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USE TAX COLLECTION ON INTERNET PURCHASES: SHOULD THE MAIL ORDER INDUSTRY SERVE AS A MODEL?

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I. INTRODUCTION

States must have the authority to collect taxes from Internet[1] vendors who sell goods[2] within the state but who reside elsewhere. For example, Illinois should have the ability to tax an Internet vendor who sells a product in Illinois, yet resides in Maine. Without this authority, local retailers (like those who reside in Illinois) are hindered by a price differential. In addition, state governments are denied access to a vast and growing tax base.[3]

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1. The Internet is a "network of thousands of computer networks, in a more pragmatic sense it is purely a concept;" there is no "National Internet Corporation." STEVEN LAMBERT & WALTER HOWE, INTERNET BASICS: YOUR ONLINE ACCESS TO THE GLOBAL ELECTRONIC SUPERHIGHWAY 2 (1993). "Technically, a computer is on the Internet if it uses the TCP/IP network protocol to exchange data with other computers on the largest worldwide TCP/IP network." *Id.* The Internet's origins can be traced back to the United States Defense Department's Advanced Research Projects Agency (ARPA). ADAM GIFFIN, EVERYBODY'S GUIDE TO THE INTERNET 16 (1994). ARPA's goal was to develop a data network that could survive a nuclear attack. *Id.*

2. The sale of Internet goods, which this article contemplates, is the sale of tangible goods made to individual consumers. Internet shoppers may access a company's home web page, make a purchase with a credit card, and never leave their home. Internet purchases undertaken by business organizations are outside the scope of this article.

3. *Sales on Net Escape Tax: Reported Explosion of Cyber-Shopping Threatens Revenue Base of Cities and Counties*, SAN JOSE MERCURY, Aug. 17, 1995, at 1. Researchers at the University of California, Berkeley, warned governments that untaxed sales on the Internet may result in an increased loss of sales tax revenue. *Id.* Approximately 120 companies a day sign up for Internet addresses and there is about a 12 percent monthly growth rate of World Wide Web pages. *Id.* Mail-order business already costs California approximately $482 million a year in tax revenue. *Id.* Comparatively, Internet commerce is still limited, but if it keeps pace with Internet and World Wide Web growth, commerce will be substantial. *Id.*

Frequently, a local business and an Internet vendor sell an identical product. A consumer can go to the local store, price the product that he wants, and then compare that price with the price of the same product on the Internet. A disadvantage arises for a local retailer who is charged with the responsibility of collecting taxes at the point of sale (this is known as a sales tax). Unlike a local retailer, an Internet vendor is not charged with tax collection responsibilities when they are located in a state different from the consumer.

Mail-order purchases provide a useful analogy to Internet purchases.[4] While the mail-order purchaser browses through a catalog, the Internet purchaser scans a web page. Both purchasers may select wares without leaving their home, have orders filled by an out-of-state supplier, and receive ordered merchandise via the mail or a common carrier. Mail-order vendors can only be required to collect taxes for a state when they have a physical presence in that state.[5]

Whether states can impose tax collection responsibilities on Internet vendors will not remain unaddressed for long. Internet use grows at the rate of ten to twenty percent per month, with thirty million users currently on the Internet worldwide.[6] In 1994, there were ten thousand vendors on the Internet, and experts foresee that number reaching one million by the year 2000.[7] Corresponding sales estimates for the year 2000 range from $2.4 billion to $7 billion.[8] Even if the actual sales are

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A further look at Internet commerce reveals that advertising and marketing are more cost-effective than traditional methods. Ken Yamada, *Net Profits: Making More Money Online; Industry Contemplates Web Uncertainty*, COMPUTER RESELLER NEWS, Aug. 14, 1995, at 41. Many of the costs associated with traditional methods of commerce such as postage, real-estate, and staff compensation continue to increase while the costs of computer components are decreasing. *Id.*

4. In 1994, mail order sales exceeded $250 billion a year. *Start a business at home with a personal computer and one of these good ideas,* MONEY, Aug. 1, 1995, at 31. This was an eight percent increase from 1993. *Id.*

5. Quill Corp. v. North Dakota, 504 U.S. 298, 311-18 (1992); *see also* National Bellas Hess v. Dep't of Revenue of Illinois, 386 U.S. 753 (1967) (holding that states have no power to impose liability on out-of-state mail order firm to collect use taxes, where all contacts which firm had with state were via United States mail or common carrier).

6. 56 St. Tax Rev. (CCH) No. 33, at 8 (Aug. 14, 1995).

7. *Id.* at 13. Tangible goods can be purchased from a variety of Internet locations. Some of these include:

http://www.21stcenturyplaza.com/;
http://www.pacprod.com/index.sht;
http://plaza.xor.com/;
http://www.designerdirect.com/;
http://www.kcnovelties.com/;
http://www.datasolv.com/;
http://www.webcom/tbrown/malls.html;
http://aconection.com/anet/

8. 56 St. Tax Rev. (CCH) No. 33, at 13 (Aug. 14, 1995).

closer to $2.4 billion, this shift in commerce will result in lost sales for traditional retailers. Furthermore, revenue generated from state sales taxes will be reduced. These factors should force states to develop a tax collection scheme directed at Internet vendors. Predictably, Internet vendors will resist new tax collection systems and inevitably a tribunal will determine whether states have authority to impose tax collection duties on Internet vendors.

In order to collect taxes on Internet purchases, state governments must reconcile proposed tax schemes with the commerce clause's physical presence requirement.[9] Current commerce clause analysis requires a vendor to have a physical presence in a state before that state can require the vendor to collect and remit sales and use taxes.[10] However, Congress has the authority to modify the commerce clause's physical presence requirement.[11]

This article illustrates why Congress should exercise its authority to preempt the Supreme Court's adherence to an outdated concept of the commerce clause's physical presence requirement. Section II provides background on taxes and constitutional limitations on tax collection. Section III examines methods states might employ to impose tax collection duties on Internet vendors, and Section IV recommends that Congress establish a nexus test based on an economic presence rather than a physical presence.

II. BACKGROUND

A. SALES AND USE TAX GENERALLY

Although the "sales tax" has its roots in ancient Egypt, Greece, and Rome,[12] sales tax became a prominent revenue source among the states

9. *Quill*, 504 U.S. 298 (holding that imposition of tax collection responsibilities on mail-order vendor who did not have a physical presence in the state violated the commerce clause); *See also Bellas Hess*, 386 U.S. 753 (holding that states have no power to impose liability on out-of-state mail order firm to collect use taxes, where all contacts which firm had with state were via United States mail or common carrier).

10. *Quill*, 504 U.S. at 312. In *Quill*, North Dakota filed an action in state court to require the Quill Corporation to collect and pay a use tax on goods purchased for use in North Dakota. *Id.* at 298. Incorporated in Delaware, the Quill Corporation is an out-of-state mail-order house which does not have any retail outlets or salesman in North Dakota. *Id.* at 302. The company sells office equipment and supplies through catalogs, national advertisements, and telephone calls. *Id.* In *Quill*, the court held that the commerce clause prevents states from requiring out-of-state vendors to collect use tax on mail-order purchases when the vendor has no physical presence in the state. *Id.* at 312; *see also Bellas Hess*, 386 U.S. 753.

11. *Quill*, 504 U.S. at 318.

12. PAUL J. HARTMAN, FEDERAL LIMITATIONS ON STATE AND LOCAL TAXATION § 10.1 (1981).

during the Great Depression.[13] Today, "sales tax" encompasses a large variety of levies where the tax is "separately stated and collected on a transaction-by-transaction basis from the consumer."[14] Even though the economic burden of *paying* the sales tax is borne by the consumer, the duty to *collect* and remit the tax to the taxing jurisdiction is often imposed upon the seller.[15]

To combat concerns about potential loss of revenue from out-of-state purchases, states implemented the "use tax" as a companion levy to the sales tax.[16] Use taxes are typically "imposed upon the storage, use, or consumption of tangible personal property within the state, property upon which sales tax has been paid being exempt."[17] The use tax "protect[s] sales tax revenues and put[s] local retailers subject to the sales tax on a competitive parity with out-of-state retailers exempt from the sales tax."[18]

Together, sales and use taxes have become a significant source of revenue in the fiscal structure of most states.[19] Thus, the ability of states to collect these taxes plays a major role in a state's fiscal health. While sales tax is collected at the point of sale, use taxes are generally collected from three sources.[20]

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13. *Id.*

14. *Id.* "Sales taxes are distinguishable from gross income or gross receipt taxes." *Id.* Sales taxes are imposed upon the consumer, whereas the gross income or gross receipt tax are imposed upon the seller. *Id.* Gross income and gross receipt taxes create a liability to the recipient of gross income or receipts and are typically collected annually. *Id.*

However, it should be noted that there are varying uses of the term "sales tax." Sales tax has been referred to in different jurisdictions as a license tax, privilege tax, occupation tax, income or gross income tax, and excise tax. 68 AM. JUR. 2D *Sales and Use Tax* § 1 (1993). Yet, "sales tax" has also been distinguished from franchise tax, income tax, privilege tax, license tax, occupation tax, and property tax. *Id.* at § 4.

15. 68 AM. JUR. 2D *Sales and Use Tax* § 1 (1993).

16. HARTMAN, *supra* note 12, § 10:1.

17. JOHN F. DUE & JOHN L. MIKESELL, SALES TAXATION: STATE AND LOCAL STRUCTURE AND ADMINISTRATION 246 (1981). The constitutionality of a use tax is settled. National Geographic Soc'y v. California Bd. of Equalization, 430 U.S. 551, 555 (1977). "A tax upon the privilege of use or storage when the chattel used or stored has ceased to be in transit is now an impost so common that its validity has been withdrawn from the arena of debate." Henneford v. Silas Mason Co., 300 U.S. 577, 582-83 (1937). In *Silas Mason*, the plaintiffs were participating in the construction of the Grand Coulee Dam and were bringing machines, materials, and supplies into Washington. *Id.* at 579. These items were purchased at retail in other states and the Tax Commissioner of Washington imposed a use tax on this property. *Id.* The plaintiffs alleged that the use tax obstructed interstate commerce. *Id* at 581. The court denied the plaintiff relief, holding that the use tax was "not upon the operations of interstate commerce, but upon the privilege of use after commerce is at an end." *Id.* at 582.

18. *National Geographic*, 430 U.S. at 555.

19. 68 AM. JUR. 2D *Sales and Use Tax* § 2 (1993).

20. DUE & MIKESELL, *supra* note 17, at 249.

First, out-of-state vendors who have a "sufficient nexus" with the taxing state may be required to register, collect, and remit use taxes.[21] Out-of-state vendors have a "sufficient nexus" with a state when they maintain a place of business within the taxing state,[22] solicit business by a representative,[23] and when the vendor conducts non-sales activities within the taxing state.[24] However, a retail vendor whose only contacts with a taxing state are by mail or common carrier lacks a "sufficient nexus" with the taxing state, and cannot be required to collect use tax from in-state customers.[25]

Second, a purchaser located within the taxing jurisdiction must remit a use tax if the tax is not collected by the out-of-state vendor.[26] How-

21. DUE & MIKESELL, *supra* note 17, at 249.

22. Nelson v. Sears, Roebuck & Co., 312 U.S. 359, 364-66 (1941). This case involved a suit by Sears, Roebuck & Co. [hereinafter Sears], to enjoin the Iowa State Board of Assessment and Review from canceling Sears's permit to do business in Iowa. *Id.* at 362. Sears maintained retail stores in Iowa and also conducted a separate mail order business in Iowa. *Id.* The retail stores collected the appropriate taxes on sales made at those stores, including mail orders placed at the Iowa stores even though the goods were shipped directly to the purchaser from an out-of-state branch. *Id.* However, Sears refused to collect the tax on mail orders made by Iowa residents which were accepted and filled by out-of-state branches. *Id.*

The Court held there was a sufficient nexus to require Sears to collect the use tax on the mail orders. *Id.* at 364-66. The Court reasoned that since Iowa extended to Sears the privilege of doing business in Iowa, Iowa could require Sears to collect use tax as the price of enjoying this privilege. *Id.* at 364. *See also* Nelson v. Montgomery Ward & Co., 312 U.S. 373 (1941) (concerning an issue identical to a case the court decided earlier in the day—Nelson v. Sears, Roebuck & Co., 312 U.S. 359 (1941)).

23. *See, e.g.*, Scripto Inc. v. Carson, 362 U.S. 207 (1960). In *Scripto*, a Georgia corporation was liable for Florida use tax. *Id.* at 210-12. Orders were solicited by ten Florida brokers, who were not full-time salesman for the corporation. *Id.* at 209. The corporation did not maintain an office or have any regular employees in Florida and accepted and filled orders in its Georgia office. *Id. See also, e.g.*, Felt & Tarrant Mfg. Co. v. Gallagher, 306 U.S. 62 (1939) (holding that an out-of-state seller who rented office space so as to facilitate solicitation of orders by two non-employee commissioned sales agents, constituted a physical presence).

24. *See, e.g., National Geographic*, 430 U.S. at 551 (holding that National Geographic's two advertising offices in California were sufficient to require the society to collect use tax on its mail order sales, even though there was no relationship between the California offices and the California sales).

25. *Quill*, 504 U.S. at 311.

26. DUE & MIKESELL, *supra* note 17, at 258. Wisconsin is attempting to make sure that residents pay use tax on out-of-state purchases. *DOR Collects $315,000 in Back Taxes From Attorneys*, 68 WIS. LAW., Mar. 1995, at 8. Between April of 1994, and January 31, 1995, the Wisconsin Department of Revenue [hereinafter DOR] collected $315,000 in back use tax on out-of-state purchases from Wisconsin attorneys and law firms. *Id.* The DOR began its collection efforts by sending self-audit worksheets to the professionals who most often give tax advice: attorneys and certified public accountants. *Id.*

Attorneys and accountants usually expose themselves to use tax liability when they make a mail order purchase from an out-of-state vendor who is not required to collect sales ever, collection from numerous individual purchasers presents an impossible undertaking,[27] and administrators regard attempts to secure remittance by these individuals as fruitless.[28]

Third, out-of-state vendors volunteer to collect and remit use taxes even though they are not legally obligated.[29] They may volunteer so that their customers are not concerned with compliance matters.[30] An out-of-state vendor may also volunteer to collect and remit use taxes when a state offers concessions or threatens to assess in-state customers.[31]

The Supreme Court has consistently supported states' efforts to impose use tax collection duties on out-of-state vendors.[32] There are two exceptions: one, solicitation of business via advertising;[33] and two, regu-

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or use tax. *Id.* Many law offices incur a use tax liability when they buy law books, reference material, office equipment, furniture, supplies, computer hardware, software, gifts and promotional items. *Id.*

Recipients of the use tax self-audit worksheets must respond to DOR regardless of whether they have any additional use tax. *Id.* If the recipient fails to respond to the first notice, DOR sends a second notice. *Id.* If there is still no response, DOR may dispatch an estimated tax assessment or conduct an audit. *Id.*

27. HARTMAN, *supra* note 12, § 10:8. A purchase over the Internet from an unknown location to an unknown vendor is nearly impossible for a state to detect. HARTMAN, *supra* note 12, § 10:8.

28. DUE & MIKESELL, *supra* note 17, at 258. Nevertheless, states routinely attempt to enforce compliance from individuals in two areas: motor vehicles that must be registered and businesses that are subject to sales tax audits. DUE & MIKESELL, *supra* note 17, at 258.

29. DUE & MIKESELL, *supra* note 17, at 256-57.

30. DUE & MIKESELL, *supra* note 17, at 257.

31. DUE & MIKESELL, *supra* note 17, at 257. States may promise not to audit a company in exchange for volunteering to collect sales and use taxes. DUE & MIKESELL, *supra* note 17, at 257. The state may exert pressure on an out-of-state vendor by threatening to follow an out-of-state vendor's delivery truck to its destination and then assess the customer. DUE & MIKESELL, *supra* note 17, at 257.

32. *See Scripto,* 362 U.S. 207 (holding that solicitation of orders by nonresident salesman was sufficient presence to impose use tax collection responsibilities on nonresident corporation); *See also* Goldberg v. Sweet, 488 U.S. 252 (1989) (noting that tax on interstate telephone calls was required to be collected by long distance telephone carrier); *see also* Standard Pressed Steel Co. v. Washington Dep't of Revenue, 419 U.S. 560 (1975) (noting that an engineer/consultant working out of his home in Washington constituted sufficient business activity to impose a tax on a manufacturer whose plants and offices were located in Pennsylvania and California); *see also* D.H. Holmes Co., v. McNamara, 486 U.S. 24 (1988) (imposing use tax on catalogs printed outside the state and mailed directly to prospective customers within the state).

33. *Bellas Hess,* 386 U.S. at 753. In this landmark case, Bellas Hess, a mail order retailer located in Missouri, mailed catalogues and flyers to residents in Illinois. *Id.* at 754. Merchandise orders were mailed to Missouri and the goods were then sent directly to the customers either by mail or common carrier. *Id.* at 754-55. Bellas Hess' relationship with Illinois was described by the State Supreme Court as follows:

> [Bellas Hess] does not maintain in Illinois any office, distribution house, sales house, warehouses or any other place of business; it does not have in Illinois any agent, salesman, canvasser, solicitor or other type representative to sell or take

lar delivery of goods by an out-of-state vendor into the taxing jurisdiction.[34]

B. Commerce Clause Requirements

The Commerce Clause is an express grant of power: "The Congress shall have Power . . . to regulate Commerce with foreign Nations, and among the several States . . . ."[35] Thus, any state statute regulating interstate commerce and conflicting with federal law is void.[36] In addition to the express grant of power, a judicially created extension of the

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> orders, to deliver merchandise, to accept payments, or to service merchandise it sells; it does not own any tangible property, real or personal, in Illinois; it has no telephone listing in Illinois and it has not advertised its merchandise for sale in newspapers, on billboards, or by radio or television in Illinois.

Id. at 754. Yet under Illinois statute, Bellas Hess was required to collect and pay use tax from customers in Illinois. *Id.* at 755. Bellas Hess did not comply with the statute and the Illinois Department of Revenue brought an action to recover assessed taxes. *Id.* at 754.

The court found that Bellas Hess only communicated with customers in Illinois by mail or common carrier and, therefore, could not constitutionally be required to collect and remit use tax to Illinois. *Id.* at 758. However, the court was vague as to whether the holding was grounded on the commerce clause or the due process clause. *Id.* at 756. After the court noted that the tests for the two clauses are similar, the court explained that a state tax statute will be constitutional under the commerce clause when "[s]tate taxation falling on interstate commerce . . . [i]s designed to make such commerce bear a fair share of the cost of the local government whose protection it enjoys." *Id.* Under the due process clause, a state tax statute will pass constitutional muster when "the state has given anything for which it can ask return." *Id.*; *see also Quill*, 504 U.S. 298 (holding that the imposition of tax collection responsibilities on mail-order vendor who did not have a physical presence in the state violated the commerce clause).

34. Miller Bros. Co. v. Maryland, 347 U.S. 340 (1954). A Delaware store made over-the-counter sales to Maryland residents and occasionally delivered the goods by truck into Maryland. *Id.* at 342. The Supreme Court held that Maryland could not require the Delaware store to collect the tax because Maryland could not satisfy due process requirements. *Id.* at 348. *See also* Laptops Etc. Corp. v. District of Columbia, 164 B.R. 506 (Bankr. D. Md. 1993) (state could not impose a tax on a vendor whose only physical presence in taxing state was "rare and non-recurring instance when the debtor's agent would accompany a common carrier into the jurisdiction").

35. U.S. Const. art. I, § 8, cl. 3.

36. Gibbons v. Ogden, 22 U.S. (9 Wheat.) 1 (1824); *see also* Dennis v. Higgins, 498 U.S. 439 (1991) (holding that a state tax violating the commerce clause supports a claim for attorney's fees under 42 U.S.C. § 1983). In *Dennis*, a motor carrier with a principal place of business in Ohio, owned tractors and trailers that were registered in Ohio and other states including Nebraska. *Dennis*, 498 U.S. at 441. The motor carrier filed a class action in Nebraska claiming that certain "retaliatory" taxes and fees which Nebraska imposed constituted an unlawful burden on interstate commerce. *Id.* The motor carrier sought declaratory and injunctive relief, refunds for the retaliatory taxes and fees paid, and attorney's fees and costs under 42 U.S.C. § 1983. *Id.* Section 1983 provides:

> Every person who, under color of any statute, ordinance, regulation, custom, or usage, of any State or Territory or the District of Columbia, subjects, or causes to be subjected, any citizen of the United States or other person within the jurisdiction thereof to the deprivation of any rights, privileges, or immunities secured by

commerce clause has evolved; the "dormant" commerce clause.[37] The Supreme Court views the dormant commerce clause as a limit to state regulation of commerce, even where Congress has failed to legislate upon the subject.[38] This limit extends to the prohibition of certain state taxes.[39]

> the Constitution and laws, shall be liable to the party injured in an action at law, suit in equity, or other proper proceeding for redress.

42 U.S.C. § 1983 (1995).

The court reasoned that the statute's language, legislative history, and court decisions require a broad construction of § 1983. *Dennis*, 498 U.S. at 443-46. As such, the Court held that suits for violations of the commerce clause may be brought under § 1983. *Id.* at 450.

37. Justice Johnson intimated that the commerce clause is more than an affirmative grant of power; he suggested that the clause has a negative aspect as well. *Gibbons*, 22 U.S. (Wheat. 9) at 231-32, 239. "[T]he dormant commerce clause doctrine is not textually based . . . [and] is exclusively the product of judicial thinking." David S. Day, *The Rehnquist Court and the Dormant Commerce Clause Doctrine: The Potential Unsettling of the "Well-Settled Principles,"* 22 TOLEDO L. REV. 675, 677 (1990).

Sometimes the dormant commerce clause is referred to as the "silent" or "negative" commerce clause. LAURENCE H. TRIBE, AMERICAN CONSTITUTIONAL LAW § 6-2, at 380 (2d ed. 1988). The dormant commerce clause is called "negative not only because it negates state regulation of commerce, but also because it does not appear in the Constitution." Oklahoma Tax Comm'n v. Jefferson Lines, Inc., 115 S. Ct. 1331 (1995) *(reh'g denied)* (Scalia, J., and Thomas, J., concurring).

Jefferson Lines involved a common carrier that did not collect or remit the Oklahoma state sales tax on bus tickets sold in Oklahoma for interstate travel. *Id.* at 1335. After Jefferson Lines filed bankruptcy, the Oklahoma Tax Commissioner filed a claim for the uncollected taxes. *Id.* Jefferson Lines argued that the tax placed an undue burden on interstate commerce because it allowed Oklahoma to collect a percentage of the full purchase price of all tickets for interstate travel, even though a portion of the full purchase price was generated from travel through states other than Oklahoma. *Id.* The Bankruptcy Court, the District Court, and the Appellate Court all held in favor of Jefferson Lines. *Id.* However, the Supreme Court applied the *Complete Auto* four-part test and reversed the lower court holding that Oklahoma's tax was consistent with the commerce clause. *Id.* at 1335-46.

Some commentators have argued that the dormant commerce clause should be abandoned. *See* Amy M. Petragnani, Comment, *The Dormant Commerce Clause: On Its Last Leg*, 57 ALB. L. REV. 1215, 1237-53 (1994) (contending that the dormant commerce clause is not supported textually by the Constitution, there was no intent by the framers to grant such power to the judiciary, and the dormant commerce clause violates the principles of separation of powers and the balance of federalism).

38. Northwestern States Portland Cement Co. v. Minnesota, 358 U.S. 450, 458 (1959).

39. *Jefferson Lines*, 115 S. Ct. at 1335; *Quill*, 504 U.S. at 309 (business required to have a physical presence in taxing state); H.P. Hood & Sons, Inc. v. Du Mond, 336 U.S. 525, 532-35 (1949) (state *may not* promote its own economic advantages by burdening interstate commerce); *cf. Complete Auto*, 430 U.S. 274, 279 (state tax will pass commerce clause muster if a four part test is satisfied); *Northwestern States*, 358 U.S. at 452 (state may tax the net income from a foreign corporation provided the tax is not discriminatory, is properly apportioned to activities within the taxing state, and there is a sufficient nexus between the activities and the state).

Prior to 1977, the Supreme Court's analysis of the dormant commerce clause vacillated between a rule distinguishing between direct and indirect taxation,[40] and a rule examining the practical effect of the state tax on interstate commerce.[41] Then in *Complete Auto Transit, Inc., v. Brady*,[42] the court settled on a rule that examines the practical effects of a tax on interstate commerce.[43]

Complete Auto established a four prong test to determine when a tax will be upheld against a commerce clause attack. The tax must: (1) be applied to an activity with a substantial nexus with the taxing State; (2) be fairly apportioned; (3) not discriminate against interstate commerce; and (4) be fairly related to the services provided by the state.[44] The first prong of this analysis, the prong this article focuses on, has been further refined. In order to establish a substantial nexus with the taxing state, the vendor must have a physical presence in the taxing state which exceeds the "slightest presence."[45]

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40. In Leloup v. Port of Mobile, 127 U.S. 640, 648 (1888), the Supreme Court stated that "no State has the right to lay a tax on interstate commerce in any form." The rule distinguishing direct and indirect taxation prohibited the imposition of a tax that had direct burdens on interstate commerce. Freeman v. Hewitt, 329 U.S. 249 (1946). The *Freeman* case involved an Indiana tax upon the receipt of the *entire* gross income of residents and domiciliaries. *Id.* at 250. The Court found that the interstate commerce clause created a "zone of trade free from interference by the States." *Id.* at 252. This "free trade zone" philosophy has been replaced by the modern commerce clause philosophy, which examines the practical effect of the state tax. *Complete Auto*, 430 U.S. at 279; Spector Motor Serv., Inc., v. O'Connor, 340 U.S. 602 (1951).

41. The Commerce Clause does not relieve those engaged in interstate commerce from their share of state tax burden even though it increases the cost of doing business. *Freeman*, 329 U.S. at 254.

For a history of state taxation of interstate commerce see Michael C. Wagner, *Oklahoma Tax Commission v. Jefferson Lines: Commerce Clause Restraints on State Taxing Power*, 14 J.L. & COM. 277 (Spring 1995).

42. *Complete Auto*, 430 U.S. at 279.

43. *Id.* at 276. In *Complete Auto*, a Michigan corporation transported automobiles manufactured outside of Mississippi into Mississippi by common carrier. *Id.* The Mississippi Tax Commission assessed taxes on Complete Auto for the sale of transportation services. *Id.* at 277. Complete Auto paid the taxes and filed an action for a refund claiming that Mississippi had imposed a tax on the privilege of doing interstate business. *Id.* The court stated that prior decisions have not considered the formal language of the tax statute, "but rather its practical effect" and have sustained a tax against commerce clause challenges when the four part test is met. *Id.* at 279.

44. *Id.*

45. *National Geographic*, 430 U.S. at 555-56. In *National Geographic*, a nonprofit corporation maintained two offices in California in order to solicit advertising for its magazines. *Id.* at 552. The corporation made mail order sales to California through an office in the District of Columbia. *Id.* The court held that the corporation could be required to collect California use tax on its mail order sales even though there was *no relationship* between the corporation's mail order activity conducted from the District of Columbia and the two advertising offices located in California. *Id.*

C. DUE PROCESS REQUIREMENTS

The taxing power of the states is restrained by two different constitutional limits: the due process clause and the commerce clause.[46] The due process clause contemplates the "fundamental fairness of governmental activity," while the commerce clause is concerned "about the effects of state regulation on the national economy."[47] Thus, a state tax may violate the commerce clause even though that tax is consistent with the due process clause.[48]

The due process clause requires a defendant to have *minimum contacts* with the taxing jurisdiction "such that the maintenance of the suit does not offend the 'traditional notions of fair play and substantial justice.'"[49] Unlike the commerce clause, the due process clause does not re-

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46. *Quill*, 504 U.S. at 305.

47. *Id.* at 312.

48. Tyler Pipe Indus., Inc. v. Washington State Dep't of Revenue, 483 U.S. 232 (1987). In *Tyler Pipe*, the state of Washington imposed a manufacturing tax that contained an exemption. *Id.* at 234-37. The exemption only applied to Washington manufacturers who sold their products within the state. *Id.* The exemption did not apply to products manufactured in Washington and sold to out-of-state customers. *Id.* The court found that Washington had jurisdiction to tax Tyler, but that the tax discriminated against interstate commerce, thus violating the commerce clause and invalidating the tax. *Id.* at 239-52.

49. *Quill*, 504 U.S. at 307; International Shoe Co. v. Washington, 326 U.S. 310, 316 (1945) (quoting Milliken v. Meyer, 311 U.S. 457, 463 (1940)). In *International Shoe*, the state of Washington brought an action against International Shoe Co. ("Shoe") to collect state unemployment taxes based on the commissions paid to the salesmen located in Washington. *Id.* at 311. Shoe manufactured and sold shoes and other footwear. *Id.* at 313. Shoe was incorporated in Delaware and had its principal place of business in Missouri. *Id.* Shoe employed commission-based salesmen who lived in the state of Washington, but who reported directly to the St. Louis sales office. *Id.*

Shoe did not have an office in Washington and did not have any activities in Washington other than the solicitation of orders via the commissioned salesmen. *Id.* Sometimes the salesmen rented display rooms to exhibit samples and the cost was reimbursed by Shoe. *Id.* at 314. The salesmen's authority was limited; they could not enter into contracts, and all orders were approved and shipped by the St. Louis office. *Id.*

The Supreme Court held that Washington could exercise jurisdiction over Shoe and not violate the due process clause. *Id.* at 320. The court reasoned

> due process requires only that in order to subject a defendant to a judgment *in personam*, if he be not present within the territory of the forum, he have certain minimum contacts with it such that the maintenance of the suit does not offend 'traditional notions of fair play and substantial justice.'

Id. at 316 (quoting Milliken v. Meyer, 311 U.S. 457, 463 (1940)). The court applied this standard in concluding that Shoe's activities were systematic, continuous, and resulted in a large volume of interstate business. *Id.* at 320. Since the cause of action arose from those activities, it followed that Shoe had sufficient contacts with Washington to make it reasonable and just to allow Washington to enforce state laws. *Id.*

Cf. Hanson v. Denckla, 357 U.S. 235 (1958) (stating that foreign corporation did not have minimum contacts with state). In *Hanson*, a Pennsylvania woman named Donner created a trust and appointed a Delaware bank as trustee. *Id.* at 238. She gave herself a life estate in the trust and reserved the power to dispose of the remainder of the trust quire a physical presence within a state. Rather, the focus is whether a defendant's contacts with the forum are *reasonable* enough to require him to defend a suit in that state.[50]

Minimum contacts are evaluated by whether the commercial actor's efforts are purposefully directed toward residents of the forum.[51] Examples of such efforts include advertising in the forum state, providing regular advice to customers in the forum state, and marketing products through a distributor who acts as a sales agent in the forum state.[52]

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either by will or *inter vivos* transfer. *Id.* Ten years later, Donner moved to Florida and subsequently assigned the remainder of her trust to her grandchildren. *Id.* at 239-40. However, in her will she passed the remaining assets of the trust to her two daughters who were residents of Florida. *Id.*

The daughters sued in Florida for a declaratory judgment that Donner's assignment of the trust to the grandchildren was invalid. *Id.* at 240. The grandchildren sued in Delaware for a declaratory judgment that the funds had passed to them through the assignment. *Id.* The Florida court found for the daughters and the Delaware court found for the grandchildren. *Id.* at 241-42. The decisions were appealed to the Supreme Court to determine whether Florida could acquire jurisdiction over the Delaware trustee. *Id.* at 242-43. The Court decided that Florida could not acquire jurisdiction because:

> The [trust] agreement was executed in Delaware by a trust company incorporated in that State and a settlor [then] domiciled in Pennsylvania. The first relationship Florida had to the agreement was years later when the settlor became domiciled there .... But [sic] the record discloses no instance in which the *trustee* performed any acts in Florida .... Consequently this suit cannot be said to be one to enforce an obligation that arose from a privilege the defendant exercised in Florida.
>
> The unilateral activity of those who claim some relationship with a nonresident defendant cannot satisfy the requirement of contact with the forum State. The application of that rule will vary with the quality and nature of the defendant's activity, but it is essential in each case that there be some act by which the defendant purposefully avails itself of the privilege of conducting activities within the forum state, thus invoking the benefits and protections of its laws.

Id. at 253-54.

50. Burger King v. Rudzewicz, 471 U.S. 462, 476 (1985). Where a defendant deliberately engages in significant activities or continues obligations between himself and the forum state, the defendant "manifestly avail[s] himself of the privilege of conducting business there, and because his activities are shielded by the benefits and protections of the forum's law it is presumptively not unreasonable to require him to submit to the burdens of litigation in that forum as well." *Id.*; *cf.* World-Wide Volkswagen Corp. v. Woodson, 444 U.S. 286 (1980). In *World-Wide*, the court also applied this reasonableness principle, but held that the due process clause prevented an Oklahoma court from exercising jurisdiction over a New York car dealer whose only connection was a customer who elected to drive there. *Id.*

51. *Burger King*, 471 U.S. at 476. The purposeful availment requirement prevents a defendant from being haled into a state's court because of "random," "fortuitous," or "attenuated" contacts. *Id.* at 475 (citing Keeton v. Hustler Mag., Inc., 465 U.S. 770, 774 (1984)).

52. Asahi Metal Indus. Co. v. Superior Court, 480 U.S. 102, 112 (1987) (O'Connor, J., concurring). In *Asahi Metal*, a motorcycle operator lost control while riding in California and was severely injured. *Id.* at 105-6. The operator filed an action against the tire manufacturer, Cheng Shin, claiming that the rear tire was defective. *Id.* at 106. Cheng Shin filed suit for indemnification against Asahi, the manufacturer of the tire's valve. *Id.* The court held that although Asahi was aware that some of the valves would be used in tires

III. ANALYSIS

A. Internet Vendors do not have Substantial Nexus

The first prong of the *Complete Auto* test, whether there is a substantial nexus, is the most troublesome prong to any state attempting to collect use tax from Internet vendors. To establish a substantial nexus, the Supreme Court requires something more than a minimal physical presence.[53] When a mail-order vendor's only "presence" in the taxing state is by mail or common carrier, the physical presence requirement is not satisfied.[54] Thus, in these situations, vendors have enjoyed immunity from state attempts to force vendors to collect taxes.

Likewise, an Internet vendor's presence is limited. Except for the state in which the vendor is located, the only presence an Internet vendor has is the appearance of a web page on a computer screen. A web page is nothing more than an intangible electronic presence. If an Internet vendor has no salesmen, no offices, or no other non-sales related activities outside the state in which the vendor is located, then the only state where the vendor has a physical presence is the state in which the vendor is located. Even the most liberal construction of the physical presence requirement will not enable a web page to establish a physical presence, and thereby satisfy the substantial nexus requirement. Therefore, under current law, states cannot impose tax collection responsibilities upon Internet vendors unless they have a physical presence within the taxing state.

B. State Remedies for Lack of Substantial Nexus

In order to avoid the same use tax collection problems of the mail order industry,[55] the states will need assistance from either federal leg-

sold in California, California could not exert jurisdiction over Asahi unless Asahi had purposefully availed itself of California markets. *Id.* at 112.

53. *See Quill*, 504 U.S. at 298; *see National Geographic*, 430 U.S. at 551.

54. *See Quill*, 504 U.S. at 298; *see National Bellas Hess Inc.*, 386 U.S. at 753.

55. The problem states have with the mail-order industry is that a consumer can price a product at a local store that is obligated to collect tax, and then compare that product to the identical product offered by a mail-order company who does not collect the tax. *Interstate Sales Tax Collection, Before the Subcomm. on Procurement, Taxation & Tourism of the House Comm. on Small Business*, 103rd Cong., 2nd Sess. (1994) (statement of James H. Bilbray, Representative). During the subcommittee hearing, several small businessmen revealed the impact that non-collection of taxes by out-of-state mail order companies has on their companies. *Id.*

The owner of a forty-one year old appliance & video store headquartered in Carson City, Nevada offered testimony about the non-collection of taxes. *Interstate Sales Tax Collection, Before the Subcomm. on Procurement, Taxation & Tourism of the House Comm. on Small Business*, 103rd Cong., 2nd Sess. (1994) (statement of Joe Bookwalter, Owner, Baker Appliance & Video). The owner stated that his business survived by providing exceptional service and knowledgeable salesmen. *Id.* The owner noted that the proliferation of mail islators or the Supreme Court. Currently, when a consumer compares a product between a local retailer and an out-of-state Internet vendor, the local retailer is placed at a disadvantage because it has to collect sales tax. To rectify this inequity, either Congress must intervene or the Supreme Court must modernize its view of the Commerce Clause. If neither happens, states are powerless to protect local vendors and preserve state coffers.

1. *Federal Intervention*

The federal government can resolve the states' dilemma by passing legislation granting states the authority to impose tax collection responsibilities on out-of-state Internet vendors. "Congress has the power to protect interstate commerce from intolerable or even undesirable burdens."[56] Congress has made numerous attempts to pass similar legislation in the mail-order arena,[57] but remains unsuccessful. This failure is attributable to the financial and political clout of the mail-order industry.[58] However, legislation impacting Internet vendors stands a better chance of being enacted because Internet commerce is in its infancy and lacks the organized financial and political clout of the mail-order industry.

Presumably, Internet vendors will align themselves with the mail-order industry in efforts to stymie legislation which imposes tax collection duties upon them. After all, the arguments presented by the mail-

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order catalogs had caused an increasing number of people to use his store's trained salesmen to select their product, but then buy the product out-of-state to avoid paying sales tax. *Id.* Although the purchaser is obligated to pay a use tax when the goods are purchased out-of-state, the purchaser rarely complies. *Id.* Then when the equipment needs repair, the purchaser brings the equipment to his store and he is obligated by manufacturer agreement to provide warranty repair at the store owners expense. *Id.*

The U.S. Senate is considering the *Consumer and Main Street Protection Act*, S. 545, 104th Cong. 1st Sess. § 3845 (1995). This bill would authorize the collection of certain state and local taxes with respect to the sale, delivery, and use of tangible personal property. *Id.*

56. *Quill*, 504 U.S. at 320.

57. *See infra* note 67 (illustrating unsuccessful bills in which Congress tried to grant states the power to require out-of-state retailers to collect use taxes).

58. The mail order industry has the support of several national associations. The Direct Marketing Association ("DMA") was founded in 1917 and represents 6,800 members. ENCYCLOPEDIA OF ASSOCIATIONS, Vol. 1, 303 (30th ed. 1996). DMA members market products through the mail, electronic and print media, and telemarketing. *Id.* The association studies consumer attitudes, offers assistance and education to members, maintains a library, and provides publications that review pending federal and state regulations that affect the mail order industry. *Id.*

There are at least two other mail order industry associations: The National Mail Order Association; and, The American Mail Order Association which describes one of its activities as "providing expertise to legislators." *Id.* at 301, 305.

order industry have thus far been effective.[59] The arguments include: administrative burdens; loss of sales; and fewer benefits from states where there is no physical presence.

The mail-order industry asserts that legislation imposing tax collection duties on out-of-state mail order vendors would be administratively burdensome. Such legislation would require tracking over six thousand different rates, forty-six different sets of rules, and forty-six potential audits.[60] However, in actuality the required tracking does not pose significant administrative burdens. As early as 1986, inexpensive software was available to make compliance an easy proposition.[61]

59. *See infra* note 67 (illustrating unsuccessful bills in which Congress tried to grant states the power to require out-of-state retailers to collect use taxes).

60. *Interstate Sales Tax Collection, Before the Subcomm. on Procurement, Taxation & Tourism of the House Comm. on Small Business*, 103d Cong., 2d Sess. (1994) (statement of Robert J. Levering, Senior Vice-President, Direct Marketing Association).

61. Paul J. Hartman, *Collection of the Use Tax on Out-of-State Mail Order Sales*, 34 VAND. L. REV. 993, 1011-12 (1986). The administrative feasibility and the fiscal feasibility should have been dead issues long ago:

> The advent of automated accounting systems, so prevalent in most businesses in America today makes it possible for a nationally organized sales concern to automatically bill and remit for the appropriate local tax in thousands of jurisdictions. The software program which would be used for billing and tax purposes would identify taxpayers of a given political subdivision by their zip codes. The same operation which would generate shipping and billing invoices would also accrue the appropriate state or local tax for the zip code of destination for the shipment. The same programming would also accumulate data for preparation of a Sales Tax Return for each applicable jurisdiction. Additionally, the program could also accumulate the total sales for a given time period so that the mail-order house would have timely information if they passed a sales threshold for reporting to a given state.
>
> The difficulty in any programming of this nature is the constant updates and modifications which would be required whenever a local taxing jurisdiction changed its rates. The cost to a mail-order house of setting up a software program of this type and the constant review and revision which would be required to maintain its currency in a number of jurisdictions would be prohibitive for many of the smaller wholesale houses. These vendors do not, to our experience, have sufficient in-house programming personnel and data processing capabilities to keep their State Sales Tax programs current.
>
> Fortunately, the market has stepped in to fill this technological niche. State Tax software programs are currently available in the market-place at a cost which would not be prohibitive to the medium or large mail-order vendor. Updates of this program are supplied by the fabricators of the software for a nominal monthly or yearly maintenance fee. At $5,000 per software package and a monthly maintenance agreement, which would cost a minimum of several hundred dollars a year, programs in this price range would be prohibitive, I believe, for a vendor whose annual gross sales were less than $500,000 a year.

Id. (citing letter from John R. Gregory). Mr. Gregory is the former head of the Tennessee Sales and Use Tax Division and he has represented many state and local taxpayers. *Id.* at 1011 n.69.

Vertex Inc., of Berwyn Pennsylvania, "supplies software to clients that continually updates county, city, and state sales and use tax laws." *Special Report; Tax Issues Emerge as EC Business Grows*, FINANCIAL SERVS. BULL., June 19, 1996. "It covers the Internet sales

The mail-order industry claims legislation would reduce sales. This contention is frivolous, given that one of the largest mail-order firms in the country reported to its shareholders that while "collecting use taxes would likely influence the buying decisions of some customers, the company believes there would be no material adverse affects on financial results."[62] Moreover, a Gallup Survey found that seventy-eight percent of mail-order customers view sales tax as totally irrelevant.[63] Hence, mail-order vendors' fears of lost sales are unfounded and thus, by analogy, should not be a concern for Internet vendors.

A third mail-order industry argument is that mail-order firms, without a physical presence in a state, receive fewer state-provided benefits than the local retailers.[64] Assuming this is true, mail-order and Internet vendors still receive several important state-provided benefits. These benefits include a police patrolled infrastructure to assist in the transfer of goods, a sound banking institution to support credit transactions, a court in which to pursue collection of unpaid accounts, waste disposal of mail and packaging material, and consumer protection laws.[65] This "fewer state benefits" argument cannot carry the day. The bestowal of the aforementioned benefits is a generous *quid pro quo* for merely collecting use taxes.

Considering the weakness of the mail-order industry's arguments, federal legislation appears to be a viable solution.[66] Yet Congress has

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tax issues in all seven thousand jurisdictions and monitors more than six hundred changes each year at every level." *Id.*

Moreover, the ability to track these rates and rules in a cost-effective manner is evidenced by the largest U.S. mail order company. *Taxes on Mail-Order Purchases, Hearings on S. 1825 Before the Senate Comm. on Small Business,* 103d Cong., 2d Sess., 3845 (1994) (statement of Jerry Hux, Member of Board of Directors, National Home Furnishings Association).

62. *Collection of Certain State and Local Taxes, Hearings on S. 545 Before the Senate,* 104th Cong., 1st Sess. 3845 (1995) (statement of Dale Bumpers, Senator) (citing from Lands' End's first quarterly report of 1994). During the last quarter of 1993, Fingerhut reported in its annual report to shareholders that to the extent any states are successful in requiring use tax collection, the increased cost of doing business would not be material. *Id.*

63. *Taxes on Mail-Order Purchases, Hearings on S. 1825 Before the Senate Comm. on Small Business,* 103d Cong., 2d Sess., 3845 (1994) (statement of Jerry Hux, Member of Board of Directors, National Home Furnishings Association).

64. *Interstate Sales Tax Collection, Before the Subcomm. on Procurement, Taxation & Tourism of the House Comm. on Small Business,* 103rd Cong., 2nd Sess. (1994) (statement of Robert J. Levering, Senior Vice-President, Direct Marketing Association).

65. *Id.*; *Quill,* 504 U.S. at 328 (White, J., dissenting). Consumer protection laws protect the buyer from fraud and benefit the seller "by creating a climate of consumer confidence that inures to the benefit of reputable dealers in mail order transactions." *Quill,* 504 U.S. at 328 (White, J., dissenting).

66. An alternative legislative approach is for Congress to impose a federal tax directly on Internet purchases and then remit the proceeds to the states. Hartman, *supra* note 61, at 1015.

made at least thirteen unsuccessful attempts to grant states the power to require out-of-state retailers to collect use taxes.[67] This failure was due to lobbying efforts by the mail order industry[68] and Congressional insecurity about the constitutionality of such legislation.[69] However, the Supreme Court recently removed any legitimate Congressional insecurity when the Court acknowledged that Congress was better qualified to evaluate tax burdens on interstate commerce.[70]

67. S. 545, 104th Cong. 1st Sess. §3845 (1995); S. 1825, 103rd Cong., 2nd Sess. (1994); H.R. 2230, 101st Cong., 1st Sess. (1989) (granting states the power to require collection of use taxes by out-of-state vendors if the vendor engages in regular or systematic solicitation of business in the state and has annual sales exceeding either $12.5 million in the United States or $500,000 in the taxing state); S. 480, 101st Cong., 1st Sess. (1989) (granting states the power to require collection of use taxes by out-of-state vendors if the vendor engages in regular or systematic solicitation of business in the state and has annual gross sales exceeding either $12.5 million in the United States or $500,000 in the taxing state); S. 2368, 100th Cong., 2d Sess. (1988) (granting states the power to require use tax collection by out-of-state vendors if the vendor engages in regular or systematic solicitation of business in the state and has annual gross sales exceeding $15,000,000 in the United States or $750,000 in the taxing state); H.R. 3521, 100th Cong., 1st Sess. (1987) (granting states the power to require use tax collection by out-of-state vendors if the vendor engages in regular or systematic solicitation of business in the state and has annual gross sales exceeding $12,500,000 in the United States or $500,000 in the taxing state); H.R. 1891, 100th Cong., 1st Sess. (1987) (granting states the power to require use tax collection by out-of-state vendors if the vendor engages in regular or systematic solicitation of business in the state and has annual gross sales exceeding $12,500,000 in the United States or $500,000 in the taxing state); H.R. 1242, 100th Cong., 1st Sess. (1987) (granting states the power to require use tax collection by out-of-state retailers with annual nationwide sales exceeding $5,000,000 and requiring retailers to file annual information returns); S. 1099, 100th Cong., 1st Sess. (1987) (granting states the power to require use tax collection by out-of-state vendors if the vendor engaged in regular or systematic solicitation of business in the state and had annual gross sales exceeding $12,500,000 in the United States or $500,000 in the taxing state); S. 639, 100th Cong., 1st Sess. (1987) (granting states the power to impose a sales or use tax on interstate sales by out-of-state retailers); S. 2913, 99th Cong., 2d Sess. (1987) (granting states the power to require use tax collection by an out-of-state vendor if the vendor engages in regular or systematic solicitation, has annual gross sales exceeding $100,000 in the United States or $25,000 within the taxing state, and requires one uniform sales tax and use tax rate per state); H.R. 3549, 99th Cong., 1st Sess. (1985) (granting states the power to require use tax collection by an out-of-state vendor if the vendor engages in business in that state, has annual national gross sales exceeding $5,000,000 and requires one uniform sales tax and use tax rate per state); S. 1510, 99th Cong., 1st Sess. (1985) (granting states the power to require use tax collection by out-of-state retailers on any interstate sale); S. 983, 96th Cong., 1st Sess. (1979); S. 282, 93 Cong., 1st Sess. (1973).

68. Pamela M. Krill, *Quill Corp. v. North Dakota: Tax Nexus Under the Due Process and Commerce Clause No Longer the Same*, WIS. L. REV. 1405, 1429 (1993). The largest trade association representing the mail-order industry conducted a national campaign to prevent federal legislation. *Id.* at 1429 n.152.

69. *Id.* at 1429.

70. *Quill*, 504 U.S. at 318. "[C]ongress is now free to decide whether, when, and to what extent the States may burden interstate mail-order concerns with a duty to collect use taxes." *Id.*

2. *The Court's View of Substantial Nexus is Outdated*

According to Supreme Court commerce clause doctrine, a vendor must have something more than a *mere physical presence* in a state to establish substantial nexus.[71] Substantial nexus between an out-of-state vendor and the taxing state must exist before the taxing state can impose tax collection duties on the vendor. The Supreme Court's position on commerce clause nexus is untenable for three reasons: (1) the commerce clause analysis in *Quill Corp. v. North Dakota,*[72] was flawed; (2) justification of a physical presence standard is unsustainable; and (3) an economic presence is sufficient in other tax matters.

The Quill Corporation sold office equipment and supplies nationwide.[73] Quill had no sales representatives that worked or resided in North Dakota, nor did it own any retail outlets or tangible property (other than a few computer diskettes) in North Dakota.[74] Quill solicited business in North Dakota by catalog, direct mail, flyers, trade journals, and telephone.[75] All merchandise purchased by North Dakota customers was delivered by mail or common carrier.[76]

North Dakota imposed a use tax upon property purchased at retail for storage, use, or consumption[77] and required retailers who "engage in regular or systematic solicitation of consumer markets in the state" to collect and remit the tax to the state.[78] The North Dakota statute defined "regular or systematic solicitation" as three or more advertise-

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71. *Quill*, 504 U.S. at 315 n.8; *see also National Geographic*, 430 U.S. at 551.

72. *See Quill*, 504 U.S. at 298.

73. *Id.* at 302. Quill is a Delaware corporation and has annual sales exceeding $200 million; $1 million of which is derived solely from North Dakota. *Id.* Quill sells products nationwide, but has offices in Illinois, California, and Georgia. *Id.*

74. *Id.* at 302. Quill licensed a computer software program to some of its North Dakota customers. *Id.* at 302 n.1. The software allowed the customers to examine Quill's inventory and prices, and enabled customers to make orders directly. *Id.*

75. North Dakota v. Quill Corp., 470 N.W.2d 203, 204 (N.D. 1991).

76. *Id.*

77. N.D. CENT. CODE § 57-40.2-02.1(1) (Supp. 1991). "[A]n excise tax is imposed on the storage, use, or consumption in this state of tangible personal property purchased at retail for storage, use, or consumption in this state, at the rate of five percent of the purchase price of the property." *Id.*

78. *Id.* at § 57-40.2-07(1). This section provides:

> Every retailer maintaining a place of business in this state and making sales of tangible personal property for use in this state, . . . shall obtain a permit from the commissioner to collect the tax imposed by this chapter, . . . and at the time of making such sales, whether within or without the state, shall . . . collect the tax imposed by this chapter from the purchaser.

Id. Section § 57-40.2-01(7) further defines a "retailer maintaining a place of business in this state": "[I]t includes every person who engages in regular or systematic solicitation of sales of tangible personal property in this state by the distribution of catalogs, periodicals, advertising flyers, or by other advertising." 11 N.D. CENT. CODE § 57-40.2-01(7).

ments within a twelve month period.[79]

Quill did not comply with North Dakota's use tax statute.[80] Quill's noncompliance prompted the Tax Commissioner to seek a declaratory judgment that Quill was a "retailer maintaining a place of business" in North Dakota and, therefore, Quill must collect and remit use tax on sales to North Dakota customers.[81] The trial court entered judgment for Quill,[82] but the North Dakota Supreme Court reversed;[83] ultimately, the United States Supreme Court granted a writ of *certiorari*.[84]

In *Quill*, the Supreme Court had to decide whether a state could require use tax collection from an out-of-state vendor who lacked a physical presence, but nevertheless purposefully availed itself of the taxing state's economic markets.[85] The Court revised its justification of a physical presence requirement and held that the commerce clause required a physical presence.[86]

a. The Quill Court's Commerce Clause Analysis

The *Quill* Court's justification of a physical presence requirement introduced a novel view of the commerce clause.[87] The Court identified *separate* nexus requirements under the commerce and due process clauses.[88] The Court held that under modern due process analysis, a physical presence was no longer required and thus, the North Dakota

79. N.D. ADMIN. CODE § 81-04.1-01-03.1 (1988).

80. North Dakota v. Quill Corp., 470 N.W.2d at 205.

81. *Id.* at 203.

82. *Quill*, 504 U.S. at 314-15. The trial court, relying primarily upon *Bellas Hess*, 386 U.S. at 753, found that North Dakota had failed to establish a sufficient nexus between Quill and North Dakota. *Quill*, 504 U.S. at 315. In *Bellas Hess*, the court held that the absence of a physical presence by a mail-order retailer prevented Illinois from satisfying the nexus requirements of the due process and commerce clauses. *Bellas Hess*, 386 U.S. at 753.

83. North Dakota v. Quill Corp., 470 N.W.2d 203. The North Dakota Supreme Court found that *Bellas Hess* was no longer controlling and reversed the trial court. *Id.* at 208-15. The North Dakota Supreme Court based its decision on two grounds; first, "the economic, social, and commercial landscape upon which *Bellas Hess* was premised no longer exists, save perhaps in the fertile imaginations of attorneys representing mail order interests." *Id.* at 208. The mail order business has grown from an "inconsequential market niche, into a goliath." *Id.* Second, the legal landscape, with regard to the Due Process and Commerce Clauses, made following *Bellas Hess* inappropriate. *Id.* at 209. The North Dakota Supreme Court held that the first prong of the *Complete Auto* test, substantial nexus, did not require a physical presence and, therefore, Quill's significant economic presence was sufficient to warrant North Dakota's imposition of use tax collection duties upon Quill. *Id.* at 219.

84. *Quill*, 504 U.S. at 298.

85. *Id.* at 301-04.

86. *Id.* at 317-19.

87. *Id.* at 325-26 (White, J., dissenting).

88. *Quill*, 504 U.S. at 312.

use tax as applied to Quill was valid.[89] However, more importantly, the Court held that under commerce clause analysis a physical presence is still required.[90] Thus, the North Dakota use tax as applied to Quill was unconstitutional.[91] This bifurcation of the nexus requirement was unprecedented and incompatible with the origins of the requirement and the policy grounds underlying it.[92]

b. Physical Presence is Unjustifiable

The Court stated that its holding might differ if the issue were a case of first impression.[93] Nevertheless, the Court offered several justifications. The Court pointed to the administrative advantages of a physical presence standard, the mail-order industry's reliance interest, *stare decisis*, and Congress's ability to resolve the issue through legislation.[94] These reasons, however, are insufficient to require a physical presence standard.

The Court thought that a bright-line rule requiring physical presence would avoid controversy and confusion.[95] The Court acknowledged that this rule might "appear artificial at its edges," but thought the rule would establish the boundary of state authority to impose collection duties and reduce litigation.[96]

What the Court thought appeared artificial, *is* artificial. The physical presence standard is a bright-line test by name, but the test becomes quite blurry when applied by courts. The test requires courts to make a determination of what constitutes a physical presence and this leads to unpredictable results. For example, in *Quill*, a few computer diskettes in the taxing state was an insufficient physical presence,[97] yet, in *Orvis Co.*

89. *Id.* at 308.

90. *Id.* at 311.

91. *Id.* at 309-19.

92. James L. Kronenberg, Note, *A New Commerce Clause Nexus Requirement: The Analysis of Nexus in Quill Corp. v. North Dakota*, ANN. SURV. OF AM. L. 1 (1994). The origins of the nexus requirement in due process and commerce clause jurisprudence suggest that the commerce clause nexus inquiry subsumes the due process nexus inquiry. *Id.* Thus, the *Quill* court improperly separated the due process and commerce clause nexus requirements. *Id.*

93. *Quill*, 504 U.S. at 311. The Court stated that "contemporary Commerce Clause jurisprudence might not dictate the same result were the issue to arise for the first time today." *Id.*

94. *Id.* at 315-20.

95. *Id.* at 315.

96. *Id.* One commentator suggests that the bright-line rule of physical presence provides too much protection to the mail industry, especially when balanced against the state's ability to raise revenue. Shane D. Buntrock, Note, *Quill Corporation v. North Dakota: Spawning the Physical Presence "Nexus" Requirement Under the Commerce Clause*, 38 S.D. L. REV. 130, 132 (1993).

97. *Quill*, 504 U.S. at 315 n.8.

v. New York Dep't of Taxation,[98] occasional visits to the taxing state by advisors constituted a physical presence. Where is the bright-line? Is the bright-line a few computer diskettes or is it occasional advisory visits to the taxing state? This standard is malleable, does not establish collection boundaries, and will not reduce litigation.

The majority in *Quill* also asserted that the physical presence standard created a reliance interest by encouraging settled expectations, which in turn fostered investment.[99] The Court attributed the extensive growth in the mail-order industry over the last twenty-five years to the bright-line rule.[100] However, since the rule was announced in *Bellas Hess*, subsequent decisions have signalled the elimination of a physical presence standard.[101] Furthermore, by continuing to impose the physical presence requirement, the Court has made an economic decision favoring out-of-state mail-order vendors to local retailers.[102]

Stare decisis provided another ground for the *Quill* court's holding.[103] *Stare decisis* was offered as a justification even though the Court

98. 86 N.Y.2d 165 (1995). *Orvis* involved two decisions pertaining to two Vermont vendors. *Id.* at 168. The petitioner, Orvis, sells camping, fishing, hunting equipment, clothing, food, and gift items both at retail and wholesale. *Id.* Orvis's retail sales were predominately mail-orders which were filled in Vermont and delivered by common carrier or the United States mail. *Id.* New York retailers also purchased merchandise from Orvis at wholesale. *Id.* Orvis's salesmen who resided in Vermont visited New York retailers on an average of four times a year. *Id.* at 173.

The Vermont Information Processing Inc. (VMI) was the other company involved in this action. *Orvis*, 86 N.Y.2d at 168. VMI markets computer software and hardware to beverage distributors. *Id.* VMI is also located in Vermont and fills most of its orders by common carrier or United States mail. *Id.* However, a New York audit revealed that VMI's employees had visited New York customers to resolve problems and give advice. *Id.*

The New York Commissioner of Taxation and Finance sought to impose tax collection duties upon Orvis and VMI, but the Appellate Division held that the commerce clause required a *substantial* physical presence and, therefore, prevented New York from imposing such a duty. Matter of Orvis Co. v. Tax Appeals Tribunal State of N.Y., 204 A.D.2d 916 (1994); Matter of Vermont Information Processing, Inc. v. Tax Appeals Tribunal of N.Y., 206 A.D.2d 764 (1994). On appeal, the Court of Appeals of New York found that *Quill* did not require a *substantial* physical presence. *Id.* at 919. The appellate court then held that Orvis's systematic trips to New York and VMI's repair and advice trips were sufficient for New York to impose tax collection responsibilities. *Id.* *See also* Brown's Furniture, Inc. v. Wagner, 665 N.E.2d 795, (1996) (finding that a Missouri furniture store that made 942 deliveries in Illinois during a ten month period had a physical presence in Illinois). *Cf.* SFA Folio Collections, Inc. v. Tracy, 652 N.E.2d 693 (1995) (stating that a foreign retailer did not have a physical presence in Ohio even though its sister corporation operates retail stores in Ohio that accept returned merchandise on the foreign retailers behalf, and distributes the foreign retailer's catalogs).

99. *Quill*, 504 U.S. at 316.

100. *Id.*

101. *Id.* at 331 (White, J., dissenting).

102. *Id.*

103. *Quill*, 504 U.S. at 317-18.

has overruled precedents under the commerce clause "when they have become anachronistic in light of later decisions."[104] Additionally, the rationale behind *stare decisis*, namely settled expectations, was not evident in this case. Quill did not claim any reliance on the *Bellas Hess* holding, and if Quill did rely on *Bellas Hess*, that reliance was unreasonable because Quill failed to comply with North Dakota law.[105]

Lastly, the *Quill* court justified its decision by stating that Congress has the power to resolve the use tax collection issues.[106] Although Congress has the power to legislate in this area, the Court should not adhere to a decision when "later cases and economic reality can no longer" justify the prior decision.[107]

c. Economic Presence Providing Sufficient Nexus

The presence of intangibles was sufficient to satisfy the due process and commerce clauses in an income tax setting.[108] In *Geoffrey, Inc., v. South Carolina Tax Comm'n*,[109] the South Carolina Supreme Court held that an out-of-state licensor's royalty income was taxable when the licensee used a trademark within the taxing state, even though the licensor had no physical presence in the taxing state.[110]

The court determined that adequate grounds existed to satisfy due process concerns.[111] The due process clause requires "some minimum connection between a state and the . . . transaction it seeks to tax."[112] This nexus requirement "can be satisfied even where the corporation has no physical presence in the taxing state if the corporation has purposefully directed its activity at the state's economic forum."[113] The court found two bases for due process nexus. First, Geoffrey had licensed its trademarks and trade names for use in South Carolina but had prohibited the use of these intangibles in other states.[114] Thus, Geoffrey's failure to prohibit the use of trademarks and trade names in South Carolina manifested Geoffrey's purposeful direction of activity toward South Carolina.[115] Alternatively, the presence of accounts receivable and a

104. *Id.* at 331 (White, J., dissenting).
105. *Id.* at 331-32 (White, J., dissenting).
106. *Id.* at 318-19.
107. *Quill*, 504 U.S. at 333 (White, J., dissenting).
108. Geoffrey, Inc. v. South Carolina Tax Comm'n, 437 S.E.2d 13 (S.C. 1993), *cert. denied*, 510 U.S. 992 (1993).
109. *Id.*
110. *Id.* at 18-19.
111. *Id.* at 16.
112. *Geoffrey*, 437 S.E.2d at 16 (citing *Quill*, 504 U.S at 306).
113. *Geoffrey*, 437 S.E.2d at 16 (citing *Quill*, 504 U.S. at 306-08).
114. *Geoffrey*, 437 S.E.2d at 16.
115. *Id.*

franchise in South Carolina provide the necessary "minimum contacts."[116]

Commerce clause nexus was of less concern to the court. Geoffrey's claim that a physical presence is required for substantial nexus was rejected by the court which found "it is well settled that the taxpayer need not have a tangible, physical presence in a state for income to be taxable there."[117] The court went on to hold that substantial nexus had been established because Geoffrey licensed intangibles for use in South Carolina and received income from them.[118] Satisfied that both the due process and commerce clauses nexus requirements had been met, the court held that Geoffrey's royalty income could be taxed.[119]

This decision leaves the states with a valuable weapon in their efforts to collect sales and use taxes on Internet purchases. The states may assume that the Supreme Court's denial of *certiorari* signals an affirmation that an intangible presence is a physical presence sufficient enough to satisfy commerce clause nexus. Whether or not this assumption is valid is irrelevant because states will eagerly follow South Carolina's initiative. The states will assert that an Internet vendor's web page provides an intangible presence sufficient to satisfy commerce clause nexus and therefore the states should be permitted to impose use tax collection duties upon the vendor.[120] Although, there is considerable

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116. *Id.*

117. *Id.* at 18. The *Geoffrey* court dismissed Quill's physical presence requirement in a footnote claiming that it was only applicable to the sales and use tax, but had not been extended to other types of taxes. *Id.* at 18 n.4. *See also* International Harvester Co. v. Wisconsin Dep't of Taxation, 322 U.S. 435, 441-42 (1944) (stating that income of a nonresident can be taxed if it is fairly attributable to either property within the taxing state or transactions which occur within the taxing state and are entitled to state protection or other benefits); American Dairy Queen Corp. v. Taxation & Revenue Dep't, 605 P.2d 251 (N.M. 1979) (determining that the presence of intangible property is sufficient to establish nexus with a state).

In *Dairy Queen*, the taxpayer is a Delaware Corporation that develops, licenses, franchises, and services stores which sell dairy desserts, foods, and beverages to the public under the trade names of "Dairy Queen," "Brazier," and "Mr. Misty." *Id.* at 253. Dairy Queen entered into franchise agreements with operators in New Mexico and received a license fee for the use of the "Dairy Queen" trade name. *Id.*

The New Mexico Department of Taxation & Revenue claimed the fees received by Dairy Queen fit within the state's definition of gross receipts and was therefore subject to tax. *Id.* The court found that Dairy Queen's trade name, trademark, and related intangibles were being used by operators in New Mexico and thus Dairy Queen was engaged in business and any consideration received was taxable as gross receipts. *Id.* at 254.

118. *Geoffrey,* 437 S.E.2d at 18.

119. *Id.* at 19.

120. Another method for states to collect use tax on out-of-state Internet purchases is to expand on a concept used in the mail order arena. Under this concept, states impose the collection burden upon themselves. Krill, *supra* note 68, at 1430-31. This method has nominal administrative costs and the potential for audits coaxes taxpayers into compliance. *Id.*

uncertainty as to the accuracy of such an argument, it nonetheless has serious implications to the taxpayer. After all, the taxpayer bears the burden of proving the contrary.

IV. RECOMMENDATION

The states must persuade federal legislators to help them in their tax collection efforts. The states should seek federal legislation that focuses on an Internet vendor's economic presence in a taxing state rather than a physical presence in a taxing state.[121] Under such legislation, a vendor's web page would merely establish an informational presence in a state, but would not satisfy the commerce clause nexus requirement. A vendor would be considered to have an informational presence in the taxing state when someone in that state accesses the web page. This informational presence will continue during any correspondence between the vendor and the person contacting the vendor. However, the safe haven that the informational presence provides will be terminated when the vendor makes his *first* Internet sale to a party in the taxing jurisdiction. The "first sale" will act as a trigger mechanism to change the Internet vendor's status. The vendor's informational presence will be transformed into an economic presence. This new economic presence will be sufficient to satisfy the nexus requirement of the commerce clause.

There are two alternatives to this method; the "aggressive" or "Maine" approach and the "conservative" strategy. *Id.*

States that follow the aggressive approach include a line on the individual income tax return and require the taxpayer to fill in the amount of mail-order purchases made during the tax period. *Id.* If the taxpayer enters "$0" there is no tax, but if the taxpayer leaves the line blank, the state automatically assesses a tax based on a percentage of the taxpayer's income. *Id.* Several states employ this method including Maine, Idaho, Indiana, Kentucky, New Jersey, Utah, Vermont, West Virginia, and Wisconsin. *Id.* at 1430-31 n.163.

The conservative method uses a strategy similar to the aggressive method, but does not have the automatic assessment characteristic. *Id.* at 1431. The states either include a line on the individual tax return or have separate use tax return. *Id.* Several states have adopted this method including Illinois, Michigan, Minnesota, Nevada, North Carolina, North Dakota, South Dakota, Virginia, and Washington. *Id.* at 1431 n.164.

An additional practice attempted involves the exchange of information between state tax departments. *Id.* at 1431 n.166. States conduct a full audit of mail-order vendors physically located in their state and in so doing, obtain customer lists. *Id.* The information is then exchanged with other states. *Id.* This allows states to identify customers within their taxing jurisdiction and assess individuals a use tax. *Id.*

121. Although unenforceable, twenty-five states already require mail-order sellers to collect use tax if they have an "economic presence." ALL STATES TAX HANDBOOK, RESEARCH INSTITUTE OF AMERICA, ¶ 252 (1995). The following states require collection of tax by mail order vendors if they regularly or systematically exploit an in-state market: Alabama, Arizona, California, Florida, Idaho, Illinois, Indiana, Iowa, Kansas, Louisiana, Massachusetts, Minnesota, Mississippi, Missouri, Nebraska, Nevada, North Carolina, North Dakota, Rhode Island, South Carolina, South Dakota, Tennessee, Texas, Utah, and Virginia. *Id.*

States will then be able to impose tax collection responsibilities on the Internet vendor.

This test is fair and will eliminate any valid vendor complaints. The test is equitable because it creates a true bright-line, removes a competitive disadvantage faced by local retailers, and enables states to tap a growing revenue source. Also, Internet vendors should not quarrel about such legislation. For it is the vendor who has voluntarily chosen to establish an economic presence in the taxing state. The vendor voluntarily creates the web page, accepts the purchase order, and delivers the goods into the taxing state. Moreover, the vendor will receive significant benefits from the taxing state. These benefits include: a court system in which to pursue delinquent accounts, waste disposal for packaging materials, consumer protection laws, and an infrastructure upon which delivery vehicles can travel.

V. CONCLUSION

The current commerce clause nexus requirements need to be updated to reflect the realities of modern commerce. The physical presence requirement is outdated and inequitable. Although the Supreme Court is unwilling to modify the nexus requirements, the judiciary has stated a willingness to acquiesce to any congressional revisions. Yet, given the mail-order industry's historical record, it does not appear that Congress will eagerly embrace suggestions to alter the status quo. Time may be the best hope for state treasuries and local retailers. As the importance of use tax collection on Internet purchases continues to grow, legislators may become more receptive to the needs of local retailers and state governments who are trying to satisfy their thirst for revenue.[122]

122. National Tax Association, 1994 Annual Conference 165 (1995).