reporting requirements. *See* Colo. Rev. Stat. § 39-26-102(8) (2011); *id.* § 39-21-112(3.5)(c), (d) (requiring “retailers” that do not collect Colorado use tax to satisfy the notice and reporting requirements).

<sup>218</sup> *See* Colo. Reg. 39-21-112.3.5(2) (2010).

<sup>219</sup> *Id.* 39-21-112.3.5(3)(c).

vendors must provide the Colorado Department of Revenue with an annual summary of purchases made by Colorado residents and the aggregate amount that each resident purchased.<sup>220</sup> Failure to satisfy any of these requirements results in a fine, which ranges from \$5,000 to \$100,000.<sup>221</sup>

Unlike the referrer-nexus and related-entity-nexus approaches, we expect that the information-reporting-requirements approach would be largely successful were it constitutional. However, of the three major approaches we conclude that the information-reporting-requirements approach most clearly violates the Commerce Clause and *Quill*'s physical presence requirement. As Edward Zelinsky argues, "Six thousand different state and local reporting requirements would constitute the same 'welter of complicated obligations' as an equivalent number of conflicting tax collection responsibilities."<sup>222</sup> If we take the *Quill* decision seriously that the purpose of the physical presence requirement is to prevent the excess burden on remote vendors that might result from numerous taxing jurisdictions imposing tax compliance obligations, then the physical presence rule should also apply to information-reporting requirements.

Andy Haile has argued that information-reporting requirements are "significantly less onerous than the burden of actually collecting use taxes."<sup>223</sup> This may be so,<sup>224</sup> but *Quill*'s bright-line rule was designed so that courts would not need to inquire into the magnitude of the burden on interstate commerce.<sup>225</sup> Haile has also argued that information-reporting requirements should be evaluated as regulations rather than as taxes, such that *Quill*'s physical presence requirement should not apply to information-reporting requirements.<sup>226</sup> This argument has some plausibility, and we applaud Haile for making this innovative argument, but we ultimately are not persuaded.<sup>227</sup>

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<sup>220</sup> *Id.* 39-21-112.3.5(4).

<sup>221</sup> *Id.* 39-21-112.3.5(2)(f)(i), (4)(f)(ii)(3).

<sup>222</sup> Zelinsky, *The Siren Song*, *supra* note 11, at 698.

<sup>223</sup> Haile, *supra* note 182, at 764. *But see* Zelinsky, *The Siren Song*, *supra* note 11, at 698 (questioning Haile's argument).

<sup>224</sup> Or it may not be so. To comply with information-reporting requirements, a remote vendor must know each taxing jurisdiction's rules for tax-exempt sales, sales tax holidays, and product coding. And "[d]etermining how to handle tax-exempt sales, sales tax holidays, and product taxability coding can be a daunting task, particularly for small and midsize businesses. It has been estimated that sales tax exemptions account for 60 percent of the cost of compliance for small businesses." Griffeth, *supra* note 120, at 354.

<sup>225</sup> *See supra* Part II.D.

<sup>226</sup> Haile, *supra* note 182, at 763-64.

<sup>227</sup> The reason we are not persuaded is because we take the Court seriously in its statements that Commerce Clause doctrine is to be applied pragmatically rather than formalistically. *See* notes 164-174 and accompanying text. In contrast, Andy Haile argues in a forthcoming article that the Court has adopted a form of "exceptionalism" with respect to sales and use taxes wherein formalism dominates. Andy Haile, *Affiliate Nexus in E-Commerce* 42-47 (unpublished manuscript) (on file with authors). To the extent Haile is

The sole purpose of imposing information-reporting requirements is to support a use tax regime. Given that the Court has repeatedly emphasized that the analysis of sales and use taxes under the Commerce Clause is to be based on “practical effects”<sup>228</sup> and “economic realities”<sup>229</sup> rather than on “formalism,”<sup>230</sup> we think it unlikely that lower courts would uphold a measure such as information-reporting requirements that has nearly identical practical effects and economic realities to requiring the actual collection of use taxes. Ultimately, unless the information-reporting-requirements approach is combined with our proposed solution of adequate vendor compensation, we expect courts to conclude that imposing information-reporting requirements fails *Quill*’s physical presence test. As Edward Zelinsky concludes, “Haile’s characterization of the Colorado Amazon law as tax-related but nevertheless a ‘nontax’ law [is unhelpful]. . . . It is more persuasive to characterize tax reporting laws as tax laws, subject to the dormant commerce clause constraints on tax laws.”<sup>231</sup>

For these reasons, the U.S. District Court for the District of Colorado has preliminarily enjoined the enforcement of Colorado’s information-reporting requirements.<sup>232</sup> In finding the law unconstitutional, the court held that “the information reporting obligations of the Colorado Amazon statute are indistinguishable from the responsibility to collect tax.”<sup>233</sup> Although litigation remains ongoing, we think there is little chance that the courts will allow states to tax interstate e-commerce using the information-reporting-requirements approach,<sup>234</sup> unless that approach is combined with our proposed solution of adequate vendor compensation.

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correct and the Court intends the Commerce Clause to be applied formalistically with respect to sales and use taxes, then our proposal may be far more constitutionally suspect and the information-reporting requirements approach far less so. Arguably, the best approach for a state wishing to levy use tax obligations on remote vendors may be to combine our approach of full and adequate vendor compensation with the Colorado information-reporting requirements approach (as analyzed by Haile). By combining these two approaches, a state should be able to impose obligations on remote vendors regardless of whether the courts determine that the Commerce Clause should be applied pragmatically or formalistically. We highly recommend Haile’s work for readers interested in further discussion along these lines. We also thank Darien Shanske for helpful comments on this subject.

<sup>228</sup> *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977).

<sup>229</sup> *Id.*

<sup>230</sup> *Quill Corp. v. North Dakota*, 504 U.S. 298, 310 (1992).

<sup>231</sup> Zelinsky, *The Siren Song*, *supra* note 11, at 698.

<sup>232</sup> *Direct Mktg. Ass’n v. Huber*, No. 10-cv-01546-REB-CBS, 2011 U.S. Dist. LEXIS 9589 (D. Colo. Jan. 26, 2011).

<sup>233</sup> Zelinsky, *The Siren Song*, *supra* note 11, at 698.

<sup>234</sup> Further analysis can be found in Kranz, Smith & Freeman, *supra* note 11, at 55.

B. *Implications for the States*

We propose that the states adopt our approach of requiring remote vendors to remit use taxes while compensating the remote vendors for all tax compliance costs thereby imposed. Our approach should have obvious attractiveness for the states that are currently contemplating Amazon laws. We have argued that the current strategies underlying the states' Amazon laws will be ineffective, are likely to be held unconstitutional, or both.<sup>235</sup> In contrast, we have argued that our approach should be both effective and constitutional.<sup>236</sup>

Granted, to the extent the states can actually reach remote vendors with the existing Amazon-law strategies, our approach might generate slightly less revenue due to the need to compensate for compliance costs. But even if the need to compensate for compliance costs reduces the revenue-generating potential of our approach, this disadvantage should be more than offset because our approach would not incentivize e-commerce vendors to move their operations out of state.<sup>237</sup>

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

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

Similarly, by combining our approach with the information-reporting-requirements strategy, states could greatly improve the likelihood of the information-reporting requirements being held constitutional. We expect other

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<sup>235</sup> See *supra* Part III.A.

<sup>236</sup> See *supra* Part II.

<sup>237</sup> See, e.g., Eric Anderson, Nathan Fong, Duncan Simester & Catherine Tucker, *How Sales Taxes Affect Customer and Firm Behavior: The Role of Search on the Internet*, 47 J. MARKETING RES. 229, 230 (2010) ("We find that retailers that conduct most of their business through direct channels avoid opening a first store in high-tax states. We conclude that these retailers appear to be forward-looking, anticipating the growth of the Internet channel and avoiding the potential risk to this future revenue stream.").

courts to follow the lead of the U.S. District Court for the District of Colorado in determining that information-reporting requirements violate the Commerce Clause, at least when not combined with adequate vendor compensation.<sup>238</sup> But we conclude that all Commerce Clause concerns would be completely alleviated were a state to impose information-reporting requirements while adequately compensating remote vendors for all of the compliance costs they thereby incur.<sup>239</sup>

Furthermore, we suggest that even states not currently contemplating Amazon laws should adopt our approach. Because our approach eliminates any potential for burdening interstate commerce while generating revenues for the states, there is no reason for the states to continue offering remote e-commerce vendors a tax cost advantage over in-state competitors. To level the playing field, every state that levies a sales tax should adopt our approach so that in-state consumers would decide whether to purchase from in-state vendors or from remote e-commerce vendors based on market factors rather than on differential tax treatment.<sup>240</sup> States that do not want to raise additional tax revenues could use the revenues generated by adopting our approach to reduce the general sales tax rate affecting all vendors.<sup>241</sup>

Finally, our approach is fully compatible with multistate efforts to simplify and unify sales and use taxation. Indeed, our approach would incentivize the states to reduce compliance costs to the extent possible, as the states would bear those costs rather than remote vendors. We applaud current multistate efforts to simplify and unify sales and use tax administration – such as the Streamlined Sales and Use Tax Agreement.<sup>242</sup> However, we also recognize that there may be valid reasons why states may wish to avoid completely unifying their sales and use taxes.<sup>243</sup> For example, centralization potentially interferes with the states' customizing their tax laws to meet local needs and

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<sup>238</sup> *Supra* Part III.A.

<sup>239</sup> *Supra* Part III.A.

<sup>240</sup> See John A. Swain, *State Sales and Use Tax Jurisdiction: An Economic Nexus Standard for the Twenty-First Century*, 38 GA. L. REV. 343, 345 (2003) (arguing that, from “a normative tax policy perspective,” all consumer purchases “should be taxed to avoid discrimination” and to “keep a level playing field” and that “it is more administratively practical to collect the tax from the seller”).

<sup>241</sup> Or the state could reduce other state taxes.

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

<sup>243</sup> See, e.g., Plattner, Smirlock & Ladouceur, *supra* note 177, at 187 (“Moreover, for legitimate reasons, approximately half the states imposing a sales tax, including California, Texas, Florida, New York, Illinois, and Pennsylvania, have not chosen to join SSUTA.”); Swain & Hellerstein, *supra* note 242, at 612-16 (describing potentially divergent local interests).

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with their experimenting with new approaches so as to foster a laboratory of democracy.<sup>244</sup> Our approach balances the competing goals of unification and of maintaining local discretion by causing states to internalize the costs of complexity and non-unification. Except where local needs overpower the cost-saving advantages of unifying a state's sales and use tax laws with those of the other states, our approach should lead the states to pursue simplification and unification based on their own self-interest in minimizing the costs of compensating remote vendors.

### C. *Implications for the Courts*

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

Indeed, realizing that our approach is available ought to make the courts more comfortable in ruling that the existing Amazon-law strategies violate the Commerce Clause. We take no stance on how the courts should actually rule on evaluating the referrer-nexus or related-entity-nexus strategies.<sup>245</sup> But judges uncertain about the constitutionality of these strategies might appropriately be influenced by our proposal's being available as a superior alternative.

If the Supreme Court accepts a case challenging any of the existing Amazon laws, many scholars hope that it will overturn the *Quill* decision.<sup>246</sup> Even with our proposed approach available as a means for states to tax remote e-commerce vendors, these scholars might still argue that the physical presence rule grants remote e-commerce vendors an unjustified advantage over multistate retailers that need to maintain a physical presence within their customer states.<sup>247</sup> If subject to use taxation, both a multistate retailer with

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<sup>244</sup> Justice Brandeis famously praised the states as laboratories of democracy in his dissent in *New State Ice Co. v. Liebman*, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting).

<sup>245</sup> Evaluating the constitutionality of these approaches is beyond the scope of this Article. For our purposes, it suffices to note that these strategies are constitutionally questionable and that they are in any case unlikely to be effective. In contrast, as we have already mentioned, we agree with the U.S. District Court for the District of Colorado that the information-reporting-requirements approach is unconstitutional (unless combined with providing adequate vendor compensation). See *supra* Part III.A.

<sup>246</sup> *Supra* notes 14-17 and accompanying text.

<sup>247</sup> See, e.g., Swain, *supra* note 240, at 363 ("The physical presence test is not an effective tool for sorting out relative burdens among taxpayers.").

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physical presence and a multistate e-commerce retailer without physical presence would bear tax compliance costs. Yet our proposal would only require states to reimburse the multistate e-commerce vendor for those costs.

A good case can be made that the states should also provide adequate vendor compensation for multistate retailers that maintain a physical presence within the state.<sup>248</sup> But we think the case for requiring states to compensate remote e-commerce vendors for tax compliance costs is much stronger. A vendor acquires physical presence within a taxing jurisdiction by purposefully choosing to locate operations within that jurisdiction. By doing so, the vendor knowingly becomes subject to a wide variety of local laws and regulations. A vendor should thus only choose to maintain physical presence within a jurisdiction if selling to customers within that jurisdiction is of more than incidental importance to the vendor's business. In contrast, a remote e-commerce vendor may end up selling within a taxing jurisdiction due to customers within that jurisdiction finding the vendor's website – without the e-commerce vendor making any purposeful decision to sell to that jurisdiction.

That a vendor has physical presence within a jurisdiction is thus suggestive of the vendor's deriving significant value from selling to that jurisdiction.<sup>249</sup> Undoubtedly, evaluating the magnitude of a vendor's sales into a jurisdiction would be a better proxy than physical presence for the importance of selling into that jurisdiction for the vendor's business. But courts are poorly equipped to design quantitative tests such as evaluating the magnitude of sales.<sup>250</sup>

We recognize that our argument here blurs Commerce Clause considerations with Due Process Clause considerations. But the Commerce Clause is properly concerned with preventing states and local taxing jurisdictions from disproportionately burdening multistate vendors with tax compliance costs. By creating a permissive Due Process Clause test for when states can tax remote vendors, *Quill* left the Commerce Clause as the primary deterrent to states' imposing excess compliance costs on multistate vendors conducting only a small magnitude of sales within a state or local taxing jurisdiction. Again, because courts have no ready means for evaluating what magnitude of sales is

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<sup>248</sup> We would urge states to reimburse all multistate vendors for tax compliance costs based on the interests of sound tax policy, but we do think that the Commerce Clause should be interpreted so as to require states to compensate for the compliance costs incurred by multistate vendors who maintain physical presence within the state.

<sup>249</sup> This connection is far from perfect, and the absence of physical presence does not imply that a vendor does not gain significant value from selling into a jurisdiction. Still, the maintenance of physical presence is not meaningless; for instance, it also serves as a rough proxy for representation in the political process. See Edward A. Zelinsky, *Rethinking Tax Nexus and Apportionment: Voice, Exit, and the Dormant Commerce Clause*, 28 VA. TAX REV. 1, 51-59 (2008). Courts need not protect in-state vendors by requiring reimbursement of tax compliance costs because in-state vendors are able to advocate for their own interests in the local political process by leveraging the benefits they bring to the state. In contrast, remote vendors may not have the same leverage.

<sup>250</sup> Swain, *supra* note 240, at 364.

significant, physical presence can function as a very rough proxy for the importance a vendor places on selling into a jurisdiction.

We would therefore oppose the Supreme Court's overturning *Quill* as long as *Quill* is interpreted to permit our proposed approach for the states to tax interstate e-commerce while providing adequate vendor compensation. We admit that our proposed approach would grant multistate e-commerce vendors a small tax cost advantage over multistate physical retailers (with the advantage being equal to the magnitude of tax compliance costs).<sup>251</sup> But we find this weakness of our approach considerably less troubling than would be overturning *Quill* and allowing the states to burden interstate commerce by imposing excess tax compliance costs on multistate e-commerce vendors lacking physical presence. Whereas a retailer with physical presence must necessarily be rather large in order to make sales within thousands of taxing jurisdictions, even a small e-commerce retailer may end up selling across the entire United States. Moreover, the tax cost advantage that our proposed approach would grant to remote e-commerce vendors is much smaller than the tax cost advantage these vendors currently enjoy due to their being shielded from both direct tax costs and tax compliance costs.

Arguably, excess tax compliance costs represent only a small burden for the largest e-commerce vendors like Amazon.<sup>252</sup> Yet even a small burden on interstate commerce is worth preventing to the extent possible. If forced to choose between completely overturning *Quill* and thereby allowing states to tax remote vendors without restriction or interpreting *Quill* such that states would not be allowed to tax remote vendors even with compensation for all tax compliance costs, we would undoubtedly prefer the former approach. But we continue to believe that our interpretation of *Quill* provides a better way forward than either of these alternatives. Unlike the alternatives, our proposed approach permits the states to raise most of the revenue available from taxing interstate e-commerce without creating any burden on interstate commerce.

Moreover, focusing on the potential burden on the largest e-commerce vendors like Amazon ignores the strongest arguments for the physical presence rule. Excess compliance costs are potentially far more burdensome to smaller e-commerce vendors.<sup>253</sup> A state might alleviate this concern by using a very high threshold for the amount of sales within the state that would trigger a remote e-commerce vendor being subject to use taxation. But adopting such a high threshold would in effect discriminate against large e-commerce vendors, granting small remote e-commerce vendors an unfair tax advantage both as compared to their larger competitors and as compared to in-state vendors of all

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<sup>251</sup> But a state could completely alleviate this advantage by also adequately compensating in-state vendors for sales and use tax compliance costs.

<sup>252</sup> As Michael Mazerov has explained, Amazon already collects sales taxes for other companies that sell on its website, implying that the burden of doing so is not prohibitive. MAZEROV, *supra* note 182, at 4-5.

<sup>253</sup> *Supra* note 121 and accompanying text.

sizes.<sup>254</sup> Again, we might support this outcome if the only alternative were to completely prohibit states from subjecting any remote vendors to use taxation. But our proposed approach would allow the states to better tailor their thresholds so as to only exempt from use taxation those remote vendors who conduct a truly minimal amount of sales within the state.

#### D. *Implications for Congress*

By holding that only the Commerce Clause prevents states from imposing use tax compliance obligations on the major e-commerce vendors – and that the Due Process Clause does not – the *Quill* decision opened the door for Congress to regulate state taxation of interstate e-commerce.<sup>255</sup> There have since been repeated calls by scholars and state tax officials for Congress to authorize the states to subject remote vendors to use taxation.<sup>256</sup> Many of these commentators have suggested that Congress should require the states to unify and simplify their sales and use taxes along specified dimensions as a precondition for allowing the states to tax interstate e-commerce.<sup>257</sup>

Congress has so far shown little inclination to expand the states' ability to tax interstate commerce.<sup>258</sup> When Congress has chosen to act, it “has generally adopted even greater nexus protections” rather than facilitating state taxation of remote vendors.<sup>259</sup> Nevertheless, many commentators continue to hope that Congress will eventually resolve the problems created by the *Quill* decision.<sup>260</sup> The most noteworthy recent action along these lines is the Main Street Fairness Act sponsored by Senator Richard Durbin (D-IL) and Congressman John Conyers (D-MI).<sup>261</sup> The Main Street Fairness Act would authorize the states to extend their use taxes to reach remote vendors but would only do so for states

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<sup>254</sup> For instance, Amazon has opposed federal legislation that would set a threshold of \$5 million in annual nationwide sales, arguing that such a high threshold would grant small e-commerce vendors an unfair tax cost advantage as compared to both larger e-commerce vendors (like Amazon) and against small Main Street retailers. MAZEROV, *supra* note 182, at 8-9. We think that Amazon has a valid argument on this point.

<sup>255</sup> Swain, *supra* note 240, at 346.

<sup>256</sup> *E.g.*, *id.* at 370; Zelinsky, *supra* note 16, at 104.

<sup>257</sup> See Hellerstein, *supra* note 17, at 549-50 (describing a “broad consensus among academic tax specialists regarding general principles” including the need for simplification to make destination-based taxation of sales feasible).

<sup>258</sup> See, *e.g.*, Griffeth, *supra* note 120, at 352 (“Congress has historically been reluctant to address state revenue issues, preferring instead to leave tax administration to the states.”); Swain & Hellerstein, *supra* note 242, at 615.

<sup>259</sup> Swain, *supra* note 240, at 370.

<sup>260</sup> *E.g.*, Zelinsky, *supra* note 16, at 104.

<sup>261</sup> Press Release, Nat'l Taxpayers Union, Beware of Fiscal Potholes in Congress's Latest “Main Street Fairness Act,” Taxpayer Group Warns (July 29, 2011), available at <http://www.ntu.org/news-and-issues/taxes/729-beware-of-fiscal-potholes-in.html>.

that agree to the Streamlined Sales and Use Tax Agreement – a multistate compact for simplifying and unifying sales and use taxes.<sup>262</sup>

We have argued that congressional action is unnecessary for the states to reach remote vendors with their use taxes as long as the states are willing to compensate the remote vendors for all tax compliance costs thereby imposed. But if Congress does decide to pass legislation enabling the states to tax remote vendors – or if the courts rule against our proposed solution, making such action necessary – we would urge Congress to allow the states to impose use tax compliance obligations on remote vendors only if the states compensate the remote vendors for all tax compliance costs. Further, we would exhort Congress not to place any additional simplification or unification requirements on the states beyond conditioning the states' abilities to impose use tax compliance obligations on remote vendors on the states' also compensating the remote vendors for all use tax compliance costs. Rather than force the states to adopt a specific form of simplification and unification as a precondition for taxing remote vendors, Congress should incentivize the states toward unification and simplification while maintaining flexibility for each state to decide how to balance the goals of simplification and unification against local interests that might call for divergent tax design.<sup>263</sup> Hence, even if Congress decides to clarify the scope of the Commerce Clause, we would urge Congress to adopt our proposed approach as the best way forward for state taxation of e-commerce.

#### CONCLUSION

We hope that our proposed solution of adequate vendor compensation will resolve the two decades of controversy over the scope of *Quill*. Yet it is worth pondering why no commentator has advocated for our proposed solution before now. Although previous vendor compensation schemes have been incomplete and inadequate, vendor compensation is not a new component of sales and use tax design.<sup>264</sup> Why then has no one proposed full and adequate vendor compensation as a means for states to impose use tax compliance obligations on remote vendors without burdening interstate commerce? Indeed, when we have discussed our arguments with state tax practitioners, some have responded to our analysis with disbelief.<sup>265</sup>

Because the *Quill* majority partially justified *Quill's* Commerce Clause holding based on stare decisis, some commentators appear to have concluded

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<sup>262</sup> *Id.* For discussion of the Streamlined Sales and Use Tax Agreement, see sources cited *supra* note 242.

<sup>263</sup> See, e.g., Plattner, Smirlock & Ladouceur, *supra* note 177, at 191 (“A major problem with the streamlined approach is that it offers a ‘one size fits all’ solution to states whose circumstances widely differ.”).

<sup>264</sup> *Supra* notes 151-152 and accompanying text.

<sup>265</sup> Other state tax practitioners have told us they find our analysis compelling. All have been surprised by our arguments.

that *Quill* affirmed the entirety of the *Bellas Hess* physical presence rule.<sup>266</sup> But the *Quill* decision very clearly held that *Bellas Hess*'s physical presence rule does not apply with respect to the Due Process Clause.<sup>267</sup> Indeed, Justice White, concurring in part and dissenting in part, criticized the majority's creating separate rules for the Due Process Clause and the Commerce Clause as "an uncharted and treacherous foray,"<sup>268</sup> noting that the Court had "never before found, as we do in this case, sufficient contacts for due process purposes but an insufficient nexus under the Commerce Clause."<sup>269</sup>

From the beginning, it has been understood that *Quill*'s separate holdings for the Due Process Clause and the Commerce Clause means that Congress can authorize the states to tax remote vendors.<sup>270</sup> Nevertheless, in light of Congress's failure to act, state tax practitioners have come to see *Quill* as a limitation on states' taxing powers. That *Quill* actually expanded states' taxing powers with respect to the Due Process Clause has received comparatively little attention. Because *Quill* has come to stand so firmly in practitioners' minds as a victory for remote vendors, there has been little inquiry into the implications of *Quill*'s overturning of the physical presence rule with respect to the Due Process Clause. Even those who argue that states should be able to tax remote vendors have focused their rhetoric on criticizing *Quill*'s Commerce Clause holding.<sup>271</sup>

In contrast, we believe that *Quill*'s Due Process Clause holding is potentially far more important than its Commerce Clause holding. The *Quill* majority made clear that they were upholding *Bellas Hess*'s physical presence rule with respect to the Commerce Clause because "it is not inconsistent with *Complete Auto* and our recent cases."<sup>272</sup> The *Quill* majority further explained that upholding the physical presence rule based on the Commerce Clause is compatible with *Complete Auto* because the physical presence rule serves to "limit the reach of state taxing authority so as to ensure that state taxation does not unduly burden interstate commerce."<sup>273</sup> The *Quill* majority then cited *Bellas Hess* to explain that the potential burden on interstate commerce that justified upholding the physical presence rule results from the excess tax compliance costs that "might be imposed by the Nation's 6,000-plus taxing

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<sup>266</sup> *E.g.*, Rosen & Hedstrom, *supra* note 15, at 932.

<sup>267</sup> *Quill Corp. v. North Dakota*, 504 U.S. 298, 308 (1992) ("Thus, to the extent that our decisions have indicated that the Due Process Clause requires physical presence in a State for the imposition of duty to collect a use tax, we overrule those holdings as superseded by developments in the law of due process.").

<sup>268</sup> *Id.* at 325 (White, J., concurring).

<sup>269</sup> *Id.*

<sup>270</sup> *Id.* at 318-19 (majority opinion).

<sup>271</sup> *E.g.*, Swain, *supra* note 240, at 356-65.

<sup>272</sup> *Quill*, 504 U.S. at 311.

<sup>273</sup> *Id.* at 313.

jurisdictions.”<sup>274</sup> By basing the potential burden on interstate commerce on excess tax compliance costs – rather than on direct tax costs – the *Quill* majority reconciled the physical presence rule with *Complete Auto*’s affirmation that it is “not the purpose of the commerce clause to relieve those engaged in interstate commerce from their just share of state tax burden even though it increases the cost of doing business.”<sup>275</sup>

As we have argued, the very steps the *Quill* majority took to demonstrate that a physical presence rule under the Commerce Clause is compatible with *Complete Auto* and other modern Commerce Clause cases necessarily limit the scope of the physical presence rule to apply only when remote vendors might be burdened by excess tax compliance costs. As a result, the physical presence rule should not apply if states fully and adequately compensate remote vendors for all tax compliance costs such that there is no potential for burdening interstate commerce. Any other interpretation of *Quill* would be incompatible with *Complete Auto* and would thus contradict the *Quill* majority’s justification for upholding the physical presence rule under the Commerce Clause because “it is not inconsistent with *Complete Auto* and our recent cases.”<sup>276</sup>

*Quill*’s expansion of state taxing powers with respect to the Due Process Clause thus paves the way for our proposed solution of adequate vendor compensation as an effective and constitutional means for states to tax interstate e-commerce. We urge the states to adopt our proposed approach – either on its own or in combination with the existing state Amazon-law strategies.<sup>277</sup> Once the states begin to do so, we predict a rapid end to the sales and use tax exemption currently enjoyed by Amazon and the other major e-commerce vendors, moving us toward a fairer and more efficient multistate sales and use tax regime.

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<sup>274</sup> *Id.* at 313 n.6.

<sup>275</sup> *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977) (quoting *W. Live Stock v. Bureau of Revenue*, 303 U.S. 250, 254 (1938)).

<sup>276</sup> *Quill*, 504 U.S. at 311.

<sup>277</sup> *See supra* Part III.B.