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ACLU Sues North Carolina Over Its Sales/Use Tax Audit Practice

The aggressiveness of some states to assert tax jurisdiction over out-of-state retailers (or to enforce tax against their customers) took another turn last week. On June 23, 2010, the American Civil Liberties Union (ACLU) filed a complaint in U.S. Federal District Court against Kenneth Lay in his official capacity as the Secretary of the North Carolina Department of Revenue in an attempt to protect the privacy of customers of Amazon.com.

Background

The North Carolina Department of Revenue (the Department) has been seeking to impose sales and use tax collection obligations on Internet retailers, including Amazon.com LLC (Amazon). In August 2009, North Carolina enacted a statute that asserts taxing jurisdiction over an Internet retailer if the retailer had entered into "affiliate" relationships with North Carolina residents (whereby North Carolina residents refer potential customers to the Internet retailer in exchange for compensation). N.C. Gen. Stat. § 105-164.8. In anticipation of the legislation, Amazon had severed its ties with its North Carolina affiliates on June 26, 2009. Nevertheless, the Department has pursued Amazon and has been engaged in an audit of Amazon.

North Carolina's Demand for Customer Names and Purchases

On April 19, 2010, Amazon filed a complaint seeking a declaratory judgment against the Department in the U.S. District Court for the Western District of Washington. During the course of its audit of Amazon, the Department had requested detailed information about Amazon's North Carolina customers – including the identities of these customers. This information was purportedly necessary to enable the Department to determine whether Amazon was subject to North Carolina's use tax collection obligations. According to its complaint, Amazon had already provided the Department with sufficient information for North Carolina to conduct its audit, including detailed sales information, but would not disclose information identifying its customers. The Department's request for customer-identifying information led Amazon to commence its declaratory judgment action in federal court, the action in which the ACLU has now sought to intervene.

ACLU's Intervention

The ACLU intervened in the case on behalf of six anonymous plaintiffs and one named plaintiff to protect their interests in keeping their purchase histories private. The cause of action is based on the First and Fourteenth Amendments to the U.S. Constitution, and the federal Video Privacy Protection Act. Amazon is a defendant in the ACLU's complaint only with respect to the claims under the Video Privacy Protection Act.

The complaint sets forth details of the plaintiffs' purchasing histories, and outlines why the plaintiffs have an interest in keeping their purchasing histories private. Some of the purchases were politically controversial items. Other purchases were items related to a personally sensitive topic, such as mental

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illness, divorce, or religious beliefs. The plaintiffs have various personal and economic reasons for wanting to keep their purchases private: some do not want their coworkers to know about their religious beliefs; some do not want their customers and potential customers to know about past personal issues; and some do not want potential future employers to know about their political views.

One of the plaintiffs' set of facts is of particular note. Jane Doe 5 is the mother of another plaintiff, Jane Doe 4. Jane Doe 5 resides in Florida and occasionally purchases items from Amazon to send to her daughter who lives in North Carolina. According to the complaint, the Department's request for information is worded in a manner that results in the Department requesting identifying information about purchases made by out-of-state residents.

Sutherland Observation: While the Department's request for Amazon's North Carolina customer identities and purchase information is problematic on several fronts, the scope of it is particularly disturbing. Requesting information about the identities of non-North Carolina purchasers who purchase goods for North Carolina residents has significant implications.

Sutherland Observation: The Department's request fits within a growing trend of states requiring the disclosure of information that is not necessary to administer the tax laws related to that taxpayer or tax collector. While the federal and state governments routinely require disclosure by taxpayers and withholding agents of information about third parties as part of their administration of taxes (including income taxes), the North Carolina case demonstrates that these disclosure requirements are becoming more intrusive. Other recent examples of such intrusive disclosure requirements include Colorado's Internet sales tax reporting requirements and Maryland's requirement to report corporate income tax information as if Maryland imposed unitary combined reporting.

Conclusion

Frustrated with the U.S. Supreme Court's decision to allow states to assert sales and use tax jurisdiction only with respect to sellers that have an in-state physical presence, the states continue to develop theories to expand their tax or tax enforcement jurisdiction over out-of-state sellers, their customers, and alleged "intermediaries." North Carolina provides an interesting example because it has engaged in the following actions:

- Participation in the Streamlined Sales Tax Project, which seeks to eliminate the physical presence nexus standard in the context of alleged reduction in sales tax complexity;
- Enactment of a statute aimed at out-of-state Internet retailers to force them to collect tax if they have an arrangement with an in-state person who refers potential Internet customers to the retailer; and
- Audit practices that allegedly violate the U.S. constitutional rights of out-of-state Internet retailers and their customers.



If you have any questions about this development, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

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