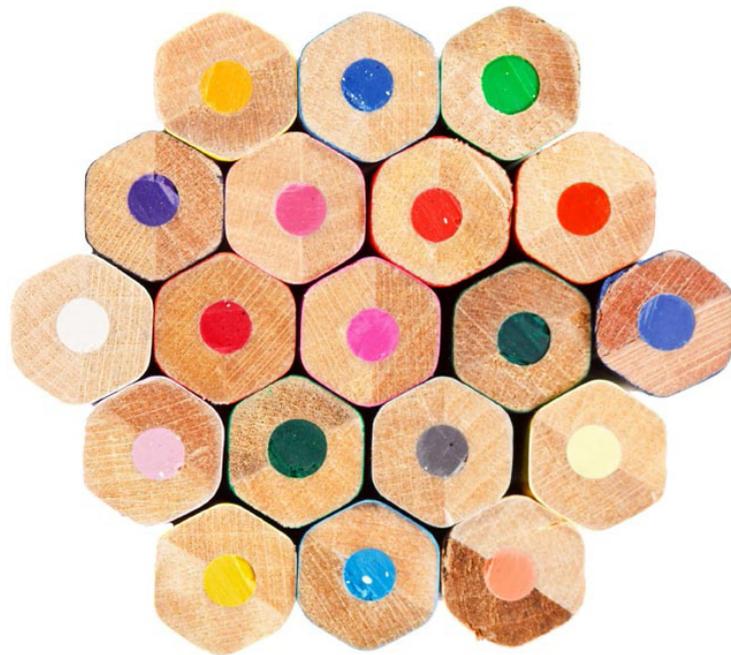


# Direct Marketing Association v. Huber, Federal District Court Finds Colorado Use Tax Reporting Requirements Unconstitutional



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### **Constitutional Limitations**

Supreme Court precedent creates a safe harbor under the Commerce Clause that frees out-of-state vendors from state-imposed duties to collect sales and use tax when their only connection with customers in the taxing state is by common carrier or the United States mail. Alex Meleney, Principal with Deloitte Tax LLP, inquires whether the compensatory tax doctrine, which allows states to impose compensatory taxes to equalize the intrastate and interstate tax burdens, may provide an analytical basis for determining the constitutionality of state reporting requirements imposed on these out-of-state vendors as a means of enhancing enforcement of state use tax on in-state purchasers.

## **Direct Marketing Association v. Huber, Federal District Court Finds Colorado Use Tax Reporting Requirements Unconstitutional**

BY ALEX MELENEY<sup>1</sup>

### **INTRODUCTION**

In *The Direct Marketing Association v. Huber*, No. 10-cv-01546-REB-CBS, (D. Colo. 2012), the United States District Court for the District of Colorado struck down as unconstitutional under the Commerce Clause Colo. Rev. Stat. §39-21-112(3.5), which imposed use tax reporting requirements on out-of-state retailers that made sales to Colorado customers but did not col-

lect the Colorado sales or use tax.<sup>2</sup> The district court found that the Colorado law both discriminated against interstate commerce and placed an undue burden on interstate commerce by imposing an obligation on out-of-state retailers with insufficient contacts with the state under *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992). While it remains to be seen whether the case will be appealed, on the surface the court's analysis appears to be a straight forward application of existing precedent and is likely to be sustained. However, a more detailed look indicates that the court may have overlooked some deeper issues and it is possible, but one cannot say likely, that a higher court might take a different view.

### **THE FACTS AND DISTRICT COURT DECISION**

This case was brought by the Direct Marketing Association ("DMA"), an association of businesses and organizations that market products directly to consumers through catalogues, magazine and newspaper advertisements, broadcast media, and the internet. DMA challenged Colo. Rev. Stat. §39-21-112(3.5), which, beginning on March 1, 2010, required any retailer with

<sup>1</sup> The author would like to thank Fred Paladino, a Director with Deloitte Tax LLP's Washington National Tax – Multistate Group, for his contributions to this article.

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<sup>2</sup> For purposes of this article, the term "out-of-state retailer" refers to a retailer that does not have sufficient nexus with a state to be subject to the requirement to collect and remit the state's sales or use tax under *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

\$100,000 or more of sales to customers in Colorado on which it does not collect and remit Colorado sales tax to: (i) notify its Colorado customers that the retailer does not collect Colorado sales tax and that the customer is required to self-report and pay use tax to the Colorado Department of Revenue (“Department”); (ii) provide to its Colorado customers with over \$500 in annual purchases an annual report detailing the purchases for the previous calendar year; and (iii) provide to the Department an annual report concerning each of the retailer’s Colorado customers, including each customer’s name, billing address, shipping address, and total purchases. DMA asserted that Colorado’s use tax notice and reporting obligations violated the Commerce Clause of the United States Constitution because they either: (i) discriminated against interstate commerce, or (ii) imposed an undue burden on interstate commerce.<sup>3</sup>

In addressing the claim that Colorado’s reporting requirements discriminated against interstate commerce, the district court explained that a state law will be deemed violative of the dormant Commerce Clause, “if it discriminates against interstate commerce either facially or in practical effect.”<sup>4</sup> This requires a two-tier analysis, which the district court explained by reference to the U.S. Supreme Court’s discussion in *Brown-Forman Distillers Corp. v. N.Y. State Liquor Authority*, 476 U.S. 573 (1986) as follows:

[Under the first tier,] “(w)hen a state statute directly regulates or discriminates against interstate commerce, or when its effect is to favor in-state economic interests over out-of-state interests, we have generally struck down the statute without further inquiry.” When “a statute has only indirect effects on interstate commerce and regulates evenhandedly, we have examined whether the State’s interest is legitimate and whether the burden on interstate commerce clearly exceeds the local benefits.” The second tier of the analysis is the balancing of a state’s legitimate interests with the burden on interstate commerce . . . .<sup>5</sup>

Applying the first tier of this analysis, the district court noted that in-state retailers must collect the sales tax and that the reporting requirements only applied to retailers that did not collect the sales tax. Since only out-of-state retailers are not required to collect sales tax and are thus subject to the statute’s use tax notice and reporting requirements, the statute and regulations di-

rectly regulate and discriminate against out-of-state retailers and, therefore, interstate commerce.<sup>6</sup> As stated by the district court, Colorado’s “enactment of a statutory scheme and concomitant regulations that produce, in effect, a geographic distinction between in-state and out-of-state retailers discriminates patently against interstate commerce.”<sup>7</sup>

Given this determination, the district court then addressed the second tier of the analysis, namely, whether the statute and regulations “advance a legitimate local purpose that cannot be served adequately by reasonable nondiscriminatory alternatives.”<sup>8</sup> In this regard, the court found: “The record contains essentially no evidence to show that the legitimate interests advanced by the defendant [Colorado Department of Revenue] cannot be served by reasonable nondiscriminatory alternatives.”<sup>9</sup> For these reasons, the court ruled that Colo. Rev. Stat. §39-21-112(3.5) was unconstitutional under the dormant Commerce Clause.

In addressing the claim that the Colorado use tax notice and reporting requirements imposed an improper burden on interstate commerce, the district court explained that the first and fourth prongs of the four-part test enunciated by the U.S. Supreme Court in *Complete Auto Transit Inc. v. Brady*<sup>10</sup> operate to “limit the reach of state taxing authority so as to ensure that state taxation does not unduly burden interstate commerce.”<sup>11</sup> As explained further by the district court, *Quill* established that “vendors whose only connection with customers in the [taxing] State is by common carrier or the United States mail . . . are free from state-imposed duties to collect sales and use taxes.”<sup>12</sup>

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**The court found essentially no evidence to show that the legitimate interests advanced by the state cannot be served by reasonable nondiscriminatory alternatives.**

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According to the district court, that safe harbor or bright line established in *Quill* “is meant to delineate and define the limits of the substantial nexus requirement of the *Complete Auto* test to ensure that a state tax law does not impose an undue burden on interstate

<sup>3</sup> The Commerce Clause authorizes the U.S. Congress to “regulate Commerce . . . among the several States.” *The Direct Marketing Association v. Roxy Huber*, No. 10-cv-01546-REB-CBS (D. Colo. Mar. 30, 2012), slip. op. at 5, citing U.S. Const. art. 1, §8. The Commerce Clause has been interpreted as having a “negative” or “dormant” application as well, prohibiting “certain state actions that interfere with interstate commerce” (*The Direct Marketing Association*, slip. op. at 5, quoting *Quill v. North Dakota*, 504 U.S. 298, 309 (1992)), and denying “States the power unjustifiably to discriminate against or burden the interstate flow of articles of commerce” (*The Direct Marketing Association*, slip. op. at 5, quoting *South Carolina State Highway Dept. v. Barnwell Brothers Inc.*, 303 U.S. 177, 185 (1938)).

<sup>4</sup> *The Direct Marketing Association*, slip. op. at 5-6, citing *Hughes v. Oklahoma*, 441 U.S. 322, 336 (1979).

<sup>5</sup> *The Direct Marketing Association*, slip. op. at 6, quoting *Brown-Forman Distillers Corp. v. N.Y. State Liquor Authority*, 476 U.S. 573, 578 - 579 (1986) (citations omitted).

<sup>6</sup> *The Direct Marketing Association*, slip. op. at 9-11.

<sup>7</sup> *The Direct Marketing Association*, slip. op. at 11.

<sup>8</sup> *The Direct Marketing Association*, slip. op. at 11, citing *Oregon Waste Systems Inc. v. Department of Environmental Quality of Oregon*, 511 U.S. 93, 101 (1994).

<sup>9</sup> *The Direct Marketing Association*, slip. op. at 13.

<sup>10</sup> The first and fourth prongs enunciated in *Complete Auto* provide that a state tax will survive a Commerce Clause challenge if the tax is applied to an activity with a substantial nexus with the taxing state and is fairly related to the services provided by the state. *Complete Auto Transit Inc. v. Brady*, 430 U.S. 274 (1977).

<sup>11</sup> *The Direct Marketing Association*, slip. op. at 15-16, quoting *Quill*, 504 U.S. at 313.

<sup>12</sup> *The Direct Marketing Association*, slip. op. at 15, quoting *Quill*, 504 U.S. at 315.

commerce.”<sup>13</sup> The court also noted that in applying this safe harbor test, it is important to “look . . . past the formal language of a state statute to its practical effect.”<sup>14</sup> Applying the foregoing to the facts before it, the district court pointed out that although the notice and reporting obligations imposed by the Colorado statute and regulations are,

somewhat different than the burden of collecting and remitting sales and use taxes[.]. . . the sole purpose of . . . [these] burdens . . . is the ultimate collection of use taxes when sales taxes cannot be collected. Looking at the practical effect of the Act and Regulations, as *Quill* instructs, I conclude that the burdens . . . are inextricably related in kind and purpose to the burdens condemned in *Quill*.<sup>15</sup>

Accordingly, the court concluded that Colo. Rev. Stat. §39-21-112(3.5) and its associated regulations impose an undue burden on interstate commerce and thus are unconstitutional under the Commerce Clause.

### DISCRIMINATION AGAINST INTERSTATE COMMERCE

The district court in *Direct Marketing Association* appears to be correct that Colo. Rev. Stat. §39-21-112(3.5) imposed burdens on out-of-state retailers that were not imposed on in-state retailers. However, the court appeared to overlook one principle that might cause an appellate court to reach a different conclusion on whether the reporting requirements actually discriminated against interstate commerce. The district court failed to consider whether the reporting requirements were justified under the compensatory tax doctrine, which allows states to impose compensatory taxes to equalize the intrastate and interstate tax burdens.

The district court in *Direct Marketing Association* found that the use tax reporting requirements imposed under Colo. Rev. Stat. §39-21-112(3.5) only applied to out-of-state retailers and therefore discriminated against interstate commerce. However, the compensating use tax is itself discriminatory against interstate commerce as it is imposed only on retailers that have out-of-state sales. Nevertheless, in *Henneford v. Silas Mason, Co.*, 200 U.S. 577 (1937), the U.S. Supreme Court upheld a compensating use tax as not discriminating against interstate commerce because it resulted in an equal burden on intrastate and interstate commerce.

Under that exception, a tax that discriminates against interstate commerce may be upheld if it compensates for an intrastate tax so that the two taxes, when considered together, do not discriminate. The exception is very narrow and in *Oregon Waste Systems Inc. v. Department of Environmental Quality of Oregon*, 511 U.S. 93 (1994), a case relied upon extensively by the district court in *Direct Marketing Association*, the U.S. Supreme Court described the requirements for upholding a compensating tax as follows:

To justify a charge on interstate commerce as a compensatory tax, a State must, as a threshold

matter, “identif[y] . . . the [intrastate tax] burden for which the State is attempting to compensate.” *Maryland, supra*, at 758. Once that burden has been identified, the tax on interstate commerce must be shown roughly to approximate—but not exceed—the amount of the tax on intrastate commerce. See, e.g., *Alaska v. Arctic Maid*, 366 U.S. 199, 204-205 (1961). Finally, the events on which the interstate and intrastate taxes are imposed must be “substantially equivalent;” that is, they must be sufficiently similar in substance to serve as mutually exclusive “prox[ies]” for each other. *Armco, supra*, at 643. As Justice Cardozo explained for the Court in *Henneford*, under a truly compensatory tax scheme “the stranger from afar is subject to no greater burdens as a consequence of ownership than the dweller within the gates. The one pays upon one activity or incident, and the other upon another, but the sum is the same when the reckoning is closed.” 300 U.S., at 584.<sup>16</sup>

Under the compensatory tax doctrine, the Colorado use tax is presumably valid, and it would appear that the district court should have inquired whether the reporting burden placed on out-of-state retailers was greater than the reporting burden placed on in-state retailers. The reporting obligations are different. In-state retailers are required to collect the tax, file returns, and remit the collected tax. Under Colo. Rev. Stat. §39-21-112(3.5), out-of-state-retailers with over \$100,000 of Colorado sales are required to provide information returns to purchasers and the state with respect to purchasers who purchase over \$500 of goods. The information reporting to purchasers is clearly in addition to what in-state retailers are required to report, and the detailed reporting to the state concerning individual purchasers may be more burdensome than the actual collection and filing obligations imposed on in-state retailers. However, the court did not consider the question.

Admittedly, the doctrine applies to “compensating taxes” and the issue here is information reporting, but it is not clear whether the principle should be applied similarly. What if Colorado had adopted a statute that required an out-of-state retailer to file information returns that contained all the information that would have been supplied in a sales or use tax return of a retailer subject to Colorado’s tax, except that the out-of-state retailer did not have to collect and remit the tax?<sup>17</sup> The burden would be the same on in-state and out-of-state retailers and the first part of the district court’s analysis with respect to the reporting requirements’ discrimination against interstate commerce would seem not to apply. In which case, the only issue would be the second issue addressed by the court, whether the reporting requirement placed an undue burden on interstate commerce under the standards established in *Quill*. Should the court have considered the reasonableness of “compensating” reporting requirements?

### UNDUE BURDEN ON INTERSTATE COMMERCE

<sup>16</sup> *Oregon Waste Systems Inc. v. Department of Environmental Quality of Oregon*, 511 U.S. 93, 103 (1994).

<sup>17</sup> The author offers no opinion on the usefulness of the required information to the state.

<sup>13</sup> *The Direct Marketing Association*, slip. op. at 16, quoting *Quill*, 504 U.S. at 313.

<sup>14</sup> *The Direct Marketing Association*, slip. op. at 15, citing *Quill*, 504 U.S. at 310.

<sup>15</sup> *The Direct Marketing Association*, slip. op. at 16-17.

The real issue was not whether the Colorado reporting requirements discriminated against interstate commerce. After all, the out-of-state retailers are not required to collect and remit the sales or use tax, as in-state retailers are required to do. Instead, the real issue is whether the out-of-state retailers had sufficient nexus with Colorado for the state to impose the reporting burden on the out-of-state retailers. Here, the district court in *Direct Marketing Association* was on solid ground in relying on *Quill*. Only retailers that did not meet the *Quill* test for having nexus with Colorado and being required to collect the Colorado sales or use tax were required to comply with the reporting requirements in Colo. Rev. Stat. §39-21-112(3.5). As the court found, the dual reporting requirements imposed by the statute, which required reporting to the purchasers and the state, appear to be as onerous as, or at least comparable to, the requirement to collect and remit the use tax. Thus, as under *Quill*, the out-of-state retailers' connections to Colorado were insufficient to justify the state imposing the reporting requirements on the out-of-state retailers.

Although the district court's reliance on *Quill* as established precedent was sound, it was not necessarily inevitable and it remains to be seen what appellate courts will do, including the U.S. Supreme Court, if the case advances that far.<sup>18</sup> An appellate court could either: (i) differentiate between the burden imposed by the reporting requirements imposed under Colo. Rev. Stat. §39-21-112(3.5) and the collection burden at issue in *Quill* and find that the reporting burden did not unduly burden interstate commerce, or (ii) discern an evolution in the law that reverses *Quill* and liberalizes the states' ability to impose taxes on out-of-state retailers.

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**Colorado's statute requires mailing information to potentially thousands of customers as well as reporting on those same customers to the state.**

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With respect to the degree of burden imposed on interstate commerce, *Quill* relied extensively on an earlier supreme court case, *National Bellas Hess Inc. v. Department of Revenue of the State of Illinois*, 386 U.S. 753 (1967). That case involved essentially the same facts as *Quill* and reached the same conclusion as *Quill* with respect to the invalidity of the state's use tax collection obligation under the Commerce Clause. In justifying its holding, the *Bellas Hess* court had said:

[I]f 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

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<sup>18</sup> As of this writing, the author is unaware of Colorado's intentions with respect to appealing *Direct Marketing Association*.

jurisdictions with no legitimate claim to impose "a fair share of the cost of the local government." [Footnotes omitted.]<sup>19</sup>

Accordingly, the *Bellas Hess* court was concerned that a use tax collection obligation would require the out-of-state retailer to become entangled in state rules concerning state and local tax rates, exemptions, filing obligations, etc.<sup>20</sup> However, the Colorado reporting requirements involve a once-a-year report on sales to Colorado residents. The information needed to complete such a report is completely within the control of the out-of-state retailer and requires no knowledge of the state sales and use tax law beyond the reporting obligations.<sup>21</sup> Thus the reporting burden imposed under Colo. Rev. Stat. §39-21-112(3.5) may not be as onerous as the tax collection burden involved in *Bellas Hess* and, indirectly, in *Quill*. The district court in *Direct Marketing Association* equated the reporting burden with the tax collection burden without serious analysis. An appellate court could find the Colorado reporting requirements sufficiently less burdensome as to pass muster under the Commerce Clause.<sup>22</sup>

Although an appellate court could find the reporting requirements in Colo. Rev. Stat. §39-21-112(3.5) less burdensome than the tax collection and remittance obligations prohibited under *Bellas Hess* and *Quill*, there is certainly a basis for the opposite conclusion. Unlike the typical periodic sales tax returns filed with the state that report gross taxable sales and are accompanied by the remittance of tax, Colo. Rev. Stat. §39-21-112(3.5) requires mailing information to potentially thousands of customers that purchase over \$500 worth of goods as well as reporting the name, address, and purchase information on the same thousands of customers to the state.

Will Colorado then seek to audit such information reporting, thus requiring the out-of-state seller to have maintained detailed records and incur the time and expense necessary to respond to such audit? When viewed in this light, the reporting burden imposed by the Colorado statute appears to be substantial and an appellate court may have to consider whether the *Quill* requirement of physical presence in a state applies equally to

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<sup>19</sup> *National Bellas Hess Inc. v. Department of Revenue of the State of Illinois*, 386 U.S. 753, 759 (1967).

<sup>20</sup> Monitoring the various state and local rules would have been an especially burdensome task in 1967 before the advent of modern computers.

<sup>21</sup> The information required to be reported should be within the knowledge of the out-of-state retailer, but the retailer is required to tell the purchaser whether the purchase was taxable or exempt if known to the retailer. Col. Rev. Stat. §39-21-112(3.5)(d)(I)(A) states that:

Such notification shall include, if available, the dates of purchases, the amounts of each purchase, and the category of the purchase, including, *if known by the retailer, whether the purchase is exempt or not exempt from taxation.* [Emphasis added.]

<sup>22</sup> On the other hand, Colorado has over 60 home rule cities that each have their own unique sales and use tax laws that administer their own sales and use tax regimes. If each of these cities were to pass reporting ordinances similar to Colorado's reporting statute (which could easily happen if the Department won this case), there would be an even more substantial argument that an undue burden would be placed on interstate commerce collectively by the state of Colorado and its subdivisions.

reporting requirements or whether there is something intrinsically offensive to the Commerce Clause about requiring a taxpayer to collect and remit taxes that limits the application of *Quill* to those situations.

Finally, the *Quill* court's adherence to *Bellas Hess* can possibly be characterized as "reluctant" and an appellate court might find that 20 years later it is time to abandon the bright line physical presence test of *Quill*. While discussing the *Bellas Hess* precedent, the *Quill* court stated:

While contemporary Commerce Clause jurisprudence might not dictate the same result were the issue to arise for the first time today, *Bellas Hess* is not inconsistent with *Complete Auto* and our recent cases.<sup>23</sup>

The *Quill* court then discussed the value of its precedent as creating settled law that contributed to the establishment and growth of the mail order business, finally concluding:

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. To the contrary, the continuing value of a bright-line rule in this area and the doctrine and principles of *stare decisis* indicate that the *Bellas Hess* rule remains good law. For these reasons, we disagree with the North Dakota Supreme Court's conclusion that the time has come to renounce the bright-line test of *Bellas Hess*.<sup>24</sup>

<sup>23</sup> *Quill Corp. v. North Dakota*, 504 U.S. at 311.

<sup>24</sup> *Id.* at 317-318.

Now, 20 years later, would the court continue to adhere to a rule established in 1967 that might not have been adopted if first considered in 1992? *Quill* contains its own example of changing constitutional standards, as seen in the court's holding with respect to the *Bellas Hess* decision. In *Bellas Hess*, the Illinois use tax collection obligation imposed on an out-of-state retailer was held to be unconstitutional under both the Due Process and Commerce Clauses of the United States Constitution. Although *Quill* followed *Bellas Hess* in holding that the use tax obligations violated the Commerce Clause, the court found that its "due process jurisprudence has evolved substantially in the 25 years since *Bellas Hess*, particularly in the area of judicial jurisdiction" and reversed its holding in *Bellas Hess* with respect to the Due Process Clause:

In 'modern commercial life' it matters little that such solicitation is accomplished by a deluge of catalogs rather than a phalanx of drummers: 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.<sup>25</sup>

The current supreme court is very different from the court that decided *Quill*. However, it would appear that the *Quill* court at least left open the door for a reevaluation of the "physical presence" test under the Commerce Clause should "modern commercial life" and developing Commerce Clause jurisprudence indicate that a change is called for.

<sup>25</sup> *Id.* at 308.