

**Testimony Supporting
H.B. 5481: An Act Concerning the Collection and Remittance
of the Sales Tax by Remote Sellers**

Jeffrey M. Tebbs* and Eric Mitzenmacher⁺
Committee on Finance, Revenue, and Bonding
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Senator Daily, Representative Staples, and distinguished Members of the Finance, Revenue, and Bonding Committee,

I am testifying today on behalf of Connecticut Voices for Children, a research-based public education and advocacy organization that works statewide to promote the well-being of Connecticut's children, youth, and families. I submit this testimony because the manner in which Connecticut raises and spends its revenues is of great importance to the state's children and families.

Connecticut Voices for Children strongly supports H.B. 5481, An Act Concerning the Collection and Remittance of the Sales Tax by Remote Sellers.

1. The proposed legislation levels the playing field for Connecticut's "Main Street" retailers.

Increasingly, Connecticut residents are purchasing goods online, rather than in Connecticut's local stores. Yet, online retailers exempt from collecting Connecticut sales taxes currently enjoy a 6% price advantage over their local competitors. In the retail industry, profit margins tend to be small, and a 6% price change can mean the difference between profitability and failure. Leading e-commerce vendors openly admit that their exemption from collecting sales taxes is essential to their profitability.¹

As a matter of fundamental fairness, Connecticut should require online retailers with Connecticut affiliates to collect sales taxes on purchases by Connecticut residents.² In addition to promoting fairness, the proposed legislation would bolster Connecticut retailers and promote economic efficiency. Connecticut's current practice of exempting retailers that engage with the Connecticut consumer market but avoid any physical presence in the state distorts decisions as to where these retailers locate assets and hire employees.³

* Research Associate for Tax Policy, Connecticut Voices for Children.

⁺ Mr. Tebbs and Mr. Mitzenmacher are students at Yale Law School. This testimony was prepared through the Yale Law School Legislative Advocacy Clinic under the supervision of J.L. Pottenger, Jr., Nathan Baker Clinical Professor of Law, Shelley Geballe, Distinguished Senior Fellow at Connecticut Voices for Children and Clinical Visiting Lecturer at Yale Law School, and Jamey Bell, Executive Director at Connecticut Voices for Children.

2. The proposed legislation represents an important step toward modernizing Connecticut's sales tax.

Connecticut's sales tax is rapidly falling out of sync with the modern economy. As consumption shifts from the sale of tangible goods to the sale of services, and as more purchases occur online instead of in-store, Connecticut's sales tax covers a shrinking segment of overall retail transactions.

Electronic sales represent a significant and expanding fraction of total retail sales. According to the U.S. Census Bureau, \$127 billion in business-to-consumer sales occurred online in 2007, equal to 3.2% of total retail sales.⁴ Respected forecaster Forrester Research projects that online retail sales will top \$172 billion in 2010 and will grow 10% per year for the next five years.⁵

Economists from the University of Tennessee have estimated that the exemption of online retailers will prevent Connecticut from collecting \$48.3 million in sales tax revenue in 2010.⁶ This estimate accounts for the fact that retailers with both an online and physical presence in Connecticut are already required to collect sales tax on electronic purchases. For instance, Barnes & Noble Booksellers collects and remits sales taxes in all states, regardless of whether a purchase is made in-store or on the company's website.⁷

H.B. 5481 will not address the full scope of the electronic commerce problem, but it is an important first step. The draft bill only permits Connecticut to require sales tax collection by those electronic retailers that have agreements with Connecticut affiliates to solicit sales from Connecticut residents. More than 210 of the Internet's 250 largest retailers operate affiliate programs. Under these programs, local newspapers, civic organizations, product reviewers, and businesses agree to post links on their websites that direct viewers to the online retailer. These affiliates then receive commissions when consumers purchase items after clicking-through these links.

Since the vast majority of the major online retailers operate affiliate programs, the legislation targets a substantial segment of online sales.⁸ The new collections required by the bill would allow Connecticut to capture a non-negligible fraction of the full \$48.3 million it is estimated to lose in sales tax revenue from certain electronic sales. By way of comparison, New York enacted a comparable law in 2008, and it expects to garner an additional \$70 million in tax revenue in the fiscal year ending March 31, 2010.⁹ That \$70 million in revenue constitutes slightly more than 10% of the \$654.9 million in New York's total revenue loss attributable to e-commerce sales predicted in the University of Tennessee study.

Connecticut should not be bullied by threats from major online retailers that they will terminate their affiliate agreements rather than subject themselves to collection requirements. Some major Internet retailers are withdrawing noisily from jurisdictions that have adopted or considered similar legislation in an attempt to frighten lawmakers from closing this egregious loophole. For instance, Amazon has cancelled its Amazon Associates program in Colorado, North Carolina, and Rhode Island, but has not withdrawn from the New York market, where it has instead elected to challenge the constitutionality of the legislation in court.¹⁰

Connecticut should not be deterred by the threat of cancelled affiliate agreements. As additional states enact similar legislation, online retailers will find it difficult to cancel affiliate programs without hampering their own sales growth. Commission-based affiliate marketing constitutes one of the most cost-effective forms of advertising for online retailers. Under these agreements, affiliates typically receive compensation only if a consumer actually purchases a product from the online retailer. For example, under the Amazon Associates program, affiliates earn referral fees equal to up to 15% of the purchase price of a product sold on Amazon.¹¹ Amazon reportedly spends “hundreds of millions of dollars” on its Associates program each year.¹² Relationships such as these treat in-state affiliate as sales agents rather than blanket advertisers. Marketing dollars are not wasted on Web users who never become customers, and the efficacy of the marketing scheme can be measured precisely.

Since 2008, four states have enacted legislation pertaining to the taxation of online sales, two state legislatures have passed comparable legislation that was later vetoed, and eleven additional states have considered (or are considering) similar bills. As electronic commerce continues to grow and state budget deficits mount, additional states will undoubtedly adopt similar legislation.

Legislation Enacted	<ol style="list-style-type: none"> 1. Colorado (enacted without affiliate language but with requirement to notify residents of use tax liability) 2. New York 3. North Carolina 4. Rhode Island
Legislation Passed But Vetoed	<ol style="list-style-type: none"> 1. California 2. Hawaii
Legislation Considered	<ol style="list-style-type: none"> 1. Connecticut 2. Illinois 3. Iowa 4. Maryland 5. Minnesota 6. Mississippi 7. New Mexico 8. Tennessee 9. Vermont 10. Virginia 11. Wisconsin

Although select retailers may temporarily withdraw their affiliate agreements in Connecticut, ample opportunities exist for former affiliates to provide their services to online retailers that already collect the sales tax in Connecticut. Many multichannel online retailers with stores in Connecticut already remit the sales and use tax to the Connecticut Department of Revenue Services. For instance, Best Buy collects Connecticut sales tax for applicable online purchases and operates an affiliate program. The same is true of Barnes & Noble

and numerous other retailers.¹⁴ Connecticut's Department of Economic and Community Development could channel affiliates that are spurned by online retailers seeking to avoid an obligation to collect sales taxes toward comparable affiliate programs operated by firms that collect state sales taxes.

Amazon, Overstock, and other major online retailers are treating their affiliates as pawns in their effort to avoid collecting sales taxes, but Connecticut should not be dissuaded from enacting legislation that will level the playing field for in-state businesses, modernize the sales tax, and potentially raise significant revenue for the state.

3. The proposed legislation enables Connecticut to address some of the challenges posed by electronic commerce without waiting interminably for federal action.

In 1992, the Supreme Court held it unconstitutional for states to impose collection responsibilities on remote sellers that do not have a “physical presence” within a state.¹⁵ Since that time, state government officials have aggressively lobbied Congress for corrective legislation with zero success. The political economy of the situation is simple: if Congress adopts legislation enabling states to exercise sales tax jurisdiction over remote sellers, it will irritate electronic retailers without generating any additional revenue to solve budget problems at the *federal* level. While a comprehensive national solution is the optimal long-run outcome, Connecticut would be ill-advised to wait for such a solution to come to fruition. Rather, joining other states in an effort to collect some of these much needed revenues is a wiser course of action.

4. Although the legal landscape is uncertain, it is likely that courts will uphold a modified version of H.B. 5481 as a constitutional exercise of Connecticut's taxing authority.

The seminal case on this issue is the United States Supreme Court's 1992 decision in *Quill v. North Dakota*, which invalidated a collection requirement for a mail-order vendor that did not maintain a “physical presence” in North Dakota.¹⁶ Since *Quill*, the Supreme Court has pursued two parallel standards regarding the reach of the federal Commerce Clause – *Quill's* “physical presence” standard and a “substantial economic nexus” standard originally articulated in the 1977 case *Complete Auto Transit, Inc. v. Brady*.¹⁷ Three relatively recent state court decisions, all of which the U.S. Supreme Court declined to review, have found that “nexus” can be established for income tax purposes through the mere licensing of intellectual property for use in a state.¹⁸ Although these cases pertained to state income taxes, their conclusion that physical presence is unnecessary to establish nexus may eventually be extended to state sales taxes.

However, even if the U.S. Supreme Court persists in requiring “physical presence” in the electronic age to impose an obligation for remote sellers to collect and remit sales tax, H.B. 5481 still meets this threshold. The Supreme Court has held on two occasions that a retailer has a “physical presence in a state if it uses in-state third parties to help ‘establish and maintain a market’ for its goods within the state.”¹⁹ In *Tyler Pipe*, the U.S. Supreme Court held that the presence of a sales force within a state – regardless of whether the salespeople are employees of a company or mere independent contractors – is sufficient to establish physical presence if the sales force plays a substantial role in maintaining a vendor's market in the state.²⁰

In the proposed legislation, Connecticut would presumptively treat affiliates that refer customers to an online retailer as establishing a retailer's physical presence in the state.²¹ This presumption would be rebuttable and is likely to be considered a legitimate method of clarifying the standards by which the state will classify economic relationships. Indeed, in the first round of litigation over comparable legislation in New York, the trial court dismissed Amazon's claims on precisely these grounds.²²

Ultimately, the validity of the statutory presumption created by this legislation depends on whether "there is some rational connection between the fact proved and the ultimate fact presumed."²³ **This Committee should limit the proposed statute to affiliate programs where in-state contractors are compensated on a commission basis.** At present, the proposed language is broad enough to capture traditional advertisement and click-through arrangements, which are difficult to characterize as sales agent relationships.²⁴ Modifying the language to reflect the differences between commission-based revenue and other advertising contracts would draw the bill even more soundly into line with present Supreme Court precedent. To this end, the Committee could amend lines 52 through 54 of the bill to read "if the retailer enters into an agreement with a resident of this state, under which the resident, for a commission or other performance-based consideration. . . ."

5. Requiring remote sellers to collect sales taxes poses only a trivial administrative cost. In this modern era, software algorithms can easily apply the rules of different state and local sales tax regimes without imposing an unreasonable burden on electronic retailers. For instance, Amazon already collects the sales tax on behalf of several different companies that sell products through its website. Amazon "calculates and collects sales taxes in every state except one for the Target department store chain, which has outlets in those states and therefore acknowledges an obligation to charge tax on its Internet sales made on Amazon's site."²⁵

6. Connecticut will be entitled to retain any revenue collected even if this law is challenged by remote retailers and found to be unconstitutional. Any litigation pertaining to this law will address whether a retailer has sufficient nexus with Connecticut for the state to require it to collect sales taxes. However, Connecticut residents still owe "use taxes" on these purchases regardless of whether a retailer collects it from them. As a consequence, the only damages available to an online retailer if it successfully challenged this statute if enacted would equal whatever additional costs a retailer incurred through its collection activities. In point of fact, Amazon is not seeking the refund of taxes it is collecting under the New York statute despite challenging the constitutionality of the legislation.²⁶

¹ For example, Amazon's 2008 10-K report states that "A successful assertion by one or more states . . . that we should collect sales or other taxes on the sale of merchandise or services could . . . decrease our ability to compete with traditional retailers and otherwise harm our business." Amazon.com, Inc., 2008 Form 10-K, at 14. *See generally* MICHAEL MAZEROV, CTR. ON BUDGET & POL'Y PRIORITIES, AMAZON'S ARGUMENTS AGAINST COLLECTING SALES TAXES DO NOT WITHSTAND SCRUTINY (2009), <http://www.cbpp.org/files/11-16-09sfp.pdf>.

² In this testimony, I use the term "sales taxes" to refer to both sales taxes and use taxes. Under the "use tax," Connecticut residents already are obligated to pay taxes on goods purchased in another state for use within Connecticut. *See* CONN. GEN. STAT. § 12-411 (Westlaw 2010) ("An excise tax is hereby imposed on the storage, acceptance, consumption or any other use in this state of tangible personal property purchased from any retailer for storage, acceptance, consumption or any other use in this state, the acceptance or receipt of any services constituting

a sale . . . purchased from any retailer for consumption or use in this state, or the storage, acceptance, consumption or any other use in this state of tangible personal property which has been manufactured, fabricated, assembled or processed from materials by a person, either within or without this state, for storage, acceptance, consumption or any other use by such person in this state") ; CONN. GEN. STAT. § 12-407 (Westlaw 2010) (definition of use). The instructions for filing the 2009 Connecticut personal income tax return for the first time remind Connecticut residents of their obligation to pay use tax on purchases made online, by catalog, or out-of-state for use in Connecticut, as required by PA 09-03.

³ For instance, Amazon's CEO, Jeff Bezos, has openly admitted that he selected Seattle as the location for the business in order to have access to a talented workforce "without all the tax consequences." See Randall Stross, *Sorry, Shoppers, buy Why Can't Amazon Collect More Tax?*, N.Y. TIMES, Dec. 26, 2009, at BU3.

⁴ U.S. Census Bureau, E-Stats, May 28, 2009, <http://www.census.gov/econ/estats/2007/2007reportfinal.pdf>.

⁵ *E-Retail Will Influence 53% of Purchases by 2014, Forrester Says*, INTERNET RETAILER, Mar. 8, 2010, <http://www.internetretailer.com/dailyNews.asp?id=33828>.

⁶ Donald Bruce, William F. Fox, and LeAnn Luna, *State and Local Government Sales Tax Revenue Losses from Electronic Commerce*, The University of Tennessee, Apr. 13, 2009, tbl. 5.

⁷ Barnes & Noble, General Tax Information – Barnes & Noble, <http://www.barnesandnoble.com/help/cds2.adp?PID=8115> (last visited Mar. 14, 2010).

⁸ MICHAEL MAZEROV, CTR. ON BUDGET & POL'Y PRIORITIES, NEW YORK'S "AMAZON LAW": AN IMPORTANT TOOL FOR COLLECTING TAXES OWED ON INTERNET PURCHASES 6, n.19 (2009), <http://www.cbpp.org/files/7-23-09sfp.pdf> (citing *Internet Retailer Top 500 Guide*).

⁹ Robert D. Platner, Deputy Commissioner, Office of Tax Policy Analysis, N.Y. State Dep't of Taxation & Finance, Letter to the Editor, *'Amazon' Law Expected to Raise \$70 Million for Fiscal 2009*, STATE TAX TODAY, Dec. 7, 2009. New York collected \$53 million in the three quarters of FY 2008 for which the new law was in effect.

¹⁰ Similarly, Overstock.com has cancelled internet affiliate programs in California, Hawaii, North Carolina, and Rhode Island.

¹¹ Amazon.com, What is the Amazon Associates Program?, <https://affiliate-program.amazon.com/gp/associates/join/getstarted> (last visited Mar. 15, 2010).

¹² MAZEROV, *supra* note 8, at 7.

¹³ JOSEPH HENCHMAN, TAX FOUNDATION, "AMAZON TAX" LAWS SIGNAL BUSINESS UNFRIENDLINESS AND WILL WORSEN SHORT-TERM BUDGET PROBLEMS (2010).

¹⁴ MAZEROV, *supra* note 8, at 9.

¹⁵ See *Quill v. North Dakota*, 504 U.S. 298, 317 (1992).

¹⁶ See *Quill v. North Dakota*, 504 U.S. 298, 317 (1992).

¹⁷ See *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 297 (1977).

¹⁸ See *Geoffrey, Inc. v. Comm'r of Revenue*, 453 Mass. 17 (2009); *Geoffrey, Inc. v. Okla. Tax Comm'n*, 132 P.3d 632 (Okla. Civ. App. 2006); *Geoffrey, Inc. v. S.C. Tax Comm'n*, 313 S.C. 15 (1993). Could sales tax be different than income tax? Perhaps, but the current legal climate does not provide unambiguous answers.

¹⁹ MAZEROV, *supra* note 8, at 4.

²⁰ See *Tyler Pipe Indus., Inc. v. Wash. State Dep't of Revenue*, 483 U.S. 232, 249-50 (1987).

²¹ See Conn. H.B. 5481§ 1(12)(L).

²² See *Amazon.com, LLC v. N.Y. State Dep't of Tax'n & Fin.*, 877 N.Y.S.2d 842, 847-48 (N.Y. Sup. Ct. 2009)

²³ *Mobile, Jackson, & Kansas City R.R. Co. v. Turnipseed*, 219 U.S. 35, 43 (1910).

²⁴ See Conn. H.B. 5481§ 1(12)(L) (triggering the presumption whenever an affiliate "directly or indirectly refers potential customers . . . to the retailer").

²⁵ MICHAEL MAZEROV, *supra* note 1, at 2.

²⁶ MAZEROV, *supra* note 8, at 6.