

Goodbye, California? Will California's New 'Amazon Tax' Send E-Retailers Packing?

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Gov. Jerry Brown recently signed into law California's 2011-2012 budget bill, and trailer bills related to the budget bill. One such trailer bill contains language commonly referred to as the "Amazon law."¹ This law-also known as California's affiliate nexus law-will require out-of-state retailers who: (1) engage in business in California through the use of affiliates; and (2) have cumulative sales of greater than \$500,000 during a preceding 12-month period, to collect and remit taxes on sales made within California. In incorporating this legislation into its new budget, California becomes the latest in a growing list of states-Texas, Colorado, Connecticut, Arkansas, Illinois, Hawaii, Rhode Island, North Carolina, and New York-to enact a law making online retailers, who have no physical presence of their own in these states, subject to sales and/or use tax obligations as a result of the activities of their in-state affiliates.

The Reach of California's New 'Amazon Law'

California's new affiliate nexus law poses significant changes for all out-of-state retailers making sales into the state. Specifically, the legislation broadens the definition of nexus by making the activities of an out-of-state company's affiliates sufficient, by themselves, to cause the out-of-state company to be engaging in business in the state for determining physical presence in California.

The budget legislation specifically amends Section 6023 of the California Revenue and Taxation Code to expand the definition of "retailer engaging in business in this state" to now include any retailer entering into agreements under which a person in California, for a commission or other consideration, directly or indirectly refers potential purchasers, whether by an Internet-based link or an Internet Web site, or otherwise, to the retailer, and where the affiliate has gross income as a result of its referrals in excess of \$10,000. Additionally, the measure pulls in retailers who are members of a commonly controlled group and members of a combined reporting group who perform services in the state in connection with tangible property sold within the state by the out-of-state retailer, into the new, expanded, definition of "retailer engaging in business in the state."

New Section 6023 is expected to trigger California nexus for Amazon in two ways: First, through the approximately 25,000 Amazon affiliates (e.g., California-based partners that receive revenues for placing Amazon product links on their websites, often along with editorial content that socially promotes Amazon as a preferred retailer) whose affiliate relationships with Amazon create more than \$10,000 in cumulative sales during a preceding 12-month period. Second, through the presence of two of Amazon's subsidiaries that fall within the controlled group/combined reporting group servicing provision: A9, a Palo Alto-based company that works on improving Amazon's search technology, and Cupertino-based Lab126, which designs improvements for, among other products, Amazon's popular Kindle eReader.

What Does California's Amazon Law Mean?for Out-of-State Retailers?

The Board of Equalization has announced that any retailer that falls under the new criteria of Section 6023 should begin collecting and remitting the sales tax as of July 1, 2011.² The law effects a presumption that retailers will fall under Section 6023 if:

- Total cumulative sales from affiliate engagements in a preceding 12-month period is in excess of \$10,000; or
- The out-of-state retailer has cumulative sales of greater than \$500,000 during a preceding 12-month period within California.

Retailers will also fall under Section 6023 if, through the in-state presence of a member of a commonly controlled group and a combined reporting group, they perform services in connection with tangible property sold by the retailer within California.

Notably, California-like many other states that have enacted affiliate nexus tax laws-has included a "rebuttable presumption" clause in Section 6023. Similar to the rebuttable presumption clause enacted by the New York legislature in 2008, the law does provide that the presumption of nexus that attaches when a retailer falls under the criteria of Section 6023 can be rebutted if the retailer can establish that its in-state affiliates have not engaged in any active solicitation in the state, but rather have merely posted online advertisements on behalf of the retailer that link to the retailer's website.

Although there are no compliance guidelines per se as to how retailers might rebut this presumption, retailers in New York are required to enter into written agreements whereby their

affiliates specifically agree not to do anything other than provide links on a website (e.g., no advertisements, endorsements, coupons, etc.), and must annually obtain signed Certificates of Compliance from each in-state affiliate attesting that the affiliate has not engaged in any so-called prohibited solicitations on its website on behalf of the retailer.?

Goodbye, Amazon? (Stay, eBay!): First Impacts of California's Affiliate Nexus Tax

As a result of the new legislation, Amazon has notified all of the California-resident members of its Amazon Associates Program that it will terminate its associate relationship with them as of July 1, 2011, and that as of that termination date, California residents will no longer receive advertising fees for sales referred to Amazon.com or its subsidiaries (e.g., Endless.com, MYHABIT.com, and SmallParts.com). The Performance Marketing Association, an advocacy group that represents affiliate-marketing industry, anticipates that many of Amazon's 25,000 California affiliates (especially larger ones with several employees), are likely to leave the state, and that Amazon's California affiliates combined paid \$152 million to California in income taxes for 2010.³ There has been no response from Amazon as to the fates of its subsidiary/control group "servicers" in Palo Alto and Cupertino.

Notably, and likely with San Jose-based eBay in mind, the new California law exempts out-of-state retailers who sell less than \$500,000 a year worth of personal property within California. It was thought that this threshold would be sufficiently high to exclude most, if not all, of the out-of-state retailers that sell through eBay. Interestingly, the effort to preserve eBay's presence in the state may not have gone far enough. eBay reportedly told lawmakers before the passage of the law that many of its sellers generate more than \$500,000 a year worth of business in California.⁴ eBay has not yet responded to the filing of the signed budget.

Also significant for Amazon and other e-retailers falling within Section 6023 is the potential boost the legislation may give to the affiliate marketing programs of their California brick-and-mortar competitors. Historically, some of these brick-and-mortar retailers have been among the most vocal advocates for affiliate nexus laws, arguing that the affiliate programs used by out-of-state e-retailers take advantage of an uneven playing field as brick-and-mortar stores are required to collect and remit sales taxes. One member of the Board of Equalization has suggested that Amazon and Overstock affiliates looking for alternatives should seek out affiliate relationships

with major brick-and-mortar retailers such as Sears and Wal-Mart, as these companies have purportedly extended invitations for affected affiliates to join their network programs.⁵

Goodbye, Amazon Law? Will the Law Survive (Inevitable) Challenge?

Based on the proliferation of challenges that have been raised in other states following their enactments of similar affiliate nexus laws, the new California law likely will soon be the subject of multiple challenges.

There is a question as to whether or not the enactment of ABX1 28, the legislation incorporated into the budget bill, requires a two-thirds vote for passage per California's Proposition 26. Enacted in November 2010, Proposition 26 amended the California Constitution to provide that in order to pass legislation that would result in any taxpayer paying a higher tax, a two-thirds vote of the membership—rather than the majority vote requisite to pass the budget—is required (a position arguably also affirmed in Article IV, Section 12(d) of Proposition 25, which speaks to the two-thirds vote requirement in budget legislation providing, "appropriations in the budget bill and in other bills providing for appropriations related to the budget bill, are void unless passed in each house by roll call vote entered in the journal, two-thirds of the membership concurring.")

Aside from this procedural challenge, the new affiliate nexus law is almost certainly going to be challenged on United States constitutional grounds. In its 1992 decision in *Quill v. North Dakota*, the U.S. Supreme Court held that the dormant Commerce Clause barred a state from imposing a sales or use tax collection obligation on an out-of-state seller, unless the seller had a physical presence in the state. Out-of-state retailers are likely to challenge the California affiliate nexus law on the basis that it creates a presumption of physical presence that may be difficult or impossible to rebut, even where no physical presence exists.⁶ Given the stakes for Amazon and other affected retailers, both procedural and constitutional challenges are likely inevitable.

California's New Affiliate Nexus Law: Reed Smith's Recommendations

Retailers concerned about California's new affiliate nexus law should contact a member of the Reed Smith State Tax Team to discuss immediate and long-term implications for their affiliates and subsidiaries, and whether they may qualify for exemption under the rebuttable presumption test provided under new Section 2063.



For more information on California's new affiliate nexus law and other California tax issues, contact the primary authors of this *Alert* or a member of the Reed Smith's California Team. For more information on Reed Smith's California tax practice, visit www.reedsmith.com/catax.

About Reed Smith State Tax

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1. ABX1 28, Approved by governor June 28, 2011. Filed with the CA Secretary of State June 29, 2011; Assembly Bill No. 28 (Ch. 7) ("An act to amend Section 2063 of the Revenue and Taxation Code, relating to taxation, and making the appropriation therefore, to take effect immediately, bill related to the budget.")
 2. Andrew S. Ross, "Internet Sellers Must Collect Tax, Like It or Not," *The San Francisco Chronicle* (Thursday, June 30, 2011).
 3. Marc Lifsher, "California Tells Online Retailers to Start Collecting Sales Taxes from Customers," *Los Angeles Times* (June 30, 2011).
 4. Dale Kasler, "eBay Leery of 'Amazon Tax,'"? *The Sacramento Bee* (June 23, 2011).
 5. *See note 2.*
 6. Last month, the Performance Marketing Association filed a complaint in Federal District Court in Northern Illinois challenging Illinois' affiliate nexus law. Interestingly, the suit was not filed on behalf of the remote retailers (vendors), but rather on behalf of marketing affiliates, alleging discrimination against electronic forms of advertising. Further analysis of this case, as well as HB 3569-Illinois' "Amazon law"-will be provided in a forthcoming *Client Alert*.



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