Constitutional Limitations on States' Power to Tax Internet Vendors

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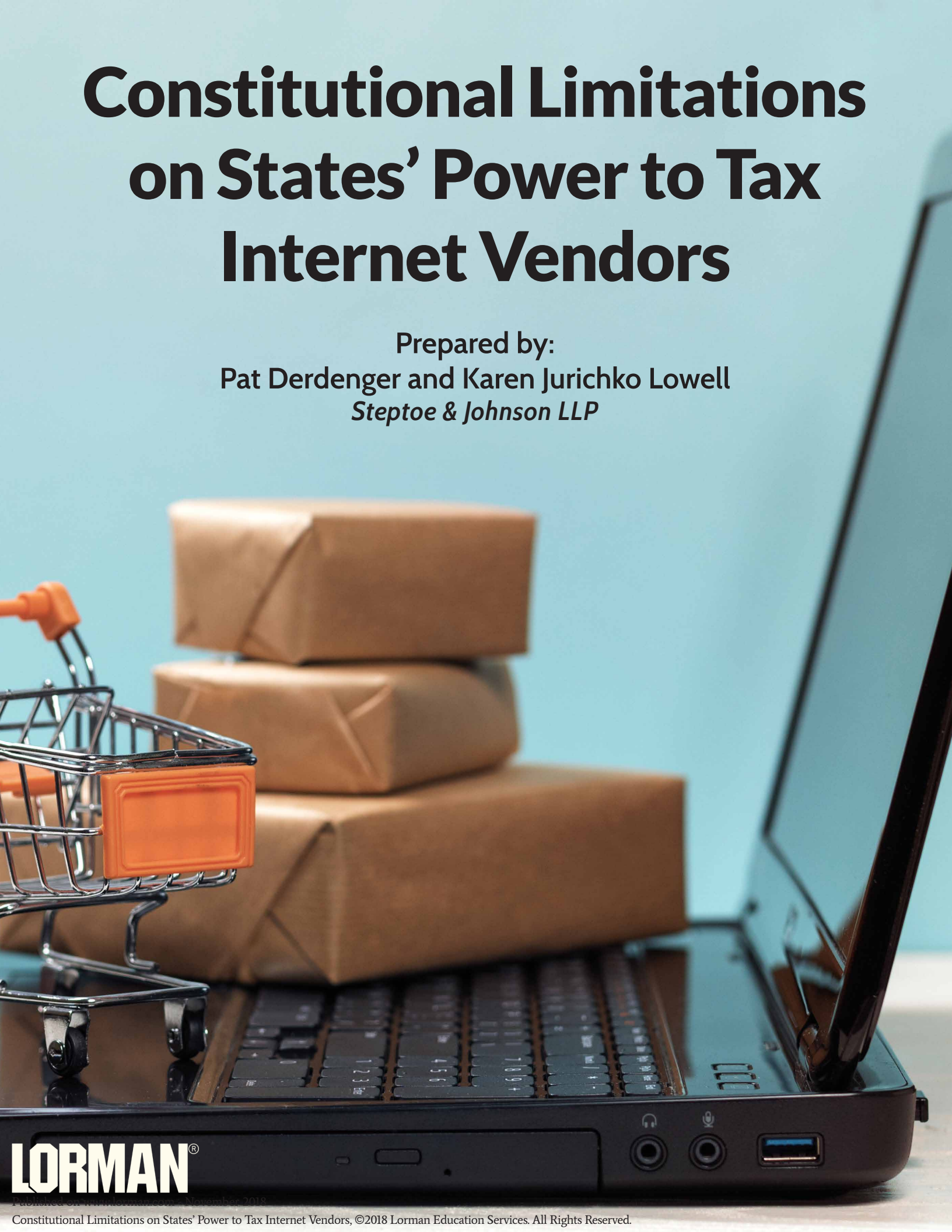

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Constitutional Limitations on States' Power to Tax Internet Vendors

Both the Due Process Clause and the Commerce Clause of the United States Constitution limit the state's power to impose sales taxes or a use tax collection obligation on an out-of-state vendor, including an internet vendor. Both of these constitutional limitations come into play, in the main, when dealing with interstate sale transactions, and limit a state's ability to impose a sales tax or use tax collection duty on an interstate sale transaction.

1.1 The Due Process Clause – Actual Physical Presence Not Needed.

Section 1 of the Fourteenth Amendment to the United States Constitution provides that … "[n]o State shall … deprive any person of life, liberty or property, without due process of law." The Due Process Clause "requires some definite link, some minimum connection between a state and the person, property or transaction it seeks to tax." *Miller Brothers Co. v. Maryland* , 74 S. Ct. 535, 539 (1954). This "definite link" or "minimum connection" is referred to generally as "nexus." The focus of most cases in this area has been to determine what set of factual circumstances satisfies the requirement of that "definite link" or "minimum connection."

The Due Process Clause applies not just to tax cases, but to other situations as well, and particularly to the question of when a state has personal jurisdiction over an out-of-state defendant for purposes of maintaining a suit in that state. One of the leading Due

Process Clause cases arose in this context. In *International Shoe Co. v. Washington*, 326 U.S. 310 (1945), the United States Supreme Court dealt with the question of what contact an out-of-state defendant needed with the state for purposes of the states' asserting personal jurisdiction over that out-of-state defendant. The inquiry as framed by the Supreme Court is whether the defendant had minimum contacts with the jurisdiction "such that the maintenance of the suit does not offend traditional notions of fair play and substantial justice." The test dealing with personal jurisdiction has evolved from requiring the defendant to have a "presence" in the foreign state to a more flexible test of whether a person's contacts with the foreign state make it reasonable to require it to defend a suit there. *See State and Local Taxation Second Edition*, Vol. 1, Pomp and Oldman, page 299.

When it comes to taxation, "the controlling question is whether the state has given anything for which it can ask in return." *Wisconsin v. J. C. Penney Co.*, 311 U.S. 435 (1940).

In *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), the United States Supreme Court was faced with an out-of-state mail order retailer making mail order sales into North Dakota, and the obligation of the out-of-state retailer to collect the destination state's use tax. North Dakota imposed that use tax collection obligation on Quill and Quill challenged the state on both due process and Commerce Clause grounds. On the due process side, the Supreme Court essentially applied its approach to personal jurisdiction cases to the use tax collection obligation. The Court stated "if a foreign corporation purposely avails itself of the benefits of an economic market in the foreign State, it may subject itself to the State's personal jurisdiction even if it has no physical presence in the State." *Id.* at 307. The Court

further stated that "it is an escapable fact of modern commercial life that a substantial amount of business is transacted solely by mail and wire communication across the state lines, thus obviating the need for physical presence within a State in which business is conducted." *Id.* at 308, quoting *Burger King Corp. v. Rudzewicz*, 471 U.S. 462, 476 (1985). The Court then went on to conclude that "[c]omparable reasoning justifies the imposition of the collection duty on a mail-order house that is engaged in continuous and widespread solicitation of business within a State." *Id.* at 308.

In so holding, the United States Supreme Court concluded that actual physical presence in a state was not necessary to satisfy Due Process Clause concerns. Rather, the economic exploitation of the market state, by an out-of-state retailer, is sufficient. Thus, under the Due Process Clause alone, an out-of-state mail-order retailer with no physical presence in the destination state would be required to collect that destination state's use tax, as long as it was "engaged in continuous and widespread solicitation of business within" that state.

As will be noted, the *Quill* court concluded that something more than the "slightest physical presence" is still needed to satisfy the nexus concerns of the Commerce Clause. As a result, the nexus focus for tax cases is now on the Commerce Clause.

1.2 Commerce Clause – Actual Physical Presence Required.

Cl. 3, section 8, article 1 of the United States Constitution provides that "the Congress shall have the power … to regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes." The focus or concern of the Commerce Clause is on the effects of state regulation on the national economy. The

power to regulate commerce between and among the states was left with the Congress, and not with the individual states. While the Commerce Clause does not, by its own wording, expressly protect interstate commerce, the United States Supreme Court has held that the Commerce Clause "by its own force prohibits certain state actions that interfere with interstate commerce." *Quill* at 304, *citing South Carolina State Highway Dept. v. Barnwell Brothers, Inc.*, 303 U.S. 177 (1938). This facet of the Commerce Clause is called the "negative" or the "dormant" Commerce Clause.

1.3 The Evolution of the Dormant Commerce Clause.

The dormant Commerce Clause has evolved over the years. There have been three significant tests or evolutions:

No tax on interstate commerce. The initial interpretation of the dormant Commerce Clause was that no state has the right to lay a tax on interstate commerce in any form. *Leloup v. Port of Mobile,* 127 U.S. 640 (1888); *Brown v. Maryland*, 25 U.S. 419 (1827).

No <u>direct</u> tax on interstate commerce. The flat prohibition against a tax in any form on interstate commerce was liberalized and evolved into the interpretation that no state has the right to lay a *<u>direct</u>* tax on interstate commerce. *Spector Motor Service v. O'Connor*, 340 U.S. 602 (1951); *Freeman v. Hewit,* 329 U.S. 249 (1947). This distinction between a direct tax on interstate commerce and a prohibition on a tax in any form allowed an indirect tax such as a franchise tax on interstate sales.

States have the right to tax interstate commerce if a four-prong test is met. The most recent evolution of the Commerce Clause is found in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274

(1977). In that case, the Supreme Court specifically overruled *Spector Motor Service*, and held that all states have the right to lay a tax on interstate commerce so long as the tax:

1. Is applied to an activity with substantial nexus with the taxing state,

2. Is fairly apportioned,

3. Does not discriminate against interstate commerce, and

4. Is fairly related to the services provided by the state.

This four prong test is generally referred to as the *Complete Auto* test.

In *Goldberg v. Sweet*, 488 U.S. 252 (1989), the United States Supreme Court applied the four prong *Complete Auto* test to Illinois' imposition of a sales tax on interstate phone calls. The Court went through each prong, analyzed it in view of the interstate telecommunications tax in question, and concluded that the Illinois tax, under the four prong test of *Complete Auto,* did not violate the Commerce Clause. *Goldberg* is one of the more recent and substantial cases dealing with the application of the four part *Complete Auto* test.

1.4 The Nexus Component of the Four Part Complete Auto Test – "Substantial Nexus."

The first prong of the *Complete Auto* test requires "substantial nexus" between the taxing state and the activity being taxed. That substantial nexus test must be satisfied before a tax will be found to not violate the dormant Commerce Clause. Following is the case law development of that "substantial nexus" test in the mail-order retailer and use tax collection context.

A. *National Bellas Hess* – Physical Presence Required.

In *National Bellas Hess, Inc. v. Department of Revenue*, 386 U.S. 753 (1967), the United States Supreme Court was faced with the issue of what constituted sufficient nexus for a destination state to require an out-of-state mail-order vendor to collect use tax on mail-order sales made into the state. National Bellas Hess was a mail-order company with no offices, warehouses or distribution centers in Illinois. It had no employees, salesmen or agents in the state, nor did National Bellas Hess have any tangible personal property or real property located in the state. It had no telephone listing in Illinois and did not advertise its products on Illinois television, radio, billboards, or in Illinois newspapers. The only contact National Bellas Hess had with Illinois was its mailings of catalogs and advertising fliers into the state through the U.S. mail common carrier.

Illinois imposed the use tax collection duty on National Bellas Hess for its Illinois mail-order sales. National Bellas Hess challenged that tax under both the due process and Commerce Clauses, focusing on the nexus requirement. The Supreme Court relied on the Commerce Clause and held:

> Indeed, it is difficult to conceive of commercial transactions more exclusively interstate in character than the mail-order transactions here involved. And if the power of Illinois to impose use tax burdens upon National were upheld, the resulting impediments upon the free conduct of the 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 virtual welter of complicated obligations to local jurisdictions with no legitimate claim to impose a fair share of the cost of the local government.

386 U.S. at 759.

With that as background, the court established a bright line, physical presence test:

> In order to uphold the power of Illinois to impose use tax burdens on National in this case, we would have to repudiate totally the sharp distinction which these and other decisions have drawn between mail-order sellers with retail outlets, solicitors, or property within a State [physical presence], and those who do no more than communicate with customers in the State by mail or common carrier as part of a general interstate business. But this basic distinction, which until now has been generally recognized by the state taxing

> authorities, is a valid one, and we decline to obliterate it.

386 U.S. at 758.

The *National Bellas Hess* rule is quite simply that the Commerce Clause prohibits states from imposing the use tax collection duty on an out-of-state mail-order retailer that does not have any physical presence in the state.

B. The Quill Case – Upholds National Bellas Hess On The Commerce Clause Analysis.

Quill Corp. v. North Dakota, 504 U.S. 298 (1992) was a re-run of *National Bellas Hess.* The facts were essentially the same and both involved mail-order retailers with no physical presence in the destination state, making mail-order sales into that state.

In *Quill,* North Dakota imposed its use tax collection duty on Quill, an out-of-state mail-order of office products. The North Dakota Supreme Court upheld the use tax collection obligation and the U.S. Supreme Court granted certiorari (took review). Both the due process and Commerce Clauses were at issue in *Quill* as they were in *National Bellas Hess*. The *Quill* court distinguished the two clauses, recognizing the distinctions between the two.

For Due Process Clause purposes, the court referred to *Miller Brothers* and reaffirmed that the Due Process Clause requires a definite link or minimum connection between the state and the person it seeks to tax. However, the court observed that its due process analysis in the area of personal jurisdiction had evolved over the recent years and that formalistic tests focusing on a defendant's

physical presence in the state had been relaxed in favor of a broader analysis of all of the defendants contacts with the state to determine whether jurisdiction was reasonable under the circumstances. The court held that under the evolution of the Due Process Clause, physical presence was not necessary in order to satisfy the due process nexus requirement:

> Thus, to the extent that our decisions have indicated that the Due Process Clause requires physical presence in a State for the imposition of a duty to collect a use tax, we overrule those holdings as superseded by developments in the law of due process.
>
> In this case, there is no question that *Quill* has purposely directed its activities at North Dakota residents, that the magnitude of those contacts are more than sufficient for due process purposes, and that the use taxes related to the benefits *Quill* receives from access to the State. We therefore agree with the North Dakota Supreme Court's conclusion that the Due Process Clause does not bar enforcement of that state's use tax against *Quill*.

504 U.S. at 308.

On the Commerce Clause side, the Court reaffirmed the four part test of *Complete Auto*, and that test continues to govern the validity of

a state's ability to tax interstate commerce under the Commerce Clause.

As previously noted, the first prong of the *Complete Auto* test is that there be substantial nexus between the activity being taxed and the state. The United States Supreme Court recognized that an out-of-state seller, such as Quill, could satisfy the much lower standard of the Due Process Clause of "minimum contacts", without also satisfying the more rigorous test of the Commerce Clause of "substantial nexus." The Court then reaffirmed the physical presence test for the Commerce Clause:

> In sum, although in our cases subsequent to *Bellas Hess* and concerning other types of taxes we have not adopted a similar bright-line, physical-presence requirement, our reasoning in those cases does not compel that we now reject the rule that *Bellas Hess* established in the area of sales and use taxes. To the contrary, the continuing value of a black line rule in this area and the doctrine and principles of *stare decisis* indicate that the *Bellas Hess* rule remains good law. For these reasons, we disagree with the North Dakota Supreme Court's conclusion that the time has come to renounce the bright-line test of *Bellas Hess*.

504 U.S. at 317-318.

It should be noted that the Supreme Court commented that there is no constitutional bar to congressional legislation in this area, since the Commerce Clause relegates to Congress the power to regulate interstate commerce. Thus, Congress could pass legislation establishing a lower threshold for use tax collection than physical presence. Such congressional legislation has been introduced over the past several years, but there has been no real agreement between the mail-order industry and states over the particulars of such a congressional test. At this juncture, such legislation has not been passed.

C. *South Dakota v. Wayfair* – What Will Become of the Physical Presence Standard?

In 2015 the United States Supreme Court's Justice Anthony Kennedy urged the legal community to revisit the physical presence requirement of *Quill* and *National Bellas Hess* in light of the rise in e-commerce and sales over the internet. In *Direct Marketing Ass'n. v. Brohl*, 575 U.S. _____, 135 S.Ct. 1124 (2015), Justice Kennedy noted the "continuing injustice" and "extreme harm and unfairness" faced by states because of *Bellas Hess* and *Quill* and asked the legal system to "find an appropriate case for this Court" to reexamine the holdings in those cases.

In response to Justice Kennedy's call to action, states enacted a number of nexus laws specifically designed to test the validity of *Quill*'s physical presence standard (for a detailed discussion of these legislative initiatives, see Section 5, below). In particular, South Dakota's S.B. 106, adopted March 22, 2016, included a provision to fast-track legislation with the express goal of getting the law before the US Supreme Court. On January 12, 2018, the Supreme Court

accepted review in *South Dakota v. Wayfair, Inc. et al*, No. 17-494. Oral arguments are scheduled for April 17, 2018.

1.5 The Physical Presence Test – How Much Is Required.

The focus or inquiry of the cases since *Quill*, is how much physical presence in a state is required for "substantial nexus", and use tax collection. There are two schools of thought on this question.

A. Any Physical Presence.

The first view is that "any" physical presence in the state, that does not constitute a de minimis connection is sufficient for "substantial nexus." *Quill's* reference to the bright-line test as creating "a safe harbor for vendors whose only connection with customers in the State is by common carrier or the United States mail" (504 U.S. at 315) is the basis of this view; the converse of such a statement is that *any* physical presence in the state would be sufficient.

B. More Than Slightest Physical Presence.

The other, and, this author believes, better view is that "substantial nexus" requires some type of ongoing physical presence in the state, which is more than the "slightest physical presence." *Quill* rejected the "slightest physical presence" standard in *National Geographic Society v. California Board of Equalization,* 430 U.S. 551 (1977). If the "slightest presence" standard was rejected by *Quill*, doesn't physical presence require something more than "slightest physical presence?" This view is also supported by the language in *Quill* that "whether or not a state may compel a vendor to collect a sales or use tax may turn on the presence in the taxing state of a small sales force, plant or office." 504 U.S. at 315. Wouldn't this

language mean that physical presence requires a plant, office, or a small sales force (perhaps one individual) present in the state? It should. And, as previously mentioned, the post-*Quill* litigation primarily involves the interpretation and application of the physical presence test; essentially, how much physical presence in the state is required before the "substantial nexus" requirement of the Commerce Clause is satisfied?

In fact, the court in *Quill* noted that "although title to a few floppy diskettes present in a state might constitute some minimal nexus, in *National Geographic Society v. California Board of Equalization* [citation omitted] we expressly rejected the slightest presence standard of constitutional nexus." *Quill*, 504 U.S. at 314, n. 8. So, the in-state presence of computer disks, and perhaps even other types of de minimis property and equipment, would not satisfy the substantial nexus test under *Quill.* This interpretation was applied by the Kansas Supreme Court in *In re Appeal of Intercard, Inc.*, 14 P.3d 1111 (Kan. 2000). It noted that a slightest physical presence was not sufficient to establish substantial nexus, but that some states had found that more than a slight presence is sufficient. Applying this standard, it held that 11 visits by employees of the taxpayer into Kansas to install electronic card readers at photocopy centers was insufficient to establish substantial nexus with the state, when the taxpayer was not incorporated or registered in Kansas, approved all contracts or sales from out-of-state, and had no offices or employees in Kansas.

1.6 Physical Presence and the Relation to the Activity Being Taxed.

The first prong of the *Complete Auto* test requires that the tax be applied to an activity with a substantial nexus with the taxing state. This language suggests that the activity sought to be taxed must have the substantial nexus with the taxing state.

A. Use Tax – Indirect Relationship is Sufficient.

Just a month after the *Complete Auto* decision, the United States Supreme Court issued its decision in *National Geographic*, supra. *Complete Auto* involved a sales tax, while *National Geographic* involved a use tax collection duty. The United States Supreme Court distinguished a use tax from a direct sales tax and concluded that although disassociation between the activity within the state and the activity sought to be taxed is fatal to a direct, sales tax it is not an impediment to the imposition of the use tax collection duty. *National Geographic* involved California's imposition of the use tax collection duty on National Geographic's sales of maps, globes, atlases and other items to California residents from its Washington, D.C. headquarters. California based this duty on the existence in California of two National Geographic sales offices that solicited advertising for the magazine. The activities conducted by advertising sales offices were disassociated from the National Geographic's operations that sold tangible personal property. The Supreme Court concluded, though, that the presence in the state of a physical activity disassociated from the sales sought to be taxed, is sufficient substantial nexus for the imposition of the use tax collection duty.

B. Sales Tax – Direct Relationship is Necessary.

The Supreme Court in *Norton Co. v. Department of Revenue*, 340 U.S. 534 (1951) held that for sales tax purposes, the particular

transaction to be taxed must be associated with the taxpayer's in-state activity, and if it is not, that is fatal to a direct tax on the particular transaction. It should be noted, though, that *Norton* was decided in the same year that *Spector Motor Service* laid out the interpretation of the dormant Commerce Clause that no state has the right to lay a direct tax on interstate commerce. It should also be noted that *Quill* made no distinction between a sales and a use tax in this area, and we might well expect states to test the distinction between the sales and use tax as laid out in *National Geographic* and *Norton* with the states arguing that there should be no distinction between the two, and for sales tax purposes, the transaction sought to be taxed can be disassociated from the taxpayer's in-state physical presence.