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In this edition of Noonan's Notes, the authors address sales and use tax issues regarding online marketplaces.

"Amazon is doing great damage to tax paying retailers," tweeted President Trump this past August. (Now there's a sentence the Founding Fathers couldn't have imagined!) "Towns, cities and states throughout the U.S. are being hurt — many jobs being lost!" added the president, in what was at least his second tweet directed at the online retail giant.

While the president's tweet doesn't tell the whole story — effective April 1, 2017, Amazon began collecting and remitting sales and use taxes in all 45 states that levy them — he is correct that many online sales completed through Amazon go untaxed, which critics argue hurts local bricks-and-mortar retailers. Specifically, Amazon does not collect sales and use taxes on online sales made through its Amazon Marketplace, where third-party sellers can sell products alongside Amazon's regular offerings. These third-party marketplace sales now make up as much as 40 percent of Amazon's annual sales, and, not surprisingly, states have started to take notice.

But like many aspects of state and local taxes, not all states take the same approach as to who must collect and remit the tax due on taxable sales made over online marketplaces, such as Amazon. This raises tough questions for sellers, marketplaces, and online shoppers alike. And since the majority of our readers likely fall into one of those three categories, we thought it time to evaluate the landscape and detail the current sales and use tax issues lingering in online marketplaces.

The Parties

To understand how online marketplace sales work, and who may be on the hook for unpaid sales and use taxes, we need to first introduce the relevant parties. Imagine the following scenario:

Tim, a New York resident, wants to purchase a Buffalo Bills lunch pail for his son. (Go Bills!) Craig, a Buffalo expat who currently lives in Colorado, recently opened a part-time business selling NFL-themed school supplies. Not wanting his part-time gig to take over his life, Craig partnered with Amazon to sell his products through Amazon's Fulfillment by Amazon (FBA) marketplace service. Other than his relationship with Amazon, however, all of Craig's business property is located in Colorado. And Craig has no employees or other representatives providing any services outside his home state, including no out-of-state bloggers with links on their webpages directing potential buyers to his online store.[1]

Business with Amazon was so good that Craig bragged to his friend Josh, another Buffalo expat, about his new income stream. Eager to get on the gravy train, Josh, who now lives in Florida, decided to open his own NFL-themed supply business.

For a fee, Amazon handles all of Craig's and Josh's fulfillment services — including billing, payment processing, and returns. In fact, Amazon processes all of Craig's and Josh's orders without any communication between the sellers and their customers. Craig and Josh generally send their inventory to Amazon. And although Amazon does not take title to the property, Amazon decides where to house it. Also, under a concept known as "commingling," Amazon reserves the right to mix and match Craig and Josh's inventory, so that if Tim buys his Bills lunch pail from Craig but Amazon has one of Josh's identical lunch pails housed in a warehouse closer to New York,[2] Amazon may choose to send Tim one of Josh's lunch pails, replacing Josh's inventory with one of Craig's lunch pails at a later date. Amazon then sends Tim an email confirming his order and collects and processes Tim's payment. In other words, without any solicitation, approval, or facilitation from Craig, Tim can purchase a lunch pail from Craig but pay Amazon for the product, and then receive one of Josh's lunch pails as a substitute. Welcome to the 21st century!

Who Owes the Tax?

Both Craig and Josh are responsible business owners, so they know that when customers from their respective states buy their products, they need to collect and remit the appropriate state and local sales and use taxes. And, taking advantage of another service that Amazon offers, both Craig and Josh have asked Amazon to collect the tax on their behalf, which Amazon does (again, for a fee). But what about sales to other customers? More specifically, what about the sale to Tim in New York?[3] This is where states are divided, with some treating the marketplace as the vendor responsible for collecting sales and use taxes, and others looking to the third-party sellers for the tax. In other words, this is where Amazon's relationship with its third-party sellers has the potential to sour as the parties argue over who sold what to whom and where.

The Marketplace as the Seller

Leading the charge in targeting the online marketplaces is South Carolina. In July 2017 the South Carolina Department of Revenue issued a $12.5 million assessment against Amazon Services LLC, an affiliate of Amazon.com Inc. Amazon has since protested the assessment, and South Carolina Chief Administrative Law Judge Ralph King Anderson III was recently assigned to preside over the dispute.[4] The primary issue in the case is set to be who sells the tangible personal property that is purchased on the Amazon Marketplace: Amazon or its third-party sellers? Amazon, or Craig and Josh?

According to South Carolina, "the totality of [Amazon's] activities clearly demonstrates that [Amazon] is in the 'business of selling tangible personal property at retail,'" which is a prerequisite under the state's tax laws for a business to be required to collect sales and use taxes on sales made to South Carolina residents.[5] According to the state's assessment, because Amazon handles the majority of the

[1] Over the past several years, numerous states have enacted so-called Amazon laws that presume to treat out-of-state sellers as retailers based on their "click through" arrangements with in-state persons who, for a commission or other consideration, refer potential customers, whether by a link or other website, to a seller. *See* Timothy P. Noonan, Christopher L. Doyle, and Daniel P. Kelly, "The *Amazon* Decision: A New Nexus Standard for the Internet Age?" *State Tax Notes*, Apr. 22, 2013, p. 289; and Noonan and Joshua K. Lawrence, "Merchants and Affiliates Struggle to Navigate New York's 'Amazon Law'" *State Tax Notes*, Apr. 6, 2009, p. 73.

[2] In September Amazon announced the arrival of a new fulfillment center on Staten Island, set to open in 2018.

[3] It is worth noting that New York's rules regarding unaffiliated fulfillment service providers may protect Craig in our hypothetical. Under N.Y. Tax Law section 1101(b)(8), a seller who is not otherwise required to register in New York state may purchase fulfillment services from a New York fulfillment services provider who is not an affiliated person without being required to register as a vendor in New York state. We chose New York in our hypothetical mainly so that we could say, "Go Bills!"

[4] The newly docketed case in the South Carolina Administrative Law Court is *Amazon Services LLC v. South Carolina Department of Revenue* (No. 17-ALJ-17-0238-CC).

[5] S.C. Code Ann. section 12-36-910(A).

sale functions — that is, hosting the online marketplace, controlling to whom and to where products are sent, accepting payment for the products, and managing customer service and returns — Amazon is in the business of selling tangible personal property at retail in the state, and its sales are therefore subject to tax.

Although Amazon argues that its online marketplaces are akin to a digital mall, whereby they merely provide the infrastructure and basic services needed for third-party sellers to complete their transactions, South Carolina views the Amazon marketplace as an online consignment shop. And just like any other consignee under South Carolina law, Amazon, according to the DOR, is "the seller and the legally liable taxpayer of the sales and use taxes due."

Other states have attempted to follow South Carolina's lead. New York, for example, proposed a similar position in the governor's 2016-2017 executive budget by introducing draft legislation to treat large (that is, those managing $100 million or more in annual sales) online marketplaces as "vendors" under New York state's tax laws, thereby forcing the marketplaces to collect and remit sales and use taxes.[6] Although the governor's proposal did not make it into the final budget, other states, such as California, have issued like-minded administrative guidance.

In October 2016 the California State Board of Equalization issued a publication addressing "Online Marketplaces and Fulfillment Centers."[7] According to the publication, depending on the specific services offered by the online marketplace, "either the seller *or* the marketplace operator may be the retailer for sales and use tax purposes,"[8] but if the marketplace provider offers fulfillment services similar to what the Amazon FBA program provides, then "the marketplace operator will be considered the retailer if it has possession of the property at the time of sale and it can transfer ownership to the purchaser without further action" by the third-party seller.

Similarly, in a September 2016 policy statement, the Arizona DOR determined that if a business that otherwise has nexus with the state "operates an online marketplace through which third-party merchants sell tangible personal property at retail," then the marketplace would be "deemed the retailer" for purposes of Arizona's transaction privilege tax.[9] According to the statement, "In addition to providing a platform on which to sell products, marketplace businesses also provide support services," and often "the third-party merchants play no role in the customer's decision to shop on a specific marketplace, rather it is the marketplace brand that is seen as the retailer." The statement concludes that "[b]ecause of the activities undertaken by the online marketplace on behalf of third-party vendors, the online marketplace is considered to be representing the merchant(s) collectively and should be treated as the 'retailer' for Arizona [transaction privilege tax] purposes."

Third-Party Vendors as the Seller

Other states, however, appear to be targeting third-party sellers. Minnesota, for example, recently enacted legislation that expands the definition of a retailer maintaining a place of business in the state to include sellers that have a "marketplace provider" operating on their behalf in Minnesota for "any purpose, including . . . facilitating [or] processing sales."[10] And although Minnesota's new laws also indicate that marketplace providers themselves may be on the hook for the taxes due on sales facilitated through their websites, the new law appears to significantly expand collection requirements for remote retailers making sales to Minnesota customers.

And perhaps the most telling example of states placing third-party sellers on their radar is the Multistate Tax Commission's recent

[6] N.Y. 2016-17 Exec. Budget, Part BB, section 1.

[7] Calif. Board of Equalization Information Pub. No. 109 (Oct. 1, 2016).

[8] *Id.* (emphasis added).

[9] Ariz. Transaction Privilege Tax Ruling No. 16-3 (Sept. 20, 2016).

[10] Minn. Stat. section 297A.66. The law carves out a de minimis exemption for retailers with less than $10,000 in annual sales to Minnesota customers.

Online Marketplace Seller Voluntary Disclosure Initiative.[11] The MTC program, which ran from August 17 through October 17, 2017,[12] allowed third-party marketplace sellers to register their businesses with participating states in exchange for the states agreeing to limit their lookback of the seller's potential past-due liability. In fact, most states participating in the MTC program agreed to waive the lookback period entirely.[13] But if these states didn't believe third-party sellers were the parties legally required to collect and remit tax, then what would there be for these sellers to voluntarily disclose?

As of September 1, 23 states and the District of Columbia said they were participating in the amnesty, eight of which are also home to Amazon FBA fulfillment centers. The participating states were Alabama, Arkansas, Colorado, Connecticut (FBA facility), Florida (FBA facility), Idaho, Iowa, Kansas (FBA facility), Kentucky (FBA facility), Louisiana, Massachusetts, Minnesota, Missouri, Nebraska, New Jersey (FBA facility), North Carolina, Oklahoma, South Dakota, Tennessee (FBA facility), Texas (FBA facility), Utah (FBA facility), Vermont, and Wisconsin (FBA facility).

To be eligible for the program, sellers must (1) have not yet registered with the state taxing authority or filed tax returns in the state; (2) operate as an online marketplace seller using a "marketplace provider/facilitator (such as the Amazon FBA program or similar platform or program) to facilitate retail sales into the state"; (3) have no other nexus-creating contacts in the state; (4) timely apply through the MTC's online application process (available at www.mtc.gov); and (5) register as a seller or retailer with the state in order to collect, report, and remit sales and use taxes and file returns on all taxable retail sales to customers in the state, beginning no later than December 1, 2017. It's no coincidence that the program's timing coincided with the start of the holiday shopping season.

Who's Right?

Critics of the MTC program note that states participating in the amnesty were working under the questionable assumption that the obligation to collect sales and use tax properly falls on out-of-state, third-party sellers and not on the marketplaces themselves. Whether this criticism is fair is a matter of debate.

As regular readers of our column know all too well, a state's ability to impose sales and use tax collection or payment obligations on an out-of-state seller is dependent on whether the seller has sufficient contacts or "nexus" with the taxing state. According to the U.S. Supreme Court, in order for a state to impose these obligations, the out-of-state seller's nexus with the state must satisfy both the due process and dormant commerce clauses of the U.S. Constitution.

To satisfy the due process clause, an out-of-state seller must have "some definite link" or "minimal connection" with a state before that state can assert its taxing authority.[14] An out-of-state company will generally satisfy the "minimum contacts" standard by simply taking advantage of the benefits of the state's economic market, which can be a fairly low threshold. But courts have set a decidedly stricter standard when it comes to the commerce clause. Specifically, for purposes of sales and use taxes, the U.S. Supreme Court announced in *Quill Corp. v. North Dakota* that out-of-state sellers must have some type of "physical presence" in a state before the state can impose its sales and use tax collection obligations.[15] And while *Quill* has recently

[11] Multistate Tax Commission, "Online Marketplace Seller Voluntary Disclosure Initiative," Sept. 1, 2017.

[12] As this article went to press, the MTC's Nexus Committee announced an emergency meeting scheduled for Oct. 11, 2017 to determine whether to extend the deadline for applying to the Voluntary Disclosure Initiative. *See* http://www.mtc.gov/getattachment/Nexus-Program/Nexus-Committee-Agenda/Emergency-Nexus-Committee-Meeting/PUBLIC-NOTICE-(emergency-Nexus-Committee-10-11-2017).pdf.aspx.

[13] The states that agreed to waive the lookback period entirely (meaning that sellers would have prospective liabilities only) were Alabama, Arkansas, Connecticut, Florida, Idaho, Iowa, Kansas, Kentucky, Louisiana, Missouri, New Jersey, North Carolina, Oklahoma, South Dakota, Texas, Utah, and Vermont. *See* MTC, "Online Marketplace Seller Voluntary Disclosure Initiative," Sept. 1, 2017.

[14] *See Miller Brothers Co. v. Maryland*, 347 U.S. 340 (1954).

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

come under fire (from both state legislatures[16] and sitting U.S. Supreme Court justices[17]), it remains the law of the land.

According to the Court in *Quill*, having a physical presence in a state ensures that out-of-state companies meet the "substantial nexus" threshold under the commerce clause. Notably, *Quill* does not say that the physical presence itself need be "substantial," but rather that physical presence is sufficient as a threshold for "substantial nexus." The *Quill* court did, however, announce in a footnote to its decision that a de minimis level of physical presence may still be insufficient to trigger substantial nexus, even under the bright-line physical presence test.[18]

Under this constitutional framework, most states' laws make clear that the presence of inventory in a state is sufficient to create nexus. And when a seller purposefully delivers or stores its inventory in a state, these rules make sense. But what about when a seller, take Craig for example, delivers his inventory to Amazon with no direction, and no knowledge, as to where that inventory ends up? Does that arrangement satisfy the "substantial nexus" requirements of the U.S. Constitution?

Arguably, in situations in which Amazon has commingled a third-party seller's inventory with those of other sellers and moved that inventory without any input from the sellers, the out-of-state sellers' connection with any particular state housing their inventory reflects no more than a mere "slightest presence," which is too tenuous of a connection to qualify as "substantial nexus." Support for this argument is found in case law addressing the question whether a lessor of property can be held liable for taxes based on the presence of property in other states where the *lessee* has taken that property outside the lessor's control.

In *Kentucky Tax Commission v. American Refrigerator Transit Co.*,[19] for example, Kentucky's Court of Appeals held that a Missouri-based company with no connection to Kentucky other than railroad cars leased to other parties traveling on Kentucky railroads could not be subject to income tax on its receipts, despite the presence of its railroad cars in the state. Recognizing that the lessor's cars merely "traverse the state in interstate commerce" and that the company "exercises no control over the routing of the cars," the court found that "the business activities of the lessee railroads and their connecting lines are not legally attributable to the lessor," and that only the state where the cars were initially leased and delivered could impose tax on the leases. Similarly, in *Williams v. American Refrigerator Transit Co.*,[20] Georgia's Court of Appeals held that the same Missouri-based company, again leasing railroad cars that were subsequently brought into Georgia, was not "doing business" in Georgia, and thus its receipts could not be subject to the state's income tax.

Although online marketplaces do not involve leased property, an analogy can certainly be made between the two scenarios. It would be fair, for example, to say that Craig's lunch pails merely "traverse" through the various states with Amazon FBA fulfillment centers on their way to Tim, without Craig exercising any control over the routing of his items. And this raises the question whether Craig has more than a mere "slightest presence" in the states housing his inventory.

This is not to say, however, that marketplaces should necessarily be on the hook for collecting taxes in these scenarios either. In response to its recent South Carolina assessment, Amazon raises valid arguments that it too lacks a sufficient nexus with the state in order to be forced to collect sales and use

[16]Several states, including Alabama, South Dakota, and Tennessee, have recently adopted "economic nexus" rules for sales and use tax purposes, whereby the states are attempting to force out-of-state sellers to collect and remit sales tax based solely on the amount of revenue from or the number of sales made to in-state customers.

[17]In a concurring opinion in the Court's recent decision in *Direct Marketing Association v. Brohl*, 135 S. Ct. 1124 (2015), Justice Anthony M. Kennedy criticized the decision in *Quill* and noted that "[t]he legal system should find an appropriate case for this Court to reexamine" the case.

[18]*Quill*, 504 U.S. at footnote 8. The Court agreed that Quill's software-licensing activity, which resulted in "a few floppy disks" owned by the company being physically located in North Dakota, was insufficient to create nexus, as the Court had previously, in *National Geographic Society v. California Board of Equalization*, 430 U.S. 551 (1977), "expressly rejected" a "'slightest presence' standard of constitutional nexus."

[19]294 S.W.2d 554 (Ky. Ct. App. 1956).

[20]86 S.E.2d 336 (Ga. Ct. App. 1955); *see also Appeal of John H. Grace Co.*, Calif. BOE, Oct. 28, 1980.

taxes and that the proposed assessment violates the Internet Tax Freedom Act, a federal law that prohibits discriminatory internet taxes. Also, Amazon disputes that its marketplaces are akin to consignment stores, arguing instead that they are nothing more than online shopping malls. And the last time we checked, shopping malls, which like Amazon do not ever take title to the items sold under their roofs, aren't liable to collect and remit tax on their tenants' sales.

Conclusion

In the end, if Craig doesn't collect the tax, and if Amazon doesn't collect the tax, what are states to do? Well, there's always the use tax that Tim would owe on his untaxed purchase. But as most people familiar with sales and use tax issues will tell you, collecting use taxes from customers is like asking our president to stop tweeting. It's not going to happen.[21]

That means that states will continue to look elsewhere and to target both marketplaces and third-party online retailers in an attempt to capture lost revenue. And with online shopping showing no signs of slowing down, everyone involved in this corner of the digital economy needs to consider the Abbott and Costello-esque question: Who sold what to whom and where? ■

[21]For the record, though, the real "Tim" would pay the use tax himself.