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The Fading Bright Line of Physical Presence: Did *KFC Corporation v. Iowa Department of Revenue* Give States the Secret Recipe for Repudiating *Quill*?

Adam B. Thimmesch¹

INTRODUCTION

THE Supreme Court has long held that the Commerce Clause of the United States Constitution prohibits states from imposing sales- or use-tax collection requirements on vendors that do not have a physical presence within their jurisdictions.² That limitation on state power was challenged as an anachronism in the early 1990s, but the Supreme Court affirmed the continued validity of its physical-presence mandate in *Quill Corporation v. North Dakota*.³ Since that case, the legitimacy of the physical-presence test has been largely accepted for purposes of state sales and use taxes.⁴ However, states' frustrations with that rule have only increased during that time.

States' growing frustrations with the physical-presence rule are due in large part to the explosive growth of the Internet in the two decades since *Quill*. That technological development has expanded the pool of vendors that are protected by the physical-presence rule from a relatively small group of retailers (principally mail-order vendors) to a much larger group that is buoyed significantly by Internet retailers. That expanded pool of protected vendors, together with widespread consumer use-tax noncompliance, has

¹ Assistant Professor of Law, University of Nebraska College of Law. I would like to thank Bruce Ackerman for his guidance and comments on earlier drafts and my family for their patience and support.

² See *Nat'l Bellas Hess, Inc. v. Dep't of Revenue*, 386 U.S. 753 (1967), *abrogated by* *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

³ *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

⁴ In recent years, an increasing number of state courts have refused to apply the physical presence standard to state *income* taxes. Those courts have accepted *Quill* as it applies to sales and use taxes, but note the Supreme Court's failure to apply that test to income tax cases. (That is not to say that the Supreme Court has not had the opportunity to do so. As discussed *infra* in Section II.A, the Court has refused to grant *certiorari* in a number of cases presenting this question over the last two decades.) These actions by state courts (discussed *infra* in Section II.A), and the concomitant lack of guidance from the Court, have led to significant debate among taxpayers, tax authorities, tax practitioners, and academics regarding the applicability of the physical-presence test to state income taxes. Sufficient ink has been dedicated to this issue and this Article does not add to that debate.

resulted in significant revenue losses for states across the nation.⁵ States have responded to these losses by aggressively and continuously lobbying Congress to legislatively overturn the physical-presence rule.⁶ Despite those efforts, however, Congress has not yet given states the reprieve that they seek.

States have responded to Congress's inaction in this area by taking steps aimed at mitigating the impact of *Quill's* physical-presence directive. Those actions include adopting statutory provisions attributing a physical presence to remote vendors,⁷ adopting unique information-reporting requirements that impose significant burdens on those vendors,⁸ and actively discussing challenging *Quill's* ongoing validity in court.⁹ The Oklahoma legislature also recently boldly declared that "the sales and use tax system established under Oklahoma law does not pose an undue burden on out-of-state retailers"—a noted concern of the *Quill* court in affirming the physical-presence standard.¹⁰ Ultimately, however, none of those efforts to mitigate *Quill's* impact have provided states with any real relief from the physical-presence test.¹¹ That test still requires that vendors have some physical presence in the taxing state, something that many Internet retailers lack.

5 The tax losses attributable to these factors were previously projected to be as much as \$11 billion in 2011. See Donald Bruce et al., *State and Local Sales Tax Revenue Losses from E-Commerce*, 52 STATE TAX NOTES 537: 540 (2009).

6 Opposing bills have been presented in Congress through the years that would either statutorily impose the physical-presence test or restrict or remove that test. Most recently, the *Main Street Fairness Act* (introduced on July 29th, 2011) would allow states that are members of the Streamlined Sales and Use Tax Agreement to require remote vendors to collect their sales and use taxes. *Main Street Fairness Act*, H.R. 2701, 112th Cong. § 4(a)(1) (as referred to the H.R. Subcomm. on Courts, Commercial and Admin. Law, Aug. 18, 2011); *Main Street Fairness Act*, S. 1452, 112th Cong. § 4(a)(1) (as referred to the S. Comm. on Fin., July 19, 2011). Similar provisions have been considered in recent Congressional sessions. See, e.g., STEVEN MAGUIRE & NONNA A. NOTO, CONG. RESEARCH SERV., RL 33261, INTERNET TAXATION: ISSUES AND LEGISLATION 11, (2008), available at http://ipmall.info/hosted_resources/crs/RL33261_080707.pdf; STEVEN MAGUIRE & NONNA A. NOTO, CONG. RESEARCH SERV., RL 33261, INTERNET TAXATION: ISSUES AND LEGISLATION IN THE 109TH CONGRESS 9 (2006), available at <http://www.ait.org.tw/infousa/enus/economy/technology/docs/RL33261.pdf>; STEVEN MAGUIRE & NONNA A. NOTO, CONG. RESEARCH SERV., RL 31929, INTERNET TAXATION: ISSUES AND LEGISLATION IN THE 108TH CONGRESS 10 (2004), available at http://ipmall.info/hosted_resources/crs/RL31929_041217.pdf.

7 See *infra* notes 123-25. For purposes of this Article, the terms "remote vendors," "out-of-state retailers," and "out-of-state vendors" refer to such persons who do not have a physical presence within the taxing state.

8 See *infra* text accompanying notes 128-170.

9 See *infra* text accompanying notes 182-183.

10 Act of June 9, 2010, ch. 412, § 6, 2010 Okla. Sess. Laws 1692, 1698.

11 And their prospects for doing so took an initial hit in January 2011, when the State of Colorado was preliminarily enjoined from enforcing its new information-reporting law. See *infra* text accompanying notes 157-162.

States desiring a reprieve from the physical-presence rule therefore must find either a new method of attributing a physical presence to such retailers or obtain the yet-elusive reversal of that rule. Neither is an easy task. However, the Iowa Supreme Court's decision in *KFC Corporation v. Iowa Department of Revenue* may have introduced an avenue for effectively achieving both.¹² In that case, the Iowa Supreme Court upheld the state's ability to impose its income tax on an out-of-state franchisor merely because it received royalties from franchisees in the state. That decision followed a long line of state-court decisions that rejected the physical-presence standard in favor of an economic-nexus standard for purposes of state *income* taxation. The case is unique, however, in that the court took the extraordinary step of also finding that KFC had actually met *Quill's* physical-presence test.¹³ The court came to that conclusion by relying on two factors unrelated to the physical actions of KFC: (1) the use of KFC's intellectual property by its franchisees in the state; and (2) KFC's derivation of income based upon transactions occurring in the state.¹⁴

The *KFC* court's reliance on those two factors greatly expanded the types of activities that have been historically understood to create a physical presence in a state and, in doing so, appears to ignore the very basis and purpose of the physical-presence requirement. The *KFC* court's rationale could thus provide states with the method for which they have been looking to require sales- and use-tax collection and remittance from Internet retailers, but it represents a stark deviation from Supreme Court precedent and seems to have a limited basis in existing law. This Article evaluates the scope of the *KFC* decision and whether it represents a legitimate application, or an effective rejection, of the physical-presence test.

To help understand this case in a historical context, Part I of this Article reviews the Supreme Court's jurisprudence regarding the limits on state sales and use taxation under the Commerce Clause. That section discusses the origin and development of the physical-presence test adopted in *National Bellas Hess* and affirmed in *Quill*.

Part II discusses the various actions that have been taken by states to limit the physical-presence test, from its outright rejection in cases involving taxes other than sales or use taxes to state legislative action in the sales and use tax area. That section looks at recent laws in Colorado, Oklahoma, South Dakota, and Vermont, as well as recent actions by state intergovernmental tax agencies challenging *Quill's* authority. That discussion sets the framework for *KFC* and its importance.

Part III discusses the *KFC* case and its *Quill* analysis. Part IV evaluates

¹² *KFC Corp. v. Iowa Dep't of Revenue*, 792 N.W.2d 308 (Iowa 2010), *cert. denied*, 2011 WL 4530160, at *1 (Oct. 3, 2011).

¹³ *Id.* at 323–24.

¹⁴ *Id.*

that analysis and concludes that *KFC* must be read as a rejection of the physical-presence test despite its statements to the contrary. Part V evaluates *Quill's* continuing validity amid calls to the contrary.

I. BACKGROUND

A. *Development of the Commerce Clause's Restrictions on State Sales and Use Taxes*

The Commerce Clause of the United States Constitution grants Congress the power “[t]o regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes.”¹⁵ The Supreme Court has interpreted this clause to grant both a positive power and a negative power.¹⁶ That is, the Commerce Clause grants Congress an affirmative power to regulate interstate commerce, as well as a negative or “dormant” power to limit state taxation measures that would infringe on Congress’s right to do so.¹⁷

The Dormant Commerce Clause has developed over time from a strict prohibition on state taxation of interstate commerce to a test requiring a multi-factor analysis of the state tax regulation at issue.¹⁸ In the context of state sales and use taxes, the Court’s analysis has focused on the boundaries of states’ power to require out-of-state vendors to collect and remit the states’ sales or use taxes. The basic framework of this analysis was formed on one day in 1944, when the Court issued two complementary decisions—*McLeod v. J.E. Dilworth Co.*¹⁹ and *General Trading Co. v. State Tax Commission*.²⁰

In *McLeod*, the Court ruled that the State of Arkansas could not impose its sales tax on out-of-state transactions simply because the purchased goods were delivered to consumers in the state.²¹ The sellers that challenged the Arkansas tax were Tennessee corporations principally operated in Memphis.²² None of the sellers were qualified to do business in Arkansas nor had any places of business in the state.²³ The transactions on which

15 U.S. CONST. art. I, § 8, cl. 3.

16 See *Cooley v. Bd. of Wardens*, 53 U.S. (12 How.) 299, 319 (1851); *Brown v. Maryland*, 25 U.S. (12 Wheat.) 419, 448-49 (1827); *Gibbons v. Ogden*, 22 U.S. (9 Wheat.) 1, 72-78 (1824).

17 WALTER HELLERSTEIN, *STATE TAXATION* ¶ 4.01[1][a]-[b] (3d ed. 2011), available at Westlaw WGL-STATE. For a detailed discussion of the Dormant Commerce Clause, see BORIS I. BITTKER, *BITTKER ON THE REGULATION OF INTERSTATE AND FOREIGN COMMERCE*, ch. 6 (1999 & Supp. 2011).

18 For a detailed history of the development of the Supreme Court’s Commerce Clause jurisprudence, see HELLERSTEIN, *supra* note 16, ¶¶ 4.07-12.

19 *McLeod v. J.E. Dilworth Co.*, 322 U.S. 327 (1944).

20 *Gen. Trading Co. v. State Tax Comm’n*, 322 U.S. 335 (1944).

21 *McLeod*, 322 U.S. at 330.

22 *Id.* at 328.

23 *Id.*

Arkansas attempted to impose its sales tax were all purchases of goods accepted in, and shipped from, Tennessee.²⁴

The State of Arkansas argued that the imposition of its tax was constitutionally firm because it could have levied the same tax on the transactions in the form of a *use* tax²⁵ without violating the Constitution.²⁶ The Court recognized the similarity in result between the two taxes, but adopted a formalistic approach, noting that sales and use taxes are “different in conception” and are “assessments upon different transactions.”²⁷ As a result, the Court rejected Arkansas’s attempt to tax the out-of-state transactions, holding that “[f]or Arkansas to impose a tax on such transactions would be to project its powers beyond its boundaries and to tax an interstate transaction.”²⁸

In contrast to *McLeod*, the *General Trading* case involved the imposition of a *use* tax on an in-state purchaser’s use of goods purchased outside of the state.²⁹ The statute at issue imposed an obligation on the out-of-state vendor to collect the use tax from the consumer and remit the same to the state.³⁰ This difference in the action being taxed (the purchaser’s *use* of the goods rather than the *purchase* of the goods, as in *McLeod*) compelled a different conclusion by the Court. The Court held that this imposition of tax was proper because “[t]he exaction is made against the ultimate consumer—the Iowa resident who is paying taxes to sustain his own state government.”³¹ The Court was not influenced by the fact that the tax was actually collected from the out-of-state retailer.³²

Through these two cases, the Court created the basic structure for analyzing state impositions of sales and use taxes, with states having much greater power over the latter in connection with out-of-state sales. The

²⁴ *Id.*

²⁵ Sales and use taxes are different, but complementary, taxes. A sales tax is generally imposed on retail transactions. Such taxes are generally collected by the retailer making the sale, but the economic incidence falls on the consumer. *See* HELLERSTEIN, *supra* note 16 at ¶ 12.01. In contrast, use taxes are imposed on the use or consumption of taxable property or services in the taxing state. Such taxes compensate the state for the tax revenue lost when a taxpayer travels out of state to make a purchase. *Id.* at ¶ 16.01[2]. Use taxes are thus imposed at the same rate as the states’ sales taxes, but taxpayers generally receive a credit against that tax for any sales tax paid on the purchase of the goods in the other state. *Id.* A state’s use tax cannot have a broader base than a state’s sales tax without running afoul of the Commerce Clause’s restriction on facially discriminatory taxes on out-of-state purchases. *Id.*

²⁶ *McLeod*, 322 U.S. at 330.

²⁷ *Id.*

²⁸ *Id.*

²⁹ *Gen. Trading Co. v. State Tax Comm’n*, 322 U.S. 335, 336 (1944).

³⁰ *Id.* at 336–37.

³¹ *Id.* at 338.

³² *Id.* (“To make the distributor the tax collector for the State is a familiar and sanctioned device.”).

Court did not, however, enunciate any precise limits on states' power to impose use-tax collection obligations on remote vendors. That guidance was finally provided ten years later in *Miller Brothers Co. v. Maryland*.³³

Miller Brothers involved an attempt by the State of Maryland to require the Miller Brothers furniture store, located in Delaware, to collect Maryland use tax on products sold to Maryland residents. Miller Brothers had no place of business or employees in Maryland, nor did it send any sales personnel into the state.³⁴ Its business activity with respect to Maryland consisted of selling products to Maryland purchasers (some of whom took delivery of the products in Maryland via Miller Brothers's trucks), engaging in advertising that reached Maryland customers, and mailing certain circulars to former customers, including Maryland residents.³⁵

The State of Maryland asserted that it had the ability to require Miller Brothers to collect its use tax and seized a truck owned by Miller Brothers when it was in Maryland delivering purchased goods. The state held Miller Brothers liable for use tax on all goods that it sold to Maryland residents from its Delaware store.³⁶ Miller Brothers challenged this action as a violation of the Due Process Clause of the Fourteenth Amendment to the U.S. Constitution.³⁷

In its review of the Maryland case, the Court recognized that its decisions regarding states' power to tax nonresidents were "not always clear as to the grounds on which a tax is supported."³⁸ However, "the course of decisions does reflect at least consistent adherence to one time-honored concept: that due process requires some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax."³⁹ The Court then undertook a review of its cases evaluating states' power to tax nonresidents, but was unable to find any authority to support Maryland's imposition of tax.⁴⁰ The Court noted that Miller Brothers had not invaded or exploited the market in Maryland, but that its sales "resulted from purchasers traveling from Maryland to Delaware to exploit its less tax-burdened selling market."⁴¹ On those facts, the Court found that Maryland's imposition of a use-tax collection duty on the out-of-state retailer violated the Due Process Clause of the U.S. Constitution.⁴²

33 *Miller Bros. Co. v. Maryland*, 347 U.S. 340 (1954).

34 *Id.* at 341.

35 *Id.* at 341-42.

36 *Id.* at 341.

37 *Id.*

38 *Id.* at 344.

39 *Id.* at 344-45.

40 *Id.* at 345.

41 *Id.* at 347.

42 The Court noted that it did not need to consider the Commerce Clause implications given its determination on the Due Process Clause. *Id.*

The Court evaluated the *Miller Brothers* standard again six years later in *Scripto, Inc. v. Carson*,⁴³ a case addressing the ability of the State of Florida to require an out-of-state retailer to collect the state's use tax on items that it sold and shipped to Florida consumers from its place of business in Georgia.⁴⁴ *Scripto* was based in Atlanta and did not own, lease, or maintain any business locations in Florida, have any regular employees or agents located in the state, or own or maintain any bank accounts or inventories in the state.⁴⁵ *Scripto* did, however, have a connection to the state in the form of independent contractor brokers that solicited sales in the state.⁴⁶ Any orders generated by those in-state brokers were sent to Atlanta for approval and processing, and the brokers received commissions for such sales.⁴⁷ Under the Florida law at issue, *Scripto* was responsible for collecting Florida's use tax as a "dealer" in the state.⁴⁸

The *Scripto* Court applied the *Miller Brothers* standard that there must be "some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax."⁴⁹ The Court found that the necessary link was present in the case because *Scripto*'s local representatives had solicited sales within the state.⁵⁰ *Scripto* argued that it had no more of a connection to the taxing state than did the taxpayer in *Miller Brothers* because it had no personnel in the state—its only in-state representatives, its brokers, were independent contractors rather than employees. The Court rejected that argument and found that the state's imposition of tax did not violate either the Due Process or Commerce Clauses of the U.S. Constitution because *Scripto* had exploited the Florida market through the use of local representatives.⁵¹ The Court found *Scripto*'s use of independent contractors rather than employees to be "without constitutional significance."⁵²

43 *Scripto, Inc. v. Carson*, 362 U.S. 207 (1960).

44 *Id.* at 207-08.

45 *Id.* at 208-09.

46 *Id.* at 209.

47 *Id.*

48 *Id.* at 210.

49 *Id.* at 210-11 (citation omitted).

50 *Id.* at 211.

51 *Id.* at 211-13.

52 *Id.* at 211. The Court's ruling in *Scripto* was thus notable for two reasons. First, it established that taxpayers cannot insulate themselves from taxation in a state merely by using in-state independent contractors rather than employees. Second, it also extended the *Miller Brothers* analysis to a Commerce Clause challenge. Thus, the Court set up a parallel test under the Due Process and Commerce Clauses.

*B. Creating a Bright-Line Physical-Presence Test:
National Bellas Hess and Quill*

Miller Brothers and *Scripto* set up parallel tests under the Due Process and Commerce Clauses, but neither case created a concrete test for evaluating whether the minimum-connection standard was met in a particular case. It was clear that non-targeted sales to in-state customers along with the occasional presence of delivery trucks in the state was insufficient (as in *Miller Brothers*), whereas the use of in-state independent contractors who continuously solicited sales (as in *Scripto*) was sufficient to find a minimum connection. Beyond those situations, however, the limitations placed on states when imposing use-tax-collection obligations were unclear until the Court's 1967 decision in *National Bellas Hess v. Department of Revenue of the State of Illinois*.⁵³

1. *National Bellas Hess v. Department of Revenue of the State of Illinois*.—*National Bellas Hess* again involved a dispute regarding a state's imposition of a use-tax collection obligation on an out-of-state retailer.⁵⁴ *National Bellas Hess* was a mail-order house based in Missouri that made sales to Illinois customers, but it did not maintain any offices, sales houses, or distribution centers in Illinois, nor did it have any agents, salesman, or other representatives in the state.⁵⁵ *National Bellas Hess* created a connection with Illinois by mailing catalogues to its active and recent customers throughout the United States, including in Illinois, and by mailing advertising flyers to past and occasional customers.⁵⁶ Orders for goods from *National Bellas Hess* were mailed to, and accepted by, the company at its principal place of business in Missouri.⁵⁷ Customers received the goods either by mail or via common carrier.⁵⁸ Illinois law required *National Bellas Hess* to collect Illinois use tax based upon its limited actions in the state.⁵⁹ *National Bellas Hess* challenged that requirement as a violation of both the Due Process and Commerce Clauses of the U.S. Constitution.⁶⁰

The Court began its analysis of the case by reviewing its historical decisions regarding the limitations imposed by those clauses and noting its "sharp distinction . . . between mail order sellers with retail outlets, solicitors, or property within a State, and those who do no more than communicate with customers in the State by mail or common carrier as part

⁵³ *Nat'l Bellas Hess, Inc. v. Dep't of Revenue*, 386 U.S. 753 (1967).

⁵⁴ *Id.* at 754.

⁵⁵ *Id.* at 753-54.

⁵⁶ *Id.* at 754.

⁵⁷ *Id.* at 754-55.

⁵⁸ *Id.* at 755.

⁵⁹ *Id.*

⁶⁰ *Id.* at 756.

of a general interstate business.”⁶¹ (This distinction represents the Court’s first explicit recognition of a physical-presence requirement for state sales and use taxation.) The Court declined to “obliterate” that distinction, reasoning that:

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.”⁶²

The Court thus determined that the State of Illinois’s imposition of its use-tax obligations on National Bellas Hess was impermissible under the Commerce Clause.⁶³

2. *Tyler Pipe Industries, Inc. v. Washington State Department of Revenue*.—Post-*National Bellas Hess*, the Court had the opportunity to reiterate its *Scripto* holding in *Tyler Pipe Industries, Inc. v. Washington State Department of Revenue*, a case evaluating the imposition of a gross receipts tax on a taxpayer whose only presence within the taxing state was the use of a single in-state sales representative.⁶⁴ Tyler Pipe sold products to customers in Washington through the use of its in-state independent contractor, but had no offices, property, or employees in the state.⁶⁵ Tyler Pipe challenged the tax assessment as a violation of the Commerce Clause.

The Supreme Court’s analysis of the case was straightforward and focused on the role that Tyler Pipe’s in-state agent played in its ability to exploit the market in Washington. The Court again rejected a formalistic inquiry that rested on the legal classification of an in-state representative and held that “the crucial factor governing nexus is whether the activities performed in this state on behalf of the taxpayer are significantly associated with the taxpayer’s ability to establish and maintain a market in this state for the sales.”⁶⁶ The Court recognized that the case was a mere extension

⁶¹ *Id.* at 758.

⁶² *Id.* at 758–60 (footnotes omitted).

⁶³ *Id.* at 760. Interestingly, the Court did not cite the Due Process Clause in its holding despite National Bella Hess’s challenge under that constitutional provision.

⁶⁴ *Tyler Pipe Indus., Inc. v. Wash. State Dep’t of Revenue*, 483 U.S. 232, 249 (1987).

⁶⁵ *Id.*

⁶⁶ *Id.* at 249–50 (citing *Tyler Pipe Indus., Inc. v. Wash. State Dep’t of Rev.*, 715 P.2d 123, 126 (Wash. 1986)).

of *Scripto* and upheld the imposition of tax on Tyler Pipe based upon the actions of its in-state agent.⁶⁷

3. *Quill Corporation v. North Dakota*.—The Court got another opportunity to evaluate *National Bellas Hess* five years after *Tyler Pipe* (and thus twenty-five years after *National Bellas Hess*) in *Quill Corporation v. North Dakota*.⁶⁸ The statute at issue in *Quill* imposed use-tax collection obligations on mail-order retailers that placed three or more advertisements in the state during a twelve-month period, without regard to whether those vendors had business locations or sales representatives in the state.⁶⁹ That statute was therefore in clear conflict with *National Bellas Hess*.

North Dakota adopted its rule based upon an assumption that legal and economic developments since *National Bellas Hess* had made its holding obsolete. The Supreme Court of North Dakota agreed with that reasoning, relying upon "the tremendous social, economic, commercial, and legal innovations" since that case.⁷⁰ The court thus held that the state could impose a use-tax-collection obligation on *Quill* because of its "significant economic presence within the State and its retained ownership of property within the State."⁷¹ (*Quill* retained an interest in a few floppy diskettes that contained software that it licensed to certain of its customers in the state.)⁷² *Quill* appealed this ruling to the Supreme Court, arguing that *National Bellas Hess* was still valid.

The *Quill* court undertook its analysis by first "uncoupling" the Constitutional safeguards provided by the Due Process and Commerce Clauses.⁷³ The Court held that the different purposes for those provisions allowed for different standards, with the Due Process Clause requiring less connection with a state than the Commerce Clause.⁷⁴ The Court agreed that the North Dakota statute did not violate the Due Process Clause.⁷⁵

The *Quill* court then turned to an analysis of the Commerce Clause, briefly laying out the history of its jurisprudence under that provision of the U.S. Constitution.⁷⁶ The Court noted that "[w]hile contemporary Commerce Clause jurisprudence might not dictate the same result were the issue to arise for the first time today, [*National*] *Bellas Hess* [wa]s not

67 *Id.* at 250-51.

68 *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

69 *Id.* at 301-03.

70 *State v. Quill Corp.*, 470 N.W.2d 203, 208 (N.D. 1991).

71 *Id.* at 219.

72 *Quill*, 504 U.S. at 302 n.1.

73 *Id.* at 305-06.

74 *Id.* at 305.

75 *Id.* at 308.

76 *Id.* at 309-11.

inconsistent with . . . [its] recent cases.”⁷⁷ The Court thus rejected North Dakota’s argument that the Court’s intervening decisions had undercut the Commerce Clause holding of *National Bellas Hess*, noting that it had continued to cite that case with approval.⁷⁸ The Court also explained the analytic differences between the Due Process and Commerce Clauses—the former being concerned with “the fundamental fairness of governmental activity”⁷⁹ and the latter being focused on “concerns about the effects of state regulation on the national economy.”⁸⁰ The Court’s prohibition of discrimination against and undue burdens upon interstate commerce was a result of the latter concern.⁸¹

Having laid this framework for its decision, the Court next defended its physical-presence test by explaining that “[u]ndue burdens on interstate commerce may be avoided not only by a case-by-case evaluation of the actual burdens imposed by particular regulations or taxes, but also, in some situations, by the demarcation of a discrete realm of commercial activity that is free from interstate taxation.”⁸² The Court was not blind to the artificiality of such a bright-line test, but held that such artificiality was “more than offset by the benefits of a clear rule.”⁸³ Namely, “[s]uch 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.”⁸⁴ The Court found that such benefits were important because the

⁷⁷ *Id.* at 311.

⁷⁸ *Id.* at 311–12, 314.

⁷⁹ *Id.* at 312.

⁸⁰ *Id.*

⁸¹ *Id.* To this final point, the Court included a footnote in its opinion that has framed much of the debate around the case. Footnote six of the Court’s opinion reads as follows:

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.

Id. at 313 n.6.

⁸² *Id.* at 314–15.

⁸³ *Id.* at 315.

⁸⁴ *Id.* Justice White questioned whether the physical-presence rule would actually provide the litigation-reduction benefit that the Court espoused, noting that “[r]easonable minds surely can, and will, differ over what showing is required to make out a ‘physical presence’ adequate to justify imposing responsibilities for use tax collection. . . . [I]t is a sure bet that the vagaries of ‘physical presence’ will be tested to their fullest in our courts.” *Id.* at 330–31 (White, J., concurring in part and dissenting in part). This concern has proven to be true, but focuses on only one-half of the equation. To quote the Michigan Court of Appeals, “the ‘bright-line’ of *Quill* does not cut as cleanly on both sides. It definitively answers the question who cannot be taxed . . . but leaves somewhat open the question who may be taxed.” *Magnetek Controls, Inc. v. Revenue Div., Dep’t of Treasury*, 562 N.W.2d 219, 222 n.5 (Mich.

uncertainty and confusion present in that area of state taxation represented a "quagmire."⁸⁵ Further, the court was concerned that the lack of a bright-line rule would leave "much room for controversy and confusion and little in the way of precise guides."⁸⁶ In contrast, "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."⁸⁷ The Court recognized that the mail-order industry's growth in the preceding twenty-five years was due in part to the bright-line test established in *National Bellas Hess*.⁸⁸

The Court also cited principles of *stare decisis* in its decision⁸⁹ and noted that its decision was "made easier" because Congress not only had the power to resolve the issue, but that Congress was also better equipped to do so.⁹⁰ Thus, the Court recognized that "even if we were convinced that *Bellas Hess* was inconsistent with our Commerce Clause jurisprudence, 'this very fact [might] giv[e us] pause and counse[l] withholding our hand, at least for now. Congress has the power to protect interstate commerce from intolerable or even undesirable burdens.'"⁹¹

Quill stands as the Court's last word on the applicability and efficacy of the physical-presence test. Further, as discussed above, Congress has declined the Court's invitation to address that test on its own. The physical-presence test thus stands today as the safeguard upon which remote vendors rely to shield themselves from multistate use-tax burdens.

Ct. App. 1997).

⁸⁵ *Quill*, 504 U.S. at 315 (internal quotation marks omitted).

⁸⁶ *Id.* (quoting *Nw. States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 457-58 (1959)).

⁸⁷ *Id.* at 316.

⁸⁸ *Id.* Professor Hellerstein notes that the *Quill* Court's focus on the mail-order industry may counsel towards limiting the physical-presence test to that industry. HELLERSTEIN, *supra* note 16, ¶ 19.02[3][b] (Supp. No. 3 2010) ("Many of the reasons the Court advanced for adhering to the physical-presence standard relate principally, if not exclusively, to sales and use taxes on the mail-order industry. . . . *Quill*, therefore, may arguably be read to have established a 'bright-line' physical-presence standard only for sales and use taxes on the mail-order industry alone."). He quickly offers a counter argument that seems to have the better of the issue. As he notes, his analysis of *Quill*'s potential limitation

is not to suggest that such a reading is the only plausible reading *Quill* may be given. Indeed, as an original matter, one would be hard put to justify a constitutional rule that applied to only one industry. It is, after all, not an administrative code but 'a constitution we are expounding.' Moreover, the creation of a constitutional 'safe harbor' for only one industry has the feel of a legislative rather than an adjudicative determination, which tends to validate Justice Scalia's disenchantment with the entire edifice of the Court's negative Commerce Clause jurisprudence.

Id. (emphasis omitted) (footnotes omitted).

⁸⁹ *Quill*, 504 U.S. at 317-18.

⁹⁰ *Id.* at 318.

⁹¹ *Id.* (alterations in original) (quoting *Commonwealth Edison Co. v. Montana*, 453 U.S. 609, 637 (1981) (White, J., concurring)).

II. STATE LIMITATIONS ON THE PHYSICAL-PRESENCE STANDARD

States, not surprisingly, disfavor the physical-presence test. Many have therefore sought to limit the scope of that test by whatever means available, including by rejecting the test for taxes other than sales and use taxes, passing legislation to bypass that test, and engaging in intergovernmental-agency action to do the same. Each of those actions is discussed briefly below.

A. State Judicial Limitations of the Physical-Presence Standard to Sales and Use Taxes

1. *Geoffrey v. South Carolina Tax Commission*.—*Quill*'s physical-presence test stood for only one year before a state court found it applicable only to sales and use taxes.⁹² In *Geoffrey Inc. v. South Carolina Tax Commission*, the South Carolina Supreme Court declined to extend the *Quill* test beyond sales and use taxes and thus held that the state could impose its *income* tax on an out-of-state company with no physical presence in the state.⁹³ The taxpayer in *Geoffrey* was an out-of-state company that licensed intellectual property to a related entity (Toys R Us) operating in the state.⁹⁴ During the years at issue, South Carolina Code section 12-7-230 imposed the state's corporate income tax on foreign and domestic corporations "transacting, conducting, doing business, or having an income within the jurisdiction" of the state.⁹⁵ The state asserted that Geoffrey was subject to tax in the state because it earned income from the use of its intellectual property in the state under its licensing agreements with Toys R Us. Geoffrey challenged the imposition of tax as a violation of both the Due Process and Commerce Clauses of the U.S. Constitution.

The South Carolina Supreme Court found that neither the Due Process nor Commerce Clauses of the U.S. Constitution were violated by the state's imposition of tax on Geoffrey. With respect to the Due Process Clause, the court found that "Geoffrey purposefully directed its activities toward South Carolina," that it had the required minimum connection with the state, and that "South Carolina ha[d] conferred benefits upon Geoffrey to which the challenged tax [was] rationally related."⁹⁶

Turning to Geoffrey's Commerce Clause challenge, the court stated that "[i]t is well settled that the taxpayer need not have a tangible, physical

92 *Geoffrey, Inc. v. S.C. Tax Comm'n*, 437 S.E.2d 13 (S.C. 1993).

93 *Geoffrey*, 437 S.E.2d at 21-23.

94 *Id.* at 16-17.

95 S.C. CODE ANN. § 12-7-230 (1992) (repealed 1995) (current version at S.C. CODE ANN. §§ 12-6-530 (2010), 12-6-2210(A) (2010)).

96 *Geoffrey*, 437 S.E.2d at 19-20, 22.

presence in a state for income to be taxable there.”⁹⁷ The court dismissed Geoffrey’s argument that *Quill*’s physical-presence standard applied with a mere footnote stating that the *Quill* decision itself had “noted that the physical presence requirement had not been extended to other types of taxes [beyond sales and use taxes].”⁹⁸ Geoffrey petitioned the Supreme Court to review the case, but the Court denied that request.⁹⁹

2. *Physical Presence. after Geoffrey.*—From 1993 to 2004, state courts vacillated with respect to whether *Quill* applied to taxes other than sales and use taxes. Courts in Illinois,¹⁰⁰ New Mexico,¹⁰¹ North Carolina,¹⁰² Ohio,¹⁰³ and Washington¹⁰⁴ all held that *Quill* did not so apply. In contrast, courts in Tennessee,¹⁰⁵ Texas,¹⁰⁶ and New Jersey¹⁰⁷ did extend *Quill* beyond sales and use taxes. The tide shifted significantly towards state taxing authorities and against taxpayers beginning in 2005.

On June 27, 2005, the West Virginia Circuit Court reversed the West Virginia Office of Tax Appeals, holding that MBNA Bank, an out-of-state credit card company, had sufficient nexus with the state (for purposes of the state’s income tax) based merely upon its solicitation of, and business with, West Virginia customers.¹⁰⁸ The West Virginia Supreme Court affirmed this decision in 2006, and the U.S. Supreme Court declined to review the case in 2007.¹⁰⁹

On August 24, 2005, the New Jersey Superior Court, Appellate Division, reversed the New Jersey Tax Court and held that an out-of-state intangible

⁹⁷ *Id.* at 23.

⁹⁸ *Id.* n.4 (citing *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992)).

⁹⁹ *Geoffrey*, 510 U.S. 992 (1993). The Supreme Court’s Commerce Clause analysis is subject to criticism on many grounds. See HELLERSTEIN, *supra* note 16, ¶ 6.11[2] (Supp. No. 3 2010).

¹⁰⁰ *Borden Chems. & Plastics, L.P. v. Zehnder*, 726 N.E.2d 73, 80 (Ill. App. Ct. 2000).

¹⁰¹ *Kmart Props., Inc. v. Taxation & Revenue Dep’t*, 131 P.3d 27, 35-36 (N.M. Ct. App. 2001), *cert. granted*, 40 P.3d 1008 (N.M. 2002), *cert. quashed and order issued sub nom.*, *Kmart Corp. v. Taxation & Revenue Dep’t*, 131 P.3d 22, 22-23, 27 (N.M. 2005).

¹⁰² *A & F Trademark, Inc. v. Tolson*, 605 S.E.2d 187, 193-96 (N.C. Ct. App. 2004) (declining to adopt position that *Quill* applies to all taxes).

¹⁰³ *Couchot v. State Lottery Comm’n*, 659 N.E.2d 1225, 1231 (Ohio 1996).

¹⁰⁴ *Gen. Motors Corp. v. City of Seattle*, 25 P.3d 1022, 1028-29 (Wash. Ct. App. 2001).

¹⁰⁵ *J.C. Penney Nat’l Bank v. Johnson*, 19 S.W.3d 831, 839 (Tenn. Ct. App. 1999).

¹⁰⁶ *Rylander v. Bandag Licensing Corp.*, 18 S.W.3d 296, 299-300 (Tex. App. 2000).

¹⁰⁷ *Lanco, Inc. v. Dir., Div. of Taxation*, 21 N.J. Tax 200, 207-19 (N.J. Tax Ct. 2003), *rev’d*, 879 A.2d 1234 (N.J. Super. Ct. App. Div. 2005), *aff’d*, 908 A.2d 176 (N.J. 2006).

¹⁰⁸ *Steager v. MBNA Am. Bank, N.A.*, 2005 WL 1978490 (W. Va. Cir. Ct. 2005), *aff’d sub nom.*, *Tax Comm’r v. MBNA Am. Bank, N.A.*, 640 S.E.2d 226 (W. Va. 2006).

¹⁰⁹ *Tax Comm’r v. MBNA Am. Bank, N.A.*, 640 S.E.2d 226, 234 (W. Va. 2006), *cert. denied*, 551 U.S. 1141 (2007).

holding company¹¹⁰ had nexus with New Jersey for income-tax purposes based simply upon its receipt of royalty income from its related-party licensor in the state.¹¹¹ The Supreme Court of New Jersey affirmed that decision in 2006, and the U.S. Supreme Court declined to review the case in 2007.¹¹²

On December 23, 2005, the Oklahoma Court of Civil Appeals held that no physical presence was required under the Commerce Clause for the state to impose its income tax on an out-of-state, intangible holding company.¹¹³ The New Mexico Supreme Court followed this decision six days later with its determination in *Kmart Corp. v. Taxation & Revenue Department*, 131 P.3d 22 (N.M. 2005), another case involving an intangible holding company.¹¹⁴

The aforementioned cases do not stand alone. Judicial decisions and administrative rulings in Arizona,¹¹⁵ Florida,¹¹⁶ Indiana,¹¹⁷ Iowa,¹¹⁸

¹¹⁰ Much of the evolution of the economic-nexus concept has occurred in cases involving the intangible holding company structure (IHC) or passive investment company structure (PIC). See Sheldon H. Laskin, *Only a Name? Trademark Royalties, Nexus, and Taxing that Which Enriches*, 22 AKRON TAX J. 1, 8-16 (2007). Although a discussion of the IHC or PIC structure is beyond the scope of this article, it should be noted that IHC or PIC cases involve related taxpayers and is a structure that is typically created rather than one that forms organically. For a brief discussion of this structure, see *id.* at 5-8.

¹¹¹ *Lanco, Inc. v. Dir., Div. of Taxation*, 879 A.2d 1234, 1241-42 (N.J. Super. Ct. App. Div. 2005).

¹¹² *Lanco, Inc. v. Dir., Div. of Taxation*, 908 A.2d at 177 (N.J. 2006), *cert. denied*, 551 U.S. 1131 (2007). The New Jersey Supreme Court later reiterated its economic-nexus holding. See *Praxair Tech., Inc. v. Dir., Div. of Taxation*, 988 A.2d 92 (2009).

¹¹³ *Geoffrey, Inc. v. Okla. Tax Comm'n*, 132 P.3d 632 (Okla. Civ. App. 2005).

¹¹⁴ *Kmart Corp. v. Taxation & Revenue Dep't*, 131 P.3d 22, 23 (N.M. 2005). The procedural history of this case is unique. The New Mexico Supreme Court originally granted certiorari on two issues: first, whether the state's imposition of its gross receipts tax on the taxpayer was proper, and second, whether the state's imposition of its income tax on the taxpayer was proper. The court's decision held against the state on the first issue on statutory grounds and quashed certiorari on the income tax issue, effectively upholding the court of appeals' findings on that issue. *Id.* For further discussion of this case and its procedural history, see Walter Hellerstein, *Green Light, Red Light, or Blue Light? New Mexico Supreme Court Sends Mixed Signals with Kmart Decision*, 39 STATE TAX NOTES 141 (2006).

¹¹⁵ See [Redacted], Case No. 200700083-C (Ariz. Dep't of Revenue Decision Mar. 28, 2008), available at <http://www.azdor.gov/LinkClick.aspx?fileticket=9ZY8i7xZVNE%3d&tabid=105&mid=474> (finding that physical presence does not extend to corporate business tax).

¹¹⁶ See Fla. Dep't of Revenue Op. No. 07C1-007 (Oct. 17, 2007), available at <https://taxlaw.state.fl.us/wordfiles/CIT%20TAA%2007C1-007.doc> (expressing that the physical presence requirement does not extend to corporate income tax).

¹¹⁷ *MBNA Am. Bank, N.A. v. Ind. Dep't of State Revenue*, 895 N.E.2d 140, 142-43 (Ind. T.C. 2008).

¹¹⁸ *KFC Corp. v. Iowa Dep't of Revenue*, 792 N.W.2d 308, 325-28 (Iowa 2010), *cert. denied*, 2011 WL 4530160, at *1 (U.S. Oct. 3, 2011).

Louisiana,¹¹⁹ Massachusetts,¹²⁰ Missouri,¹²¹ and Washington¹²² have all rejected the application of the physical-presence test to taxes other than sales and use taxes. The great weight of the authority has thus rejected the application of *Quill* outside of those taxes, and all but the most optimistic of taxpayers expect that trend to continue unless and until the Supreme Court determines to review the issue.

*B. State Legislative Actions Eroding the Physical-Presence Requirement
for State Sales and Use Taxes*

State legislatures have not been blind to the trend rejecting a physical-presence test for purposes of state income taxation. States thus have not been shy to impose their state income or business-activity taxes based upon an economic-nexus concept rather than a physical-presence standard.¹²³ In contrast, state legislatures generally have succumbed to the Court's physical-presence mandate for state sales and use taxes. States have instead focused their energies on finding ways to attribute a physical presence to out-of-state retailers. From related-party attributional nexus provisions¹²⁴ to the current trend towards Amazon-style affiliate-nexus provisions,¹²⁵

¹¹⁹ *Bridges v. Geoffrey, Inc.*, 984 So. 2d 115, 128 (La. Ct. App. 2008).

¹²⁰ *Geoffrey, Inc. v. Comm'r of Revenue*, 899 N.E.2d 87, 94-95 (Mass. 2009), *cert. denied*, 129 S. Ct. 2853 (2009); *Capital One Bank v. Comm'r of Rev.*, 899 N.E.2d 76, 84 (Mass. 2009), *cert. denied*, 129 S. Ct. 2827 (2009).

¹²¹ *Acme Royalty Co. v. Dir. of Revenue*, No. 99-2839 RI, 2002 WL 200921, at *11 (Mo. Admin. Hearing Comm'n Jan. 3, 2002), *rev'd on other grounds*, 96 S.W.3d 72 (Mo. 2002); *Gore Enter. Holdings, Inc. v. Dir. of Revenue*, No. 99-2856 RI, 2002-WL 200918, at *8 (Mo. Admin. Hearing Comm'n Jan. 3, 2002), *rev'd on other grounds*, 96 S.W.3d 72 (Mo. 2002).

¹²² *Lamtec Corp. v. Dep't of Revenue*, 246 P.3d 788, 794 (Wash. 2011), *cert. denied*, 2011 WL 4530146, at *1 (2011).

¹²³ See, e.g., CAL. REV. & TAX. CODE § 23101(b) (West Supp. 2011); CONN. GEN. STAT. § 12-216a (Supp. 2011); OHIO REV. CODE ANN. § 5751.01(H) (LexisNexis Supp. 2011).

¹²⁴ These provisions attribute nexus to out-of-state retailers based upon their relationships with entities that operate in the taxing state. See, e.g., ALA. CODE § 40-23-190 (LexisNexis 2003); COLO. REV. STAT. § 39-26-102(3)(b)(II) (2011); GA. CODE ANN. § 48-8-2(8)(J) (Supp. 2009); IDAHO CODE ANN. § 63-3611(3) (Supp. 2011); IOWA CODE ANN. § 423.1(45)-(46) (West Supp. 2011); KAN. STAT. ANN. § 79-3702(h)(2) (Supp. 2010); KY. REV. STAT. ANN. § 139.340(2)(a) (West 2010); MINN. STAT. ANN. § 297A.66, subd. 1(a)(1) (West 2010); N.Y. TAX LAW § 1101(b)(8) (McKinney Supp. 2011); OHIO REV. CODE ANN. § 5741.01(I)(5) (LexisNexis 2008); OKLA. STAT. ANN. tit. 68, § 1401(9) (West Supp. 2011); UTAH CODE ANN. § 59-12-107 (LexisNexis Supp. 2009); WIS. STAT. ANN. § 77.51(13g)(d) (West 2011); 2011-4 Ark. Adv. Legis. Serv. 484 (LexisNexis).

¹²⁵ These provisions attribute nexus to out-of-state retailers based upon their contractual relationships with in-state personnel who refer customers to the retailer for consideration. See CONN. GEN. STAT. ANN. § 12-407(a)(12)(L) (West Supp. 2011); 35 ILL. COMP. STAT. ANN. 105/2 (West Supp. 2011); N.Y. TAX LAW § 1101(b)(8)(vi) (McKinney Supp. 2011); N.C. GEN. STAT. § 105-164.8(b)(3) (2009); R.I. GEN. LAWS § 44-18-15(a)(2) (2010); 2011-4 Ark. Adv. Legis. Serv. 484. (LexisNexis); 2011-3 Vt. Adv. Legis. Serv. 188-89 (LexisNexis) (effective on the

states have looked for new ways of establishing a physical presence by out-of-state entities through in-state parties' actions. However, attribution can only get a state so far, and two states—Colorado and Oklahoma—abandoned that approach during their 2010 legislative sessions.¹²⁶ Two more—South Dakota and Vermont—joined them in 2011.¹²⁷ Those states broke new ground by eschewing statutes simply requiring use-tax collection by out-of-state vendors in favor of statutes that impose information-reporting or information-provision requirements on those vendors.¹²⁸ These new laws serve two principal functions. First, they address the use-tax information gap by requiring actions that notify consumers of their use-tax obligations. Second, they impose compliance costs on remote vendors that potentially economically compel such vendors to voluntarily collect the states' sales taxes. (As shown below, this second function is principally implicated by the Colorado statute.) These statutes are discussed briefly below.

1. *Colorado Sales Tax Information-Reporting Statute.*—The Colorado legislature originally considered a bill that would have imposed use-tax collection obligations on out-of-state retailers that had affiliates in the state.¹²⁹ The legislature instead adopted a set of burdensome information-reporting requirements that are imposed on retailers who make sales to

date that fifteen or more states have adopted similar rules, as determined by the attorney general). For an introduction to these laws, their constitutional dimensions, and their labeling as "Amazon" laws," see Edward A. Zelinsky, *New York's 'Amazon' Law: Constitutional But Unwise*, 54 STATE TAX NOTES 715 (2009).

¹²⁶ Act of Feb. 24, 2010, ch. 9, 2010 Colo. Sess. Laws 55; Act of June 24, 2010, ch. 412, § 2, 2010 Okla. Sess. Law Serv. 1692, 1695 (West).

¹²⁷ Act of June 30, 2011, ch. 59, 2011 S.D. Sess. Laws 159; Act of May 6, 2011, ch. 32, § 36b, 2011 Vt. Acts & Resolves 37, 38. The California legislature also considered similar information-reporting requirements, but it ultimately only passed into law more traditional, attributional-nexus provisions. See Act of June 28, 2011, ch. 7, 2011 Cal. Stat. (yet to be published); John Buhl, *Sears and Wal-Mart Pursuing Amazon Online Affiliates*, 59 STATE TAX NOTES 759, 759 (2011); Karen Setze, *California Lawmakers Again Proposing 'Amazon' Laws*, 59 STATE TAX NOTES 235, 235-36 (2011). After much resistance and lobbying by Amazon, however, that law was ultimately repealed in a unique settlement. See Act of Sept. 23, 2011, ch. 313, 2011 Cal. Stat. (forthcoming); John Buhl, *California Lawmakers and Amazon Reach Tentative Deal*, 61 STATE TAX NOTES 691, 691-92 (2011); Amy Hamilton, *Amazon Proposes Deal in California*, 61 STATE TAX NOTES 616 (2011); Zelinsky, *supra* note 124, at 83. Under the new law, the effective date of the state's nexus-attribution provisions is delayed pending the passage of a federal law overturning the physical-presence rule by July 31, 2012. Act of Sept. 23, 2011, ch. 315, § 6, 2011 Cal. Stat. (forthcoming).

¹²⁸ As discussed *infra* note 171, the Vermont legislation is actually a hybrid. That legislation imposes an information-provision requirement until a number of states have adopted legislation similar to that discussed *supra* note 12. Act of May 24, 2011, Pub. L. No. 45, § 37(13), 2011 Vt. Acts & Resolves 169, 188.

¹²⁹ Joe Hanel, *Colorado Senate Approves 'Amazon' Law*, 55 STATE TAX NOTES 468, 468 (2010).

Colorado customers¹³⁰ but who do not collect the state's sales or use tax.¹³¹ A de minimis rule exempts retailers who make less than \$100,000 in sales to Colorado purchasers during the prior calendar year and who reasonably expect to be within that limit for the current year.¹³²

This law (the "Colorado Act") imposes three information-reporting requirements. The first is a transaction-based notice that must be provided to Colorado purchasers during the course of their purchase transaction.¹³³ The second is an annual report that must be provided to Colorado purchasers who make \$500 or more of purchases from the retailer during the calendar year.¹³⁴ The third is an annual summary that must be provided to the Colorado Department of Revenue.¹³⁵ These are discussed briefly below.

a. Transactional Notice.

The transactional notice required by the Colorado Act must be provided anywhere that the seller indicates that no tax is due on the transaction or on each invoice.¹³⁶ If no invoice is provided, the notice must be provided "as part of the sale, either immediately before, as part of, or immediately after the sale."¹³⁷ The notice must inform the purchaser that the retailer does not collect Colorado sales or use tax, that "[t]he purchase is not exempt from [such taxes] merely because it is made over the Internet or by other remote means," and that Colorado requires the purchaser to file a sales or use tax return reporting any non-taxed purchases and to pay tax on such purchases.¹³⁸ A penalty of \$5 applies to every sale to a Colorado purchaser for which the required transactional notice does not appear.¹³⁹

¹³⁰ The Colorado Department of Revenue has enacted regulations defining the term "Colorado purchaser" to mean, "[w]ith respect to sales of goods that are shipped . . . a purchaser that requests the goods be shipped to Colorado." 1 COLO. CODE REGS. § 39-21-112.3.5(1)(b) (i) (2010). Where goods are purchased by one party for shipment to another in Colorado, "the Colorado purchaser is the purchaser of the goods, not the recipient of the goods." *Id.*

¹³¹ COLO. REV. STAT. § 39-21-112(3.5)(c)-(d) (2011).

¹³² 1 COLO. CODE REGS. § 39-21-112.3.5(1)(a)(iii) (2010).

¹³³ *Id.* § 39-21-112.3.5(1)(c); *see also id.* § 39-21-112.3.5(2).

¹³⁴ COLO. REV. STAT. § 39-21-112(3.5)(d)(I)(A) (2011); 1 COLO. CODE REGS. § 39-21-112.3.5(3)(a), (c) (2010).

¹³⁵ COLO. REV. STAT. § 39-21-112(3.5)(d)(II)(A) (2011); 1 COLO. CODE REGS. § 39-21-112.3.5(3)(a), (c) (2010).

¹³⁶ 1 COLO. CODE REGS. § 39-21-112.3.5(2)(a) (2010).

¹³⁷ *Id.* § 39-21-112.3.5(2)(a)(ii).

¹³⁸ *Id.* § 39-21-112.3.5(2)(b)(i)-(iii).

¹³⁹ *Id.* § 39-21-112.3.5(2)(f)(i). Penalty-mitigation applies in certain circumstances. *Id.* § 39-21-112.3.5(2)(f)(ii), (iii).

b. Annual Purchase Summary.

The annual purchase summary required by the Colorado Act is an annual report that must be provided to each of the out-of-state retailer's Colorado customers and must provide a summary of the dates of the Colorado customer's purchases, the types of items purchased, and the dollar amounts of the purchases.¹⁴⁰ The notice must also inform the purchaser that (i) the State of Colorado requires him, her, or it to file a sales or use tax return at the end of the year to report and pay tax on the taxable purchases for which no tax has been collected¹⁴¹ and (ii) that the retailer is required by law to inform the Colorado Department of Revenue of the total dollar value of purchases made by the purchaser during the year (but not any other information about those purchases).¹⁴² The Notice must be provided only to consumers whose Colorado purchases equal or exceed \$500 during the year¹⁴³ and must be sent by January 31 of each year.¹⁴⁴ A penalty of \$10 applies to each annual purchase summary that is required to be sent but that is not sent by the out-of-state vendor.¹⁴⁵

Of particular interest, the Colorado Act and administrative regulations thereunder require that the annual purchase summary be sent to the Colorado purchasers by first-class mail and prohibit it from being included with any other shipments from the retailer to the customer.¹⁴⁶ In addition, the envelope containing the summary must be "prominently marked" with the words "Important tax document enclosed."¹⁴⁷

c. Customer Information Report.

The third element of the Colorado Act is a customer information report that must be filed with the Colorado Department of Revenue.¹⁴⁸ This report must contain the names and addresses of all Colorado purchasers and the total dollar amount of the purchases made by such purchasers for

¹⁴⁰ COLO. REV. STAT. § 39-21-112(3.5)(d)(I)(A) (2011); 1 COLO. CODE REGS. § 39-21-112-3.5 (3)(a)(ii) (2010).

¹⁴¹ COLO. REV. STAT. § 39-21-112(3.5)(d)(I)(A) (2011); 1 COLO. CODE REGS. § 39-21-112-3.5 (3)(a)(iii) (2010).

¹⁴² COLO. REV. STAT. § 39-21-112(3.5)(d)(II)(A) (2011); 1 COLO. CODE REGS. § 39-21-112-3.5 (3)(a)(iv) (2010).

¹⁴³ 1 COLO. CODE REGS. § 39-21-112-3.5(3)(c)(i) (2010).

¹⁴⁴ *Id.* § 39-21-112-3.5(3)(a)(vi).

¹⁴⁵ *Id.* § 39-21-112-3.5(3)(d)(i). As is the case with the transactional notice, certain penalty-mitigation provisions apply. *See id.* § 39-21-112-3.5(3)(d)(ii)-(iii).

¹⁴⁶ COLO. REV. STAT. § 39-21-112(3.5)(d)(I)(B) (2011); 1 COLO. CODE REGS. § 39-21-112-3.5 (3)(a)(i) (2010).

¹⁴⁷ 1 COLO. CODE REGS. § 39-21-112-3.5(3)(a)(i) (2010).

¹⁴⁸ COLO. REV. STAT. § 39-21-112(3.5)(d)(II)(A) (2011); 1 COLO. CODE REGS. § 39-21-112-3.5(4)(a) (2010).

the prior calendar year.¹⁴⁹ Under the department's regulations, retailers are prohibited from disclosing any information regarding the products that their customers purchase.¹⁵⁰ The customer information report must be filed by March 1 of each year.¹⁵¹

A penalty of ten dollars applies for each Colorado customer that the retailer fails to include on the annual filing.¹⁵² Penalty-mitigation provisions apply to failures to provide this filing in certain situations.¹⁵³

d. Purpose of the Colorado Act.

Analysis of these three reporting requirements quickly reveals the ultimate purpose of the Colorado Act—to impose burdens on out-of-state retailers that are so onerous as to make the actual collection of the state's use tax a less burdensome choice. This is highlighted principally by the requirements imposed by the annual purchase summary, many of which appear to serve no information-gathering justification.

As described above, the annual purchase summary requires not only that the non-collecting retailer provide its Colorado purchasers with certain information related to their use-tax obligations, but also imposes significant restrictions on the manner in which the information must be provided. The new requirements prohibit vendors from sending the summary with any other information or product sent to the customer, require that the summary be sent by first class mail (currently costing the retailer at least forty-four cents per customer),¹⁵⁴ and require that it be included in a specially printed envelope.¹⁵⁵ Those requirements cannot be justified simply on an information-reporting basis. Rather, the extent of those requirements evidences the state's true intent—to shift the cost-benefit analysis in favor of collecting the state's use tax.

This unique attempt at avoiding *Quill* presents significant constitutional questions under the Commerce Clause.¹⁵⁶ The information-reporting

149 1 COLO. CODE REGS. § 39-21-112-3.5(4)(a) (2010).

150 *Id.* § 39-21-112-3.5(4)(a)(iv). For a review of the Constitutional uncertainty that the required provision of such information can create, see *Amazon.com LLC v. Lay*, 758 F. Supp. 2d 1154, 1172 (W.D. Wash. 2010) (holding that North Carolina's attempt to gather customer identifying information coupled with information about particular purchases by those customers violated the First Amendment and the federal Video Privacy Protection Act).

151 COLO. REV. STAT. § 39-21-112(3.5)(d)(II)(A) (2011).

152 *Id.* § 39-21-112(3.5)(d)(III)(B); 1 COLO. CODE REGS. § 39-21-112(3.5)(4)(f)(i) (2010).

153 COLO. REV. STAT. § 39-21-112(3.5)(d)(III)(B) (2010); 1 COLO. CODE REGS. § 39-21-112-3.5 (4)(f)(ii)-(iii) (2011).

154 *First-Class Mail*, UNITED STATES POSTAL SERVICE, <https://www.usps.com/ship/first-class.htm> (last visited Feb. 13, 2011).

155 COLO. REV. STAT. § 39-21-112(3.5)(d)(I)(B) (2011); 1 COLO. CODE REGS. § 39-21-112-3.5(3)(a)(i).

156 See, e.g., Stephen P. Kranz et al., *Colorado's End Run: Clever, Coercive, and Unconstitu-*

requirements impose the type of burdensome restrictions on interstate commerce that the *Quill* court invalidated. Additionally, the information-reporting requirements functionally apply only to out-of-state retailers, raising questions as to its discriminatory impact on interstate commerce. The Colorado Act raises significant questions under other provisions of the U.S. Constitution as well.¹⁵⁷ As could be expected, litigation challenging this new law was initiated shortly after its enactment.

e. Legal Challenge to the Colorado Act.

On June 30, 2010, the Direct Marketing Association (the “DMA”) filed suit against the State of Colorado in the United States District Court for the District of Colorado.¹⁵⁸ The DMA argued that the Colorado Act violated a number of state and federal constitutional provisions, including the Due Process and Commerce Clauses of the U.S. Constitution.¹⁵⁹ On August 13, 2010, the DMA filed a motion for a preliminary injunction against the enforcement of the Colorado Act based upon its Commerce Clause claims.¹⁶⁰ The District Court granted that motion on January 26, 2011.¹⁶¹ The court held that there was a substantial likelihood that the act violated the Commerce Clause by (1) imposing its information-reporting requirements only on out-of-state retailers¹⁶² and thus discriminating against interstate commerce and (2) imposing burdens that are “inextricably related in kind and purpose to the burdens condemned in *Quill*.”¹⁶³ The court granted the DMA’s motion for summary judgment and made its preliminary injunction permanent on March 30.¹⁶⁴

tional, 56 STATE TAX NOTES 55 (2010). *But see, e.g.*, Edward A. Zelinsky, *The Constitutionality (and Futility) of Colorado’s ‘Amazon’ Law*, 56 STATE TAX NOTES 113 (2010).

¹⁵⁷ See Kranz et al., *supra* note 155 (discussing those potential violations).

¹⁵⁸ Complaint, Direct Mktg. Ass’n v. Huber, 2011 WL 250556 (D. Colo. June 30, 2010) (No. 1:10-cv-01546), 2010 WL 2724158.

¹⁵⁹ *Id.* at 1-2.

¹⁶⁰ Motion for Preliminary Injunction, Direct Mktg. Ass’n v. Huber, 2011 WL 250556 (D. Colo. Aug. 13, 2010) (No. 10-cv-01546), 2010 WL 6646490.

¹⁶¹ Direct Mktg. Ass’n v. Huber, No. 10-cv-01546-REB-CBS (D. Colo. Jan. 26, 2011) (order granting preliminary injunction).

¹⁶² *Id.* at 4. The court recognized that the act’s information-reporting requirements would technically also apply to in-state retailers who did not collect sales tax in violation of Colorado law. Those retailers would be doing so, however, in violation of Colorado law and the court felt that the new law’s impact on those retailers was negligible compared to its impact on out-of-state retailers. *Id.* at 5-7.

¹⁶³ *Id.* at 5.

¹⁶⁴ Direct Mktg. Ass’n v. Huber, No. 10-cv-01546-REB-CBS (D. Colo. Mar. 30, 2012).

2. *Oklahoma Legislation*.—On May 28, 2010, the Oklahoma legislature passed H.B. 2359 (the “Oklahoma Act”), which contained an information-reporting statute based upon the Colorado law enacted earlier in the year.¹⁶⁵ Although the Oklahoma Act was based upon the Colorado Act, the scope of reporting requirements under the former is much more limited. The Oklahoma law requires only a transactional notice.

The Oklahoma transactional notice is required of any retailer that is “not currently registered to collect and remit Oklahoma sales and use tax” and “who makes sales of tangible personal property from a place of business outside of Oklahoma to be shipped to Oklahoma for use and who is not required to collect Oklahoma sales or use taxes.”¹⁶⁶ A *de minimis* rule exempts retailers from the notice requirement if their total gross sales in Oklahoma in the prior year *and* their reasonably expected gross sales in Oklahoma in the current year are less than \$100,000.¹⁶⁷ Retailers subject to the new notice requirement are required to provide a notice with every sale to Oklahoma purchasers.¹⁶⁸ The notice must include the following information:

(A) The non-collecting retailer is not required, and does not collect Oklahoma sales or use tax;

(B) The purchase is subject to Oklahoma use tax unless it is specifically exempt from taxation;

(C) The purchase is not exempt merely because it is made over the Internet, by catalog, or by other remote means;

(D) The State of Oklahoma requires Oklahoma purchasers to report all purchases that were not taxed and pay tax on those purchases. The tax may be reported and paid on the Oklahoma individual income tax return [Form 511] or by filing a consumer use tax return. [Form 21-1]; and

(E) The referenced forms and corresponding instructions are available on the Oklahoma Tax Commission website, www.tax.ok.gov.¹⁶⁹

The notice is required to be provided on “a page necessary to facilitate the applicable transaction” or on the order form for catalog sales.¹⁷⁰ The notice must also be provided on the invoice for any Internet sale and on the “purchase order, bill, receipt, sales slip, order form, or packaging statement.”¹⁷¹

As noted above, the Oklahoma law does not require a customer information report or annual purchase summary. It also does not include any penalty provisions. As a result, the enactment of this law does not put

¹⁶⁵ Act of June 9, 2010, ch. 412, 2010 Okla. Sess. Laws 1692 (West).

¹⁶⁶ OKLA. ADMIN. CODE § 710:65-21-8(a)(3) (2011).

¹⁶⁷ *Id.* § 710:65-21-8(a)(2).

¹⁶⁸ *Id.* § 710:65-21-8(b).

¹⁶⁹ *Id.* § 710:65-21-8(b)(1).

¹⁷⁰ *Id.* § 710:65-21-8(b)(2).

¹⁷¹ *Id.* § 710:65-21-8(b)(3).

the same stress on the constitutional protections afforded to taxpayers under *Quill* as does the Colorado Act. However, another provision of the Oklahoma Act more than compensates for the relative timidity of that limited reporting law.

In addition to creating the transactional-notice requirement, the Oklahoma Act created a new statutory section that is nothing short of a direct rejection of *Quill*. That section contains no operative provisions, but lists a series of bold declarations. Those declarations are as follows:

A. It is hereby declared to be the intent of the Oklahoma Legislature to specifically include within the use tax levied by this article all storage, use or other consumption of tangible personal property purchased or brought into this state through the continuous, regular or systematic solicitation in the Oklahoma consumer market by out-of-state retailers through the Internet, mail order and catalog publications.

B. The Oklahoma Legislature finds that out-of-state retailers purposefully direct their activities through the Internet and other media at Oklahoma residents, that the magnitude of those contacts are more than sufficient for due process purposes, and that the use tax is related to the benefits the out-of-state retailers receive from access to the state. . . .

C. The Oklahoma Legislature finds that the sales and use tax system established under Oklahoma law does not pose an undue burden on out-of-state retailers and provides sufficient simplification to warrant the collection and remittance of use taxes by out-of-state retailers that are due and owing to the State of Oklahoma and its local jurisdictions.¹⁷²

The totality of these declarations amounts to a unilateral determination by the Oklahoma legislature that the imposition of Oklahoma's sales and use tax against remote vendors would not violate the Commerce Clause. This determination is apparently based on a belief that *Quill*'s bright-line test was principally motivated by the burdens imposed on multistate taxpayers by the multitude of sales-and-use-tax rules and regulations across the nation and the belief that such burdens are sufficiently mitigated by Oklahoma's adherence to the Streamlined Sales and Use Tax Agreement ("SSUTA"). The scope and impact of the SSUTA is discussed briefly below in Section C.1.

3. *South Dakota and Vermont Legislation.*—South Dakota and Vermont enacted Oklahoma style tax-reporting statutes in 2011.¹⁷³ Each statute

¹⁷² OKLA. STAT. tit. 68, § 1407.5(A)-(C) (Supp. 2010). The statutory provision then lists the various ways that Oklahoma has simplified its sales and use tax provisions. *Id.* § 1407.5(C) (1)-(17).

¹⁷³ Act of March 10, 2011, ch. 59, 2011 S.D. Sess. Laws 159; Act of May 24, 2011, Pub. L. No. 45, 2011 Vt. Acts & Resolves 169. Vermont's enactment was particularly interesting because the legislature simultaneously adopted a nexus provision like those discussed *supra* note 124. However, that nexus provision does not take effect until fifteen states have adopted similar laws. *See* § 37(13), 2011 Vt. Acts & Resolves at 188. At the time that the nexus provision

effectively mirrors the Oklahoma law by requiring only a transactional notice that contains the same types of information as required in Oklahoma.¹⁷⁴ The notices are required of all retailers that are not required to collect South Dakota or Vermont sales and use tax, that do not voluntarily register to do so, and that “makes sales of tangible personal property, services, and products transferred electronically from a place of business outside [South Dakota or Vermont] for use, storage, or consumption.”¹⁷⁵ Another key similarity is the lack of any penalty for non-compliance. Indeed, both the South Dakota and Vermont legislation explicitly provide that “[n]o criminal penalty or civil liability may be applied or assessed for failure to comply . . .” with their provisions.¹⁷⁶

*C. Intergovernmental Actions Related to the Physical-Presence
Requirement For Sales and Use Tax*

States do not act in isolation when developing their tax systems or lobbying Congress for favorable legislation. Rather, states have created organizations dedicated to uniformity, information sharing, and coordinated lobbying efforts. Actions taken by two such groups—the Streamlined Sales and Use Tax Governing Board and the Multistate Tax Commission—are of particular relevance to the current debate regarding *Quill*. Those actions are discussed below.

1. *Streamlined Sales and Use Tax Agreement*.—The SSUTA was born from multiple efforts to simplify and coordinate state sales and use taxation.¹⁷⁷ It ultimately was created through the actions of the Streamlined Sales Tax Project (“SSTP”) in the early 2000s and is overseen by the Streamlined Sales and Use Tax Governing Board.¹⁷⁸ The SSUTA has evolved over the years and is currently a 198-page agreement intended to “simplify and modernize sales and use tax administration in the member states in order

is applicable, the use-tax reporting requirements will be repealed. *Id.* § 37(14).

¹⁷⁴ VT. STAT. ANN. tit. 32, § 9783(c) (2011); Act of March 10, 2011, ch. 59, § 2, 2011 S.D. Sess. Laws 159, 159.

¹⁷⁵ VT. STAT. ANN. tit. 32 § 9783(a)(2)(2011); Act of March 10, 2011, ch. 59, §§ 1(3), 2, 2011 S.D. Sess. Laws 159, 159.

¹⁷⁶ VT. STAT. ANN. tit. 32 § 9783(d)(6) (2011); Act of March 10, 2011, ch. 59, § 9, 2011 S.D. Sess. Laws 159, 161. Given the extreme similarity of the South Dakota and Vermont provisions to the Oklahoma provision, further discussion of those laws is unnecessary for purposes of this Article.

¹⁷⁷ See HELLERSTEIN, *supra* note 16, ¶ 19A.01[1].

¹⁷⁸ *Id.* ¶ 19A.02[4]. For a complete discussion of the history of the SSTP, see *id.* ¶ 19A.02; see also WALTER HELLERSTEIN & JOHN A. SWAIN, STREAMLINED SALES AND USE TAX, ch. 2 (2008-2009 ed. 2009); John A. Swain, *State Sales and Use Tax Jurisdiction: An Economic Nexus Standard for the Twenty-First Century*, 38 GA. L. REV. 343, 371-72 (2003).

to substantially reduce the burden of tax compliance.”¹⁷⁹ To that end, the SSUTA provides model rules for a range of sales and use tax matters including administrative matters, tax bases, definitions, sourcing rules, exemptions, returns, and remittances.¹⁸⁰ Importantly, the SSUTA does not create a standardized legislative template to which all member states adhere. Member states are free, for example, to determine their tax bases and exemptions.¹⁸¹ Currently, twenty-four states have been admitted as members of the SSUTA and have passed legislation conforming to, at least in substantial part, the SSUTA.¹⁸²

The most notable aspect of the SSUTA for purposes of this Article is the impact that certain parties believe that it has on *Quill*. As noted above, footnote six of *Quill* identified the lack of uniformity that existed in state and local sales and use taxation as support for the idea that taxation of parties without a physical presence in a state could unduly burden interstate commerce. The SSUTA directly addresses that concern by creating uniformity in key administrative areas. It also may undercut the Court’s *stare decisis* rationale by changing the legal landscape since *Quill*.¹⁸³ It is not surprising, then, that the SSUTA is cited as support for directly overturning *Quill* in court.¹⁸⁴ In late-2010, the Streamlined Sales Tax Governing Board joined this crowd, announcing that it was studying the option of overturning *Quill* directly through litigation.¹⁸⁵

179 STREAMLINED SALES TAX GOVERNING BD., STREAMLINED SALES AND USE TAX AGREEMENT § 102 (2010), available at http://www.streamlinedsalestax.org/uploads/downloads/Archive/SSUTA/SSUTA%20As%20Amended%2012_13_10.pdf [hereinafter STREAMLINED SALES AND USE TAX AGREEMENT]. A full discussion of the SSUTA is beyond the scope of this Article. For more information on the SSUTA, see the authorities cited *supra* note 167.

180 STREAMLINED SALES AND USE TAX AGREEMENT § 102.

181 *Id.* § 103. For a more detailed discussion of the level of uniformity required by the SSUTA, see HELLERSTEIN & SWAIN, *supra* note 177, at ch. 3; Swain, *supra* note 177, at 372-79.

182 *Frequently Asked Questions*, STREAMLINED SALES TAX GOVERNING BD., <http://www.streamlinedsalestax.org/index.php?page=faqs> (last visited Nov. 5, 2011) [hereinafter *Frequently Asked Questions*]. Those states include Arkansas, Georgia, Indiana, Iowa, Kansas, Kentucky, Michigan, Minnesota, Nebraska, Nevada, New Jersey, North Carolina, North Dakota, Ohio, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, Vermont, Washington, West Virginia, Wisconsin and Wyoming. *Id.*

183 Swain, *supra* note 177, at 383 (“As a constitutional matter, SSUTA removes the *stare decisis* underpinnings of *Quill* by changing the underlying legal and factual environment . . .”).

184 See *id.* at 382-83; see also Robert D. Plattner, Daniel Smirlock & Mary Ellen Ladouceur, *A New Way Forward for Remote Vendor Sales Tax Collection*, 55 STATE TAX NOTES 187, 187-97 (2009).

185 John Buhl, *Governing Board Studying Option of Overturning Quill*, 58 STATE TAX NOTES 386, 386-88 (2010).

2. *Multistate Tax Commission Model Information-Reporting Statute*.—The Multistate Tax Commission (the “MTC”) is “an intergovernmental state tax agency working on behalf of states and taxpayers to administer, equitably and efficiently, tax laws that apply to multistate and multinational enterprises.”¹⁸⁶ The MTC focuses its efforts on:

Facilitating the proper determination of State and local tax liability of multistate taxpayers, including the equitable apportionment of tax bases and settlement of apportionment disputes;
Promoting uniformity or compatibility in significant components of tax systems;
Facilitating taxpayer convenience and compliance in the filing of tax returns and in other phases of tax administration; [and]
Avoiding duplicative taxation.¹⁸⁷

The MTC focuses much of its effort on the creation of model legislation for consideration by its compact members. Following the enactment of the Colorado Act, the MTC committed to work on a model statute in the same vein.¹⁸⁸ This model statute is framed after the Colorado Act and thus includes a transactional notice, an annual information return, and a customer information report.¹⁸⁹ It also provides penalty, administrative, and confidentiality provisions.¹⁹⁰ The MTC is currently working on this model legislation and sent a draft to its member states for review in June 2011.¹⁹¹ In December, 2011, the Executive Committee of the MTC sent the draft back to the Sales and Use Tax Uniformity Subcommittee to provide a specific *de minimis* threshold, and the subcommittee is currently undertaking that task.¹⁹² The MTC model legislation, regardless of how its details are determined, will appear to suffer the same fate as the Colorado Act. The two are so structurally intertwined that the Commerce Clause

¹⁸⁶ *About the Multistate Tax Commission*, MULTISTATE TAX COMMISSION, <http://www.mtc.gov/About.aspx?id=40> (last visited Nov. 5, 2011).

¹⁸⁷ *Id.*

¹⁸⁸ John Buhl, *MTC Panel to Draft ‘Amazon’ Law Model Legislation*, 55 STATE TAX NOTES 678, 678-79 (2010).

¹⁸⁹ MODEL SALES & USE TAX NOTICE AND REPORTING ACT § (c) (Tentative Draft 2011), available at http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Committee_and_Subcommittees/2011_Winter_Committee_Meeting/UTR%20UC%20Memo%202-18-11.pdf.

¹⁹⁰ *Id.* § (a), (d)-(h).

¹⁹¹ Amy Hamilton, *Wal-Mart Supports MTC Draft Model ‘Amazon’ Statute*, 60 STATE TAX NOTES 770 (2011).

¹⁹² Amy Hamilton, *MTC Advances Draft on Tax Collection by Hotels and Online Travel Companies*, 62 STATE TAX NOTES 719, 719-20 (2011); Amy Hamilton, *MTC Panels Tweak Colorado-Style ‘Amazon’ Draft Statute, UDITPA Amendments*, 63 STATE TAX NOTES 439, 439-40 (2012) (explaining that the subcommittee held a January 31, 2012 meeting in which it appeared to prefer a recommendation that the model statute include a small-seller exception that would apply to retailers with less than \$200,000 of gross sales and another exception that would apply to retailers with less than \$100,000 of gross in-state deliveries.)

concerns under the Colorado Act will apply equally to the MTC's model act.

III. *KFC CORPORATION V. IOWA DEPARTMENT OF REVENUE*

The discussion above evidences the pressure that the *Quill* physical-presence test has faced in recent years. States have attempted various methods to obtain reprieve from the limitations imposed by that test, including rejecting the test outright outside of sales and use taxes, expanding their attributional-nexus provisions, and imposing extensive information-reporting requirements on vendors who do not voluntarily collect the states' taxes. Ultimately, however, none of those efforts provide states with the full power that they desire to require out-of-state retailers to collect their use taxes. *Quill* still provides a bright-line test limiting state action in that area.

States wanting to expand their authority without directly challenging *Quill* must therefore find ways of extending its boundaries within a physical-presence framework. Such a method may have been introduced by the Iowa Supreme Court in *KFC Corp. v. Iowa Department of Revenue*.¹⁹³ That decision appears to significantly diminish the impact of *Quill*, without expressly holding that it is no longer valid law. *KFC* thus could represent the opening for which states have been looking to expand their reach without requiring a direct challenge to Supreme Court precedent.

A. Background

KFC Corporation is incorporated in Delaware and maintains its headquarters in Louisville, Kentucky.¹⁹⁴ Its principal business is the ownership and licensing of intellectual property related to its restaurant business and business method.¹⁹⁵ KFC operates company-owned restaurants, but also licenses its trademarks and business system to independent, unrelated franchisees for their use in daily operations.¹⁹⁶ In exchange for those rights, franchisees pay KFC royalties based upon a percentage of their gross revenues each month.¹⁹⁷

On October 19, 2001, the Iowa Department of Revenue issued an assessment to KFC for unpaid corporate income taxes, penalties, and

¹⁹³ *KFC Corp. v. Iowa Dep't of Revenue*, 792 N.W.2d 308 (Iowa 2010).

¹⁹⁴ *Id.* at 310.

¹⁹⁵ *Id.*

¹⁹⁶ *Id.*

¹⁹⁷ *Id.* at 311; see also FAQ's: QSR Restaurant: Kentucky Fried Chicken Franchise, KFCFRANCHISE.COM, <http://www.kfcfranchise.com/faqs-qsr-restaurant.php> (last visited July 2, 2011) (indicating that franchisees pay an initial franchise fee of \$45,000, a monthly royalty fee of 5% of gross sales, and a monthly advertising fee of 5% of gross sales).

interest for the years 1997, 1998, and 1999.¹⁹⁸ During that period, KFC had franchisees, but no company-owned stores or employees, in the state.¹⁹⁹ KFC challenged the Department's assessment as a violation of the Commerce Clause through an administrative hearing process and before an Iowa district court without success.²⁰⁰ KFC appealed the district court's ruling to the Iowa Supreme Court, which issued its ruling on December 30, 2010.²⁰¹

B. IOWA SUPREME COURT PROCEEDINGS

KFC's principal argument to the Iowa Supreme Court was that the physical-presence standard of *Quill* barred the state's income-tax assessment.²⁰² KFC argued that the Supreme Court had never before upheld an imposition of state income tax on a party without a physical presence in the taxing state.²⁰³ The Department countered by arguing that *Quill* was inapplicable to state income taxes and thus had no application in the case at hand.²⁰⁴ The Department's arguments mirrored those made by other state taxing authorities in the *Geoffrey* line of cases discussed above.²⁰⁵ The Department argued that those cases evidenced that "[t]he overwhelming weight of authority" supported its assessment.²⁰⁶

The Iowa Supreme Court issued a unanimous decision upholding the assessment of tax against KFC on the last day of its 2010 term.²⁰⁷ The court

¹⁹⁸ *KFC*, 792 N.W.2d at 310.

¹⁹⁹ *Id.*

²⁰⁰ *Id.* at 311-12.

²⁰¹ *Id.* at 308.

²⁰² Brief of Appellant and Request for Oral Argument at 13-24, *KFC Corp.*, 792 N.W.2d 308 (No. 09-1032). KFC also raised state law claims in opposition of the assessment. *See id.* at 25-42. Those claims are beyond the scope of this Article and are not discussed herein.

²⁰³ *Id.* at 15 ("The United States Supreme Court has never sanctioned the imposition of a state tax against a corporation based on its alleged 'economic nexus' with the state.").

²⁰⁴ Brief of Appellee and Notice of Oral Argument at 12, *KFC Corp.*, 792 N.W.2d 308 (No. 09-1032).

²⁰⁵ *Id.* at 13-28.

²⁰⁶ *Id.* at 12.

²⁰⁷ The decision was handed down as a unanimous decision, although Justice Wiggins concurred only with the result. *KFC Corp.*, 792 N.W.2d at 330. The timing of the court's decision was notable given the historic removal of three of the justices following a contentious retention election in November 2010. The justices were subject to vigorous negative campaigning after the court's decision in *Varnum v. Brien*, 763 N.W.2d 862 (Iowa 2009), which struck down a state restriction on same-sex marriages as a violation of the equal protection clause of the Iowa Constitution. *Id.* at 872. The removal of the justices was effective on January 1, 2011, but December 30 was the justices' last day on the court given the New Year's Eve holiday that closed the court on December 31. *See* Grant Schulte, *Iowans Dismiss Three Justices*, DES MOINES REGISTER, Nov. 3, 2010, at A1, available at <http://www.desmoinesregister.com/article/20101103/NEWS09/11030390/Iowans-dismiss-three-justices> (reporting the historic

began with a historical analysis of the Court's restrictions on state taxation under the Commerce Clause, focusing on the genesis of the Court's physical-presence test.²⁰⁸ The court then looked at how the Supreme Court's Commerce Clause jurisprudence had been applied by state courts in cases involving state *income* taxes.²⁰⁹ The *KFC* court recognized that certain courts had extended *Quill* beyond sales and use taxation, but determined that "the weight of state authority" was against that extension.²¹⁰

Having completed its review of the relevant case law, the court began its analysis of the case by first evaluating whether *Quill*'s physical presence test was met by KFC.²¹¹ That analysis was surprising given the lack of any argument in either of the parties' briefs or oral arguments regarding whether KFC had a physical-presence in the state. The issue addressed by the parties was simply whether the physical-presence test applied to the state's income tax. It is thus unclear why the court addressed this issue, but its analysis cannot be ignored.

The *KFC* court commenced its *Quill* analysis by noting that *KFC*'s facts differed from those presented in *Quill* because KFC was not a mail-order retailer but rather licensed intangible property to parties within the state and derived royalty income therefrom.²¹² The court contrasted KFC's "presence" in Iowa (the use of its intangible property in the state) with *Quill*'s minimal physical presence in North Dakota (presented by title to a few floppy diskettes) and viewed KFC's licensing agreements as a "far greater involvement" within Iowa because its intellectual property was

election in Iowa).

208 *KFC*, 792 N.W.2d at 312-20.

209 *Id.* at 320-22.

210 *Id.* at 322. The court concluded its historical review by recognizing that the authority supporting a limitation of *Quill* was not necessarily indicative of the ultimate views of the United States Supreme Court, noting that "it might be argued that state supreme courts are inherently more sympathetic to robust taxing powers of states than is the United States Supreme Court." *Id.* Despite this nod to skeptical taxpayers and tax practitioners, the court did not let this factor influence its adoption of the economic-nexus concept for purposes of Iowa income taxation.

211 *Id.* at 323. Before embarking on this analysis, the court noted that its "task" in the case was:

to determine, to the best of our ability, how the United States Supreme Court would decide this case under its case law and established dormant Commerce Clause doctrine. In performing this task . . . we do not seek to improve or clarify Supreme Court doctrine. We simply do our best to predict how the Supreme Court would decide the issues presented in this case.

Id. This comment becomes especially puzzling as one analyzes the court's discussion and holding with respect to whether KFC had a physical presence in Iowa under *Quill*. The court's holding on this issue certainly did not fall within existing Supreme Court precedent and can be seen only (in its most favorable light) as "improving or clarifying" Supreme Court doctrine.

212 *Id.*

used within Iowa to produce income.²¹³

Having made this factual determination, the court next looked at pre-*Quill* case law that established that the use of intangible property in a state could support the imposition of *ad valorem* and income taxes where that intangible property had established a business situs in the taxing state.²¹⁴ The court also looked at a secondary line of pre-*Quill* cases that supported the notion that the receipt of income from transactions within a state provided a sufficient nexus with that state under the Commerce Clause.²¹⁵ Without further explanation, the court concluded its *Quill* analysis by holding that:

[T]he Supreme Court would likely find intangibles owned by KFC, but utilized in a fast-food business by its franchisees that are firmly anchored within the state, would be regarded as having a sufficient connection to Iowa to amount to the functional equivalent of 'physical presence' under *Quill*. Furthermore, the fact that the transactions that produced the revenue were based upon use of intangibles in Iowa also provides a sufficient basis to support the tax under the Commerce Clause.²¹⁶

This holding purported to be an application of *Quill*, but the court's language and analysis leads to confusion regarding what the holding actually represents. The court's citation to, and discussion of, pre-*Quill* cases outside of the context of sales and use taxes are not instructive on the physical-presence test. Further, the court's secondary focus on KFC's mere derivation of revenue from transactions within the state is simply irrelevant in a physical-presence analysis. The generation of revenue from a state can be achieved wholly independent of a taxpayer's physical presence in that state. Based on these factors, one could infer that the court was really driving towards a determination that a physical-presence was simply not required for the state income tax assessment at issue. However, the court clearly was not intending to do so. The court offered this analysis in a section of its opinion that it labeled an "[a]pplication of *Quill*."²¹⁷ Further, the court referenced the physical-presence test in its holding. The court thus certainly intended its analysis to be an application of the physical-

²¹³ *Id.*

²¹⁴ *Id.* (citing *Mobil Oil Corp. v. Comm'r of Taxes*, 445 U.S. 425, 445-46 (1980) (allowing the apportionment of income from intangible property); *N.Y. ex rel. Whitney v. Graves*, 299 U.S. 366 (1937) (upholding an assessment based upon the income earned from selling an intangible right to a seat on the New York Stock Exchange); *Wheeling Steel Corp. v. Fox*, 298 U.S. 193 (1936) (holding that intangible property can acquire a business situs in a state other than the corporation's state of domicile)). For a full discussion of these cases, see *infra* text accompanying notes 228-41.

²¹⁵ *KFC*, 792 N.W.2d at 323-24 (citing *Int'l Harvester Co. v. Wis. Dep't of Taxation*, 322 U.S. 435 (1944); *Curry v. McCannless*, 307 U.S. 357 (1939); *Shaffer v. Carter*, 252 U.S. 37 (1920)).

²¹⁶ *Id.* at 324.

²¹⁷ *Id.* at 323.

presence rule.

This conclusion is confirmed by the next section of the court's decision, which analyzes whether the physical-presence requirement even applied to the state's income tax.²¹⁸ That section starts by explicitly setting up its analysis as an "alternative" holding.²¹⁹ The court's initial holding thus represents an explicit determination that KFC had, in fact, met *Quill's* physical-presence test. This holding is a new and expansive application of that test and is discussed in great detail in Section IV, below.

The court's secondary analysis of whether the physical-presence test even applied to Iowa's income tax repeated the litany of reasons cited by other state courts in rejecting the application of *Quill* to their state income taxes.²²⁰ The *KFC* court followed that "weight of authority" and limited the scope and purpose of *Quill* to nothing more than a begrudging nod to *stare decisis*.²²¹ The court held that:

[A] physical presence is not required under the dormant Commerce Clause of the United States Constitution in order for the Iowa legislature to impose an income tax on revenue earned by an out-of-state corporation arising from the use of its intangibles by franchisees located within the State of Iowa. We hold that, by licensing franchises within Iowa, KFC has received the benefit of an orderly society within the state and, as a result, is subject to the payment of income taxes that otherwise meet the requirements of the dormant [sic] Commerce Clause.²²²

The court's rejection of a physical-presence standard for purposes of the state's income tax thus falls in line with the current weight of state authority.²²³

²¹⁸ *Id.* at 324-28.

²¹⁹ The court stated that "[i]n the alternative, even if the use of intangibles within the state in a franchised business does not amount to 'physical presence' under *Quill*, the question arises whether the Supreme Court would extend the *Quill* 'physical presence' requirement" to state income taxes." *Id.* at 324.

²²⁰ *Id.* at 324-28. Interestingly, the court also referred to the potential for tax evasion that the physical-presence test "engenders." *Id.* 327-28. This comment evidences the taint that the intangible-holding-company cases have had on the evolution of the economic-nexus doctrine.

²²¹ *Id.* ("The lynchpin of the Supreme Court's opinion in *Quill* was not logic, or the developing Commerce Clause jurisprudence, but *stare decisis*.").

²²² *Id.* at 328 (emphasis omitted). The court went on to analyze certain state law claims that had been offered by KFC, but held against KFC on those points as well. *Id.* at 328-29.

²²³ On April 28, 2011, KFC petitioned the U.S. Supreme Court for a writ of certiorari to the Iowa Supreme Court. That petition was denied on October 3, 2011. *KFC Corp. v. Iowa Dep't of Revenue*, 132 S. Ct. 97 (2011). Interestingly, however, the question presented by KFC was "[w]hether the decision of the Iowa Supreme Court, in acknowledged conflict with the decisions of other state courts, violates the Commerce Clause by holding that a State may tax the income of an out-of-state business that maintains no physical presence in the taxing State." Petition for Writ of Certiorari at i, *KFC Corp.*, 132 S. Ct. 97 (No. 10-1340), 2011 WL 1633948 at *i. Thus, KFC did not ask the court to address the Iowa court's physical-presence

IV. EVALUATING KFC'S NEW WORLD OF PHYSICAL PRESENCE

The KFC court's *Quill* analysis was surprising and certainly unique. Courts evaluating earlier economic-nexus cases did not even consider whether the taxpayers in those cases met the physical-presence test, but simply determined that the test did not apply. KFC thus stands on its own as an apparent expansion of state power. Its scope and validity must therefore be evaluated. As discussed above, states have been searching for the method to finally relax (or dispense with) *Quill*, and the KFC court's analysis could provide one possible path for doing so.

Whether KFC provides that path depends on the validity of the two lines of reasoning that the court relied upon in its physical-presence analysis: (1) that KFC's licensing of intellectual property to its Iowa franchisees had created the *functional equivalency* of a physical presence in the state; and (2) that KFC's derivation of revenue from transactions in the state was sufficient to justify the imposition of tax under *Quill*.²²⁴ The court's functional-equivalency analysis is a unique extension of *Quill*'s physical-presence test and is worthy of discussion. However, the second rationale given by the Iowa Supreme Court can be dispensed with much more quickly. The court's determination that physical presence nexus could be established based simply on the generation of income from transactions occurring in the taxing state is indefensible.²²⁵ That reasoning is simply economic nexus by another name. Reliance on that reasoning would therefore effectively repeal *Quill* and the court should have presented it as such. The remainder of this Article thus focuses on the court's functional-equivalency ruling and evaluates whether it stands as a possible avenue for extending state power while adhering to *Quill*, or whether it too is an effective repeal of the physical-presence test.

A. *The Origin of the Functional-Equivalency Test*

The KFC court's physical-presence analysis began with a discussion of the scope of KFC's market presence in Iowa. The court felt that the "nexus presented by the use of KFC's intangible property within the State of Iowa," was "far more than title to a few floppy diskettes"²²⁶ and that KFC's licensing agreements were a "far greater involvement" within Iowa

holding.

²²⁴ See *supra* text accompanying notes 213-15.

²²⁵ The court's analysis also ignores that the transactions generating revenue for KFC were the licensing agreements entered into between KFC and its franchisees outside of the state. The transactions that occurred in Iowa (KFC franchisees' sales of product to customers) merely determined the *magnitude* of the income under the out-of-state transactions. One can argue the impact of this distinction, but it should be addressed nonetheless.

²²⁶ KFC, 792 N.W.2d at 323.

than *Quill*'s involvement in North Dakota.²²⁷ Based on that presence, the court determined that "the Supreme Court would likely find intangibles owned by KFC, but utilized in a fast-food business by its franchisees that are firmly anchored within the state, would be regarded as having a sufficient connection to Iowa to amount to the *functional equivalent* of 'physical presence' under *Quill*."²²⁸

The *KFC* court did not offer any insight into the source of, or support for, its functional-equivalency test. The court merely cited a string of pre-*Quill* cases—*Wheeling Steel Corp. v. Fox*, *Whitney v. Graves*, and *Mobil Oil Corp. v. Commissioner of Tax*—in support of its decision.²²⁹ These citations are curious, however, because none of those cases involved sales or use taxes, or discussed a functional-equivalency concept.

Wheeling Steel involved an *ad valorem* tax levied by the state of West Virginia on a taxpayer's property in the state, including certain accounts receivable and bank deposits.²³⁰ The taxpayer was a Delaware corporation, but maintained its general business offices in West Virginia. The taxpayer argued that the imposition of tax on the value of its accounts receivable and bank deposits violated the Due Process and Equal Protection Clauses of the Fourteenth Amendment.²³¹ The crux of the case was whether the taxpayer's accounts receivable and bank deposits had obtained a business situs in West Virginia.²³² The Supreme Court analyzed the taxpayer's business activities carried on inside and outside of West Virginia, determined that the assets *were* properly attributable to West Virginia, and determined that the taxation of the intangible property by West Virginia violated neither the Due Process Clause nor the Equal Protection Clause.²³³ The Court did not discuss either a physical-presence requirement or a functional-equivalency doctrine. Indeed, the taxpayer's operations were based in the

227 *Id.* As discussed above, the *KFC* court also initially explained that *KFC*'s facts differed from those presented in *Quill* because *KFC* was not a mail-order retailer but rather licensed intangible property to parties within the state and derived royalty income therefrom. *Id.* at 323. One could infer that the court was attempting to lay the groundwork for Professor Hellerstein's argument that *Quill*'s physical-presence test may be limited to the mail order industry. See *supra* note 87. This argument certainly seems supported by the court's analysis, which focused on factors other than physical presence. *KFC*, 792 N.W.2d at 323-24. The court ultimately undercut this argument, however, by referring back to the physical-presence test in its holding. *Id.* at 324. Thus, it does not appear that the *KFC* court meant to suggest that *Quill* applied only to mail-order vendors.

228 *KFC*, 792 N.W.2d at 324 (emphasis added).

229 *Id.* at 323.

230 *Wheeling Steel Corp. v. Fox*, 298 U.S. 193, 200 (1936).

231 *Id.*

232 *Id.* at 210-11 ("In the instant case, both parties recognize the principle and the exception. It is appellant's contention that the state creating a corporation has the sole right to tax its intangible property 'unless such intangible property has acquired a 'business situs' elsewhere.'").

233 *Id.* at 211-16.

taxing state so it clearly had a physical presence there. The issue in the case was the proper situs for intangible assets for property-tax purposes, not any jurisdictional bar on the imposition of tax against the taxpayer before the court.

Whitney was factually much more similar to *KFC* than was *Wheeling Steel*, but is similarly non-instructive on the physical-presence test. *Whitney* involved a due process challenge to the imposition of New York income tax on gains from the sale of a fractional membership on the New York Stock Exchange by an out-of-state taxpayer.²³⁴ *Whitney* was a resident of Massachusetts who did business in Boston. *Whitney's* membership on the Exchange gave him rights to trade on the Exchange and access to certain other benefits, including an insurance fund and access to reduced commissions for transactions undertaken on his behalf.²³⁵

Whitney challenged the imposition of New York income tax on his gains from the sale of his fractional membership, arguing that the membership did not have a business situs in New York.²³⁶ The Supreme Court evaluated the rights to which *Whitney's* membership entitled him and determined that the very nature of the asset was that it was "localized" at the exchange.²³⁷ The Court noted that, wherever the owner of such a membership right resides, "he must go to the Exchange to exercise his privilege to trade upon its floor."²³⁸ The Court held that "the dominant attribute of relator's membership in the New York Stock Exchange so links it to the situs of the Exchange as to localize it at that place and hence to bring it within the taxing power of New York."²³⁹

The *Whitney* court made no attempt to analyze *Whitney's* physical presence in New York. Rather, the Court evaluated the business situs of *Whitney's* property for purposes of a challenge under the Due Process Clause. This case is thus of no utility to an analysis under *Quill*.

²³⁴ N.Y. *ex rel.* *Whitney v. Graves*, 299 U.S. 366, 369-70 (1937).

²³⁵ *Id.* at 370-71.

²³⁶ *Id.* at 371-72.

²³⁷ *Id.* at 374.

²³⁸ *Id.* at 373.

²³⁹ *Id.* at 374.

The third and final case cited by the *KFC* court in its functional-equivalency analysis was *Mobil Oil*. That case involved a corporate income tax imposed by the state of Vermont on apportioned income that included certain foreign-source dividends.²⁴⁰ The taxpayer resisted the inclusion of those dividends in its apportionable income on three grounds: (1) that the dividends had no nexus to the taxing state; (2) that such inclusion would create an unconstitutional burden of multiple taxation; and (3) that the foreign source of the dividend payments precluded taxation because of the risk of multiple taxation on an international level.²⁴¹ None of these arguments rested on a physical-presence analysis. Mobil admittedly had a physical presence in the taxing state.

The only relevance that *Mobil Oil* has to the *KFC* court's physical-presence analysis is its brief business-situs discussion. As part of its multiple-taxation argument, Mobil argued that the Court's business-situs cases indicated that its state of commercial domicile (New York) had the right to tax its dividend income without apportionment and that, as a result, Vermont was prohibited from taxing that income.²⁴² The Court responded to this argument by distinguishing its property tax cases (which allowed allocation of intangibles to a single situs) from cases involving income taxes (which allowed the apportionment of income from intangibles).²⁴³ The Court thus rejected the taxpayer's Commerce Clause challenge. Most notably, however, the Court did not discuss the taxpayer's physical presence in the taxing state.

A brief review of the three cases cited by the *KFC* court in its functional-equivalency analysis quickly evidences their lack of relevancy to the functional-equivalency concept. It appears as though the court may have cited these cases for their business-situs analyses, but those analyses are simply irrelevant for purposes of a traditional physical-presence inquiry.

The functional-equivalency test is similarly not rooted in *National Bellas Hess* or *Quill*. Those cases established the physical-presence test as a bright-line safe harbor. The *Quill* Court reiterated the necessity of the physical-presence test by noting that "[s]uch a rule firmly establishes the boundaries of legitimate state authority to impose a duty to collect sales and use taxes

240 *Mobil Oil Corp. v. Comm'r of Taxes*, 445 U.S. 425, 425 (1980). The foreign-source dividends included both dividends from organizations formed in the U.S. but operated abroad, and organizations both formed and operated abroad. *Id.* at 435. The concept of "apportionable" income relates to the tax base for domestic corporations. See HELLERSTEIN, *supra* note 16, ch. 8. Among the concepts relevant to determining a corporation's apportionable income is the extent to which the income is earned from the conduct of a "unitary business." *Id.* ¶ 8.07.

241 *Mobil Oil*, 445 U.S. at 436.

242 *Id.* at 443-44.

243 *Id.* at 445 ("Although a fictionalized situs for intangible property sometimes has been invoked to avoid multiple taxation of ownership, there is nothing talismanic about the concepts of 'business situs' or 'commercial domicile' that automatically renders those concepts applicable when taxation of income from intangibles is at issue.").

and reduces litigation concerning those taxes. . . . Moreover, a bright-line rule in the area of sales and use taxes also encourages settled expectations²⁴⁴ Further, even in those cases, the Court rejected the limited physical presence that common carriers and limited tangible property provided in the taxing states. Neither *Bellas-Hess* nor *Quill* therefore supports the concept of a functional-equivalency test.²⁴⁵

The only apparent source for the court's test may be the New Mexico Court of Appeals' decision in *Kmart Properties, Inc. v. Taxation and Revenue Department*.²⁴⁶ That case is generally recognized for its adoption of the economic-nexus test for purposes of the state's income tax,²⁴⁷ but the case also involved an analysis of the applicability of the state's gross receipts tax to royalties received by an out-of-state intangible holding company (KPI) that had no employees, operations, offices, or facilities located in the state.²⁴⁸

The New Mexico Court of Appeals' analysis of whether KPI had a physical presence in the state under these circumstances was much more robust than the Iowa Supreme Court's similar analysis in *KFC*. The *Kmart* court focused its analysis on the relationship between KPI and Kmart and evaluated Kmart's use of, and obligations with respect to, KPI's marks. The court noted that KPI's marks were used for the "mutual benefit" of the companies and that Kmart's use of those marks allowed Kmart "to facilitate merchandise sales in New Mexico."²⁴⁹ In that way, "Kmart employees, wearing KPI's trademarks and working at stores with KPI's trademark on the marquee, have acted to represent and promote the goodwill of KPI's marks to the New Mexico consuming public."²⁵⁰ The court also looked to the licensing agreements between Kmart and KPI, noting that such agreements "further demonstrate[] that Kmart Corporation represented KPI's goodwill in New Mexico by requiring Kmart employees, at least in some form, to act on behalf of KPI's interests."²⁵¹

The court's analysis responded to the New Mexico Taxation and

²⁴⁴ *Quill Corp. v. North Dakota*, 504 U.S. 298, 315-16 (1992).

²⁴⁵ The lack of authority or support for this test calls into question the *KFC* court's statement that its task was not to "engage in independent constitutional adjudication" or to "improve or clarify Supreme Court doctrine." *KFC Corp. v. Iowa Dep't of Revenue*, 792 N.W.2d 308, 322 (Iowa 2010).

²⁴⁶ *Kmart Props., Inc. v. Taxation & Revenue Dep't*, 131 P.3d 27 (N.M. Ct. App. 2001), *rev'd sub nom*, *Kmart Corp. v. Taxation & Revenue Dep't*, 131 P.3d 22 (N.M. 2005).

²⁴⁷ See *supra* text accompanying note 113.

²⁴⁸ *Kmart Props., Inc.*, 131 P.3d at 36-41. Ultimately, the New Mexico Supreme Court determined that the state could not impose its gross receipts tax on the intangible holding company (KPI) for statutory reasons and overturned the Court of Appeals's determination on this issue on that ground. *Kmart Corp.*, 131 P.3d at 25-27.

²⁴⁹ *Kmart Props., Inc.*, 131 P.3d at 37.

²⁵⁰ *Id.*

²⁵¹ *Id.*

Revenue Department's argument that KPI had a nexus in the state under the authority of *Tyler Pipe* and *Scripto*.²⁵² The Department believed that "Kmart Corporation used its stores and employees in New Mexico as local representatives of KPI's goodwill . . . to promote both its own sales and the goodwill of KPI's marks."²⁵³ This type of *Tyler Pipe* analysis was unique in that it applied not to a retailer selling products in a state, but to an out-of-state entity that simply licensed intellectual property to in-state retailers. That application of *Tyler Pipe* thus represented a significant expansion of its doctrine. The court recognized this aspect of the Department's argument and stated that the distinction between the types of businesses and nature of the property interests being promoted did not require any different result.²⁵⁴ The *Kmart* court ultimately concluded that:

The case before us presents far more than just merchandise bearing out-of-state trademarks for sale in New Mexico stores. An extensive apparatus of Kmart stores, signs, and employees are also physically present in New Mexico to work on behalf of KPI's goodwill and associated interests. That apparatus represents KPI's property interests in New Mexico, pursuant to a licensing agreement that requires Kmart Corporation to act on KPI's behalf.

Considering the Quill standard in the context of this case, we conclude that the combination of Kmart Corporation's activities in New Mexico, together with the tangible presence of KPI's marks, constitutes the functional equivalent of physical presence as afforded by the independent representatives in *Scripto* and *Tyler Pipe*.²⁵⁵

The New Mexico Court of Appeals' ruling thus enunciated a functional-equivalency standard, but did so in the context of a *Tyler Pipe* analysis. In this way the *Kmart* functional-equivalency test is similar only in name to the *KFC* functional-equivalency test. The *KFC* court did not cite to *Kmart*, *Tyler Pipe*, or *Scripto* in its analysis, nor did it focus on the activities of KFC's franchisees with respect to its marks. Given this silence, it is difficult to propose that the *KFC* test was adopted based upon a *Tyler Pipe* analysis.²⁵⁶

The preceding analysis undercuts the three potential sources of authority for the *KFC* functional-equivalency test—the three cases cited by the court, *Quill* itself, and *Kmart*. That test thus appears to have no source

²⁵² *Id.* at 38.

²⁵³ *Id.*

²⁵⁴ *Id.*

²⁵⁵ *Id.* at 39 (emphasis added).

²⁵⁶ In its opposition brief to KFC's petition for a writ of certiorari, the State of Iowa did raise an argument that rested on *Kmart*-like factors. The State argued that KFC had a physical presence in Iowa by pointing to the quality-assurance activities that were undertaken in Iowa on KFC's behalf and the role that KFC's Iowa franchisees played in protecting KFC's trademarks that were utilized in the state. See Respondent's Brief in Opposition at 4-7, *KFC Corp. v. Iowa Dep't of Revenue*, 132 S. Ct. 97 (2011) (No. 10-1340), 2011 WL 2632403.

in current authority and is either a new relaxation of the physical-presence test or a thinly veiled rejection of the same.²⁵⁷

B. The Scope of the Functional-Equivalency Test

In one sense, the *KFC* court's functional-equivalency doctrine could be viewed as nothing more than an unnecessary and irrelevant deviation from the court's ultimate economic-nexus holding. The court could be seen as simply providing some meaningless analysis before turning to its decision's true import—its rejection of *Quill* as applied to the Iowa income tax. This interpretation is belied, however, by the structure and scope of the court's decision. The court devoted an entire section of its opinion to evaluating whether *Quill*'s physical-presence test had been met by *KFC*. The court also expressly indicated that its economic-nexus holding was an alternative holding.²⁵⁸ The court's functional-equivalency holding thus should not be cast aside as mere curiosity. As discussed above, states have been looking to limit the physical-presence test. If the functional-equivalency test is valid, it could give states a method for doing so without waiting for a direct rejection of *Quill*.²⁵⁹

Ultimately, the utility of the functional-equivalency test depends heavily on its scope, something that the *KFC* court did not define. The court's opinion focused solely on the use of *KFC*'s property by its Iowa

257 It should be noted that the *Geoffrey OK* court hinted at a similar *Kmart*-like functional equivalency test, but determined that it need not address the issue given its economic-nexus holding. See *Geoffrey, Inc. v. Okla. Tax Comm'n*, 132 P.3d 632, 639 & n.8 (Okla. Civ. App. 2005).

258 *KFC Corp. v. Iowa Dep't of Revenue*, 792 N.W.2d 308, 324 (Iowa 2010).

259 This discussion necessarily assumes that the functional-equivalency test is applicable to state sales and use taxes. However, one can frame an argument that the functional-equivalency test should not so apply, but should be limited to state income taxes. The *KFC* court enunciated that test in the context of a state income tax assessment, and, given state courts' bent towards limiting *Quill* to sales and use taxes based partly on similar rationale, it would seem fitting to limit the functional-equivalency test to state income taxation. This bifurcation of the physical-presence test would seem unusual, but would appear consistent with the lower level of Commerce Clause protection apparently afforded to state income taxes (assuming that states' assertions of the economic-nexus standard are ultimately ruled to be constitutional exercises of their power). In this way, the functional-equivalency test could be seen as nothing more than a secondary method of obtaining an economic-nexus standard for state income taxation.

The natural response to this limitation is to ponder what purpose the test would serve if so limited. States already feel uninhibited by the physical-presence test for purposes of state income taxation. A liberalization of that test for those purposes would thus seem to have no purpose or effect. Additionally, there does not appear to be any inherent reason that the *KFC* court's analysis should be limited to income taxation. The court was purporting to apply *Quill*'s test, which taxpayers have argued for years applies equally to state sales and use taxes and income taxes. Based on these factors, it seems that the *KFC* functional-equivalency test is equally applicable to state sales and use taxes, and this Article proceeds on that assumption.

licensees,²⁶⁰ and the court's only citations to legal authority involved cases discussing the "situs" of intangible property.²⁶¹ The court did not offer any other insight into the source of its functional-equivalency test nor did it rely upon settled *Tyler Pipe* principals. Given this silence, the only clear application of the functional-equivalency test is to situations like that presented by KFC—the licensing of intangible property to in-state businesses for their use in daily retail business activities. Persons who employ that business model should thus consider the impact that KFC will have on their sales- and use-tax obligations in Iowa and in other states that may adopt its reasoning. Outside of the facts presented in the KFC case, however, what actions could constitute the functional equivalence of physical presence?

The first natural limitation of the functional-equivalency test is the business-situs rationale of the few cases that the court actually cited in its decision. Under that reading, a physical presence based upon the functional-equivalency test could only be found where an out-of-state party had some intangible property that had obtained a business situs in the state. This reading would be intellectually satisfying in that it has some grounding in existing law.²⁶² At the same time, it leaves much to be desired. The legal requirements for the establishment of a business situs for intangible property are not defined so clearly as to provide an easily administrable rule. More importantly, the KFC decision simply does not impose that limitation. The KFC court merely held that the intangibles owned by KFC were "firmly anchored" in Iowa and thus would be "regarded as having a sufficient connection to Iowa to amount to the functional equivalent of 'physical presence' under *Quill*."²⁶³ Although this language parallels a business-situs analysis, the court's holding certainly did not expressly apply, nor was its result expressly conditioned on, such an analysis.

If the functional-equivalency test is not tethered to the business-situs concept, what are its limits? Could it be extended to reach Internet

²⁶⁰ KFC, 792 N.W.2d at 323-24.

²⁶¹ *Id.*

²⁶² It could also be argued that for an intangible to acquire a business situs in a state, there must be some other business activity in the state that can be attributed to the out-of-state party. For example, it could be argued that KFC's intellectual property could not have acquired a business situs in Iowa without their use by KFC's licensees in tangible form (*i.e.*, logos on uniforms, signs, buckets, *etc.*). If this argument is accepted, it is difficult to imagine a case where an intangible can acquire a business situs in a state where the taxpayer does not have some other physical presence in the state. The quick response to this argument, however, is that it is nothing more than a *Kmart*-style functional-equivalency argument. If physical assets (employees or tangible property) are to be attributed to a remote vendor, then the proper analysis is to be done with respect to those assets. Short of *Tyler Pipe* attributional nexus for those assets, a physical presence should not simply be bootstrapped with a business situs analysis for intangible property.

²⁶³ *Id.* at 324.

retailers? On its face, the test appears to offer an avenue for doing just that. Just as KFC's trademarks are used daily in its franchisees' locations, web browsers in the state undoubtedly display the websites and trademarks of Internet retailers like Amazon.com and Overstock.com every day. Those repeated in-state website visits would not create a business situs for such an online vendor's intellectual property in the state,²⁶⁴ but one *could* argue that the type of market presence established by those actions is the functional equivalent of a *Quill*-era physical presence. That is, one could argue that the Internet gives modern retailers access to remote markets that the *Quill* court could have assumed was only possible through a true physical presence. In this way, a retailer like Amazon.com could be considered to have the functional equivalent of a physical presence in states across the nation regardless of its true physical footprint. The functional-equivalency test read this broadly thus would pull Internet retailers within states' grasps without directly rejecting *Quill*.

This broad reading may appeal to state taxing authorities, but can the *KFC* decision be extended that far? The *KFC* case certainly seems to open the possibility for such a broad application of the functional-equivalency

264 The recognition of the establishment of a business situs for intangible property for tax purposes goes back to a series of cases from the turn of the twentieth century involving *ad valorem* taxes. See Michael T. Fatale, Geoffrey *Sidesteps Quill: Constitutional Nexus, Intangible Property and the State Taxation of Income*, 23 HOFSTRA L. REV. 407, 438 (1994); HELLERSTEIN, *supra* note 16, ¶ 9.03[3]. Those initial cases upheld the taxation of taxpayers who were not physically present in the taxing state but who held receivables attributable to businesses located within the state. Fatale, *supra* at 439-40. The Court reaffirmed this idea in *Wheeling Steel*, discussed above. *Wheeling Steel Corp. v. Fox*, 298 U.S. 193, 213-14 (1936). The *Wheeling Steel* court "recognize[d] the principle that choses in action may acquire a situs for taxation other than at the domicile of their owner, if they have become integral parts of some local business." *Id.* at 210 (quoting *Farmers' Loan & Trust Co. v. Minnesota*, 280 U.S. 204, 213 (1930)). The Court extended this concept to state income taxes in *Whitney*. As noted above, that case involved the imposition of New York income tax on the gain derived by an out-of-state individual who sold a fractional membership in the New York Stock Exchange. *New York ex rel. Whitney v. Graves*, 299 U.S. 366, 369 (1937). The taxpayer argued that New York could not tax him based solely on that interest, because it had a business situs in Massachusetts, where he engaged in business. *Id.* at 371-72. The court disagreed, explaining that:

When we speak of a "business situs" of intangible property in the taxing State we are indulging in a metaphor. We express the idea of localization by virtue of the attributes of the intangible right in relation to the conduct of affairs at a particular place. The right may grow out of the actual transactions of a localized business or the right may be identified with a particular place because the exercise of the right is fixed exclusively or dominantly at that place. In the latter case the localization for the purpose of transacting business may constitute a business situs quite as clearly as the conduct of the business itself.

Id. at 372. Applying this concept, the Court had no trouble in holding that the situs of the taxpayer's seat on the New York Stock Exchange was New York and upheld the New York tax. *Id.* at 372-74. The application of these business situs rulings to the Internet retailing industry would be a profound and inexplicable expansion upon that doctrine and is not discussed herein as a reasonable application of those rules.

test. Indeed, the court practically invites this result by diverging from a truly physical physical-presence test. The boundaries of the *KFC* court's functional-equivalency test are simply unclear and are thus prone to be extended until otherwise limited by the Supreme Court. This of course begs the question: Can *KFC* be construed as a valid extension of the physical-presence test, or must it be viewed as a rejection of the same?

C. *The Functional-Equivalency Test as a Repudiation of Quill*

The discussion above evidences the potentially broad applications of the *KFC* court's functional-equivalency test. Whether the test is limited to a business-situs analysis or is extended to encompass other types of market presences that are equivalent to a *Quill*-era physical presence, the test establishes a new avenue for states looking to expand their use tax enforcement powers. However broadly construed, the test's extension of *Quill* beyond its traditional scope widens the boundaries of the physical-presence test in ways not seen before. That very extension, however, serves to erode the legitimacy of that test. By moving beyond the physical realm, the test abandons the fundamental underpinnings of the physical-presence standard.

The Court's physical-presence test is a bright-line rule that is marked by a physical action—the actual physical presence of a taxpayer in the taxing state.²⁶⁵ The functional-equivalency test, if taken at its word, erases that bright line. Even if intellectual property can obtain a business situs or create a significant market presence in a state, it cannot physically manifest itself. Intellectual property is inherently, and necessarily, intangible and simply cannot be physically present in a state.²⁶⁶ Once the physical-presence test is extended to something that can be met through the use of intangible assets, the test is no more.²⁶⁷

265 Of course, this physical presence can be established though the presence of a taxpayer's independent contractors in the state. See *Scripto, Inc. v. Carson*, 362 U.S. 207, 211 (1960); *Tyler Pipe Indus., Inc. v. Wash. State Dept. of Revenue*, 483 U.S. 232, 250-51 (1987).

266 Indeed, the Supreme Court has already recognized this point, labeling intangibles as "relationships" that are "not related to physical things." HELLERSTEIN, *supra* note 16, ¶ 19.02[8][d] (quoting *Curry v. McCannless*, 307 U.S. 357, 365-66 (1939)). In a sense, this is no different than a corporation itself. A corporation, at some level, is nothing more than a grant of power from a state. A corporation is incorporeal and has no independent physical presence. One could thus question why attributing a physical presence based upon an intangible asset like a trademark would be such a novel extension of the physical-presence rule. After all, corporations are routinely accepted as having a physical presence.

This question simply obfuscates the issue. The legal right of incorporation does not have a physical presence. A corporation, as a taxpayer, however, can *obtain* a physical presence when it acts through physical means—its employees, property, or independent contractors. The same cannot be said for an intangible asset.

267 Indeed, Professor Hellerstein refers to the *KFC* court's physical-presence holding as "semantic nonsense" and labels the idea that intangible rights can create the functional

The test also fails to comport with the underlying principles of the Court's physical-presence jurisprudence. Nothing in the Court's decisions regarding sale and use taxes would support this move beyond a truly physical physical-presence test. The *Quill* Court adopted its bright-line rule in part to provide ease of administration and to reduce confusion.²⁶⁸ The Court viewed the test as providing a "clear rule" that firmly established the "boundaries of legitimate state authority."²⁶⁹ Nothing in this language supports an amorphous extension of the physical-presence test to take into account changed business or economic conditions. Such a reading would directly undermine the *Quill* court's non-stare decisis purposes for its decision. Thus, even if the *Quill* Court's ruling was based upon its notion of the limited market presence that could be obtained without a true physical presence, and even if the Internet has changed that economic reality, expanding the physical-presence test beyond its roots would be contrary to the Court's stated goals and purpose for that test.

This discussion leads one to the conclusion that the functional-equivalency test can be viewed only as a direct repudiation of *Quill*. Therefore, like the court's in-state-transaction rationale, the functional-equivalency doctrine must be evaluated in that light. That test simply cannot be valid as long as *Quill* stands.

Given this determination, the import of the *KFC* functional-equivalency test is uncertain unless and until the Court opines on that test. Until that time, the test will stand as a purportedly valid application of the physical-presence rule, and states are unlikely to abandon this new opportunity to expand their power. However, the test presents a quandary for state tax authorities—it has utility only as long as *Quill* stands, but it cannot be squared with that case. States hoping to utilize the functional-equivalency test therefore must be prepared to explain how it can co-exist with *Quill*. On the other side, taxpayers against whom a functional-equivalency argument is raised must provide adequate counsel to the reviewing court regarding the test's true consequence. State courts sympathetic to their states' revenue plights may view the test as a method of paying lip service to *Quill* while avoiding a direct disapproval of that case. Only time (or Supreme Court intervention) will tell whether and how successful the functional-equivalency test may be in extending state sales- and use-tax jurisdiction beyond its traditional roots.

equivalent of a physical presence an "oxymoronic suggestion." HELLERSTEIN, *supra* note 16, ¶ 6.11[3][a][xvii]. He offers the same unabashed critique of the *Kmart* decision. *Id.* ¶ 19.02[8][d] ("All of this is nonsense, and irrelevant nonsense, to boot. It is nonsense because intangibles, by definition, have no physical presence *anywhere*.").

268 *Quill Corp. v. North Dakota*, 504 U.S. 298, 314-16 (1992).

269 *Id.* at 315.

V. EPILOGUE: IN DEFENSE OF A DOCTRINE

The preceding discussion has evidenced the various pressures that states have placed on *Quill*'s physical-presence test in recent years. Oklahoma's direct rejection of that test, coupled with the *KFC* court's effective repudiation, signals a shift in the battle over *Quill*'s continuing validity from the income-tax realm into that test's heart—state sales and use tax. These actions raise a very simple question of Constitutional law: Is *Quill* still good law? Although this Article is not directed towards a full defense or condemnation of that case, some closing comments are warranted.

From a simplistic standpoint, *Quill* certainly still stands. The Court has offered no indication that it is interested in reviewing that decision, and it seems content to rely on Congress to make any changes that it deems warranted. However, it seems likely that one or more state revenue authorities emboldened by the Court's denials of *certiorari* in several high-profile income-tax cases will simply take North Dakota's approach after *National Bellas Hess* and self-declare the death of the physical-presence test. Oklahoma certainly has made the first move in this regard with its legislative declaration of *Quill*'s inapplicability. As a conceptual matter, then, is there any reason to believe that *Quill* is no longer valid?

A. A Modern Critique of *Quill*

Professor John Swain has been at the forefront of the modern calls to abandon *Quill* on both normative²⁷⁰ and positive²⁷¹ grounds. His positive critique centers around three categories of analysis in *Quill* that he has labeled the "Three Faces of *Quill*."²⁷² These include the "Stare Decisis *Quill*," the "Burdens *Quill*," and the "Disappearing Ink *Quill*."²⁷³ Stare Decisis *Quill* refers, of course, to the Court's reliance on *stare decisis* in its ruling. Burdens *Quill* refers to the Court's focus on the burdens that broadly applied sales and use taxes could have on interstate commerce. Disappearing Ink *Quill* refers to the Court's recognition it was not yet ready to repeal the physical-presence rule and that Congress was ultimately able to alter the Court's result by exercising its affirmative power over interstate commerce.

Professor Swain notes significant degradation of each of these faces of *Quill*.²⁷⁴ With respect to Stare Decisis *Quill*, he cautions that "[t]he Court

²⁷⁰ See Swain, *supra* note 177, at 351-55.

²⁷¹ John A. Swain, *State Income Tax Jurisdiction: A Jurisprudential and Policy Perspective*, 45 WM. & MARY L. REV. 319, 331-44 (2003).

²⁷² *Id.* at 337-44.

²⁷³ *Id.* at 338-44.

²⁷⁴ See Swain, *supra* note 177, at 358-65.

may have given too much weight to the pragmatic factors.”²⁷⁵ He questions whether the mail-order industry (and by extension the Internet retail industry) really has a “reasonable reliance interest” on a result that places it at an advantage to in-state competitors.²⁷⁶ He also compares the benefits that the rule provides to the “countervailing burdens” that it imposes on state and local governments, particularly noting the assumed competitive disadvantage that it creates for local merchants, its reduction in state tax revenues, and its impact on the “overall efficiency of the national economy.”²⁷⁷

Professor Swain limits *Burdens Quill* to a concern about the compliance burdens placed on low-volume sellers who have contacts with many states.²⁷⁸ He thus indicates that uniformity efforts like the SSUTA could obviate the physical-presence standard.²⁷⁹ Indeed, he argues not only that the SSUTA erodes the *stare decisis* rationale of *Quill*, but that it “remedies *Quill*’s compliance burden concerning the only substantive legal leg of the *Quill* decision.”²⁸⁰

Finally, Professor Swain notes that the passage of time, coupled with the accelerated rate of change in society, “ha[ve] made geography and physical presence irrelevant in ways that could not have been contemplated by the *Quill* court.”²⁸¹ Disappearing Ink *Quill* then would counsel towards a judicial reevaluation of the doctrine, which he labels simply as “a relic of [a] bygone era.”²⁸²

As to not leave the wrong impression, Professor Swain has indicated that he believes that Congress, rather than the courts, should address these issues.²⁸³ However, his critique of *Quill* would certainly be used by any state leading the charge to overturn that case in a judicial forum.

B. Turning the Other Cheek

Professor Swain’s assessment of *Quill*’s ongoing relevance is well-taken,

²⁷⁵ *Id.* at 360.

²⁷⁶ *Id.*

²⁷⁷ *Id.*

²⁷⁸ *Id.* at 361-63 (“Though not clearly stated, the Court’s burdens concern seems to be that businesses with low volume contacts with multiple states may have costs of compliance that are excessive in comparison to the amount of business done in those states and to the taxes that would be collected.”).

²⁷⁹ *Id.* at 363-64.

²⁸⁰ *Id.* at 383.

²⁸¹ *Id.* at 365.

²⁸² *Id.* at 392.

²⁸³ *Id.* at 369-70 (“Regarding a frontal judicial assault on *Quill*, however, states might be wise to withhold their hand, ‘at least for now’ . . .”); John A. Swain & Walter Hellerstein, *Town Fair Tire and the Silliness of the Physical Presence Rule for Use Tax Collection Nexus*, 50 STATE TAX NOTES 447, 450-51 (2008).

but is not without room for debate. The three faces of *Quill* may not always be pretty, but in many ways they have not changed in material fashion since *Quill* was decided. Therefore, a response to the analysis offered above is warranted.²⁸⁴

1. *Stare Decisis*.—The *Quill* court's *stare decisis* rationale was undoubtedly a major factor in its determination to uphold *National Bellas Hess*. Indeed, the Court recognized that it might not have adopted the physical-presence test if it were then being asked to do so for the first time.²⁸⁵ Professor Swain critiques the Court's reliance on *stare decisis* in part by critiquing its focus on pragmatic factors, questioning whether taxpayers' reliance on *National Bellas Hess* is reasonable given the advantage that it gives to remote vendors.²⁸⁶

Absent normative appeals, it is difficult to accept this critique as a sufficient dismissal of the Court's *stare decisis* rationale. Justice Scalia's concurrence in *Quill* is particularly instructive on this point. Justice Scalia first addressed the *stare decisis* issue by noting that the Court has "long recognized that the doctrine of *stare decisis* has 'special force' where 'Congress remains free to alter what we have done.'"²⁸⁷ Justice Scalia then noted that the Court could not disregard reliance interests on *National Bellas Hess* merely by arguing that its protection for remote vendors had become "unreasonable."²⁸⁸ Instead, he cautioned that the Court should not inflict "economic hardship upon those who took [the Court] at [its] word" and cautioned that taxpayers should not have to "anticipate [its] overrulings."²⁸⁹ Justice Scalia's opinion was that "reliance upon a square, unabandoned holding of the Supreme Court is *always* justifiable reliance."²⁹⁰

Justice Scalia's point is more than fair. Businesses should not have the burden of doing equity analyses when making determinations regarding their tax duties. Apparent (or perceived) unfairness that results from a Supreme Court decision is a concern for policy makers, not for taxpayers wrestling with compliance burdens in a multitude of commercial areas. The latter group (and their tax advisors) must rely on stated law, communicate that law to administrative personnel, and proceed with the conduct of their

284 This analysis is particularly important at this juncture with states seeking to challenge *Quill* on positive grounds rather than waiting for reprieve from the Court or Congress.

285 *Quill Corp. v. North Dakota*, 504 U.S. 298, 311 (1992).

286 See, e.g., Swain, *supra* note 177, at 359-60.

287 *Quill*, 504 U.S. at 320 (Scalia, J., concurring in part and concurring in the judgment) (quoting *Patterson v. McLean Credit Union*, 491 U.S. 164, 172-73 (1989)). This was a direct nod to the Court's invitation for Congress to act on this issue.

288 *Id.*

289 *Id.*

290 *Id.*

business.²⁹¹ As Professor Hellerstein has noted, it is “a *constitution* we are expounding,”²⁹² and different protections for different industries is not the norm—even if one industry benefits (or is perceived to benefit) more than another.

For these reasons, retailers’ reliance interests on *Quill* stand on firm ground (even if the theoretical basis for the physical-presence rule does not). The remedy, then, is not for the Court to determine that the Commerce Clause has shifted such that it no longer provides protection to remote vendors; it is to compel Congressional action setting forth a prospective rule after due debate and deliberation.²⁹³ That assumes, of course, that such action is deemed desirable.

Professor Swain also criticizes the *Stare Decisis Quill* by pointing to the burdens that the physical-presence test imposes on states—providing a competitive disadvantage to in-state merchants, reducing state tax collections, and impacting overall economic efficiency.²⁹⁴ This analysis adequately highlights the difficulties that states encounter when remote vendors do not collect their sales or use taxes on transactions with customers in their states. However, each of those ills is only *indirectly* attributable to the physical-presence test. The inability of a state to collect its use tax from a remote vendor does not have any impact on the imposition of that tax. The use tax is fundamentally and directly a tax on the in-state consumer. That tax is due regardless of whether the remote vendor collects the tax. Any competitive disadvantage, reduced tax revenue, or inefficiencies are thus caused first and foremost by consumer noncompliance in reporting and paying that tax.²⁹⁵

Admittedly, this analysis presents a pristine view of the universe. In actuality, use-tax compliance is very low and it is much simpler for a state to collect its use tax from merchants rather than from the merchants’

291 Of course, to discount the *stare decisis* effect based upon a viewpoint of what taxpayers should have viewed as fair begs the question of fairness itself.

292 HELLERSTEIN, *supra* note 16, ¶ 6.02[2] (citing *McCulloch v. Maryland*, 17 U.S. (4 Wheat.) 316, 407 (1819) (emphasis in original)).

293 For more on this point, see Arthur R. Rosen & Matthew P. Hedstrom, *Quill—Stare at the Decision*, 60 STATE TAX NOTES 931, 931–36 (2011) (providing a vigorous defense of *Quill*’s *stare decisis* rationale and urging that any action will (and should) be taken by Congress and not the Court). See also Edward A. Zelinsky, *The Siren Song of ‘Amazon’ Laws: The Colorado Example*, 59 STATE TAX NOTES 695, 695 (2011).

294 Swain, *supra* note 177, at 360–61.

295 It is also too simple to distill a competitive advantage down to these tax-collection requirements. Brick-and-mortar operations and Internet retailers each have advantages and disadvantages over the other. Just as Internet retailers may benefit by lower tax compliance burdens, they suffer from slower access to consumers, shipping delays and costs, and the lack of a local presence for customer service and advertising purposes. Attributing an absolute competitive advantage to remote vendors based on sales tax preferences ignores the wide variety of market factors at play. Local and Internet retailing are not on equal planes but for sale and use taxes.

multitudes of customers. However, increased difficulty of administration does not change the fundamental issues facing states—consumer ignorance about, and noncompliance with, their use-tax duties. The plight of state revenue authorities in attempting to promote compliance is noteworthy and unfortunate, but the negative effects that it creates should not be attributed to the physical-presence test. Constitutional protections routinely require government to seek out less efficient means for enforcing its laws.²⁹⁶ Good administrative and tax policy do not automatically trump Constitutional policy.

2. *Undue Burdens*.—Professor Swain limits *Burdens Quill* to a concern about small retailers²⁹⁷ who have limited contacts with many states.²⁹⁸ However, as Professor Swain recognizes, this concern is not actually stated by the Court.²⁹⁹ It could be equally true that the Court was concerned that *any* burden on remote vendors (whether large or small) was undue.

The nearest that the *Quill* Court came to discussing its concerns in this area was in footnote six of its decision.³⁰⁰ That footnote discussed the potential burdens that use-tax collection requirements *could* have on interstate commerce if they applied to taxpayers with little contact with a state. However, the Court did not indicate that its burdens analysis was limited to such taxpayers. The Court followed footnote six with a discussion of the evolution of its Commerce Clause decisions, but held that “[u]ndue burdens on interstate commerce may be avoided not only by a case-by-case evaluation of the actual burdens imposed by particular regulations or taxes, but also, in some situations, by the demarcation of a discrete realm of commercial activity that is free from interstate taxation.”³⁰¹ This is not language lamenting burdens on particular taxpayers, but language more akin to a determination that any burden may be “undue” in this realm.

296 Take, for example, the Fourth Amendment’s prohibitions on unreasonable searches or seizures or the Fifth Amendment’s protection from self-incrimination or its requirement of Due Process. Each of those provisions requires states to seek less efficient means for enforcing their laws than may otherwise be available. However, those burdens are not sufficient to justify a retreat from the fundamental Constitutional protections that are their cause. This is not to say that the Constitutional protection should be free from debate, but that the debate is not settled by focusing on the burdens that a Constitutional protection may place on states.

297 For purposes of this discussion, references to “small” or “large” retailers refer only to the magnitude of such retailers’ commercial connections to a state, not the overall size of their enterprises.

298 Swain, *supra* note 177, at 363.

299 *Id.* (“*Though not clearly stated*, the Court’s burdens concern seems to be that businesses with low volume contacts with multiple states may have costs of compliance that are excessive in comparison to the amount of business done in those states and to the taxes that would be collected.” (emphasis added)).

300 See *Quill Corp. v. North Dakota*, 504 U.S. 298, 313 n.6 (1992).

301 *Quill*, 504 U.S. at 314–15.

The Court's additional analysis provides more of the same. The Court followed its burdens discussion by addressing the artificiality of its bright-line rule and explaining that the artificiality was "more than offset by the benefits of a clear rule" (i.e., "firmly establish[ing] the boundaries of . . . state authority," "encourag[ing] settled expectations," and "foster[ing] investment").³⁰² The Court then discussed the benefits of settled expectations before concluding its analysis. Nowhere in this additional analysis did the Court indicate a concern for small retailers over large retailers. Rather, the Court adopted a position where *any* burden is undue where the burdened party is an out-of-state taxpayer without a physical presence in the taxing state. Thus, even if the Court was concerned about small retailers, nothing in its opinion tips its hand to that effect.³⁰³ This reading of *Quill* may not produce a result that matches up with contemporary normative beliefs about tax policy, but it is more supported on the face of *Quill* than a reading that limits the *Quill* Court's analysis to an expression of concern for small retailers.³⁰⁴

Professor Swain also refers gently to the improvements made by the SSUTA in his Burdens *Quill* analysis. The Oklahoma legislature and the Streamlined Sales and Use Tax Governing Board have been much more aggressive on that front.³⁰⁵ One should not downplay the SSUTA and the uniformity that it has brought. However, in a similar vein, those efforts should not be oversold. True, twenty-four states have adopted its basic structure. Compared to the state of the law in 1992, this is an impressive feat. Using 1992 as the benchmark, however, misplaces the argument. Even if some uniformity has been achieved, current law provides little comfort to multistate enterprises. The Streamlined Sales and Use Tax Governing Board itself recognizes that its member states represent just

³⁰² *Id.* at 315-16. The Court also pointed to the rule as assisting in the growth of the mail-order industry between *National Bellas Hess* and *Quill*. This rationale applies equally today to the Internet retailing industry. The simplified system of tax collection begot by the physical-presence rule has made it possible to quickly and efficiently do business through electronic means without worrying about the multiplicity of state rules and regulations attached to sales and use tax compliance.

³⁰³ Of course, the opinion can be read that way if one assumes that such a concern would be the only way for the Court to have come to its conclusion. The problem with that analysis is that it rests upon an initial determination that large retailers are not unduly burdened by a nexus standard other than physical-presence. That conclusion may be accurate, but it is not the Court's.

³⁰⁴ Even if the Court did not intend that any burdens were undue where a retailer did not have a physical presence, a focus on "small" retailers would be too much of an exercise in relativity. The burdens of multistate tax compliance are very real even for large retailers. It is no small relief to such taxpayers to say that those costs are dwarfed by their sales or activities, especially where those sales or activities do not necessarily translate to a higher level of profitability.

³⁰⁵ See *supra* text accompanying note 171.

a third of the population of the United States.³⁰⁶ Major population and commercial centers, including New York, California, Illinois, and Texas are non-members.³⁰⁷ Further, even a state's status as a signatory to the SSUTA does not mean that its laws are fully uniform with other SSUTA members' laws. Taxpayers still must evaluate each state's laws to determine whether and where they differ from the SSUTA norm.

The reality is that the SSUTA does not yet provide the great sense of uniformity and simplicity that both states and taxpayers would hope. Further, mere improvement from 1992 simply does not appear sufficient to claim that the current-day structure provides relief from the concerns noted by the *Quill* Court. Perhaps someday the SSUTA will achieve such wide and uniform adoption that its proponents can truly argue that the project has made multistate compliance constitutionally insignificant. Until then, the arguments based on simplification and uniformity are weakened in the face of the current state of affairs in sales and use taxation.

As a final point with respect to Burdens *Quill*, the Court was not blind to the rule's artificiality.³⁰⁸ Indeed, as discussed above, the Court noted that such artificiality was "more than offset by the benefits of a clear rule" (i.e., "firmly establish[ing] boundaries of . . . state authority", "encourag[ing] settled expectations", and "foster[ing] investment").³⁰⁹ None of those benefits have changed since *Quill*. Abandoning that bright-line rule would therefore sacrifice those benefits in exchange for a facts-and-circumstances test requiring a quantitative analysis that courts are poorly suited to adopt or apply.³¹⁰ Such a test would thus leave room for the controversy and confusion that the *Quill* Court purposefully prevented with its adoption of the physical-presence test.³¹¹ This factor also counsels towards Congressional action rather than state-driven change.

3. *Passage of Time.*—The passage of time has undoubtedly changed the economic realities present when the *Quill* court reaffirmed the physical-

306 *Frequently Asked Questions*, *supra* note 181.

307 Conforming legislation has been introduced in Illinois and Texas, among other states. *Id.*

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

309 *Id.* at 315-16.

310 In this regard, see Swain, *supra* note 177, at 364.

311 *Quill*, 504 U.S. at 315-16. To say that the physical-presence test has prevented controversy or confusion does not mean that it has prevented *all* controversy or confusion. The physical-presence rule only prevents litigation on one side (i.e., taxpayers without a physical presence). See *supra* note 83. Litigation has continued with respect to taxpayers who had only a minimal physical presence in the taxing state. See HELLERSTEIN, *supra* note 16, ¶ 19.02[5] [a]; Laskin, *supra* note 109, at 11 n.46. However, this continued litigation does not negate the value that the test has provided. For each controversy that has occurred regarding minimal physical presence, countless others regarding economic presence may have been avoided. A useful prevention tool is useful even if it does not prevent all controversy.

presence test. This factor, along with Congress's inaction since that case was decided, may give reason for the Court to offer its hand at this time.³¹² Consider, however, that taxpayers would equally argue that Congress's continued inaction (coupled with the lively debate regarding this test) could counsel towards a continued adherence to the physical-presence test unless Congress intervenes. That may be preferable, as well, because the test has taken on a political overtone at this point and may be a matter for legislative action.

As a final point, none of the reasons presented as justifications for *Quill*'s rejection (other than perhaps the uniformity efforts of the SSUTA) are particularly different than the arguments addressed by the *Quill* court. Indeed, one could see the same decision, with the same rationale, being issued today under a different name. The North Dakota Supreme Court's references to "the tremendous social, economic, commercial, and legal innovations" since *National Bellas Hess*³¹³ are no different than the arguments presented for *Quill*'s demise today. Disappearing Ink *Quill* thus has the same significance as its brethren and further indicates that the continued viability of *Quill* is properly addressed by Congress, not the courts.

CONCLUSION

The physical-presence test currently is under immense pressure from many directions. State fiscal crises have magnified the issues created by the sales and use tax gap. States thus are seeking new ways to extend their enforcement powers, while, in most cases, abiding by the Supreme Court's physical-presence mandate. The Iowa Supreme Court's decision in *KFC* offers an interesting view into how such an extension might take shape. Ultimately, however, that expansion should be seen as nothing more than a rejection of *Quill*.

Never before has the United States Supreme Court determined that a state could impose a use-tax collection obligation on a vendor without an actual physical presence in the taxing state. This standard has suffered from erosion in the context of state income taxes and has been clarified with respect to the use of in-state agents, but has not been eroded to the point determined by the *KFC* court. *Quill* stands today as it stood in 1992—a bright-line rule that is inherently arbitrary, decreases litigation, increases investment, and provides settled expectations. Recent state frustration with changes to the marketplace and the difficulty faced by states in trying to collect use tax from those who are clearly responsible for that tax do not change this fundamental doctrine.

³¹² Recall that the *Quill* court noted only that it would withhold its hand "for now." *Quill*, 504 U.S. at 318.

³¹³ *State v. Quill*, 470 N.W.2d 203, 208 (N.D. 1991).

All of this is not to say that the physical-presence test is conceptually the “right” answer or the answer that is the most intellectually satisfying. The rule is both under-inclusive and over-inclusive, and admittedly suffers from defect. The question of its legitimacy, however, has been determined by the Court. Unless and until Congress acts to either affirm or reject that test, *Quill*’s bright-line test should continue to shine.

