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North Carolina's Audit Practice Violates the First Amendment

On October 25, a U.S. District Court granted Amazon.com, LLC's (Amazon) motion for summary judgment and held that the North Carolina Department of Revenue (Department) was not entitled to demand both product and customer information as part of its sales tax audit.¹ Amazon successfully argued that the Department's request for customer information violated the First Amendment. The court also held that the Tax Injunction Act did not bar a federal court from granting declaratory relief.

Summons for Customer and Purchase Information Violates First Amendment

As summarized in Sutherland's June 28 [Legal Alert](#), the Department demanded detailed information about Amazon's customers, including customer names and addresses, as part of its audit of Amazon's sales tax liability. While Amazon provided the Department with sales information, including the product sold and zip code information, it did not provide customer-identifying information. Amazon challenged the Department's demand for customer information in the U.S. District Court for the Western District of Washington. The American Civil Liberties Union (ACLU) intervened on behalf of six anonymous persons (Intervenors) in support of Amazon.

The Department argued that it needed the customer-identifying information to determine if any exemptions applied to the customer purchases so it could calculate Amazon's tax liability. Further, the Department contended that it would not be able to match the product and zip code information it already possessed with the customer-identifying information it demanded from Amazon. The U.S. District Court judge ruled that the Department's request for customer names and addresses violated the First Amendment because the First Amendment protects the disclosure of an individual's reading, listening, and viewing habits.² The court held that the Department's request was overbroad and not the least restrictive means for obtaining that information, and that the Department had not shown a compelling governmental interest for the information.

Sutherland Observation: The court's ruling provides that the Department can either require the disclosure of customers' names and addresses, or product information, but not both sets of information.

The Tax Injunction Act Does Not Bar Challenge of State Summons

The court also determined that the Tax Injunction Act (TIA) and comity principles did not bar Amazon from bringing this case in U.S. federal district court. The TIA generally bars taxpayers from challenging state taxes in U.S. federal courts. Federal courts may not "enjoin, suspend, or restrain the assessment, levy, or

¹ *Amazon.com, LLC v. Kenneth R. Lay*, Case No. C10-664 MJP, U.S. District Court, Western District of Washington at Seattle.

² The judge also found that the request violated the Video Privacy Protection Act (VPPA). VPPA is a federal statute that prohibits video service providers from disclosing personally identifiable information. The judge found that Amazon is a video service provider and thus could not disclose the requested information. There were other grounds and arguments made in the motions, but the decision in favor of Amazon was based on the VPPA and the First Amendment.

collection of any tax under State law.”³ A taxpayer may only bring such a suit in federal court when there is no plain, speedy, and efficient remedy in state court. The court found that the declaratory relief it granted was not prevented by the TIA because the relief did not prevent the Department from levying, assessing, or collecting tax.

Further, the court found that neither the Intervenor nor Amazon had a plain, speedy, or efficient remedy in the North Carolina courts or administrative processes. The court determined that the “procedure governing tax summons disputes in North Carolina lacks certainty,” and thus the remedy was not plain. The court relied on a recent North Carolina case⁴ where the North Carolina Supreme Court determined that a summons proceeding had its own specialized procedure that supplants the standard rules of civil procedure in the state, and that there was no guarantee that constitutional or federal objections could be raised.

Sutherland Observation: The court outlined a path for taxpayers to challenge a tax summons in the future. Many states issue tax summons to ascertain information from taxpayers but these procedures often are unclear or uncertain. If taxpayers can prove that these processes are not plain, they may be able to challenge the summons in federal court. The North Carolina summons procedure did not provide Amazon with a certain path forward to challenge it, and thus Amazon was able to bring a suit in federal court.

Conclusion

As states continue to engage in aggressive audit practices in their quest to impose sales and use taxes on Internet transactions, taxpayers will seek to resist the unconstitutional imposition of taxes and to protect the privacy of their customers. For more information regarding this Legal Alert, please contact a Sutherland State and Local Tax attorney.



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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³ 28 U.S.C. § 1341.

⁴ *In re Summons to Ernst & Young, LLP*, 684 S.E.2d 151 (N.C. 2009).

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