THE INTERNET AND PUERTO RICO'S TAXING POWER: HOW THE DORMANT COMMERCE CLAUSE IS AFFECTING SMALL AND MEDIUM BUSINESSES AND WHAT CAN BE DONE ABOUT IT

ARTICLE

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Introduction 496
I. Due Process Restrictions on a State's Authority to Require Out of State Sellers to Collect Sales and Use Taxes 497
II. Commerce Clause Restrictions on a State's Authority to Require Out of State Sellers to Collect Sales and Use Taxes 500
A. Commerce Clause Restrictions on State Taxation 501
B. Commerce Clause Restrictions on a State's Authority to Impose and Require the Collection of Sales and Use Taxes to a Vendor Engaged in Interstate Commerce 504
C. Sufficient Nexus with the Taxing State where the Vendor has Employees or Independent Contractors 506
D. Sufficient Nexus with the Taxing State where the Vendor has no Physical Presence 507
E. Quill Corp. v. North Dakota 510
i. Facts 510
ii. The Separation of the Nexus Requirement of the Due Process Clause from that of the Commerce Clause 510
iii. Arguments for Sustaining the Physical Presence Requirement 511
a. *Stare Decisis* and Settled Expectations 511
b. *Safe Harbor* for Out-of-State Vendors 512
c. Congressional Action 513
iv. The Physical Presence Requirement Today 514
III. Federal Preemption of the Excise Tax Collection Mechanism 514
A. The Commerce Clause and the Puerto Rico Federal Relations Act 516
B. The Federal Aviation Administration Authorization Act (F.A.A.A.A.) and its Preemption of the Excise Tax Collection Mechanism 517
IV. Recommendations 518
A. Impose a Tax other than a Sales or Use Tax 518
B. Impose the Collection Obligation on the Payment Processor 522
i. Activity that has a Substantial Nexus with the State 523

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ii. Fairly Apportioned to Activities Carried on by the Taxpayer in the State 523
iii. Does not Discriminate against Interstate Commerce 523
iv. Is Fairly Related to Services Provided by the State 523
C. Require from all Vendors the Collection of the Existing Use Tax and Invoke Section Three of the Puerto Rico Federal Relations Act against any Dormant Commerce Clause Challenge 524
i. Procedural note: The *Butler Act* 526
Conclusion 528

INTRODUCTION

THE GOVERNMENT OF THE COMMONWEALTH OF PUERTO RICO IS CONSIDERing a broad reform of its tax system that seeks to increase revenue, reduce tax evasion and promote production and investment.[1] In order to shift the focus of taxation away from production and towards consumption, the Government has proposed to significantly increase the consumption tax rate and to make it applicable to a much broader base, while reducing income tax rates.[2] We believe that the proposed reform is one that is necessary, and agree, in principle, that shifting the focus of taxation from production to consumption is desirable.

Nonetheless, we believe that such a steep increase in the rate of taxation of consumption will have the unintended consequence of incentivizing consumers to make more of their purchases through the internet. Currently, a state cannot require an out-of-state vendor with no physical presence in the state to collect sales or use taxes.[3] While the purchaser is still responsible for paying the corresponding use tax, there is no effective mechanism to enforce it. This means that any vendor with no physical presence in Puerto Rico may sell its products tax free to the Island's residents. This creates an uneven playing field between merchants with stores in Puerto Rico who sell the same products that companies, such as Amazon.com, Inc. (Amazon), sell on their websites. This situation is not new or recent. What is recent is the Government's intention to significantly raise the tax on consumption. With the tax at seven percent, it could be argued that the price difference between a product sold in a brick and mortar store in Puerto Rico, and an identical product sold online, was somehow mitigated by having to wait for the product to be shipped to the purchaser's location (and related shipping costs, if any) versus having the product immediately available. With a much

1 P. de la C. 2329 de 11 de febrero de 2015, 5ta Ses. Ord., 17ma Asam. Leg.

2 *Id.* at 5-6.

3 Quill Corp. v. North Dakota, 504 U.S. 298, 317 (1992).

higher rate, this consideration will be significantly diminished, and the incentive to shop online will be that much greater.

In this article we will examine the United States Supreme Court's Commerce Clause jurisprudence that has led to this current state of affairs.[4] We will also analyze why, as an alternative to requiring vendors to collect the tax when the purchase is made, Puerto Rico is barred from collecting the tax when the merchandise arrives to its airports due to federal preemption of regulations affecting air carriers. Finally, we will suggest alternatives or solutions on how these constitutional limitations may be avoided. Our ultimate goal is to prompt the Legislature to even the playing field and impose a similar tax burden on online purchases from vendors with no physical presence in Puerto Rico to the one currently being imposed on vendors that do have such physical presence.

I. DUE PROCESS RESTRICTIONS ON A STATE'S AUTHORITY TO REQUIRE OUT OF STATE SELLERS TO COLLECT SALES AND USE TAXES

The two constitutional provisions usually invoked when challenging a state's power to impose and require vendors to collect sales and use taxes are the Due Process Clause of the Fourteenth Amendment[5] and the Commerce Clause,[6] as these are "the primary sources of federal restraint on state tax laws."[7] Even though the Due Process Clause no longer presents a significant impediment to a state's authority to tax, since this was not always the case, its limitations will be briefly discussed.[8]

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4 U.S. CONST. art. I, § 8, cl. 3.

5 U.S. CONST. amend. XIV, § 1.

6 U.S. CONST. art. I, § 8, cl. 3. *See also* WALTER HELLERSTEIN, STATE TAXATION § 19.02(1) (2014).

7 FERDINAND P. SCHOETTLE, STATE AND LOCAL TAXATION: THE LAW AND POLICY OF MULTI-JURISDICTIONAL TAXATION 213 (2003).

8 *Quill Corp.*, 504 U.S. at 298. Comparing the requirements of the Due Process Clause and Commerce Clause, the *Quill* Court stated the following:

> Thus, although we have not always been precise in distinguishing between the two, the Due Process Clause and the Commerce Clause are analytically distinct.
>
> "'Due process' and 'commerce clause' conceptions are not always sharply separable in dealing with these problems. . . . To some extent they overlap. If there is a want of due process to sustain the tax, by that fact alone any burden the tax imposes on the commerce among the states becomes 'undue.' But, though overlapping, the two conceptions are not identical. *There may be more than sufficient factual connections, with economic and legal effects, between the transaction and the taxing state to sustain the tax as against due process objections. Yet it may fall because of its burdening effect upon the commerce*. And, although the two notions cannot always be separated, clarity of consideration and of decision would be promoted if the two issues are approached, where they are presented, at least tentatively as if they were separate and distinct, not intermingled ones."

Id. at 305-06 (Rutledge, J., concurring in part and dissenting in part) (emphasis added) (quoting International Harv. Co. v. Dept. of Treas., 322 U.S. 340, 353 (1944)).

The Due Process Clause of the Fourteenth Amendment states that no state "shall . . . deprive any person of life, liberty, or property, without due process of law."[9] In the context of state taxation, the Clause has been held to require "some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax."[10] Essentially, the issue is whether the state has given anything (protection, infrastructure, institutions, etc.) to the taxpayer for which it can ask for something in return.[11] Before *Quill*, the United States Supreme Court treated the requirements of the Due Process Clause as similar to those of the nexus requirement of the Commerce Clause.[12] In *National Bellas Hess, Inc. v. Department of Revenue of the State of Illinois*, the Court said the following regarding the relationship between both clauses:

> [Appellant] argues that the liabilities which Illinois has thus imposed violate the Due Process Clause of the Fourteenth Amendment and create an unconstitutional burden upon interstate commerce. *These two claims are closely related*. For the test whether a particular state exaction is such as to invade the exclusive authority of Congress to regulate trade between the States, and the test for a State's compliance with the requirements of due process in this area are similar.[13]

The Court went on to hold that an Illinois statute that imposed upon National Bellas Hess Inc., the obligation to collect the tax imposed by the State upon residents who purchase products from the firm, violated the nexus requirement of both clauses because the only connection that the firm had with Illinois' residents was through a common carrier or United States Mail. Although far from using crystal clear language, the Court in *National Bellas Hess, Inc.* appears to have held that the physical presence requirement was embedded in both, the Due Process Clause and the nexus requirement of the Commerce Clause. This is significant because an action deemed to violate the Commerce Clause by the Court might be subsequently validated by Congress.[14] The same

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9 U.S. CONST. amend. XIV, § 1.

10 Miller Bros. Co. v. Maryland, 347 U.S. 340, 344-45 (1954).

11 In *Wisconsin v. J.C. Penney Co.*, the Court held that "[t]he simple but controlling question is whether the state has given anything for which it can ask return." Wisconsin v. J.C. Penney Co., 311 U.S. 435, 444 (1940).

12 HELLERSTEIN, *supra* note 6, § 19.02(3)(c)(ii). For a state tax to pass Commerce Clause scrutiny it must meet the following four-prong test: (1) substantial nexus with the taxing state; (2) be fairly apportioned to activities carried on by the taxpayer in the state; (3) not discriminate against interstate commerce, and (4) be fairly related to services provided by the state. Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 279 (1977). The focus of this article will be on the nexus requirement, since that is the one that has been found missing when a state seeks to impose on an out-of-state vendor, with no physical presence in the state, the obligation to collect sales or use taxes. *See Quill Corp.*, 504 U.S. at 315-16.

13 Nat. Bellas Hess v. Dept. of Revenue, 386 U.S. 753, 756 (1967) (emphasis added).

14 In *Prudential Ins. Co. v. Benjamin*, the Court said the following of Congress' right to overturn the Court's holdings on the *dormant* aspect of the Commerce Clause:

thing, however, cannot be said of the Due Process Clause of the Fourteenth Amendment. Only through amendments to the Constitution may Congress overturn a decision based on the Due Process Clause.

As noted above, the Court overturned this holding in *Quill v. North Dakota*, by ruling that the nexus requirement of the Commerce Clause and the Due Process Clause are "analytically distinct."[15] After noting that the nexus requirements of both clauses are different, the Court went on to hold that:

> The requirements of due process are met irrespective of a corporation's lack of physical presence in the taxing State. Thus, to the extent that our decisions have indicated that the Due Process Clause requires physical presence in a State for the imposition of duty to collect a use tax, we overrule those holdings as superseded by developments in the law of due process.[16]

Quill, like *National Bellas Hess, Inc.*, involved attempts by a state to require an out-of-state vendor, with no outlets or representatives within the taxing state's borders, to collect and pay a use tax on goods that would be consumed in the state. It is important to emphasize that in *Quill*, the Court found the out-of-state vendor to have sufficient nexus with the taxing state to meet Due Process requirements. The Court explained that:

> [The vendor] purposefully avail[ed] itself of the benefits of an economic market in the forum State . . . . [by actively engaging] in continuous and widespread solicitation of business within a State. Such a corporation clearly has "fair warning that [its] activity may subject [it] to the jurisdiction of a foreign sovereign."[17]

In so holding, the Court found that whether there is sufficient nexus for the imposition of a collection duty is an inquiry similar to the minimum contacts

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> The commerce clause is in no sense a limitation upon the power of Congress over interstate and foreign commerce. On the contrary, it is, as Marshall declared in *Gibbons v. Ogden*, a grant to Congress of plenary and supreme authority over those subjects. The only limitation it places upon Congress' power is in respect to what constitutes commerce, including whatever rightly may be found to affect it sufficiently to make congressional regulation necessary or appropriate.
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> . . . [There have been] situations where the silence of Congress or the dormancy of its power has been taken judicially, on one view or another of its constitutional effects, as forbidding state action, only to have Congress later disclaim the prohibition or undertake to nullify it. Not yet has this Court held such a disclaimer invalid or that state action supported by it could not stand. On the contrary in each instance it has given effect to the Congressional judgment contradicting its own previous one.

Prudential Ins. Co. v. Benjamin, 328 U.S. 408, 423-24 (1946) (footnotes omitted). In the same light, Nowak & Rotunda explain: "If [a] state law violates the *dormant* commerce clause, Congress may enact a law that expressly adopts or approves of that state law." JOHN E. NOWAK & RONALD D. ROTUNDA, PRINCIPLES OF CONSTITUTIONAL LAW 163 (4th ed. 2010).

15 *Quill Corp.*, 504 U.S. at 305.

16 *Id.* at 308.

17 *Id*. at 307-08 (quoting Shaffer v. Heitner, 433 U.S. 186, 218 (1977) (Stevens, J., concurring).

doctrine used to determine whether a state may exercise *in personam* jurisdiction over a defendant.

Justice White was of the opinion that the nexus requirement of the Commerce Clause should be the same one that the Due Process Clause demands.[18] As shall be discussed in the next section, the majority in *Quill* thought differently and held that, while the imposition of the obligation to collect use taxes on the out-of-state vendor was valid under the Due Process Clause, it did not meet the nexus requirement of the Commerce Clause, and thus was held unconstitutional.

II. COMMERCE CLAUSE RESTRICTIONS ON A STATE'S AUTHORITY TO REQUIRE OUT OF STATE SELLERS TO COLLECT SALES AND USE TAXES

The United States Constitution conferred upon Congress the power to "regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes."[19] Although its interpretation of what authority this disposition grants to Congress has varied widely, today the Court "interprets the commerce clause as a broad grant of power."[20] By its words, the Commerce Clause gives Congress an affirmative right to regulate commerce. Nonetheless, the Court has also held that the Commerce Clause "by implication, placed a limitation on state or local laws related to interstate commerce."[21]

This limitation is what is often referred to as the *dormant* Commerce Clause or *the negative implications* of the Commerce Clause.[22] To justify these *implications*, the Court has resorted to the history of the Constitution and the federal structure.[23] During the time of the Confederation, economic protectionism broke out among the states, which eventually led to trade wars between them. Every state legislated according to its own economic interests. This behavior threatened "the peace and safety of the Union."[24] Accordingly, it was believed that centralized regulation of commerce among the states was a necessity. Addressing the Commerce Clause, Justice Cardozo once stated: "The Constitution was

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18 In *Quill*, Justice White stated the following: "The cases from which the *Complete Auto* Court derived the nexus requirement in its four-part test convince me that the issue of 'nexus' is really a due process fairness inquiry." *Id.* at 326 (White, J., concurring in part and dissenting in part).

19 U.S. CONST. art. I, § 8, cl. 3.

20 NOWAK & ROTUNDA, *supra* note 14, at 83.

21 *Id.* at 162.

22 *Id.* In *ELA v. Northwestern Selecta, Inc.*, the Puerto Rico Supreme Court removed any doubt as to the applicability of the *dormant* Commerce Clause to Puerto Rico: "In light of the foregoing, *today we hold that the constraints of the dormant Interstate Commerce Clause apply to Puerto Rico ex proprio vigore*. Consequently, *Puerto Rico*, like the states of the Union, *is constitutionally barred from imposing economic measures that burden interstate commerce*." ELA v. Nw. Selecta, Inc., 185 DPR 40, 70 (2012) (translation provided by author).

23 KATHLEEN M. SULLIVAN & NOAH FELDMAN, CONSTITUTIONAL LAW 220 (18th ed. 2013).

24 *Id.*

framed under the dominion of a political philosophy less parochial in range. It was framed upon the theory that the peoples of the several states must sink or swim together, and that in the long run prosperity and salvation are in union and not division."[25] It was believed that a free flow of goods, labor and capital across state lines would best promote the economic welfare of the nation.[26]

To that effect, the *dormant* aspect of the Commerce Clause has been invoked to invalidate state actions that discriminate against interstate commerce. The Court's Commerce Clause jurisprudence has not always been consistently clear.[27] Having said that, modern jurisprudence shows that the following types of state laws may run afoul with the Commerce Clause: (1) "laws that *facially discriminate* against out of state commerce;" (2) laws that on their face do not discriminate "between in-state and out-of-state [commerce] but . . . have an *impermissibly protectionist purpose* or effect," and (3) neutral laws that "have a *disproportionate adverse effect* on interstate commerce."[28]

A. Commerce Clause Restrictions on State Taxation

In its earliest stages, the Court was convinced that the Commerce Clause prohibited state taxation of interstate commerce.[29] In *Western Live Stock v. Bureau of Revenue*, the Court adopted a different approach.[30] In this case, the publishers of a journal produced in New Mexico, which circulated both inside and outside of the State, challenged the validity of a gross receipts tax imposed by

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25 Baldwin v. G.A.F. Seelig, 294 U.S. 511, 523 (1935).

26 In *Oklahoma Tax Commission v. Jefferson Lines, Inc.*, Justice Souter provided a succinct summary of the justification and history of the *dormant* aspect of the Commerce Clause:

> Despite the express grant to Congress of the power to "regulate Commerce . . . among the several States," . . . we have consistently held this language to contain a further, negative command, known as the dormant Commerce Clause, prohibiting certain state taxation even when Congress has failed to legislate on the subject. We have understood this construction to serve the Commerce Clause's purpose of preventing a State from retreating into economic isolation or jeopardizing the welfare of the Nation as a whole, as it would do if it were free to place burdens on the flow of commerce across its borders that commerce wholly within those borders would not bear. The provision thus "'reflect[s] a central concern of the Framers that was an immediate reason for calling the Constitutional Convention: the conviction that in order to succeed, the new Union would have to avoid the tendencies toward economic Balkanization that had plagued relations among the Colonies and later among the States under the Articles of Confederation.'"

Okla. Tax Comm'n v. Jefferson Lines, Inc., 514 U.S. 175, 179-80 (1995) (quoting U.S. CONST. art. I, § 8, cl. 3; Wardair Can. Inc. v. Fla. Dep't of Revenue, 477 U.S. 1, 7 (1986)).

27 NOWAK & ROTUNDA, *supra* note 14, at 166.

28 SULLIVAN & FELDMAN, *supra* note 23, at 232-33. *See also* NOWAK & ROTUNDA, *supra* note 14, at 166-67.

29 In *Leloup v. Port of Mobile*, the Court stated the following: "In our opinion such a construction of the Constitution leads to the conclusion that no state has the right to lay a tax on interstate commerce in any form . . . ." Leloup v. Port of Mobile, 127 U.S. 640, 648 (1888).

30 W. Live Stock v. Bureau, 303 U.S. 250 (1938).

the State on the sale of advertising space. The publishers alleged that since some of the receipts upon which the tax was being imposed were from advertisers from outside of the State, they could not be taxed. The Court disagreed and, in so doing, "deviated sharply from the traditional free trade approach to the Commerce Clause [that had prevailed up until that point]."[31] The Court stated 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 the business. 'Even interstate business must pay its way.'"[32]

This meant that states would now be able to tax interstate commerce. The question, then, was not if a state could tax interstate commerce, but how could it do so without placing an undue burden. In an attempt to answer this question, Justice Stone devised what has come to be known by commentators as the *multiple taxation doctrine*.[33] The primary concern of this doctrine is that a *value* should not be taxed more than once, or by more than one state, because this would impose a cumulative burden on interstate commerce.[34] In Justice Stone's words:

> [W]e think the tax assailed here finds support in reason, and in the practical needs of a taxing system which, under constitutional limitations, must accommodate itself to the double demand that interstate business shall pay its way, and that at the same time it shall not be burdened with cumulative exactions which are not similarly laid on local business.[35]

The multiple taxation doctrine was eventually found lacking and unfit to handle some of the most pressing state taxation issues that came before the Court.[36] The Court would temporarily abandon it in a period in which it returned to the formalism that surrounded the Commerce Clause in the past.[37]

In *Complete Auto Transit, Inc. v. Brady*,[38] the Court would complete its shift towards focusing Commerce Clause inquiries on the economic effects of a state tax, and away from the emphasis on whether a tax directly burdened interstate commerce or not. In this case, the Court openly and purposefully sought "to consider anew the applicable principles in this troublesome area."[39] The brief period alluded to earlier in which the Court's Commerce Clause jurisprudence

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31 WALTER HELLERSTEIN, *supra* note 6, § 4.09(1).

32 *W. Live Stock*, 303 U.S. at 254 (quoting Postal Telegraph-Cable Co. v. City of Richmond, 249 U.S. 252, 259 (1919)).

33 HELLERSTEIN, *supra* note 31, at § 4.09(1).

34 SCHOETTLE, *supra* note 7, at 231.

35 *W. Live Stock*, 303 U.S. at 258.

36 SCHOETTLE, *supra* note 7, at 231.

37 *Id.* at 231-32.

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

39 *Id.* at 275.

retreated to the strict formalism of old left a standing prohibition on *any* law that set to tax the *privilege of doing business* in a state. In *Complete Auto Transit, Inc.* the taxpayer was a Michigan corporation that transported motor vehicles to Mississippi from other states in which they where assembled. The taxing authority of Mississippi assessed a tax deficiency on Complete Auto Transit, Inc., because it had failed to pay the applicable tax on the gross proceeds that it had earned while transporting vehicles to Mississippi. The corporation alleged that the tax violated Commerce Clause case law to the effect that a tax on the privilege of doing business in a state may not be assessed against an activity that is part of interstate commerce. This argument found support in the Court's decision in *Spector Motor Service v. O'Connor*.[40] In turn, the Taxing Authority of Mississippi defended the validity of the tax by alluding to expressions of the Court to the effect that the Commerce Clause did not exempt those engaged in interstate commerce from paying their fair share of taxes.[41]

The Court was clearly not satisfied with the holdings of its recent decisions involving the Commerce Clause. As a result, the Court developed four criteria that would determine whether a state tax affecting interstate commerce is valid under the Commerce Clause. In the Court's own words, a state tax may be invalid if the activity that it seeks to tax "is not sufficiently connected to the State to justify a tax, or . . . the tax is not fairly related to benefits provided the taxpayer, or . . . the tax discriminates against interstate commerce, or . . . the tax is not fairly apportioned."[42] These criteria can be summarized as follows: (1) sufficient nexus; (2) fair apportionment; (3) no discrimination against interstate commerce, and (4) relationship with the services provided by the state. The rationale behind this test is to examine the practical effect on interstate commerce of the challenged state tax.[43]

The Court upheld the Mississippi tax, noting that "no claim is made that the activity is not sufficiently connected to the State to justify a tax, or that the tax is not fairly related to benefits provided the taxpayer, or that the tax discriminates against interstate commerce, or that the tax is not fairly apportioned."[44] The Court reiterated its belief that the Commerce Clause does not exempt interstate commerce from state taxation, citing the *Western Live Stock* decision discussed earlier.[45] In every Commerce Clause case since, the Court has adhered to *Complete Auto Transit, Inc.*'s four-part test.[46]

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40 Spector Motor Service v. O'Connor, 340 U.S. 602, 603 (1951).

41 *Complete Auto Transit, Inc.*, 430 U.S. at 279.

42 *Id.* at 287.

43 HELLERSTEIN, *supra* note 6, § 4.12(1).

44 *Complete Auto Transit, Inc.*, 430 U.S. at 287.

45 W. Live Stock v. Bureau, 303 U.S. 250 (1938).

46 HELLERSTEIN, *supra* note 6, § 4.12(1).

B. Commerce Clause Restrictions on a State's Authority to Impose and Require the Collection of Sales and Use Taxes to a Vendor Engaged in Interstate Commerce

Before *Complete Auto Transit, Inc.* the Court had established a "basic analytical framework . . . [that governed a] state's power to impose and collect sales and use taxes on goods sold in interstate commerce . . . ."[47] Essentially, if an out-of-state vendor had sufficient nexus with the state where the purchaser is located, that state has the authority to impose on the vendor the obligation to collect a use tax on the item sold. In *General Trading Co. v. State Tax Commission of Iowa*, the Court upheld the obligation to collect a use tax imposed by the State of Iowa on a Minnesota based vendor that did not have any employees or place of business in Iowa.[48] The vendor did employ solicitors that traveled to Iowa to sell its products. The Court did not find any problems with a tax being imposed on the consumption of property within the state's borders. Neither did it have a problem with requiring the vendor to collect it, stating that "[t]o make the distributor the tax collector for the State is a familiar and sanctioned device."[49]

However, a case decided on the same day reached a very different conclusion. In *McLeod v. J. E. Dilworth Co.*, the Court held that an Arkansas sales tax imposed on goods being shipped from Tennessee violated the Commerce Clause.[50] The facts of the case were very similar to those in *General Trading Co.* The out-of-state vendor did not have any office or employees in Arkansas, but employed sellers that traveled to Arkansas to solicit business. The Court found that Arkansas could not impose a sales tax on a purchase that had taken place in Tennessee, even if the item being purchased was delivered to Tennessee. As Justice Frankfurt said:

> We would have to destroy both business and legal notions to deny that under these circumstances the sale—the transfer of ownership—was made in Tennessee. For Arkansas to impose a tax on such transactions would be to project its powers beyond its boundaries and to tax an interstate transaction.[51]

The same thing could have been said of the transaction in *General Trading Co.* For the Court, the difference lied in the fact that the tax at issue in *General Trading Co.* was a use tax, whereas the tax in *McLeod* was a *sales* tax. It reasoned that this difference merited distinct treatment: "A sales tax and a use tax in many instances may bring about the same result. But they are different in conception, are assessments upon different transactions, and in the interlacings of the two

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47 *Id.* § 19.02.

48 Gen. Trading Co. v. Tax Comm'n, 322 U.S. 335, 337 (1944).

49 *Id.* at 338.

50 McLeod v. Dilworth Co., 322 U.S. 327, 330, 332 (1944).

51 *Id.* at 330.

legislative authorities within our federation may have to justify themselves on different constitutional grounds."[52] This distinction that the Court draws between a *sales* tax and a use tax may give rise to the situation in which one state may impose a sales tax on a transaction that takes place within its borders, and another state may impose a use tax on the items that were sold in that transaction, if they are consumed within its limits; contrary to the multiple taxation doctrine exposed by Justice Stone in *Western Live Stock*.[53] In his concurring opinion in *McLeod*, Justice Rutledge explained that this could not be so:

> Where the cumulative effect of two taxes, by whatever name called, one imposed by the state of origin, the other by the state of market, actually bears in practical effect upon such an interstate transaction, there is no escape under the doctrine of undue burden from one of two possible alternatives. Either one tax must fall or, what is the same thing, be required to give way to the other by allowing credit as the Iowa tax does, or there must be apportionment.
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> . . . .
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> If in this case it were necessary to choose between the state of origin and that of market for the exercise of exclusive power to tax, or for requiring allowance of credit in order to avoid the cumulative burden, in my opinion the choice should lie in favor of the state of market rather than the state of origin.[54]

In summary, a state may impose an obligation on an out-of-state vendor to collect a use tax if the vendor has sufficient nexus with the state.[55] A use tax offers the advantage over a sales tax in that "the local use of property [lies] within the state's taxing power"[56] whereas a sales tax may be more problematic because a determination of where the sale actually takes place needs to be made. It should be noted that in order to avoid *multiple taxation*, all states that have imposed sales and use taxes allow for a credit for sales or use taxes paid to other states.[57]

After these cases, the recurrent issue before the Court when addressing challenges to state taxes under the Commerce Clause has been whether the out-of-state vendor being taxed has sufficient nexus with the state imposing the tax. This is the first prong of *Complete Auto Transit, Inc.*'s test,[58] even though it has been a concern of the Court since before the case was decided. We proceed to analyze the nexus requirement in more detail.

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52 *Id.*

53 W. Live Stock v. Bureau, 303 U.S. 250 (1938).

54 *McLeod*, 322 U.S. at 360-61 (Rutledge, J., concurring) (emphasis added).

55 HELLERSTEIN, *supra* note 6, § 19.02.

56 *Id*. § 19.02(1).

57 *Id*. § 19.02.

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

C. Sufficient Nexus with the Taxing State where the Vendor has Employees or Independent Contractors

In the two cases just discussed, *General Trading Co.* and *McLeod*, the companies at issue employed persons who traveled to the state which sought to impose a tax.[59] This proved sufficient nexus in *General Trading Co.* In *McLeod*, the issue was not so much if the company had sufficient nexus with the State, but whether the *transaction* or sale had sufficient nexus with the State. Based on the Court's expressions, it seems that if Arkansas had imposed a use tax collection obligation on *McLeod*, it would have been sustained and no issue of nexus would have arisen.[60] In *Scripto, Inc. v. Carson*, the Court had before it a similar situation than in *General Trading Co.* and *McLeod*, but with the added complication that the *salesmen* were not regular employees of the company, but rather independent contractors.[61] The Court found "that such a fine distinction is without constitutional significance."[62] Justifying its reasoning, the Court added that: "[t]o permit such formal 'contractual shifts' to make a constitutional difference would open the gates to a stampede of tax avoidance."[63] Almost thirty years later, in *Tyler Pipe Industries, Inc. v. Washington State Department of Revenue*,[64] the Court would reaffirm the principle established in *Scripto, Inc.*, "that nexus with an out-of-state seller may be established by the activities of unrelated third parties who act on behalf of the seller in the state."[65]

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59 Gen. Trading Co. v. State Tax Comm'n, 322 U.S. 335 (1944); *McLeod*, 322 U.S. at 327.

60 HELLERSTEIN, *supra* note 6, § 19.02.

61 Scripto v. Carson, 362 U.S. 207 (1960).

62 *Id.* at 211.

63 *Id.* It should be noted that the Court, similar to its reasoning in *National Bellas Hess, Inc.*, treated the Commerce Clause and the Due Process Clause challenges to the State's tax, as one. Not specifying whether it was referring to the Commerce Clause or Due Process Clause, the Court stated:

> There must be, as our Brother Jackson stated in *Miller Bros. Co. v Maryland*, *"some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax*." We believe that such a nexus is present here. First, *the tax is a nondiscriminatory exaction* levied for the use and enjoyment of property which has been purchased by Florida residents and which has actually entered into and become a part of the mass of property in that State.

Id. at 210-11 (emphasis added) (citations omitted) (quoting Miller Bros Co. v. Maryland, 347 U.S. 340, 344-45 (1954)). The first requirement, which the Court says that a state tax needs to meet, is *some definite link* or *minimum* connection with the object being taxed. That is Due Process Clause language. Either the Court is treating both nexus inquiries as one and the same, or the Court is only addressing the Due Process inquiry in that passage. However, just two sentences after, the Court addresses *nondiscrimination*, a Commerce Clause inquiry. This passage lends support to Justice White's position that nexus inquiry of both clauses was treated by the Court as the same, until *Quill*. *See* Quill Corp. v. North Dakota, 504 U.S. 298, 321 (1992) (White, J., concurring in part and dissenting in part).

64 Tyler Pipe Indus. v. Dept. of Revenue, 483 U.S. 232, 253 (1987).

65 HELLERSTEIN, *supra* note 6, § 19.02(2)(a).

D. Sufficient Nexus with the Taxing State where the Vendor has no Physical Presence

In *National Bellas Hess, Inc.*,[66] the Court first addressed the power of a state to impose a use tax collection obligation on an out-of-state vendor with no employees or independent contractors, either traveling to or working in the state, as well as no place of business within its borders.[67] In other words, the Court addressed for the first time the power of a state to impose a tax collection obligation, when the vendor has no physical presence in the taxing state. In this case, National Bellas Hess, Inc., based out of Missouri, was a mail-order house, which sold to consumers in Illinois through its catalogues, which were mailed twice a year. Illinois imposed on National Bellas Hess, Inc. the obligation to collect from its residents the use tax levied on goods purchased from the company for use within the state. Addressing the company's Due Process and Commerce Clause challenges in tandem, the Court explained that it "has never held that a State may impose the duty of use tax collection and payment upon a seller whose only connection with customers in the State is by common carrier or the United States mail."[68] In this case, the Court showed great concern for the administrative burdens that such a collection duty may impose on out-of-state vendors if they were subject to such duties in every state in which they did business, and the subsequent effect that this would have in interstate commerce. At the outset of the opinion, the Court described the Illinois tax in the following manner:

> When collecting this tax, National must give the Illinois purchaser "a receipt therefor in the manner and form prescribed by the [appellee]," if one is demanded. It must also "keep such records, receipts, invoices and other pertinent books, documents, memoranda and papers as the [appellee] shall require, in such form as the [appellee] shall require," and must submit to such investigations, hearings, and examinations as are needed by the appellee to administer and enforce

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66 Nat. Bellas Hess v. Dept. of Revenue, 386 U.S. 753 (1967).

67 In *Miller Bros. Co. v. Maryland*, the Court had before it a similar, yet different in a fundamental sense, set of facts. In this case, the State of Maryland sought to tax a Delaware vendor with no physical presence in Maryland, even when the only transactions that the vendor conducted with Maryland residents where through the vendor's place of business in Delaware. Maryland's residents traveled to Delaware to take advantage of the lower tax burden on purchases in the State, and Maryland, concerned with the loss of revenue, sought to impose on the Delaware vendor the obligation to collect Maryland's use tax. The Court ruled that the obligation violated the Due Process Clause. As the Court explained:

> Here was no invasion or exploitation of the consumer market in Maryland. *On the contrary, these sales resulted from purchasers traveling from Maryland to Delaware to exploit its less tax-burdened selling market.* That these inhabitants incurred a liability for the use tax when they used, stored or consumed the goods in Maryland, no one doubts. But the burden of collecting or paying their tax cannot be shifted to a foreign merchant in the absence of some jurisdictional basis not present here.

Miller Bros. Co. v. Maryland, 347 U.S. 340, 347 (1954) (emphasis added).

68 *Nat. Bellas Hess*, 386 U.S. at 758.

> the use tax law. Failure to keep such records or to give required receipts is punishable by a fine of up to $5,000 and imprisonment of up to six months.[69]

The Court clearly wanted to draw attention to the heavy burdens of complying with Illinois' use tax legislation. At the end of the opinion, the Court again emphasized these *impediments* on interstate commerce:

> For if Illinois can impose such burdens, so can every other State, and so, indeed, can every municipality, every school district, and every other political subdivision throughout the Nation with power to impose sales and use taxes. The many variations in rates of tax, in allowable exemptions, and in *administrative and record-keeping requirements could entangle National's interstate business in a virtual welter of complicated obligations* to local jurisdictions with no legitimate claim to impose "a fair share of the cost of the local government."
>
> The very purpose of the Commerce Clause was to ensure a national economy free from such unjustifiable local entanglements. Under the Constitution, this is a domain where Congress alone has the power of regulation and control.[70]

A brief commentary on the economic implications of use tax collection duties must be made. For the Court, the potential imposition of use tax collection duties by every jurisdiction in which a seller does business is contrary to the goal of a free national economy that the *dormant* Commerce Clause seeks to protect. To say that use tax collection duties are burdensome is hardly debatable. However, to conclude that this burden serves as an impediment to a free economy, and that the only way to avoid such an impediment is to require that states only tax vendors with a physical presence within its borders is not so intuitive. The only rational relationship between the physical presence requirement and a free economy is that, by requiring a physical presence, the amount of jurisdictions that will subject a vendor to collection duties is probably less than the amount of jurisdictions in which it does business. Nonetheless, as a vendor, the burden of collecting a tax is the same in a jurisdiction in which you have physical presence (as defined by the Court's Commerce Clause jurisprudence) as it is in a jurisdiction in which you do not have such a presence.[71] Amazon, for example, sells to consumers in virtually all taxing jurisdictions in the United States. Is it reasonable to believe that the costs that it incurs in collecting use taxes in Pennsylvania, where it has a physical presence, are any less than the costs that it would incur in

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69 *Id.* at 755 (footnotes omitted) (quoting ILL. REV. STAT. c. 120, §§ 439.5, 439.11 (1965))

70 *Id.* at 759-60 (emphasis added) (footnotes omitted).

71 This is even more apparent when it is considered what *physical presence* means for the Court. In *National Geographic v. Cal. Equalization Bd.*, the Court ruled that the State of California had sufficient nexus with National Geographic Society to impose on it an obligation to collect use tax on the magazines that it sold to California residents, even though its mail order business had no physical presence in California. The Court found that the fact that National Geographic had two offices in California constituted sufficient nexus with the State to be subject to use tax collection duties, even when the two offices were unrelated to the mail order business which sold the magazines to California residents, reasoning that "such dissociation does not bar the imposition of the use-tax-collection duty." Nat'l Geographic v. Cal. Equalization Bd., 430 U.S. 551, 560 (1977) (footnote omitted).

collecting use taxes in Puerto Rico, where it does not have a physical presence? This reasoning may have been sensible in 1967, when the case was decided, when the internet as we know it did not exist, and when the costs of sharing information and doing business where proportionately much higher than what they are today, but it seems wildly out of touch with the world in which we live in today.

Three dissenting Justices were willing to uphold the imposition on Illinois' use tax on National Bellas Hess, Inc. The Justices where not convinced, even in 1967, that the burdens to which the majority alluded to where enough to make the obligations an undue impediment on interstate commerce. As Justice Fortas wrote:

> It is hardly worth remarking that appellant's expressions of consternation and alarm at the burden which the mechanics of compliance with use tax obligations would place upon it and others similarly situated should not give us pause. The burden is no greater than that placed upon local retailers by comparable sales tax obligations; and the Court's response that these administrative and record keeping requirements could "entangle" appellant's interstate business in a welter of complicated obligations vastly underestimates the skill of contemporary man and his machines. There is no doubt that the collection of taxes from consumers is a burden; but it is no more of a burden on a mail order house such as appellant located in another State than on an enterprise in the same State which accepts orders by mail; and it is, indeed, hardly more of a burden than it is on any ordinary retail store in the taxing State.[72]

The dissenting Justices were concerned with the competitive advantage that the Majority's ruling would grant out-of-state vendors, which is the situation that has prompted the writing of this article. As the dissent explains:

> To excuse Bellas Hess from this obligation is to burden and penalize retailers located in Illinois who must collect the sales tax from their customers . . . . [W]hen it is realized that in some communities the sales tax . . . [is] as much as 5% . . . *the competitive discrimination becomes apparent*.[73]

We have placed significant emphasis in *National Bellas Hess, Inc.*, because, as it relates to the Commerce Clause, it remains the law of the land today, with some modifications made in *Quill*,[74] which we proceed to consider next.

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72 *Nat. Bellas Hess*, 386 U.S. at 766 (Fortas, J., dissenting).

73 *Id.* at 763 (Fortas, J., dissenting) (emphasis added) (footnote omitted).

74 Quill Corp. v. North Dakota, 504 U.S. 298, 317 (1992).

E. Quill Corp. v. North Dakota

i. Facts

Quill was a Delaware corporation with offices in Illinois, California and Georgia, which sold office equipment through catalogs, flyers, advertisements and telephone calls. It did not have a physical presence in North Dakota, yet it was the sixth largest vendor of office supplies in the state. Pursuant to a 1987 amendment of its sales and use tax legislation, which declared that "'every person who engages in regular or systematic solicitation of a consumer market in th[e] state'"[75] had to collect the use tax from the consumer and remit it to the State. North Dakota required Quill to collect and remit the use tax on items sold for consumption in the State. Quill refused, and the State's Tax Commissioner brought action against the corporation to require the payment of all taxes due since the amendments to the sales and use tax legislation. These facts are nearly indistinguishable from those in *National Bellas Hess, Inc.*, decided twenty-five years earlier. The Trial Court in North Dakota saw it this way and ruled that there was no nexus between Quill and North Dakota that would allow the State to demand from Quill the collection and payment of use taxes on the items sold to residents of North Dakota.

The North Dakota Supreme Court also saw the facts of *Quill* as identical to those of *National Bellas Hess, Inc.* However, it reversed the Trial Court's decision, arguing that "'wholesale changes' in both the economy and the law made it inappropriate to follow *Bellas Hess* today."[76] This means that already in 1992 a state supreme court was convinced that the physical presence requirement developed in *National Bellas Hess, Inc.* should have been overturned because its justifications were no longer valid in light of "advances in computer technology [that] greatly eased the burden of compliance with a 'welter of complicated obligations' imposed by state and local taxing authorities."[77]

ii. The Separation of the Nexus Requirement of the Due Process Clause from that of the Commerce Clause

As was anticipated above, the United States Supreme Court affirmed the part of the decision which dealt with the Due Process Clause, and in so doing overruled that portion of *National Bellas Hess, Inc.*[78] Yet, surprisingly,[79] the

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75 *Id.* at 302-03 (alteration in original) (quoting N.D. CENT CODE § 57-40.2-01(6) (Supp. 1991)).

76 *Id.* at 303 (citations omitted).

77 *Id.* (quoting State v. Quill Corp., 470 N.W.2d 203, 215 (N.D. 1991)).

78 *Id.* at 308.

79 Referring to the Court's decision in *Quill*, professor Hellerstein has noted that "[i]t [was] a victory that many observers would never have predicted considering that the drift of the law had clearly been toward relaxed nexus standards." HELLERSTEIN, *supra* note 6, § 19.02(3)(c)(vi).

Commerce Clause analysis and conclusion of the State's Supreme Court was overruled, and correspondingly, *National Bellas Hess, Inc.*'s physical presence requirement was validated. For the first time, the Court ruled that there could be sufficient nexus between a taxpayer and the taxing state for purposes of the Due Process Clause, but not for purposes of the Commerce Clause.

As the Court understood *Complete Auto Transit, Inc.*'s test, its first prong requires *substantial* nexus because it is informed by "structural concerns about the effects of state regulation on the national economy."[80] On the other hand, the nexus requirement of the Due Process Clause is concerned with the "fundamental fairness of governmental activity,"[81] and providing notice or fair warning. The Court, however, did not explain why, even when accepting the sound premise that both clauses serve different purposes and are motivated by different concerns, the nexus requirement for Commerce Clause purposes needed to be more *substantial* than the one for Due Process.

iii. Arguments for Sustaining the Physical Presence Requirement

To justify the physical presence requirement, the Court offered three main arguments: (1) *stare decisis*; (2) the requirement serves as a *safe harbor* for out-of-state vendors, and (3) that Congress not only has the power to overturn it, but is better equipped to do so. We proceed to consider these in more detail.

a. *Stare Decisis* and Settled Expectations

One of the most notable parts of the Court's decision in *Quill* is when it conceded that "contemporary Commerce Clause jurisprudence might not dictate the same result were the issue to arise for the first time today . . . ."[82] This validates the North Dakota Supreme Court's position that *National Bellas Hess, Inc.* was an outdated ruling. Nonetheless, the Court decided to uphold the physical presence requirement because it is:

> [A] bright-line rule in the area of sales and use taxes [that] encourages settled expectations and, in doing so, fosters investment by businesses and individuals. 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*.[83]

We will not dispute the Court's historical account of the mail order industry's growth. However, we must ask whether settled expectations in this area continue to foster investment by businesses and individuals. It is very likely that

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80 *Quill Corp.*, 504 U.S. at 312.

81 *Id.*

82 *Id.* at 311.

83 *Id.* at 316.

a business does take into account the physical presence requirement when it is considering whether to invest or where to invest. Yet, it is probably for all the wrong reasons. The rule penalizes having a physical presence in a state because it will subject the company to use tax collection duties. As it stands, it promotes having a physical presence in as few states as possible. Additionally, it distorts decisions as to where a company will invest. A company may find it more profitable to invest in State A, but it may opt to invest in State B because investing in State A may subject it to new tax collection duties.

We also believe that the concern with *stare decisis* is overstated. As was discussed earlier, the Court's decisions in this area have varied significantly from formalism to pragmatism, and back. Even though *Quill*, by the Court's own admission, represents a shift back towards formalism, in previous cases it had exhibited a tendency towards pragmatism and a relaxation of nexus requirements.[84] In other words, the Court has not been shy to set aside *settled expectations* when it has determined that the principle in question is no longer valid. We will have more to say on *stare decisis* when we discuss the alternatives and solutions to the physical presence requirement.

b. *Safe Harbor* for Out-of-State Vendors

The only Commerce Clause related argument that the Court presented in favor of sustaining the physical presence requirement was that it served as a *safe harbor* for out-of-state vendors. The bright line rule allowed them to know with certainty when they could not be subject to tax collection duties. Even though it recognized that the rule could be seen as artificial, the Court explained that the law on this subject "is something of a 'quagmire'", and that a case by case evaluation of the actual burdens of each particular tax or regulation would be unduly burdensome to interstate commerce.[85] The rule allows a vendor to avoid use tax collection obligations by avoiding having a physical presence in the taxing state, regardless of how burdensome the obligation actually may be.

We do not doubt that the rule serves as a *safe harbor* for vendors doing business across state lines. What we are not certain about is whether this privilege is called for. The reader should remember Justice Stone's remarks in *Western Live Stock*: "It was not the purpose of the commerce clause to relieve those engaged in interstate commerce from their just share of state tax burden even

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84 *See* HELLERSTEIN, *supra* note 6, § 19.02(3)(c)(vi). See also *Quill Corp.*, 504 U.S. at 314, where the Court stated:

> *Complete Auto*, it is true, renounced *Freeman* and its progeny as "formalistic." But not all formalism is alike. *Spector*'s formal distinction between taxes on the "privilege of doing business" and all other taxes served no purpose within our Commerce Clause jurisprudence, but stood "only as a trap for the unwary draftsman." In contrast, the bright-line rule of *Bellas Hess* furthers the ends of the dormant Commerce Clause.

Id.

85 *Quill Corp.*, 504 U.S. at 315.

though it increases the cost of doing the business. 'Even interstate business must pay its way' . . . ."[86] If an out-of-state vendor has no place of business, no employees or independent contractors in a state, yet it exploits its consumer market and avails itself of the protections that the state offers, then one must ask, how is it that the vendor is paying its way or shouldering its fair share of the state tax burden?

c. Congressional Action

Some commentators believe that the Court decided the way it did in order to prompt congressional action.[87] It seems likely that this is the reason why the Court agreed to see the case, because the practical result of the decision is that *National Bellas Hess, Inc.*'s rule was affirmed in all material aspects except its limitation to congressional action, the Due Process Clause holding, which was abrogated. The Court itself stated that:

> [O]ur decision is made easier by the fact that the underlying issue is not only one that Congress may be better qualified to resolve, but also one that Congress has the ultimate power to resolve. No matter how we evaluate the burdens that use taxes impose on interstate commerce, Congress remains free to disagree with our conclusions. Indeed, in recent years Congress has considered legislation that would "overrule" the *Bellas Hess* rule. Its decision not to take action in this direction may, of course, have been dictated by respect for our holding in *Bellas Hess* that the Due Process Clause prohibits States from imposing such taxes, but today we have put that problem to rest. 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 use taxes.[88]

It is hard to argue that it is better for the branch of government that is accountable directly to the people to handle an issue such as the limits of state taxation. However, it is curious that the Court concludes that Congress is better qualified to resolve the issue, when it was the Court who created the issue in the first place. After all, the *issue* is that the United States Supreme Court ruled that a state may not impose on a vendor, with no physical presence within it, the obligation to collect use taxes. Regardless of the original merits of its decision to leave the controversy for Congress to resolve, the fact is that over two decades after the case was decided, Congress has not acted, and with a divided government it is not likely to do so any time soon.

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86 W. Live Stock v. Bureau, 303 U.S. 250, 254 (1938) (quoting Postal Telegraph-Cable Co. v. City of Richmond, 249 U.S. 252, 259 (1919)).

87 "*Quill* did, to be sure, make it clear that there is no constitutional bar to congressional legislation in this area. Moreover, the Court's opinion in *Quill may, as a political matter, have been driven largely by a desire to achieve this result*." HELLERSTEIN, *supra* note 6, § 19.02(3)(c)(vi) (emphasis added).

88 *Quill Corp*, 504 U.S. at 318.

iv. The Physical Presence Requirement Today

Quill, decided in 1992, and *National Bellas Hess, Inc.*'s Commerce Clause holding, decided in 1967, have not been overruled, and the physical presence requirement remains in force. When *Quill*'s apologetic defense of this ruling is considered along with how much technology has developed since, and how much easier it is for a vendor to collect taxes, it is truly hard to fathom how the case is still good law. Many states have tried to legislate around it,[89] courts have sometimes ignored it,[90] and commentators have either called for or anticipated its abrogation.[91] The end of *Quill* appears to be near. In a recent case, Justice Kennedy, whose vote often determines where the Court goes, said the following about *Quill*:

> Given these changes in technology and consumer sophistication, it is unwise to delay any longer a reconsideration of the Court's holding in *Quill*. *A case questionable even when decided, Quill now harms States to a degree far greater than could have been anticipated earlier*. It should be left in place only if a powerful showing can be made that its rationale is still correct.
>
> The instant case does not raise this issue in a manner appropriate for the Court to address it. It does provide, however, the means to note the importance of reconsidering doubtful authority. *The legal system should find an appropriate case for this Court to reexamine Quill and Bellas Hess*.[92]

As shaky as the ruling may have seemed when it was issued, and as inadequate as it is today, a state still may not impose the obligation to collect use taxes on a vendor that has no physical presence within its borders. We now proceed to discuss alternatives that the Legislature may have at its disposal to void the competitive advantage that the rule affords out-of-state vendors over local merchants and to mitigate the loss of tax revenue. First, we consider a mechanism that the Government of the Commonwealth of Puerto Rico used to collect the excise tax that was imposed on goods imported into the Island, which was deemed preempted and unconstitutional by the First Circuit Court of Appeals.

III. FEDERAL PREEMPTION OF THE EXCISE TAX COLLECTION MECHANISM

In *United Parcel Service, Inc. v. Flores Galarza*, United Parcel Service, Inc., (U.P.S.) challenged in federal court a scheme that the Puerto Rico Treasury De-

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89 *See generally* HELLERSTEIN, *supra* note 6, § 19.02(7).

90 *See* Brianne N. De Sellier & John M. Kelleher, *Revisiting Nexus Standards: Establishing U.S. Jurisdiction to Tax Cross-Border Commerce*, 88 FLA. B.J. 31, 32 (2014). *See also* Geoffrey, Inc. v. Commisioner of Revenue, 899 N.E.2d 87 (Mass. 2009).

91 *See* Walter Hellerstein, *Deconstructing the Debate over State Taxation of Electronic Commerce*, 13 HARV. J.L. & TECH. 549 (2000). *See also* John A. Swain, *State Sales and Use Tax Jurisdiction: An Economic Nexus Standard for the Twenty-First Century*, 38 GA. L. REV. 343, 365 (2003).

92 Direct Marketing Assn. v. Brohl, 135 S.Ct. 1124, 1135 (2015) (Kennedy, J., concurring) (emphasis added) (citations omitted).

partment (Treasury) had implemented to enforce collection of its excise tax, precursor to the current Sales and Use Tax (S.U.T.).[93] The excise tax was imposed on the use and consumption of goods as soon as the goods were imported into the Island. This is a key difference with the current S.U.T., which is imposed at the end of the distribution chain or at the retail level.[94] As an enforcement mechanism, all taxable goods imported into the Island had to be authorized by the Secretary of the Treasury before they could be delivered to the recipient.[95] Authorization by the Secretary was contingent upon the presentation of a certificate that evidenced the payment of the excise tax due on the imported goods. The issue with air or even common carriers was that they were not the ones who owed the tax; the tax was levied on the recipients. This meant that they had to collect the tax from the recipient before importing the goods into Puerto Rico. Apparently, this was too burdensome for carriers.

As a result, an alternative mechanism was set up, where carriers could prepay the taxes owed, deliver the goods, and then seek reimbursement from the recipients.[96] This alternative mechanism was "a complex statutory and regulatory scheme resembling the federal customs system."[97] As the First Circuit Court of Appeals saw it, U.P.S. had to "alter significantly the business practices it employ[ed] for the rest of the United States to comply with the Commonwealth's prepayment scheme."[98] More importantly, U.P.S. had to:

> [D]elay the delivery of packages until all necessary data have been obtained, or until Treasury agents have had an opportunity to inspect the packages on site. UPS also bears the burden of seeking reimbursement from consignees, pays additional amounts if agents alter assessments on packages after they have been delivered, and maintains a $1.5 million bond. UPS incurs more than $4.6 million per year in costs associated with its compliance with the prepayment scheme.[99]

Based on the burdens that the excise tax collection mechanism imposed on U.P.S.'s operation, it would seem that U.P.S. had a solid Commerce Clause challenge against the mechanism. However, as we discuss below, this argument is not as strong as it may first appear to be.

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93 United Parcel Serv., Inc. v. Flores-Galarza, 318 F.3d 323 (1st Cir. 2003).

94 A Value Added Tax (V.A.T.) would be imposed throughout the distribution chain, starting from when the goods are initially imported into the Island all the way up to the final sale to the consumer. The current S.U.T. was altered in 2013 in order to resemble a V.A.T., at least as it concerns goods. *See* Enmiendas al Código de Rentas Internas para un Nuevo Puerto Rico, Ley Núm. 46 de 30 de junio de 2013, 2013 LPR 511. The current mechanism, however, is restricted by the ruling in *United Parcel Serv., Inc.,* 318 F.3d 323.

95 CÓD. REN. INT. PR 1994 sec. 2066, 13 LPRA § 9066 (repealed 2011).

96 *Id.* § 9077 (repealed 2011).

97 *United Parcel Serv., Inc.,* 318 F.3d at 326.

98 *Id.* at 327.

99 *Id.*

A. The Commerce Clause and the Puerto Rico Federal Relations Act

As was discussed above in our section on the history of the Commerce Clause, even though the text of the clause is an affirmative grant to Congress of the right to regulate interstate commerce, the United States Supreme Court has attributed to this text an implication that states may not unduly interfere with how Congress regulates commerce. This is what is known as the *dormant* Commerce Clause.[100] The ultimate goal of the *dormant* Commerce Clause is to "[prevent] a State from retreating into economic isolation or jeopardizing the welfare of the Nation as a whole."[101] The power to regulate commerce is Congress's and Congress's alone. This is why Congress is free to overturn a decision based on the Commerce Clause by passing a law that so disposes.[102] This is also why in *Quill*, the Court explicitly said that Congress should have the last word in that controversy. It could be said that Commerce Clause jurisprudence is merely the Court anticipating how Congress would want a given area of interstate commerce to be regulated, which means that this interpretation is displaced when Congress actually communicates its preferences.

In *United Parcel Service, Inc.*, the problem that the plaintiffs had with a Commerce Clause challenge was that Congress had indeed spoken. Section 3 of the *Puerto Rico Federal Relations Act* grants Puerto Rico the power to "lev[y] and [*collect* internal revenue-taxes] as [the Puerto Rico] legislature may direct, on . . . articles subject to . . . tax, as soon as the same are manufactured, sold, used, or brought into the island."[103] This section has been interpreted to grant Puerto Rico a taxing power that the states of the Union do not have.[104] Although it could still be argued that Congress did not intend to allow Puerto Rico to enforce such a burdensome collection mechanism when it passed the *Puerto Rico Federal Relations Act*, the First Circuit Court of Appeals recognized that it presented significant hurdles to U.P.S.'s Commerce Clause claim.[105]

The First Circuit Court of Appeals ultimately opted to rule on U.P.S.'s much stronger argument, based on preemption by a federal statute and the Supremacy Clause,[106] which we proceed to consider next.

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100 *See* NOWAK & ROTUNDA, *supra* note 14, at 82-83.

101 Okla. Tax Comm'n v. Jefferson Lines, Inc., 514 U.S. 175, 180 (1995).

102 *See* Prudential Ins. Co. v. Benjamin, 328 U.S. 408, 423-24 (1946). *See also* NOWAK & ROTUNDA, *supra* note 14, at 163.

103 Puerto Rico Federal Relations Act § 3, 48 U.S.C. § 741a (2014) (emphasis added).

104 *See* W. India Oil Co. v. Domenech, 311 U.S. 20 (1940).

105 "Taken alone, Section 3 [of the *Puerto Rico Federal Relations Act*] would seem to strengthen the Secretary[of the Treasury]'s hand in challenges to the tax and perhaps even its 'no delivery' feature, at least as to those challenges based on the Commerce Clause." United Parcel Serv., Inc. v. Flores-Galarza, 318 F.3d 323, 332 (1st Cir. 2003).

106 The Supremacy Clause reads as follows:

> This Constitution, and the Laws of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United

B. The Federal Aviation Administration Authorization Act (F.A.A.A.A.)[107] and its Preemption of the Excise Tax Collection Mechanism

The F.A.A.A.A. established that no state may "enact or enforce a law, regulation, or other provision having the force and effect of law related to a price, route, or service of an air carrier . . . when such carrier is transporting property by aircraft or by motor vehicle . . . ."[108] The key phrase in that definition is *related to*, since courts have given it a very broad meaning.[109] Using a very expansive definition of *related to* a price, route or service of an air carrier, the First Circuit Court of Appeals ruled that the Treasury's mechanism for collecting the excise tax due on imported goods had "a forbidden significant effect on UPS's prices, routes or services."[110] Referring to the mechanism employed by the Treasury, the Appeals Court was of the opinion that:

> Compliance with this provision significantly affects the timeliness and effectiveness of UPS's service, which includes the delivery of packages on an express or time-guaranteed basis. Likewise, the prepayment mechanism imposes extensive requirements that must be met before a carrier may make a lawful delivery. These requirements create a substantial burden on UPS, in the form of additional labor, costs, and delays. The undisputed record, as chronicled by the district court below, shows that this burden directly and significantly affects UPS's routes and services, which depend upon an orderly flow of packages.[111]

As a result, the Treasury was barred from requiring air carriers to prepay the excise due on imported goods or from prohibiting air carriers to deliver imported goods before presenting certifying to the Treasury that the applicable excise tax had been paid. This ruling is a serious blow to the tax collection efforts of the Treasury because it negates one of the most significant advantages of being an island. Most imported goods arrive either through Puerto Rico's ports or through its main airport. After this case, the Commonwealth may not effectively collect taxes on imported goods at the airport, since it cannot in any way slow down or interfere with an air carrier's operations. It must instead either rely on self-reporting by consumers, or track them down, a difficult task to say the least. Even though the Government eventually substituted the excise tax system for the sales and use tax currently in place, this decision is still relevant for two rea-

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> States, shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding.

U.S. CONST. art. VI, cl. 2.

107 Federal Aviation Administration Authorization Act of 1994, Pub. L. No. 103-305, 108 Stat. 1569 (codified as amended in scattered sections of 49 U.S.C.).

108 Preemption of Authority Over Prices, Routes, and Service, 49 U.S.C. § 41713(b)(4)(A) (2012).

109 *United Parcel Serv., Inc.*, 318 F.3d at 335.

110 *Id.*

111 *Id.* at 336.

sons. First, the current S.U.T. system was transformed into a hybrid of sorts, in which services are taxed at the consumer level, but goods are taxed at the beginning of the distribution chain when they are imported into the Island, much like a Value Added Tax (V.A.T.).[112] Second, the Commonwealth is considering moving towards a V.A.T. system. The efficacy of a V.A.T. system where the Government cannot collect a tax at the beginning of the distribution chain (for goods arriving by air carrier, which is the case of most goods purchased online from out-of-state vendors) is highly questionable.

IV. RECOMMENDATIONS

As Justice Kennedy has ably stated, "*Quill* now harms States to a degree far greater than could have been anticipated earlier."[113] The loss of tax revenue that it has inflicted upon state governments is substantial, with some estimating that it may exceed over ten billion dollars a year.[114] Even more serious is the competitive disadvantage that small and medium businesses are being placed in. Many *mom and pop* shops are only able to sell through brick and mortar stores. They have to compete with giants such as Amazon, which are not only able to offer lower prices precisely because they do not have the overhead costs of physical stores. To add insult to injury, they don't have to charge sales or use taxes, making their products seem artificially cheaper than their competitors in brick and mortar stores.[115] This must not be confused with arguing against a free economy or free trade; far from it. Elimination of this rule would not only even the playing field among competitors, but also remove undue distortions in our economy.

We believe that the situation is urgent, and could gain even more urgency if the consumption tax is increased as substantially as it is being proposed. What follows next are a few alternatives that the Government of the Commonwealth of Puerto Rico and the Legislature may implement in order to eliminate the artificial competitive advantage being given to out-of-state vendors.

A. Impose a Tax other than a Sales or Use Tax

Some commentators have noted that before *Quill*, the Court had been moving away from *National Bellas Hess Inc.*'s physical presence requirement.[116] The

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112 *See* Enmiendas al Código de Rentas Internas para un Nuevo Puerto Rico, Ley Núm. 46 de 30 de junio de 2013, 2013 LPR 511.

113 Direct Marketing Assn. v. Brohl, 135 S.Ct. 1124, 1135 (2015) (Kennedy, J., concurring).

114 *See* David Gamage & Devin J. Heckman, *A Better Way Forward for State Taxation of E-Commerce*, 92 B.U. L. REV. 483, 484 nn.3-4 (2012).

115 This was already the case in 1967. *See* Nat. Bellas Hess, Inc. v. Dept. of Revenue, 386 U.S. 753, 760 (1967) (Fortas, J., dissenting).

116 "[Before *Quill*] the law had clearly been toward relaxed nexus standards. Indeed, in the quarter century demarcated by *Bellas Hess* and *Quill*, the Court did not strike down a single state tax on grounds of insufficient nexus." HELLERSTEIN, *supra* note 6, § 19.02(3)(c)(vi).

Court seems to have conceded this point when it asserted: "[A]lthough in our cases subsequent to *Bellas Hess* and concerning other types of taxes we have not adopted a similar bright-line, physical-presence requirement, our reasoning in those cases does not compel that we now reject the rule that *Bellas Hess* established in the area of sales and use taxes."[117] This means that even though in 1992 the Court upheld the physical presence requirement, it took care to emphasize that it was only doing so for sales and use taxes.

All of this is consistent with the interpretation that *Quill* was decided primarily because of *stare decisis* and a concern for *settled expectations*,[118] not because of its merits. This seems as the only reasonable justification for imposing the physical presence requirement in the area of sales and use taxes, and imposing a more flexible approach for other types of taxes. There is nothing inherent in the collection of sales or use taxes that calls for stricter or more formal nexus requirement when compared to income, excise or other types of taxes. What the Court seems to be saying in the above cited passage from *Quill* is that there are no legitimate reliance interests or *settled expectations* regarding *National Bellas Hess, Inc.*'s physical presence requirement when other types of taxes, aside from sales and use taxes, are involved.

In *Tax Commissioner of State v. MBNA America Bank*, the Supreme Court of Appeals of West Virginia seems to have taken this view.[119] In this case, an out of state credit card company with no physical presence in West Virginia sought a refund of the state's business franchise tax and corporation net income tax, alleging that it did not have the *substantial nexus* with West Virginia required by the Commerce Clause, that would justify the imposition of those taxes because it did not have a physical presence within it. The Supreme Court of Appeals rejected the argument by holding that:

> [T]he United States Supreme Court's determination in *Quill Corp. v. North Dakota*, that an entity's physical presence in a state is required to meet the "substantial nexus" prong of *Complete Auto Transit, Inc. v. Brady*, applies only to

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117 Quill Corp. v. North Dakota, 504 U.S. 298, 317 (1992).

118 Although there where eight votes in favor of upholding the physical presence requirement in *Quill*, three of those votes where only in favor of doing so because of *stare decisis*. Justice Scalia, joined by Justices Thomas and Kennedy, explained:

> I also agree that the Commerce Clause holding of *Bellas Hess* should not be overruled. Unlike the Court, however, I would not revisit the merits of that holding, but would adhere to it on the basis of *stare decisis*. Congress has the final say over regulation of interstate commerce, and it can change the rule of *Bellas Hess* by simply saying so. We have long recognized that the doctrine of *stare decisis* has "special force" where "Congress remains free to alter what we have done."

Id. at 320 (Scalia, J., concurring) (citation omitted) (quoting Patterson v. McLean Credit Union, 491 U.S. 164, 172-73 (1989)). At least one of those Justices has already expressed that *stare decisis* concerns no longer justify *Quill*'s holding. *See Direct Marketing Assn.*, 135 S.Ct. 1124 (Kennedy, J., concurring).

119 Tax Com'r of State v. MBNA Am. Bank, N.A., 640 S.E.2d 226 (W. Va. 2006), *cert. denied*, 551 U.S. 1141 (2007).

> state sales and use taxes and not to state business franchise and corporation net income taxes.[120]

The Supreme Court of Appeals instead opted to apply what it referred to as a *significant economic presence test*:

> [A] substantial economic presence standard "incorporates due process 'purposeful direction' towards a state while examining the degree to which a company has exploited a local market." Further, "[a] substantial economic presence analysis involves an examination of both the quality and quantity of the company's economic presence." Finally, under this test, "[p]urposeful direction towards a state is analyzed as it is for Due Process Clause purposes," and the Commerce Clause analysis requires the additional examination of "the frequency, quantity and systematic nature of a taxpayer's economic contacts with a state."[121]

Using this test,[122] the Supreme Court of Appeals determined that the credit card company had a *substantial nexus* with West Virginia that allowed the State to impose the taxes in question. The United States Supreme Court denied *certiorari*.

In *Capital One Bank v. Commissioner of Revenue*, the Supreme Judicial Court of Massachusetts appears to have reached a similar conclusion.[123] The State of Massachusetts imposed on Capital One Bank (Capital One) an excise tax on the net income generated from transactions with its residents. Capital One alleged that the tax violated the Commerce Clause because the bank did not have a substantial nexus with the state. Specifically, it alleged that *Quill's* physical presence requirement was applicable since "sales and use taxes do not impose a more significant burden on interstate commerce than income-based taxes such that the two types of taxes should be treated differently under the commerce clause."[124]

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120 *Tax Com'r of State*, 640 S.E.2d at 234 (citations omitted).

121 *Id.* (citing Christina R. Edson, *Quill's Constitutional Jurisprudence and Tax Nexus Standards in an Age of Electronic Commerce*, 49 TAX. LAW. 893, 943-45 (1996)).

122 The West Virginia Supreme Court of Appeals made some strong expressions against the physical presence requirement:

> [W]e believe that the *Bellas Hess* physical-presence test, articulated in 1967, makes little sense in today's world. In the previous almost forty years, business practices have changed dramatically. When *Bellas Hess* was decided, it was generally necessary that an entity have a physical presence of some sort, such as a warehouse, office, or salesperson, in a state in order to generate substantial business in that state. This is no longer true. The development and proliferation of communication technology exhibited, for example, by the growth of electronic commerce now makes it possible for an entity to have a significant economic presence in a state absent any physical presence there. For this reason, we believe that the mechanical application of a physical-presence standard to franchise and income taxes is a poor measuring stick of an entity's true nexus with a state.

Tax Com'r of State, 640 S.E.2d at 234.

123 Capital One Bank v. Comm'r of Revenue, 899 N.E.2d 76 (Mass. 2009), *cert. denied*, 557 U.S. 919 (2009).

124 *Id.* at 81.

The Supreme Judicial Court of Massachusetts read *Quill* differently and, as support, the Court's decision in *MBNA America Bank*: "Like the West Virginia court, we conclude that the constitutionality, under the commerce clause, of the Commonwealth's imposition of the [excise tax] is determined not by *Quill*'s physical presence test, but by the 'substantial nexus' test articulated in *Complete Auto*."[125] While not mentioning the *economic presence test* that the West Virginia court adopted, the Massachusetts court did mention that the *substantial nexus* requirement of the Commerce Clause is more flexible than just a physical presence requirement, although it requires greater presence than necessary under a Due Process Clause inquiry.[126] Shortly after, in *Geoffrey, Inc. v. Commissioner of Revenue*, the Supreme Judicial Court held that the imposition of its corporate excise tax on a corporation with no physical presence in the State was valid under the Commerce Clause.[127] As in *Capital One Bank*, the Supreme Judicial Court concluded that *Quill's* physical presence requirement was inapplicable.[128] The United States Supreme Court denied *certiorari* in both cases.

The experience in these three cases strengthens the argument that *Quill*'s physical presence requirement will be interpreted as narrowly as possible.[129] Although still ultimately a tax on consumption, a value added tax is different in fundamental ways to a sales and use tax, since it is a levy imposed on each step of a distribution chain with a complex system of credits, whereas a sales tax is imposed at the end of the retail chain and usually to a smaller base.[130] The V.A.T. could be structured in a way in which the Government does not impose a collection obligation, but rather taxes the value that is added by the vendor in the transaction.

If the imposition of an obligation related to a consumption tax is off the table, the Commonwealth should seek to levy a compensating tax on out-of-state vendors, such as a corporate excise tax similar to the one upheld in *Geoffrey, Inc.*, or like the business franchise tax and corporation net income tax validated in *MBNA America Bank*. Although these taxes would not appear in the sale price of the items sold by out-of-state vendors, they would still increase the out-of-state vendors' operational costs, which, all else being equal, should have an effect on the prices at which they are able to sell their goods and mitigate the advantage that they enjoy over merchants with physical presence.

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125 *Id.* at 86.

126 *Id.*

127 Geoffrey, Inc. v. Comm'r of Revenue, 899 N.E.2d 87 (Mass. 2009), *cert. denied*, 557 U.S. 920 (2009).

128 *Id.* at 88-89.

129 William Joel Kolarik II, *Untangling Substantial Nexus*, 64 TAX LAW. 851, 885-86 (2011).

130 *See generally*, AM. BAR ASS'N, VALUE ADDED TAX: A MODEL STATUTE AND COMMENTARY ch. 1 (1989).

B. Impose the Collection Obligation on the Payment Processor

It is hard to imagine a transaction over the internet that does not involve a credit or debit card. In the United States, there are four major payment card companies that process most of these transactions: Visa, MasterCard, American Express and Discover. The first two process payments in a very different manner than the last two. When a consumer uses a card branded by Visa or MasterCard, there are four major parties involved: the merchant, the *acquiring* bank, the *issuing* bank and the payment network. The acquiring bank is the institution with which the merchant has contracted to handle credit card transactions. The *issuing* bank is the bank that has issued the card and is the one that provides the funds for the transaction and bears the ultimate credit risk of a cardholder's payment.[131] The payment network is either Visa or MasterCard. When a consumer uses one of these cards for payment, the merchant's card reader sends the relevant information to the acquiring bank, which sends the information to the payment network, which in turn relays the information to the issuing bank. The issuing bank then approves the transaction if the cardholder has sufficient credit available.[132] The issuing bank then pays the acquiring bank, after deducting a fee. After receiving payment, the acquiring bank retains a processing fee and then remits the funds to the merchant. Visa and MasterCard charge service and transaction fees to the banks that issue their cards.[133] In the case of American Express and Discover, the process is less complex. When a consumer makes a purchase with an American Express or Discover card, the merchant contacts these companies directly, and they pay the merchant after discounting a fee.[134]

The obligation to collect the use tax on a transaction where goods are sold could be imposed to one of these four parties. Since the issuing bank is the party with the most involvement (facilitates the funds, earns the highest fee,[135] approves the transaction and bears the ultimate credit risk), and is a common denominator present in the use of all four major payment networks, we suggest that it bear the responsibility to collect the sales or use tax from an eligible transaction. For this obligation to be valid, it must pass *Complete Auto Transit, Inc.*'s four-prong test.[136] We will briefly consider all four parts of this test as applied to the imposition of a use tax collection obligation on an issuing bank.

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131 *See Capital One Bank*, 899 N.E.2d at 79.

132 United States v. Visa U.S.A., Inc., 344 F.3d 229, 235 (2d Cir. 2003).

133 *Id.*

134 *Id.* at 236.

135 *Id.* at 235.

136 Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977). *See* HELLERSTEIN, *supra* note 6, at § 4.12(1).

i. Activity that has a Substantial Nexus with the State

This requirement may be the most troublesome. In the specific situation that we are considering, the obvious issue will be whether the issuing bank is based out of Puerto Rico or not. The payment of a transaction of goods to be consumed in Puerto Rico, by all accounts, has *substantial* nexus with the Island if the issuing bank is in Puerto Rico. Since it would require the disbursement of funds located in Puerto Rico, the transaction would have to make its way through Puerto Rico's financial system, thus availing itself of the protections provided by the Commonwealth. Consequently, the ultimate credit risk would reside in the Island, which means that any collection efforts would involve the local legal system. If the issuing bank is not located in Puerto Rico, then the *substantial* nexus could be harder to establish.

ii. Fairly Apportioned to Activities Carried on by the Taxpayer in the State

In order to meet this test, a tax must be internally and externally consistent.[137] The internal and external consistency of an obligation to collect sales or use taxes does not change if it is imposed on a card issuing bank instead of the vendor, thus we do not foresee apportionment being an issue in this scenario.

iii. Does not Discriminate against Interstate Commerce

In order to meet this requirement, the issuing bank would probably have to be required to collect sales or use taxes for all transactions that it processes involving taxable goods. It may be impermissible to limit the obligation to transactions involving out-of-state vendors.

iv. Is Fairly Related to Services Provided by the State

This requirement will be met as long as the substantial nexus requirement is met, since an issuing bank that is established in the Island clearly avails itself of the infrastructure, protections, and legal system provided by the government of the Commonwealth of Puerto Rico.

Puerto Rico is in a much better position than the states of the Union to impose this obligation on the card issuing banks, that process payments for goods purchased for use in the Island, because most of its residents use cards issued by local banks in these types of transactions. This makes it more likely that the obligation would pass *Complete Auto Transit, Inc.*'s four part test if it were to be challenged on *dormant* Commerce Clause grounds.

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137 Okla. Tax Comm'n v. Jefferson Lines, Inc., 514 U.S. 175, 185 (1995).

C. Require from all Vendors the Collection of the Existing Use Tax and Invoke Section Three of the Puerto Rico Federal Relations Act against any Dormant Commerce Clause Challenge

This recommendation may seem to go directly against *Quill* (at least as it concerns out-of-state vendors with no physical presence in Puerto Rico), which as we have mentioned has not been overruled. Examining the Court's decision and rationale, however, may lead to a different conclusion if Puerto Rico's unique legal situation is considered. In *Quill*, the Court stressed how Congress was free to overturn the physical presence requirement. Some might even argue that the Court *wanted* Congress to do so.[138] The main issue with the *Quill* situation is that Congress has not acted and remains silent about its position on the physical presence requirement, at least as it pertains to the states. Puerto Rico could be a different story.

Congress, through section three of the *Puerto Rico Federal Relations Act*, granted Puerto Rico a taxing power that none of the states of the Union have.[139] Because of its importance, we reproduce it in its entirety:

> The internal-revenue taxes levied by the Legislature of Puerto Rico in pursuance of the authority granted by this chapter on articles, goods, wares, or merchandise may be levied *and collected as such legislature may direct*, on the articles subject to said tax, *as soon as the same are manufactured, sold, used, or brought into the island*: *Provided*, That no discrimination be made between the articles imported from the United States or foreign countries and similar articles produced or manufactured in Puerto Rico. The officials of the Customs and Postal Services of the United States are directed to assist the appropriate officials of the Puerto Rican government in the collection of these taxes.[140]

An important detail is when it is said that taxes may be "collected as such legislature may direct . . . as soon as the [taxable articles] are manufactured, sold, used, or brought into the island . . . ."[141] This is a very broad grant of authority as it relates to the collection of taxes on imported articles. We emphasize that a *dormant* Commerce Clause challenge is proper when Congress has failed to legislate on the subject. Thus, we are of the opinion that a *dormant* Commerce Clause challenge against the imposition of an obligation on an out-of-state vendor, by the Government of the Commonwealth of Puerto Rico, to collect use tax on merchandise sold for use in Puerto Rico, would be unsuccessful because, among other reasons, Congress affirmatively granted Puerto Rico the power to collect such a tax in section three of the *Puerto Rico Federal Relations Act*.

This is a similar argument to the one presented by the Secretary of the Treasury in defense of the excise tax collection mechanism at issue in *United*

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138 *See* HELLERSTEIN, *supra* note 6, § 19.02(3)(c)(vi).

139 W. India Oil Co. v. Domenech, 311 U.S. 20, 25-28 (1940).

140 Puerto Rico Federal Relations Act § 3, 48 U.S.C. § 741a (2014) (emphasis added).

141 *Id.*

Parcel Serv., Inc. The reason why the argument was not successful in that case was because the mechanism was *preempted* by federal legislation. The mechanism was not held to be in violation of the Commerce Clause even though it substantially burdened interstate commerce.[142] The First Circuit Court of Appeals instead reasoned that section three of the *Puerto Rico Federal Relations Act* could not have authorized Puerto Rico to restrict the delivery of packages by air carriers. The Appeals Court conceded that this interpretation was necessary in order to avoid conflict between two federal statutes, in this case the *Puerto Rico Federal Relations Act* and the F.A.A.A.A.[143] In the case of an imposition of a use tax collection duty on an out-of-state vendor, there would be no conflict with another federal statute since, as the Supreme Court recognized in *Quill*, there is no Congressional directive on this subject.[144]

The appeal of this course of action is, of course, that it does not require overruling a standing precedent of the United States Supreme Court (as weak as some may argue it to be), because section three of the *Puerto Rico Federal Relations Act* does not apply to the states and was not considered in either the *National Bellas Hess, Inc.*, holding nor in *Quill*'s. We have already discussed strong reasons to believe that the Court will take any opportunity that is given for it to *not* follow *Quill*, and rule on other grounds. We believe that the Court was hesitant to follow *Quill,* even before it decided *Quill*. The case upheld a rule established in 1967 by the Court in *National Bellas Hess Inc.*,[145] while apologetically stating that "contemporary Commerce Clause jurisprudence might not dictate the same result were the issue to arise for the first time today."[146]

We have also seen that the Court has been shy in reviewing decisions in which challenges to state statutes that may not be consistent with *Quill* have been rejected. Some of this may be evident in the Court's refusal to grant *certio-*

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142 United Parcel Serv., Inc. v. Flores-Galarza, 318 F.3d 323, 332-34 (1st Cir. 2003).

143 As the Appeals Court explained:

> In our view, the Federal Relations Act and the FAA Authorization Act can co-exist harmoniously. Our analysis proceeds down a well worn path: where two federal statutes are alleged to be in conflict, we look to whether they touch upon the same subject, and if so, whether we can give effect to both statutes. We are further guided by the familiar principle of construction that implied repeals are disfavored. *Here, the statutes at issue address two very different subjects: Puerto Rico's taxing authority on the one hand and deregulation of the air transportation industry on the other*.

Id. at 333-34 (citations omitted) (emphasis added).

144 In *Quill*, the Court said the following:

> [Congress'] decision not to take action in this direction may, of course, have been dictated by respect for our holding in *Bellas Hess* . . . but today we have put that problem to rest. 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 use taxes.

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

145 Nat. Bellas Hess, Inc. v. Dept. of Revenue, 386 U.S. 753 (1967).

146 *Quill Corp.*, 504 U.S. at 311.

rari in *Overstock.com, Inc. v. New York State Department of Taxation & Finance*.[147] At issue in this case was a law passed by the State of New York that established a *presumption* that an out-of-state vendor had sufficient nexus with New York for it to impose an obligation to collect use tax on items sold for consumption in New York if the out-of-state vendor has an agreement with a resident of New York under which the resident refers potential customers to the seller by a link in an internet website.[148] As we saw in *Tyler Pipe Industries, Inc.*, the use of an independent contractor procuring sales in a state may provide sufficient nexus for the imposition of use tax collection duties.[149] Thus, in so far as the New York resident procures sales on behalf of the out-of-state vendor, the presumption does not pose any problems. The problem arises when the New York resident merely provides a link to the out-of-state vendor's website in its own page. It is doubtful that the mere advertisement in a state establishes the physical presence requirement of *National Bellas Hess Inc.* and *Quill*.[150] Although the statute does provide for a rebuttal of the presumption in the event that the New York resident does not solicit business on behalf of the out-of-state vendor, the process for doing so is an uphill climb. New York's highest Court ruled that the statute complied with the *substantial* nexus requirement because through the agreements that the statute contemplates, a vendor is deemed to have established a local sales force. Regarding the difficult issue of the situation in which the resident, contrary to the statutory presumption, did not actively engage in the solicitation of business for the out-of-state vendor, the New York Court of Appeals held that the statute gave "a fair opportunity for the opposing party to make [a] defense."[151]

The United States Supreme Court denied *certiorari*. The statute has since been adopted in many states,[152] including Puerto Rico in 2013.[153]

i. Procedural note: The *Butler Act*

We have just discussed a defense that the Commonwealth of Puerto Rico could present in the case of a Commerce Clause challenge to its imposition of an obligation to collect use taxes on an out-of-state vendor with no physical pres-

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147 Overstock.com, Inc. v. Dept. of Taxation & Fin., 987 N.E.2d 621 (N.Y. 2013), *cert. denied*, 134 S. Ct. 682 (2013).

148 N.Y. Tax Law § 1101(b)(8)(vi) (McKinney 2014).

149 Tyler Pipe Indus. v. Dept. of Revenue, 483 U.S. 232 (1987).

150 As professor Hellerstein explains: "Because we doubt that an out-of-state vendor has substantial nexus in New York from posting advertisements on New York residents' property, resulting in $10,000 of sales to New York customers, we doubt that the digital analogue to such an arrangement should create nexus." HELLERSTEIN, *supra* note 6, at § 19.02(7)(a).

151 *Overstock.com, Inc.*, 987 N.E.2d at 622 (citations omitted).

152 HELLERSTEIN, *supra* note 6, § 19.02(7)(a) n.310.

153 Enmiendas al Código de Rentas Internas para un nuevo Puerto Rico, Ley Núm. 42 de 30 de junio de 2013, 2013 LPR 511.

ence in Puerto Rico. It is important to point out that, under federal law, any challenge to a Puerto Rico statute that imposes such an obligation would have to be seen in the local courts.

The *Butler Act* establishes that "[n]o suit for the purpose of restraining the assessment or collection of any tax imposed by the laws of Puerto Rico shall be maintained in the United States District Court for the District of Puerto Rico."[154] The *Butler Act* has been interpreted to be the equivalent of the *Tax Injunction Act*,[155] which asserts: "The district courts shall not enjoin, suspend or restrain the assessment, levy or collection of any tax under State law where a plain, speedy and efficient remedy may be had in the courts of such state."[156] Referring to the scope of the *Tax Injunction Act*, the United States Supreme Court has said:

> It is plain from this language that the Tax Injunction Act prohibits a federal district court, in most circumstances, from issuing an injunction enjoining the collection of state taxes. Although this Court once reserved the question, we now conclude that the Act also prohibits a district court from issuing a declaratory judgment holding state tax laws unconstitutional.
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> . . . [T]he Act divests the district court not only of jurisdiction to issue an injunction enjoining state officials, but also of jurisdiction to take actions that "suspend or restrain" the assessment and collection of state taxes.[157]

The *Butler Act* affords the Commonwealth of Puerto Rico a significant advantage over a plaintiff that challenges the constitutionality of the imposition of a tax collection duty because the suit would have to be presented in state court.[158] The only federal remedy available would be a review by the United States Supreme Court after the case has made its way through Puerto Rico's courts. Assuming a ruling favorable to the Government by Puerto Rico's highest court, it seems unlikely that the United States Supreme Court would grant *certiorari* and reverse the decision because this would require upholding *Quill*. Even in the improbable scenario in which the Court accepts to review the case, it

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154 Butler Act, 48 U.S.C. § 872 (2014).

155 Trailer Marine Transport Corp. v. Rivera Vazquez, 977 F.2d 1, 5 (1st Cir. 1992).

156 Tax Injunction Act, 28 U.S.C. § 1341 (2012).

157 California v. Grace Brethren Church, 457 U.S. 393, 408 (1982).

158 In *United Parcel Service, Inc. v. Flores-Galarza*, the First Court of Appeals concluded that the District Court had jurisdiction to see the case, notwithstanding the *Butler Act*, because the relief that U.P.S. sought was from the prohibition or interference with its delivery of packages, not from the imposition or collection of a tax. As the Appeals Court explained:

> [T]he action initiated by UPS sought to enjoin only those provisions of the laws and regulations of Puerto Rico that prohibit or interfere with the delivery of packages. UPS did not challenge the amount or validity of the excise tax, nor the authority of the Secretary to assess or collect it. The relief sought by UPS leaves the Secretary free to collect the tax from those who owe it.

United Parcel Serv., Inc. v. Flores-Galarza, 318 F.3d 323, 330-31 (1st Cir. 2003).

seems more plausible that either *Quill* is overruled,[159] or the Court opts to rule on other grounds, such as the one we are proposing under section three of the *Puerto Rico Federal Relations Act*.[160]

CONCLUSION

If there is one thing that Puerto Ricans can currently agree on, it is that Puerto Rico needs more jobs and economic growth, and that the burden of funding the government should be distributed more fairly than it is today. The physical presence requirement of *Quill* frustrates both aspirations by placing local merchants in an artificial competitive disadvantage and exempting out-of-state vendors from paying their fair share of the tax revenue that supports the consumer market that they exploit. A higher tax on consumption, as sound economic and fiscal policy as it may be, may exacerbate this situation.

In this article we have reviewed the origins of the Commerce Clause and the principles for which the Court has interpreted that it stands for. The Commerce Clause has been a tool used to make the United States one nation, instead of a patchwork of states, by empowering Congress to adopt economic policies that promote the welfare of the nation as a whole. It has been accepted that the welfare of the nation is best promoted through the free flow of commerce, labor and capital. Laws or regulations implemented by the states that have unduly burdened interstate commerce and the free flow of commerce, labor and capital have been struck down under the doctrine of the *dormant* Commerce Clause. The overriding concern of the Court when interpreting the Commerce Clause has been state regulations with protectionist intentions that look to favor in state interests at the expense of interstate commerce.

We have discussed how the physical presence requirement upheld in *Quill* serves none of these interests. We believe that, as it stands, it is closer to promoting economic disintegration than a unified national economy. The rule rewards the lucky states in which big retailers have established operations and deprives those states that have not, from valuable tax revenue. The exact same transaction may be taxable in one state, but not in another, merely because of where a vendor has a physical presence and not because of the public policy of any state to that effect. By protecting out-of-state vendors at the expense of local merchants, the Judiciary is determining winners and losers in our economy, instead of the forces of the free market.

The dramatic development of information technology, in the time since *Quill* was decided, has completely undermined the concerns that the Court had of the burden on out-of-state vendors of having to collect taxes on behalf of hundreds of taxing jurisdictions. The rise of electronic payments and the soft-

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159 See *Direct Marketing Assn. v. Brohl*, where Justice Kennedy declared that "[t]he legal system should find an appropriate case for this Court to reexamine *Quill* and *Bellas Hess*." Direct Marketing Assn. v. Brohl, 135 S.Ct. 1124, 1135 (2015) (Kennedy, J., concurring).

160 Puerto Rico Federal Relations Act § 3, 48 U.S.C. § 741a (2012).

ware to manage them has allowed merchants to comply with complex regulatory and taxing requirements without having to devote a significant amount of human resources in doing so. Although the Court in *Quill* rejected the argument about changes in technology and the economy in the twenty-five years that transpired between *National Bellas Hess, Inc.*, and *Quill,* and justified doing away with the physical presence requirement, we believe that the systemic and structural changes that have taken place since *Quill* are much more dramatic and would merit a revision of the rule. Justice Kennedy, who voted in *Quill* in favor of upholding the physical presence requirement on *stare decisis* grounds, has already said as much.[161]

Just as we believe that the Court should not wait any longer on Congress, Puerto Rico should not wait until the Court overrules *Quill* to take action on this matter. In 2013, the Legislature recognized the problem, and took some steps in the right direction by approving the *click through nexus* statute passed in New York.[162] Clearly, however, more needs to be done. We have proposed three possible courses of action that would address the ills that *Quill* is currently inflicting in Puerto Rico. Aside from these suggestions, the message that we have set out to convey is that *Quill* is a weak precedent bound to fall at any time. Considering our current economic hardship, now is the time to act to protect our small and medium businesses from unfair competition.

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161 *See* Quill Corp. v. North Dakota, 504 U.S. 298, 319 (1992) (Scalia, J., concurring). In *Direct Marketing. Assn.*, Justice Kennedy asserted that:

> Three Justices concurred in the judgment, stating their votes to uphold the rule of *Bellas Hess* were based on *stare decisis* alone. (Scalia, J., joined by Kennedy, J., and Thomas, J., concurring in part and concurring in judgment). *This further underscores the tenuous nature of that holding*—a holding now inflicting extreme harm and unfairness on the States.

Direct Marketing Assn., 135 S.Ct. at 1134 (Kennedy, J., concurring) (emphasis added) (citation omitted).

162 Enmiendas al Código de Rentas Internas para un nuevo Puerto Rico, Ley Núm. 42 de 30 de junio de 2013, 2013 LPR 511.