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Battle California! Sales Tax Nexus Gets Even More Interesting

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In the past, we have reported on so-called affiliate nexus or "Amazon" statutes and the challenges brought by Amazon.com against New York's nexus law.[1] Those statutes generally impose a sales and use tax collection responsibility on out-of-state retailers that have agreements with in-state entities, when the in-state entities refer customers to the retailer, either by Internet website link or otherwise.[2] The in-state entities are often known as Internet affiliate marketers.

In addition to asserting nexus based on Internet affiliate marketing relationships, many states, including New York, have also passed statutes that impose nexus on an out-of-state retailer based on the in-state activities performed by a member of the retailer's corporate family (common ownership nexus).

In this article, we bring you an update on the latest nexus law passed in California, which includes components relating to both Internet affiliate marketers and commonly owned entities. We also summarize a few significant developments in the battles over sales tax nexus around the country, including the ways in which large retailers are coping with the changing landscape. Finally, we provide a few benchmarks regarding the ways in which we believe the affiliate nexus laws should be interpreted to assist retailers in managing their relationships with Internet affiliate marketers and commonly owned entities in light of the sales tax nexus risks.

California: The Latest Sales Tax Nexus Statute

On June 28 Gov. Jerry Brown (D) signed into law California's budget for fiscal 2011-2012.[3] The budget includes a bill that creates nexus for out-of-state retailers based on the in-state presence of Internet marketing affiliates and the in-state presence of commonly owned entities, under some circumstances.

Internet Affiliate Marketing Nexus

The Amazon law portion of the bill imposes a sales tax collection responsibility on out-of-state retailers that have certain Internet affiliate marketing relationships with persons in the state.[4] Specifically, the bill modifies the definition of retailer engaged in business in this state to include "any retailer entering into an agreement . . . under which a person . . . in this state, for a commission or other consideration, directly or indirectly refer[s] potential purchasers . . . by an Internet-based link or an Internet Web site, or otherwise," as long as some de minimis sales thresholds are met.[5] The rule does not

[1] *See* Thomas H. Steele and Kirsten Wolff, "Reflections on the Current State of 'Attributional Nexus': When May a State Use the Presence of an In-State Entity to Claim Jurisdiction Over an Out-of-State Seller," Major Tax Planning — USC Law School Annual Institute on Federal Taxation, Matthew Bender (2009) (Attributional Nexus); Steele, Andres Vallejo, and Wolff, "No Solicitation: The 'Amazon' Laws and the Perils of Affiliate Advertising," *State Tax Notes*, Mar. 28, 2011, p. 939, *Doc 2011-5376*, or *2011 STT 59-1* (No Solicitation).

[2] Technically, asserting nexus on an out-of-state retailer that sells into the state results in imposing a duty to collect use taxes due for the customer. Because sales and use taxes are complementary taxes paid at the same rate, in this article we adopt the common practice of referring to nexus as giving rise to a sales tax collection responsibility.

[3] ABX1 28, 2011-2012 Leg., 1st Ex. Sess. (Cal. 2011).

[4] *Id.*

[5] *Id.*, section 1 (codified at Calif. Revenue and Taxation Code section 6203(c)(5)(A)). The law applies only if the retailer's total sales in the state over the past 12 months exceed $500,000 and the sales based on referrals from Internet affiliate marketers (that is, persons who refer purchasers to the retailer by Internet-based links or otherwise) exceed $10,000. ABX1 28, 2011-2012 Leg., 1st Ex. Sess. (Cal. 2011) (codified at Calif. Revenue and Taxation Code section 6203(c)(5)(A)(i), (ii)).

apply "if the retailer can demonstrate that the person in [California] with whom the retailer has an agreement did not engage in referrals in the state on behalf of the retailer that would satisfy the requirements of the commerce clause of the United States Constitution."[6]

California's statute makes clear that an Internet affiliate that merely advertises for an out-of-state retailer does not create nexus.

California's statute provides some additional detail, which is not present in other states' statutes, on the application of the new nexus standard to advertising. In particular, California's law states that agreements to provide advertising (whether on television, radio, in print, or on the Internet) do not trigger nexus, unless (1) the fee for the advertisement is a commission or otherwise based on sales and (2) (at least for advertising on a website) the in-state person also "directly or indirectly solicits potential customers in [California] through use of flyers, newsletters, telephone calls, electronic mail, blogs, microblogs, social networking sites. . . ."[7] Thus, in contrast to many other affiliate nexus statutes, California's statute makes clear that an Internet affiliate that merely advertises for an out-of-state retailer does not create nexus, even if the payment for the advertising service is commission-based.[8]

Common Ownership Nexus

In addition to the Internet affiliate marketing nexus provisions, California's new law also includes a provision that imposes a sales tax collection obligation on an out-of-state retailer based on that retailer's relationships with other members of a commonly controlled group that are also members of a combined reporting group.[9] Nexus based on common control is triggered when the member of the group "performs services in [California] in connection with tangible personal property to be sold by the retailer, including, but not limited to, design and development of tangible personal property sold by the retailer, or the solicitation of sales of tangible personal property on behalf of the retailer."[10]

This law seems to trigger nexus based on in-state activities that are plainly beyond the scope of the activities identified in *Tyler Pipe* as the types of in-state activities on which nexus for an out-of-state retailer can permissibly be based. The standard articulated in *Tyler Pipe* was, of course, that an in-state entity's activities on behalf of an out-of-state retailer could create nexus for the retailer when the activities help the retailer "establish and maintain a market in th[e] state for the sales."[11]

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[6] *Id.* (codified at Calif. Revenue and Taxation Code section 6203(c)(5)(E)).

[7] ABX1 28, 2011-2012 Leg., 1st Ex. Sess., section 1, (Cal. 2011) (codified at Calif. Revenue and Taxation Code section 6203(c)(5)(B), (C)).The newly adopted Calif. Revenue and Taxation Code section 6203(c)(5)(C) provides in full:

> Notwithstanding subparagraph (B) [which provides that agreements to provide advertising for commission-based compensation trigger nexus], an agreement under which a retailer engages a person in this state to place an advertisement on an Internet Web site operated by that person, or operated by another person in this state, is not an agreement described in subparagraph (A) [which provides that an agreement with a person in the state to refer customers in exchange for a commission creates nexus], unless the person entering the agreement with the retailer also directly or indirectly solicits potential customers in this state through use of flyers, newsletters, telephone calls, electronic mail, blogs, microblogs, social networking sites, or other means of direct or indirect solicitation specifically targeted at potential customers in this state.

[8] Similarly, New York's statute requires an out-of-state seller that advertises in the state to collect New York sales tax, but only "if such person has some additional connection with the state which satisfies the nexus requirement of the United States Constitution." N.Y. Tax Law section

(Footnote continued in next column.)

1101(b)(8)(i)(C)(II). In contrast, other states' laws seem to create affiliate nexus based merely on advertising, regardless of the compensation structure. *See* R.I. Gen. Laws section 44-18-15(a)(6); HB 6652, 2011 Gen. Assemb., Reg. Sess. (Conn. 2011) (to be codified at Conn. Gen Stat. section 12-407(a)(15)(A)(v)).

[9] A commonly controlled group is defined variously as a parent and subsidiary corporate family in which the parent owns more than 50 percent of at least one of the subsidiaries; two or more corporations, at least 50 percent of the stock of which is owned by the same person; two or more corporations that are stapled entities; or two or more corporations, more than 50 percent of the stock of which is owned by members of the same family. Calif. Revenue and Taxation Code section 25105(b)(1)-(4).

[10] ABX1 28, 2011-2012 Leg., 1st Ex. Sess. (Cal. 2011) (codified at Calif. Revenue and Taxation Code section 6203(c)(4)). As we have stated elsewhere, *see* Attributional Nexus, *supra* note 1, at para., 209, we believe a statute that bases a nexus finding on nothing more than common ownership should not survive a constitutional challenge. Similarly, we do not believe that merely engaging in a unitary business relationship with an in-state company confers nexus over the out-of-state company. *See, e.g.*, *Current, Inc. v. State Bd. of Equalization*, 29 Cal. Rptr. 2d 407 (Ct. App. 1884). One might question the fundamental approach of state laws that treat activities of a commonly owned entity as creating nexus when the same activities by a third party plainly would not create nexus. For example, would anyone reasonably assert that using a third party in California to assist in product design somehow creates nexus for the out-of-state company that ultimately sells that product in the state? And if not, why should those same activities by a commonly owned subsidiary produce different results?

[11] *Tyler Pipe Indus. v. Washington State Dep't of Revenue*, 483 U.S. 232, 250 (1987) (internal quotation marks omitted).

California's law seems to reach beyond that category of activities to impose nexus based on a potentially broad array of services provided by the in-state entity, some of which have little or nothing to do with selling or creating a market for the tangible personal property in the state, including, for instance, the design and development of property sold by the retailer. According to some reports concerning the legislation, that provision was likely intended to create nexus for Amazon based on the research and development work for the Kindle, an e-book reader sold exclusively by Amazon, performed in California by Amazon's subsidiary, Lab126.[12]

Indeed, comparing California's new statute with other states' laws that create nexus based on relationships with members of a commonly owned group reveals that the California law has taken its nexus claim to a new level. Other states' laws sometimes impose nexus on an out-of-state retailer when the in-state member of the commonly owned group sells the same or similar product and uses the same or similar business name or trademarks as the out-of-state retailer.[13] Limiting the nexus trigger to those activities is plausible, at least if it creates no more than a presumption that the sales of common products may provide the necessary link to solicitation required by the U.S. Constitution. The California statute, in contrast, infers a market connection even when the activity is quite distinct from, and in many cases distant from, the process of marketing or selling, as would be the case for activities that are directed simply to the design or development of a product.[14] Moreover, the taxpayer does not have a right to overcome the presumption by showing that the commonly owned entity did not engage in referrals satisfying the constitutional requirements for solicitation.

Amazon and Others Strike Back

In the face of the new statutes passed by California and other states, Amazon and other retailers have initiated a variety of legal and political measures to challenge these new laws.

One measure typically used has been to simply cancel affiliation relationships, often quite publicly, stressing to state legislatures that their quest for new sales tax revenues may well have an effect on local jobs.[15]

Taking a different tactic in Tennessee and South Carolina, Amazon successfully brokered deals with those states' legislatures under which the lawmakers have given Amazon an exemption on sales tax collection in exchange for Amazon's development of job-creating distribution centers in those states. South Carolina enacted a statute giving Amazon and similar retailers a five-year pass on collecting sales tax in the state, and Tennessee simply declined to pursue affiliate nexus legislation.[16]

In other cases, retailers have challenged the laws through litigation. For example, the Direct Marketing Association challenged and obtained a preliminary injunction against Colorado's variant on the nexus statute by arguing that it discriminated against interstate commerce by requiring compliance and reporting of out-of-state sellers, which was not required of in-state sellers.[17]

Another trade association that supports Internet marketers, the Performance Marketing Association, has filed suit against Illinois, presenting a straightforward commerce clause challenge to Illinois's new Amazon law, which requires out-of-state retailers to collect Illinois sales tax based on the in-state presence of Internet affiliate marketers.[18] This case joins

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[12]*See* Declan McCullagh, "California targets Kindle lab in Amazon tax spat," CNET, June 29, 2011, *available at* http://news.cnet.com/8301-31921_3-20075651-281/california-targets-kindle-lab-in-amazon-tax-spat/.

[13]*See* N.Y. Tax Law section 1101(b)(8)(i)(I); Idaho Code Ann. section 63-3615A; SB 1, 82nd Leg., 1st Called Sess. (Texas 2011) (codified at Texas Tax Code Ann. section 151.107(a)(7)).

[14]The California statute may be compared with Texas's new law that creates nexus based on sales of similar products with a similar business name by an in-state corporate parent or subsidiary, or based on advertising or any other activity "intended to establish or maintain a marketplace for the retailer" in Texas. SB 1, 82nd Leg., 1st Called Sess. (Texas 2011) (to be codified at Texas Tax Code section 151.107(a)(7)(B)). Although the breadth of the Texas statute will no doubt be tested for constitutionality, its list of activities seems at least plausibly related to the Court's pronouncements in *Tyler Pipe* (483 U.S. at 250).

[15]*See, e.g.*, Matt Richtel and Verne G. Kopytoff, "Amazon Backs End to Online Sales Tax in California," *The New York Times*, July 11, 2011, *available at* http://www.nytimes.com/2011/07/12/technology/amazon-backs-end-to-online-sales-tax-in-california.html; Janet Novack, "Illinois Governor Signs Amazon Internet Sales Tax Law," *Forbes*, Mar. 10, 2011, *available at* http://www.forbes.com/sites/janetnovack/2011/03/10/illinois-governor-signs-amazon-internet-sales-tax-law/.

[16]*See* 2011 S.C. Acts 32.

[17]*Direct Mktg. Ass'n v. Huber*, No. 10-cv-01546-REB-CBS, 2011 U.S. Dist. LEXIS 9589 (D. Colo. Jan. 26, 2011). Colorado's legislature considered, but ultimately rejected, a measure that would have repealed the legislation that requires out-of-state sellers to report to the state the names of customers from whom they did not collect the state's use tax and to report to the customers the amount of sales made to that customer each year so that the customer can pay the use tax. Colo. Rev. Stat. section 39-21-112(3.5); 1 Colo. Code Regs section 201-1.

[18]Complaint, *Performance Mktg. Ass'n, Inc. v. Hamer*, No. 1:11-cv-03690 (N.D. Ill. June 1, 2011); 35 Ill. Comp. Stat. 105/2.

the case brought by Amazon and Overstock.com against New York's law as another challenge to the aggressive nexus positions adopted by states around the country.[19]

In California Amazon has adopted an even more dramatic approach that if successful could send shockwaves across the country. After California passed ABX1 28, Amazon not only terminated all its affiliate relationships in the state, but also began work on a referendum petition to include a measure on the November ballot that asks voters to repeal the new law. The attorney general has approved the petition and Amazon is hard at work gathering the over 500,000 signatures necessary to get the referendum on the ballot.

What's a Retailer to Do in This Aggressive Nexus Climate?

It is tough to navigate the ever-changing nexus rules, especially for an online retailer with business in several states. Nevertheless, we believe that there are a few principles retailers should be able to rely on for guidance and a reasonable level of security in their online marketing and cooperation with commonly owned entities.

First, we continue to maintain that for Internet affiliate marketing, engaging a third party to provide basic advertising should not be enough contact with a state to trigger nexus. We believe that principle should hold true whether the third-party advertiser is an Internet affiliate marketer posting banner ads online or a more traditional media outlet printing copy in a magazine. Some state statutes, like North Carolina's, seem to specifically protect standard advertising from triggering the nexus standard.[20] California's statute appears to create a safe harbor for Internet advertising as long as the Internet marketer does not engage in additional solicitation activities.[21] Other statutes have rejected that distinction and expressly include standard advertising in the state as a nexus trigger.[22] Still other states protect advertising only if the advertiser is not compensated by commission.[23] Nevertheless, although there is some variation in the way in which states treat advertising, it is our view that to impose a sales tax collection obligation on an out-of-state retailer solely on the basis that the retailer engages in advertising in the state violates *Quill* and is unconstitutional regardless of whether the advertiser is paid on a commission basis.[24]

Second, a so-called marketing affiliate should not be treated as creating nexus for the remote seller unless the affiliate has both a significant presence in the state and performs activities in the state that are directly related to solicitation, sales, or marketing support. The first of those requirements is presented in Amazon's challenge to the New York law. That statute says that the entity making the referrals of potential customers must be a resident of New York but then provides no definition of the term "resident."[25] Under those circumstances, Amazon has argued that it would be impossible for it to determine which of its Internet affiliate marketers are residents, presumably because one can imagine a variety of often insubstantial activities that might lead one to be treated as a resident, particularly if the affiliate is a corporation.[26]

> ***California has pushed the edges of the nexus envelope by imposing nexus on out-of-state retailers on the basis of referrals made apparently by any person physically present in the state, regardless of whether that person is a resident.***

The California law aggravates this problem by basing nexus on agreements with any *persons in the state*.[27] No matter how broadly the term "resident" may be defined, the phrase "persons in the state" is almost certainly broader. Thus, California has pushed the edges of the nexus envelope by imposing nexus on out-of-state retailers on the basis of referrals made apparently by any person physically

[19]*See* Attributional Nexus, *supra* note 1, at para. 208; No Solicitation, *supra* note 1, at 939-942.

[20]*See* N.C. Gen. Stat. section 105-164.8(b)(5).

[21]ABX1 28, 2011-2012 Leg., 1st Ex. Sess. (Cal. 2011) (codified at Calif. Revenue and Taxation Code section 6203(c)(5)(C)).

[22]*See* R.I. Gen. Laws section 44-18-15(a)(6); HB 6652, 2011 Gen. Assem., Reg. Sess. (Conn. 2011) (to be codified at Conn. Gen. Stat. section 12-407(a)(15)(A)(v)).

[23]*See* ABX1 28, 2011-2012 Leg., 1st Ex. Sess. (Cal. 2011) (codified at Calif. Revenue and Taxation Code section 6203(c)(5)(A)-(C)) (suggesting that television, radio, and print advertising, if paid based on commission, creates nexus). As noted, Web-based advertising is protected regardless of whether the advertiser is paid a commission.

[24]*Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

[25]N.Y. Tax Law section 1101 (b)(8)(vi).

[26]*Amazon.com LLC v. N.Y. State Dep't of Taxation & Fin.*, 2009 N.Y. slip op. 29007, 6 (N.Y. Sup. Ct. 2009); *Amazon.com, LLC v. N.Y. State Dep't of Taxation & Fin.*, 2010 N.Y. slip op. 7823, 15 (N.Y. App. Div. 2010). The statutes in Rhode Island, North Carolina, and Arkansas contain a provision similar to New York's that bases nexus on relationships with "residents" of the state. R.I. Gen Laws. section 44-18-15(a)(2); N.C. Gen. Stat. section 105-164.8(b)(1), (3); Ark. Code section 26-52-117(d)(1).

[27]ABX1 28, 2011-2012 Leg., 1st Ex. Sess. (Cal. 2011) (codified at Calif. Revenue and Taxation Code section 6203(c)(5)(A)).

present in the state, regardless of whether that person is a resident. As difficult as Amazon has claimed it would be to identify its Internet affiliates who are New York residents, it certainly will be a much more challenging task to determine which Internet affiliates are merely present in California. For example, a blogger who uses Internet affiliate marketing as a revenue stream to support her blog may spend 11 months in Hawaii and one month in California. If she is viewed as a person in the state, she would trigger nexus for the out-of-state retailer under the California statute, even though the out-of-state retailer may have no contact with or even knowledge of the fact that she is in California.[28]

The second of the requirements relating to "presence" of the affiliate is perhaps even more fundamental, namely whether the marketing affiliate (even if a resident of the state) is actually performing any activities *in that state* that should be viewed as marketing support. That is particularly problematic when the affiliate is a large company with operations in the marketing state that creates the necessary residency or presence in the state but when the activities of the affiliate in that state do not constitute solicitation because the company's sales and marketing support is provided by operations located entirely in other states. For example, assume a website that belongs to a large airline is resident in New York because the airline's planes fly into New York's airports. Assume also that the airline has an office in Florida that is responsible for all of the site's affiliate marketing and advertising activities. Even if this airline's affiliate presence in New York may be viewed as significant, that presence should not trigger nexus for an out-of-state retailer that effectively deals only with the Florida operation that handles the website.[29]

Conclusion

In sum, the battles over nexus for sales tax collection purposes will certainly continue, in the courts, in the halls of the state legislatures, and in California — maybe — in the voting booths. Other states are likely to jump on the bandwagon by passing similar nexus statutes. We will continue to monitor the developments and keep you posted. ☆

[28]The new nexus statutes in Illinois and Connecticut also base nexus on referrals made by a "person located in the state." 35 Ill. Comp. Stat. 105/2(1.1), (1.2). HB 6652, 2011 Gen. Assemb., Reg. Sess. (Conn. 2011) (to be codified at Conn. Gen. Stat. sections 12-407(a)(12)(L) and 12-407(a)(15)(A)(x)).

[29]*See J.C. Penney Nat'l Bank v. Johnson*, 19 S.W.3d 831, 833, 841 (Tenn. Ct. App. 1999) (holding that a Delaware bank had no nexus with Tennessee because the third-party activities that the state attributed to the bank were conducted wholly outside the state). (For the decision, see *Doc 1999-39731* or *1999 STT 248-17*.)