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COMMENT

CHOPPING DOWN THE RAINFOREST: FINDING A SOLUTION TO THE “AMAZON PROBLEM”

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Current economic conditions in the United States have led to a dramatic decrease in state tax revenue.¹ Without these funds, states will be unable to support important public services, and hundreds of thousands of jobs in the public and private sectors are at risk of being cut, as states work to close \$103 billion in budget gaps.² Accomplishing that will involve overcoming many hurdles, such as the unpopularity of raising taxes during times of economic trouble, but one largely untapped source could provide a significant amount of income to states. States currently lose around \$23 billion annually in uncollected use taxes,³ about half of which likely would have come from transactions with Web retailers.⁴ Use taxes act as an adjunct to sales taxes on purchased goods and services that are not subject to sales taxes.⁵ But because this tax is voluntarily collected from the consumer instead of the retailer, compliance is extremely low.⁶

As a significant number of transactions only taxed by a use tax occur between in-state consumers and online retailers such as

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1. Elizabeth McNichol, Phil Oliff, and Nicholas Johnson, States Continue to Feel Recession's Impact, CENTER ON BUDGET AND POLICY PRIORITIES (Mar. 9, 2011), <http://www.cbpp.org/cms/index.cfm?fa=view&id=711>.

2. *See id.*

3. John Minassian, *Minimizing Self-Assessed Consumer Use Tax Liability Through Automation*, 21 J. MULTISTATE TAXATION & INCENTIVES 14, 17 (2011).

4. See Stu Woo, *Amazon Battles States Over Sales Tax*, WALL STREET JOURNAL (Aug. 3, 2011), <http://online.wsj.com/article/SB10001424053111904772304576468753564916130.html> (citing a study showing that state and local governments lost \$10.1 billion to \$11.3 billion in sales taxes not collected by Web retailers in 2009).

5. See Scott W. Gaylord and Andrew J. Haile, *Constitutional Threats in the E-Commerce Jungle: First Amendment and Dormant Commerce Clause Limits on Amazon Laws and Use Tax Reporting Statutes*, 89 N.C. L. REV. 2011, 2018-19 (2011).

6. See Joshua Sibble, *Recent Developments in Internet Law*, 23 No. 4 INTELL. PROP. & TECH. L. J. 12.

Amazon.com,⁷ the increasing dominance of e-commerce over brick and mortar retail has given rise to a major threat to a long-established and relatively stable mechanism for providing states with tax revenue. But the states' tools to address this issue have been severely limited by a nearly twenty-year-old Supreme Court decision that imposes an antiquated bright-line rule over sales tax imposition, leaving states to choose between legislative options that are either ineffective, overly costly, or unconstitutional.⁸ Meanwhile, an inactive Congress has repeatedly failed to enact legislation that would address this issue.

Federal legislation that unifies and clarifies interstate sales tax policies would be both effective and constitutional, but courts should reexamine the merits and logic of *Quill Corp. v. North Dakota*. An easing of the bright-line requirement of a physical presence to constitute a sufficient nexus would likely spur Congressional action that would address concerns that national retailers have about being exposed to sales tax obligations.

THE *QUILL* CONUNDRUM

Quill attempted to clarify the oft-changing law regarding when states could require out-of-state businesses to collect use taxes on sales to in-state consumers. Acknowledging a shift away from formalistic jurisprudence in this area in recent years,⁹ the Supreme Court held that the jurisdictional requirement of purposeful availment was easily met in this and similar cases.¹⁰ But while the Due Process Clause may not have been offended, the Court ultimately concluded that a state instead runs afoul of the Dormant Commerce Clause and unduly burdens interstate commerce if it taxes a business that lacks a "physical presence" in the state.¹¹ The Court folds this rule into the first inquiry of the four-part test for constitutionality of a tax under the Commerce Clause introduced in *Complete Auto Transit v. Brady*: whether a

7. See Minassian, *supra* note 3, at 18 (tracing the increase in e-commerce shipments for all sectors of the economy since 2000).

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

9. *Id.* at 311.

10. See *id.* at 306-07.

11. *Id.*

tax is “applied to an activity with a 'substantial nexus' with the taxing State.”¹²

In his opinion for the majority, Justice Stewart emphasized that the requirements of the Dormant Commerce Clause are animated by “structural concerns about the effects of state regulation on the national economy” and the need to protect against the types of restrictions on interstate commerce that proved cancerous under the Articles of Confederation.¹³ But states, in seeking to tax purchases from out-of-state merchants, are not attempting to gain an unfair advantage for in-state businesses. Rather, they are trying to correct out-of-state businesses’ advantage over in-state businesses. Surely the law, and those who apply it, can distinguish between a tax that discriminates against foreign businesses from one that treats them no differently from businesses that physically exist within the state.¹⁴

Such a standard is perhaps not as predictable as some would like, and the Court in *Quill* put much stock in the value of a clear rule over the potential dangers of 'artificiality.' Specifically, the court believed that this decision would “firmly establish[] the boundaries of legitimate state authority...and reduce litigation concerning...taxes” as well as “encourage[] settled expectations...foster[ing] investment by business and individuals.”¹⁵

In the years since *Quill*, the artificiality of this rule has only become clearer¹⁶ while the supposed benefits have remained murky. The boundaries of state authority may indeed be clearer today, but they are certainly not unlitigated.¹⁷ And whatever clarity we have gained has come at a price. States are forced to accept the loss of huge sums of revenue due to being unable to

12. 430 U.S., at 279.

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

14. See Gaylord, *supra* note 5, at 2074 (finding support for such an idea in *Philadelphia v. New Jersey*, 437 U.S. 617 (1978)).

15. *Quill*, 504 U.S. at 315-16.

16. See Gaylord, *supra* note 5, at 2083-84 (“With the rapid expansion of e-commerce, that “artificiality” has been amplified, creating a substantial tax disparity between internet retailers and traditional brick-and-mortar retailers.”); see also Zelda Ferguson, *Is the Tax Holiday Over for Online Sales?*, 63 TAX LAW. 1279, 1281-82 (2010).

17. See *Quill*, 504 U.S. at 330 (“Reasonable minds surely can, and will, differ over what showing is required to make out a 'physical presence' adequate to justify imposing responsibilities for use tax collection.”) (J. White, J., concurring in part and dissenting in part.)

implement a taxation scheme motivated not by prejudice against interstate commerce but a desire to receive payment from transactions that benefit from their own laws and infrastructure.

It is true, of course, that this rule has succeeded in encouraging the development of interstate business, and there may be economic justifications for a rule that privileges national retailers over local ones. But do those benefits outweigh the increasing costs to state resources? As our economy continues to shift towards a higher proportion of online transactions, it is worth reexamining the value of such a policy.¹⁸

At the end of the day, *Quill* imposes a hard limit on a state's taxing power. But it may also provide hints of its own future demise. Stewart suggests that it may be time for a bright-line rule to be replaced by a more contextual inquiry when it becomes anachronistic, rarely applied by courts, or when there is no strong reliance interest that would be upset by abandoning it.¹⁹ At the time, the court felt this protected the "physical presence" rule, but a court examining a similar case today should arrive at the opposite conclusion. Arguably already anachronistic when enacted,²⁰ the rise of e-commerce has surely supplanted much of the traditional understanding of sales that formed the rule's policy foundation. While businesses engaging in interstate commerce may claim there is sufficient reliance to maintain the rule, being required to pay a tax that in-state businesses are already expected to pay does not seem an unfair imposition that must be prevented. And while courts have faithfully applied the rule since its adoption, it has been applied "as is," without much further development or extension. *Quill* is an empty branch of law, and it would benefit us to chop it off.

STATE SOLUTIONS AFTER *QUILL*

Unable to directly tax out-of-state retailers, states generally require purchasers of products and services purchased from these

18. *See id.* at 329 ("Very questionable is the rationality of perpetuating a rule that creates an interstate tax shelter for one form of business...but no countervailing advantage for its competitors.") (White, J., concurring in part and dissenting in part).

19. *Id.* at 316-17.

20. *See id.* at 328. ("In today's economy, physical presence frequently has very little to do with a transaction a State might seek to tax.") (J. White, J., concurring in part and dissenting in part).

retailers to pay a use tax equal to the sales tax that would be imposed normally. A perfect solution, spare one major caveat: consumers almost never pay them.²¹ Efforts have been made to improve compliance through education and increased enforcement, but both of these solutions cost money, and neither has led to much success.²²

North Carolina recently attempted to improve its enforcement ability by auditing the identity and purchases of state customers who purchased from out-of-state retailers, but this method was struck down as unconstitutional, and similar techniques bear concerning implications for privacy and free expression.²³

At least fourteen states²⁴ have created laws commonly known as “Amazon laws,” crafted to enable the state to tax retailers that pay commissions to in-state affiliates (people who link potential customer’s to the retailer’s website) even if the retailer does not have an in-state physical presence.²⁵ The constitutionality of such laws has so far been upheld in New York courts, perhaps incorrectly,²⁶ owing to a line of cases decided before *Quill* that considers the presence of contracted sales agents as constituting a physical presence in a state.²⁷ But these laws may not survive long enough for their constitutionality to be conclusively tested, as the standard response by out-of-state retailers is to simply adjust their behavior so as not to trigger them.²⁸

While *Quill* restricts a state’s ability to directly tax out-of-state retailers, Congress possesses the ability to enact legislation that would empower the states to do so, and there have been attempts to push them to do so. In the early 2000’s, a national coalition drafted the Streamlined Sales and Use Tax Agreement (SSUTA), which was intended to make state tax laws more uniform, and thus reduce the “undue burden” on retailers faced with paying

21. Gaylord, *supra* note 5, at 2017.

22. *Id.* at 2025 (mentioning that efforts to inform North Carolinians about their use tax obligation have been unsuccessful.).

23. *See id.*

24. *See* Ferguson, *supra* note 16, at 1293.

25. *See* Daniel Tyler Cowan, *New York’s Unconstitutional Tax on the Internet*, 88 N.C. L. REV. 1423, 1434-35 (2010).

26. *See* Ferguson, *supra* note 16.

27. *Scripto v. Carson*, 362 U.S. 207 (1960); *Tyler Pipe Indus. v. Washington State Dep’t of Revenue*, 483 U.S. 232 (1987).

28. *See* Gaylord, *supra* note 5, at 2033; Ferguson, *supra* note 16, at 1294.

taxes on interstate transactions.²⁹ The drafters hoped that this would lead to Congressional action permitting states to require these retailers to collect taxes despite having no “physical presence” in the state.³⁰ Yet each time this has been proposed in Congress, lobbying by Internet and other typically out-of-state retailers has led to its defeat.³¹ Recently, a proposal was introduced into Congress in the form of the “Marketplace Fairness Act”³² that would allow states to tax transactions with out-of-state retailers if they adopted measures to simplify the payment process.³³ Amazon has lent its support to the proposal, but other online retailers such as eBay have opposed it, and its passage through the present Congress remains uncertain.

Internet retailers resist legislation that would require them to pay new taxes, as this removes a competitive edge they use to maintain lower prices than in-state retailers. Amazon in particular has created a corporate structure that maintains a physical presence under *Quill* in as few states as possible, operating only non-selling facilities in others.³⁴ It also meticulously tracks its sales activity in each state to ensure their employees' actions in a state do not activate a state provision requiring collection of tax, and limits its activity in states with “aggressive tax offices.”³⁵ Relaxing the *Quill* standard would also expose retailers to sales tax collection requirements that vary significantly state by state, greatly increasing retailers' compliance costs. For its part, Amazon has resisted state legislation while voicing support for a national standard set by Congress.³⁶

However, sales tax collection would not be the death knell of the competitive advantage and market share enjoyed by online retailers. At least one study has suggested that Amazon would still

29. See Gaylord, *supra* note 5, at 2029.

30. *Id.* at 2030.

31. *Id.*

32. S. 1832, 112TH CONGRESS, 1st Session.

33. Jim Puzanghera, *Prospect of Online Sales Tax Grows*, LOS ANGELES TIMES, Nov. 10, 2011, <http://articles.latimes.com/2011/nov/10/business/la-fi-us-amazon-sales-tax-20111110>.

34. Stu Woo, *Amazon Battles States Over Sales Tax*, WALL STREET JOURNAL, Aug. 3, 2011, <http://online.wsj.com/article/SB10001424053111904772304576468753564916130.html>.

35. *Id.*

36. Marc Lifsher, *California Senate Approves Amazon Sales Tax Deal*, LOS ANGELES TIMES, September 9, 2011, http://latimesblogs.latimes.com/money_co/2011/09/amazon-tax-california-legislature.html.

be able to offer lower prices than its rivals even if it has to pay more taxes.³⁷ Smaller outfits may not enjoy the same comfort in the market as Amazon, but their alarm will likely be heard loud and clear by lawmakers, who would likely be persuaded to reconsider legislation imposing a national standard that would require consistency between each state's taxation system. This would prevent national retailers from the difficulty of complying with wildly different taxation schemes in different states. Amazon for its part seems to have decided that having to comply with a national sales tax scheme is preferable over continued battles with state lawmakers.³⁸

On the flipside, this shift would bring in much-needed revenue for states, as well as eliminate an unfair advantage enjoyed by out-of-state businesses engaged in interstate commerce. It would even lessen the disparate impact of sales taxes on lower income households, as their wealthier neighbors can no longer avoid taxes through Internet shopping.³⁹

The *Quill* decision was penned with an eye towards encouraging Congress to use its constitutionally granted power to regulate interstate commerce to make its own determination of the proper limits of a state's ability to tax interstate transactions.⁴⁰ Unfortunately, Congress has not done its part, and the antiquated physical presence rule continues to poison the ability of states to lawfully tax transactions between in-state consumers and Internet retailers whose electronic presence in a state weighs just as heavily as brick and mortar. The proposed Marketplace Fairness Act could address this problem, but its passage is uncertain. There is little reason to cling to *Quill*. We are better served by recognizing its obsolescence and forcing Congressional involvement than having to tiptoe around it and risk further complicating this system.

37. See *The Walmart of the Web*, *ECONOMIST*, Oct. 1, 2011, at 65, 66.

38. See Woo, *supra* note 34.

39. Ferguson, *supra* note 16, at 1294.

40. See *Quill Corp. v. North Dakota*, 504 U.S. 298, 317 (“The underlying issue is not only one that Congress may be better qualified to resolve, but also one that Congress has the ultimate power to resolve. No matter how we evaluate the burdens that use taxes impose on interstate commerce, Congress remains free to disagree with our conclusions.”)