

## “Amazon Tax” Laws Signal Business Unfriendliness and Will Worsen Short-Term Budget Problems

By Joseph Henchman  
Tax Counsel, Tax Foundation

Hearing on S.B. 824 – “Sales and Use Tax – Online Sales Presumption”  
Before the Senate Budget & Taxation Committee

*March 17, 2010*

### Mr. Chair and members of the Committee:

My name is Joseph Henchman and I am currently Tax Counsel at the Tax Foundation, a non-partisan, non-profit research institution founded in 1937 to analyze tax issues and raise economic awareness among taxpayers, lawmakers, and media. We track tax-related issues at all levels of government and follow estate tax issues at the federal and state levels.

We appreciate the opportunity to submit this written testimony regarding S.B. 824 to the Budget & Taxation Committee. The Tax Foundation takes no position on the bill but is eager to provide information about the subject.

New York, Rhode Island, and North Carolina have in the last three years passed laws nicknamed “Amazon taxes,” (also known as affiliate nexus taxes or affiliate taxes) which purport to impose a sales tax collection obligation on out-of-state companies if the company has a contractual relationship with an in-state “affiliate.” Colorado recently enacted a modified version.

Proponents claim that these laws raise easy revenue for the state, have passed constitutional scrutiny, and level the playing field between brick-and-mortar and online stores. None of these claims bear out.<sup>1</sup>

### Key Findings

- ◆ An Amazon tax law requires retailers that have contracts with “affiliates”—independent persons within the state who post a link to an out-of-state business on their website and get a share of revenues from the out-of-state business—to collect the state's sales and use tax. Such laws currently exist in New York, Rhode Island, North Carolina, and Colorado.
- ◆ Amazon taxes are unlikely to produce revenue in the near term. New York continues to face a lengthy legal constitutional challenge. Rhode Island has even seen a drop in income tax collections due to the law.
- ◆ Amazon taxes do not level the playing field between brick-and-mortar and Internet-based businesses because they require Internet-based businesses to track thousands of sales tax bases and rates while brick-and-mortar businesses need to track only one.
- ◆ Unconstitutionally expansive nexus standards like the Amazon tax undermine legal certainty, burden interstate commerce, and harm economic growth.

## Amazon Taxes Do Not Result in Revenue Windfall; Revenue Drop More Likely

Sponsors have promised that a revenue windfall would follow enactment of an Amazon tax, but no windfalls have been forthcoming so far. This is often because online companies respond to Amazon tax law enactments by ending their affiliate programs. Rhode Island revenue-analysis office head Paul Dion stated in December 2009 that the six-month-old law had collected no revenue.<sup>2</sup> An affiliate trade group believes that Rhode Island has seen less tax revenue come in, because the elimination of the affiliate program reduced income and thus income tax collections.<sup>3</sup> State Treasurer Frank Caprio echoed this, saying, “The affiliate tax has hurt Rhode Island businesses and stifled their growth, as they’ve been shut out of some of the world’s largest marketplaces, and should be repealed immediately.”<sup>4</sup>

Similarly, legislative officials estimated that North Carolina’s Amazon tax would raise \$13 million in its first year of operation, but the termination of affiliate programs in the state makes this unlikely. Revenue officials have stated that they are not tracking Amazon tax revenues.<sup>5</sup>

Even a prominent supporter of Amazon tax laws has conceded that they will not generate revenue for immediate budget needs. Center on Budget and Policy Priorities (CBPP) Senior Fellow Michael Mazerov, author of a paper<sup>6</sup> encouraging states to adopt Amazon tax laws, conceded during a panel in early February 2010 that the laws will not raise revenue in the short term.<sup>7</sup> (Mazerov argues that there are long-term benefits to the approach.)

## New York Mired in Litigation over Amazon Tax Law’s Constitutionality

In New York, 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. The case is currently on appeal to New York’s intermediate court, the New

York Supreme Court, Appellate Division.<sup>8</sup> (New York’s highest court is called the Court of Appeal; the trial-level court is the New York Supreme Court. This nomenclature has resulted in some erroneous reports that the Amazon tax has been upheld by the state’s highest court, when in fact it is the trial court.)

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.<sup>9</sup> These “attributional nexus” cases have been described by the Supreme Court itself as the “furthest extension” of nexus.<sup>10</sup>

The trial court, in finding for the state and upholding the law, did not 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.<sup>11</sup> 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.

New York’s law is an unprecedented expansion of state taxing authority. The affiliates provide referrals for only 1.5 percent 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 a 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 under even *Scripto* and *Tyler Pipe*.

In the *Quill* case of 1992, the Supreme Court struck down a 1987 North Dakota law imposing a 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.

Adjusting for inflation and population, the \$1 million threshold in North Dakota that the U.S. Supreme Court found low enough to pose an intolerable burden in 1987 would be the equivalent of \$51 million in New York in 2009, and yet New York still set its Amazon threshold at a mere \$10,000. (Maryland’s law also sets this low \$10,000 threshold.)

The trial court also claimed that Amazon.com is “avoiding” taxes.<sup>12</sup> 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 appellate court is expected to reach a decision sometime in 2010.

## **Far from Leveling the Playing Field, Amazon Taxes Unlevel It**

Amazon tax supporters often claim that the current tax environment is unfair to brick-and-mortar businesses in that they must collect sales tax on their sales while Internet-based businesses do not. Consequently, the Amazon tax is urged as a way to equalize this disparate treatment.

Far from creating a level playing field, Amazon taxes move away from one. Brick-and-mortar businesses collect sales tax based on where the business is located, so they need to track only one sales tax rate and base. Under Amazon taxes, though, out-of-state businesses are required to collect sales tax based on where the customer is located. Thus, each retailer no matter how large or small must track 8,000+ sales tax rates and bases. Further, these constantly change and (contrary to common assumptions) are not aligned with even 5-digit zip codes, let alone 9-digit zip codes.

Various databases exist to assist with figuring sales tax but they are often expensive, not comprehensive, and can be slow to keep up to date. Some states offer websites with sales tax “maps” but these are not widespread and do not address which items are in the base. These shortcomings are particularly problematic for sales

taxes, since under-collecting can result in heavy penalties from the state, and over-collecting can result in a class action lawsuit from customers.

Brick-and-mortar stores have long blamed everyone else for their decline: big department stores in the city, suburban shopping malls, catalogs, the Internet, and now the tax system. There is some truth in all of that, but brick-and-mortars also have the advantages of better locations for immediate purchases and deeper customer interaction. Changing the tax laws to impose new burdens on their competitors is not a productive solution for a state’s economic growth.

The real concern should be the extent of state powers. Should states be able to reach beyond their geographic borders and impose their tax system on everything everywhere? Do we really need to make sure that taxes are the same between New York and other states, and that people can’t shop by tax rates as they shop by price, quality, or convenience?

Unless every state has an identical tax system, there will be inconsistencies in taxes paid on items in different jurisdictions. Some states have high taxes and extensive public services while others prefer lower taxes and less extensive public services. This should not be viewed as a problem to be eradicated but rather an essential element of our federalism that should be embraced. Amazon taxes are incompatible with this notion of limiting states’ powers to prevent harm to the national economy, because they presume that states should have whatever power is needed to equalize tax rates.

## **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.<sup>13</sup> 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.”<sup>14</sup> Regrettably, because economic integration is greater now than it was in 1787, 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. 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.<sup>15</sup> 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.

## Conclusion

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.

Thank you again for the opportunity to submit this testimony; we are happy to answer any questions that you may have on this or other tax subjects.

---

## Notes

- <sup>1</sup> This testimony is drawn from two papers on nexus: Joseph Henchman, “Why the Quill Physical Presence Rule Shouldn’t Go the Way of Personal Jurisdiction”, *46 State Tax Notes* 387 (2007), <http://tinyurl.com/quillnexus>; and Joseph Henchman, “Amazon Tax’ Laws Signal Business Unfriendliness and Will Worsen Short-Term State Budget Problems,” *Tax Foundation Special Report No. 176* (Mar. 2010), at <http://www.taxfoundation.org/publications/show/25949.html>.
- <sup>2</sup> Ted Nesi, “Amazon tax’ has not generated revenue,” *Providence Business News* (Dec. 21, 2009), [http://www.pbn.com/detail.html?sub\\_id=2976531d0961&page=1](http://www.pbn.com/detail.html?sub_id=2976531d0961&page=1).
- <sup>3</sup> Shawn Collins, “Advertising Tax Generates Zero Taxes in Rhode Island,” *AffiliateTip.com* (Feb. 2, 2010), <http://affiliatetip.com/news/article003119.php>.
- <sup>4</sup> David Sims, “Virginia Advances Online Sales Tax Despite Track Record,” *TMCNet* (Feb. 11, 2010), <http://voice-quality.tmcnet.com/topics/phone-service/articles/75297-virginia-advances-online-sales-tax-despite-track-record.htm>.
- <sup>5</sup> Telephone interview with Robert Whitt, Spokesman, North Carolina Department of Revenue (Mar. 3, 2010).
- <sup>6</sup> Michael Mazerov, “New York’s ‘Amazon Law’: An Important Tool for Collecting Taxes Owed on Internet Purchases,” *Center on Budget and Policy Priorities Report* (Jul. 23, 2009).
- <sup>7</sup> Mazerov’s response was to a question posed by the author at a Tax Analysts panel on Feb. 5, 2010.
- <sup>8</sup> The Tax Foundation has filed an amicus curiae brief in support of Amazon.com in the appeal. See Joseph Henchman & Justin Burrows, “Amazon Tax’ Unconstitutional and Unwise,” *Tax Foundation Fiscal Fact*, No. 187 (Sep. 15, 2009), <http://www.taxfoundation.org/news/show/25120.html> (citing Tax Foundation Amicus Curiae Brief in *Amazon.com, LLC v. New York State Department of Taxation and Finance*, No. 601247-2008).
- <sup>9</sup> 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.”); *Id.* 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.”); *Scripto, Inc. v. Carson*, 362 U.S. 206, 211 (1960) (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]”).
- <sup>10</sup> *Quill Corp.*, 504 U.S. at 306, citing *Scripto*, 362 U.S. 206; *Tyler Pipe*, 482 U.S. at 250.
- <sup>11</sup> 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.”).
- <sup>12</sup> 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.”).

<sup>13</sup> 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.”).

<sup>14</sup> Daniel Shaviro, “An Economic and Political Look at Federalism in Taxation,” 90 Mich. L. Rev. 895, 902 (1992).

<sup>15</sup> See *Quill*, 504 U.S. at 313 n.6.

---

## **ABOUT THE TAX FOUNDATION**

The Tax Foundation is a non-partisan, non-profit research institution founded in 1937 to educate taxpayers on tax policy. Based in Washington, D.C., the Foundation’s economic and policy analysis is guided by the principles of sound tax policy: simplicity, neutrality, transparency, and stability. The Tax Foundation seeks to make information about government finance more understandable, such as with the annual calculation of “Tax Freedom Day,” the day of the year when taxpayers have earned enough to pay for the nation’s tax burden and begin earning for themselves.

## **ABOUT THE CENTER FOR STATE FISCAL POLICY AT THE TAX FOUNDATION**

The Tax Foundation’s Center for State Fiscal Policy produces timely, high-quality, and user-friendly data and analysis for elected officials, national groups, state-based groups, grassroots activists, the media, business groups, students, and the public, thereby shaping the state policy debate toward simple, neutral, transparent, stable, and pro-growth tax policies.

## **ABOUT THE CENTER FOR LEGAL REFORM AT THE TAX FOUNDATION**

The Tax Foundation’s Center for Legal Reform educates the legal community and the general public about economics and principled tax policy. The Center’s research efforts focus on the scope of taxing authority, the definition of tax, economic incidence, and taxpayer protections.