INTERNET TAXES ON TRIAL: NEW STRATEGIES FOR LITIGATING REMOTE-SELLER SALES AND USE TAX CASES

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In 2013, two novel legal theories emerged out of litigation in Illinois and Colorado over whether the states could collect taxes on sales made by remote sellers over the Internet. In *Performance Marketing Association, Inc. v. Hamer*, ___ N.E.2d ___, 2013 IL 114496 (Ill. 2013), the Illinois Supreme Court held that the state's "click-through" nexus law was preempted by the federal Internet Tax Freedom Act.[1] In Colorado, the U.S. Court of Appeals for the 10th Circuit held in *Direct Marketing Ass'n v. Brohl*, ___ F.3d ___, 2013 WL 4419324 (10th Cir. 2013), that the federal Tax Injunction Act precluded federal jurisdiction over a challenge to a Colorado law requiring online retailers to report purchaser information to the state.[2] These cases represent new ways to litigate cases involving states' attempts to tax Internet sales. Taxation of these sales has proven difficult, if not impossible, for the states since the U.S. Supreme Court issued its landmark decision in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

This article examines the significance of *Performance Marketing* and *Direct Marketing* to litigators challenging or defending attempts by states to collect tax on sales by remote sellers. The novelty of these opinions lies in the willingness of the courts to base their holdings on federal statutes rather than *Quill*. These cases represent a new vein of argumentation that may allow courts to decide multi-state taxation cases without reaching the merits under *Quill*.

Quill and its Consequences

The *Quill* case involved an office equipment and supply company, Quill Corp., that solicited business through catalogs, flyers, advertisements in national periodicals, and telephone calls.[3] One of the states in which it solicited business was North Dakota, a state where Quill Corp. had at least 3,000 customers.[4] None of Quill Corp.'s employees or facilities were located in North Dakota.[5] All of its merchandise was delivered to North Dakota customers via mail or common carrier from locations outside of the state.[6]

Quill Corp. took the position that North Dakota did not have the power to compel it to collect a use tax on goods that it sold to its North Dakota customers.[7] The tax commissioner of North Dakota filed suit in state court to compel Quill Corp. to collect use taxes on its North Dakota sales. The Supreme Court of North Dakota departed from prior U.S. Supreme Court precedent to hold that Quill Corp. was obligated to collect and remit use tax to the state.[8] The U.S. Supreme Court reversed, holding that Quill Corp. lacked sufficient "nexus," or connection, with the state to allow North Dakota to compel collection of use taxes on Quill Corp.'s sales to North Dakota residents.[9]

The *Quill* decision created two distinct "nexus" tests based on the U.S. Constitution's Due Process Clause and Commerce Clause, respectively. These tests were intended to help courts decide whether a state has a close enough connection to a remote seller to allow it to impose taxes on its sales. A state must "pass" both nexus tests under *Quill* in order to constitutionally impose tax on transactions between state residents and remote sellers.[10]

The due process nexus test is a "flexible" standard that is not dependent on a seller's physical presence within a state.[11] Instead, a remote seller can meet the due process nexus requirement through "purposeful direction" of its efforts toward a state to solicit business.[12] The flexibility of this standard reflects the purpose of the Due Process Clause, which is primarily about "the fundamental fairness of government activity."[13] The relevant question is, therefore, whether the remote seller has purposefully availed itself of the economic market in the forum state.[14] Under *Quill*, a remote seller is unlikely to win a challenge to a state statute based on the due process nexus requirement; a remote seller that avails itself of a state's economic market to any significant degree will invariably satisfy the due process nexus requirement.

The Commerce Clause nexus test created under *Quill* is a bright-line test that requires a seller to have a physical presence in a state before the state can impose a duty to collect use taxes.[15] Though *Quill* itself addressed a company engaged in mail-order sales, its holding should substantially apply to Internet retailers as well: Unless a vendor has a physical presence in a given state, that state cannot require the vendor to collect sales or use taxes on a sale to a resident of that state.[16]

The Court in *Quill* may have anticipated the effect its ruling would have on state tax revenues due to the growth of remote sale industry. The Court recognized that the mail-order industry had realized "dramatic growth" in the years preceding its decision, partly as a result of the bright-line exemption from the duty to collect use taxes under *National Bellas Hess, Inc. v. Department of Revenue of Illinois*, 386 U.S. 753 (1967), the Court's prior statement on the issue.[17] The Court deferred to Congress as the proper venue for establishing a nationwide framework for taxing remote sales that would apply to all 50 states.[18] The Court noted that its decision was "made easier" by recognizing that Congress could step in to overrule its decision at any time, and all but invited Congress to do so.[19] Despite the high court's invitation, Congress has been unable or unwilling to address the issue for the last 20 years.

Congress' inaction has led states to try to take matters into their own hands by legislating around the edges of *Quill* to collect the taxes that have "gone missing" from their budgets.[20] One popular method used by states in this effort has been the enactment of "click-through nexus" or "affiliate nexus" laws.[21] These laws commonly state that a remote vendor has nexus with the taxing state if it has business arrangements with state residents to refer potential

customers to the remote vendor through links on an Internet website or otherwise.[22] The physical presence of the remote seller's "affiliate" within the state is presumed to be enough to trigger liability for the remote seller to collect and remit tax on its sales to state residents.[23] The state of New York was the first to pioneer this model.[24]

Illinois' click-through nexus law is modeled on the "New York" pattern.[25] The state of Colorado followed a different path, passing a law that required remote sellers with over $100,000 in sales to Colorado residents to provide a report to the state Department of Revenue detailing the amounts purchased by state residents along with the residents' contact information.[26] Affected retailers also had to provide reports and notices to their customers informing them about their obligation to pay use tax on their purchases.[27] Legal challenges to the Illinois and Colorado laws precipitated the *Performance Marketing* and *Direct Marketing* cases that are the subject of this article.[28]

Illinois' Click-through Nexus Law and *Performance Marketing*

The Illinois law that precipitated the *Performance Marketing* decision is a "click-through" nexus law.[29] The law changed the definition of a retailer or serviceman "maintaining a place of business" in the state of Illinois to include the following:

[A] retailer having a contract with a person located in this [s]tate under which the person, for a commission or other consideration based upon the sale of tangible personal property by the retailer, directly or indirectly refers potential customers to the retailer by a link of the person's Internet website....

[A serviceman] having a contract with a person located in this [s]tate under which the person, for a commission or other consideration based on the sale of service by the serviceman, directly or indirectly refers potential customers to the serviceman by a link on the person's Internet website.[30]

These definitions effectively create nexus with remote sellers that have referral arrangements with Illinois residents. Such remote sellers are, therefore, required to collect use tax on sales to Illinois residents.[31]

The plaintiff in *Performance Marketing* challenged the Illinois law on two grounds: First, that the law violated the Commerce Clause under *Quill* ; and second, that the law was expressly preempted by the Internet Tax Freedom Act, 47 U.S.C. §151 (note) (2000) (ITFA).[32] The trial court decided the case on summary judgment in favor of the plaintiffs, holding that the Illinois law was both unconstitutional under the Commerce Clause and that it was preempted by ITFA.[33]

On direct appeal to the Illinois Supreme Court, the court affirmed the summary judgment *only* on the basis of preemption under the ITFA.[34] The court specifically declined to reach the plaintiff's "alternative" argument that the law violated the Commerce Clause under *Quill*.[35]

In a vigorous dissent, Justice Karmeier took the majority to task for not squarely addressing the Commerce Clause issue that was ripe for decision. The justice correctly noted that the Court of Appeals of New York considered and rejected a similar Commerce Clause challenge to New York's click-through nexus law while the Illinois appeal was still pending.[36] In Justice Karmeier's opinion, the Illinois Supreme Court missed an opportunity to weigh in on a singularly important issue in the world of multi-state taxation.[37]

Justice Karmeier's observation about the missed opportunity is certainly correct. The decision by the Court of Appeals of New York in *Overstock.com, Inc. v. New York State Department of Taxation and Finance,* 987 N.E.2d 621 (N.Y. 2013), *cert. den.* , __ U.S. __ (Dec. 2, 2013), represented one of the best opportunities for the U.S. Supreme Court to revisit *Quill* in decades. Had the Illinois Supreme Court issued a ruling on the merits of Illinois' law under *Quill,* its decision would have added a significant voice to the debate.

Though the Illinois court declined to step into the fray over *Quill*, its decision added a wrinkle to the case law that may prove significant in future litigation. The Illinois Supreme Court held that Illinois' click-through nexus law was preempted due to the ITFA's prohibition of "discriminatory taxes on electronic commerce."[38] The Illinois Supreme Court reached this conclusion by focusing on the law's tax on Internet-based "performance marketing" to the exclusion of similar, "off-line" arrangements found in the print and broadcast media.[39]

According to the Illinois Supreme Court, the "performance marketing" business model in the case before them is a contractual arrangement whereby an advertising affiliate is paid by a retailer only when "a specific action, such as a sale, is completed."[40] The court observed that "[i]n performance marketing, the retailer tracks the success or 'performance' of the marketing campaign and sets the affiliate's compensation accordingly."[41] The success of Internet-based performance marketing arrangements is tracked on the basis of "click-through" actions from one website resulting in sales from another.[42] Similar campaigns are found in print and broadcast media through the use of promotional codes that allow sales to be tracked.[43]

The Illinois Supreme Court seized on the conceptual similarity of online and off-line performance marketing arrangements to hold that taxing only the Internet-based arrangements unfairly discriminated against electronic commerce under the ITFA.[44] The ITFA defines a discriminatory tax on Internet commerce as one that "imposes an obligation to collect or pay tax *on a different person or entity* than in the case of transactions involving similar property, goods, services, or information *accomplished through other means*. "[45] The Illinois Supreme Court held that the Illinois law was "discriminatory" under the ITFA because it

imposed a use tax collection obligation on remote sellers that have Internet-based performance marketing arrangements with Illinois residents and not on remote sellers with similar off-line arrangements.[46] The court, therefore, held that the ITFA preempted the Illinois law.[47]

As noted in Justice Karmeier's dissent, the ITFA is scheduled to expire on November 1.[48] If Congress does not reauthorize the ITFA, the Illinois law will be revived and come back into full force and effect.[49] However, if the ITFA is reauthorized by Congress without revision of its "discriminatory tax" language, the ITFA will retain its preemptive force over Illinois' click-through nexus law.

The ITFA was originally enacted in 1998 and has been extended three times.[50] Given the systematic extension of the ITFA, and the calls for making its "moratorium" on taxation of Internet services permanent, the chances for a fourth extension appear positive.[51] Should the ITFA be extended, the *Performance Marketing* analysis of discriminatory taxation may prove to be an important argument for litigators to consider when challenging or defending a "click-through" nexus law.

Colorado's Reporting Requirement Law and *Direct Marketing*

The Colorado law that precipitated the *Direct Marketing* decision differs from the "click-through" nexus laws favored by Illinois and New York in that it does not impose a duty on remote sellers to collect use tax on their sales. Instead, the law requires remote sellers with more than $100,000 in gross sales to Colorado residents to "(1) provide transactional notices to Colorado purchasers, (2) send annual purchase summaries to Colorado customers, and (3) annually report Colorado purchaser information to the [Colorado] Department [of Revenue]."[52] This method allows the state to target its collection efforts on state residents who have not remitted use tax on their purchases from remote sellers.[53]

The Colorado law was challenged by the Direct Marketing Association (DMA), a group that represents businesses and organizations that market products to Colorado residents through "catalogs, advertisements, broadcast media, and the Internet."[54] The DMA sued the state in federal court, alleging that the law violated the Commerce Clause under *Quill*.[55] The district court ruled in favor of the DMA, granting summary judgment against the state and entering a permanent injunction against enforcement of the law.[56]

On appeal, the 10th Circuit declined to address the merits of the district court's opinion.[57] Instead, the 10th Circuit held that the Tax Injunction Act (TIA), 28 U.S.C. §1341, divested the district court of jurisdiction over DMA's claims.[58] The 10th Circuit, therefore, remanded the case to the district court with orders to dismiss the case for lack of jurisdiction and to dissolve the permanent injunction.[59]

The Tax Injunction Act, upon which the 10th Circuit grounded its opinion, provides that "district courts shall not enjoin, suspend or restrain the assessment, levy or collection of any tax under [s]tate law where a plain, speedy and efficient remedy may be had in the courts of such [s]tate."[60] The purpose of the TIA is the recognition that, under our federal system, states have "the imperative need" to administer their own fiscal operations.[61] The 10th Circuit engaged in a two-part analysis of DMA's claims in order to determine whether the TIA divested the federal courts of jurisdiction.

First, the 10th Circuit examined whether the DMA sought to enjoin, suspend, or restrain the assessment, levy, or collection of a state tax. DMA argued that the TIA did not divest the federal court of jurisdiction because 1) the DMA was not a taxpayer seeking to avoid a tax, and 2) because the challenged law involved reporting requirements rather than imposition of a tax.[62] As to the first part of DMA's argument, the 10th Circuit held that the TIA is not limited to challenges by taxpayers. Rather, any action brought to enjoin a state's sovereign power to collect taxes is within the TIA's purview.[63] As to the second part of DMA's argument, the 10th Circuit conducted an exhaustive analysis of whether the lawsuit was brought to "restrain" Colorado's ability to collect taxes even though the challenged law dealt facially with reporting requirements.[64] The 10th Circuit concluded that DMA's lawsuit was essentially a challenge to a collection method and would have the effect of constraining Colorado's ability to collect the taxes owed by its citizens.[65]

After dispensing with DMA's threshold arguments, the 10th Circuit examined whether the DMA had a "plain, speedy, and efficient remedy" available to it in Colorado.[66] The court noted that the remedy envisioned by the TIA is not the general redress to courts available to all citizens, but rather "a remedy tailormade for taxpayers."[67] The 10th Circuit held that Colorado's procedures for protesting taxes and penalties as specifically set forth by statute were sufficient to meet the TIA's requirement of a taxpayer-specific remedy.[68]

The 10th Circuit's reasoned opinion in *Direct Marketing* should serve as notice to any party contemplating a challenge to a "reporting requirement" law like Colorado's that the federal courts may not have jurisdiction to hear such a challenge. Practically, this means that state courts will be the venue for challenging state laws that track Colorado's reporting requirement formulation rather than the click-through nexus strategy employed by Illinois, New York, and other states.

Conclusion

Both *Performance Marketing* and *Direct Marketing* offer a new set of arguments for litigants to consider when challenging or defending laws that attempt to collect taxes on Internet commerce. Unless and until the U.S. Supreme Court revisits *Quill*, this kind of litigation is sure to flourish as states attempt to recoup tax revenue lost to remote seller transactions.

[1] The Internet Tax Freedom Act is codified at 47 U.S.C. §151 (note) (2000).

[2] The Tax Injunction Act is codified at 28 U.S.C. §1341 (2000).

[3] *Quill*, 504 U.S. at 301.

[4] *Id.*

[5] *Id.*

[6] *Id.*

[7] *Id.* at 303.

[8] *Id.* at 302. The prior precedent that the state supreme court departed from was *National Bellas Hess, Inc. v. Department of Revenue of Illinois*, 386 U.S. 753 (1967). The reason for its departure was that "the tremendous social, economic, commercial, and legal innovations" in the years leading up to the decision rendered *Bellas Hess* obsolete. *Quill*, 504 U.S. at 301 (quoting *North Dakota v. Quill Corp.*, 470 N.W.2d 203, 208 (N.D. 1991).

[9] *Quill*, 504 U.S. at 320.

[10] Such taxes must also be fairly apportioned, not discriminate against interstate commerce, and be fairly related to the services provided by the state. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977).

[11] *Quill*, 504 U.S. at 308.

[12] *Id.*

[13] *Id.* at 312.

[14] *Id.* at 308, 312.

[15] *Id.* at 317.

[16] A commenter noted that, though *Quill* used the terms "sales tax" and "use tax" interchangeably, only North Dakota's use tax was properly before the court. H. Beau Baez III, *Taxing Internet Sales: Trying to Make a Two-Thousand-Year-Old Jurisdiction Test Work in the Dot-Com Economy*, 64 The Tax Lawyer 807, 821 (2011). Use tax was also the only issue before the court in *Bellas Hess*, the U.S. Supreme Court case that preceded *Quill*. *Bellas Hess*, 386 U.S. at 754. According to Baez, the nexus requirement for sales taxes is arguably different than

that for use taxes, and the physical presence standard may not necessarily apply. Though the author has not found a court that has endorsed this idea as of yet, creative litigators may bring the concept to life if the Supreme Court declines to revisit *Quill*.

[17] *Quill*, 504 U.S. at 316 ("Indeed, it is not unlikely that the mail-order industry's dramatic growth over the last quarter century is due in part to the bright-line exemption from state taxation created in *Bellas Hess*. ").

[18] *Id.* at 318.

[19] *Id.* ("Accordingly, Congress is now free to decide whether, when, and to what extent the [s]tates may burden interstate mail-order concerns with a duty to collect use taxes.").

[20] *See* Gordon Yu, *Formulation and Enforcement of "Amazon" Taxes*, 64 State Tax Notes at 321 (2013) (surveying state attempts to tax internet commerce).

[21] *See* David Gamage & Devin J. Heckman, *A Better Way Forward for State Taxation of E-Commerce*, 92 B.U. L. Rev. 483, 519 (2012). Gamage and Heckman refer to both varieties as "referrer nexus" laws.

[22] *Id*.

[23] *Id*.

[24] *See id.* at 520.

[25] *Performance Marketing*, 2013 IL 114496 at *7 ("Public Act 96-1544, the legislation being challenged in this case, is the Illinois version of New York State's Amazon Law.") (Karmeier, J., dissenting).

[26] Tyler Murray & Eric J. Zinn, *Colorado and the "Amazon Tax" – Recent History*, 41 Colo. Law. 43, 48 (June 2012) (detailing how Colorado's law differs from the New York model).

[27] *Id.*

[28] Florida has not enacted a similar law, though attempts have been made. *E.g.*, Fla. SB 88 (2013) (proposed amendment to statute taxing mail order sales; died in committee).

[29] *Performance Marketing*, 2013 IL 114496 at *1.

[30] *Id*. (quoting Ill. Pub. Act 96-1544, §§5, 10)

[31] *Id*. ("Thus, pursuant to the [a]ct, out-of-state [I]nternet retailers and servicemen are required to collect state use tax if they have a contract with a person in Illinois who displays a link on his or her website that connects an Internet user to that remote retailer or serviceman's website.").

[32] *Id*.

[33] *Id*.

[34] *Id*. at *5.

[35] *Id*.

[36] *Id*. at *8.

[37] *Id*.

[38] *Id*. at *3.

[39] *Id*. at *4-5.

[40] *Id.* at *2.

[41] *Id*.

[42] *Id*.

[43] *Id*.

[44] *Id*. at *4-5.

[45] 47 U.S.C. §151 (note) (§1105(2)(A)(iii) of the ITFA) (emphasis added).

[46] *Performance Marketing*, 2013 IL 114496 at *5.

[47] *Id*.

[48] *Id*. at *9.

[49] *Id*.

[50] The ITFA was enacted in its original form in 1998. Pub. L. 105-277, div. C, title XI, Oct. 21, 1998, 112 Stat. 2681-719. It was extended for the first time in 2001, then twice more in 2004 and 2007, respectively. *See* Pub. L. 107-75, §2, Nov. 28, 2001, 115 Stat. 703; Pub. L. 108-435, §§2-6A, Dec. 3, 2004, 118 Stat. 2615-2618; Pub. L. 110-108, §§2-6, Oct. 31, 2007, 121 Stat. 1024-1026.

[51] *See* Henry J. Reske, *U.S. Senators Move to Make Ban on Internet Access Taxes Permanent*, Tax Analysts (Aug. 2, 2013), *available at* http://www.taxanalysts.com/www/features.nsf/Articles/2E2B9082688AEF3485257BC700458B79?OpenDocument.

[52] *Direct Marketing*, 2013 WL 4419324 at *2.

[53] *See id*.

[54] *Id*. at *1.

[55] *Id*. at *3.

[56] *Id*.

[57] *Id*.

[58] *Id*. The 10th Circuit indicated that the TIA had to be addressed due to its jurisdictional limitation regardless of whether it was raised below. *Id*. at *4.

[59] *Id*. at *15.

[60] *Id*. at *4 (quoting 28 U.S.C. §1341).

[61] *Id*. at *4 (quoting *Rosewell v. LaSalle Nat'l Bank*, 450 U.S. 503, 522 (1981)).

[62] *Id*. at *5.

[63] *Id*. at *6-7.

[64] *Id*. at *8-9.

[65] *Id*. at *9 ("We have little problem concluding that DMA's lawsuit would hamper Colorado's ability to raise revenue.").

[66] *Id*. at *13. Before delving into this analysis, the court addressed other arguments raised by DMA about the breadth of the TIA and how it should apply. This argument is outside the scope of this article but is worth reading. *See id*. at *9-12.

[67] *Id*. at *13

[68] *Id*. at *14.

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