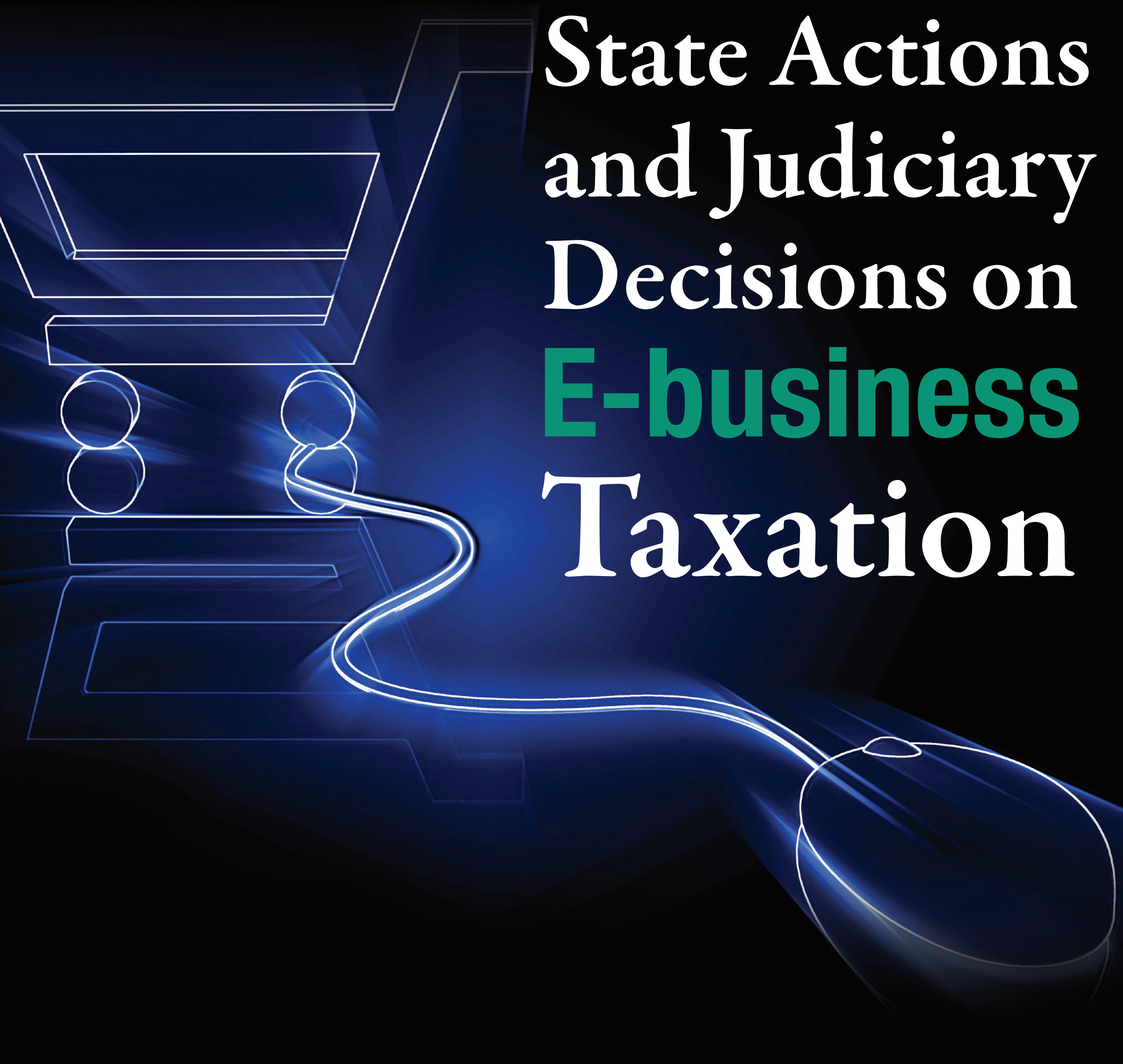
State Actions and Judiciary Decisions on E-business Taxation



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Internet commerce is a driving engine in today's economy. Annual e-business had reached $297 billion, totaling 6.4 percent of retail sales as of 2014, with a growth rate at 15.7 percent a year.[1] Problematically, sales tax is the purview of state and local governments. When seller and buyer reside in different states, responsibility for collecting sales tax is unclear. State governments have no authority over out-of-state sellers, whereas in-state buyers frequently ignore their use tax paying duties. Thus, state governments stand to lose a huge amount of sales tax revenue, by recent estimate, up to $23 billion a year.[2] The problem will only grow as most businesses today move to the Internet.

A sales transaction gives rise to sales tax. If the seller and buyer reside in the same state, it is the seller's responsibility to collect sales tax. If they reside in two different states, can the buyer's state government require an out-of-state seller to collect the sales tax? The 14th amendment of the U.S. Constitution requires due process to do so. The due process is meant to be nexus between the seller and the state. Evidently, what constitutes nexus becomes the key issue. The criteria are ambiguous and controversial. In the past six decades, 12 cases went to the U.S. Supreme Court for rulings. This article will review some of the major ones.

The guiding principle in making these court decisions was the concept of "physical presence." Nevertheless, in the last decade many state legislatures have been evolving to "economic nexus." This article will explain the differences between them. It will review four states and will also explore the most recent decisions by the U.S. Supreme Court. It will further offer an overview of the requirements of the new "Marketplace Fairness Act of 2013." The purpose is to point out that the developing trend of Internet commerce taxation has been shifting from the principle of "physical presence" to "economic nexus."

Transactions crossing a state border involve interstate commerce affecting almost all e-business transactions. States cannot require out-of-state sellers to collect tax unless there is a nexus between the seller and the state that satisfies the Commerce or Due Process clauses. For the state to impose tax collecting duties on an out-of-state seller, there must be a minimum connection between them.

Current Status of E-business Taxation by U.S. High Court Decisions

In the last six decades, the U.S. Supreme Court made at least a dozen rulings on tax collection from out-of-state sellers. Some of the major ones are:

- Mail orders of a company with a branch in the buyer's state constitute physical presence requiring tax collection. *Nelson (Iowa) v. Sears, Roebuck & Co.* (1941),[3] and *Nelson (Iowa) v. Montgomery Ward & Co.* (1941).
- Mail orders of a company without a branch or any contacts in the buyer's state are not subject to tax. *National Bellas Hess Co. v. Illinois Department of Revenue* (1967),[4] and *Quill Corp. v. North Dakota* (1992).[5]
- Sending traveling salespeople to a buyer's state subjects the seller to tax. *General Trading Co. v. Iowa State Tax Commission* (1944).[6]
- A dispute involved whether customers from a neighboring state should give rise to physical presence. The decision was negative. *Miller Brothers Co. v. Maryland* (1954).[7]
- Independent contractors in the buyer's state subject the seller to tax. *Scripto, Inc. v. Carlson* (Florida1960).[8]

These decisions were based on the principle of "physical presence," which defined the requirement of "due process." The business environment operates differently now.

By 2008, the principle of "physical presence" started to change. The Internet age had arrived. Computers connected with one another. An email can reach a targeted customer, replacing a salesperson. Employee physical presence is unnecessary. The transaction is executed online in real time. Many products can be digitized and downloaded from one computer to another, such as e-books. Offices, warehouses and branches are unnecessary.

In all these cases, despite the lack of physical presence, the seller derived profit from the buyers. The requirement of physical presence between the seller and the state becomes questionable. As a result, the concept of "economic nexus" began to evolve. As long as an out-of-state seller receives benefits from the state, it must be required to collect tax from the in-state buyer. The action comes from the state governments. The sellers always claim lack of physical presence to avoid collecting sales tax, costing state governments a huge amount of sales tax revenue. So far, many actions have been taken by state governments. The following section reviews four major ones.

New York's Amazon Tax Involving an Affiliate's Website Link

In 2008, the state of New York's Legislature enacted a new tax statute as follows:[9]

"The term *vendor* includes persons who solicit business within the state through employees, independent contractors, agents or other representatives and, by reason thereof, make sales to persons within the state of tangible personal property or services that are subject to sales tax."

An out-of-state seller is required to register as a vendor and collect sales tax if the following two conditions are met:

- The seller enters into an agreement(s) with a New York resident(s) under which, for a commission or other consideration, the resident representative directly or indirectly refers potential customers to the seller, whether by link on an Internet website or otherwise. A resident representative would be indirectly referring potential customers to the seller where, for example, the resident representative refers potential customers to its own website, or to another party's website, which then directs the potential customer to the seller's website.
- The cumulative gross receipts from sales by the seller to customers in New York as a result of referrals to the seller by all of the seller's resident representatives under the type of contract or agreement described above total more than $10,000 during the preceding four quarterly sales tax period.

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The statute deals with online sales as follows:

"Also, an e-commerce retailer that uses persons to act as its representative in the state to solicit sales or to make and maintain a market in return for commissions, referral fees or other types of compensation is considered to be soliciting business within this state through the use of independent contractors or representatives. Therefore, the e-commerce retailer must register as a vendor for New York State and local sales tax purposes."

However, the statute provides for exceptions as follows:

"In addition, an agreement to place an advertisement does not give rise to the presumption described above. For this purpose, placing an advertisement does not include the placement of a link on a website that, directly or indirectly, links to the website of a seller, where the consideration for placing the link on the website is based on the volume of completed sales generated by the link."

"STATE GOVERNMENTS HAVE NO AUTHORITY OVER OUT-OF-STATE SELLERS, WHEREAS IN-STATE BUYERS FREQUENTLY IGNORE THEIR USE TAX PAYING DUTIES."

Amazon.com's headquarters is in Seattle, Washington. It has no branch in New York and no "physical presence." However, it did enter into agreements with many affiliates in New York to put its website link "amazon.com" on the affiliates' websites so customers could order merchandise from Amazon by using this link. The statute cites the website link as an evidence of "nexus" between Amazon and New York. The concept of "nexus" now means "economic nexus," since Amazon derives benefits from New York.

Many other companies have affiliates in New York, including overstock.com, eToy.com, luggage.com, RitzCamera.com, geeks.com, etc. There are 200,000 such affiliates nationwide, generating $14 billion in sales revenue. They have earned $6.5 billion in commissions. Lost sales tax revenue in New York by Amazon alone was $73 million in 2009. New York is not the only state to enact this tax statute. Other enacting states include Arkansas, California, Colorado, Connecticut, Florida, Kentucky, Illinois, Missouri, New Jersey, Nevada, North Carolina, Ohio, Pennsylvania, South Carolina, Texas, Tennessee and Virginia.[10]

State Judiciary Decision on New York's Amazon Tax Law

On July 16, 2008, amazon.com and overstock.com filed suit against New York in the New York Supreme Court, arguing that "Amazon had no physical presence – no real estate, employees or sales agent – in New York, and it therefore indisputably lacked a substantial nexus with the state. It had only website advertising affiliates and their in-state activities in Amazon's behest did not create a substantial nexus. Indeed, the physical location of Amazon associates was irrelevant and unknown to Internet consumers. Those websites could draw "hits" from anywhere, and there was nothing New York-centric about such advertising posting.[11] Amazon argued the affiliates are not Amazon's employees. Amazon had no control over them. All computers are connected today. The website link is nothing more than an "advertising channel." It should not be construed as physical presence and, hence, there is no nexus. This argument attempted to portray the affiliates as independent contractors who were paid commissions under contract. But per the *Scripto* case, independent contractors constitute physical presence.

New York countered that "... Amazon's business model depended on a closer relationship with its representatives than the simple publication of advertising; that Amazon's compensation plans for its representatives rewards them for actively marketing rather than passively placing links on websites; that Amazon does authorize its representatives to solicit business in New York for Amazon through means beyond the placement of links on websites ..."

On Jan. 12, 2009, the court ruled in favor of New York. Amazon.com and overstock.com appealed to the New York Supreme Court, Appellate Division. On Nov. 4, 2010, the court ruled again in favor of New York.[12]

The "New York Amazon Tax Law" has completely changed the landscape of Internet commerce taxation by introducing the concept of "economic nexus." A seller having no physical presence in a state, but having derived profit from it, would be construed to have nexus. The seller is then required to collect sales tax from the buyer. It has also changed the interpretation of the requirement of "due process." As a consequence, many online retailers have terminated agreements with their affiliates in New York, such as amazon.com, overstock.com, eToy.com, luggage.com, RitzCamera.com, geeks.com, etc. This may have a devastating impact on the state's economy.

Illinois Also Adopts "Amazon Tax," but Rejected by Court

In line with New York's "Amazon Tax Law," on March 10, 2011, the Illinois General Assembly enacted Public Act 096-1544. It provided that "1.1. Beginning July 1, 2011, a retailer 'maintaining a place of business in the state' now includes a retailer having a contract with a person located in this state under which the person, for a commission or other consideration based upon the sale of tangible personal property by the retailer, directly or indirectly refers potential customers to the retailer by a link on the person's Internet website. The provisions of this paragraph 1.1 shall apply only if the cumulative gross receipts from sales of tangible personal property by the retailer to customers who are referred to the retailer by all persons in this state under such contracts exceed $10,000 during the preceding four quarterly periods ending on the last day of March, June, September and December."[13]

This provision means that any out-of-state online seller with affiliates in Illinois is required to collect sales and use tax from the buyers in

Illinois. It is the same as New York's law. However, the Performance Marketing Association immediately filed a lawsuit against the Illinois Department of Revenue to the Circuit Court of Cook County. The court ruled against the state of Illinois on the grounds that an out-of-state online seller has no substantial nexus with Illinois under the Commerce Clause. The state appealed to the Supreme Court of Illinois. It was again ruled against the state on the basis that the Illinois statute discriminates against out-of-state sellers.[14] The statute was ruled to be in violation of the Internet Tax Freedom Act of 1998.[15]

The decision by the Illinois Supreme Court was obviously in direct contradiction to the decision by the New York Appeals Court on the same subject. Not to be deterred, the Illinois Legislature passed a revised act in 2014 that imposes the obligation to collect Illinois sales tax on out-of-state retailers that are deemed to have a taxable presence in the state even though they don't have a physical presence.[16] Amazon had decided as a corporate matter that it would build several facilities in Illinois by 2017, including one to be built in 2015. Thus, it announced it would comply with the law and withhold Illinois sales tax. Other out-of-state retailers wishing to not collect the tax would have to challenge the Illinois statute as a violation of the Commerce Clause, and the cost of the challenge may just be sufficient to deter any action on their part.

North Carolina Requirement – Customers' Personal Information

Amazon engaged in at least 50 million transactions between 2003 and 2008 in North Carolina, but never collected sales tax due to lack of physical presence. On Dec. 1, 2009, the North Carolina Department of Revenue ordered Amazon to supply buyers' names, addresses, nature of products and amounts of purchase, for the purpose of tracking down the buyers and demanding payment of use tax. The order covered all products, including video. Amazon released the nature of products and amounts purchased, but not the names and addresses. On March 19, 2010, North Carolina sent out a second request threatening to subpoena Amazon's records. Amazon immediately filed a petition to the United States District Court Western District of Washington, claiming that North Carolina violated both the First Amendment and the Video Privacy Protection Act.

"The First Amendment protects a buyer from having the expressive content of her purchase of books, music and audiovisual materials disclosed to the government. Citizens are entitled to receive information and ideas through books, films and other expressive materials anonymously."

The Video Privacy Protection Act makes it illegal for a video tape service provider to disclose "personally identifiable information concerning any consumer."[17]

On Oct. 25, 2010, the court ruled in favor of Amazon granting declaratory relief. "The court therefore declares: to the extent the March Information Request demands that Amazon disclose its customers' names, addresses or any other personal information, it violates the First Amendment and 18 U.S.C. §2710, only as long as the Department of Revenue continues to have access to or possession of detailed purchase records obtained from Amazon (including ASIN numbers)."[18]

Notwithstanding the above, for reasons unexplained, Amazon started collecting sales tax on North Carolina purchases in 2014. Once again, it seems like the states may be losing the battles, but winning the war.

Colorado Makes Seller Responsible for Tax Enforcement

On March 1, 2010, the Colorado House enacted a bill, 10-1193, as follows:

- "(I)(A) Each retailer that does not collect Colorado sales tax shall send notification to all Colorado purchasers by January 31 of each year showing such information as the total amount paid by the purchaser for Colorado purchases made from the retailer

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in the previous calendar year. 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. The notification shall state that Colorado requires a sales or use tax return to be filed and sales or use tax paid on certain Colorado purchases made by purchaser from the retailer."

- "(II)(A) Each retailer that does not collect Colorado sales tax shall file an annual statement for each purchaser to the Department of Revenue on such forms … showing the total amount paid for Colorado purchases of such purchasers during the preceding calendar … and such annual statement shall be filed on or before March 1 of each year."

Out-of-state sellers must submit three reports:

- Transactional Notice to in-state buyers informing them the seller did not withhold sales tax from the buyers, and the buyers must pay use tax to the Department of Revenue.
- Purchase Summary to in-state buyers showing all details of each transaction, including the name of the product and the amount of purchase.
- Customer Information Report to the Department of Revenue showing the purchasers' names, addresses, nature of the products and amounts of purchase for all purchasers and all transactions in the current year.

On Aug. 13, 2010, the Direct Marketing Association (DMA) filed a petition to the United States District Court for an injunction to stop enforcement of the Colorado statute. On Jan. 26, 2011, the court ruled in favor of the association. "It is ordered that … Colorado Department of Revenue is enjoined and restrained from enforcing the provisions of §39-21-112(3.5), C.R.S. (2010) and the regulations … 1 Colo. Code regs. §201-1:39-21-112.3.5 (2010) …"[19]

The court stated "… the Direct Marketing Association (DMA) has shown a substantial likelihood that it will succeed in showing that the act and the regulations are discriminatory because, in practical effect, they impose a burden on interstate commerce that is not imposed on in-state commerce." Furthermore, "the act and the regulations impose these burdens on out-of-state retailers who have no connection with Colorado customers other than by common carrier or the United States mail. Those retailers likely are protected from such burdens on interstate commerce by the safe harbor established in Quill." The court concluded, "if, in the end, the act and the regulations are found to be unconstitutional because they violate the Commerce Clause, the affected retailers would be unable to recover these compliance costs from the state of Colorado. Under these circumstances, the compliance costs faced by retailers subject to the act and the regulations constitute irreparable injury." In other words, Colorado is prohibited from requiring the out-of-state retailers to enforce the tax reporting responsibilities.

Colorado appealed the District Court injunction to the 10th Circuit Court of Appeals, which in August, 2013 sent the case back to the District Court with an order to lift the injunction, because federal courts are not allowed to become involved in state tax disputes. The DMA appealed this decision to the U.S. Supreme Court, which in 2015 overturned the 10th Circuit decision. This leaves it up to the 10th Circuit to either send the case back to the U.S. District Court for a hearing on the merits or to refer the case to the Colorado courts based on the principle of comity, which allows one court to defer to another when both courts have jurisdiction. Eventually, this may mean the case on the merits will find its way back to the Supreme Court. As it stands now, Colorado is still prohibited from enforcing its tax reporting responsibilities. Evidently, the status of e-business taxation is currently in the state of confusion.

Most Recent U.S. Supreme Court Decision

The New York Appeals Court decision on the case of the "Amazon Tax" on Nov. 4, 2010, as mentioned earlier, was not over yet. Amazon and Overstock immediately appealed again to the U.S. Supreme Court. On Dec. 2, 2013, the petition was denied. The court did not give any reason. This means that any out-of-state seller with Amazon-type Internet business is required to collect sales tax from an in-state buyer, regardless of whether the seller has "physical presence" in the state. If that is indeed the conclusion, the argument between the "physical presence" and the "economic nexus" has come to an end. Unless a court in a state with a statute similar to New York's comes to a different conclusion and holds for the taxpayer, it is unlikely that the Supreme Court will again become involved in this issue.

This U.S. Supreme Court decision implies that all its own decisions in the past concerning the requirements for physical presence are no longer relevant in deciding the responsibility for collecting the sales tax. Those sellers who have physical presence certainly have "economic nexus." However, those who have "economic nexus" may not have "physical presence." In today's Internet commerce environment, almost all sellers are outside the state. They have economic nexus, but not physical presence. As such, all of them are required to collect sales tax from an in-state buyer. This concept is unusually radical.

In fact, there is another new development. In the midst of the endless debate between the state governments and the out-of-state sellers concerning the sales tax, the U.S. Congress stepped in and enacted the *Marketplace Fairness Act of 2013*, as will be explained below.

Marketplace Fairness Act of 2013

Before the U.S. Supreme Court made the decision on Dec. 2, 2013, as mentioned above, on May 6, 2013, the U.S. Senate passed the *Marketplace Fairness Act of 2013*, though it has not yet been passed in the U.S. House of Representatives, as of Nov. 1, 2015. It attempts to settle the tumultuous arguments as to whether a state government can require an out-of-state seller to collect sales and use tax from the in-state buyer without "physical presence." The answer is affirmative with some conditions. It provides that "each member state under the Streamlined Sales and Use Tax Agreement is authorized to require all sellers … to collect and remit sales and use taxes with respect to remote sales sourced to that member state …"[20] This provision grants authority to the state government to require any out-of-state seller to collect sales and use tax from an in-state buyer, even if the seller has no physical presence in that state.

However, the state government must be a member of the so-called

Streamlined Sales and Use Tax Agreement (SSUTA).[21] What is the SSUTA? If a seller is required to collect and remit the sales and use tax to each state jurisdiction, it is almost an insurmountable task. There are 9,646 such jurisdictions. Each jurisdiction has a different tax base and tax rate. The tax administration is too much a burden. It discourages the sellers to comply with the tax law. To simplify the task, on Nov. 12, 2002, 44 states entered into the SSUTA. It stipulates that:

- Each state can have only one single tax collecting agency.
- Each state can have only one rule for determining what merchandise is taxable and what is nontaxable.
- Each state can have only one sales tax rate.
- Each state can have only one rule in determining what constitutes in-state sales and out-of-state sales, because these two kinds of sales have two different tax rates.

States that are not members of the SSUTA may still benefit from requiring out-of-state sellers to collect sales and use tax, as long as the state meets the above requirements and provides free computer software for the seller to use. It must also enact a law to relieve any liability on the part of the seller caused by the errors in the software or state tax agency. The purpose is to simplify the tax administration task and encourage the seller to collect sales and use tax.

A Changing Environment

This article dealt with the problem of e-business taxation. E-business gives rise to sales tax enacted by state and local governments. It involves the question as to whether the seller or buyer should collect sales tax. Today, e-business is interstate commerce, but a state government has no authority over an out-of-state seller. Under the Commerce Clause, an out-of-state seller is not responsible for sales tax collection unless "due process" is satisfied. However, the concept of due process requires court rulings to define it.

Under many court cases, the principle of "physical presence" had been the criteria for due process. To satisfy due process, the seller must maintain employees or a place of business in the state. In recent years, the business environment has changed. Computers replace employees and transactions are carried out online. Many products can be digitized. Many online retailers don't maintain a physical presence in a state, but still receive benefits from the state. Physical presence evolves to the concept of "economic nexus." As long as an out-of-state seller derives profits from a state, it must be required to collect sales tax from the in-state buyers. Many state governments have taken actions to require this sales tax.

This article reviewed four cases and the new *Marketplace Fairness Act of 2013*. It shows the evolving trend in the principle of taxation on Internet commerce. The act is the most updated and current prevailing law governing e-business taxation today, though it's still pending in the U.S. House of Representatives. Most likely, it will eventually be enacted.

Footnotes

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