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"Amazon Tax" Unconstitutional and Unwise

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Amazon.com, LLC v. New York State Department of Taxation and Finance

On September 9, 2009, the Tax Foundation filed an *amicus curiae* brief ("friend of the court") in the New York Supreme Court, Appellate Division, First Department, in the case of *Amazon.com, LLC v. New York State Department of Taxation and Finance*, No. 601247-2008. The case is on appeal from the trial-level Supreme Court of New York. (The highest court in New York is called the Court of Appeal.)

States Can Only Tax Businesses That Have "Substantial Nexus" With the State

When a consumer buys something online, in many cases that consumer is not charged sales tax by the online retailer. The U.S. Supreme Court has ruled that, to prevent disruptions to interstate commerce, a state may force only those businesses with a "substantial connection" with the state ("nexus") to collect its sales tax.¹ Otherwise, businesses would face an enormous burden of complying with over 8,000 separate sales tax jurisdictions, with ever-changing bases and rates.² Thus, only businesses with employees or property in a state usually collect a state's sales tax, even if the employees or offices are not directly involved in soliciting sales in the state.³

Substantial nexus does not exist if a company has no employees, offices, or outlets in the state, nor independent persons whose activities are crucial for establishing and maintaining the in-state market for the company's sales.⁴

New York and Two Other States Enact "Amazon Tax" Law

Frustrated by its residents who purchase items online but do not pay the sales or use tax they owe, New York targeted online retailers with only the slightest connection to New York by enacting the so-called "Amazon tax" in April 2008. It is designed to force online retailers like Amazon.com to collect New York sales tax on purchases made by New Yorkers, even though

Amazon has no property or employees in New York. The law requires retailers that have contracts with "affiliates"—independent persons within the state who post a link to Amazon.com on their website and get a share of revenues—to collect New York sales tax.

In 2009, Rhode Island and North Carolina enacted identical laws. The legislatures of California and Hawaii also passed "Amazon taxes," but they were vetoed by their respective governors. Sponsors emphasized a revenue windfall that would follow from passage, but the law's dubious constitutionality guarantees significant litigation, ensuring that it cannot be a short-term revenue solution.

"Amazon Tax" Challenged as Violating U.S. Constitution

Amazon.com challenged the law as violating the U.S. Constitution, arguing that they have no property or employees in New York and thus cannot constitutionally be required by the state to collect its taxes. New York relied on two U.S. Supreme Court cases, *Scripto, Inc. v. Carson* and *Tyler Pipe Indus. v. Washington Dep't of Revenue*, where in-state independent persons were so necessary and significant in establishing and maintaining the out-of-state company's market in the state that the companies were deemed to be present in the state.⁵ These "attributorial nexus" cases have been described by the Supreme Court itself as the "furthest extension" of nexus.

A trial court in New York, confusingly named the Supreme Court of New York, found for the state and ruled that the law was constitutional. The court refused to consider how significant the affiliates were in establishing or maintaining Amazon.com's New York market; instead they simply held that Amazon.com gained economic benefits and thus nexus was established.⁶ Whether Amazon.com gains economic benefits is the test for *employees*, not for *independent persons*. The trial court thus confused two unrelated tests and therefore reached the wrong conclusion.

The trial court also claimed that Amazon.com is "avoiding" taxes.⁷ This is not true; the taxes are owed by New Yorkers purchasing items online. Under the New York law, Amazon.com would collect these taxes, but the dollars would be paid by New York consumers. (The burdens of collection, however, would be imposed on Amazon.com.)

The "Amazon Tax" Goes Beyond Any Previous Extension of Physical Presence

New York's law is an unprecedented expansion of state taxing authority. The affiliates are responsible for only 1.5% of Amazon.com's sales in New York, and there is no evidence that the affiliates even target New Yorkers (they operate via websites, available worldwide). The affiliates neither engage in direct solicitation nor provide any crucial sales support for Amazon.com in the state. At minimum the court must find that the affiliates are essential for Amazon.com's market in the state before deeming the out-of-state company to be "present" in the state.

In the *Quill* case of 1992, the Supreme Court struck down a North Dakota tax collection obligation on mail-order businesses, where the threshold was \$1 million of in-state sales. By contrast, New York's law applies to businesses with just \$10,000 in in-state sales. If New York's threshold is adjusted for population (New York in 1987 had 27 times the population of North

Dakota) and inflation (\$1 in 1987 = \$1.90 in 2009), North Dakota's equivalent threshold in 1987 would have been \$194.73. Conversely, North Dakota's threshold (again, one found to be insufficient by the Supreme Court) today would be the equivalent of \$51 million in annual sales in New York.

Unconstitutionally Expansive Nexus Standards Like the "Amazon Tax" Undermine Legal Certainty, Interstate Commerce, and Economic Growth

The people of the United States adopted the U.S. Constitution in large part because their existing national government had no power to stop states from imposing trade barriers between each other, to the detriment of the national economy.⁸ In the Commerce Clause of the U.S. Constitution, Congress and the courts thus have the power to strike down laws that burden interstate commerce.

The economic and technological developments of the past few decades make preserving a bright-line physical presence nexus rule for state taxation all the more vital. The importance of the Commerce Clause and its protections for interstate business is only enhanced in an age of economic integration. "Today's more integrated national economy presents far greater opportunities than existed in 1787 for states in effect to reach across their borders and tax nonconsenting nonbeneficiaries." Daniel Shaviro, *An Economic and Political Look at Federalism in Taxation*, 90 Mich. L. Rev. 895, 902 (1992). Regrettably, because economic integration is greater now than it was in 1780, the economic costs of nexus uncertainty are also greater today and can ripple through the economy much more quickly.

Widespread adoption of vague and expansive nexus standards will expand these compliance costs and cause adverse impacts on interstate commerce. (For more, see Joseph Henchman's article, *Why the Quill Physical Presence Rule Shouldn't Go the Way of Personal Jurisdiction*, 46 State Tax Notes 387 (2007), available at <http://tinyurl.com/quillnexus>.) Compliance costs for businesses engaged in interstate commerce will increase. Businesses that merely expand their sales into such states will have to understand the local tax base, any applicable tax rates, available tax incentives, and differing apportionment formulas. Differing nexus standards among the states means businesses will have to guess about whether to file and pay taxes or not.

Concerns about the cost of complying with multiple state tax systems, and the resulting economic harm, was at the heart of the *Quill* decision. The Court specifically recognized that economic harm that would come from requiring *Quill* to potentially collect tax in over 6,000 (now 8,000) separate tax jurisdictions, all with different tax systems.⁹ Such concerns are equally pressing in this case, where an unconstitutional and breathtakingly expansive nexus standard will lead either to a decrease in economic expansion or a lower rate of return for those that choose to press ahead.

The "Amazon tax" is just the latest in a series of efforts to eliminate the long-standing "physical presence" standard and replace it with a nebulous, arbitrary standard of "economic presence." Businesses throughout our nation's history could always ply their trade across state lines. Today, with new technologies, even the smallest businesses can more easily reach across geographical borders to sell their products and services in all fifty states. If such sales can now expose these

businesses to tax compliance and liability risks in states where they merely have customers, they will be less likely to expand their reach into those states.

Notes

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1. See *Quill Corp. v. North Dakota*, 504 U.S. 298, 311 (1992); *Nat'l Geographic Soc. v. Cal. Bd. of Equalization*, 430 U.S. 551, 556 (1977) (rejecting a "slightest presence" standard as insufficient and establishing that there must be "a much more substantial presence than the expression 'slightest presence' connotes"). See also *Borders Online, LLC v. Cal. Bd. of Equalization*, 129 Cal. App. 4th 1179, 1200 (2005) (finding no substantial nexus if the in-state activities of independent persons are 'de minimis local activities or proof that the local activities do not generate any significant proportion of local sales.');" *St. Tammany Parish Tax Collector v. Barnesandnoble.com*, 481 F. Supp. 2d 575 (E.D.L.A. 2007) (finding no substantial nexus where in-state company was not a "marketing presence" for the out-of-state company nor provided it with any substantial operational benefit); *J.C. Penney Nat'l Bank v. Johnson*, 19 S.W.3d 831, 833, 841 (Tenn. App. 1999) (finding no substantial nexus where mail solicitation and credit card processing conducted by independent contractors did not "substantially contribute[] to the taxpayer's ability to maintain operations in the taxing state," nor did the contractors "actually perform[] any services on behalf of [the credit card company] in the State.").

2. See *Quill Corp.*, 504 U.S. at 312. ("Commerce Clause and its nexus requirement are informed . . . by structural concerns about the effects of state regulation on the national economy.").

3. See *Standard Pressed Steel Co. v. Department of Revenue of Washington*, 419 U.S. 560, 562 (1975) (company employees); *Matter of Orvis Co. v. Tax Appeals Tribunal*, 86 N.Y.2d 165, 178 (1995) (company employees); *Nat'l Geographic*, 430 U.S. at 560-61 (company offices); *Nelson v. Sears, Roebuck & Co.*, 312 U.S. 359 (1941) (company offices); *Nelson v. Montgomery Ward*, 312 U.S. 373 (1941) (company offices).

4. See *Quill Corp.*, 504 U.S. at 315 (finding that contact with in-state customers by mail or common carrier, or presence of floppy diskettes owned by the company, did not establish substantial nexus); *National Bellas Hess*, 386 U.S. 753 (1967) (finding that an out-of-state company's contact by "mail or common carrier" alone did not establish substantial nexus); *J.C. Penney*, 19 S.W.3d at 840 (finding that in-state presence of credit cards legally titled to the issuing credit card company did not establish substantial nexus.).

5. See *Tyler Pipe Indus. v. Washington Dep't of Revenue*, 482 U.S. 232, 250 (1987) (stating that the non-employee's activity must be "significantly associated with the taxpayer's ability to establish and maintain a market in [the] state for [its] sales."); *Quill Corp.*, 504 U.S. at 249. See, e.g., *Scripto*, 362 U.S. at 211 (finding physical presence where 10 independent contractors

engaged in a "local function of solicitation" that was "effective[] in securing a substantial flow of goods into [the state]"); *Tyler Pipe*, 482 U.S. at 251 (finding physical presence where in-state independent contractors "acted daily on behalf of [an out-of-state company] in calling on [in-state] customers and soliciting orders," rendering them "necessary for maintenance of [the company's] market and protection of its interests."); *Quill Corp.*, 504 U.S. at 249.

6. *See Amazon.com LLC v. New York State Dept. of Taxation and Finance*, 877 N.Y.S.2d 842, 849 (N.Y. Sup. 2009) ("Amazon further states that Associates' referrals to New York customers are not significantly associated with its ability to establish and maintain a market for sales in New York. . . . None of these allegations, however, sufficiently state a claim for violation of the Commerce Clause.").

7. *See id.* ("Amazon has not contested that it contracts with thousands of New Yorkers and that as a result of New York referrals to New York residents it obtains the benefit of more than \$10,000 annually. Amazon should not be permitted to escape tax collection indirectly, through use of an incentivized New York sales force to generate revenue, when it would not be able to achieve tax avoidance directly through use of New York employees engaged in the very same activities.").

8. *See Gibbons v. Ogden*, 22 U.S. (9 Wheat.) 1, 224 (1824) (Johnson, J., concurring) ("[States' power over commerce,] guided by inexperience and jealousy, began to show itself in iniquitous laws and impolitic measures . . . , destructive to the harmony of the states, and fatal to their commercial interests abroad. This was the immediate cause, that led to the forming of a convention.").

9. *See Quill*, 504 U.S. at 313 n.6.