State Efforts to Impose "Amazon Tax" on Internet Vendors

*By Kenneth K. Lee**

Burdened by unfunded pensions and other fiscal calamities, cash-strapped states have scoured for new and creative sources of revenue. One seductive scheme that has tempted many states is the so-called "Amazon tax," a tax that would apply to out-of-state online retailers that have no physical presence within that particular state.

The "Amazon tax" technically is not a tax on out-of-state online companies such as Amazon or Overstock. Most states cannot directly tax them because these online-only retailers do not have any employees, offices, or stores in those states. For the same reason that, say, New Mexico cannot tax New Yorkers who do not live or have any property there, New Mexico cannot tax out-of-state companies that have no physical presence within the state. Rather, the "Amazon tax" would compel out-of-state online retailers to collect sales taxes from out-of-state customers who are obligated (but almost certainly neglect) to report and pay a "use tax" on their out-of-state purchases.

States find the "Amazon tax" politically enticing because it brings in potentially millions of dollars into the states' coffers—at the expense of faceless out-of-state companies and citizens who have no political clout. As far as most states are concerned, a tax obligation imposed on Seattle-based Amazon.com is a political and economic problem for the state of Washington. And brick-and-mortar businesses have lobbied hard for such a tax, claiming that certain out-of-state internet companies have a competitive advantage because their customers do not pay any sales tax.

But upon closer scrutiny, the "Amazon tax"—like internet get-rich schemes—is too good to be true. It likely will not yield the gusher of tax revenues that states anticipate, and ultimately may not pass constitutional muster.

The landmark Supreme Court case that poses as a major obstacle to the "Amazon tax" is *Quill Corp. v. North Dakota.*[1] In that case, the state of North Dakota attempted to compel Quill, an office supplies company, to collect taxes on items sold within the state, even though Quill had no employees, stores, or facilities in North Dakota. The Supreme Court struck down the tax on the grounds that it placed an undue burden on interstate commerce in violation of the Dormant Commerce Clause. Specifically, the Supreme Court held that the company lacked a "substantial nexus" with North Dakota to justify the tax. Substantial nexus has been defined as physical presence within the state (e.g., offices, stores, or employees).

But online retailers typically have a physical presence in only their home state and possibly a few other states where they may have, for example, warehouses. Faced with this *Quill* precedent, New York, California, and several other states have concocted an ingenious idea to purportedly establish "substantial nexus": These states have revised or proposed altering the state tax code to require an out-of-state internet retailer to collect sales taxes if it enters into any agreement with an out-of-state resident or business which refers potential purchasers via an internet link in exchange for a commission.

For example, Amazon sponsors the Amazon Associates program in which individuals and businesses advertise an item on their websites with a link, which if clicked, sends the user to Amazon's website. If the user purchases the item, the Amazon Associate receives a portion of the sales proceeds. Overstock and other online retailers have similar affiliate marketing arrangements.

These states have latched onto these affiliate marketing programs to claim that out-of-state internet retailers now have a "substantial nexus" with the taxing state. But this legal fig leaf falls apart under the strain of precedent and logic.

States typically rely on the Supreme Court's half-century-old decision in *Scripto v. Carson* to defend their bills.[2] The Supreme Court in that case found that Florida could impose a tax collection obligation on Georgia companies, despite the lack of employees or facilities in the Sunshine State, because they had independent contractors who solicited sales within the state. The reasoning in *Scripto* makes sense. Otherwise, companies like Avon or Mary Kay could avoid tax collection obligations altogether because they rely almost solely on independent contractors to sell their goods.

Online affiliates, however, are not like "Avon ladies" or other independent contractors who roam a state and solicit sales from individuals within the state. Advertising links by online affiliates are more akin to standard advertisements in flyers, periodicals, or even internet banner ads, which are not sufficient to establish "substantial nexus."[3] A Nevada company that has no connection to California, for instance, cannot be compelled to collect sales taxes merely because it advertised in the *Los Angeles Times* newspaper or website.

Taken to its logical conclusion, the legal justification for the "Amazon tax" scheme would arguably allow *any* state to impose tax collection obligations on *any* out-of-state business if it merely advertises on the internet because the reach of the internet is global. The fact that independent "affiliates" of online retailers receive commissions does not matter because the constitutionality of a tax should not hinge on the type of compensation.

Like most relatively obscure constitutional issues, clear precedent on this issue is sparse. A state trial court in New York upheld New York's version of the Amazon tax, but that case is on appeal and Amazon is currently collecting use taxes in New York. But some states' decisions suggest that they may not follow New York's lead.

For example, in *Borders Online, LLC v. State Board of Equalization*, the California Court of Appeal relied on the Supreme Court's *Tyler Pipe v. Washington Department of Revenue*[4] decision in emphasizing that "the crucial factor governing nexus is whether the activities performed in [the] state on behalf of the taxpayer are significantly associated with the taxpayer's ability

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** Kenneth K. Lee is a litigation partner at Jenner & Block's Los Angeles office. He previously served as an Associate Counsel to President George W. Bush. A different version of this article appeared in the Los Angeles Daily Journal.*

to establish and maintain a market in [the] state for the sales."[5] The court held that Borders Online, an out-of-state bookseller without any physical presence in California, had to collect sales taxes because of its intertwined relationship with its sister bricks-and-mortar company, Borders Books. The two Borders entities shared financial data and filed tax returns on a combined report, and further engaged in synergistic marketing (e.g., a customer of Borders Online could return books to Borders Books). Under the reasoning in this case, it seems unlikely that a court will find that Amazon or other online retailers share such a similar relationship with its independent affiliates or rely on them to "establish and maintain" a market in a particular state.

But this constitutional issue may not be resolved in the courts. Many states, ranging from California to Indiana, have reached agreements with Amazon in which the states agreed to defer taxation for a number of years in return for Amazon agreeing to build distribution centers there. In other states such as North Carolina and Rhode Island, Amazon has cut ties with its affiliates, most of which are small business owners that relied on the affiliate marketing programs to generate revenue. In these cases, the expected tax revenues did not materialize and, indeed, the "Amazon tax" has reduced revenues and crippled job growth. As *The New York Times* reported earlier this year, the founder of the Illinois-based FatWallet took his fifty-four employees to nearby Wisconsin after the Land of Lincoln imposed a new birth of taxation.[6] In light of these unintended consequences, some in Congress have pushed for a streamlined federal law to address the issue of state taxation in the 21st century, but no bill has come close to being enacted.

In addressing this issue, legislators and judges may want to thumb through Federalist Paper No. 22, in which Alexander Hamilton cautioned that "interfering and unneighborly regulations of some States, contrary to the true spirit of the Union," would lead to "injurious impediments" to national economic growth. That warning from the 18th-century parchment of Publius remains just as relevant in today's information technology world.

Endnotes

1 504 U.S. 298 (1992).

2 362 U.S. 207 (1960).

3 *See Quill*, 504 U.S. 298.

4 482 U.S. 232, 250 (1987).

5 29 Cal. Rptr. 3d 176, 188 (Cal. App. Ct. 2005).

6 *See* Ian Mount, *States' Drive to Collect Taxes on Internet Sales Is a Blow to Marketers*, N.Y. Times, Jan. 25, 2012, at B4.