Defending Colorado’s Use Tax Reporting Requirement

by Andrew J. Haile

In the course of the recent back-and-forth between states and Internet retailers over the collection of use taxes, Colorado enacted HB 1193, which imposes notice and reporting requirements on retailers that do not collect use taxes on behalf of the state. Unsurprisingly, an action has now been filed challenging the constitutionality of those requirements. The action, brought by the Direct Marketing Association (DMA)1 in Colorado federal district court, contends that the statute’s notice and reporting requirements violate the dormant commerce clause doctrine.2 A Pinch of SALT viewpoint by Stephen P. Kranz, Diann L. Smith, and Beth Freeman, published by State Tax Notes in April (the SALT viewpoint) argued the same.3 The DMA complaint and the SALT viewpoint might reach the correct conclusion, but whether they do is hardly obvious and most likely turns on the standard of review the court applies to the reporting requirements. In fact, there are plausible, and perhaps even persuasive, arguments that HB 1193 should survive commerce clause review. This article presents some of those arguments.

I. A Quick Overview of HB 1193’s Notice and Reporting Requirements

HB 1193 imposes three separate notice and reporting requirements on retailers that do not collect Colorado use taxes (referred to as “non-collecting retailers” in the regulation enacted under HB 1193).4 The requirements inform Colorado purchasers of their obligation to pay use taxes and to enable the Department of Revenue to determine whether the purchasers are properly paying their use taxes without having to resort to auditing every taxpayer. HB 1193 requires that a noncollecting retailer:

- state on each invoice sent to its Colorado purchasers that Colorado sales or use tax may be due on some sales by the retailer and that the purchaser is required to pay the tax to the Department of Revenue (the transactional notice);
- send to each Colorado purchaser by first-class mail an annual statement summarizing the purchaser’s Colorado purchases for the preceding calendar year and informing the purchaser that he or she is required to pay sales or use tax on those purchases (the annual purchase summary); and
- file with the DOR an annual report identifying each Colorado purchaser and setting forth the total amount of purchases by the purchaser from the retailer during the prior calendar year (the customer information report).

There are two de minimis exceptions to the reporting requirements. First, any noncollecting retailer that had gross sales in Colorado of less than $100,000 in the previous year and that reasonably expects to have gross sales in Colorado of less than $100,000 in the current year is exempt from the reporting requirements. Also, a noncollecting retailer need not send an annual purchase summary

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1 The complaint in the action describes the DMA as “the nation’s largest trade association of organizations marketing products directly to consumers via mail order, telephone orders, and the Internet.” See Direct Mktg. Ass’n v. Huber, No. 10-cv-1546 (D. Colo. June 30, 2010) (complaint, para. 2).
2 The DMA complaint also makes other claims for finding HB 1193’s notice and reporting requirements unconstitutional, including claims arising under the First and 14th amendments. This article only addresses the commerce clause claim.

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1 CCR 201-1 (effective July 30, 2010), hereinafter referred to as Colo. reg. section 39-21-112(3.5).
to any Colorado purchaser whose purchases for the prior calendar year total less than $500.5

Failure by a noncollecting retailer to comply with the reporting requirements carries potentially substantial penalties. Each failure to provide a transactional notice subjects the noncollecting retailer to a $5 penalty. Each failure to provide either an annual purchase summary or a customer information report results in a $10 penalty.6 A regulation issued by the Colorado Department of Revenue places some limits on these penalty provisions — particularly for a failure to comply in the first year that the reporting requirements are applicable to a noncollecting retailer — but ignoring the reporting requirements could result in hefty penalties.

II. Analyzing the Constitutionality of HB 1193’s Notice and Reporting Requirements

Under the Dormant Commerce Clause

One central question about the Colorado legislation is whether these notice and reporting requirements violate the dormant commerce clause. Given the complexity of the dormant commerce clause analysis in the e-commerce context, a little background is necessary to answer this question.

A. Some Context for the Reporting Requirements

In Quill v. North Dakota,7 the U.S. Supreme Court held that a state may not impose a use tax collection obligation on retailers that have no physical presence in the state. Stated differently, a retailer must have a physical presence in a state before the state can require the retailer to collect use tax. A retailer with no physical presence may voluntarily collect use tax, but a state cannot require it to do so. Quill left open the possibility of Congress enacting legislation enabling the states to require use tax collection by retailers with no in-state physical presence. Several bills have been introduced to that effect, including the current Main Street Fairness Act (H.R. 5660). To date, however, none of those bills have been enacted.

As a result of that congressional inaction, and because of the physical presence requirement set by the Court in Quill, the obligation to report purchases from out-of-state retailers8 and to pay the taxes owed on those purchases often falls entirely on the purchaser. But with no reporting mechanism to inform the state when out-of-state purchases are made, a state typically has no way to determine whether a purchaser is actually meeting its use tax obligation unless the state performs an audit of the purchaser. Of course, auditing every taxpayer is both inefficient (given the small amount of use tax liability that may be involved for any individual taxpayer) and ineffective (given the limited resources available to the state to perform audits).

Many taxpayers appear to have recognized the difficulty states have in policing their use tax statutes; they frequently fail to self-report their out-of-state purchases and to pay the use taxes they owe on those purchases. For example, a 2008 study by Washington state used information from a random sample of state audits to estimate that use tax noncompliance in Washington was approximately 25 percent (compared with sales tax noncompliance of 1.7 percent).9

A 2009 study by economists at the University of Tennessee conservatively estimates that nationwide annual state and local tax losses resulting from purchasers’ failure to pay use taxes on Internet purchases will exceed $8.6 billion in 2010, with Colorado’s share of these losses totaling at least $130 million.10 That estimate includes only Internet sales; other forms of remote sales (including mail-order and telephone sales) also suffer from substantial use tax noncompliance. The same study estimates that nationwide losses from use tax noncompliance on mail-order purchases will reach $6.8 billion by 2012. Of course, losses on Internet sales are expected to grow as the volume of business taking place over the Internet continues to expand. The University of Tennessee study estimates that nationwide revenue losses from use tax noncompliance on Internet purchases will reach as high as $12.65 billion in 2012.

States have made several attempts to improve use tax compliance. These efforts include notifying consumers of the use tax obligation by mailing informational letters to taxpayers and adding a use tax self-reporting line on the state’s individual tax returns.11 More recently, some states have sought legislative remedies by deeming a retailer to have an in-state physical presence based on the retailer’s

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6C.R.S.A. section 39-21-112(3.5) (2010).
8As used throughout this article, “out-of-state retailers” refers to retailers with no in-state physical presence that would render them subject to a use tax collection obligation.

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marketing relationships with in-state companies.\(^\text{12}\)
However, none of those measures have produced widespread success.
HB 1193’s reporting requirements represent Colorado’s attempt to deal with the growing problem of use tax noncompliance.

**B. Constitutionality Under the Dormant Commerce Clause**

And so, back to the question of HB 1193’s constitutionality under the dormant commerce clause. DMA’s complaint and the SALT viewpoint argue that the statute’s reporting requirements violate the dormant commerce clause for three basic reasons:

- they run afoul of the Supreme Court’s *Quill* decision;
- they discriminate against interstate commerce by imposing a burden on out-of-state retailers that does not apply to in-state retailers; and
- even if not discriminatory, the reporting requirements impose burdens on interstate commerce that outweigh the benefits resulting from the requirements.

Each of those arguments will be addressed in turn.

**1. The Reporting Requirements’ Alleged Inconsistency With Quill**

Both the complaint and the SALT viewpoint argue, though for different reasons, that the Supreme Court’s holding in *Quill* invalidates the reporting requirements. The complaint contends that a state may not impose an information reporting requirement on retailers that have no physical presence in the state. It says that “there must be a sufficient, minimum connection between an out-of-state retailer and a state, in the form of a physical presence, before the state may impose regulatory obligations on such retailers of the type imposed by [HB 1193].”\(^\text{13}\)

In effect, the complaint argues that the same nexus requirement that applies to use tax collection obligations also applies to information reporting obligations, and therefore the same physical presence requirement holds in both situations. The SALT viewpoint, however, argues that HB 1193’s reporting requirements conflict with what the viewpoint authors see as the underlying basis for the Court’s decision in *Quill*: a concern over the burden on businesses that would result if they had to comply with use tax collection obligations in the thousands of different taxing jurisdictions throughout the country.

**a. The DMA’s Proposed Extension of the Physical Presence Requirement.** The DMA’s attempt to extend the physical presence requirement to information reporting fails because it extends the *Quill* decision beyond its intended bounds. In summarizing its holding, the Supreme Court in *Quill* specified that the physical presence requirement it had first announced 25 years earlier in *National Bellas Hess, Inc. v. Department of Revenue of Illinois*\(^\text{14}\) and confirmed in *Quill* was intended to dictate the permissible reach of sales and use tax collection obligations but did not apply to other taxes. The *Quill* Court made this clear by summarizing its holding in the case as follows: “In sum, although 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.”\(^\text{15}\)

To extend the limited physical presence requirement to information reporting statutes contradicts the Court’s intention to limit the requirement to sales and use tax collections.

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\(^{13}\) *National Bellas Hess, Inc. v. Dept’ of Rev. of Ill.*, 386 U.S. 753 (1967).


the DMA’s attempt to create a physical presence requirement for information reporting statutes based on a nexus standard that is entirely inapplicable to nontax statutes misses the mark.

b. Overemphasis on the Administrative Burden in Quill. The SALT viewpoint’s argument that HB 1193’s reporting requirements create the exact type of burden on interstate commerce that Quill sought to avoid overemphasizes the relevance of the burden analysis in Quill and overstates the burden associated with HB 1193’s reporting requirements. The Quill Court expressed concern that if North Dakota could extend its use tax collection obligation to out-of-state retailers, “similar [use tax collection] obligations might be imposed by the Nation’s 6,000-plus taxing jurisdictions.”

But that concern was not determinative in the Court’s decision to uphold the physical presence requirement.

Rather, the Court relied on two other reasons for reaching the decision it did in Quill. First, it explained that a bright-line physical presence rule for imposing a use tax collection obligation “encourag[e(d)] settled expectations” about the reach of sales and use tax statutes and “in so doing, fostered investment by businesses and individuals.”

Also, the Quill Court cited the “doctrine and principles of stare decisis” as the basis for maintaining the physical presence rule that (as previously noted) had been established a quarter-century earlier in Bellas Hess. In fact, the Court at least implicitly rejected the idea that the administrative burden associated with use tax collection, standing alone, would have caused it to maintain the physical presence requirement. The Court said that if it were considering the physical presence requirement as a matter of first impression, “contemporary Commerce Clause jurisprudence might not dictate the same result as Bellas Hess.” Therefore, the burden caused by the use tax collection obligation constituted a consideration for the Court, but did not dictate the result in Quill.

It appears likely that the Court would consider the reporting requirements to be significantly less onerous than the burden of actually collecting use taxes.

Also, contrary to the argument made in the SALT viewpoint, it appears likely that the Court would consider the reporting requirements to be significantly less onerous than the burden of actually collecting use taxes that was considered in Quill. In considering a tax collection obligation, the Quill Court noted the “many variations in rates of tax, in allowable exemptions, and in administrative and record-keeping requirements” that might apply in each of the “6,000-plus taxing jurisdictions” that could impose a duty to collect use tax. With an information reporting requirement, however, two of those concerns (rates of tax and allowable exceptions) do not even apply. There is no need to keep track of changing tax rates or occasional exceptions (like sales and use tax holidays), as would be required with a use tax collection obligation. Moreover, under the final regulations issued under HB 1193, the reporting requirements call for out-of-state retailers to report information that practically every business of any size already maintains, thereby minimizing the “administrative and record-keeping” concern mentioned in Quill.

For example, the regulation under HB 1193 specifies that the transactional notice, which must be sent along with any invoice for an out-of-state purchase, need only state the following:

- the noncollecting retailer does not collect sales or use tax;
- the purchase is not exempt from Colorado sales or use tax merely because it is made over the Internet or by other remote means; and
- Colorado requires that the purchaser file a sales or use tax return at the end of the year reporting all the taxable Colorado purchases that were not taxed and pay taxes on those purchases.

The noncollecting retailer may also include the following information in a transactional notice:

- The retailer will provide an end-of-year summary of Colorado purchases to the customer to assist in filing their tax report.

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16Quill, supra note 14, at 313 n.6.
17Id. at 316. This point seems less relevant to Internet commerce today than it may have to mail-order businesses at the time the Supreme Court first established the physical presence requirement in Bellas Hess in 1967. Internet commercial activities constitute a significant and rapidly expanding component of the national economy. See, e.g., Fair Housing Council v. Roomates.com, LLC, 551 F.3d 1157 (9th Cir. 2008) (“The Internet is no longer a fragile new means of communication that could easily be smothered in the cradle by overzealous enforcement of laws and regulations applicable to brick-and-mortar businesses. Rather, it has become the dominant — perhaps the preeminent — means in which commerce is conducted.”). That makes it difficult to argue that imposing any form of burden (no matter how minimal) on remote Internet sales will critically hamper investment in Internet commerce by businesses and individuals. In contrast, the Quill Court attributed the “mail-order industry’s dramatic growth over the last quarter century . . . in part to the bright-line exemption from state taxation created in Bellas Hess.”
18Id. at 317.
19Id. at 316.
Details of how and when to file a return may be found on the Department of Revenue’s website.

The retailer is required to provide the Department of Revenue with an annual report of the total dollar amount of all of a Colorado purchaser’s Colorado purchases at the end of the year. The retailer will not provide any other details of the transaction to the Department other than the amount of the purchase.  

All of that information, including the required statements, amounts essentially to boilerplate language intended to inform the purchaser of the obligation to pay use taxes and that the DOR will receive limited information allowing it to confirm whether the purchaser is meeting that obligation. The annual purchase summary sent to the purchaser at the end of the year requires much of that same boilerplate information, as well as a summary of the ‘date(s) of purchase(s), a description of the type of item(s) purchased (e.g., food, books and movies, electronics, software, digital goods, prescription medications), and the dollar amount(s) of the purchase(s).’  

In effect, the annual purchase summary calls for only three bits of purchase-specific information (when, what, and how much). Finally, the customer information report to be filed with the DOR is even simpler: It requires only the name, address, and ‘total dollar amount of Colorado purchases made by each Colorado purchaser during the prior calendar year.’ Given that any business with less than $100,000 in Colorado sales is exempt from all three reporting requirements, the information called for by the reporting requirements should be readily available to any business subject to the requirements. The SALT viewpoint’s position that the reporting obligation may be more burdensome than actual use tax collection is difficult to accept given the basic information called for by the reporting requirements.

The SALT viewpoint also expressed concern over the number of taxing jurisdictions that could require comparable reporting. That same issue applied to another state: The retailer is required to provide a similar notice [to the annual purchase notice], and the retailer provides a single such notice to all purchasers with respect to items purchased for delivery in all states, the notice required [by Colorado] shall be sufficient if it contains substantially the information required in a form that is generalized to any state.  

Although that language doesn’t eliminate the problem of multiple taxing jurisdictions requiring information reports, it mitigates the problem and again reduces the reporting burden compared with the use tax collection burden considered in Quill.

The SALT viewpoint overemphasizes the role that concern about administrative burden played in the Court’s Quill decision and overstates the actual burden created by the reporting requirements.

In sum, the arguments made by the DMA complaint and the SALT viewpoint that Quill dictates finding the reporting requirements unconstitutional suffer from some shortcomings. The DMA complaint attempts to extend Quill’s physical presence requirement beyond the narrow bounds in which the Court intended it to apply. The SALT viewpoint overemphasizes the role that concern about administrative burden played in the Court’s Quill decision and overstates the actual burden created by the reporting requirements.

2. The Allegation That the Reporting Requirements Discriminate

Both the complaint and the SALT viewpoint argue that the reporting requirements discriminate against interstate commerce. Under the Supreme Court’s precedent, if the reporting requirements discriminate they are presumed invalid:

When a state statute clearly discriminates against interstate commerce, it will be struck down unless the discrimination is demonstrably justified by a valid factor unrelated to economic protectionism. Indeed, when the state statute amounts to simple economic protectionism, a "virtually per se rule of invalidity" has applied.

If a state statute is found to discriminate, the burden falls on the state “to justify it both in terms of the local benefits flowing from the statute and the

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unavailability of nondiscriminatory alternatives adequate to preserve the local interests at stake.”

The Court has referred to this standard of review for discriminatory state statutes as “rigorous scrutiny.” Only in a limited number of cases have statutes withstood that rigorous scrutiny, and those cases have involved issues relating to public health and safety.

However, if the court determines that the statute does not discriminate, a much more lenient standard of review applies. In particular, in Pike v. Bruce Church, Inc., the Court held that if a statute does not discriminate, a reviewing court balances the competing interests:

Where the statute regulates even-handedly to effectuate a legitimate local public interest, and its effects on interstate commerce are only incidental, it will be upheld unless the burden imposed on such commerce is clearly excessive in relation to the putative local benefits. If a legitimate local purpose is found, then the question becomes one of degree. And the extent of the burden that will be tolerated will of course depend on the nature of the local interest involved, and on whether it could be promoted as well with a lesser impact on interstate activities.

a. What Makes a Statute Discriminatory?

Despite the importance of the inquiry into whether a statute discriminates against interstate commerce, the Supreme Court has failed to offer clear guidance on that point. In fact, the Court has acknowledged that there is no “clear line” in determining whether a statute discriminates. In one context, the Court has said that discrimination “simply means differential treatment of in-state and out-of-state economic interests that benefits the former and burdens the latter.” In other cases, the Court has taken a less expansive interpretation of the term, saying that discrimination “in the constitutionally prohibited sense” refers to a “protectionist enactment.” The Court has also indicated that in some instances differential treatment between in-state and out-of-state economic interests may not constitute discrimination.

For example, in Philadelphia v. New Jersey the Court considered the constitutionality of a New Jersey statute prohibiting the importation of “solid or liquid waste which originated outside the territorial limits” of New Jersey. In considering the commerce clause challenge to the statute, the Supreme Court stated that “the crucial inquiry . . . must be directed to determining whether [the statute] is basically a protectionist measure, or whether it can fairly be viewed as a law directed to legitimate local concerns, with effects upon interstate commerce that are only incidental.” New Jersey argued that the statute was intended to protect the state’s environment, while those challenging the statute argued that its true purpose was “to suppress competition and stabilize the cost of solid waste disposal for New Jersey residents.” Ultimately, however, the Court said that it did not need to decide the parties’ dispute over the legislative purpose for the statute because “whatever New Jersey’s ultimate purpose, it may not be accomplished by discriminating against articles of commerce coming from outside the State unless there is some reason, apart from its origin, to treat them differently.” This indicates that a statute with a discriminatory effect on out-of-state economic interests will be struck down unless there is a legitimate, non-protectionist reason to treat those out-of-state interests differently. Moreover, the Court’s reference to “whatever New Jersey’s ultimate purpose” (whether environmental or economic) implies that disparate effects based even on economic interests (like effective tax enforcement) may withstand commerce clause review if there is a legitimate reason for that disparate treatment.

Despite the importance of the inquiry into whether a statute discriminates against interstate commerce, the Supreme Court has failed to offer clear guidance.

And so “discrimination” for commerce clause purposes has in some instances been explained as simply disparate treatment of out-of-state economic interests. In other situations, however, it appears that the Court considers whether the legislation is protectionist — in either purpose or effect. And even if there is a protectionist effect, that effect still might not constitute discrimination “in the constitutionally prohibited sense” if there is a legitimate reason for the differential treatment of out-of-state economic interests. Or, as previously stated by the Court, “[a]ny...
notion of discrimination assumes a comparison of substantially similar entities.\textsuperscript{38} If economic interests are not similarly situated, then disparate treatment may not constitute “discrimination.”

The issue over what standard of review to apply to HB 1193’s reporting requirements may turn, then, on whether the reviewing court simply looks at differential treatment of out-of-state retailers or whether the court considers the reason for that treatment. Clearly, the reporting requirements place a burden on out-of-state retailers that differs from the burden placed on in-state retailers. In-state retailers must collect and remit sales or use tax,\textsuperscript{39} but they are not subject to HB 1193’s reporting requirements. On the other hand, any retailer “that sells goods to Colorado purchasers and that does not collect Colorado sales or use tax” must either come within the de minimis exemptions to the reporting requirements or comply with those requirements.\textsuperscript{40}

There is, of course, a legitimate basis for that differential treatment: Only out-of-state retailers have no legal obligation to collect and remit use tax on behalf of the state. There would be no rational reason for applying the reporting requirements to in-state retailers — they actually collect the tax. So although the reporting requirements fall exclusively on out-of-state retailers, there is a legitimate, non-protectionist basis for that differential treatment that may lead a court to consider the statute non-discriminatory. Stated differently, in-state and out-of-state vendors are not substantially similar entities because on in-state vendors must collect sales tax, a burden not borne by out-of-state vendors.

b. Any Case Law on Point? During the era of modern commerce clause jurisprudence, the U.S. Supreme Court has not considered the constitutionality of a reporting statute that falls exclusively on out-of-state economic interests,\textsuperscript{41} but one state supreme court has. In First Family Mortgage Corp. of Florida v. Durham,\textsuperscript{42} the “sole issue” before the New Jersey Supreme Court was whether New Jersey’s Corporation Business Activities Reporting Act (the Reporting Act) violated the commerce clause.\textsuperscript{43} The Reporting Act\textsuperscript{44} required that foreign corporations not registered to do business in New Jersey file an activities report annually with the director of the Division of Taxation if the corporation received payments from persons residing in New Jersey, or businesses located in New Jersey, aggregating more than $25,000 regardless of any other connections with the state.\textsuperscript{45}

The purpose of the activities report requirement, as explained by the New Jersey Tax Policy Committee, was to ensure compliance by foreign corporations with New Jersey’s second-tier income tax. The second-tier income tax required companies not registered to do business in New Jersey to pay income tax to the state on income derived from New Jersey sources (like mortgage payments by New Jersey residents). To that end, the Tax Policy Committee proposing the Reporting Act explained:

It is important, in order to safeguard the state’s revenues, and reduce unfair tax-free competition with businesses that pay taxes to this State, that the Legislature adopt a more effective technique for discovering foreign corporations that may be taxable, but that are now paying no taxes, and would otherwise escape the broadened jurisdiction of the proposed second tier tax. To seek to accomplish that objective we propose that a statutory provision be adopted requiring certain non-qualified foreign corporations to file with the Division of Taxation a Notice of Business Activity.\textsuperscript{46}

The New Jersey Legislature accepted the recommendation from the Tax Policy Committee and adopted the Reporting Act, including its activities report requirement. The activities report required foreign corporations to answer a series of questions\textsuperscript{47} aimed at enabling the Division of Taxation, rather than foreign corporations themselves, to determine whether the corporations were subject to taxation in New Jersey.\textsuperscript{48}

First Family Mortgage Corp.’s challenge to the Reporting Act came about because the company had

\textsuperscript{38} General Motors Corp. v. Tracy, 519 U.S. 278, 298 (1997).

\textsuperscript{39}N.J.S.A. section 39-26-102(3) (defining “doing business in this state”); sections 39-26-105 (imposing sales tax collection and remittance duties on retailers doing business in Colorado).

\textsuperscript{40}Colo. reg. section 39-21-112 (1)(a)(i).

\textsuperscript{41}The U.S. Supreme Court did uphold a reporting statute under commerce clause review in Arkansas Louisiana Gas Co. v. Dept. of Utilities, 304 U.S. 61 (1938), but that statute did not apply solely to out-of-state companies and the decision turned on the narrow definition of commerce applicable at the time.


\textsuperscript{43}Id. at 279.

\textsuperscript{44}N.J.S.A. 14A:13-14 to -23.


\textsuperscript{46}First Family Mortgage Corp. of Florida v. Durham, 108 N.J. at 283.

\textsuperscript{47}Examples of the questions asked included whether the corporation derived income from sources located in New Jersey; whether the corporation solicited sales in New Jersey; and whether the corporation owned, rented, or leased any property located in New Jersey. See NJ CBA-1, Division of Taxation, Notice of Business Activities Report by a Foreign Corporation.

\textsuperscript{48}See First Family Mortgage Corp. of Florida v. Durham, 500 A.2d 746, 747-748 (N.J. Super. A.D. 1985) (stating that the information required in the activities report “permits the (Footnote continued on next page.)
failed to submit the statutorily required activities reports. Under a separate provision in the Reporting Act, any foreign company that failed to meet the reporting requirement was barred from “maintaining an action or proceeding in any state or federal court in New Jersey to enforce any cause of action accruing during an accounting period in which the corporation failed to file an Activities Report.”

First Family had brought a foreclosure action against a New Jersey borrower, only to have that action dismissed because of the company’s violation of the Reporting Act. Consequently, the company challenged the constitutionality of the Reporting Act.

The New Jersey Supreme Court rejected First Family’s commerce clause challenge to the Reporting Act’s requirement for filing activities reports. In reaching this result, the court said that “in general, a state regulation affecting commerce will be upheld if (a) the regulation is rationally related to a legitimate state end, and (b) the regulatory burden imposed on interstate commerce, and any discrimination against it, are outweighed by the state interest in enforcing the regulation.”

In effect, even though the reporting requirement applied only to out-of-state businesses, the New Jersey Supreme Court applied the less rigorous balancing test to the statute and determined that the benefit of the statute (allowing the New Jersey Division of Taxation to determine tax liability) exceeded the burden placed on foreign corporations in filing the activities reports.

The court did not expressly discuss its reason for applying the balancing test rather than the more rigorous scrutiny applicable to discriminatory statutes. One possible reason is that the problem addressed by the Reporting Act (determining whether foreign corporations were properly reporting income subject to New Jersey’s second-tier income tax) related exclusively to out-of-state corporations and therefore justified differential treatment between in-state and out-of-state entities. Whatever the court’s reasons, First Family provides an example of a court considering and upholding a tax reporting statute that applied only to out-of-state economic interests.

c. Final Thoughts on the Issue of Discrimination. In sum, it is unclear what standard of review the federal district court that is hearing the DMA case will give HB 1193’s reporting requirements. If the reporting requirements are deemed to be discriminatory and therefore receive “rigorous scrutiny,” it is likely they will be struck down because discriminatory measures are rarely upheld and those that are typically deal with health and safety issues not involved here. Alternatively, if the court finds that the reporting requirements address a legitimate problem unique to out-of-state retailers (noncompliance in the use tax owed on goods sold by these retailers), the court, like the New Jersey Supreme Court in First Family, might apply the Pike balancing test in assessing the reporting requirements’ constitutionality under the commerce clause.

3. Weighing the Burdens and Benefits of the Reporting Requirements

If the court finds the reporting requirements are not discriminatory, the court must then apply the Pike balancing test to determine whether “the burden imposed on [interstate] commerce is clearly excessive in relation to the putative local benefits” of the requirements. That balancing exercise has been criticized by one current Supreme Court justice as follows:

This process is ordinarily called “balancing,” but the scale analogy is not really appropriate, since the interests on both sides are incommensurate. It is more like judging whether a particular line is longer than a particular rock is heavy.

Comparing the benefits and burdens of the reporting requirements exemplifies the difficulty of that task.

An obvious benefit to the state from the reporting requirements is the expected increase in tax revenue because of improved enforcement of its use tax statute. As previously mentioned, one study has estimated Colorado’s lost revenue from use tax noncompliance from Internet sales alone at $130 million for 2010. The reporting requirement will not result

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52Pike, 397 U.S. at 142.
53Bendix Autolite Corp. v. Midwesco Enterprises, 486 U.S. 888, 897 (1988) (Justice Antonin Scalia, concurring). One respected commentator has argued that while courts purport to engage in a balancing analysis under the commerce clause, all they actually do (and all they should do) is determine whether the challenged statute has a protectionist purpose. Donald H. Regan, “The Supreme Court and State Protectionism: Making Sense of the Dormant Commerce Clause,” 84 Mich. L. Rev. 1091, 1092 (1986) (“In the central area of dormant commerce clause jurisprudence . . . the Court has been concerned exclusively with preventing states from engaging in purposeful economic protectionism.”).
in collection of all those delinquencies, but it will enable the state to target and pursue the worst use tax scofflaws.

Also, the reporting requirements’ education function and improved use tax enforcement may result in better taxpayer compliance. That will bring in additional revenue. Further, a reduction in noncompliance may itself be regarded as a benefit to the state. Disregard for the tax laws (whether intentional or out of ignorance) may undermine the entire tax system, and if Colorado has anywhere near Washington’s 25 percent noncompliance rate, the court may consider an improvement in compliance rate from the reporting requirements a real, though difficult to monetize, benefit.

On the other side of the ledger, out-of-state retailers will argue that the reporting requirements unduly burden interstate commerce by imposing a costly and time-consuming obligation burden on retailers — even though the retailers themselves are not liable for the use tax, the purchasers are. A recent Government Accountability Office study, although not directly on point, may help in estimating the financial cost of this burden.54 Almost certainly, however, the parties will have to engage experts to estimate the financial burden of assembling and sending the information called for by the reporting requirements.

In addition to that financial burden, some retailers may argue that even though the regulations call only for “the total dollar amount of Colorado purchases” and no other information to be reported to the DOR in the customer information reports (the end-of-year reports filed by the retailer), the identity of the retailer may itself convey some information to the government that the purchaser prefers not to disclose. Consider, for example, a purchase from a pharmaceutical company with a “revealing” name or from a retailer known to sell controversial or embarrassing products. The prospect of such a disclosure might chill purchases from out-of-state retailers, and either result in consumers not making the purchases at all or shifting those purchases to in-state retailers, which have no reporting obligation. That argument might have limited application, given the regulation calling only for purchase amounts and no other information to be reported to the state. Also, that “burden” on out-of-state retailers is difficult to monetize. Nevertheless, the “cost” of disclosing information about purchasers’ buying habits might factor into the court’s balancing.

Certainly there are more benefits and burdens that can, and will, be presented to the court. Whether either party is ultimately persuasive may depend on empirical studies that have not yet been undertaken. Alternatively, the court could rely less on empirical information and more on precedent and reasoning, for example by accepting the argument set forth above that HB 1193’s reporting requirements create less burden than actual use tax collection which, had the Court been writing on a clean slate in Quill, might well have been upheld. After all, as explained by the Supreme Court, “It was not the purpose of the commerce clause to relieve those engaged in interstate commerce from their just share of the state tax burden even though it increases the cost of doing business.” Even so, if the DOR prevails in arguing that the Pike balancing test applies, it is difficult to predict how the court will undertake the balancing analysis or the result that will emerge in comparing the length of a line with the weight of a rock, as Justice Antonin Scalia might characterize this situation.

III. Conclusion

HB 1193 represents an innovative attempt by Colorado to address the common problem of use tax noncompliance. The constitutionality of the statute’s reporting requirements under the commerce clause will most likely turn on the standard of review given those requirements, which depends on whether they are found to be discriminatory. If so, they will receive rigorous scrutiny and likely will fail commerce clause review. If, however, they are viewed as non-protectionist and therefore subject to the Pike balancing test, there is a far greater likelihood they will be upheld.

The constitutionality of the statute’s reporting requirements under the commerce clause will most likely turn on the standard of review given those requirements.

Ultimately, if the court strikes down the reporting requirements, Colorado (and other states) will be more dependent on Congress’s acceptance of the Supreme Court’s invitation in Quill to exercise its commerce clause authority and formulate workable sales and use tax collection rules. Legislation to that effect has been introduced in the Main Street Fairness Act (H.R. 5660). But if congressional inaction persists, the states will have no choice but to continue their own innovative, though ultimately less effective, efforts to address the growing problem of use tax noncompliance on Internet sales — with more litigation sure to follow.

54See, e.g., GAO Report to the Committee on Finance, U.S. Senate, Tax Administration: “Costs and Uses of Third-Party Information Returns” (Nov. 2007) (examining the costs of new federal information reporting requirements).
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