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NEW YORK'S "AMAZON LAW": AN IMPORTANT TOOL FOR COLLECTING TAXES OWED ON INTERNET PURCHASES

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Summary

The inability to collect all sales taxes that are legally due on purchases made over the Internet costs states billions of dollars a year in lost revenue. In 2008, New York State enacted an innovative law that helps to address this problem. Rhode Island adopted a similar measure this year. All states with sales taxes should give serious consideration to doing so as well.

New York and Rhode Island's new laws are directed toward online retailers that are located outside the state and do not collect the sales tax that is due on sales to in-state customers. The laws rely on the fact that many such out-of-state retailers enlist independent in-state websites known as "affiliates" to promote sales. Affiliates place links on their websites to the retailer's site and receive a commission when someone follows the link and buys something from the retailer. The states determined that this relationship with affiliates satisfies the requirement set down by the U.S. Supreme Court that states can require sales tax collections only from retailers with in-state property, employees, or independent sales representatives. A New York court has already upheld the law, and the Tennessee attorney general has issued a formal opinion that a version introduced there was constitutional.

New York's measure — an amendment to the state's sales tax code — has been dubbed the "Amazon law" because Amazon.com is the nation's largest Internet retailer and until passage of New York's law did not collect sales taxes from any New York customers. In addition to Amazon, scores of other online retailers are potentially affected. New York's law is already raising tens of millions of dollars a year — enough to pay the salaries of hundreds of schoolteachers, firefighters and police officers.

Legislators in at least seven other states introduced similar bills this year. The California and Hawaii legislatures approved them but did not override their governors' vetoes. A similar bill is still pending in North Carolina, and press reports indicate the legislature is likely to approve it.

Sales taxes are already legally due on Internet sales if the item is taxable in a local store. The consumer is supposed to pay the tax directly to the state, but by far the most effective way to obtain the revenue is to require the seller to charge the tax. Because the measure enacted in New York and

Rhode Island extends such responsibility to the large number of Internet merchants with affiliate programs, it represents a valuable tool to begin to chip away at the problem of untaxed Internet sales. The law:

- Mitigates states' loss of much-needed revenue;
- Reduces the competitive disadvantage faced by local merchants and those Internet sellers (like Amazon competitors Barnes & Noble and Best Buy) that do collect sales taxes; and
- Reduces the disproportionate impact of sales taxes on low-income persons arising from their frequent inability to buy online and thus avoid the taxes.

Because most of the largest Internet retailers operate affiliate programs, a significant portion of the revenue loss arising from untaxed Internet sales could be avoided if numerous states enacted and enforced similar laws. Those online retailers that choose to drop their in-state affiliates rather than collect taxes seem likely to lose market share to local merchants and to online sellers that *do* collect taxes. If a significant number of the largest states enact these laws, it seems likely that many Internet retailers will eventually reinstate their affiliate programs and begin collecting the sales tax.

Not every Internet retailer operates an affiliate program, so emulating New York's law is only a partial response to the Internet sales tax problem. A comprehensive solution will require a federal law empowering states and localities that have simplified and harmonized their sales taxes to require all large remote sellers to collect sales taxes, whether or not they are physically present in their customers' states. Bills to do this have been introduced in Congress for many years, but they have not advanced.[1] In the meantime, the action taken by New York and Rhode Island is an important strategy for states to adopt on their own behalf.

Failure to Tax Internet Sales Is Harmful and Inequitable

The current state of affairs, where some Internet retailers collect sales tax and some do not, has prevailed for far too long. The failure to collect taxes owed on Internet sales costs states and local governments billions of dollars a year in lost revenue, making it harder to fund critical public services like education and health care.[2] It forces lower-income households to shoulder an unfairly large share of sales tax obligations as more affluent consumers avoid sales taxes by shopping online.[3]

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1 The most recent such bill was H.R. 3396, introduced in 2007. Reintroduction of similar legislation is expected in the current session of Congress in the next few months.

2 A recent study by economists at the University of Tennessee estimated that state and local governments lost a minimum of $7.2 billion in uncollected sales taxes on e-commerce in 2007, and that this will rise to $11.4 billion by 2012. See: Donald Bruce, William F. Fox, and LeAnn Luna, "State and Local Government Sales Tax Revenue Losses from Electronic Commerce," April 13, 2009; www.streamlinedsalestax.org/Execitive%20Committee/Previous_meetings/4_13_09/SSTP%20e-commerce%202009%20REV041309.pdf. These estimates do not include lost revenue from catalog, TV home shopping, and other forms of interstate or "remote" sales.

3 The most recent data available from the U.S. Census Bureau indicate that in 2005, only 33 percent of people with incomes in the lowest 20 percent of the income distribution used the Internet for any purpose (including shopping), compared to 80 percent of people in the highest-income 20 percent. www.census.gov/population/socdemo/computer/2007/tab04.xls.

It also undermines local businesses. Remote sellers get a 5 percent to 10 percent price advantage over "Main Street" businesses when they do not charge sales tax. Given the inherently narrow profit margins in retailing, the loss of sales to remote sellers resulting from this price advantage can make it much harder for some local businesses to survive.[4]

Adding to the inequity of the current situation is the fact that remote sellers benefit extensively from the public services their customers' home states provide. States and localities play a critical role in providing the range of safeguards and services that permit interstate commerce to flourish. For example, they furnish the roads that enable goods to travel between remote sellers and their customers, as well as the police and fire protection for the goods in transit. Buyers and sellers thousands of miles apart are willing to do business because they know that consumer protection agencies and courts of the purchaser's state can adjudicate disputes over product quality and payment obligations.

Perhaps unsurprisingly, not every online retailer shares this view. The CEO of Overstock.com, an outspoken opponent of the new law, claims it would be "patently unfair" to have to collect California sales taxes under a proposed law in that state because "[W]e don't impose the same burdens on local state infrastructure that locally based business do."[5] Yet Overstock.com does, in fact, benefit from California tax-funded services — as one example, it is using the tax-funded California court system to pursue a litigation campaign against hedge funds and brokerage firms it alleges are attempting to drive down the value of its stock.[6]

It can be argued that booksellers in particular benefit heavily from the public services their customers' states provide: tax-supported public schools are where most Americans learn to read. In light of the benefits remote sellers receive from public services in their customers' states, at least large remote sellers should collect sales tax from their customers on behalf of the states. And if there is a legal means of achieving this, states are justified in pursuing it.

How New York's Law Works

The New York law requires many Internet retailers operating "affiliate programs" in the state to charge sales tax on the retailer's sales to New York residents. These affiliates — which can be local bloggers, newspapers, nonprofit organizations, and other types of businesses — post on their websites links to online retailers and receive a commission when purchases are made through those

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[4] Numerous studies have confirmed that the possibility of avoiding sales taxes motivates some people to make purchases from online sellers. See, for example, Glenn Ellison and Sara Fisher Ellison, "Tax Sensitivity and Home State Preferences in Internet Purchasing," August 2008 (unpublished, http://econ-www.mit.edu/files/3201).

[5] "Overstock.com Drops Internet Affiliate Advertisers in California, Hawaii, North Carolina, and Rhode Island," Overstock.com press release, July 1, 2009. Overstock.com CEO Patrick Byrne also stated: "[P]oliticians have to remember that a tax is the price that government charges for a service, and when they raise their prices, we're going to buy less of their services." "Buy" implies payment, but Overstock.com pays these states nothing for the services it receives; it does not have to pay a corporate income tax in states in which it has customers because of federal Public Law 86-272, nor does it collect sales and use taxes on behalf of such states.

[6] *Overstock.com, Inc. et al.* v. *Gradient Analytics, Inc. et. al*, California Court of Appeal Case A113397. *Overstock.com, Inc. et al.* v. *Morgan Stanley & Co., Incorporated et al.*, Superior Court of California, County of San Francisco, Case Number: CGC-07-460147.

connections. New York's law requires retailers making more than $10,000 in annual sales in the state through New York affiliates to charge New York sales tax on *all* sales in the state, not just those resulting from the affiliate program. The retailer can avoid this obligation, however, if it can demonstrate that its New York-based affiliates do nothing to encourage such sales other than place a link to the retailer on their websites.

The law is a response to the difficulty states have in compelling many out-of-state Internet (and catalog) retailers to collect and remit their sales taxes. Two U.S. Supreme Court decisions have held that states can impose such an obligation only on a retailer with some type of "physical presence" in the state.[7] While that would seem to bar states from requiring retailers with no presence in the state to collect sales taxes, two other Supreme Court decisions clearly establish that an out-of-state seller *is* deemed to have a physical presence in a state if it uses in-state third parties to help "establish and maintain a market" for its goods within the state.[8] New York's law is grounded in these latter decisions.

Many retailers are complying with New York's law. Among them is Amazon.com, but Amazon also has challenged the law in court. The initial trial court upheld the constitutionality of the law in January 2009; Amazon has appealed.

The Law Helps States Collect Taxes Already Due

Though states lack the legal authority to require *sellers* who do not have a physical presence in the state to charge sales tax, every state requires *purchasers* to remit the tax directly to their state department of revenue. (Technically, the tax is an equivalent "use tax" rather than a sales tax.[9]) A state use tax is always due on an item purchased from an out-of-state Internet or catalog merchant if state sales tax is due on the same item when purchased in a local store.

However, very few consumers fulfill this obligation to self-remit use taxes, and states cannot collect this revenue from individual households cost-effectively unless they can compel the seller to collect it from the purchaser at the time of sale. Courts have long recognized the legitimacy and practical necessity of imposing the collection obligation on sellers if they have a connection or "nexus" with the state. That is what the new law does. It does not impose a new tax. Rather, it simply helps states collect taxes that are already legally due.

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[7] The more recent of the two decisions is *Quill Corporation* vs. *North Dakota*, 1992.

[8] *Scripto* (1960) and *Tyler Pipe* (1987) establish, respectively, that in-state solicitation of sales by independent contractors and other in-state activities conducted by third parties that are "significantly associated with the [out-of-state] taxpayer's ability to establish and maintain a market in this state for [its] sales" create a tax collection or payment obligation for the out-of-state company. Both decisions were explicitly cited in the 1992 *Quill* decision as examples of the "physical presence" required under the Commerce Clause of the Constitution to obligate an out-of-state company to collect a use tax on behalf of its customers' states. For example, the Court wrote: "Like other bright-line tests, the [physical presence] rule appears artificial at its edges; whether or not a State may compel a vendor to collect a sales or use tax may turn on the presence in the taxing State of a small sales force, plant, or office. Cf. . . . . *Scripto, Inc.* v. *Carson*. . . ."

[9] At least 22 states now include a line on the state personal income tax form to permit the simultaneous payment of the income tax and use taxes.

For large Internet retailers, at least, a nationwide responsibility to collect and remit sales taxes is not unreasonably burdensome. Many large online merchants already collect sales taxes on behalf of nearly all states; indeed, Amazon calculates and collects sales tax in every state except Vermont on behalf of Target, which sells on Amazon's website.[10] Several companies sell software that substantially automates the process, and other companies enable retailers to outsource the collection process — just as many Internet retailers outsource operation of their affiliate programs.[11]

Courts Likely to Uphold Law, and States Face Little Risk if They Do Not

Considerable evidence suggests that courts will continue to uphold these affiliate nexus laws as a legal solution to part of the Internet sales tax problem:

- It has long been established that states can require out-of-state sellers to collect sales taxes if they use independent in-state representatives paid on commission to solicit business.[12] While the courts will have to decide whether New York's law as applied is consistent with these decisions — and there is certainly room for debate — the initial trial court decision in New York dismissed Amazon's claim that the law is *inherently* unconstitutional.

- The New York Department of Taxation and Finance is interpreting and enforcing the law in a narrow way that makes it even more likely that higher courts will uphold it. New York is *not* taking the position that the mere presence of a member of an affiliate program in the state obligates the out-of-state retailer to collect and remit New York sales taxes. Rather, the New York affiliates must engage in additional in-state activities aimed at encouraging their readers to buy through the affiliates' links to the retailer (such as targeted mailings).[13]

- The attorney general of Tennessee issued a formal letter opining that Tennessee's proposed (but ultimately not enacted) version of the New York's law, H.B. 1947, was constitutional.[14]

- Finally, two prominent legal scholars have written that courts seem likely to uphold the law as constitutional as applied to at least some factual circumstances. Walter Hellerstein and John

[10] http://www.amazon.com/gp/help/customer/display.html?ie=UTF8&nodeId=468512&qid=1245865150&sr=1-1.

[11] Examples of some of these companies may be found at http://www.streamlinedsalestax.org/certified%20service%20provider.htm.

[12] See Note 8.

[13] See: New York State Department of Taxation and Finance, Office of Tax Policy Analysis, Taxpayer Guidance Division, "New Presumption Applicable to Definition of Sales Tax Vendor," May 8, 2008, and "Additional Information on How Sellers May Rebut the New Presumption Applicable to the Definition of Sales Tax Vendor as Described in TSB-M-08(3)S," June 30, 2008.

[14] Opinion No. 09-101, May 28, 2009.

Swain wrote that there are "plausible factual scenarios under which substantial nexus will exist" in the states in which Internet retailers operate affiliate programs.[15]

The fact that Amazon.com, the nation's largest Internet retailer, decided to comply with New York's law is further evidence of its likely legality. So are the decisions of some retailers to end their affiliate programs in New York, Rhode Island, and other states rather than flout the law (see below).

Even were a state court or the U.S. Supreme Court to overturn a state's law, it is unlikely the state would have to refund any revenue collected in the interim. The decision would only address the issue of whether the companies were obligated to collect the tax. Since any tax that had been collected was, in fact, legally payable by consumers, it is unlikely that courts would order refunds. In fact, in its New York litigation, Amazon.com is not seeking a refund of the taxes it is collecting in the state.

If Widely Adopted, Law Could Close Significant Part of Internet Sales Tax Gap

Should a large number of states enact and achieve broad compliance with laws dealing with in-state affiliates of Internet retailers, the sales tax revenues collected could make a meaningful dent in the Internet sales tax gap. Affiliate programs are a widespread and critical mechanism by which Internet merchants promote sales. At least 210 of the 250 largest Internet retailers operate affiliate programs.[16] Many of these retailers at present collect sales tax in only a handful of states. Amazon reported having 500,000 affiliates in its "Associates" program in 2000[17] and likely has many more today; accordingly, it likely has many affiliates in every state levying a sales tax.

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[15] Hellerstein and Swain go on to predict that if a court were to overturn the Amazon law, it would likely do so because of the burden of proof the law places on Internet retailers to demonstrate that their affiliates are not engaged in additional in-state activities beyond placing links on their websites (in which case the law would not apply to them), not because the court determined that the New York affiliate did not effectively constitute physical presence of the retailer in the state.

Notwithstanding their assessment that courts are likely to uphold the legality of the Amazon law as applied in at least some circumstances, Hellerstein and Swain appear to believe personally that the mere presence of an affiliate in a state should not create nexus for the retailer:

> Because we doubt that an out-of-state vendor has substantial nexus in New York from posting advertisements on a New York resident's property, resulting in $10,000 of sales to New York customers, we doubt that the digital analogue to such an arrangement *should* create nexus. [Emphasis added.]

As noted in the body of the report, however, New York is not taking the position that the mere presence of the affiliates in the state creates a "substantial nexus" for the retailer. Hellerstein and Swain do not say whether or not they believe that New York's application of the law (as set forth in the two statements of formal guidance it has issued) is constitutional.

See: Walter Hellerstein and John A. Swain, "Challenge to New York Statute Establishing Presumption of Nexus with Online Retailers Who Pay Commissions to State Residents Who Post Links on Their Web Sites," Thomson Reuters State and Local Tax Commentary, March 2009; http://ria.thomsonreuters.com/taxresearch/statelocal/Hellerstein.pdf

[16] *Internet Retailer Top 500 Guide*, 2008 Edition.

[17] "Amazon.com Associates Program Celebrates 500,000 Member Milestone with New-Customer Referral Bonuses," Amazon.com press release, August 3, 2000. Amazon did not disclose how many of those Associates were located in the United States.

New York tax officials believe that approximately 30 retailers have begun collecting its sales tax because of the new law. The state estimates that these retailers generated $25 million in new state sales tax collections in fiscal year 2009 and predicts that they will generate $33 million in new state revenue in 2010. Local sales tax collections for each year are approximately equivalent to the state collections, meaning that the tax law change is raising well over $100 million over two years.[18] Should New York appellate courts uphold the law, these figures will likely rise. A proposed California version of the law would have generated $150 million annually in combined state and local sales taxes.[19]

Retailers' Threats to Eliminate Affiliate Programs Are No Reason to Reject Law

A number of Internet retailers responded to the enactment of New York's law by eliminating their relationships with New York affiliates. More recently, Overstock.com (one of the companies that terminated its New York affiliates) and Amazon.com publicly threatened to eliminate their affiliate programs in any other state that enacts such a law. Press reports indicate that one or both companies carried out this threat when similar legislation approached enactment in California, Hawaii, North Carolina, and Rhode Island, and that these terminations remain in place in the latter two states.

While large companies like Amazon and Overstock can eliminate their affiliate programs in a few states to garner publicity and make their threats credible without doing too much damage to their nationwide sales, the ability to do so in a large number of states for a long period of time seems questionable. Amazon pays its Associates sales commissions totaling "hundreds of millions of dollars per year."[20] For the Internet retailing industry as a whole, such commissions totaled $2.1 billion in 2008, according to the Jupiter Research consulting firm.[21] The ubiquity of affiliate programs and the amount of money that retailers spend on them suggest that they are highly valuable to retailers, presumably because they are effective. (The fact that some of these retailers are household names does not mean they don't need strong marketing campaigns; even well-established non-Internet brands like Coke and McDonalds must engage in constant marketing to counter their competitors.) It could be quite costly for Amazon and Overstock to replicate with conventional advertising and other marketing tools the impact of having hundreds of thousands of websites constantly displaying their products and funneling customers to their online stores. Smaller retailers with fewer financial resources would find it even more difficult.

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[18] Personal communication, New York State Department of Taxation and Finance.

[19] California State Board of Equalization Staff Legislative Bill Analysis for AB 178, 2009.

[20] "Attention Amazon Associates Web Service Developers," post on Amazon.com's in-house blog for Associates, May 8, 2009. Amazon's annual report to the Securities and Exchange Commission for 2008 indicates that the company spent $482 million worldwide on marketing. Assuming that commissions to affiliates are included in that figure, Amazon's statement that it pays "hundreds of millions of dollars" to affiliates implies that such commissions represent a very significant share of its overall marketing expenditures.

[21] "Sales Tax Woe and Social Networking on Affiliate Marketers' Minds," *Internet Retailer* web site, July 2008, www.internetretailer.com/printArticle.asp?id=26904.

Some industry analysts argue that it could be unwise for Internet retailers to carry out their threats to end affiliate programs. Bruce Cundiff of Javelin Strategy and Research told *E-Commerce Times*: "Strategically, Amazon is farming more and more of its business to those affiliates. . . . This is very important to Amazon's present and future. . . . For Amazon, at the end of the day, it's cutting off your nose to spite your face."[22] Tom Barlow of the widely read BloggingStocks website wrote: "I suspect Amazon is swimming against an insurmountable tide. If it drops all its marketing affiliates in each state that proposes this tax, it threatens to compromise one of the cornerstones of its marketing program."[23] Rich Duprey of Motley Fool wrote: "Losing affiliates and, therefore, one more avenue to sell its wares was the last thing Overstock needed, because it has had virtually no sales growth over the past three years."[24] Shawn Collins, who writes a well-known blog aimed at members of affiliate programs, warned online retailers:

> I would recommend that you not boot out affiliates living in New York, as some companies have done. This sort of kneejerk reaction may or many not impact purchases from New York customers, but it will definitely have a negative impact on your reputation among affiliates. After all, even if I am not in a state that currently has such a tax, there is always a chance the same sort of legislation could come in the near future. So, if I see you removing affiliates due to this sort of law, I am going to be less inclined to promote you, since I figure I could be kicked out after doing a lot of work to make sales for you. Also, if the New York law catches on elsewhere, as it seems to be doing, we may well be in a situation where most states have a nexus law. In that case, you'll either have a shallow pool of affiliates to partner with or you'll try to re-recruit the same affiliates you alienated in the affected states.[25]

The affiliates and retailers have argued that the new laws are self-defeating: retailers that cancel their affiliate programs will not collect the sales tax anyway, and affiliates' loss of income due to those cancellations has a negative "multiplier effect" on local economic activity, reducing income and sales tax revenue. But Internet retailers that suspend their affiliate programs likely will make fewer sales in those states, and some of the sales they lose will shift back to in-state stores (thereby

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[22] Mike Pearson, "Amazon Turns Gears of Internet Tax Wars," E-Commerce Times, July 1, 2009; www.ecommercetimes.com/story/Amazon-Turns-Gears-of-Internet-Tax-Wars-67489.html.

[23] Tom Barlow, "Amazon Warns California Against Internet Sales Tax," June 24, 2009; www.bloggingstocks.com/2009/06/24/amazon-warns-california-against-internet-sales-tax/.
Conversely, some analysts argue that since affiliate programs are directly responsible for only a fraction of Internet retailers' sales, their elimination would have no significant adverse financial consequences:

> Dropping affiliates doesn't cause significant financial damage to e-commerce companies. Forrester Research analyst Sucharita Mulpuru estimates affiliates drive between 8% and 20% of the sales for e-commerce sites. But many of those buyers would find their way to online retailers anyway. (Geoffrey A. Fowler and Erica Alini, "States Plot New Path to Tax Online Retailers, Wall Street Journal, July 3, 2009.)

This argument, however, ignores the fact that in an industry with high fixed costs (for example, for marketing, operating warehouses and server farms, and maintaining a website) and relatively low margins on merchandise sales, the incremental 8 percent to 20 percent of sales attributable to an affiliate program may well represent the difference between profitability and unprofitability for certain companies.

[24] Rich Duprey, "These 5 Underdogs Are No Dogs," Motley Fool website, July 16, 2009; http://www.fool.com/investing/general/2009/07/16/these-5-underdogs-are-no-dogs.aspx.

[25] Shawn Collins, "Affiliate Programs and the New York Nexus Law," March 16, 2009; http://affiliatetip.com/news/article002541.php.

boosting the local economy) or shift to other Internet retailers that have always collected the state's sales tax or begin doing so under the new law.

Furthermore, state economic development departments in states enacting laws like New York's could help affiliates who are cut off by their retailers to identify compatible affiliate programs run by Internet retailers that *do* collect tax in their states. For example, an affiliate cut off by Amazon could join the affiliate program of IndieBound[26] (a network of the websites of independent local bookstores) or Barnes & Noble (a national Internet bookseller that competes with Amazon and collects sales tax in nearly every state). A website providing links to Amazon's home electronics products could join the affiliate program of Best Buy, which collects sales tax in every state in which it has a store.

As in most conflicts, there is strength in numbers. If a significant number of states enacts and enforces these laws despite threats from Internet retailers, eventually many retailers will likely begin collecting the states' taxes. One way to facilitate such interstate cooperation would be to enact the law as an interstate compact that would not go into effect in any state until a threshold number of states joined.

Conclusion

In its 1992 *Quill* decision reaffirming a "physical presence requirement" for the collection of sales and use taxes by remote sellers, the Supreme Court essentially invited Congress to intervene in the issue and set reasonable ground rules under which at least some sellers could be required to collect these taxes. Representatives of state and local governments have been petitioning Congress for such action ever since, even as their revenue losses have continued to mount.

Until Congress acts, states should not allow their tax bases to be eroded and the competitiveness of their local businesses harmed if they can effectively and legally address part of the problem themselves. They now have an important self-help strategy for that effort.

[26] See: Kristen McLean, "An Alternative for Ex-Amazon Affiliates," June 30, 2009; http://news.shelf-awareness.com/msgget.jsp?mid=2935145.