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QUITTING QUILL: STATE LAWS CHALLENGE QUILL'S PHYSICAL PRESENCE STANDARD FOR OUT-OF-STATE TAX COLLECTION

❖ ARTICLE ❖

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Abstract

Over the last fifty years, one of the bedrock principles of state and local tax jurisprudence has been the physical presence standard. The rise of E-commerce and a shifting economy, however, have for years called into question its validity. States, too, have taken notice, and new state laws are being crafted that either bypass this requirement or challenge it head-on. It may not be long before the physical presence standard becomes a thing of the past.

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I. INTRODUCTION

Twenty-five years ago this May, the United States Supreme Court decided what has come to be one of the most controversial cases in state and local tax history: *Quill*.[1] The physical presence standard that was affirmed in *Quill*–which requires out-of-state vendors have a physical presence within a state before sales tax collection obligations can be imposed–was criticized as "obsolete" at the time.[2] Yet, this many years later, the physical presence standard is still on the books. Recently, however, states have begun enacting use tax reporting and collection statutes that seek to expand taxing authority beyond their boundaries – in complete dereliction of *Quill*.[3] These laws are setting up a showdown in the nation's highest court: one that could dramatically alter states' abilities to require out-of-state vendors to collect their taxes.

II. STATES' ATTEMPTS TO AVOID QUILL'S REQUIREMENTS

A. Evading Quill -- Colorado's Use Tax Reporting Requirements

Colorado is the first state to claim victory against *Quill*. In 2010, Colorado codified a use tax reporting requirement that forces out-of-state vendors who lack physical presence with the state–and thus, do not collect taxes on their sales into the state–to report residents' use tax obligations to the Colorado Department of Revenue.[4] The law was challenged in *Direct Marketing Association v. Brohl*,[5] but in December 2016, the Supreme Court denied cert. in the case.[6] The Supreme Court's decision, or lack thereof, essentially blessed Colorado's reporting obligation, which has allowed other states to enact similar laws. And, interestingly, Judge Gorsuch's concurring opinion in *Brohl* provides insight into the future of state sales and use tax laws as President Trump's nominee to fill Justice Scalia's vacancy on the bench.[7]

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[1] Quill Corp. v. N. Dakota, 504 U.S. 298 (1992).
[2] *Id.* at 301.
[3] COLO. REV. STAT. § 39-21-112.3.5 (2016); H.B. 3057, 100th Gen. Assemb. (Ill. 2017); 32 VT. STAT. ANN tit. 32, § 9712 (2016).
[4] COLO. REV. STAT. § 39-21-112.3.5 (2016).
[5] 814 F.3d 1129 (10th Cir.), *cert. denied*, 137 S. Ct. 591 (2016), *and cert. denied*, 137 S. Ct. 593 (2016).
[6] 137 S.Ct. 591 (2016).
[7] Amy Howe, *Trump Nominates Gorsuch to Fill Scalia Vacancy*, SCOTUSBLOG (Jan. 31, 2017, 9:51 PM), http://www.scotusblog.com/2017/01/trump-nominates-gorsuch-fill-scalia-vacancy/.

1. *Circumventing Quill -- Colorado's Law*

Colorado's use tax reporting law evaded *Quill* by forcing out-of-state vendors to disclose certain information to Colorado consumers and the Colorado Department of Revenue, rather than having the out-of-state vendor directly collect the sales taxes that consumers owed to the state.[8] The law has two primary themes: notice to purchasers and notice to the State – along with three primary requirements.

First, under the statute and regulations, every out-of-state vendor who does not collect Colorado sales tax, and who makes more than $100,000 worth of sales into the State, must send an individual transaction notice to Colorado purchasers notifying them that use tax is due on each purchase.[9] Second, an end of year notice of total purchases made must be sent to each Colorado purchaser whose purchases were greater than $500.[10] And, finally, each vendor must file an end of year statement for each purchaser with the Colorado Department of Revenue.[11] Failure to comply with the various notice and filing requirements could lead to a substantial financial penalty.[12] Thus, vendors are left with either being forced to collect the Colorado use tax, which would shield them from the notice requirements, or comply with the notice and reporting requirements – to avoid serious penalties.

2. *The Supreme Court's Blessing -- Direct Marketing Association v. Brohl*

On December 12, 2016, the United States Supreme Court constitutionally blessed Colorado's reporting statute when it denied certiorari in *Direct Marketing Association v. Brohl.*[13] This denial allowed the Tenth Circuit's prior decision in *Brohl*, which found in favor of the State, to stand.[14]

Brohl was the most prominent challenge to Colorado's law, and Direct Marketing Association ("DMA") used *Quill*'s physical presence standard to

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[8] COLO. REV. STAT. § 39-21-112.3.5 (2016).
[9] COLO. REV. STAT. § 39-21-112.3.5 (c)(I) (2016); COLO. CODE REGS. § 201-1:39-21-112.3.5 (2016).
[10] COLO. REV. STAT. § 39-21-112.3.5 (d)(I)(A) (2016); COLO. CODE REGS. § 201-1:39-21-112.3.5 (2016).
[11] COLO. REV. STAT. § 39-21-112.3.5 (2016); COLO. CODE REGS. § 201-1:39-21-112.3.5 (2016).
[12] COLO. REV. STAT. § 39-21-112.3.5 (c)(II), (d)(III)(A)–(B) (2016).
[13] 814 F.3d 1129 (10th Cir.), *cert. denied,* 137 S. Ct. 591 (2016), *and cert. denied,* 137 S. Ct. 593 (2016).
[14] *Id.* at 1131.

challenge its constitutionality.[15] DMA's argument was straightforward. Put simply, DMA's contention in *Brohl* was that *Quill*'s physical presence standard limited Colorado's ability to require out-of-state vendors to report tax obligations to Colorado consumers and the state, and, thus, requiring out-of-state vendors to make the disclosures or reports under the law unconstitutionally burdened interstate commerce.[16] However, the court saw a fatal flaw in DMA's argument. Bolstered by a previous intermediate decision by the Supreme Court in this case (the case had previously been appealed on a separate issue), the Tenth Circuit limited *Quill*'s holding to "tax collection," not tax reporting.[17] The court latched onto this idea, planted in its mind by the Supreme Court,[18] that *Quill* was not binding where the state wasn't seeking to collect tax, but rather where it sought compliance with notice and disclosure requirements.[19] Put simply, *Quill*'s strict physical presence standard did not apply in this case because it wasn't asking vendors to act as tax collectors. Because the court made this distinction, it easily found that Colorado's law did not discriminate against or unduly burden interstate commerce – upholding Colorado's reporting law as constitutional.[20]

3. Judge Gorsuch's Premonition – Other States Adopt Colorado's Approach

Buried in the Tenth Circuit's decision, in Judge Gorsuch's concurring opinion, lies an important presentment:

> [I]f my colleagues and I are correct that states may impose notice and reporting burdens on mail order and internet retailers comparable to the sales and use tax collection obligations they impose on brick-and-mortar firms, many (all?) states can be expected to follow Colorado's lead and enact statutes like the one now before us.[21]

If the court's decision withstands future scrutiny (which it somewhat already has), nearly every other state could take Colorado's approach, which would essentially erode *Quill*'s requirements. And, Judge Gorsuch was correct. Other

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[15] *Id.* at 1129.
[16] *Id.* at 1132.
[17] *Id.* at 1139.
[18] Direct Mktg. Ass'n v. Brohl, 135 S. Ct. 1124, 1131 (2015).
[19] *Direct Mktg. Ass'n*, 814 F.3d at 1147.
[20] *Id.*
[21] *Id.* at 1151 (Gorsuch, J., concurring).

states have begun adopting Colorado's approach, largely mirroring the exact language and requirements of Colorado's law.[22] The most recent state to do so being Illinois.[23]

B. Attacking Quill – States Direct Assault on the Physical Presence Standard

At least two states, Alabama[24] and South Dakota,[25] have launched direct challenges to *Quill*. Both states take direct aim at *Quill*'s physical presence standard by requiring "out-of-state sellers" who "lack physical presence" to collect state sales tax.[26] The only true limitations on the states authority are sales caps. In South Dakota, an out-of-state seller must make more than $100,000 worth of sales into the state before being obligated to collect tax.[27] In Alabama, the requirement is set at $250,000.[28] Unsurprisingly, both states' actions are being challenged by major online retailers, Wayfair and Newegg.[29] It seems likely that one of these cases could make its way to the Supreme Court, given Justice Kennedy's direct call for a case to challenge *Quill* and the constitutional issues involved.[30]

III. THE PATH FORWARD – PREPARING FOR A POST-QUILL TAX WORLD

It is not yet certain that *Quill* will disappear when challenged next. Looking at the DMA decision tells us one thing: states may require that out-of-state vendors make certain disclosures or reports within the state. But it doesn't tell us much more. The court, and especially Judge Gorsuch, were hesitant to get rid of *Quill* just yet. Gorsuch reminded everyone that the court should be hesitant to skirt prior court precedent.[31] He emphasized that *Quill* was valid where a state sought to require those who lack physical presence with a state to collect those states' taxes. But, he emphasized that *Quill* need not be

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[22] *See* H.B. 3057, 100th Gen. Assemb. (Ill. 2017); La. Stat. Ann. § 47:306.5 (2016); OKLA. STAT. ANN. tit. 68, § 1406.1 (2016); 32 VT. STAT. ANN tit. 32, § 9712 (2016).
[23] H.B. 3057, 100th Gen. Assemb. (Ill. 2017).
[24] ALA. ADMIN. CODE r. 810-6-2-.90.03 (2016).
[25] S.D. CODIFIED LAWS § 10-64-2 (2016).
[26] ALA. ADMIN. CODE r. 810-6-2-.90.03 (1) (2016); S.D. CODIFIED LAWS § 10-64-2 (2016).
[27] S.D. CODIFIED LAWS § 10-64-2 (1) (2016).
[28] ALA. ADMIN. CODE r. 810-6-2-.90.03 (1)(a) (2016).
[29] South Dakota v. Wayfair, No. 3:16-CV-03019 (D.S.D., removed May 25, 2016); Newegg, Inc. v. Dep't of Revenue, No. S. 16-613 (Ala. Tax Trib., filed June 8, 2016).
[30] Direct Mktg. Ass'n v. Brohl, 135 S. Ct. 1124, 1134–35 (2015).
[31] Direct Mktg. Ass'n v. Brohl, 814 F.3d 1129, 1148–49 (10th Cir.), *cert. denied*, 137 S. Ct. 591 (2016), *and cert. denied*, 137 S. Ct. 593 (2016) (Gorsuch, J., concurring).

extended to "comparable tax and regulatory obligations."[32] Given this reasoning, and Gorsuch's likely ascent to the nation's highest court,[33] it seems safe to say that Colorado's reporting obligation is here to stay.

Thus, Colorado has provided an approach that should withstand constitutional challenge. Given the key distinction the court drew between tax collection and tax reporting, it appears a line has been drawn as to what states may require of out-of-state vendors. They may be required to disclose or report certain information to in-state purchasers or the state itself. As soon as a state asks an out-of-state vendor, who lacks physical presence with the state, to collect tax, however, the constitutional line has been crossed. *Quill* is still good law on that point.

On the other hand, the outcome of a direct challenge to *Quill*, through Alabama's or South Dakota's laws, is much more difficult to predict. Justice Kennedy seems ready to throw *Quill* to the wayside. Calling for "[t]he legal system [to] find an appropriate case for this Court to reexamine *Quill* . . . " while emphasizing the dramatic shifts in technology and business that have now caused *Quill* to become defunct.[34] Yet, Judge Gorsuch's devotion to prior precedent could give the Court pause to overturn *Quill*.[35] Judge Gorsuch seems much more likely to side with Justice Thomas, and the late Justice Scalia, who adhered to *stare decisis* when deciding *Quill* in the first place.[36] Which could ultimately leave the decision to overturn *Quill* with Congress rather than the Judiciary.[37]

Even so, businesses must be ready for a shift away from *Quill*. At the very least, the Colorado reporting and disclosure requirements seem here to stay, and will expand into other states. Some businesses will be forced to make the reporting and notice disclosures in any state that chooses to adopt Colorado's approach – as long as their sales exceed the state thresholds, typically $100,000. Therefore, it would be wise for retailers, specifically those who lack physical presence with a state, to begin carefully analyzing where their purchases are heading and exactly how many sales they are making into each respective state.

What's less clear is whether *Quill* will be completely overturned. And, thus, whether vendor's can ultimately be required to collect state taxes, regardless of physical presence. The Tenth Circuit seemed hesitant to distinguish-away

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[32] *Id.* at 1149 (Gorsuch, J., concurring).
[33] Julie Hirschfeld Davis & Mark Landler, *Trump Nominates Neil Gorsuch to the Supreme Court*, N.Y. TIMES (Jan. 31, 2017), https://www.nytimes.com/2017/01/31/us/politics/supreme-court-nominee-trump.html.
[34] *Direct Mktg. Ass'n*, 135 S. Ct. at 1135.
[35] *Direct Mktg. Ass'n*, 814 F.3d at 1149.
[36] Quill Corp. v. N. Dakota, 504 U.S. 298, 320 (1992).
[37] *Quill Corp.*, 504 U.S. at 320; *Direct Mktg. Ass'n*, 814 F.3d at 1149.

Quill just yet, but that doesn't mean the Supreme Court wouldn't overturn the physical presence standard if, say, South Dakota's law made its way to the High Court. Nonetheless, states will be able to expand their taxing authority, whether it be through reporting or disclosure requirements – meaning added expenses for business.

IV. CONCLUSION

As states get more creative expanding their tax base, businesses now, more than ever, must be prepared to comply with state's various use tax reporting, and even collection, requirements. If *Quill*'s physical presence standard is abandoned, out-of-state businesses of all sizes may be required to collect taxes from every state they do business in – even if they make only a handful of sales into a state. Even if it survives, reporting requirements are on the rise, and if businesses fail to make the required disclosures and reports they could face serious financial penalties.

Quill's death knell has been sounding for years -- the expansion of E-commerce only hastening the tones.[38] New state reporting and collection laws should give the Supreme Court the opportunity to hammer the final nail into *Quill*'s coffin, finally laying its physical presence standard to rest. However, there is still the possibility that the Court pulls back and allows *Quill* to live on for years to come. The next few terms of the Supreme Court will largely decide the future of remote sales and use tax requirements.

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[38] U.S. Department of Commerce, *Quarterly Retail E-Commerce Sales 4th Quarter 2016*, (Feb. 17, 2017, 10:00 AM), http://www2.census.gov/retail/releases/historical/ecomm/16q4.pdf.