Use Tax Collection on Interstate Sales: The Need for Federal Legislation

by Alan D. Viard

The collection of use tax on interstate mail-order and Internet sales is a long-standing tax policy issue. Purchasers rarely pay use tax, and current constitutional doctrine prevents a state from requiring use tax collection by sellers without a physical presence in the state. In the last few years, some states have adopted laws that aggressively test the constitutional restrictions, and support has increased for proposed federal legislation to ease those restrictions. In this article, I argue that the time has come for Congress to authorize states to require use tax collection by out-of-state sellers.

I first describe the role of the use tax and the challenges that states have confronted in collecting the tax. I then argue that requiring out-of-state sellers to collect use tax does not involve an extraterritorial exercise of power by state governments and does not impose discriminatory tax burdens on interstate commerce. I observe that requiring use tax collection can, in some circumstances, constitute an undue regulatory burden on interstate commerce by imposing excessive compliance costs, particularly on small sellers. I argue, however, that the physical presence rule imposed by current constitutional doctrine is a vastly overbroad and misdirected response to that problem.

I then discuss the “Amazon” laws recently adopted by a number of states. I conclude that those laws are unlikely to offer an effective solution, because of uncertainty about their constitutionality, the lack of uniformity that they create, and the ease with which sellers can sidestep them. I then discuss the Streamlined Sales Tax Project and the potential role for federal legislation, noting the recent increase in congressional interest. I conclude that only Congress can provide an effective solution that is uniform throughout the nation and indisputably constitutional and that also helps simplify the sales tax system for all taxpayers.

The Use Tax

Forty-five states (all except Alaska, Delaware, Montana, New Hampshire, and Oregon) have general sales taxes that apply to sales made within the state. Each of the states also imposes a use tax, with a rate equal to the sales tax rate, on the use within the state of items that have not been subject to the state’s sales tax, including items purchased from out-of-state sellers. Many local governments within those states also impose sales and use taxes.

Requiring out-of-state sellers to collect use tax does not involve an extraterritorial exercise of power by state governments and does not impose discriminatory tax burdens on interstate commerce.

Although purchasers are legally responsible for payment of the use tax, compliance is low. Some business purchasers pay use tax,¹ but payments by consumers are rare. The California State Board of Equalization estimated in 2011 that the state’s residents paid only 1.4 percent of their use tax liability.² Noncompliance is partly the result of lack of knowledge; a poll by the International Council of Shopping Centers in July 2011 found that 64 percent of consumers were unaware that they were required to pay use tax.

pay use tax on Internet purchases.³ But unawareness of the tax is not the full explanation; a non-scientific survey conducted by a member of the California BOE found that 36 percent of respondents said that they did not pay use tax either because they pay too much tax already or because they disagree with the tax.⁴

Some states allow or require use tax payments to be made on individual income tax returns, avoiding the need for purchasers to file separate use tax returns. A recent report by Nina Manzi of the Research Department of the Minnesota House of Representatives provides a comprehensive survey of that practice. She finds that 10 states provide for reporting of both state and local use tax on income tax returns and that another 15 states provide for reporting of state use tax. Compliance remains modest even in those states. The fraction of income tax returns reporting use tax liability in 2009 was 9.8 percent in Maine, 7.9 percent in Vermont (which pioneered the practice of collecting use tax on income tax returns in 1974), and 5 percent in New York, but only 0.2 percent in Rhode Island and 0.3 percent in California and New Jersey. Manzi notes that 11 states require taxpayers with no use tax liability to clearly indicate that fact on their returns, and that those states have somewhat higher average collections.⁵

Although those measures may modestly increase collections, truly effective use tax enforcement can be achieved only if sellers collect and remit the tax. Under current constitutional doctrine, however, states have only limited authority to require collection by out-of-state sellers. In its 1992 decision in Quill Corp. v. North Dakota, the U.S. Supreme Court reaffirmed its 1967 holding in National Bellas Hess v. Department of Revenue that states cannot require use tax collection by sellers that lack a physical presence in the state.⁶ As further explained below, the Court reached that result solely under the dormant commerce clause of the U.S. Constitution, which prevents states from impeding interstate commerce in the absence of congressional authorization.⁷ By basing its holding on the commerce clause, the Court left the door open for Congress to override the holding, as discussed below.

**Truly effective use tax enforcement can be achieved only if sellers collect and remit the tax.**

A number of studies have attempted to estimate the revenue loss from states’ inability to effectively collect use tax. An often-cited 2009 study by Donald Bruce, William Fox, and LeAnn Luna of the University of Tennessee estimated that the nationwide revenue loss would reach $11.4 billion by 2012.⁸ Some observers have suggested that the actual revenue loss may be smaller, based on estimates of how many Internet transactions are business-to-businesses sales that may be exempt from tax or for which purchasers may already be paying tax.⁹ It seems clear, in any case, that the revenue loss is far from trivial and is likely to continue to grow.

The revenue loss is not, however, the real economic cost of the failure to collect use tax on interstate sales. The economic damage comes from the distortion in consumer behavior that arises when some sales are taxed and others are not, because the tax disparity prompts purchasers to avoid tax by shifting to untaxed goods. Statistical studies have found a significant effect of this kind. A recent study

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⁵Nina Manzi, “Use Tax Collection on Income Tax Returns,” State Tax Notes, July 2, 2012, p. 23, Doc 2012-10496, or 2012 STT 127-9. Manzi also reports that nine states provide tables with estimated use tax liabilities based on income and allow taxpayers to pay those amounts in lieu of their actual tax liability, except that use tax must still be paid on large purchases. She observes that, on average, more people report use tax liability in those states, partly offset by a slight reduction in average use tax paid by each reporting person. The economics of the approach are questionable, however, because the payment of a tax liability linked to income simply increases marginal income tax rates and imposes no marginal tax on out-of-state purchases, leaving intact the tax-advantaged status of such purchases.


⁷Article I, section 8, clause 3 of the Constitution (the commerce clause) provides that “Congress shall have Power . . . To regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes.” Although the text does not mention any restriction on state authority, the Supreme Court has long interpreted the clause as having a “dormant” or “negative” aspect that prohibits states from impeding interstate and foreign commerce in the absence of congressional authorization.


⁹For example, the Nebraska tax commissioner recently estimated his state’s revenue loss to be smaller than the loss estimated in the University of Tennessee study; see Noah Aldonas, “Nebraska: DOR Disputes E-Commerce Sales Tax Loss Estimates,” State Tax Notes, Aug. 27, 2012, p. 576, Doc 2012-17681, or 2012 STT 162-14.
by Liran Einav, Jonathan Levin, and Dan Knoepfle of Stanford University and Neel Sundaresan of eBay Research Labs estimated that a 1 percentage point increase in a state's sales tax rate results in a 2 percent increase in residents' online purchases from sellers in other states. They note that other statistical studies have estimated even larger impacts.

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In view of the economic harms of the tax disparity, I now turn to the question whether there are good grounds to restrict states from requiring use tax collection by sellers without physical presence. I conclude that the only valid argument for restricting state authority is the need to avoid imposing excessive compliance costs on sellers, a goal that can be achieved with restrictions far less sweeping than those set forth in Bellas Hess and Quill. Before discussing compliance costs, I explain why requiring sellers without physical presence to collect use tax is neither an extraterritorial application of state authority nor a discriminatory tax on interstate commerce.

Extraterritoriality and Tax Discrimination

Each state has sovereignty over a specified geographical area and generally lacks authority over transactions that are unconnected with that area or the people who live within it. The U.S. Supreme Court has recognized that fundamental limitation in a variety of contexts. For example, a state's adjudicatory authority is limited by the principle that its courts generally cannot exercise personal jurisdiction over a defendant who lacks minimum contacts with the state without the defendant's consent. Similarly, a state's regulatory authority is limited by the principle that it cannot adopt choice-of-laws principles that apply its substantive laws to a lawsuit in which it lacks a significant state interest.

The states' taxing power is similarly limited. Nobody imagines that Maine can prohibit or tax a Nevada resident's purchase of widgets in Nevada from a Nevada or Wyoming resident, except perhaps in the rare case in which the transaction has some direct substantial effect within Maine.

The existence of the territorial limitation is self-evident and undisputed. A federal system could not function if each state had authority to regulate transactions throughout the entire nation. One justification for the limitation is that it safeguards each state's sovereignty by preventing other states from intruding into its domain. Because sovereignty is only an instrumental value, though, the ultimate justification must pertain to human well-being. Ordinary people could not live their lives if their activities were taxed and regulated by 50 states, most of which have no ties to the activities and no commitment to the well-being of those involved in them. The checks and balances involved when a state taxes the activities of its own citizens would vanish, allowing each state to extract virtually unlimited resources from people in the other 49 states, resulting in a negative-sum game with devastating consequences.

The territorial limitation on state authority has no particular connection to the protection of interstate commerce. The pernicious consequences of allowing each state to tax or regulate transactions throughout the country would probably not include discrimination against interstate commerce. Without a territorial restriction, Maine would indeed have the ability and the temptation to tax commerce between Nevada and Wyoming, a highly improper result. But Maine would have the same ability and temptation to tax intrastate commerce within Nevada's boundaries, an equally improper result. Rather than protecting interstate transactions from discrimination, the territorial limitation protects all transactions from exploitative treatment by states with no connection to them.

In view of its logical disconnection from interstate commerce, it would make little sense to attribute the territorial limitation to the dormant commerce clause. Although one prong of the Supreme Court's Complete Auto four-pronged commerce clause test for state taxes requires a state to have a substantial nexus with the transaction it seeks to tax, the Court has generally not associated that nexus requirement with the territorial limitation. Instead,

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13The Court set forth the test in Complete Auto Transit v. Brady, 430 U.S. 274, 279 (1977). A state tax is consistent with the dormant commerce clause if it “is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against inter-state commerce, and is fairly related to the services provided by the State.”
the Court has generally linked the territorial limitation to a separate nexus requirement inferred from the due process clause of the 14th Amendment to the Constitution.\textsuperscript{14}

The Quill Court correctly held that the requiring use tax collection by sellers with no physical presence was consistent with the 14th Amendment, rejecting the contrary holding of Bellas Hess. (As discussed below, however, the Court reaffirmed the Bellas Hess holding that such a collection requirement was barred by the commerce clause.) The Court said:

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 . . . there is no question that Quill has purposefully directed its activities at North Dakota residents, that the magnitude of those contacts is more than sufficient for due process purposes, and that the use tax is related to the benefits Quill receives from access to the State.\textsuperscript{15}

This should not have been a difficult question. The presence within the state of one party to the transaction, the purchaser, gives the state the authority to tax the transaction. After all, there has never been any real dispute about the state’s power to impose a use tax on those transactions and to collect it from the purchaser. The state’s decision to instead require the seller to collect the tax is an administrative change that should have no relevance to whether the state is exceeding the territorial limits of its powers, although, as discussed below, it may be relevant to whether it is imposing excessive compliance costs on interstate sales. Before considering compliance costs, I explain that use tax collection from sellers without physical presence does not constitute tax discrimination against interstate commerce.

The purpose of the dormant commerce clause is, or should be, to prevent states from discriminating against interstate transactions compared with transactions that occur entirely within the state.\textsuperscript{16} In keeping with that principle of trade neutrality, the Complete Auto test for a state tax’s validity under the clause includes the requirements that the tax be “fairly apportioned” and “not discriminate against inter-state commerce.”\textsuperscript{17} Trade neutrality allows consumers and producers throughout the country to capture the full benefits of free interstate trade.

Like the territorial limitation, trade neutrality prevents a state from exploiting nonresidents. If states could tax or regulate their residents’ transactions with nonresidents more heavily than their residents’ transactions with each other, perhaps by imposing tariffs on imports or exports, they could inflict harm on nonresidents while benefiting some of their residents (those competing with nonresidents). The commerce clause prevents states from implementing those protectionist policies.

The combination of a retail sales tax and a use tax is trade neutral. In 1937 the Supreme Court correctly upheld the use tax as a nondiscriminatory measure that equalizes the taxation of interstate and intrastate sales.\textsuperscript{18} Commentators uniformly recognize that states do not discriminate against interstate trade by imposing use taxes and collecting them from purchasers. The state’s decision to instead require the seller to collect the tax is an administrative change that does not affect the trade neutrality of the tax, although, again, that decision may affect whether excessive compliance costs are being imposed on interstate sales.

From an economic perspective, the combination of a sales tax and a use tax yields a destination-based tax system that applies to all purchases by a state’s residents, whether from in-state or out-of-state sellers. That tax system merely raises the tax-inclusive prices paid by the state’s residents on all their purchases, creating no tax incentive to steer transactions within state lines.

\textsuperscript{14}Section 1 of the 14th Amendment provides, “Nor shall any State deprive any person of life, liberty, or property without due process of law.” This clause had also served as the basis of the Court’s holdings limiting the personal jurisdiction of state courts and the authority of states to impose their substantive law. Although the territorial limitation on state authority should not be treated as part of the dormant commerce clause, the due process clause of the 14th Amendment also cannot be its ultimate source, as the limitation was surely in effect before the amendment was adopted in 1868. Even without a specific textual basis, the territorial limitation was clearly a necessary part of the original constitutional design, as emphasized by Michael S. Greve, \textit{The Upside-Down Constitution} (Cambridge, Mass.: Harvard University Press, 2012), pp. 69-71. Nevertheless, there is no harm in treating the due process clause as the current source of the limitation.

\textsuperscript{15}Quill, 504 U.S. at 308.

\textsuperscript{16}Unfortunately, other Supreme Court decisions refer to the dormant commerce clause as requiring neutral treatment of nonresidents compared with the state’s residents, a profoundly different formulation that yields incoherent results, particularly when applied to state subsidies. See Alan D. Viard, “U.S. Supreme Court Upholds Balkanization for Some, but Not All, Bonds,” \textit{State Tax Notes}, June 16, 2008, p. 888, at pp. 890-891, Doc 2008-12365, or 2008 STT 117-4.

\textsuperscript{17}Complete Auto, supra note 13.

\textsuperscript{18}Henneford v. Silas Mason Co., 300 U.S. 577 (1937).
Indeed, as discussed above, it is the failure to collect tax on interstate sales that departs from neutrality, although in the unfamiliar direction of favoring interstate sales over within-state intrastate sales. The commerce clause does not prevent deviations in that direction; states that want to favor interstate sales are free to do so. But the clause does not require that favoritism; it is sufficient that states not discriminate against interstate sales.

This point is sometimes misunderstood. One recent commentary complains that states seeking to require use tax collection by out-of-state sellers are trying to “prefer in-state businesses over out-of-state businesses in the kind of anti-competitive economic discrimination the U.S. Constitution was in part adopted to prevent,” “use government power to intervene in the economy to help in-state, store-based businesses,” and “pick winners and losers based on legislative policy preferences.” In reality, it is the exemption of interstate sales that deviates from economic neutrality. The commentator further suggests that an out-of-state seller should be exempt from the market state’s destination-based tax because it is subject to origin-based taxes, such as property taxes, in its home state.19 The invalidity of that argument can be seen in a couple ways. From a heuristic perspective, an in-state seller is subject to both destination-based and origin-based taxes within its state, so it is perfectly neutral for an interstate seller to also face both types of taxes, one in its market state and the other in its home state. From an economic perspective, a uniform origin-based tax is just as trade neutral as a uniform destination-based tax and their combination does not distort trade.

The editors of The Wall Street Journal similarly argue that “Internet firms don’t use government services in the way that retailers do. If Amazon’s headquarters in Seattle catches fire, no Illinois firefighter is going to put it out.”20 An interstate transaction typically benefits from government services in both the seller’s and buyer’s state. It is perfectly appropriate for the buyer’s state to tax the interstate transaction on the same terms as transactions that occur solely within its borders and for the seller’s state to tax it on the same terms as transactions that occur solely within its borders.

Another argument made against allowing states to require use tax collection by out-of-state sellers is that it will lead to undesirable increases in the revenue and spending of state and local governments.21 That objection has little weight. To begin, it is not necessarily true that use tax revenue will result in a net tax increase, because it is possible for states to use the revenue to finance cuts in other taxes.22 Moreover, it is hardly clear that all state and local governments are collecting excessive taxes and engaging in excessive spending, although that may be true for some (or at least may become true as the economy recovers from the Great Recession). In any event, arbitrarily denying states access to a particular tax policy tool is an inefficient and ineffective way to restrict the overall level of taxes and spending.

The remaining objection to use tax collection on interstate sales pertains to compliance costs. I now examine that issue.

Compliance Costs

As explained below, this is the objection on which the Court primarily relied in Bellas Hess, as later ratified by Quill. Although compliance costs justify some restriction on state authority to require use tax collection, they do not justify the sweeping physical presence rule that the Court actually imposed.

As discussed above, the Quill Court distinguished the commerce clause’s nexus requirement from that of the due process clause. The Court stated that “the 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. . . . [T]he ‘substantial-nexus’ requirement is . . . a means for limiting state burdens on interstate commerce.”23 Even as the Court overruled the Bellas Hess holding that requiring use tax collection by sellers without physical presence violates the nexus requirement of the due process clause, it

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19 David S. Addington, “Congress Should Not Authorize States to Expand Collection of Taxes on Internet and Mail Order Sales,” Heritage Foundation Backgrounder No. 2676, Apr. 6, 2012.
21 Addington, supra note 19; The Wall Street Journal, supra note 20.
22 For example, Georgia’s Amazon law was adopted as part of a package that phased out the sales tax on energy used in manufacturing and reduced individual income taxes. See John Buhl, “Georgia Governor Signs Bill Including ‘Amazon’ Law,” State Tax Notes, Apr. 30, 2012, p. 274, Doc 2012-8414, or 2012 STT 77-9.
23 Quill, 504 U.S. at 312-313.
affirmed that decision’s holding that the policy violates the nexus requirement of the dormant commerce clause. Specifically, the Quill Court held that use tax collection cannot be required if the seller’s only connections to the state are through the use of mail and common carriers.

The Quill Court’s concerns about requiring use tax collection by sellers without physical presence were primarily related to compliance costs:

North Dakota’s use tax illustrates well how a state tax might unduly burden interstate commerce. . . . [A]bsent 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.24

In choosing how to address this concern, the Court primarily emphasized its preference for a simple bright-line rule that had already been established by prior precedent. Acknowledging that “contemporary Commerce Clause jurisprudence might not dictate the same result were the issue to arise for the first time today,”25 the Court went on to say:

Like other bright-line tests, the Bellas Hess rule appears artificial at its edges: whether or not a State may compel a vendor to collect a sales or use tax may turn on the presence in the taxing State of a small sales force, plant, or office . . . . This artificiality, however, is more than offset by the benefits of a clear rule. Such a rule firmly establishes the boundaries of legitimate state authority to impose a duty to collect sales and use taxes, and reduces litigation concerning those taxes. [T]he Bellas Hess rule has engendered substantial reliance and has become part of the basic framework of a sizable industry. . . . [T]he doctrine of stare decisis . . . . therefore counsels adherence to settled precedent.26

As discussed below, the Quill Court also relied on the fact that Congress could override the restrictions that it was imposing on state tax collection authority.

Compliance costs can effectively impose a regulatory burden on interstate commerce and are therefore a legitimate concern. Sales that cross state lines are potentially subject to compliance obligations imposed by more than one state, which creates the possibility that a business can face compliance burdens more onerous than those imposed on transactions within a single state. Quill looked to the nexus prong of the Complete Auto test to address that concern and found it expedient to define nexus in terms of physical presence.27

Although Quill sought a bright-line rule, the meaning of physical presence is not completely clear. In 1960, before Bellas Hess, the Supreme Court upheld Florida’s imposition of use tax collection responsibility on an out-of-state seller because the seller had in-state representatives, although the representatives were independent contractors paid on a commission basis.28 In 1987, after Bellas Hess and before Quill, the Court similarly upheld Washington’s imposition of collection responsibility on an out-of-state seller represented by independent contractors within the state.29

The sweeping conclusion that it is unduly burdensome for a seller to be required to collect use tax in any state in which it lacks a physical presence is clearly incorrect. Technological advances make it even less convincing as time goes on.

Michael Mazerov of the Center on Budget and Policy Priorities recently provided a cogent and comprehensive summary of the flaws of the physical presence test.30 He notes that some firms like Walmart and Target collect use tax on all sales because of their physical presence throughout the country, while other firms like Amazon collect use tax on few sales because they avoid establishing physical presence in most states. Mazerov observes that there is no reason to think that use tax collection would be any more difficult for the latter firms than for the former. He also points out that Amazon collects tax

27It seems misplaced to use the Complete Auto test, which is primarily focused on limiting the tax liability that states can impose, to address the question of when tax collection imposes excessive compliance costs. And it seems particularly odd to use a nexus concept for that purpose. It would make more sense to remove considerations of compliance costs from the Complete Auto test, thereby allowing its nexus prong to be dropped. (Of course, the nexus requirement of the due process clause would continue to enforce the territorial limitation on state authority.) The compliance costs of state tax collection would then be addressed in the same manner as other regulatory burdens on interstate commerce. Under Pike v. Bruce Church, Inc., 397 U.S. 137, 142 (1970), facially neutral regulations that impose an incidental burden on interstate commerce are unconstitutional if “the burden imposed on such commerce is clearly excessive in relation to the putative local benefits.” The Pike balancing approach obviously supplies no clear answer. Unlike a nexus standard, however, it asks the right question.


on its sales in foreign countries where it is legally obligated to do so and that it collects tax on behalf of other companies that make sales on its website.

Mazerov further notes that the physical presence test has become even more artificial as Amazon and other firms have engaged in a technique known as entity isolation. Under that strategy, a seller corporation’s wholly owned subsidiaries, rather than the seller corporation itself, establish warehouses and other indicia of physical presence in states in which they are needed.

Of course, small sellers need protection from the compliance costs that would arise if they were forced to follow the tax rules of thousands of local sales tax jurisdictions. But even relatively small sellers may be able to comply with the statewide rules of the 45 sales tax states, which suggests that the obligation to collect state use tax can be imposed more broadly than the obligation to collect local use tax. In any event, the physical presence test is clearly not well designed to protect small sellers. Some small sellers may have physical presence in several states, while large sellers like Amazon are often able to avoid establishing physical presence.

In view of those considerations, a strong case can be made that the Supreme Court should reconsider Quill. Nevertheless, it is unlikely that the Court will do that soon. Even if reconsideration were likely to occur, it might not represent the best path forward. Case-by-case litigation is a poor way to spell out clear new rules on which state and local governments and sellers can rely.

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Any replacement regime should be clearly defined, avoid creating new uncertainty, and be effective in actually collecting use tax. Ideally, the regime should also be accompanied by sales tax simplification. Although large sellers can comply even with today’s complex tax systems, costs can be reduced for all sellers if the sales tax is simplified.

There are two ways in which Quill can be undercut. First, states can chip away at it by passing laws that test its limits. As explained below, several states have recently enacted Amazon laws. Second, Congress can override Quill through legislation. I now consider the potential role of each approach in view of the criteria set forth above.

Amazon Laws

Because there is no clear-cut definition of an Amazon law, there is no consensus on exactly how many states now have enacted them. It is agreed, however, that New York began the trend when it enacted the first Amazon law on April 22, 2009.

The New York law takes the deceptively modest form of a subparagraph elaborating on what it means to solicit business in New York, which makes the soliciting party subject to tax collection responsibility. The subparagraph creates a presumption that an out-of-state seller has engaged in solicitation if it pays a New York resident to allow customers to place orders with the seller by clicking on a link to the seller’s website from the resident’s website, provided that the out-of-state seller made at least $10,000 of sales in New York in that manner during the preceding year. The out-of-state seller may rebut the presumption by demonstrating that the residents did not engage in any solicitation that satisfies constitutional nexus standards.31 The law is directed at programs such as Amazon Associates, in which website owners provide a click-through to the Amazon website. Under informal guidance provided by the New York Department of Taxation and Finance, the seller may rebut the presumption only if its contracts with the New York residents prohibit solicitation and it obtains annual certifications from all of them attesting that they have complied with the prohibition. A seller may therefore be treated as engaging in solicitation if any resident engages in unauthorized solicitation or merely fails to supply a certification attesting to the contrary each year.32

Rhode Island and North Carolina adopted similar click-through laws in 2009. On March 10, 2011, Illinois adopted a more sweeping law that denies the out-of-state seller any opportunity to rebut the presumption of solicitation. Later in 2011, Arkansas, California, and Connecticut adopted similar laws, while the Pennsylvania Department of Revenue moved to achieve a similar result through administrative guidance that took effect on September 1, 2012. Georgia enacted a click-through law in 2012.

Other states have adopted a different type of Amazon law. These laws counteract the entity isolation strategy by attributing nexus to an out-of-state seller based on the activities of its subsidiaries within the state. New York adopted legislation to this effect in 2009, as did Colorado and Oklahoma in 2010, and Arkansas, California, Illinois, South Dakota, and Texas in 2011.

Still another type of Amazon law takes the milder approach of requiring sellers to notify purchasers of their obligation to pay use tax. Oklahoma adopted a law of this kind in 2009. Colorado adopted a stricter law on February 24, 2010, that requires out-of-state

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31N.Y. Tax Law section 1101(b)(8)(vi).
sellers to both notify consumers of their obligations and to report consumers’ purchases to the state revenue department. In 2011 South Dakota adopted a law requiring notification. Vermont adopted a law in 2011 that requires notification of consumers; the law will require tax collection by out-of-state sellers if 15 states adopt similar laws.33

The constitutionality of Amazon laws has predictably been contested in court. On January 12, 2009, a New York trial court upheld that state’s law against a challenge by Amazon.com.34 On November 4, 2010, a New York appellate court affirmed the ruling upholding the law against facial attack, but remanded to the trial court for further proceedings related to Amazon’s as-applied challenge to the law. On April 25, 2012, in an order that provided almost no legal analysis, an Illinois trial court struck down that state’s law under the dormant commerce clause in a challenge filed by the Performance Marketing Association.35 A direct appeal is pending before the Illinois Supreme Court. In response to a challenge by the Direct Marketing Association, the U.S. District Court for the District of Colorado issued a preliminary injunction against enforcement of Colorado’s Amazon law on January 26, 2011, followed by a permanent injunction on March 30, 2012.36 The Colorado Department of Revenue’s appeal to the U.S. Court of Appeals for the Tenth Circuit has been fully briefed and oral argument took place on November 7, 2012. The Multistate Tax Commission, which had been working on an Amazon model statute patterned after the Colorado law, has suspended work while awaiting resolution of the appeal.

Amazon has responded aggressively to the laws named after it. It has canceled its associate agreements in states with Amazon laws, other than New York. Rebecca Madigan, executive director of the Performance Marketing Association, estimated that Amazon laws have pushed one-third of online affiliates in states with Amazon laws, other than New York. Wal-Mart, Sears, Best Buy, and Barnes & Noble have actively sought the business of displaced affiliates.38 Amazon canceled its affiliate contracts in Colorado in response to that state’s law, even though the law’s coverage was not linked to the presence of affiliate contracts. Laws that address the entity isolation technique may be somewhat harder for Amazon and other sellers to avoid, although sellers can over time turn to outside firms rather than subsidiaries for warehousing and other functions.

The majority of panelists at a February 5, 2010, Tax Analysts conference agreed that Amazon laws were not the answer to the Internet sales problem. Mazerov argued that the Amazon laws were valid, but not a full solution to the use tax enforcement problem. Stephen Kranz of Sutherland Asbill & Brennan LLP argued that Amazon laws were unconstitutional and that pushing for them undermined efforts to adopt federal legislation.39

In general, the Amazon laws have several deficiencies. First, they do not create pressure to simplify the sales and use tax system. Second, the patchwork of Amazon laws is itself a source of complexity and lack of uniformity. Third, their constitutionality under the Quill regime is uncertain and definitive resolution may not occur for many years. Fourth, many of those laws may be ineffective in spurring tax collection. Laws that rely on associate contracts can be avoided by canceling the contracts, as Amazon has shown, and laws that merely require notification of consumers may do little to encourage them to pay tax.

David Gamage and Devin Heckman discuss another potential approach, vendor compensation.40 They correctly note that because the compliance costs, not the underlying tax burden, are the only legitimate concern, states can eliminate the burden on interstate commerce by compensating out-of-state sellers for their compliance costs. Of course, there are political challenges to providing full vendor compensation and administrative challenges in computing the correct amount of compensation. Gamage and Heckman also rightly caution that despite the impeccable logic underlying the approach, there is no guarantee that the courts will uphold it.

35The trial court also ruled that the Illinois law violated the Internet Tax Freedom Act, which prohibits states from imposing “multiple or discriminatory taxes on electronic commerce” through November 1, 2014.
The vendor compensation approach seems preferable to the strategies embraced by the various Amazon laws. Full vendor compensation has drawn little interest, however, and the approach still seems inferior to congressional action, as discussed below. I therefore do not examine it further in this article. If congressional action is not forthcoming, however, vendor compensation is probably the most promising approach for states to pursue.

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Although the Amazon laws have only a limited potential to actually solve the use tax enforcement problem, their enactment may have helped create a climate for a federal solution.41 (They also may have helped pressure Amazon to reach agreements with states to begin collecting use tax, which it has done in California, Indiana, New Jersey, Pennsylvania, Tennessee, Texas, and Virginia.) Edward Zelinsky has argued that the Amazon laws may be understood as “an effort by the states to lobby Congress to pass federal legislation repealing Quill.”42

There is no constitutional barrier to federal legislation in this area. The Quill Court noted the longstanding doctrine that Congress can authorize states to enact laws that would otherwise violate the dormant commerce clause,43 and said that “the underlying issue is not only one that Congress may be better qualified to resolve, but also one that Congress has the ultimate power to resolve. No matter how we evaluate the burdens that use taxes impose on interstate commerce, Congress remains free to disagree with our conclusions.”44

Most commentators agree that congressional action is the most promising way to fashion a replacement for the Quill regime. Even Amazon professes to support federal legislation to require use tax collection by out-of-state sellers. Nevertheless, many observers have been justifiably skeptical that Congress will ever take action. As discussed below, however, prospects for federal legislation have become somewhat more promising.

### Federal Legislation

Proposals for congressional action have often been associated with the SSTP, which was established by the National Governors Association and the National Conference of State Legislatures in 1999. Twenty-two states (Arkansas, Georgia, Indiana, Iowa, Kansas, Kentucky, Michigan, Minnesota, Nebraska, Nevada, New Jersey, North Carolina, North Dakota, Oklahoma, Rhode Island, South Dakota, Utah, Vermont, Washington, West Virginia, Wisconsin, and Wyoming) are full members of the project, with Utah having attained that status on October 1, 2012. Ohio and Tennessee are associate members, meaning that they are in substantial, but not complete, compliance with the terms of the agreement.

The project’s Streamlined Sales and Use Tax Agreement seeks to simplify sales taxes along several dimensions in the belief that simplification will make Congress more receptive to proposals to require use tax collection by sellers without physical presence. For example, the agreement provides uniform definitions of product categories while leaving to each state the decision of whether to tax or exempt each category. The agreement generally provides for destination-based sourcing, although origin sourcing of local sales taxes is allowed. With limited exceptions, the state government can impose only a single sales tax rate on the goods that it taxes, with each locality in the state allowed to impose its own single rate. States must provide software on which sellers are allowed to rely with protection from liability for taxes, penalties, and interest.45

The 112th Congress has seen several proposals to authorize states to require out-of-state use tax collection. The proposed Main Street Fairness Act, introduced in July 2011 as H.R. 2701 and S. 1452,

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would have authorized collection only by states that are parties to the streamlining agreement. The most recent proposals are H.R. 3179 and S. 1832. Both bills define remote sellers as sellers that lack nexus under Quill, extend the potential collection authority to Puerto Rico and the other overseas possessions, and have severability clauses. Both bills also disclaim any implications for nexus standards applicable to business activity taxes and other state taxes.

H.R. 3179, the proposed Marketplace Equity Act of 2011, was introduced on October 13, 2011, by U.S. Rep. Steve Womack, R-Ark., and referred to the House Judiciary Committee. The bill would authorize any state, or set of states acting in concert, to require use tax collection and remittance by remote sellers, under specific conditions. The state may not require collection by any remote seller with gross receipts in the preceding calendar year “not exceeding $1 million from remote sales of items, services, and other products in the United States.” Even if a seller meets that standard, the state still cannot require collection if the seller has gross receipts “not exceeding $100,000” in the state. The state must provide a single tax return to be filed by remote sellers with a single taxing authority and cannot require remote sellers to file returns more frequently than other sellers, and no locality can require the filing of returns. States must offer remote sellers an identical tax base for sales made anywhere in the states. They also must offer remote sellers a single tax rate for sales made anywhere in the state, unless they make available adequate software “that substantially eases the burden of collecting at multiple rates within the state” and protect sellers from liability (for taxes, penalties, or interest) arising from errors in the software.

S. 1832, the proposed Marketplace Fairness Act of 2011, was introduced on November 9, 2011 by U.S. Sen. Michael B. Enzi, R-Wyo., and referred to the Senate Finance Committee. The bill would provide two mechanisms by which a state would be authorized to require use tax collection and remittance by remote sellers. First, member states under the streamlining agreement can begin to require collection at the beginning of the calendar quarter that is at least 90 days after the date of the bill’s enactment. Second, a state can require collection if it has a single state-level agency, a single audit, and a single tax return, and provides adequate software. A small-seller exception protects sellers with gross annual receipts of $500,000 or less from remote sales in the United States.

The bills have drawn bipartisan support. At the time of this writing, H.R. 3179 has 26 Democratic and 28 Republican sponsors and S. 1832 has 16 Democratic and five Republican sponsors. Although Americans for Tax Reform has indicated that support for use tax collection authority may violate the organization’s Taxpayer Protection Pledge, some Republican signatories of the pledge have nonetheless cosponsored the bills, reasonably interpreting the pledge not to apply to measures that merely facilitate the collection of a tax that is already owed.46 Although the pledge is ill-conceived under any interpretation, it becomes even more absurd if extended to tax collection provisions.

The House Judiciary Committee held a hearing on constitutional limits on state collection authority on November 30, 2011,47 and a hearing on H.R. 3179 on July 24, 2012. The Senate Commerce, Science, and Transportation Committee held a hearing on August 1, 2012.

On the other side of the debate, Rep. Daniel E. Lungren, R-Calif., introduced H. Res. 95 on February 16, 2011, and Sen. Ron Wyden, D-Ore., introduced S. Res. 309 on November 2, 2011, virtually identical bills that condemn “any new burdensome or unfair tax collecting requirements on small online businesses and entrepreneurs.” H. Res. 95 has seven Democratic sponsors and 25 Republican sponsors and S. Res. 309 has four Democratic and two Republican sponsors.

Earlier in the year, some supporters of H.R. 3179 and S. 1832 expressed the hope that Congress might act in 2012, but that possibility now appears remote. Panelists at a September 21 forum sponsored by the Urban-Brookings Tax Policy Center and the Center for State and Local Leadership at George Mason University generally expressed doubt that the bills would be acted on in the lame-duck session of the 112th Congress that is scheduled to begin on November 13. Some panelists suggested, however, that the bills had a prospect of being enacted in the 113th Congress, which will convene on January 3, 2013, with Frank Shafroth commenting that after 25 years of debate, such legislation now has its best

chances yet of approval. At an October 3 conference of the North Eastern States Tax Officials Association, Gale Garriott, executive director of the Federation of Tax Administrators, said that this was the most attention that streamlining had received in the last decade, but cautioned that no bill was likely to be passed in the lame-duck session. At the same conference, MTC Executive Director Joe Huddleston said that he did not expect Congress to pass a bill anytime soon. State Tax Notes legal editor Cara Griffith recently speculated, however, that the lame-duck session might pass a bill as part of a solution to the impending “fiscal cliff.”

H.R. 3179 and S. 1832 meet the basic standard of providing relief from compliance costs by exempting small sellers and addressing local variations in sales tax rates, but some questions are unresolved. The effectiveness of the software that both bills rely on to help remote sellers comply with their obligations has been questioned. A coalition called True Simplification of Taxation is pushing for further simplification, including a single sales tax rate in each state. Because in-state sellers do not collect tax based on the locality in which the seller resides, some observers question whether out-of-state sellers should be required to do so. Sharp disagreement persists over the proper scope of the small-seller exemption. H.R. 3179 uses a $1 million threshold for nationwide sales while S. 1832 uses a threshold only half as high. Ted Cohen of eBay argued for a $30 million threshold at the November 30, 2011, House Judiciary Committee hearing, but it is hard to see the need for such a high threshold. Another contentious issue is whether it is desirable to allow states outside the streamlining agreement to impose collection requirements.

There is no single set of right answers to those questions. I prefer an approach that emphasizes the collection of sales tax at a statewide rate, an obligation that can be imposed on even relatively small sellers, though not on the smallest ones. Sellers above a higher threshold could be required to also collect local sales taxes. To promote uniformity, it seems preferable to tie collection authority to the streamlining agreement. In any event, disagreement on those matters should not be allowed to impede the enactment of legislation.

**Conclusion**

The physical presence rule imposed by Bellas Hess and Quill has resulted in de facto tax exemption for many sales made over the Internet. Requiring sellers without physical presence in a state to collect use tax is neither an extraterritorial application of state authority nor a form of tax discrimination against interstate commerce. Legitimate concerns about compliance costs can be addressed through a small-seller exemption and do not justify the physical presence rule. Congress should adopt legislation that repeals the physical presence rule, protects small sellers from compliance costs, and promotes sales tax simplification.

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