

Seller Beware

By Peter Harris, CPA

We've all read that state treasuries continue to be hit hard by decreasing tax collections and pressure from increasing costs of services. Meanwhile, Internet sales continue to take a larger slice of the total retail sales market. Forrester Research predicts that online retail sales will grow to almost \$250 billion in 2014, or 8 percent of total U.S. retail sales. In 2009 online sales amounted to \$155 billion, or 6 percent of total U.S. retail sales.

With these two trends in place, none of us should be surprised that taxation of online sales is getting more and more attention in state legislatures and revenue departments around the country. What began in New York in 2008 has now escalated to half a dozen more states enacting laws to treat certain online sellers as taxable vendors. And at least another nine states have or will consider such legislation in 2011. This article will review the business arrangement that states are attacking, outline the provisions of the statutes that most states are adopting, highlight new developments around this topic, and offer suggestions for how to advise clients that sell products online.

Affiliate Programs Under Attack

Most readers have most likely made a purchase from Amazon or another online merchant. But stop to think for a moment how you arrived at the website where you placed your order. You may have gone directly to the website, but chances are good that you were referred to the seller's website from another source. Perhaps a website with product reviews, an email message containing a link to the seller's website or even an individual's blog about the product.

The practice of using any of these types of referral sources is commonly called "affiliate marketing." Online sellers have become experts at developing these networks to help expand their sales, often providing cutting edge tools and marketing advice to affiliates to help them maximize the number of referrals they generate. In exchange for providing this additional visibility to the online retailer, the affiliate receives a commission. Calculation of the commission can be based on "click throughs," lead generations, or completed purchases, depending on the provisions of the affiliate program.

So how do the tax laws consider these affiliates? Are they a form of advertising or an agent acting on behalf of the online retailer? Starting in 2008, New York advanced the argument that these affiliates are in fact agents, and the battle was on.



States Expand Nexus Standard for Online Sellers

Affiliate Nexus Statutes

Any discussion about nexus for sales tax purposes has to begin with the U.S. Supreme Court's Quill decision.¹ That decision, which is still applicable today, established that a seller must be physically present in a state in order to be subject to a sales or use tax collection obligation. But within this confine, it is also well established that the physical presence requirement can be met by an agent or representative that is acting on behalf of the out-of-state taxpayer to solicit sales or expand their market within a state.² This serves to frame the debate over affiliate marketing programs: are the affiliates acting as agents of the online retailers they receive commissions from, or do their activities not rise to this level of relationship?

New York amended its definition of a vendor to include a seller who enters into contracts with residents to refer customers. The statute creates a presumption that a collection responsibility exists when an out-of-state online retailer with no presence in New York pays a commission or some other consideration to an affiliate who is a resident of New York and the receipts from such sales to New York customers exceed \$10,000 in the prior 12 months.³ However, not all affiliate marketing arrangements result in nexus, and sellers are provided a means by which they can overcome the presumption of being a taxable vendor.

An affiliate marketing agreement will not create nexus for the online seller if an affiliate places a link on their website and is compensated based on the number of click throughs to the seller's website, regardless of whether a sale is completed. Furthermore, if a commission is paid for sales generated through a referral, the online seller can refute the presumption that they are a vendor by establishing that the New York affiliate did not engage in any solicitation activities targeted at New York customers. The New York Department of Taxation and Finance has issued two bulletins regarding the documentation required as evidence that no solicitation activities took place.⁴

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The New York statute, often referred to as the “Amazon Law” has served as the model by which most other states have attempted to impose nexus requirements for online sellers. However, it is important to be aware of differences between the state statutes. For example, Connecticut only provides a \$2,000 threshold for sales to its residents through affiliates before nexus is presumed. Illinois adopted an affiliate nexus statute, but with no ability to refute the presumption of nexus by documenting that affiliates are not engaged in solicitation activities. These subtle, yet important, differences between the states make it impossible to generalize when advising clients about their sales tax collection obligations.

States have also tried to codify nexus standards that consider the in-state activities of another member of the corporate affiliated group. Colorado adopted such a statute effective as of March 1, 2010.⁵ The statute provides that an online retailer will be presumed to have nexus in Colorado when such retailer is a member of a federal controlled group of corporations which has a component member with a physical retail presence in Colorado. The nexus presump-

tion can be rebutted only by proving that the in-state related party did not engage in sufficient solicitation activities on behalf of the out-of-state online seller to meet federal constitutional standards for nexus.

Current Developments – Taxpayer Challenges and New Adopting States

Online retailers have been aggressive in their challenge of the new affiliate nexus statutes. But their success to date has been very limited and no victory appears to be on the horizon. Both online retailers Amazon and Overstock filed lawsuits in New York asserting that the affiliate nexus statute was unconstitutional.⁶ The challenges were consolidated into a single matter before the court. The trial court dismissed the case, failing to find that the statute was unconstitutional either on its face or as applied to the specific facts of Amazon or Overstock.

The decision was appealed by the companies to the appellate division, where again the court did not find the statute to be unconstitutional on its face. The appellate division did, however, return the case to the trial court to address the question of whether the New York affiliates were engaged in any

active solicitation activities. Resolution of this matter by the trial court is still pending.

The Colorado nexus provision discussed previously included very onerous reporting requirements for online retailers who do not collect sales tax on Internet sales to customers in Colorado. These sellers are now required to (1) notify all purchasers that use tax is due on their purchases and that a sales or use tax return is required to be filed; (2) provide all purchasers by January 31 each year with a list of the purchases they made during the prior year that are subject to tax, including the amount and date of each purchase; and (3) provide the Department of Revenue by March 1 each year with a statement summarizing the purchases made by each Colorado resident in the prior year on which sales tax was not collected. Substantial penalties per transaction are provided for failure to comply.

These reporting requirements were successfully challenged by the Direct Marketing Association. In January 2011, a preliminary injunction was issued in Federal Court granting a temporary halt to enforcement of the Colorado reporting requirements.⁷



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Lastly, online sellers have taken drastic steps to curtail their affiliate marketing programs in states that have adopted nexus provisions for affiliates. Amazon has been the most visible of these companies, terminating contracts with thousands of affiliates in the states that now have affiliate nexus provisions. Arguably, these actions by Amazon and other online retailers are taking dollars out of state tax revenues, exactly the opposite result intended from expanding nexus requirements.

Despite the legal challenges and business reactions to affiliate nexus requirements, states continue to explore this option as a means to increase annual revenues. Illinois, Rhode Island, Connecticut, North Carolina and Arkansas have all added an affiliate nexus provision to their laws. Most significantly, California changed their law, effective June 30, 2011, to adopt both the New York and Colorado type nexus provisions. Then in a compromise measure with Amazon, they passed another bill in September 2011 to retroactively delay implementation of the new nexus provisions. The effective date is now set for September 15, 2012, if federal legislation regarding nexus for remote sellers is not enacted by July 31, 2012.

In addition to the adopting states, legislatures in Arizona, Hawaii, Massachusetts, Michigan, Minnesota, New Mexico, Tennessee, Texas, and Vermont have or will be considering such affiliate nexus measures. In Hawaii and Texas, the bills were passed in the legislature but vetoed by the governor. Vermont adopted an affiliate nexus provision which only becomes effective when 15 other states have adopted such a law. Clearly, the message is to stay tuned and watch closely for developments around the country related to changes in this area. *Continued on page 24*



How to Advise Online Retailers

Sales tax collection responsibility is an issue that no Internet seller wants to be surprised with in a state tax audit. The obligation to pay sales or use tax ultimately belongs to the consumer who purchases taxable property or services. A seller's role is limited to collection and remittance of the tax from its customers. If a seller does not have sales tax nexus then they have no obligation to collect tax on their sales. The consumer in this case has an obligation to self assess a "use tax."

More and more state tax audit resources are being devoted to the discovery of taxpayers who are not registered to collect sales tax. Traditionally, these "nexus discovery" units focused on finding taxpayers with some physical presence, such as an employee or sales representative, in the state. But now with the expansion of the affiliate nexus concept, even online sellers with no physical presence whatsoever in a state may be found to have sales tax nexus.

A seller that should have collected sales tax but does not, in effect assumes a liability that belongs to their customers. As a practical matter, a seller with a high volume of low dollar amount transactions is not going to be able to go back to their customers to recover the tax they are assessed on audit. Even sellers with high dollar transactions sometimes avoid going back to their customers to recover sales tax not collected for the fear that this will generate ill will with the customer. So the end result is that the sales tax, which in many states can run as high as 6 to 8 percent of the sales price, becomes an expense of the seller and may eliminate all or a large portion of their profit from the sale.

What should online sellers, and we as their advisors, do to avoid facing a large assessment for failure to collect sales tax? First and foremost, we should review their business practices to determine which, if any, of their activities could result in sales tax nexus in states outside of their home state. Sales and marketing programs change quickly and frequently with an online seller. It is important that whenever a change does take place, the sales and marketing side of the business communicate the change to those responsible for administering the company's tax function. This will allow the tax professional to make an informed decision about the company's collection responsibility.

When a business does have a collection obligation, then it must evaluate its tax compliance process. Typically, this will be a joint effort between the tax and information technology professionals in a company. Sales tax compliance can be extremely complex. Each state and many local counties and city jurisdictions, have their own laws regarding taxable and exempt sales, sales tax holidays, tax rates, and procedures for filing returns and paying the tax. While 45 states impose their own sales tax, the number of different unique taxing jurisdictions in the U.S. exceeds 7,500 when counties and other municipalities are considered. Outsourcing the sales tax compliance function can be a cost saving alternative for online sellers with filing obligations all across the country.

In summary, the sales tax landscape is drastically changing for businesses that sell online and do not have any physical presence in a state. These businesses need to continuously test all of their business activities

against the new and emerging requirements for sales tax nexus. Failure to respond to these new state tax requirements could have drastic consequences if Internet sellers, by default, absorbs sales tax liabilities that never should have been part of their costs. ■

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¹ Quill Corp v. North Dakota, 504 U.S. 298 (1992).

² Scripto Inc. v. Carson, 362 U.S. 207 (1960)

³ N.Y. Tax Law Section 1101

⁴ TSB-M-08(3)S

⁵ Col. Rev. Stat Section 39-21-112(3.5) C.R.S.

⁶ Amazon.com LLC v N.Y. State Dep't of Taxation and Fin. 913 N.Y.S. 2d 129 (NY App. Div 2010)

⁷ Direct Marketing Association v. Huber No. 10-CV-01546-REB-CBS

