

# Exemption of Businesses in Interstate sales and use tax collection

Considering Amazon.com and their related businesses

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## Introduction

Since its founding in 1995, Amazon.com's business plan included an aspect to limit the amount sales tax it would pay. Jeff Bezos, Amazon's founder, relocated to Seattle Washington specifically to avoid having to pay sales tax to customers in New York, his previous residence, where a large portion of Amazon's potential market was located. This strategic decision has led to a significant competitive advantage for Amazon. Amazon currently only collects sales tax in five states, providing it a price advantage to customers between 5%-9%, in most states. While many states have "use taxes" which require individuals and businesses to pay an equivalent tax on items bought out of state, these laws are largely unenforced except for large businesses and enforcing them on an individual basis is impractical. This issue has grown over the years as states have realized they are losing millions of dollars in revenue due to sales through retailers like Amazon.com. A number of states have passed legislation or gone to court to try and force Amazon to collect sales taxes. Here we will examine the legal history behind Amazon's sales tax avoidance scheme and the resulting fallout.

## Current State of Law

Businesses today are only required to collect sales taxes in locations where they have a physical presence. The current state of collection is based upon a 1992 Supreme Court case Quill vs. North Dakota. Many states have "use tax" laws which require buyers of goods to pay the equivalent to the "sales tax" on purchases that are made outside of the state and imported by the customer. These use tax laws put the burden of payment on the purchaser. Since the burden of remitting payment is on the purchaser much of the incurred use tax goes uncollected. Individuals are largely unaware of the use tax laws and many would likely not know how to remit taxes to their local state. Most mid-size and large businesses however largely do follow the use tax laws since they already have a sales tax

relationship with their local state and systems which track these taxes on individual purchases.

While Amazon has a "physical presence," namely distribution centers, in nine states it does not collect sales tax in some of those states, because of how Amazon has structured its businesses and subsidiaries. The distribution centers are operated as a separate legal entity. (Martinez, Amazon.com fights sales taxes after getting other breaks, 2011) Amazon collects sales tax in only four states based upon the "physical presence" requirement. The population of those four states collectively amounts to just 14.6M people or 4.7% of the total US population, based on 2010 census data. It also collects sales tax in New York for an additional 19.4M people under a court order requiring it to collect sales tax, but Amazon is challenging this ruling.

## Quill Corporation vs. North Dakota, 504 U.S. 298 (1992)

This case begins with the state of North Dakota filing suit in a North Dakota district court requiring the mail order company Quill Corporation, whose location was in Delaware, to collect and send to the state of North Dakota, use taxes which were incurred on behalf of North Dakota residents. The district court ruled in favor of Quill, noting that "North Dakota had failed to establish a significant nexus between the mail-order house and the state." The North Dakota Supreme Court, 470 N.W.2d 203, reversed this decision stating that the "due process clause and the commerce clause" did not require a physical presence in the state as a prerequisite to show a significant nexus. Furthermore, the state supreme court found that mail-order house benefited from the legal infrastructure of the state including the fact that Quill's 24 tons of paper catalogs annually were disposed of within the state.

The US Supreme Court reversed and remanded the North Dakota Supreme court decision. The court found that the due process clause did not prevent the state from pursuing actions against the mail-order

house. However the court then found that since the only connection between the mail-order house and the state was through a common carrier (postal and delivery services), the mail-order house lacked a substantial nexus as required by the commerce clause. The court relied upon its previous ruling in *National Bellas Hess vs. Illinois*, 386 U.S. 753 where it found that the use of only a common carrier did not constitute a sufficient nexus to for taxation purposes. The Supreme Court of North Dakota did not follow the *Bellas Hess* ruling because it felt "the tremendous social, economic, commercial, and legal innovations" rendered it mute. The idea of nexus or "connection" between the seller and the state which has a taxation scheme is a key to these cases. Substantial nexus has thus far included physical presence in the state or via a sales affiliate. A substantial nexus has not been found when the relationship has consisted only of a common carrier.

Lastly the court affirmed that Congress has the right to regulate interstate commerce via the constitution's commerce clause and thus may make future statute to cause companies doing business between the states to collect and remit use taxes.

### Amazon's Current Policy regarding Sales Tax and Corporate Structure

Amazon.com mainly sells the majority of its products through a subsidiary called Amazon.com LLC. This structure so far has permitted it to collect sales taxes in a limited number of locations. Amazon currently has physical operations in 17 states through its related entities.

Amazon's Sales Tax Help page (Amazon.com, 2011) summarizes their basic premise regarding sales tax collection:

The amount of tax charged depends upon many factors, including the identity of the seller, the type of item purchased, and the destination of the shipment.

Items sold by Amazon.com LLC, or its subsidiaries, and shipped to destinations in the states of Kansas, Kentucky, New York, North Dakota, or Washington are subject to tax.

Each of the distribution centers is a different legal entity from Amazon.com LLC, and thus have been immune from collecting sales taxes even though they have physical presences in some states. Another example includes the Amazon Kindle e-book reader which was developed by Lab126 based in Cupertino, California. Lab126, however, is a separate legal

entity, protecting Amazon.com LLC from having to collect sales tax in California. (Manjoo, 2010)

Ironically, Amazon has seen the issue of sales and use taxes coming for a long time. In 2003, Amazon's then CFO, Tom Szkutak, said collecting sales and use taxes on behalf of states, municipalities and other taxing jurisdictions is "inevitable and it's certainly something we support doing." (The Associated Press, 2003)

### Amazon's U.S. distribution network



Source: Seattle Times research

Reporting by AMY MARTINEZ Graphic by MARK NOWLIN/THE SEATTLE TIMES

### Amazon vs. North Carolina

In the pursuit of use taxes from its citizens, North Carolina has started an audit where it requested from Amazon information for all sales to North Carolina customers between August 1, 2003 and February 28, 2010. Amazon provided purchase information regarding sales during this time, but refused to provide name, address, and other personally identifiable information. (CCH, 2010) Amazon sued North Carolina to provide injunctive relief so that it would not have to provide the details of the orders to the state of North Carolina. Amazon claimed that providing this information violated the 1<sup>st</sup> amendment rights of free speech and furthermore violated the Washington State Constitution which governs where it primarily conducts business. The American Civil Liberties Union (ACLU) joined Amazon in this claim to stop the release of records which would link an individual to books and other items which were purchased. (Martinez, 2010)

Federal judge Marsha Perchman returned her decision, 2010 U.S. Dist. LEXIS 113163, on October 25, 2010 granting summary judgment to Amazon. The court found that giving the North Carolina Department of Revenue personally identifiable

information and the detailed sales records would be a violation of the 1<sup>st</sup> Amendment and the Video Protection and Privacy Act (VPPA). Previous precedence has established that the 1<sup>st</sup> Amendment protect, disclosure of media purchased or consumed by an individual.

Officials for North Carolina countered that they have no desire to know the detailed purchases of individuals; their sole focus is the collecting of sales and use taxes for residents in their state.

This case has not yet been appealed. Amazon has responded to this case by barring affiliates with North Carolina residence, reducing their nexus exposure within the state.

### **Amazon vs. New York**

In 2008, the New York legislature passed a law which was signed by governor Patterson requiring retailers who have \$10,000 or more in sales and at least one affiliate within the state to collect sales and use taxes. Specifically the statute stated that “an out-of-state vendor is presumed to have nexus in New York if the vendor (1) enters into agreements with a resident for Web site referrals or links; (2) pays commissions or fees for such referrals; and (3) the total gross receipts from sales made as a result of all such arrangements is at least \$10,000 during the preceding four quarterly periods.” (CCH, 2009) This New York law was developed based upon a related case of *Scripto vs. Carson*, 362 U.S 207 (1960).

In *Scripto vs. Carson* the Supreme Court of the United States affirmed a Florida State Supreme Court ruling which found a significant nexus between a *Scripto*, a pen manufacturer in Georgia, and *Carson*, a sales person in Florida. The state of Florida attempted to collect sales tax from *Scripto* based upon the presence of sales “associates” who were physically located in Florida. *Scripto* claimed that these associates were independent contractors and thus they did not have a physical presence in the state. The court found that the difference between a contractor and an employee had no bearing on the commerce occurring between states. This case set the precedence that a substantial nexus can be formed between a seller and a state through an independent sales association contractor who is co-located with the buyer. (Yang, 2009)

Other states such as Iowa, New Mexico, Vermont, and Virginia are considering “Amazon” laws which require companies who have an affiliate or related

party within the state to collect sales and use taxes. (CCH, 2010) Amazon thus far has responded to these laws in Colorado, North Carolina, and Rhode Island by barring affiliates in those states. (Slevin, 2010)

Amazon, however, responded differently to this legislation by challenging the constitutionality of the law in court. (Hansell, 2008) Unlike in other cases where Amazon choose to exclude local affiliates, New York’s affiliates appear to provide Amazon with a substantial revenue stream such that continuing litigation is a more effective course of action.

Amazon’s claim that the law was unconstitutional was rejected by the New York state court, 2009 NY Slip Op 29007, on January 12, 2009. The court found that Amazon’s complaint should be dismissed because it did not state a cause of action and that even if the facts of the case were deemed true there was no basis for Amazon to prevail.

Amazon appealed the decision and the appellate division of the Supreme Court of New York, 2010 NY Slip Op 7823, returned its decision on this case on November 4, 2010. The court found that the statute is constitutional based upon the application of the Commerce clause and the Due Process Clause, but the court found that further discovery is necessary to evaluate the as-applied Commerce and Due Process claims.

With the Commerce Clause challenge the court found that the taxpayer activity in New York met the standards of a “substantial nexus” since the statute only applied a tax obligation. The statute also required a substantial level of economic activity (\$10,000 per year) to show a substantial nexus. With the Due Process challenge Amazon and Overstock.com argued that the law was irrational and vague. However, the court found that the method of linking an affiliate to Amazon was reasonable. The court noted that additional discovery was necessary in the area of Commerce Clause as-applied claims. Specifically the court noted that taxpayers/affiliates should be given the option to demonstrate that they engaged only in advertising and not solicitation. The as-applied Due Process Clause test was also considered and noted the determining factor would be to find if the process of establishing a relationship solicitation entity (affiliates) constitutes and meets the substantial nexus standard. The court also found in favor of the state of New York on Equal Protection Clause specifically noting that multiple companies were treated similarly, specifically noting Amazon

and Overstock who were both challenging the law in court. (CCH, 2010)

Barnes and Noble which is based in New York extended its hand to affiliates by offering to collect and remit sales and use taxes for those who chose to offer to do business through its website. (Trachtenberg & Woo, 2011) Ironically, Amazon.com sued Barnes & Noble in 1997 over its sales tax policy of not collecting sales tax on Internet sales. (Seattle Times Staff, 1997)

Amazon has not yet appealed the New York Supreme Court decision, but one would expect them to file an appeal. The case was remanded to a lower court for hearings on the as-applied claims and one would expect Amazon to continue to fight the law in the lower courts.

### **Amazon vs. Texas**

In 2010, the state of Texas Office of the Comptroller demanded that Amazon pay \$269 million in back sales and use taxes. Amazon responded to this action by filing suit demanding the audit report upon which the \$269 million figure is based. (The Associated Press, 2011) Texas has thus far refused to provide it to Amazon stating that the audit is privileged. In February 2011, Amazon announced it was planning on closing its distribution center in Texas and cancelling plans to expand other operations there. (Castro, 2011) It seems likely that Amazon will be once again involved in protracted litigation with another state over sales and use taxes. The case in Texas is somewhat different from the cases in North Carolina and New York in that Amazon has operated a physical distribution center in that state for a number of years. In some ways this issue seems similar to *National Geographic vs. California*, 430 U.S. 551 (1977) where the United State Supreme Court ruled that a related but separate business constituted a significant nexus to force National Geographic to collect sales and use taxes in California where it had a related business. This will likely be the first test of the current corporate structure which Amazon has used to avoid collecting sales and use taxes in states in which it may have a “physical presence” through another related entity.

### **Recommendations for Changes to Current Law**

There appears to be a large inequity between traditional “brick & mortar” retailers and online retailers. In general, the law should treat similar transactions in an equitable manner. Thus it would

seem to be beneficial for Congress to act to right the current inequity between online and traditional retailers. However, the political climate is not necessarily advantageous to a change which would require retailers to submit use taxes to the various states. In the past, Congress has acted to limit taxes on Internet businesses to encourage this new form of commerce and specifically passed legislation exempting Internet sales activities from taxation including the Internet Tax Freedom Act Amendments Act of 2007 related to taxes on Internet related services. (CCH, 2007)

While the current status quo regarding use tax collection has caused a number of businesses to flourish, the continued inequity will likely only further undermine the position of companies such as Amazon who go to great lengths to preserve their sales and use tax collection loophole.

### **Conclusion**

The amount of money at stake for the various states is significant. A recent study by the University of Tennessee found that uncollected sales and use taxes could amount to \$7 billion annually. (Metz, 2009) Other studies have placed the uncollected tax as high as \$33.7 billion. (Sonnier, 2009) It seems likely that the number of cases in the courts will only increase as states to try and collect on sales and use taxes especially as state budgets have become tight due to the recession. The increase in the dollar value of these transactions as online shopping becomes more prevalent will also increase the pressure to provide equity between online and traditional purchase transactions.

The US Supreme Court appears to affirm that Congress has the power to act by statute to further regulate interstate commerce in a manner that would require companies to remit sales and use taxes to the various states. However currently it seems unlikely that the current stalemate between the states and retailers will be broken by an act of Congress. As litigation between the states and major retailers continues it is likely that the case will once again be presented to the US Supreme Court. The US Supreme Court could act to reverse its previous decision or could also uphold its decision by allowing a lower court ruling consistent with its opinion to stand.

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