Case Western Reserve Law Review

Volume 19 | Issue 2 | Article 16

1968

Constitutional Law–State Taxation of Interstate Commerce--Out-of-State Retailer as Collector of Use Tax

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CONSTITUTIONAL LAW — STATE TAXATION OF INTERSTATE COMMERCE — OUT-OF-STATE RETAILER AS COLLECTOR OF USE TAX

National Bellas Hess, Inc. v. Department of Revenue, 386 U.S. 753 (1967).

An increasing problem today concerns the taxation of commercial enterprises that do not confine their activities to a single State. This problem can best be described in terms of the conflicting and competing State and federal interests involving fiscal and commercial matters. State tax administrators, in failing to keep pace with State expenditures, have constantly been seeking new sources of revenue.[1] Yet, it is of vital importance that the commerce and trade of the country not be fettered by State taxes that prevent an expanding and prosperous economy. The United States Supreme Court recently dealt with this conflict in *National Bellas Hess, Inc. v. Department of Revenue.*[2]

The appellant, Bellas Hess, was a large retail establishment incorporated in Delaware. It operated a national retail mail-order business with headquarters in North Kansas City, Missouri. Twice each year, appellant mailed catalogues from its Missouri location to over 5 million customers residing throughout the United States, in addition to sending out intermediate sales books and merchandise flyers. All orders were received in Missouri.

Although appellant had no other contact with Illinois,[3] the appellee, Illinois Department of Revenue, obtained a judgment from the Illinois Supreme Court[4] ordering Bellas Hess to collect and pay

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[1] *See* U.S. BUREAU OF THE CENSUS, U.S. DEP'T OF COMMERCE, COMPENDIUM OF STATE GOVERNMENT FINANCES IN 1964, at 1, 6 (1965); U.S. BUREAU OF THE CENSUS, U.S. DEP'T OF COMMERCE, HISTORICAL STATISTICS OF STATE AND LOCAL FINANCES 1902-1953, at 1 (1955).

[2] 386 U.S. 753 (1967).

[3] The Illinois Supreme Court, although it held against Bellas Hess, did note that:

> [Appellant] does not maintain in Illinois any office, distribution house, sales house, warehouse or any other place of business; it does not have in Illinois any agent, salesman, canvasser, solicitor or other type of representative to sell or take orders, to deliver merchandise, to accept payments, or to service merchandise it sells; it does not own any tangible property, real or personal, in Illinois; it has no telephone listing in Illinois and it has not advertised its merchandise for sale in newspapers, on billboards, or by radio or television in Illinois. Department of Revenue v. National Bellas Hess, Inc., 34 Ill. 2d 164, 166-67, 214 N.E.2d 755, 757 (1966), *rev'd*, 386 U.S. 753 (1967).

[4] 34 Ill. 2d 164, 214 N.E.2d 755 (1966).

to Illinois the use taxes imposed by the Illinois Use Tax Act.[5] On appeal the United States Supreme Court was confronted with two closely related, yet distinguishable, questions: (1) whether the Illinois statute constituted a violation of the 14th amendment due process clause;[6] (2) whether the Illinois statute constituted a violation of the commerce clause.[7] In reversing the Illinois Supreme Court, the Court in *Bellas Hess* held that it was unconstitutional to impose a duty on appellant to collect the use tax set forth in the Illinois Use Tax Act.

An essential element in determining whether a State tax imposed on an out-of-State retailer violates the due process clause is the degree and extent of contact between the taxing State and the taxpayer. The Constitution requires a nexus, "some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax."[8] The majority in *Bellas Hess* essentially reaffirmed the Court's previous position concerning the definition of this required nexus.

In applying the nexus principle, the Court's decisions prior to *Bellas Hess* seemed to distinguish out-of-State corporations which had outlets or property,[9] and salesmen or representatives[10] within the taxing State from those firms which were exclusively out-of-State and whose only contact with the taxing jurisdiction was by mail, common carrier, local newspaper, radio, television, or maga-

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[5] ILL. REV. STAT. ch. 120, § 439.1 (Supp. 1966). The statute provides that the use tax shall be collected from the purchaser by any retailer "maintaining a place of business in this State," and makes the obligation a debt of the retailer regardless of whether the tax is actually collected. *Id.* § 439.3.

The statute defines "maintaining a place of business" as "[e]ngaging in soliciting orders within this State from users by means of catalogues or other advertising, whether such orders are received or accepted within or without this State." *Id.* § 439.2.2.

[6] U.S. CONST. amend. XIV, § 1.

[7] *Id.* art. I, § 8, cl. 3.

[8] Miller Bros. v. Maryland, 347 U.S. 340, 344-45 (1954). *See also* American Oil Co. v. Neill, 380 U.S. 451 (1965); Scripto, Inc. v. Carson, 362 U.S. 207, 210-11 (1960).

[9] Nelson v. Sears, Roebuck & Co., 312 U.S. 359 (1941). The case involved a mail-order firm which maintained retail outlets in the taxing State. The Court, in upholding the State use tax, emphasized the importance of the seller's local retail outlets and the protection these outlets received from the taxing State. *Id.* at 364; *see* Nelson v. Montgomery Ward & Co., 312 U.S. 373 (1941).

[10] Scripto, Inc. v. Carson, 362 U.S. 207 (1960). The out-of-State seller sent "10 wholesalers, jobbers, or 'salesmen' conducting continuous local solicitation" into the taxing State. *Id.* at 211. The Court held that the requisite nexus between the retailer and the taxing State was present, and thus the State had fulfilled the jurisdictional requirements. *See* General Trading Co. v. State Taxing Comm'n, 322 U.S. 335 (1944); Felt & Tarrant Mfg. Co. v. Gallagher, 306 U.S. 62 (1939).

zine advertisement.[11] The corporations which were in the former category were susceptible to local use taxation; the corporations in the latter class were not susceptible to use taxation. This classification remains as a result of *Bellas Hess.*

The dissent in *Bellas Hess* attacked the artificial and mechanical approach taken by the majority in applying the nexus principle. Mr. Justice Fortas, speaking for the dissent, suggested that the search for constitutionally sufficient contacts look toward total business activities, in this case appellant's "systematic, continuous solicitation and exploitation of the Illinois consumer market."[12] After stating this proposition, the dissent concluded that appellant's activities did satisfy the minimum contact requirements of the due process clause, and thus the tax was constitutional.

Mr. Justice Fortas' rationale for such a holding arose from the conclusion that appellant enjoyed the benefits of, and the profits from, the facilities established and "nurtured" by the State of Illinois.[13] The benefits afforded Bellas Hess by Illinois included the ability to utilize credit facilities, to make sales, and to realize a profit. In exchange for these "benefits" the dissent stated that Illinois was entitled to ask for compensation through an assessment of a local use tax.[14]

In reality, however, there is a great deal of exaggeration concerning the extent of these benefits conferred by Illinois upon appellant.[15] In fact, the benefits in most similar circumstances are

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11 Miller Bros. v. Maryland, 347 U.S. 340 (1954) which held that it was unconstitutional for Maryland to impose a use tax upon a Delaware seller who had *no* retail outlets or sales solicitors in Maryland. The seller in *Miller Bros.*, unlike the appellant in *Bellas Hess*, advertised its wares in newspapers and on television and made household deliveries. To that extent *Miller Bros.* is not controlling on *Bellas Hess.* However, the relevance of *Miller Bros.* to the majority's reasoning in *Bellas Hess* is that the Court in *Miller Bros.* refused to recognize a nexus where the seller did not send any agents into the taxing State, regardless of the fact that the seller was involved both in the solicitation of orders by interstate dissemination of general advertising, and in making of household deliveries to local customers.

12 386 U.S. at 762 (dissenting opinion).

13 *Id.*

14 *Id.* at 765-66.

15 The "benefits" extended to Bellas Hess did not arise from any activities conducted within Illinois. Appellant had no property, no representatives, or salesmen in Illinois to enjoy the benefits of the State. The exploitation referred to by the dissent consisted mainly of activities outside of the State: (1) The posting of catalogues in the United States mails in Missouri; (2) the receiving of money and orders from purchasers in Illinois; (3) delivering to the United States mails and common carriers in Missouri products addressed to the Illinois consumers. Brief for Appellant at 34, National Bellas Hess, Inc. v. Department of Revenue, 386 U.S. 753 (1967).

indirect at best.[16] And, of course, the Court has construed the Constitution as prohibiting discrimination against interstate commerce in favor of local business.[17] Using a "benefit and protection" approach, the majority decided that the benefits were not of such a nature to warrant Illinois' imposition of a tax upon appellant in return for such benefits and thus held that the due process clause was violated by the tax assessment.

Of the two approaches to the due process issue and the nexus criterion, however, the position advocated by Mr. Justice Fortas appears more formidable and realistic. Regardless of where distinctions are made and how sharply they are drawn, it may be assumed that situations will arise which will demand a further "splitting of hairs" until the original distinctions become meaningless.

One of the greatest difficulties confronting the Court in *Bellas Hess* was the distinction between the "due process clause" and the "commerce clause." The Supreme Court had recognized this problem previously when Mr. Justice Rutledge admitted:

> 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 [the tax] may fall because of its burdening effect upon the commerce.[18]

The strength and validity of the *Bellas Hess* decision clearly lies in the second issue — the possible violation of the commerce clause; for inherent in the commerce clause question are the policies that favor the mail-order houses which deal exclusively in interstate commerce.

There is little doubt that the majority in *Bellas Hess* realized

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16 A State does not maintain its markets for the benefit of out-of-State vendors, but rather for the State's own consumers and producers. Perhaps a State tolerates out-of-State sellers because its consumers are interested in out-of-State products. Some products are readily available in certain States, and yet relatively scarce in others. Studenski, *The Need for Federal Curbs on State Taxes on Interstate Commerce — An Economist's Viewpoint*, 46 VA. L. REV. 1121, 1130-31 (1960).

17 Regardless of the reasons why a State tolerates out-of-State sellers, the motivation which stimulates State governments to furnish protective services to out-of-State corporations which trade in their State is "indirect and half-hearted when compared with the very direct and full-hearted motivation which inspires them to furnish services to their own producers." *Id.* Furthermore, the benefits and services accruing to the out-of-State vendors are but a small portion of those furnished to the in-State vendors.

18 International Harvester Co. v. Department of Treasury, 322 U.S. 340, 353 (1944) (concurring opinion).

the imminent threat to mail-order houses and to interstate commerce as a whole, if the Illinois Use Tax Act were upheld. Two distinct burdens could result from the imposition of a local use tax on an out-of-State corporation.

One such burden arises from the possibility that a corporation could be taxed twice for the same transaction.[19] The second burden, which is more pertinent to *Bellas Hess*, is referred to as the "burden of compliance." This burden operates on the many corporations which are faced with the problems of State taxation of their interstate activities and transactions.

In 1958 Congress, realizing the gravity of these burdens, enacted legislation which authorized extensive studies of the matter.[20]

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[19] Commonly called the "multiple burdens doctrine," this doctrine was first enunciated by Mr. Justice Stone. Western Live Stock v. Bureau of Revenue, 303 U.S. 250 (1938). *See generally* Barrett, *State Taxation of Interstate Commerce — "Direct Burdens," "Multiple Burdens," or What Have You?*, 4 VAND. L. REV. 496, 506-15 (1951). Under this doctrine a corporation in State A which sells to a purchaser in State B could conceivably be taxed for the sale in State A and also be liable for the collection of a use tax in State B. In effect this would discriminate against interstate commerce in that a local retailer whose sole business is in State B would only be assessed one tax, thus giving him a competitive advantage over the seller incorporated in State A. *See* Michigan-Wisconsin Pipe Line Co. v. Calvert, 347 U.S. 157 (1954); Memphis Steam Laundry Cleaner v. Stone, 342 U.S. 389 (1952).

The dissent in *Bellas Hess* is strengthened by the fact that the Use Tax Act, ILL. REV. STAT. ch. 120, § 439.3(c) (Supp. 1966), was expressly intended to prevent duplicate taxation. Pursuant to the statute an out-of-State seller is exempt from the use tax in Illinois to the extent such seller pays a similar tax on the same transaction in its home State. *Id.* Consequently, multiple taxation is avoided to a large extent. Furthermore, the possibility of multiple burdens has generally been alleviated since most States have adopted a more or less uniform regulation or administrative practice recommended by the National Association of Tax Administrators. *See* NATIONAL ASSOCIATION OF TAX ADMINISTRATORS, REPORT NO. 10, PROPOSED UNIFORM REGULATION FOR TAXATION OF INTERSTATE TRANSACTIONS UNDER STATE SALES TAX LAWS (1940). This practice exempts out-of-State corporations from a sales tax on a transaction pursuant to a contract requiring shipment out of State. Such a transaction is thus left subject to a use tax by only the buyer's State and thus duplication of taxes is avoided. The taxing procedures are administrative and not statutory, and are thus subject to change. Moreover the Supreme Court use tax decisions do not preclude the possibility of a multiple burden where a sales tax is imposed by the seller's State and a use tax is imposed by the buyer's State. The potential of a multiple burden cannot be dismissed until Congress or the Court clearly sets forth which State — seller's or buyer's — may impose the tax and under what circumstances. Kust and Sak, *State Taxation of Interstate Sales*, 46 VA. L. REV. 1290, 1302 (1940).

[20] The studies concerned the increasing expansion of State taxation of interstate business. Subsequent to the decision in Northwest Portland Cement Co. v. Minnesota, 358 U.S. 450 (1959), Congress enacted legislation that (among other things) authorized the House Committee on the Judiciary and the Senate Committee on Finance to make a complete study of State taxation on income derived from interstate business activities. Act of September 14, 1959, 73 Stat. 556. After Scripto, Inc. v. Carson, 362 U.S. 207 (1960), the authorization was extended to include studies on sales and use taxes. Act of April 7, 1961, 75 Stat. 41. The hearings commenced during the 87th Congress and have continued through the present Congress. Reports were also published. Recent hearings most relevant to *Bellas Hess* are the *Hearings on H.R. 11,798 and Companion*

The problem arose from the general lack of uniformity among the various State tax laws and recording procedures. Great difficulty confronts an out-of-State vendor in determining whether or not a particular statute of a State in which he is making a sale does or does not require him to collect the use tax.[21] Furthermore, the out-of-State vendor may be unaware of the facts upon which the applicability of a use tax depends. The in-State purchaser usually does know these facts, especially in regard to the mail-order business. Smaller mail-order houses do not keep records of sales by States and the added expense of requiring them to do so would, in itself, impose a hardship upon them.[22]

The possibility of a competitive advantage accruing to the out-of-State seller is the price that must be paid to insure a free flow of interstate commerce. Furthermore, the out-of-State seller many times is not in competition with in-State corporations.[23] In these situations the competitive advantage of a mail-order seller is a myth.[24] Actually, many mail-order houses do not compete with local sellers.[25]

The conclusion to be drawn from Congressional hearings is that some of the large mail-order houses — and they comprise a small minority — would be able to cope with the various State taxes im-

Bills Before the Special Subcomm. on State Taxation of Interstate Commerce of the House Comm. on the Judiciary, 89th Cong., 2d Sess., ser. 14 (1966).

21 *Hearings on H.R. 11,798, supra* note 20, at 219. Mr. Harold Halfpenny elucidated this grave difficulty in his testimony before the 1966 House of Representatives Special Subcommittee on State Taxation of Interstate Commerce. He pointed out in 1962 that 35 States and the District of Columbia required compensating use taxes by out-of-State sellers, and among these 35 States, five separate standards were used in levying their respective use taxes:

> Five States required collection for "maintaining a place of business" in the State; 5 used "agent operating" in the State as the test, and 12 added "agent operating temporarily"; three more used "solicitation" by "agent" as a standard. The fifth and most drastic standard required collection of the use tax by out-of-state sellers who distribute catalogs or other advertising matter within the State, and have no other connection with it. *Id.*

22 *Id.* at 224.

23 Testimony of James R. Utley, vice president of a Detroit company which sells by mail order. *Id.* at 510-11.

24 James A. Alter of Chicago:

> The local wholesaler has the advantage of proximity, speed, friendship — and many other factors — that give him a competitive advantage. We are able to do business in these other States only because we carry a very large inventory of many esoteric items, and when a customer in a distant State needs something he can't order locally, he orders it from us. He certainly doesn't order from us something he can get locally. *Id.* at 1445.

25 Stephen F. Harris testified on behalf of the New England Mail Order Association that practically every mail-order business aside from the giants is based on the unusual products that have not reached local stores. *Id.* at 1321-22.

posed on interstate commerce. The remaining mail-order houses would find it practically impossible to comply with the burdens imposed by the taxing authorities of the States. The expense involved in familiarizing themselves with the technicalities of divergent tax laws would discourage these firms from entering many States. They would be compelled to hire lawyers and accountants to prepare and file various tax returns and to negotiate with tax administrators.[26]

A remaining problem not resolved by the dissent is the definition of large-scale business. Unless the Court imposes a standard, it will have to decide the issue on a case-by-case basis. And unless the burdening effect is obviated, its imposition will be proportionately greater on the smaller firms.[27]

Congress has recently taken steps toward alleviating some of the confusion through the pending Interstate Taxation Act.[28] The bill sets forth a uniform jurisdictional standard which prohibits a State or political subdivision from requiring a person to collect a sales or use tax unless that person has a business location in the State,[29] or regularly makes household deliveries.[30] One of the pur-

[26] Studenski, *supra* note 16, at 1138-39. Mr. Justice Frankfurter recognized this difficulty in Northwestern States Portland Cement Co. v. Minnesota, 358 U.S. 450, 470 (1958) (dissenting opinion), when he stated that the "small or moderate-sized" firms doing exclusively interstate business would be forced to keep books, make records, and file returns in order to comply with State taxing authorities; this cost of compliance would, in many instances, exceed the burden of the tax itself.

[27] Sparkman, *The Problems of Multistate Taxation of Interstate Commerce*, 46 A.B.A.J. 375, 377 (1960).

[28] H.R. 2158, 90th Cong., 1st Sess. (1967).

[29] *Id.* § 101(2). The act defines "business location."

> A person shall be considered to have a business location within a State only if that person — (1) owns or leases real property within the State, (2) has one or more employees located in the State, or (3) regularly maintains a stock of tangible personal property in the State for sale in the ordinary course of its business.
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> . . . .
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> (c) If a person does not own or lease real property within any State or have an employee located in any State or regularly maintain a stock of tangible personal property in any State for sale in the ordinary course of business . . . that person shall be considered to have a business location only — (1) in the State in which the principal place from which its trade or business is conducted is located, or (2) if the principal place from which its trade or business is conducted is not located in any State, in the State of its legal domicile. *Id.* § 511.

[30] *Id.* § 514: Household Deliveries: "A seller makes household deliveries . . . if he delivers goods, *otherwise than by mail or by a common carrier*, to the dwelling places of his purchasers . . . ." *Id.* (emphasis added). *See also id.* § 301 which states in part that:

> (a) A State or political subdivision thereof may impose a sales tax or require a seller to collect a sales or use tax with respect to an interstate sale of tangible personal property only if the destination of the sale is — (1) in that State, or (2) in a State or political subdivision for which the tax is required to be collected.
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> (b) A State or political subdivision thereof may not impose a use tax with