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## Equal Footing: Correcting the E-Commerce Tax Haven

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# EQUAL FOOTING: CORRECTING THE E-COMMERCE TAX HAVEN

*“Perhaps long ago a seller’s ‘physical presence’ was a sufficient part of a trade to condition the imposition of a tax on such presence. But in today’s economy, physical presence frequently has very little to do with a transaction a State might seek to tax.”<sup>1</sup>*

## INTRODUCTION

The Internet has fundamentally changed the way businesses and consumers interact. Parties are no longer limited to the goods and markets within their relative surroundings, but rather have access to people and places far beyond their physical reach. This is what makes the Internet special as a tool for interpersonal communication; it is not subject to physical restraint in the same way humans are, and thus can connect people to each other to an extent never possible before.

The downside to this elevated state of connection is that the laws governing commercial interaction are still tied to physical presence. The Commerce Clause<sup>2</sup> and its relevant interpretations<sup>3</sup> prevent a state from taxing interstate commerce unless both sides of the transaction have some form of physical presence within the state.<sup>4</sup> This physical presence requirement originated in response to the rampant state protectionism under the Articles of Confederation,<sup>5</sup> balancing states’ tax needs with the desire for free, unburdened flow of commerce. States were permitted to tax transactions within their borders, but could not extend their taxing power to parties transacting in other states.

The Internet, on the other hand, is not tied to a physical place. This liberation allows businesses to expand their interstate activity far beyond what was economically feasible in the past. As a result, online retail has the potential to effectively compete with traditional retail, yet is still afforded a tax advantage over local competitors.<sup>6</sup> Despite the equal footing with traditional commerce in terms of potential capacity, electronic commerce (e-commerce) is essentially subsidized by the government. This allows online vendors to undercut traditional competitors who are still required to comply with a range of state tax obligations.

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1. Quill Corp. v. North Dakota, 504 U.S. 298, 327–28 (1992) (White, J., concurring in part and dissenting in part).

2. U.S. CONST. art. I, § 8, cl. 3.

3. See, e.g., Quill, 504 U.S. 298; Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977).

4. Physical presence fulfills the “substantial nexus” prong of the *Complete Auto Transit* test. See discussion on *Complete Auto Transit*, *infra* Part II.

5. See *infra* Part I.

6. See discussion of *Complete Auto Transit* test, *infra* Part II.

Tax-free purchases made online in lieu of an equivalent purchase at a physical “brick-and-mortar” location not only takes revenue away from local retailers, but also deprives the relevant state and local governments of tax revenue. Every state with a sales tax system in place also has a complementary use tax, which requires individuals who purchase goods tax-free in another state or through interstate commerce to report and pay the equivalent sales tax directly to the state government.<sup>7</sup> However, most individuals are unaware that this tax even exists, and of those who are aware, very few actually take the time to report and pay what is owed.<sup>8</sup> For the states, the relatively small amounts are generally not worth pursuing on an individual basis,<sup>9</sup> but these missed payments ultimately accumulate into a fairly significant portion of tax revenue that remains uncollected every year.

Sales tax receipts made up, on average, 31.3% of state tax revenues in 2014.<sup>10</sup> In a time when state governments are struggling to meet their financial obligations, the loss of such a significant source of revenue is painful. Yet, legislative and judicial inaction has worked to maintain the status quo.<sup>11</sup>

The Supreme Court has expressly left it up to Congress to decide this issue.<sup>12</sup> Congress must act to create and apply a standard that takes into account the unprecedented effect of the Internet on trade. Instead of using the seller’s physical presence within a state as a basis for liability, the standard must be one that is applicable to Internet retailers. That standard is market presence, which determines tax liability not by physical standards, but by the retailer’s economic presence in the relevant market. By using the actual effect on a market as an objective measurement rather than irrelevant physical consideration, e-commerce retailers are placed on equal footing with traditional retailers.

Part I of this note will examine how the Supreme Court’s interpretation of the Due Process Clause and the Commerce Clause has evolved and how this has affected state authority to tax interstate commerce. Part II will analyze the current situation, and weigh the pros and cons of the current economic climate. Part III will explore other possible alternatives and discuss why they are insufficient or otherwise undesirable. Part IV will

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7. Less any sales tax already paid if purchased at a lower rate.

8. Percentage of income tax returns reporting use tax averages 2.08% nationwide. *See* Nina Manzi, *Use Tax Collection on Income Tax Returns in Other States*, MINN. H.R. 7 (Apr. 2015), <http://www.house.leg.state.mn.us/hrd/pubs/usetax.pdf>.

9. *Id.* at 4 (“[T]he tax typically involves small amounts owed on a large number of transactions for which the individual has not kept records, and the costs of collection could easily exceed the revenues collected.”).

10. Cheryl Lee et al., *State Government Tax Collections Summary Report: 2014*, U.S. CENSUS BUREAU G14-STC (Apr. 16, 2015), <http://www2.census.gov/govs/statetax/G14-STC-Final.pdf>.

11. *See infra* Part II.

12. *Quill Corp. v. North Dakota*, 504 U.S. 298, 318–19 (1992).

present a proposal for change and analyze that proposal from both sides, discussing main objections and ultimately asking whether it will improve the economic health of the country. Finally, Part V will conclude that there must be a more appropriate standard implemented to evaluate remote retailers in a realistic and fair way.

## I. BACKGROUND: EVOLUTION OF CONSTITUTIONAL LAW

The Due Process Clause of the Fourteenth Amendment and the Commerce Clause of Article I of the United States Constitution govern the states' authority to tax out-of-state business.<sup>13</sup> For a state tax on interstate commerce to survive constitutional scrutiny, it must satisfy both clauses.<sup>14</sup> To satisfy the Due Process Clause, there must be "some definite link, some minimum connection, between a state and the person, property, or transaction it seeks to tax."<sup>15</sup> Additionally, for the tax to survive a Due Process Clause challenge, "the income attributed to the State for tax purposes must be rationally related to 'values connected with the taxing State.'"<sup>16</sup> The Commerce Clause inquiry, on the other hand, is largely encompassed by the four-part test outlined in *Complete Auto Transit, Inc. v. Brady*,<sup>17</sup> which requires, among other things, a substantial nexus between the taxing state and the activity being taxed.<sup>18</sup> The inquiries stemming from each clause are somewhat similar, but each serves a different constitutional goal: the Due Process Clause is concerned with the fundamental fairness of government activity, while the Commerce Clause addresses structural concerns about the effects of state regulation on the national economy.<sup>19</sup>

### A. THE COMMERCE CLAUSE AND PHYSICAL PRESENCE

The Commerce Clause gives Congress plenary power to regulate commerce and trade amongst the states.<sup>20</sup> Inferred, in what is sometimes called the "negative" or "dormant" Commerce Clause,<sup>21</sup> is "the principle that state and local laws are unconstitutional if they place an undue burden on interstate commerce."<sup>22</sup> The central idea behind the Commerce Clause is to foster a cohesive economic structure by limiting the states' power over

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13. U.S. CONST. amend. XIV, § 1; *id.* art. I, § 8, cl. 3.

14. *See Quill*, 504 U.S. at 305–06.

15. *Miller Bros. Co. v. Maryland*, 347 U.S. 340, 344–45 (1954).

16. *Moorman Mfg. Co. v. Blair*, 437 U.S. 267, 273 (1978) (quoting *Norfolk & W. Ry. Co. v. State Tax Comm'n*, 390 U.S. 317, 325 (1968)).

17. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977).

18. *See infra* Part I.B.

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

20. U.S. CONST. art. I, §8, cl. 3 ("[Congress shall have the power] to regulate Commerce with foreign Nations, and among the several States.").

21. ERWIN CHEMERINSKY, CONSTITUTIONAL LAW: PRINCIPLES AND POLICIES 401 (4th ed. 2011).

22. *Id.* at 430.

objects or affairs that are located in or take place in other states. This restriction on state power was necessary after the federal government found itself powerless to stop the rampant protectionism occurring under the Articles of Confederation.<sup>23</sup> In order to prevent the states from impeding interstate commerce, the Framers reserved to the federal government the sole authority to regulate and tax interstate commerce, thereby restricting state authority to tax goods originating from, or bound for, places outside of its borders.<sup>24</sup>

Initially, this restriction was absolute. States were prohibited from levying a tax “on interstate commerce in any form.”<sup>25</sup> Absolute restriction gave way to a distinction between “direct burdens on interstate commerce, which were prohibited, and indirect burdens, which generally were not.”<sup>26</sup> The Supreme Court briefly moved away from this distinction in *Western Live Stock v. Bureau of Revenue*,<sup>27</sup> a relatively pragmatic decision that instead focused on whether a tax subjected interstate commerce to a risk of multiple taxation.<sup>28</sup> However, the Court soon returned to the formal distinction between direct and indirect taxes in *Freeman v. Hewit*,<sup>29</sup> in which they reformulated the distinction to be one between “a tax on ‘the privilege of doing interstate business’ and a tax on ‘the privilege of exercising corporate functions within the State,’” with the former prohibited as being unconstitutional per se.<sup>30</sup> This express prohibition of taxes on the privilege of doing interstate business was subsequently affirmed in *Spector Motor Services v. O’Connor*.<sup>31</sup>

The *Spector* rule, as it came to be known, was applied somewhat disastrously in *Railway Express Agency v. Virginia*<sup>32</sup> in 1954 (*Railway Express I*) and *Railway Express Agency v. Virginia*<sup>33</sup> in 1959 (*Railway Express II*). In *Railway Express I*, a Virginia statute imposed an annual license tax on gross receipts “‘for the privilege of doing business in [the] State.’”<sup>34</sup> The Court, utilizing the *Spector* rule, found the statute to be

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23. *Id.* at 432 (“A key impetus for the Constitutional Convention in 1787 was the absence of any federal commerce power under the Articles of Confederation.”); see also *Quill*, 504 U.S. at 312 (“Under the Articles of Confederation, state taxes and duties hindered and suppressed interstate commerce; the Framers intended the Commerce Clause as a cure for these structural ills.”).

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

25. *Leloup v. Port of Mobile*, 127 U.S. 640, 648 (1888).

26. *Quill*, 504 U.S. at 309.

27. *W. Live Stock v. Bureau of Revenue*, 303 U.S. 250 (1938).

28. *Quill*, 504 U.S. at 309 (citing *W. Live Stock v. Bureau of Revenue*, 303 U.S. 250 (1938)).

29. *Freeman v. Hewit*, 329 U.S. 249 (1946).

30. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 280 (1977) (citing *Freeman*, 329 U.S. at 254–57).

31. *Spector Motor Service v. O’Connor*, 340 U.S. 602 (1951).

32. *Ry. Express Agency v. Virginia (Railway Express I)*, 347 U.S. 359 (1954).

33. *Ry. Express Agency v. Virginia (Railway Express II)*, 358 U.S. 434 (1959).

34. *Railway Express I*, 347 U.S. at 362.

unconstitutional.<sup>35</sup> In response to the decision, Virginia revised its statute to “impose a ‘franchise tax’ on ‘intangible property’ in the form of ‘going concern’ value as measured by gross receipts,”<sup>36</sup> a development which led directly to *Railway Express II*. Despite having largely the same practical economic effect as the tax in *Railway Express I*, the Court in *Railway Express II* nevertheless upheld the new statute.<sup>37</sup> The irony of these conflicting outcomes was not lost on the Court, as the *Railway Express II* majority recognized that the rule against taxing the privilege of doing interstate business “had created a situation where ‘the use of magic words or labels’ could ‘disable an otherwise constitutional levy.’”<sup>38</sup>

In the middle of this transition from formalism to pragmatism, the Supreme Court decided the seminal case *National Bellas Hess v. Dep’t of Revenue*,<sup>39</sup> handing down a holding that still defines states’ taxing authority over interstate commerce to this day. National Bellas Hess (NBH) was a Missouri mail-order retailer serving the state of Illinois, among others.<sup>40</sup> An Illinois statute required any retailer that solicited orders through the use of mailed catalogues to collect both state and local use taxes, equivalent to comparable sales tax rates, on every purchase and remit that amount to the state.<sup>41</sup> NBH’s only contact with Illinois was through catalogues and advertisements sent via common carrier, yet the statute enabled Illinois to impose tax collection duties on the company.<sup>42</sup> NBH disputed the statute, arguing that these obligations “create[d] an unconstitutional burden upon interstate commerce” and thereby violated the Commerce Clause and Due Process Clause.<sup>43</sup> Sensing an opportunity to add some clarity to the situation, the Court agreed to hear the case.

Rather than embracing the thrust toward pragmatism, the Court instead struck down the Illinois tax.<sup>44</sup> This decision to stand firm was based largely on the desire to retain the “sharp distinction” between purely mail-order sellers and those with a physical presence within the taxing state.<sup>45</sup> Eliminating this distinction, Justice Stewart said for the majority, could “entangle [interstate] business[es] in a virtual welter of complicated obligations to local jurisdictions,”<sup>46</sup> as sellers would thereby be forced to collect taxes for, and comply with the laws of, every taxing jurisdiction in

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35. *Id.* at 369.

36. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 284 (1977) (citing *Railway Express II*, 358 U.S. 434 (1959)).

37. *Railway Express II*, 358 U.S. at 445.

38. *Complete Auto Transit*, 430 U.S. at 284 (quoting *Railway Express II*, 358 U.S. at 441).

39. *Nat’l Bellas Hess v. Dep’t of Revenue of Ill.*, 386 U.S. 753 (1967).

40. *Id.* at 753–54.

41. *Id.* at 755.

42. *Id.* at 754–55.

43. *Id.* at 756.

44. *Id.* at 760.

45. *Id.* at 758.

46. *Id.* at 759–60.

the country. However, because the statute in this case did not turn on “labeling taxes that had ‘direct’ or ‘indirect’ effects on interstate commerce,” the *Spector* rule remained good law.<sup>47</sup>

Another ten years passed before the Court finally overruled the formalist *Spector* analysis and instead took a pragmatic approach in *Complete Auto Transit*.<sup>48</sup> Complete Auto Transit (CAT) was a Michigan corporation contracted by General Motors to transport vehicles to dealerships located within the state of Mississippi.<sup>49</sup> A Mississippi statute assessed tax collection obligations on “every person operating a . . . transportation business . . . within this State,” as a condition of “the privilege of . . . doing business within [the] state.”<sup>50</sup> CAT promptly sued, citing the *Spector* rule as protection from taxes on the privilege of doing business in a state, regardless of the practical effects of the tax.<sup>51</sup> The Court found that “[i]t was not the purpose of the commerce clause to relieve those engaged in interstate commerce from their just share of state tax burden.”<sup>52</sup> The *Spector* rule, in the Court’s view, merely “attach[ed] constitutional significance to a semantic difference,”<sup>53</sup> operating only as a “rule of draftsmanship”<sup>54</sup> that “[s]imply . . . d[id] not address the problems with which the Commerce Clause is concerned.”<sup>55</sup>

Thus, the Mississippi statute was upheld despite its reference to the privilege of doing business, which alone would have invalidated it under *Spector*.<sup>56</sup> In doing so, *Complete Auto Transit* refocused Commerce Clause inquiry on practical effects rather than formal demarcations, setting forth a four-part test that would sustain a tax if it “[1] is applied to an activity with a substantial nexus with the taxing State, [2] is fairly apportioned, [3] does not discriminate against interstate commerce, and [4] is fairly related to the services provided by the State.”<sup>57</sup>

The Court found an opportunity to apply its newly formed test just a few months later. In *National Geographic Soc’y v. California Bd. Of Equalization*,<sup>58</sup> the state of California attempted to collect taxes from the

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47. *Quill Corp. v. North Dakota*, 504 U.S. 298, 322 (1992) (White, J., concurring in part and dissenting in part).

48. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 288–89 (1977) (“Accordingly, we now reject the rule of [*Spector*], that a state tax on the ‘privilege of doing business’ is per se unconstitutional when it is applied to interstate commerce, and that case is overruled.”).

49. *Id.* at 276.

50. *Id.* at 275.

51. *Id.* at 277–78.

52. *Id.* at 288 (quoting *W. Live Stock v. Bureau of Revenue*, 303 U.S. 250, 254 (1938)).

53. *Id.* at 285.

54. *Id.*

55. *Id.* at 288.

56. *Id.* at 288–89.

57. *Quill Corp. v. North Dakota*, 504 U.S. 298, 311 (1992) (quoting *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977)).

58. *Nat’l Geographic Soc’y v. Cal. Bd. of Equalization*, 430 U.S. 551 (1977).

National Geographic Society (the Society) for their mail-order sales of “maps, atlases, globes, and books.”<sup>59</sup> The State based its jurisdictional authority on two office buildings located within the state, despite the fact that “the offices perform[ed] no activities related to the . . . mail order business.”<sup>60</sup> The Society argued that the activity being taxed had no connection with the State beyond common carrier or the mail.<sup>61</sup> Regardless, the Court found the unrelated property to be a sufficient connection and upheld the tax.<sup>62</sup> The Court justified its decision on the grounds that the offices, while unrelated, generated enough revenue that they were more than “the slightest presence,” and thereby were sufficient enough to establish a nexus with the state and validate the tax in question.<sup>63</sup>

Finally, the most recent foray into state tax validity under the Commerce Clause was in *Quill Corp. v. North Dakota*.<sup>64</sup> Quill Corp. (Quill) was a Delaware corporation that sold office equipment into the state of North Dakota.<sup>65</sup> All merchandise was delivered by mail or common carrier, and Quill maintained no office or sales force in the state.<sup>66</sup> North Dakota imposed tax collection duties on every retailer with a place of business within the state.<sup>67</sup> In 1987, North Dakota amended the statutory definition of retailer to include “every person who engages in regular or systematic solicitation of a consumer market in the state,”<sup>68</sup> and in turn defined “regular or systematic solicitation” to mean three or more advertisements within a 12-month period.<sup>69</sup> Quill argued that the statute was unconstitutional and, surprisingly, the North Dakota Supreme Court ruled in Quill’s favor, refusing to follow precedent on the notion that “‘wholesale changes’ in both the economy and the law ma[ke] it inappropriate to follow [the rule from] *Bellas Hess* today.”<sup>70</sup>

The facts of *Quill* were almost identical to *Bellas Hess* and the U.S. Supreme Court ruled accordingly, ignoring the North Dakota Supreme Court’s appeal to progress and instead upholding the *Bellas Hess* bright-line rule.<sup>71</sup> Despite the apparent trend away from rigid standards seen in

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59. *Id.* at 552.

60. *Id.*

61. *Id.* at 560.

62. *Id.* at 562.

63. *Id.* at 556–57. While arguably consistent with precedent, this line of reasoning effectively removed the need for any substantial transactional or operational nexus underlying a seller’s physical presence. *See, e.g.*, *Quill Corp. v. North Dakota*, 504 U.S. 298, 324 (1992) (White, J., concurring in part and dissenting in part).

64. *Quill*, 504 U.S. 298.

65. *Id.* at 302.

66. *Id.*

67. *Id.* (citing N.D. Cent. Code § 57-40.2-07).

68. *Id.* at 302–03 (citing N.D. Cent. Code § 57-40.2-01(6)).

69. *Id.* at 303 (citing N.D. Admin. Code § 81-04.1-01-03.1).

70. *Id.* (quoting State by Heitkamp v. *Quill Corp.*, 470 N.W.2d 203, 213 (1991), *rev’d sub nom. Quill*, 504 U.S. 298).

71. *Id.* at 317.

*Complete Auto Transit* and, to a lesser extent, *National Geographic*, *Bellas Hess* had never been officially overruled. The fact that Congress had not taken steps to update or otherwise adjust the prevailing standard in the twenty-five years since its creation provided additional support for adhering to precedent.

As for the apparent trend toward pragmatism following the debacle in both *Railway Express I* and *II*, the majority claimed that *Complete Auto Transit* and its progeny all involved sellers with physical presence and were thus distinguishable from the case at hand.<sup>72</sup> *Complete Auto Transit*, the majority said, was not directed at formalism in general, but rather concerned the specific distinction between taxes on the privilege of doing interstate business and all others, which “served no purpose within [the Court’s] Commerce Clause jurisprudence.”<sup>73</sup> Indeed, the majority argued that the demarcation of mail-order sellers and sellers with a physical presence does further the ends of the dormant Commerce Clause by providing a safe harbor from state interference for purely interstate commerce.<sup>74</sup> Looking forward, the majority reconciled its position with *Complete Auto Transit* and *National Geographic* by holding that physical presence is encompassed by the substantial nexus prong of the *Complete Auto Transit* test, effectively incorporating a categorical safe harbor for mail-order sellers into the substantial nexus requirement.<sup>75</sup>

This safe harbor stands in direct opposition to the Court’s prior rejection of the philosophy underlying *Freeman* and *Spector*, that “interstate commerce should enjoy a sort of ‘free trade’ immunity from state taxation.”<sup>76</sup> However, the majority ignored this in favor of the convenience provided by a bright-line standard,<sup>77</sup> choosing instead to focus on the rejection of the words themselves without any thought as to the logical basis for the *Complete Auto Transit* Court’s rejection of *Spector*.<sup>78</sup> The *Complete Auto Transit* Court emphasized that the *Spector* rule “has no relationship to economic realities”<sup>79</sup> and “[s]imply . . . does not address the problems with which the Commerce Clause is concerned.”<sup>80</sup>

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72. *Id.* at 314.

73. *Id.*

74. *Id.* at 314–15.

75. *Id.* at 311.

76. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977) (citing *Freeman v. Hewit*, 329 U.S. 249, 252 (1944)).

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

78. As noted above, the *Complete Auto Transit* decision was based on the idea that “[i]t was not the purpose of the commerce clause to relieve those engaged in interstate commerce from their just share of state tax burden even though it increases the cost of doing business.” *Complete Auto Transit*, 430 U.S. at 288 (quoting *W. Live Stock v. Bureau of Revenue*, 303 U.S. 250, 254 (1938)).

79. *Id.* at 279.

80. *Id.* at 288.

Justice White wrote a scathing dissent along these lines for the *Quill* Court, in which he claimed the majority completely missed the point of *Complete Auto Transit* and its place in the evolution of Commerce Clause analysis.<sup>81</sup> He felt the *Complete Auto Transit* test was a waypoint in the overall evolution of Commerce Clause jurisprudence from formal, categorical distinctions, to pragmatic analysis of economic effects, evidenced in part by the Court's deliberate choice to use the term "substantial nexus" for the first prong of the test rather than physical presence.<sup>82</sup> He argued that the majority improperly conflated the two standards in the interest of preserving a clear bright-line rule, resulting in a conceptual step backwards.<sup>83</sup>

Justice White next argued rather persuasively that the *Complete Auto Transit* test is really a Due Process Clause inquiry, and that substantial nexus can be satisfied by a seller's minimum contacts with the taxing state.<sup>84</sup> Furthermore, Justice White pointed out that the Commerce Clause considerations originally used to justify the physical presence requirement were no longer served by the retention of a bright-line distinction that had effectively been rendered obsolete in the years between *Bellas Hess* and *Quill*.<sup>85</sup>

The majority ultimately acknowledged that "contemporary Commerce Clause jurisprudence might not dictate the same result were the issue to arise for the first time today."<sup>86</sup> Despite this concession, the majority felt that the benefits of a bright-line rule and principles of stare decisis persuaded against overruling *Bellas Hess* with regard to Commerce Clause analysis.<sup>87</sup> Regardless, the true basis for keeping the status quo was that the majority regarded the Commerce Clause issue as "not only one that Congress may be better qualified to resolve, but also one that Congress has the ultimate power to resolve."<sup>88</sup> True to its word, the Court has declined to revisit the issue since *Quill*.<sup>89</sup>

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81. *Quill*, 504 U.S. at 322–23 (White, J., concurring in part and dissenting in part).

82. *See id.* at 326–27.

83. *Id.* at 323 ("What [the Court] disavowed in *Complete Auto* was not just the 'formal distinction between 'direct' and 'indirect' taxes on interstate commerce' . . . but also the whole notion . . . that 'interstate commerce is immune from state taxation.'").

84. *Id.* at 327.

85. *Id.* at 327–28. Justice White believed that taxing remote vendors with minimum contacts would not burden interstate commerce to the same extent as when *Bellas Hess* was decided. It should be noted that he took this position long before e-commerce became a legitimate force in the economy. These arguments only gained strength as technology rendered established physical presence somewhat irrelevant to the retail industry.

86. *Id.* at 311 (majority opinion).

87. *Id.* at 315–17.

88. *Id.* at 318 ("Accordingly, Congress is now free to decide whether, when, and to what extent the States may burden interstate mail-order concerns with a duty to collect taxes.").

89. *See infra* Part II.

## B. THE DUE PROCESS CLAUSE AND FAIRNESS

The essence of the Due Process Clause is fairness, and central to this concept is the requirement that an individual has sufficient connections with a given state to give notice or fair warning that he or she is under the jurisdictional power of that state.<sup>90</sup> Jurisdictional analysis under the Due Process Clause was initially based on the state's physical power over people and property within its borders.<sup>91</sup> Conversely, this notion of state sovereignty precluded one state from impinging upon another state's authority over things within its own borders.<sup>92</sup> This strict physical requirement quickly became obsolete. The advent of railroads and automobiles allowed Americans much greater mobility and therefore the ability to have a much greater impact on people and property in other states.<sup>93</sup> Thus, a more flexible standard was necessary in order to adapt to the changing times.

Due Process Clause interpretation began with *International Shoe Co. v. Washington* and the creation of what is now known as the minimum contacts test.<sup>94</sup> Rather than strictly requiring physical presence as a predicate for in personam jurisdiction, the Court held that "due process requires only that . . . [the defendant] have certain *minimum contacts* with [the state] such that the maintenance of the suit does not offend traditional notions of fair play and substantial justice."<sup>95</sup> With this test, the defendant's contacts with the taxing state would serve as a proxy for notice, thus expanding state power over potential controversies while also remaining true to the underlying ideals of the Due Process Clause.<sup>96</sup> The socioeconomic climate in America was undergoing rapid change at the time of the case, and the new jurisdictional paradigm created by *International Shoe* was as much a reflection of society at large as it was a legal solution to an economic need.<sup>97</sup>

*McGee v. International Life Insurance Co.*<sup>98</sup> soon tested the boundaries of the minimum contacts test.<sup>99</sup> Lowell Franklin, a resident of California,

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90. *Quill*, 594 U.S. at 312 ("We have . . . identified 'notice' or 'fair warning' as the analytic touchstone of due process nexus analysis.").

91. *See, e.g., Pennoy v. Neff*, 95 U.S. 714 (1877).

92. *Id.* at 722.

93. RICHARD D. FREER, *CIVIL PROCEDURE* § 2.4.2 (3rd ed. 2012).

94. *Int'l Shoe Co. v. Washington*, 326 U.S. 310 (1945).

95. *Id.* at 316 (quoting *Milliken v. Meyer*, 311 U.S. 457, 463 (1940)) (emphasis added).

96. *Quill Corp. v. North Dakota*, 504 U.S. 298, 313 (1992).

97. *International Shoe* was decided in 1945 just as World War II was ending and soldiers were returning home. A unifying event of that magnitude meant that people began to think of themselves less as state citizens and more as national citizens. Interstate travel and business increased as "state lines probably meant less than they had in the past." FREER, *supra* note 93, § 2.4.3.

98. *McGee v. Int'l Life Ins. Co.*, 355 U.S. 220 (1957).

99. *Id.* at 223–24.

purchased life insurance from an Arizona company.<sup>100</sup> Another Texas insurance company later purchased the Arizona company and moved its operations to Texas.<sup>101</sup> As part of the transition, the Texas company sent reinsurance letters to all customers of the old Arizona company containing the same terms as their previous contracts.<sup>102</sup> Besides collecting Franklin's monthly insurance payments, the Texas company had no other contact with the state of California.<sup>103</sup> Once Franklin passed away, his mother, Lulu McGee, attempted to collect his life insurance payout, but the Texas company refused.<sup>104</sup>

The Court ultimately upheld jurisdiction in California predicated on the single insurance contract.<sup>105</sup> Though the decision was purportedly based in part on convenience, the main basis was that the Texas company had reached out to the plaintiff with the reinsurance contract.<sup>106</sup> The Court recognized that this was a significant extension of jurisdictional power past its traditional physical boundaries. However, noting the trend away from strict physical requirements, the Court used the new minimum contacts test from *International Shoe* to justify predicated jurisdiction on the single contract, emphasizing the "fundamental transformation of our national economy over the years."<sup>107</sup>

*McGee* marked arguably the farthest extension of jurisdictional power under the minimum contacts test. The expansion, however, was short-lived. Six months later, *Hanson v. Denckla* held that a plaintiff's "unilateral activity" cannot by itself establish contact with the state, and that the defendant must also "purposefully avail[] itself of the privilege of conducting activities within the forum State, thus invoking the benefits and protections of its laws."<sup>108</sup> Without this limitation in place, defendants would be at the mercy of the plaintiff's choice of forum.<sup>109</sup>

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100. *Id.* at 221.

101. *Id.* at 221.

102. *Id.*

103. *Id.* at 222.

104. *Id.*

105. *Id.* at 224.

106. *Id.* at 223–24. The Court raised legitimate issues as to the ability of individual defendants to afford litigation against large corporations located in remote states. However, these concerns were not only ignored in subsequent cases, but effectively overruled in terms of importance. *See, e.g., Hanson v. Denckla*, 357 U.S. 235 (1958).

107. *McGee*, 355 U.S. at 222. "Today many commercial transactions touch two or more States and may involve parties separated by the full continent. With this increasing nationalization of commerce has come a great increase in the amount of business conducted by mail across state lines." *Id.* at 222–23; *cf. Hanson*, 357 U.S. at 251 ("[I]t is a mistake to assume that this trend heralds the eventual demise of all restrictions on the personal jurisdiction of state courts.").

108. *Hanson*, 357 U.S. at 253.

109. Courts always have personal jurisdiction over the plaintiff, as the plaintiff consents by choosing the forum. FREER, *supra* note 93, at 39–40, § 2.1. Note, however, that parties must first meet the threshold requirements for subject-matter jurisdiction.

Next, *World-Wide Volkswagen Corp. v. Woodson* emphasized fairness and balance with a set of factors intended to reliably address Due Process Clause fairness concerns.<sup>110</sup> This turned Due Process Clause analysis into a two-prong test requiring a plaintiff to show both minimum contacts and fairness.<sup>111</sup> Finally, *Burger King Corp. v. Rudzewicz* both formally adopted the two-step approach from *World-Wide Volkswagen* and simultaneously expanded its use from tort claims, which was the only context in which the minimum contacts test had previously been used, to a contract dispute, thereby implicitly validating its use for all Due Process Clause analyses.<sup>112</sup> Thus, after *Burger King*, the Due Process Clause inquiry requires both that the defendant purposefully established minimum contacts within the forum state, and that the assertion of jurisdiction based on those contacts would comport with fair play and substantial justice.<sup>113</sup>

*Bellas Hess* began the modern line of tax-specific analysis under the Due Process Clause.<sup>114</sup> When deciding whether to uphold or strike down a state tax on interstate commerce, *Bellas Hess* held that the simple question that courts must ask is “whether the state has given anything for which it can ask return.”<sup>115</sup> However, the *Bellas Hess* Court ultimately departed from the general Due Process framework due to the close interrelation with Commerce Clause concerns inherently present in taxes on interstate commerce. The two clauses, the Court said, are “closely related” and that “[t]he same principles have been held applicable in determining the power of a State to impose . . . taxes upon interstate sales.”<sup>116</sup> The Court then proceeded to frame the combined analysis in terms of physical presence in the taxing state, ultimately holding that the tax in question did not satisfy Due Process Clause concerns for the same reason that it failed to satisfy the Commerce Clause.<sup>117</sup>

This framework remained largely unchanged until *Quill* addressed the issue twenty-five years later. Fittingly, the Court began by distinguishing the Due Process Clause from the Commerce Clause, noting that “though overlapping, the two conceptions are not identical.”<sup>118</sup> After acknowledging the distinction and thus giving itself room to accommodate its own

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110. *World-Wide Volkswagen Corp. v. Woodson*, 444 U.S. 286 (1980).

111. *Id.*

112. *Burger King Corp. v. Rudzewicz*, 417 U.S. 462 (1985).

113. *Id.* at 476.

114. The Court gives a succinct run-down of criteria for validity under both clauses early in the majority opinion. See *Nat'l Bellas Hess v. Dep't of Revenue of Ill.*, 386 U.S. 753, 756 (1967).

115. *Id.* (citing *Wisconsin v. J. C. Penney Co.*, 311 U.S. 435, 444 (1940)).

116. *Id.*

117. *Id.* at 757–59.

118. *Quill Corp. v. North Dakota*, 504 U.S. 298, 306 (1992) (Rutledge, J., concurring in part and dissenting in part) (quoting *Int'l Harvester Co. v. Dep't of Treasury*, 322 U.S. 340, 353 (1944)).

holding,<sup>119</sup> the Court then expressly overruled *National Bellas Hess* to the extent that it required a physical presence in the taxing state to survive Due Process Clause scrutiny.<sup>120</sup> This decision was predicated on the idea that “if a foreign corporation purposefully avails itself of the benefits of an economic market in the forum State, it may subject itself to the State’s in personam jurisdiction even if it has no physical presence in the State.”<sup>121</sup>

The *Quill* Court further supported its rejection of a physical presence requirement under the Due Process Clause with language from its decision in *Burger King*, in which it observed that “it is an inescapable fact of modern commercial life that a substantial amount of business is transacted . . . across state lines, thus obviating the need for physical presence within a State.”<sup>122</sup> Therefore, by removing the physical presence requirement from Due Process Clause analysis, the Court ensured that a seller could no longer avoid jurisdiction “merely because the [seller] did not *physically* enter the forum state.”<sup>123</sup>

In rejecting physical presence, *Quill* finally reconciled the Due Process Clause analysis of state taxing authority with the Court’s progression away from strict physical limitations under *International Shoe*. Whether Commerce Clause jurisprudence makes the same move will likely remain unknown, as the Supreme Court has refused to review any more cases on this topic.

## II. WHERE THE LAW CURRENTLY STANDS

Remote vending has grown from the niche market of mail-order catalogs described in *Bellas Hess* into a significant force in the national economy. Americans spent over \$348 billion USD on electronic and mail-order goods in 2013,<sup>124</sup> with that number expected to grow anywhere from \$414 billion<sup>125</sup> to \$493.89 billion USD<sup>126</sup> by 2018, a projected increase of 15.94 to 29.54%. Electronic and mail-order sales, as a percentage of all

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119. Had the Court not led by distinguishing Due Process Clause concerns from Commerce Clause concerns, it would have overruled its own bright-line rule that it later uses to define Commerce Clause limitations. See *supra* Part I.A; see also *Quill*, 504 U.S. at 317–18.

120. *Quill*, 504 U.S. at 308.

121. *Id.* at 307 (emphasis in original).

122. *Id.* at 308 (quoting *Burger King Co. v. Rudzewicz*, 471 U.S. 462, 476 (1985)).

123. *Id.* at 307–308 (quoting *Burger King*, 471 U.S. at 476).

124. *Annual Retail Trade Survey—2013: Sales (1992-2013)*, U.S. CENSUS BUREAU (Mar. 9, 2015) [hereinafter *Annual Retail Trade Survey*], <http://www.census.gov/retail/index.html> (follow “Sales (1992-2013): Excel”) (The data excludes food service industry figures. With food service figures included, e-commerce makes up 3.72% of all retail in 2003 and 6.95% in 2013, a similar 86.83% increase).

125. *U.S. E-Commerce Sales, 2014-2018*, INTERNET RETAILER, <https://www.internetretailer.com/trends/sales/us-e-commerce-sales-2013-2017/> (last visited Oct. 29, 2015).

126. *Retail Sales Worldwide Will Top \$22 Trillion This Year*, EMARKETER (Dec. 23, 2014), <http://www.emarketer.com/Article/Retail-Sales-Worldwide-Will-Top-22-Trillion-This-Year/1011765>.

retail sales, rose from 4.12% in 2003 to 7.79% in 2013, an 89.08% increase.<sup>127</sup> Because e-commerce is almost exclusively comprised of interstate transactions, its rise as a percentage of retail sales poses a real threat to state governments, which gained an average of 31.3% of their overall tax revenue from sales taxes in 2014,<sup>128</sup> down from 33.5% in 2002.<sup>129</sup>

As the numbers continue to grow and manifest into real-life problems, it becomes clearer that changes need to be made. Congress has made several attempts to address the issue, most recently with the Marketplace Fairness Act of 2015 (MFA).<sup>130</sup> While none of these federal attempts have been successful thus far, state and local governments collaborated with private members of the business community to create the Streamlined Sales and Use Tax Agreement (SSUTA).<sup>131</sup> SSUTA is a voluntary arrangement aimed at “simplify[ing] and moderniz[ing] sales and use tax administration in the member states”<sup>132</sup> whereby remote vendors engaging in interstate commerce agree to collect use taxes on behalf of other member states in exchange for the member states’ agreement to implement significant changes in the substance and administration of their tax codes.<sup>133</sup>

Member state simplification measures under SSUTA include: designating a single entity responsible for sales and use tax administration;<sup>134</sup> capping potential tax audits at one per state per period;<sup>135</sup> adopting a single unified tax rate throughout the state and eliminating local variations;<sup>136</sup> providing notice of and creating a sufficient grace period between enactment and implementation of rate changes;<sup>137</sup> providing a shared database of all potential tax rates in the country that is collectively maintained and updated by all member states;<sup>138</sup> implementing standardized rules for sourcing purchases;<sup>139</sup> implementing standardized rules for creating and claiming exemptions;<sup>140</sup> and creating a uniform tax return

127. *Annual Retail Trade Survey*, *supra* note 124.

128. LEE ET AL., *supra* note 10, at 1.

129. Dennis Zimmerman, *Economic Issues in Taxing Internet and Mail-Order Sales*, CONG. BUDGET OFF. 4–5 (Oct. 2003), <https://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/46xx/doc4638/10-20-internettax.pdf>.

130. *See infra* Part IV.

131. STREAMLINED SALES AND USE TAX AGREEMENT (STREAMLINED SALES TAX GOVERNING BD. 2015) (as amended through September 17, 2015) [hereinafter SSUTA].

132. *Id.* § 102.

133. *What is the Streamlined Sales and Use Tax Agreement?*, STREAMLINED SALES TAX GOVERNING BOARD, [http://www.streamlinedsalestax.org/index.php?page=gen\\_1](http://www.streamlinedsalestax.org/index.php?page=gen_1) (last visited Oct. 29, 2015).

134. SSUTA, § 301(A).

135. *Id.* § 301(B).

136. *Id.* §§ 302, 308.

137. *Id.* §§ 304, 329.

138. *Id.* §§ 305(D–I), 307(A).

139. *Id.* §§ 309–315.

140. *Id.* §§ 316–317.

refund procedure and collection remittance policy for all member states.<sup>141</sup> SSUTA also provides a liability shield for sellers that relied on erroneous data supplied by a member state.<sup>142</sup> While states have had mixed reactions to SSUTA,<sup>143</sup> it nonetheless provides an important framework for other proposed solutions such as the MFA.<sup>144</sup>

As for the federal judicial system, the U.S. Supreme Court has not addressed the tax imbalance in over twenty years. *Quill* was decided in 1992, when e-commerce was nowhere near the level it is today. Yet the Supreme Court has preferred to leave the issue up to Congress, as the *Quill* majority so plainly stated.<sup>145</sup> Some lower courts, however, have proactively dealt with the e-commerce tax issue in lieu of further legislative or judicial action.<sup>146</sup>

Recently, the case *Overstock.com v. New York Dep't of Taxation and Fin.* came before the New York Court of Appeals.<sup>147</sup> Internet retailers Overstock.com (Overstock) and Amazon.com (Amazon) challenged an amended New York statute that sought to impose tax collection duties on out-of-state companies that directly or indirectly used in-state residents for sales referrals. Overstock and Amazon claimed the amendments were unconstitutional under the Due Process and Commerce Clauses.<sup>148</sup> Both retailers had affiliate programs whereby third parties placed links on their own websites that, when clicked, directed users to Amazon's or Overstock's website.<sup>149</sup> The retailers compensated their affiliates on a commission basis, paying them a percentage of the revenue generated by affiliate-driven sales.<sup>150</sup> Some of these affiliates were physically based in New York, thus establishing physical presence under the statute.<sup>151</sup>

The Court began its analysis by noting that since the *Quill* decision, "[t]he world has changed dramatically . . . and it may be that the physical presence test is outdated. An entity may now have a profound impact upon a foreign jurisdiction solely through its virtual projection via the Internet."<sup>152</sup> Bound by *Quill* precedent, the Court looked for the slightest

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141. *Id.* §§ 318–319, 325.

142. *Id.* §§ 306, 331.

143. As of October 31, 2015, twenty-three states are full members. *Streamline Sales Tax State Members*, STREAMLINED SALES TAX GOVERNING BOARD, INC., <http://www.streamlinedsalestax.org/index.php?page=state-info> (last visited Oct. 31, 2015).

144. Marketplace Fairness Act of 2015, S. 698, 114th Cong. § 2(a) (2015). See also *infra* Part III.A.

145. See *supra* Part I.B.

146. See, e.g., *Overstock.com, Inc. v. N.Y. State Dep't of Taxation & Fin.*, 987 N.E.2d 621 (N.Y. 2013), *cert. denied*, 134 S. Ct. 682 (2013).

147. *Id.*

148. *Id.* at 622–24.

149. *Id.* at 622–23.

150. *Id.*

151. *Id.* at 623.

152. *Id.* at 625.

trace of in-state activities performed by, or on behalf of, the retailers and their employees in order to establish the required physical nexus.<sup>153</sup> Agreeing with the defendant—the N.Y. Department of Taxation—the Court found that the affiliate program outlined above constituted “[a]ctive, in-state solicitation” sufficient to bind Overstock and Amazon to the New York statute.<sup>154</sup>

The issue seemed ripe for Supreme Court review, as the facts presented a clear and salient picture of the effect of e-commerce on the retail industry, and would allow for a definitive ruling on the matter. However, the Supreme Court denied the appellants’ writ of certiorari, thereby making clear that it truly did intend to leave the issue for Congress to decide.

In his dissenting opinion in *Quill*, Justice White showed a strong desire to be rid of the anachronistic demarcation of retailers from *Bellas Hess*, arguing that the convenience of a bright-line rule does not justify the unfairness it produces.<sup>155</sup> With remarkable foresight, Justice White identified the inequality created by the e-commerce tax haven and questioned “the rationality of perpetuating a rule that creates an interstate tax shelter for one form of business -- mail-order sellers -- but no countervailing advantage for its competitors.”<sup>156</sup> Given that Justice White expressed this perspective over twenty years ago, it would have been extremely interesting to see how the Supreme Court handled the issue today. However, its rejection officially puts the situation in Congress’s hands and opens the door for proposal and debate on the topic, of which there has already been a considerable amount.

### III. ALTERNATIVE FRAMEWORKS TO GOVERN E-COMMERCE

The MFA represents the first serious consideration of whether to allow states to collect sales tax on Internet sales to make any headway in Congress. The bill has its flaws, but it serves as an important catalyst for discussion of the problem facing the retail market. Other proposals have been made to Congress by people and representatives from all over the sociopolitical spectrum, ranging from ex-Senators to nonprofit workers. These proposals include an origin-sourced tax on interstate commerce, private consumer self-reporting of use taxes, and simply implementing a uniform, flat sales tax rate nationwide.

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153. *Id.*

154. *Id.* at 626.

155. *Quill Corp. v. North Dakota*, 504 U.S. 298, 329 (1992) (citing *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 289 (1977)).

156. *Id.*

## A. THE MARKETPLACE FAIRNESS ACT OF 2015

### 1. Proposal

Senator Michael Enzi (R-WY) introduced the MFA in March of 2015.<sup>157</sup> The bill is currently sitting before the Senate Committee on Finance.<sup>158</sup> Senator Enzi introduced largely the same bill during the last Congressional term and it passed the Senate,<sup>159</sup> only to die in the House of Representatives.<sup>160</sup>

The MFA gives states the ability to compel qualified out-of-state vendors to collect and remit sales tax payments from purchasers if the state meets certain simplification requirements.<sup>161</sup> Specifically, the MFA requires states to appoint a single entity within the state responsible for: (1) all state and local sales and use tax administration; (2) limiting audits to one per state per seller; (3) consolidating sales and use tax returns for all state and local jurisdictions into one simple return to be filed with the single responsible entity; and, (4) providing a uniform sales and use tax base<sup>162</sup> among the state and local jurisdictions.<sup>163</sup> Participation in the MFA is entirely voluntary, leaving the choice of whether or not to compel tax collection on remote sales up to state legislatures.<sup>164</sup>

States are required under the bill to provide free software to any company they wish to collect taxes from.<sup>165</sup> Potential providers of the software would apply and be chosen through a certification process, after which they would be assigned a region and begin production.<sup>166</sup> The software must be able to not only calculate applicable sales and use tax rates for any and all sales, but also update itself regularly and automatically file a sales tax return to all relevant jurisdictions.<sup>167</sup> In the event of human error, such as a mistake in the program code, incorrect entries into the tax

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157. Marketplace Fairness Act of 2015, S. 698, 114th Cong. (2015).

158. *Marketplace Fairness Act of 2015 Overview*, U.S. CONGRESS, <https://www.congress.gov/bill/114th-congress/senate-bill/698?q=%7B%22search%22%3A%5B%22marketplace+fairness+act%22%5D%7D&resultIndex=1> (last visited Jan. 4, 2016).

159. *U.S. Senate Roll Call Votes 113th Congress—1st Session*, U.S. SENATE, [http://www.senate.gov/legislative/LIS/roll\\_call\\_lists/roll\\_call\\_vote\\_cfm.cfm?congress=113&session=1&vote=00113](http://www.senate.gov/legislative/LIS/roll_call_lists/roll_call_vote_cfm.cfm?congress=113&session=1&vote=00113) (last visited Jan. 4, 2016).

160. *Marketplace Fairness Act of 2013 Overview*, U.S. CONGRESS, <https://www.congress.gov/bill/113th-congress/senate-bill/743> (last visited Jan. 4, 2016).

161. S. 698, § 2(b).

162. This would eliminate local variances amongst states, allowing only one tax rate per state and thereby reduce the total number of taxing jurisdictions in the United States from over 7,000 to just forty-six—the forty-five states who currently collect sales tax and Washington, D.C.

163. S. 698, §§ 2(b)(2)(A)(i–iii).

164. The bill merely “authorizes” states to begin collecting. The bill also adds multiple conditions—mostly adaptations of the requirements from SSUTA—that a state must meet in order to gain authorization. *Id.* § 2(b).

165. *Id.* § 2(b)(2)(D)(ii).

166. *Id.* § 2(b)(2)(D)(iii).

167. *Id.* § 2(b)(2)(D)(ii).

database, or neglect by the retailer, the MFA shields the non-culpable parties from liability.<sup>168</sup> As an additional layer of protection, the MFA requires notice of any changes in tax rates from participating jurisdictions at least ninety days prior to the change.<sup>169</sup>

Perhaps the most significant provision of the MFA is the small business exception.<sup>170</sup> Under this safe harbor, sellers with annual gross receipts derived from remote sales of less than \$1,000,000 USD (the threshold) are classified as small businesses and are thereby exempt from tax collection liability.<sup>171</sup> This shields small businesses from the potentially enormous cost of compliance with forty-six different taxing jurisdictions, each with their own filing and auditing procedures, as well as the cost to integrate the free tax software into current computer sales programs and networks.

## 2. Criticism of the Marketplace Fairness Act

The MFA is an admirable attempt at a workable solution that identifies and addresses legitimate concerns typically raised in the Internet sales tax debate. There is no easy solution, as the issue is complex and nuanced, the stakes are high, and there are many competing viewpoints and interests. However, the MFA contains significant weaknesses, the most crucial of which are the small business exception and the required compliance software.

The inclusion of the small business exception suggests an implied acknowledgement by the drafters of the sizeable burden this bill imposes on retailers. The threshold is calculated on a nationwide basis,<sup>172</sup> so that companies on the margin could go from having no tax liability in any remote jurisdiction, to becoming the collection agent for forty-six different states overnight. This incentivizes tax-avoidance maneuvers, such as sales or marketing restrictions, which burden interstate commerce and reduce the overall efficiency of the national marketplace.<sup>173</sup>

The threshold is based on gross annual receipts, which, despite being expressly limited to revenue derived from online sales, sets a very low bar. Using gross sales receipts fails to take into account the size of a company's profit margin, which has more of an effect on small businesses than gross revenue. For instance, \$1,000,000 USD in gross annual receipts in an industry that typically carries a 1% margin nets \$10,000 USD in profit, whereas \$1,000,000 USD in gross annual receipts in an industry with a 6% margin nets \$60,000 USD, a difference of 500%. That \$50,000 USD difference in gross profit alone could finance most if not all of the cost of

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168. *Id.* § 2(b)(2)(E–G).

169. *Id.* § 2(b)(2)(H).

170. *Id.* § 2(c).

171. *Id.*

172. *Id.*

173. *See* discussion on efficiency concerns, *infra* Part IV.A.4.

integration, thereby putting the company with the 6% margin in a much better financial position than its counterpart, despite collecting the same amount in gross annual receipts.

To put this in a practical context, the average net margin for online retailers is around 2.34%.<sup>174</sup> This means that, after the normal costs of doing business—cost of goods sold, wages, overhead, etc.—\$1,000,000 USD translates into \$23,400 USD of net income for a sole proprietor or partnership. Integration of the software alone could easily cost that much, not to mention the cost of compliance with numerous taxing jurisdictions. The MFA does provide some protection from liability in the case of human error,<sup>175</sup> but it does not cover these integration costs, nor does it address additional costs associated with audit compliance or litigation in faraway states. Although the MFA describes its \$1,000,000 USD threshold as a protection for small businesses, once the typical net margin size is taken into account, it becomes clear that the threshold does not actually provide much protection at all.

Online auction house eBay.com (eBay) agrees<sup>176</sup> and criticizes the threshold as being “exponentially less” than what current federal standards define as the threshold between small- and medium-sized businesses.<sup>177</sup> The number, it claims, does not accurately reflect the reality of the business world and would only protect “casual online sellers, most of who [sic] would not be subject to tax collection obligations anyway.”<sup>178</sup> eBay further notes that the low threshold would strip away the opportunity the Internet presents for startup companies to expand their business online by introducing burdensome new tax obligations.<sup>179</sup>

Another weakness of the MFA is that the “free” software provided by the taxing state is not actually free. The state covers only the purchase price, leaving owners to pay out of pocket to integrate the required software into their current systems.<sup>180</sup> Integration of a new program is typically much more complicated—and costly—than simply installing the software.<sup>181</sup>

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174. Aswath Damodaran, *Margins by Sector (US)*, N.Y.U. STERN, [http://pages.stern.nyu.edu/~adamodar/New\\_Home\\_Page/datafile/margin.html](http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/margin.html) (last updated Jan. 2015).

175. S. 698, § 2(b)(2)(E–G).

176. *Debunking the Myths Around the Marketplace Fairness Act*, EBAY MAIN STREET (May 3, 2013), <http://www.ebaymainstreet.com/news-events/debunking-myths-around-marketplace-fairness-act>.

177. *Id.*

178. *Id.*

179. *Id.*

180. S. 698, § 2(b)(2)(D)(ii) (The use of the language, “[p]rovide . . . software free of charge for remote sellers,” suggests that it is just the software itself that is provided by the state, while integration costs are left to the company.).

181. Ron Shmelzer & Jason Bloomberg, *Understanding the Real Costs of Integration*, TECHTARGET (Oct. 24, 2002), <http://searchsoa.techtarget.com/news/859301/Understanding-the-real-costs-of-integration>.

After the initial setup, the company must then pay to configure the software, cover ongoing maintenance costs, and make sure to set aside cash in case there are any significant changes to the system.<sup>182</sup> Although integration expenses can be tax-deductible for those with sufficient income, the company must still cover the initial cost with cash or debt. For companies existing at the margin, the financial impact of these additional costs is magnified and can cause significant hardship.

The sudden nature of the small-business exception and corresponding threshold, combined with hidden costs associated with the proposed software system, make the MFA an unattractive proposal. High costs across the board would force many to finance implementation with debt, which can be expensive for companies without a robust balance sheet, or finance with equity, which opens the company up to extensive regulatory burdens. Financing issues could deter many smaller businesses from using the Internet to expand operations and potentially bankrupt those who do. This simply shifts the competitive edge back to local business and seriously diminishes the Internet's potential as a tool for economic growth. In short, the MFA would address the current situation, but in a decidedly undesirable way.

## **B. ORIGIN-SOURCED TAX**

### **1. Proposal**

An origin-sourced tax system calculates taxes using the seller's local tax rate.<sup>183</sup> Whereas a destination-sourced tax system requires the seller to calculate the exact tax rate of wherever the buyer happens to be located, an origin-sourced system simply requires the seller to apply one single tax rate to every transaction.<sup>184</sup> The beauty of this proposal is its simplicity: origin sourcing significantly reduces compliance costs associated with destination sourcing, eliminates the need for specialized software, and curbs the threat of unforeseen costs such as audits or litigation in the state in which the buyer resides. Instead of over 7000 separate state and local taxing jurisdictions, a seller would only need to comply with the procedures for the one in which he or she is located.<sup>185</sup> An example of this can be found in the

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182. *Id.*

183. *Exploring Alternative Solutions on the Internet Sales Tax Issue: Hearing Before the H. Comm. on the Judiciary*, 113th Cong. 127–28 (2014) [hereinafter *Hearing Transcript*] (written testimony of Andrew Moylan, Senior Fellow and Outreach Director, R Street Institute).

184. *Id.*

185. *Id.* at 127.

European Union's system of ad valorem<sup>186</sup> taxes on business-to-consumer sales and services across member-country borders.<sup>187</sup>

Origin sourcing does not require any substantial change to the current legal framework. Since it is the business that is legally obligated to pay sales tax, not the consumer,<sup>188</sup> the origin-sourced system complies with the *Bellas Hess* and *Quill* requirements in that the seller would, by definition, always have a physical presence within the taxing jurisdiction. Therefore, the collecting state would only be taxing companies that already have a physical presence within its borders.<sup>189</sup>

## 2. Criticism of Origin Sourcing

Despite the attractive simplicity and consistency of an origin-sourced tax system, the concept raises numerous issues: (1) the system constitutes taxation without representation; (2) it subjects purchasers to foreign laws without their consent; and, (3) it has the potential to instigate a "race to the bottom."

First and foremost, origin sourcing is "clearly taxation without representation."<sup>190</sup> Not only would buyers be controlled by the laws of a foreign jurisdiction, the tax revenue paid would go to the benefit of that state rather than the buyer's. If a customer in Texas wants to purchase goods from a company in Maine, that customer would be forced to pay Maine taxes, a state in which the customer has no representation. The Texas customer would be subjected to the tax laws of a jurisdiction in which he or she does not live, enacted by a legislature that he or she did not vote for, which fund public services the customer will never gain any benefit from.

The nature of the Internet as a far-reaching means of communication only exacerbates this problem, as buyers would frequently be subjected to foreign laws against their consent under an origin-sourced system. It is well established that, by physically entering the jurisdiction of a sovereign body, a person is consenting to its system of laws.<sup>191</sup> In contrast, a customer on his or her computer at home in one state, by the virtue of clicking a button, could be unwittingly binding him or herself to the laws of another state, all

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186. Ad valorem taxes are taxes that are imposed proportionally on the value of something, rather than on its quantity or volume as with an excise tax. Sales taxes are ad valorem taxes.

187. Hearing Transcript, *supra* note 183, at 128 (written testimony of Andrew Moylan, Outreach Director and Senior Fellow, R Street Institute).

188. Although the money ultimately comes from the consumer's wallet, the legal burden to collect, and resulting liability if tax is not collected, is on the seller.

189. Hearing Transcript, *supra* note 183, at 127–28 (written testimony of Andrew Moylan, Outreach Director and Senior Fellow, R Street Institute).

190. *Id.* at 199.

191. This principle stems from the theory of tacit consent as a basis for government and the rule of law. *See, e.g.,* JOHN LOCKE, TWO TREATISES OF GOVERNMENT 364 (Peter Laslett ed., Cambridge Univ. Press 1988) (1690).

depending on where the seller happens to be located.<sup>192</sup> Online purchasers could potentially be taxed by any number of governing bodies without any say in the matter.<sup>193</sup> For companies such as Amazon that have regional distribution centers, it may not be apparent even to the company itself where exactly the goods are being shipped from until after the sale is made and the customer's shipping information is received.<sup>194</sup>

This lack of representation is magnified in the context of the five states that do not levy a sales tax.<sup>195</sup> If a resident of the state of Oregon, which does not levy a sales tax, makes a purchase online and is charged, for example, Louisiana's sales tax,<sup>196</sup> not only are his individual rights as a resident of Oregon being violated, but the sovereignty of the entire state of Oregon is similarly compromised. Oregon voters have repeatedly defeated measures to implement statewide sales taxes,<sup>197</sup> yet an origin-sourced system would force Oregon residents to not only pay sales tax on the goods they purchase, but to pay it to the government of an entirely different state.

Furthermore, there is still no concrete basis for determining what exactly constitutes a physical presence, and cases such as *National Geographic* and *Overstock* only further complicate the issue.<sup>198</sup> Retailers located in a state with no sales tax face a potentially severe penalty if they are found to be incorrectly operating under the origin state's tax laws when, in fact, they had a physical presence in the destination state all along. In such a situation, all but the most financially sound companies would be considerably disabled if suddenly billed for a significant amount of back taxes, plus interest, by multiple states around the country.

Finally, origin sourcing also opens up the possibility of a "race to the bottom," in which remote sellers simply move their base of operations to a jurisdiction with little-to-no sales tax in order to take advantage of the origin-sourcing system.<sup>199</sup> At a hearing before the House of Representatives, Representative Jerrold Nadler (D-NY) recounted his experience in the N.Y. State Legislature after the U.S. Supreme Court handed down its decision in *Marquette National Bank v. First of Omaha*,<sup>200</sup>

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192. The typical online shopper is usually not aware of the jurisdiction's tax laws that he or she will be subjected to. See, e.g., Hearing Transcript, *supra* note 183, at 215–16.

193. *Id.*

194. *Id.*

195. Those states are Alaska, Delaware, Montana, New Hampshire, and Oregon. Lee et al., *supra* note 10, at 2.

196. Louisiana has among the highest sales tax rates in the United States. See, e.g., Scott Drenkard, *State and Local Sales Tax Rates in 2014*, TAX FOUNDATION (Mar. 2014), <http://taxfoundation.org/sites/taxfoundation.org/files/docs/FF420.pdf>.

197. See, e.g., *Initiative, Referendum and Recall: 1980–1987*, OREGON BLUE BOOK, <http://bluebook.state.or.us/state/elections/elections20.htm> (last visited Sept. 19, 2015).

198. See *supra* Parts I.A and II.

199. Hearing Transcript, *supra* note 183, at 131 (written testimony of Andrew Moylan, Outreach Director and Senior Fellow, R Street Institute).

200. *Marquette Nat'l Bank of Minneapolis v. First of Omaha Serv. Corp.*, 439 U.S. 299 (1978).

which held that credit card usury laws were to be sourced from the state issuing the card.<sup>201</sup> Credit customers were traditionally protected by their state's usury laws until *Marquette* officially authorized an origin-sourced system instead.<sup>202</sup> In Representative Nadler's experience, banks immediately began moving their credit card operations to states in which there were "essentially . . . no regulations."<sup>203</sup> The banks then threatened their home states to weaken or repeal their usury laws or risk losing their business entirely, and the states ultimately complied.<sup>204</sup>

There is no reason to believe that history will not repeat itself. Aside from some logistical issues involved with delivering a physical product, the incentive structure under an origin-sourced system is essentially the same as the one created by the *Marquette* decision. This becomes evident through a simple cost-benefit analysis: if the competitive edge gained by avoiding compliance costs and selling tax-free outweighs the cost of relocation—plus any other potential disincentives, such as increased property or income taxes—the best decision is for the company to relocate. Manipulation of this sort is especially likely for firms centered on e-commerce, as Internet retailers are able to handle most administrative and logistical functions from a single office building and thus do not require an extensive physical presence throughout the country. The relocation itself would be relatively easy—all the retailer has to do is pack up its servers and find some office space to rent in a state with favorable tax laws.

Simply put, the attractive simplicity of an origin-sourced system does not make up for the numerous problems it would create upon implementation.<sup>205</sup> Aside from the constitutional issues raised in requiring buyers to adhere to the laws of foreign states, origin sourcing would tip the scale too far in favor of e-retailers, as they would then be free to relocate to tax-free jurisdictions and continue to undercut competition. Therefore, the implementation of an origin-sourced tax system would only exacerbate current tax problems by increasing economic inefficiency from tax avoidance, and ultimately weakening the nation's economic health overall.

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201. Hearing Transcript, *supra* note 183, at 168 (referring to *Marquette*, 439 U.S. at 301) (account shared by Rep. Jerrold Nadler, Member of the House Committee on the Judiciary).

202. *Id.* at 168–69.

203. *Id.* at 169.

204. *Id.*

205. In reality, the simplicity of the proposal is largely negated by the fact that most retailers would still be required to comply with local tax laws of every state in which they maintain a physical presence.

## C. CONSUMER PRIVATE REPORTING

### 1. Proposal

Consumer Private Reporting (CPR) is simply the enforcement of existing use tax laws through a system of self-reporting.<sup>206</sup> Mr. James H. Sutton, Jr. proposed the CPR system at a recent hearing before the House of Representatives.<sup>207</sup> At the hearing, Mr. Sutton claimed that the main problem with the current situation is not that states cannot collect sales tax on Internet sales, but rather that use tax laws routinely go unenforced because states simply do not have either the information or the financial incentive to enforce them.<sup>208</sup> The CPR system addresses this by creating a consolidated federal database to which companies send interstate sales figures accumulated over the prior fiscal year.<sup>209</sup> The sales figures would be combined in a 1099-style format for each purchaser to access in order to file their own use tax returns with the respective states.<sup>210</sup> Relevant information would be presented as general dollar figures in order to protect consumer privacy.<sup>211</sup> However, the itemized receipts would be stored securely in the remote vendor's system, so that a customer could choose to identify specific items in order to claim an exemption.<sup>212</sup>

The filing process, as well as the mechanisms for pursuing non-filers, would utilize the existing framework in place for sales taxes.<sup>213</sup> In this way, the CPR system proposes no new laws, instead enforcing laws that are already on the books using methods that are already in place.<sup>214</sup> Sales and use tax laws would even be simplified to an extent, in that businesses would not be burdened with tax collection duties for numerous taxing jurisdictions,<sup>215</sup> and there would be no debate over where to source the tax rate. Customers of remote vendors would feel compelled to self-report remote purchases once state and local governments actually started enforcing use tax laws, thereby bringing interstate sales more in line with local sales and lessening the economic inequality.<sup>216</sup>

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206. Hearing Transcript, *supra* note 183, at 76 (written testimony of James H. Sutton, Jr., CPA, Esq., Shareholder, Moffa, Gainor, & Sutton, P.A.).

207. *Id.*

208. *Id.* at 75.

209. *Id.* at 81.

210. *Id.*

211. *Id.*

212. *Id.*

213. *Id.*

214. *Id.*

215. *Id.* at 83.

216. *Id.*

## 2. Criticism of Consumer Self Reporting

The CPR system, while conceptually appealing, raises significant practical issues. Implementation would require the creation of an enormous new federal database, new reporting mechanisms for sellers to use, and new software to access the database. Consumers would be forced to remit lump sums of tax debt out of pocket at specified times. If a consumer fails to pay, he or she will presumably be subject to the same penalties as companies who fail to remit sales tax collections along with all associated interest, fees, and potential legal costs. Finally, the CPR system introduces what could be perceived as an entirely new tax obligation, even if states are merely enforcing existing tax laws.<sup>217</sup>

Aside from the sheer logistics of creating such an enormous database from scratch, there is no guarantee that federal databases would be entirely secure. In 2013, hackers attacked Target Corp. and compromised up to 40-million credit card and debit card numbers, in addition to the corresponding encrypted personal identification numbers (PIN numbers).<sup>218</sup> If hackers could easily steal massive amounts of personal data from a mega-corporation like Target, it seems perfectly reasonable to assume that hackers could also infiltrate the security systems of a small- to medium-sized business, gaining full access to itemized records of every purchase in addition to customers' personal identification information.

On the public side, even the federal government itself is not safe. In June of 2015, federal officials discovered a massive breach of the Office of Personnel Management, whereby the personal data of millions of federal employees was stolen directly from federal databases.<sup>219</sup> Personal data is much more sensitive than the purchase data at issue, so if personal information can be so easily taken from federal databases, there is no guarantee that taxpayer use tax information will be sufficiently protected. The fact that neither the government, nor private companies, are safe from cyber-attack does not cultivate much faith in a CPR system centered on an electronic database.

The CPR system is also a very costly and time-consuming proposal, even if Congress were to include liability protection similar to that of the MFA.<sup>220</sup> Implementation would require the creation of entirely new software programs for vendors to access the relevant databases. Even if the

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217. At least, the use tax obligation would be perceived as new insofar as the consumer has never had to pay it before. *Id.* at 166 (answer given by James H. Sutton, Jr., CPA, Esq., Shareholder, Moffa, Gainor, & Sutton, P.A.).

218. Jim Finkle & David Henry, *Exclusive: Target Hackers Stole Encrypted Bank PINs—Source*, REUTERS (Dec. 25, 2013, 12:44 AM), <http://www.reuters.com/article/2013/12/25/us-target-databreach-idUSBRE9BN0L220131225>.

219. Kate Vinton, *Hackers Stole 4 Million Federal Employees' Personal Data*, FORBES (Jun. 4, 2015, 6:11 PM), <http://www.forbes.com/sites/katevinton/2015/06/04/4-million-federal-employees-personal-information-stolen-in-data-breach/>.

220. See *infra* Part IV.A.

government were to provide the software as proposed by the MFA,<sup>221</sup> the cost of implementation still presents a significant burden to small retailers. Furthermore, CPR includes no compliance threshold—every seller, regardless of size or relative ability, would immediately be required to collect customer purchasing data and remit that data to the appropriate states. Failure to comply could result in the assessment of interest, fines, and potentially even legal fees, all in addition to the increase in accounting costs required to manage potential audits from every taxing jurisdiction in the country.

The lack of security, implementation and compliance costs, negative perception, and financial inconvenience of the CPR system make it an unattractive solution. Merely enforcing existing laws is appealing on its face, but when the laws in question have not only been sparsely enforced, but would also require the creation of an entirely new reporting and collection system, it becomes clear that the solution is more trouble than it is worth.

#### **IV. PROPOSAL: MARKET PRESENCE AS A PROXY FOR PHYSICAL PRESENCE TO RESTORE FAIR COMPETITION IN THE RETAIL MARKET**

Although territorial presence frequently will enhance a potential defendant's affiliation with a State . . . it is an inescapable fact of modern commercial life that a substantial amount of business is transacted solely by mail and wire communications across state lines, thus obviating the need for physical presence within a State in which business is conducted.<sup>222</sup>

These words, written over thirty years ago, become even more relevant as the Internet attains greater prevalence in our modern economy. In many industries, the Internet has almost completely obviated the need for any physical presence within a state. We are quickly reaching the point at which a single out-of-state company, selling online, could potentially dominate the relevant market in its neighboring state without ever having to charge or collect a dime in taxes. Not only does this undercut local establishments, it also deprives the relevant state and local governments of vital tax revenue. The Commerce Clause, originally meant to protect and foster interstate commerce, now effectively discriminates against intrastate business by shielding companies with comparable sales and distribution capabilities from the same tax burdens carried by local retailers. Therefore, it is essential to adapt our constitutional analysis to reflect this paradigm shift. The applicable standard must be flexible enough to accommodate evolving

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221. *Id.*

222. *Burger King Corp. v. Rudzewicz*, 417 U.S. 462, 476 (1985).

technology, yet concrete enough to continue to meet legal and economic needs. That standard is market presence.

Part A of this section will examine both the actual mechanics as well as the resulting economic benefits of market presence. Part B will analyze market presence under the constitutional framework derived from *Bellas Hess* and its progeny to argue that it satisfies both Due Process and Commerce Clause concerns. Finally, Part C will discuss various criticisms of market presence and offer rebuttals in defense.

### A. MECHANICS OF THE MARKET PRESENCE STANDARD

Market presence is a way of establishing jurisdiction by using a company's economic presence in the market as a proxy for physical presence. Rather than focusing on whether the seller physically occupies space within the state, which often has little impact on the underlying transaction, the focus is instead on the economic reality of the situation. Market presence adapts the substantial nexus prong of Commerce Clause analysis to a more pragmatic inquiry that brings state taxation of interstate commerce in line with the rest of in personam jurisdictional analysis, which has long since moved away from rigid physical constraints.<sup>223</sup> Market presence is meant to govern situations where a state would otherwise be justified in asking a company to collect sales or use taxes on its behalf, but is barred from doing so solely because the company has no physical presence within the state. Therefore, market presence seeks to enforce justifiable taxes that comply with the underlying purpose and intent of the Commerce Clause, but are nonetheless invalidated by loopholes and technicalities in the current law.

Presence is determined through a system of intelligent thresholds based on business size standards for the specific region, industry, and market in which a particular company operates. The thresholds are meant to measure a particular company's sales volume and corresponding impact on the market in question. Once the company's cash flow from remote sales in the market become substantial enough to qualify it as a medium-sized business, market presence is established and the company can be considered effectively present for jurisdictional purposes. At this point, when the company is operating at a capacity comparable to local competitors, it is entirely fair for the state to ask it to carry a comparable tax burden.

Business size information is taken from the Small Business Administration's table of size standards<sup>224</sup> and broken down by state and region. Companies are classified by North American Industry Classification

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223. See discussion on the evolution of Due Process Clause jurisprudence, *supra* at Part I.B.

224. *Table of Small Business Size Standards Matched to North American Industry Classification System Codes*, U.S. SMALL BUS. ADMIN. (Jan. 1, 2012), [http://www.sba.gov/sites/default/files/Size\\_Standards\\_Table.pdf](http://www.sba.gov/sites/default/files/Size_Standards_Table.pdf).

System (NAICS) codes, which they can then use to determine the relevant threshold for their particular line of business. Governments can similarly use this same information for collection and enforcement purposes. The main idea is to establish a standardized, neutral, and transparent system of classification to ensure fairness and consistency of application.

Thresholds are calculated using the company's gross profits derived from the relevant market.<sup>225</sup> Each threshold is separate and distinct, so that a company can only incur tax burdens in areas where it has earned them. Gross profits are used instead of other financial measures, such as Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA) or net income, because of its location on the income statement. It is calculated after the cost of goods sold is deducted, which negates differences in profit margin from one industry to the next. Similarly, it is calculated before general and administrative expenses are deducted, which eliminates both the incentive and the ability to manipulate taxable income through creative accounting or overspending and keep the company below the threshold. By using gross profit as a benchmark, companies are less likely to base spending decisions on tax avoidance rather than value added, resulting in greater efficiency throughout the system.

Market presence takes an individualized approach to threshold calculation, addressing each industry in which a particular company maintains a presence on a distinct and individual basis.<sup>226</sup> On one hand, this requires greater specificity in bookkeeping as well as more in-depth formats for state sales tax returns. However, this also discourages unnecessary splintering into subsidiaries, which could result in inefficiency resulting from the loss of economies of scale, as companies could not avoid tax liability by separating their high-volume product lines from the rest. Most importantly, an individualized threshold approach eliminates the possibility that companies could simply release sham product lines in order to increase their aggregate threshold and thereby avoid tax liability altogether.<sup>227</sup>

Market presence undoubtedly sets a fairly high standard of liability, which means that many companies will be unaffected. However, this is necessary to ensure fairness and a truly level playing field. The fundamental idea behind interstate tax reform is that retailers of a certain size should not be exempt from sales tax collection, but it would be just as unfair to impose potentially enormous compliance costs on small businesses trying to use the

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225. Gross profit is a company's total revenue less the cost of goods sold.

226. For example, for a company that sells both clothing and mining equipment, the clothing line would be assessed separately and measured against a threshold specific to the clothing industry in that area, whereas the mining equipment would be measured against a threshold specific to the mining equipment industry in that area.

227. Under an aggregate approach, a clothing company operating above its threshold could ostensibly begin to sell mining equipment. Even if the company never sold a single unit, the new mining venture would provide plenty of cushion to continue operating its profitable clothing line free of tax liability. Utilizing an individualized approach eliminates this tactic.

Internet to expand and grow their market share. The potential for residual inequality with these companies is outweighed by the many benefits of market presence: it evens the retail field without being unfairly burdening or favoring one particular group; it protects small business owners from enormous compliance costs in allowing for pro rata accumulation and compartmentalization of tax obligations; it is adaptable and flexible enough to remain relevant as technology evolves; and, it increases efficiency in the marketplace.

### **1. Market Presence Levels the Playing Field for Interstate and Intrastate Commerce**

Market presence ignores occasional, sporadic sales that have little effect on the local economy while ensuring that legitimate competitors in an area are governed by the same rules as local establishments. Once an out-of-state company earns enough sales to surpass the threshold, it has reasonably reached the point where it is just as competitive, and its presence is just as legitimate, as local businesses. When that threshold is met, market presence is established, the competitive edge is removed, and parties are placed on level ground. Accordingly, this ensures that an out-of-state retailer will not suddenly be subjected to tax collection burdens based on a few scattered sales, as they have little effect on the state economy and thus pose little threat to local businesses. The newly acquired tax burdens will be the same as those borne by the local competitors. It is not until the out-of-state retailer starts to significantly cut into local sales that its tax-exempt status will change and it will be required to carry the same burden as local vendors. Thus, no matter the level of sales into a given market, the competitive atmosphere will be maintained.

### **2. Market Presence Protects and Fosters Small Businesses**

The most important difference between market presence and the proposals discussed previously is that market presence offers much greater protection for small businesses. Under plans like the MFA, marginal companies would suddenly be subject to tax collection obligations anywhere in the country the moment they surpass \$1,000,000 USD in total online sales for the year. This threshold would not significantly burden the likes of retail behemoths, such as Amazon, that have enough revenue to absorb the additional costs. Rather, the companies that would most struggle with this sudden burst of obligation are the smaller-to-mid-sized companies that barely clear the \$1,000,000 USD mark.

Market presence, on the other hand, distributes the overall tax burden to those states where the retailer generates enough sales, allowing for the gradual accumulation of collection obligations as the company meets gross margin benchmarks. This distributive property limits liability to where and

when the retailer is most capable of handling them, rather than forty-six different states simultaneously imposing new tax-collection duties the moment a company surpasses a given national sales threshold. As discussed above, the individualized focus of the market presence thresholds allow small business owners room to maneuver as they approach the liability threshold. Depending on the company's financial situation, management has the ability to split apart the company into subsidiaries in order to break up cash flows and avoid triggering tax liability.

Companies additionally have substantial risk management capabilities with market presence. Management can split the company apart in order to compartmentalize risk and thereby confine potential damage from litigation or extensive audits to the affected units without the entire organization suffering as a result. The separation limits the distributive property of market presence and prevents cross-contamination of business segments. While the separation would result in the loss of economies of scale, this is not as much of a concern for smaller companies, as the loss would be outweighed by the relatively large gain in liability control and reduction of potential damage.

Compliance costs are confined to a certain proportional share of a company's gross profits for a given area, ensuring that the eventual costs can be met by the time they are accrued. Retailers are able to predict, prepare for, and then safely expense compliance costs rather than being forced to finance compliance through debt. Company managers can ensure that enough taxable income exists to reap the tax benefits, thereby financing compliance in part with government assistance through a lowered tax bill. The ability to accumulate compliance costs over time also allows a retailer to take the tax savings from prior compliance efforts and put it towards impending tax burdens in other regions, adding certainty that its obligations will be met and expensive fines will be avoided.

### 3. Market Presence Increases Economic Efficiency

The physical presence standard leaves gaps and loopholes in tax enforcement that create substantial economic inefficiency. The most significant effect of this inefficiency is rising distortion costs,<sup>228</sup> which occur when either consumption decisions or business decisions, or both, are motivated by tax considerations rather than the cost efficiency of production, distribution, and sales.<sup>229</sup> Although goods sold online may use

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228. Distortion is economic inefficiency arising from uneven taxation of goods. See Zimmerman, *supra* note 129, at vii.

229. *Id.* at 8. Consider a customer who purchases books online, tax-free, for \$100 USD, inclusive of shipping costs. The same books could be purchased at a local bookstore for \$102 USD, inclusive of a \$5 USD sales tax charge. Resource costs and value for the Internet book are \$100 USD, which includes profit, materials, labor, and shipping/logistics. Resource costs and value for the local books, however, are only \$97 USD because the extra \$5 in tax is a direct

extra resources in shipping and distribution, the loopholes in the current system of tax laws create the incentive for a manufacturer to avoid expansion into physical outlets and instead choose to sell tax-free online so long as the additional logistical cost is less than potential compliance costs that would be incurred through physical presence.

This decision wastes resources in the desire for tax avoidance that could otherwise be used for production or distribution. However, with market presence, larger e-commerce retailers would not be able to take advantage of distortion costs to gain a competitive edge,<sup>230</sup> as physical location is irrelevant. At the same time, a limited safe harbor would still be available for smaller businesses to make their initial foray into a market electronically, rather than waste resources in a failed physical expansion. Market presence would not entirely remove the incentive to avoid tax compliance for businesses operating below the threshold. However, these residual costs would be offset by the elimination of the more substantial distortion costs created by larger retailers, resulting in a net efficiency gain.

#### **4. Market Presence is Flexible and Adaptable to Economic Realities**

Unlike the substantial nexus standard and its basis of physical presence from *Bellas Hess* and *Quill*, market presence is based on a relatively flexible standard. Market presence is measured by dollar amounts, sales figures, and other basic economic measurements that, unlike physical presence, will always be an integral part of any sales transaction. Industry numbers would be broken down by state and region so that each threshold for market presence is calculated to fairly represent the individual market. If a given industry grows or shrinks enough so that the threshold is no longer an accurate determination of economic effect, the threshold can be increased or decreased accordingly. Thus, while based on concrete data to an extent, the state thresholds will remain tied to fundamental notions of fairness by allowing for expansion or contraction in response to market fluctuations. The flexibility of market sensitivity combined with the solid base of hard sales data ensures that the market presence standard can adapt to the rapidly changing technological landscape and continue to be a useful tool.

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transfer from the customer to the government that uses no resources. The resulting differential from the customer's presumed noncompliance with the use tax, whether from ignorance or through a *de minimis* exception, results in a \$3 USD loss of efficiency. Rather than being used to produce \$3 USD worth of other goods or services, the \$3 USD is instead spent on unnecessary logistics and shipping costs. *Id.*

230. Currently, the incentive for large companies to choose inefficient locations based on tax avoidance is twofold: not only do large companies enjoy economies of scale that reduce the cost of competing in remote markets, but they also face greater potential compliance costs, litigation costs, and tax penalties than their local competitors due to their size.

## B. CONSTITUTIONALITY OF MARKET PRESENCE AS A JURISDICTIONAL PREDICATE

A major point worth repeating is that the Supreme Court in *Quill* explicitly left final regulatory authority up to Congress.<sup>231</sup> Thus, at least concerning the Commerce Clause, this proposal does not need to fit within current Commerce Clause jurisprudence.

Regardless, the proposal does fit neatly within the constitutional framework already in place. Rather than supplanting the established physical standard from *National Bellas Hess* and its progeny, market presence serves as a proxy for physical presence, similar to how minimum contacts serves as a proxy for notice under Due Process Clause analysis.<sup>232</sup> The only difference between the current and proposed analyses is merely an adaptation of the physical aspect of substantial nexus to a standard better suited to govern modern economic reality. Just as *International Shoe* extended the reach of personal jurisdiction past the physical boundaries set in *Pennoyer v. Neff*<sup>233</sup> while still recognizing the validity of physical presence as a jurisdictional predicate under *Pennoyer*,<sup>234</sup> market presence only supplements physical presence, extending the substantial nexus requirement to cover those retailers operating within the technological loophole implicit in the current system.

### 1. Due Process Clause

Due Process Clause analysis is fairly straightforward with market presence, as it is designed in such a way that Due Process Clause concerns are met before market presence is ever triggered. The threshold requirement is calculated to explicitly exclude sellers with brief or sporadic contact with the forum state as both a protection for small businesses and a way to maintain fairness. This ensures that the seller has undoubtedly established minimum contacts with the forum state by the time its activities are substantial enough to give rise to tax collection duties. In a way, market presence is effectively governed by the minimum contacts test, in that the same activity that establishes minimum contacts also establishes market presence. As for fairness concerns, the market presence thresholds are calculated to be at or beyond the point at which it not only becomes fair for a state to impose tax collection duties, but also the point at which it becomes unfair to continue to allow the out-of-state retailer to operate tax-free. In other words, the threshold is not triggered until the state's exercise of jurisdiction over the retailer is fair and justified.

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231. *Quill Corp. v. North Dakota*, 504 U.S. 298, 318 (1992).

232. *See, e.g., id.* at 313.

233. *Pennoyer v. Neff*, 95 U.S. 714 (1877).

234. *Int'l Shoe Co. v. Washington*, 326 U.S. 310, 319–20 (1945).

Market presence also ensures that the state provides something “for which it can ask return,”<sup>235</sup> and that taxes will be “rationally related” to the seller’s activity within the state.<sup>236</sup> Each sale made within a state requires some use of that state’s facilities in order to complete the transaction. Though remote vendors may not utilize state facilities to the same extent as local vendors, they still enjoy numerous benefits provided by the state.<sup>237</sup> Those benefits support every transaction, as state facilities are directly or indirectly necessary to complete the exchange. Thus, any incident giving rise to tax liability will have made use of state facilities and enjoyed state protection, justifying the state’s request for return under *Wisconsin v. J. C. Penney*.<sup>238</sup>

Justice Fortas noted in his *National Bellas Hess* dissent that “[NBH] enjoys the benefits of, and profits from the facilities nurtured by, the State . . . as if it were a [physical] retail store.”<sup>239</sup> Thus, any incident giving rise to tax liability will have made use of state facilities and enjoyed state protection, justifying the state’s request for return. As noted above, sales tax only arises upon completion of the sales transaction, which fully confines the taxes in question to the activities that gave rise to jurisdiction in the first place. Therefore, the income subject to taxation will always be rationally related to the activities carried out within the state.

Finally, the notice requirement of the Due Process Clause is also logically satisfied by the market presence standard. An entity that is “engaged in continuous and widespread solicitation of business within a State . . . has ‘fair warning that [its] activities may subject [it] to the jurisdiction of a foreign sovereign.’”<sup>240</sup> The threshold requirement again ensures that a business has ample notice of impending tax collection duties by the time those duties are officially imposed. Despite the lack of physical presence, a substantial amount of continuous and widespread solicitation of business within the state is required before the state is allowed to exercise taxing jurisdiction over a business. Thus, notice is easily established through the normal course of business.

Market presence has substantial requirements that must be met before it can be used as a basis for tax liability. Thus, considerations under the Due

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235. *Wisconsin v. J. C. Penney Co.*, 311 U.S. 435, 444 (1940).

236. *Moorman Mfg. Co. v. Blair*, 437 U.S. 267, 273 (1978).

237. For example, these facilities may include: police protection of the customers who gave the company their money, maintenance of an electrical grid to power the customers’ computers as they made their purchases, and the protection and support of the banking system that processes the transaction. See *Quill*, 504 U.S. at 328 (White, J. dissenting).

238. *Wisconsin*, 311 U.S. at 444.

239. *Nat’l Bellas Hess v. Dep’t of Revenue of Ill.*, 386 U.S. 753, 762 (1967) (Fortas, J., dissenting), *overruled by Quill*, 504 U.S. 298.

240. *Quill*, 504 U.S. at 308 (quoting *Shaffer v. Heitner*, 433 U.S. 186, 218 (1977) (Stevens, J., concurring)).

Process Clause are easily equaled and surpassed by the time a state can begin to exercise jurisdiction over a remote vendor.

## 2. Commerce Clause

Validity under the Commerce Clause is determined by using the four-part test from *Complete Auto Transit*,<sup>241</sup> which is designed to prohibit undue burdens on interstate commerce as well as limit the reach of state taxing authority. Market presence easily satisfies all four prongs.<sup>242</sup>

### *a. Tax Must be Applied to an Activity with a Substantial Nexus with the Taxing State*

Substantial nexus, under the Supreme Court's prevailing Commerce Clause interpretation, effectively requires a physical presence within the taxing state in order to uphold jurisdiction over an out-of-state seller.<sup>243</sup> While physical presence has not been explicitly adopted, the *Quill* Court upheld the longstanding prohibition against imposing tax collection duties on vendors "whose only connection with customers in the [taxing] State is by common carrier or the United States mail."<sup>244</sup>

Using market presence as a jurisdictional standard would likely be unconstitutional under this strict formulation. However, though the parameters of this rule may have made sense when initially decided, it is no longer an effective regulator of interstate commerce.<sup>245</sup> Market presence would supplement physical presence in situations where physical considerations are irrelevant or inapplicable by serving as a proxy-jurisdictional predicate.<sup>246</sup> Similar to the evolution of in personam jurisdiction, physical presence will always be a valid jurisdictional predicate. Adopting the market presence standard would simply allow states to retain their jurisdictional power in situations where that power is defeated by a technological progress.

### *b. Tax Must be Fairly Apportioned*

Taxes on interstate activities must be confined to the portion of the activity that took place within the taxing state.<sup>247</sup> This requires that the state "does not undertake to tax any interstate activities carried on outside the

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241. See *supra* Part II.A.

242. *Quill*, 504 U.S. at 313.

243. See *supra* Part I.A.

244. *Quill*, 504 U.S. at 315 (quoting *Nat'l Bellas Hess*, 386 U.S. at 758).

245. See, e.g., *id.* at 327–28 (White, J., concurring in part and dissenting in part).

246. This function is not unprecedented. The minimum contacts test from *International Shoe* was created in part to address the growing obsolescence of the rigid physical presence requirement from *Pennoyer* and its progeny. See FREER, *supra* note 93, at § 2.4.2.

247. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977).

state's borders; and cannot be repeated by any other state.”<sup>248</sup> Sales taxes necessarily limit collection to activities within the taxing state.<sup>249</sup> Only one state and applicable local sales tax rate is applied to each transaction,<sup>250</sup> which ensures that only one state is laying claim to the tax proceeds derived from the sale. Other states cannot (currently) tax transactions that take place in other states, so jurisdiction is limited to transactions occurring within that state's own borders. Any additional taxes that the state tried to levy on other aspects of the transaction, such as shipping or out-of-state storage in a warehouse, would be a separate issue. Thus, market presence fairly apportions the tax burden, and therefore satisfies the second prong.

*c. Tax Must Not Discriminate Against Interstate Commerce*

A tax is discriminatory if it “‘provid[es] a direct commercial advantage to local business’ . . . at the expense of out-of-state businesses.”<sup>251</sup> Far from being discriminatory, using market presence as a standard actually reduces economic discrimination by correcting the discrepancy between interstate and intrastate tax burdens. Discriminatory taxes are often discussed in reference to protectionist taxes upon interstate commerce, but the reality is that interstate commerce enjoys a substantial tax haven that is unavailable to local intrastate businesses.

This safe harbor from taxation is necessary up to a certain point, as a tax applied on a wholly equal basis would indirectly discriminate against interstate vendors by imposing enormous compliance costs relative to their intrastate counterparts. However, because modern computer technology eliminates much of the traditional components of compliance costs,<sup>252</sup> the market presence standard ensures that sellers will have enough revenue from online sales in the taxing state to cover compliance costs by the time the threshold is reached.

The market presence standard does not economically favor one category of commerce over the other. In addition, market presence actually serves to reduce the type of discrimination referred to in the test itself. Therefore, market presence satisfies the third prong.

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248. *Id.* at 282 (quoting *Memphis Nat. Gas Co. v. Stone*, 335 U.S. 80, 96–97 (1948)).

249. For example, the state of Idaho cannot charge a sales tax on a Florida woman's annual income or on a California retiree's pension payments.

250. The rate depends on what system of taxation is used. Destination-sourced systems charge the buyer's local rate, while origin-sourced systems charge the seller's local rate.

251. *Bos. Stock Exch. v. State Tax Comm'n*, 429 U.S. 318, 329 (1977) (quoting *Nw. States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 458 (1959)).

252. For example, rates can be calculated and returns can be filed via software programs rather than manually. See *Quill Corp. v. North Dakota*, 504 U.S. 298, 332 (1992) (White, J., concurring in part and dissenting in part) (“[T]he costs of compliance . . . in light of today's modern computer and software technology, appear to be nominal.”).

*d. Tax Must be Fairly Related to the Services Provided by the State*

Under the fourth prong, a state's tax will be sustained if it is "related to a corporation's local activities and the State has provided benefits and protections for those activities for which it is justified in asking a fair and reasonable return."<sup>253</sup> The idea is that a state should only be able to tax activities that it actively supports with its infrastructure and other benefits. There is little danger of a state reaching activities for which it does not provide benefits and protections, as sales taxes are inherently confined to single occurrences taking place in defined locations. Thus, market presence satisfies the fourth prong.

**C. CRITICISMS OF MARKET PRESENCE & REBUTTALS**

No single proposal creates a perfect equilibrium between interstate and intrastate commerce. Like all others, market presence has its share of weaknesses and potential areas of criticism. These include the possibility that the proposal would not have much of an effect; the integration and compliance costs imposed on those who trigger tax obligations; the absence of a regulated system of certified software providers to design and maintain the necessary software; and the potential for manipulation.

**1. Adopting Market Presence as a Jurisdictional Standard Would Not Have Much Effect**

High thresholds, the use of gross profit as a measurement, and the distribution of liability mean that only a small percentage of online retailers will ultimately be affected by the adoption of market presence as a jurisdictional standard. Indeed, liability thresholds are purposely set high enough that a retailer must be a legitimate competitor in a given market to trigger the threshold. This means that the majority of small-to-mid-size retailers will continue to operate free of tax obligations. If so few are affected, some might say, why bother trying to overhaul the system at all? What is the point of all the upheaval if the end result will be largely similar to the current system?

Limited reach is precisely one of the desired results of market presence. The ultimate goal in using this standard is to have as many of the total sales in a market as possible be transacted under the same set of tax rules. Application to a small number of high-volume businesses is the most efficient way to achieve this result and imposes the least possible compliance cost on retailers in the market. With market presence, the size and sales volume of a vendor is more important than the absolute number of

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253. *Complete Auto Transit*, 430 U.S. at 287 (quoting *Colonial Pipeline Co. v. Traigle*, 421 U.S. 100, 108 (1975)).

firms affected. Thus, while only a small percentage of vendors will be covered, a substantial percentage of overall electronic sales will be eligible for tax collection.

Market presence only applies to retailers large enough to have an appreciable negative effect on local governments and tax-burdened competitors. These affected companies are those that not only have the capacity to be a legitimate force in the market, but also large enough to take full advantage of the interstate commerce tax haven and use it to exacerbate their deleterious effect on the local economy. Small, sporadic retailers are not the ones draining public coffers and putting local companies out of business, so they are causing the problems that market presence seeks to address. Imposing potentially significant compliance costs on economically irrelevant companies without the cash flow to cover them not only cuts against fairness concerns, but also begins to discriminate against interstate commerce, both of which are prohibited under Commerce Clause jurisprudence. Furthermore, exempting small retailers is in line with the stated Congressional intent to foster growth, productivity, and innovation with regard to the Internet.<sup>254</sup>

The market presence standard seeks to strike a balance between fostering and promoting small businesses and preventing large companies from taking advantage of that loophole and, in the process, negatively impacting local and regional markets. Ideally, market presence would only apply to the sources of the problems in the retail industry and otherwise allow commerce to continue as usual. Thus, the potential that only a small portion of retailers would be affected is both desirable and perfectly in line with the intent behind market presence.

## **2. Compliance and Integration Costs Will Be Enormous**

Tax collection creates compliance costs, both in collecting the taxes up front and in dealing with any potential liability that may arise after the fact. The tax collection burden gets increasingly expensive as a company becomes obligated to more and more taxing jurisdictions nationwide. These expenses primarily take the form of the cost to implement and maintain rate calculation software, potential litigation over issues with the company's sales tax filings, and costs incurred when dealing with state audits.

The Supreme Court based their ruling in *Bellas Hess* partly on the "virtual welter of complicated obligations to local jurisdictions"<sup>255</sup> that would result if each jurisdiction were allowed to tax its portion of interstate commerce. Each new collection burden introduces an entirely new entity the seller must report to, each with its own reporting standards and audit procedures. Market presence does allow for the gradual accumulation of

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254. See, e.g., Internet Tax Freedom Forever Act, S. 431, 114th Cong. § 2 (2015).

255. Nat'l *Bellas Hess* v. Dep't of Revenue of Ill., 386 U.S. 753, 760 (1967).

liability, as opposed to the MFA, which is all-or-nothing. Nonetheless, the costs of compliance can rapidly build as more jurisdictions gain taxing authority over the seller. Thus, critics claim that market presence, like all destination-sourced tax schemes, imposes overly expansive and burdensome costs on retailers, which adversely affects the burgeoning industry of online retail.

Compliance costs are largely overstated at the front end, as the software required for compliance is relatively cheap to produce and implement into existing sales systems. Most of the cost of compliance is represented by the potential for state audits or legal action against a company, especially when the company is forced to deal with multiple states at once. Regardless, market presence is inherently suited to deal with these costs intelligently and gradually, putting companies in the best possible position to comfortably absorb the costs of tax collection burdens.

*Bellas Hess* was decided in 1967, when rate calculations and tax collections had to be performed and reported without the aid of computers. Presumably, the sheer man-hours necessary to comply with taxing jurisdictions across the country would have deterred many companies from expanding. However, the compliance process is hugely simplified by the advent of modern computers.<sup>256</sup> A program to calculate tax rates would only require the creation of a simple database in which to store the various tax rates as well as a program for searching and selecting desired rates at appropriate times.

Databases such as this would be “incredibly easy to design. Any undergraduate computer science major could do it.”<sup>257</sup> In fact, a simple online search will find a number of free websites and software programs that not only calculate the local and state tax rate for any address in the United States, but also provide free registration, filing, and remittance services as well as services to identify and apply tax exemptions.<sup>258</sup> Regardless of the cost, the threshold requirement helps to ensure that the seller has both sufficient revenue to cover software expenses up front as well as enough taxable income to later expense those costs and reduce the seller’s income tax burden accordingly.

In addition to compliance on the front end, the potential for audits and litigation on the back end also poses a threat to sellers. While not insignificant, these costs are inherent in any business venture. Ideally, the threshold requirement would allow the seller to generate enough cash flow to handle audits or litigation by the time they arose, if they even occur at all. Besides maintenance and upkeep, the front end software costs are mostly

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256. *Quill*, 504 U.S. at 332 (White, J., dissenting) (“the costs of compliance . . . in light of today’s modern computer and software technology, appear to be nominal”).

257. Telephone Interview with Terry Haynes, Student, Tulane University (Dec. 4, 2014).

258. See *Nationwide Local Sales Tax Calculator*, TAXCLOUD, <https://taxcloud.net/find-a-rate/> (last visited Sept. 19, 2015).

nonrecurring, so the seller's ability to absorb potential back-end costs grows significantly as time progresses.

Finally, the market presence threshold allows companies to compartmentalize audit and litigation risk by gradually accumulating tax obligations according to its financial ability. Increasing audit and litigation risk means that cash flow is also increasing as the company grows its presence in relevant markets. In addition, this gradual accumulation allows management to treat the company's risk exposure as a sort of investment portfolio—the danger posed by audits and litigation is reduced as the risk of incurring these costs grows. At a certain point, the principles of diversification begin to apply, so that the potential adverse impact of litigation or audit in one state is simultaneously offset by cash flow stemming from all of the other states in which the company is not facing potential adversity.

It is true that certain costs of compliance have the potential to seriously impact a seller's financial health, but the overall problem is largely overstated. Advances in computing technology have significantly reduced many traditional compliance costs. For those costs that do arise, the threshold limitation on market presence serves to incubate the retailer until compliance costs can be dealt with comfortably. Furthermore, compliance costs are inherent to any business venture, and are certainly issues that local retailers have to deal with when expanding into new markets.

### **3. System is Easy to Manipulate**

One of the major drawbacks of any destination-sourced system of taxation is that it is prone to manipulation. There is nothing to stop a buyer from simply shipping purchases to a friend or relative who lives in a low tax jurisdiction. When the goods arrive, the buyer can choose to either physically pick them up or have the other party re-ship the package to his or her true address. This method of circumvention would be as simple as entering an alternate shipping address when making the purchase. As a result, critics say it is not worth the time and effort to implement a destination-sourced system, as the ease of avoidance largely defeats the purpose.

The critics are correct in this situation, as this is always a possibility with destination sourcing. However, the potential impact of this loophole is greatly overstated. First and foremost, the difference in tax paid on an average purchase would be nowhere near enough money to make this tactic worth the extra time and effort required. Driving to pick it up personally, assuming the buyer owns a personal vehicle, requires money for gasoline as well as the opportunity cost of dedicating hours of one's day to travel. Similarly, having the goods re-shipped incurs extra shipping costs in addition to the opportunity cost of time spent waiting even longer for a purchase that could have been received and put to use days before. The

amount of tax avoided will almost never be enough to justify using these types of schemes, and so will not be of much significance.

Having said that, the entire argument is moot, as the situation described above can be done today and indeed has effectively been happening for years. Shipping goods to a low-tax jurisdiction to pick up later is no different than simply driving to that same location and purchasing the goods in-store at a local retailer. The tax rate would be identical and all actions would require the same amount of time, effort, and money to complete, except that the item is at a store in one scenario and sitting at someone's house in the other scenario. The second option—delivery and re-shipment—is practically indistinguishable from having the friend or relative in the low-tax area simply purchase the item themselves and ship it to the buyer. In fact, the current scenario is even more effective, as it removes the time and dollar costs of the initial shipment, making it a more attractive option. Therefore, if this type of scheme is not already causing widespread adversity within the taxpaying world, there is no basis for believing that it would suddenly become a problem with a destination-sourced system of tax collection.

In short, the potential for manipulation will always be present in some shape or form, regardless of the tax structure in place. This method in particular—using alternate locations to manipulate tax rates—can and does occur under the current system and is in no way a characteristic inherent to the proposed jurisdictional standard. In fact, destination-sourced systems such as this operate similar to traditional purchases—the tax rate paid online is the exact same as what the buyer would pay in person at that location, regardless of where the buyer chooses to make the purchase.

## CONCLUSION

The expansion of e-commerce will undoubtedly continue to revolutionize the retail industry on both sides of the transaction. Online marketplaces provide retailers unprecedented opportunities for market penetration and consumer engagement unrestrained by physical limitation. Consumers similarly have an expansive array of choices and offerings available, as well as corresponding repositories of product information and peer reviews to guide their choice. Most significantly, the Internet allows almost anyone to purchase almost anything from almost anywhere in the country, if not the world.

This new electronic frontier has grown from its infancy to an economic heavyweight in such a relatively short period of time that the legal framework simply has not had time to catch up. Standards and rules adopted in the 1960's are inapplicable in the context of modern e-commerce, and the resulting gap in legal guidance is having a growing effect on the rest of the economy. The jurisdictional standard in this Note provides a practical, effective solution that works in conjunction with

current tax policy and practices. The threshold requirements act as crucial limitations on state power while also functioning as an insurance policy of sorts against potential compliance costs. Gross profit provides the most objective and fair basis of classification and discourages inefficient tax avoidance. Finally, this can all be accomplished with cheap, simple, and widely available database software.

Market presence does nothing more than apply existing rules to retailers that had enjoyed a brief immunity from tax liability while the law caught up. Far from being a significant policy change, it simply re-applies the same obligations that all businesses had to deal with in the past and that businesses with physical locations have to deal with today. It is inevitable that Internet retail will continue to grow and become an increasingly important part of everyday life. Fortunately, there is still room for positive economic guidance. Using market presence to supplement existing jurisdictional standards will ensure that the growth of e-commerce is structured, positive, and ultimately beneficial to the economic health of the country.

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