

Iowa Can Do Better than the Affiliate Tax: A Proposal for an Intermediary Tax

Travis Cavanaugh*

ABSTRACT: New York was the first state to implement the affiliate tax, also commonly referred to as the “Amazon tax” due to its primary purpose of imposing sales-tax liability on Amazon.com. The tax requires many online retailers to collect sales tax on all sales of merchandise to residents of the taxing state if the retailer hires in-state residents to advertise its goods and such advertisements result in \$10,000 or more in revenue for the retailer. Recently, other states have begun implementing the New York affiliate tax. However, in all of these states, except New York, Amazon has responded by cancelling its affiliate advertising program within the state in order to avoid the corresponding tax liability. This Note proposes a different tax, an intermediary tax, which like the affiliate tax imputes the requisite “physical presence” and “substantial nexus” to retailers with substantial contractual relationships with residents of the state. The contracts used to impute such a presence are not based on the advertising and other contracts used for the affiliate tax, but rather on the retailers’ contracts to provide in-state residents with a forum to sell their goods. This proposed tax is more advantageous than the affiliate tax because, among other reasons, it is more difficult for retailers, like Amazon, to avoid the tax.

I. INTRODUCTION.....	569
II. CURRENT STANDARD FOR DETERMINING WHEN STATES CAN REQUIRE THE COLLECTION OF SALES TAX FROM OUT-OF-STATE RETAILERS.....	572
A. SCRIPTO, INC. V. CARSON.....	572
B. NATIONAL BELLAS HESS, INC. V. DEPARTMENT OF REVENUE OF ILLINOIS.....	573
C. QUILL CORP. V. NORTH DAKOTA.....	573

* J.D. Candidate, The University of Iowa College of Law, 2012; B.B.A., The University of Iowa Tippie College of Business, 2007. I would like to thank my family, friends, and the editors and student writers of Volumes 96 and 97 of the *Iowa Law Review* for their support and feedback on this Note.

III.	NEW YORK'S AFFILIATE TAX.....	575
IV.	PROBLEMS WITH THE AFFILIATE TAX.....	577
	A. <i>IMPUTING SUBSTANTIAL NEXUS</i>	577
	B. <i>ADVERTISING CONTRACTS WITH NON-EXCLUSIVE INDEPENDENT CONTRACTORS ARE THE SOLE BASIS OF TAX LIABILITY</i>	579
	C. <i>AMAZON AND OTHER RETAILERS CAN STILL AVOID THE TAX</i>	580
V.	PROPOSAL FOR THE INTERMEDIARY TAX.....	581
	A. <i>DEFINING AN INTERMEDIARY</i>	582
	B. <i>A REBUTTABLE PRESUMPTION THAT THE SUBSTANTIAL-NEXUS REQUIREMENT IS MET</i>	583
VI.	ADVANTAGES OF THE INTERMEDIARY TAX	583
	A. <i>A STRONGER SUBSTANTIAL NEXUS IS ESTABLISHED</i>	583
	B. <i>RETAILERS' ABILITY TO AVOID COLLECTING THE TAX IS REDUCED</i>	585
	C. <i>THE NUMBER OF RETAILERS REQUIRED TO COLLECT SALES TAX IS EXPANDED</i>	585
	D. <i>THE CONTRACTUAL RELATIONSHIPS USED TO IMPOSE THE COLLECTION OF SALES TAX ARE MORE DIRECTLY RELATED TO THE ACTIVITY PRODUCING THE TAX</i>	586
VII.	POTENTIAL CHALLENGES TO THE INTERMEDIARY TAX.....	587
VIII.	CONCLUSION	588

I. INTRODUCTION

With the advent of the Internet, businesses have been able to easily gain access to the national retail market with minimum cost.¹ As a result, over the past decade Internet retail sales have made up an increasingly large portion of the total national retail sales in the United States.²

All but five states in the United States impose some form of sales tax³ on retail sales.⁴ However, many online retailers that sell goods within sales-tax-collecting states are not required to collect it unless a “substantial nexus” exists between the retailer and the state in which the goods are shipped.⁵ If the retailer has a “substantial nexus” with the state in which the customer lives, then the retailer has a duty to collect sales tax at the time of the transaction.⁶ Alternatively, if sales tax does not apply, the state imposes a use tax⁷ on the buyer, which must be paid to the state at a later date—typically

1. The relative costs for creating an online business are typically estimated to be below \$1000. See Louis Allport, *Internet Business Start Up Costs—How Much Does It Really Cost To Start a Successful Business?*, EZINE ARTICLES, <http://ezinearticles.com/?Internet-Business-Start-Up-Costs-How-Much-Does-it-Really-Cost-to-Start-a-Successful-Business?&id=2912118> (last visited Oct. 30, 2011) (stating that a few years ago the cost of starting an online business was \$800, while presently the start-up cost is estimated at \$200); *Internet Web Business Start Up Costs*, WEB MARKETING CONSULTING CO., http://www.munising.com/advertise/start_up_costs.html (last visited Oct. 30, 2011) (estimating start-up costs to be approximately \$960).

2. U.S. CENSUS BUREAU, ANNUAL RETAIL TRADE REPORT (2010), available at <http://www2.census.gov/retail/releases/current/arts/sales.pdf> (showing that retail sales by “[e]lectronic shopping and mail-order houses” accounted for \$80,366 billion in sales in 1998, whereas those sales accounted for \$228,545 billion in 2008).

3. *E.g.*, IOWA CODE ANN. § 423.2(1) (West 2011) (defining sales tax as “a tax . . . upon the sales price of all sales of tangible personal property, consisting of goods, wares, or merchandise, sold at retail in the state to consumers or users”).

4. See Ret. Living Info. Ctr., *Taxes by State*, RETIREMENTLIVING.COM, <http://retirementliving.com/RLtaxes.html> (last visited Oct. 30, 2011) (“All states except Alaska, Delaware, Montana, New Hampshire and Oregon, collect sales taxes.”).

5. See *infra* Part II.

6. See IOWA CODE ANN. § 423.2 (sales tax); *id.* § 423.5 (use tax); *infra* Part II; see also *Quill Corp. v. North Dakota*, 504 U.S. 298, 313 (1992) (holding that there must be a substantial nexus between the retailer and the state where the sales tax would apply to avoid infringing on the dormant Commerce Clause).

7. *E.g.*, IOWA CODE ANN. § 423.5 (defining many instances where use tax is imposed). Generally, the use tax is applicable to the use of any “tangible personal property” in the state or “services . . . furnished in th[e] state.” *Id.* § 423.5(1), (5). The state exempts the imposition of use tax when “the sales price from the sale of [either property or services] required . . . [the] inclu[sion] . . . of the sales tax, if that tax has been paid to the department or the retailer.” *Id.* § 423.6(1).

declared and paid as part of an individual's annual income-tax return.⁸ Typically, states that impose a sales tax set the use tax at the same rate.⁹

In theory, states that tax retail sales should receive tax revenue from online sales made to in-state residents, either from the online retailer at the time of sale or from the customer later. However, the reality is that states collect only a small portion of the tax owed.¹⁰ The main reason for this is the ease with which online retailers avoid or limit their responsibility to collect sales tax by restricting their physical presence to a limited number of states.¹¹ A retailer's physical presence within a state has typically been the prerequisite for a state to impose sales tax—that is, until the advent of the affiliate tax.¹² When sales-tax collection is not required of the retailer, the state is dependent on its residents who make online purchases to report the corresponding use tax to the state.¹³ Use tax has been historically difficult for states to collect because most buyers are either unaware of their obligation to pay it or purposely under-report their obligation, both of

8. *E.g., id.* § 423.2 (sales tax); *id.* § 423.5 (use tax). Iowa has both a use and sales tax. *Id.* §§ 423.2, 423.5. Use tax typically is enacted in any state that has a corresponding sales tax to try and persuade residents not to avoid the sales tax by transacting with out-of-state sellers. Christina T. Le, *The Honeymoon's Over: States Crack Down on the Virtual World's Tax-Free Love Affair with E-Commerce*, 7 HOUS. BUS. & TAX L.J. 395, 399 (2007) (“Complementary to a jurisdiction’s sales tax is the use tax, which is levied on the ‘use or consumption of goods or services purchased outside the taxing jurisdiction for use within the taxing jurisdiction.’” (quoting ADVISORY COMM’N ON ELECTRONIC COMMERCE, REPORT TO CONGRESS (2000))).

9. *Compare* IOWA CODE ANN. § 423.2 (sales tax), *with id.* § 423.5 (use tax). In Iowa, both the sales and use tax are set at six percent. *Id.* §§ 423.2, 423.5. This makes sense since the use tax is an attempt to dissuade residents from shopping outside of the taxing jurisdiction to avoid the sales tax.

10. The reason states are turning to the affiliate tax is to make up for the shortfall in state revenue as a result of online retail sales in the state. *See* Declan McCullagh, *More States Propose Internet Sales Taxes*, CNET.COM (Mar. 8, 2010, 2:00 PM), http://news.cnet.com/8301-13578_3-10465658-38.html (“The justification for the laws is a reprise of arguments that state tax collectors have made for at least a decade: they claim that Amazon, Overstock.com, Blue Nile, and other online retailers that don’t collect taxes are unreasonably depriving states of revenue . . .”).

11. Eric A. Ess, *Internet Taxation Without Physical Representation?: States Seek Solution To Stop E-Commerce Sales Tax Shortfall*, 50 ST. LOUIS U. L.J. 893, 893 (2006) (“Unfortunately for revenue-seeking states, what enables consumers to pay less may not be competitive retail pricing, but the absence of sales tax charged on Internet purchases.”); Michael R. Gordon, Note, *Up the Amazon Without a Paddle: Examining Sales Taxes, Entity Isolation, and the “Affiliate Tax,”* 11 N.C. J.L. & TECH. 299, 300–01 (2010) (“[S]tates have begun to fight for all the tax revenue to which they believe they are entitled. Online retailers with no physical presence in a state have been, until recently, exempt from collecting the sales tax . . .” (footnotes omitted)).

12. *See* Nat’l Bellas Hess, Inc. v. Dep’t of Revenue of Ill., 386 U.S. 753, 753 (1967) (requiring some physical presence to meet constitutional challenge), *overruled by* Quill Corp. v. North Dakota, 504 U.S. 298 (1992); *infra* Part II.B.

13. *See supra* note 11 and accompanying text.

which result in the state collecting little of the obligated use tax from Internet transactions.¹⁴

States, including Iowa, have continued to struggle with how to ensure full collection of the taxes owed from online retail sales.¹⁵ This issue has become a greater priority due to the struggling economy and resulting state budget deficits.¹⁶ A recent academic study conducted in 2009 predicted that Iowa will lose over sixty million dollars in uncollected tax revenue resulting from e-commerce sales in 2010.¹⁷ States have attempted to collect this lost tax revenue in various ways. For example, some states have elected to collect owed use tax directly from their residents, but this has been found to be politically unfavorable and difficult to accomplish.¹⁸ Increasingly, states have taken the approach of altering the tax code in an attempt to apply sales tax to transactions that currently only result in use-tax liability.¹⁹

Part II of this Note analyzes the Supreme Court's current standard for determining when a state may impose sales-tax liability on a retailer without infringing on the Commerce Clause. In Part III, this Note evaluates the New York affiliate tax, which has successfully imposed sales-tax liability on a limited number of out-of-state online retailers. Part IV examines the major drawbacks of the affiliate tax. Finally, in Parts V–VII, this Note proposes and discusses an alternative to the affiliate tax—the intermediary tax—which, if adopted in Iowa, would likely be more successful in ensuring the collection

14. Ess, *supra* note 11, at 896–98. Although national Internet retail sales have more than doubled from 1998 to 2008, the number of consumer use-tax returns filed in Iowa has decreased from 27,278 in 1998 to 24,539 in 2008. Compare DEP'T OF REVENUE & FIN., STATE OF IOWA, IOWA RETAIL SALES & USE TAX REPORT (1998), available at <http://www.iowa.gov/tax/educate/Suta98.pdf>, with DEP'T OF REVENUE, STATE OF IOWA, IOWA RETAIL SALES & USE TAX REPORT XIII (2009), available at <http://www.iowa.gov/tax/educate/suta09.pdf>. With the growth of Internet e-commerce, one would expect to see an increase in the number of individuals reporting use tax rather than a decrease. See *supra* note 2 and accompanying text.

15. See Ess, *supra* note 11, at 895–99.

16. See Gordon, *supra* note 11, at 299–300; see, e.g., IOWA DEP'T OF MGMT., IOWA BUDGET REPORT FISCAL YEAR 2010, at 5 (2009), available at http://publications.iowa.gov/6908/1/Iowa_Budget_Report_Fiscal_Year_2010.pdf (discussing the difficulties that the State of Iowa is facing, which has resulted in “reducing state revenues and increasing demand for Medicaid services”); Daniel Tyler Cowan, Recent Development, *New York's Unconstitutional Tax on the Internet: Amazon.com v. New York State Department of Taxation & Finance and the Dormant Commerce Clause*, 88 N.C. L. REV. 1423, 1423 (2010) (“As the current economic downturn continues to ripple through every sector of the economy, state governments from North Carolina to California are struggling to develop innovative tax policies to boost their plummeting revenues.”).

17. DONALD BRUCE, WILLIAM F. FOX & LEANN LUNA, STATE AND LOCAL GOVERNMENT SALES TAX REVENUE LOSSES FROM ELECTRONIC COMMERCE 11 (2009), available at <http://cber.utk.edu/ecomm/ecomo409.pdf>.

18. Ess, *supra* note 11, at 897–99; see, e.g., Cowan, *supra* note 16, at 1428 n.38 (citing N.C. GEN. STAT. §§ 105-164.6(b), 105-164.16(d) (2009)).

19. See *infra* Part III.

of sales tax without many of the corresponding drawbacks associated with the affiliate tax.

II. CURRENT STANDARD FOR DETERMINING WHEN STATES CAN REQUIRE THE COLLECTION OF SALES TAX FROM OUT-OF-STATE RETAILERS

For over half a century, states have attempted to require out-of-state retailers to collect sales tax on sales made within its borders.²⁰ The Supreme Court, in three seminal cases, established the standard for determining when a sufficient relationship exists between a retailer and a state to allow the state to impose its sales tax on the retailer.²¹

A. *SCRIPTO, INC. v. CARSON*

The Supreme Court first faced this issue in *Scripto, Inc. v. Carson*.²² In *Scripto*, the Court found that Florida had the right to require a Georgia retailer to collect sales tax on sales within the state since the retailer had contracted with ten Florida “wholesalers” to solicit and collect orders from Florida residents.²³ The retailer’s contractual relationship with these ten Florida independent contractors was enough to establish a sufficient connection between the state and the retailer, granting Florida the authority to impose the tax.²⁴ The Court defined the appropriate test as “simply the nature and extent of the activities of the [retailer] in [the state attempting to require the collection of sales tax].”²⁵ The Court would further refine this test in *National Bellas Hess, Inc. v. Department of Revenue of Illinois*.²⁶

20. See *Quill Corp. v. North Dakota*, 504 U.S. 298, 301 (1992); *Nat’l Bellas Hess, Inc. v. Dep’t of Revenue of Ill.*, 386 U.S. 753, 754 (1967), *overruled by Quill*, 504 U.S. 298; *Scripto, Inc. v. Carson*, 362 U.S. 207, 207–08 (1960).

21. See *supra* note 20.

22. *Scripto, Inc.*, 362 U.S. 207.

23. *Id.* at 207–08, 211 (“The only incidence of this sales transaction that is nonlocal is the acceptance of the order.”). The only affiliation with Florida in this case was the hiring of the ten wholesalers. *Scripto* did not “(1) own, lease, or maintain any office, distributing house, warehouse or other place of business in Florida, or (2) have any regular employee or agent there.” *Id.* at 209.

24. *Id.* at 208, 211. Additionally, the Court found no issue related to the fact that the hired wholesalers were not full-time employees or that their contract identified them as “independent contractor[s],” *id.* at 209 (internal quotation marks omitted), since it did not impact the wholesalers’ “effectiveness in securing a substantial flow of goods into Florida” for the retailer, *id.* at 211.

25. *Id.* at 211–12.

26. *Nat’l Bellas Hess, Inc. v. Dep’t of Revenue of Ill.*, 386 U.S. 753 (1967), *overruled by Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

B. NATIONAL BELLAS HESS, INC. V. DEPARTMENT OF REVENUE OF ILLINOIS

In *Bellas Hess*,²⁷ a mail-order retailer argued that the imposition of sales-tax collection on it violated both the Due Process Clause and the Commerce Clause.²⁸ The Court noted that the claims were similar and evaluated them together.²⁹ The Court held that a state may not “impose the duty of [sales] tax collection and payment upon a seller whose only connection with customers in the State is by common carrier or the United States mail.”³⁰ For a state to satisfy both the Due Process Clause and the Commerce Clause, the retailer must have some kind of physical presence in the taxing state.³¹ A mail-order operation whose only connection with the state was accepting orders from in-state customers, and then shipping those orders from outside the state, did not establish sufficient contact with the state to allow the imposition of sales tax on the retailer. Therefore, the Court reasoned that the tax was unconstitutional because the retailer had no physical presence in the taxing state.³²

C. QUILL CORP. V. NORTH DAKOTA

Quill Corp. v. North Dakota provides the current framework for analyzing when a state may impose sales tax on retailers.³³ *Quill*'s facts are similar to the facts in *Bellas Hess*. Both cases involved a mail-order retailer who claimed that the state's imposition of sales-tax collection was unconstitutional on the grounds that it violated both the Due Process and Commerce Clauses.³⁴ Like in *Bellas Hess*, the sole link between the mail-order retailer and the taxing state was the retailer's acceptance and fulfillment of mail orders to residents of the state.³⁵ However, the Court in *Quill* separated the mail-order retailer's

27. National Bellas Hess was a mail-order retailer with its principal place of business in both Missouri and Illinois. *Id.* at 754. The Department of Revenue was attempting to require the retailer to collect taxes on sales within Illinois, even though it had no store outlets nor any sales representatives working for it within the state of Illinois. *Id.*

28. *Id.* at 756.

29. *Id.*

30. *Id.* at 758–59 (“[I]f the power of Illinois to impose . . . tax burdens upon National were upheld, the resulting impediments upon the free conduct of its interstate business would be neither imaginary nor remote. For if Illinois can impose such burdens, so can . . . every other political subdivision throughout the Nation with power to impose sales and use taxes.”).

31. *Id.* at 758 (stating that there is a long-standing distinction between “mail order sellers with retail outlets, [in-state] solicitors, or property within a State, and those who do no more than communicate with customers in the State by mail or common carrier as part of a general interstate business”).

32. *Id.* at 759–60.

33. *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

34. *Id.* at 302–03; *supra* note 28 and accompanying text. *Quill* was a mail-order retailer incorporated in Delaware with offices in Illinois, California, and Georgia and solicited business in North Dakota where its only link was the use of “common carrier[s] from out-of-state locations” to satisfy North Dakota customer orders. *Quill*, 504 U.S. at 302.

35. *See supra* note 34 and accompanying text.

two claims and found that each had a different nexus requirement.³⁶ Thus, the Court articulated two different tests: the Due Process nexus test and the Commerce Clause nexus test.³⁷

The test for determining if the Due Process nexus requirement is satisfied is “whether an individual’s connections with a State are substantial enough to legitim[ize] the State’s exercise of power over him.”³⁸ The primary concern in addressing this question is whether the retailer’s business within the state put the retailer on “‘notice’ or [gave] ‘fair warning’” that the state has the authority to impose the tax.³⁹

In contrast, the Commerce Clause nexus test focuses on the “structural concerns [and] the effects of state regulation on the national economy.”⁴⁰ In order to avoid an undue burden on interstate commerce, there must be a “substantial nexus” between the retailer and the state imposing the tax.⁴¹ Therefore, a state may have the “minimum contacts” required under the Due Process Clause and still lack the “substantial nexus” required under the Commerce Clause.⁴² The Court’s holding in this case was a reiteration of the holding in *Bellas Hess*—if a retailer’s only connection with the state is through mail carriers delivering goods, then the substantial nexus required under the Commerce Clause has not been met.⁴³

Many commentators have noted that the more burdensome test is the substantial-nexus requirement under the Commerce Clause test.⁴⁴ If that test

36. *Quill*, 504 U.S. at 305, 312–13 (reasoning that both claims “reflect different constitutional concerns” and that Congress only has the authority to “authorize state actions that burden interstate commerce,” and not Due Process).

37. *Id.* at 312–13, 325.

38. *Id.* at 312. The Court’s analysis of due process is focused on “whether a defendant had minimum contacts with the jurisdiction ‘such that the maintenance of the suit does not offend “traditional notions of fair play and substantial justice.”’” *Id.* at 307 (quoting *Int’l Shoe Co. v. Washington*, 326 U.S. 310, 316 (1945)).

39. *Id.* at 312.

40. *Id.* The dormant Commerce Clause prohibits “taxes that pass an unfair share of the tax burden onto interstate commerce.” *Id.* at 313.

41. *Id.* at 313 (“[T]he ‘substantial nexus’ requirement is not, like due process’ ‘minimum contacts’ requirement, a proxy for notice, but rather a means for limiting state burdens on interstate commerce.”).

42. *Id.*

43. *Id.* at 315. The State argued that given the Court’s movement away from formalistic rules, it should move away from the test requiring physical presence of the retailer within the state to a more “substantive approach.” *Id.* at 314 (internal quotation marks omitted). Although the Court agreed with the lower court’s “assessment of the evolution of [the Court’s] cases,” it did not cause the Court to overrule *Bellas Hess*. *Id.*

44. *Id.*, *supra* note 8, at 404–05 (“[The Court] backed away from its ‘physical presence’ requisite for the Due Process Clause . . . [which] [u]ltimately . . . takes the Due Process test back to requisite minimum contacts that provide a ‘definite link’ between the state and seller. . . . [Whereas] ‘[p]hysical presence’ has been interpreted as satisfying the Court’s substantial nexus [for the Commerce Clause]”); Brian S. Masterson, Note, *Collecting Sales and Use Tax on Electronic Commerce: E-Confusion or E-Collection*, 79 N.C. L. REV. 203, 211 (2000) (“Following *Quill*,

is met, then by default the substantial-nexus requirement for the Due Process Clause is met.⁴⁵ Therefore, when analyzing a proposed tax liability on out-of-state retailers, the focus of the analysis is on whether the Commerce Clause substantial-nexus test is met.

All three of the aforementioned cases were decided prior to the development of the Internet as a means of shopping.⁴⁶ Although the case history clearly establishes the requirement that a substantial nexus must exist between a retailer and the taxing state to ensure compliance with the Commerce Clause, the case history fails to clearly define what constitutes a substantial nexus and instead defines what it is not—a sole link by “common carrier.”⁴⁷

III. NEW YORK’S AFFILIATE TAX

In an attempt to require the collection of sales tax from certain online retailers, New York changed its tax code to require all retailers that

enter[] into an agreement with a resident of this state under which the resident, for a commission or other consideration, directly or indirectly refers potential customers, whether by a link on an Internet website or otherwise, to the seller, if the cumulative gross receipts from sales by the seller to customers in the state who are referred to the seller by all residents with this type of an agreement with the seller is in excess of ten thousand dollars during the preceding four quarterly periods.⁴⁸

a state court may exercise personal jurisdiction over an out-of-state taxpayer under the due process ‘minimum contacts’ standard, but if the taxpayer does not have some physical presence in the state, the state may not impose a duty to collect use tax under the Commerce Clause.” (footnote omitted)).

45. See *supra* note 44 and accompanying text.

46. Compare *Quill*, 504 U.S. 298, and *Nat’l Bellas Hess, Inc. v. Dep’t of Revenue of Ill.*, 386 U.S. 753 (1967), overruled by *Quill*, 504 U.S. 298, and *Scripto, Inc. v. Carson*, 362 U.S. 207 (1960), with Barry M. Leiner et al., *Histories of the Internet: A Brief History of the Internet*, INTERNET SOC’Y, <http://www.isoc.org/internet/history/brief.shtml> (last visited Oct. 30, 2011) (stating that the Federal Networking Council did not even define the term Internet until October 24, 1995). All three of the aforementioned cases dealt with mail-order companies and did not involve any e-commerce. See *supra* Part II.

47. *Quill*, 504 U.S. at 315 (quoting *Bellas Hess*, 386 U.S. at 758). While only defining what is not adequate to establish a substantial nexus, the Court clearly upheld the “vitality of *Bellas Hess*’ sharp distinction” leading many to conclude that a physical presence of some sort within the state is still required in order to satisfy this test. *Id.* at 311 (internal quotation marks omitted); see, e.g., *Amazon.com LLC v. N.Y. State Dep’t of Taxation & Fin.*, 877 N.Y.S.2d 842, 847 (Sup. Ct. 2009) (stating that physical presence is required to satisfy “substantial nexus”) (internal quotation marks omitted), *aff’d as modified sub nom.* *Amazon.com, LLC v. N.Y. State Dep’t of Taxation & Fin.*, 913 N.Y.S.2d 129 (App. Div. 2010); *Guardian Indus. Corp. v. Dep’t of Treasury*, 499 N.W.2d 349, 356 (Mich. Ct. App. 1993) (requiring “physical presence”).

48. N.Y. TAX LAW § 1101(b)(8)(vi) (McKinney 2011); see also *Amazon.com*, 877 N.Y.S.2d at 845-46 (discussing New York’s affiliate tax and how it operates).

When a retailer obtains \$10,000 or more in revenue from referrals of residents located in the taxing state, the law creates a rebuttable presumption that the retailer has a substantial nexus with the state.⁴⁹ This presumption can be rebutted if the retailer establishes that the commissioned residents “did not engage in any solicitation in the [taxing] state on behalf of the [retailer].”⁵⁰ The most prominent online retailer affected by the change in New York’s law is Amazon.com (“Amazon”), which runs an affiliate program in New York.⁵¹ Amazon has contracts with a number of New York website owners (affiliates) to advertise via links referring visitors to Amazon.⁵² These affiliates are then paid a commission for any sales resulting from their ads.⁵³

After New York implemented the affiliate tax, Amazon brought suit arguing that the law did not satisfy the standard established in *Quill* and was unconstitutional as applied to Amazon.⁵⁴ The New York court analyzed whether Amazon met the substantial-nexus requirement and found that the requirement was satisfied since the law was “crafted to ensure . . . a sufficient basis for requiring collection of New York taxes” by applying the law only to vendors that: (1) make contracts with New York residents; (2) hire in-state residents to refer customers to the vendor; (3) do so in exchange for compensation; and (4) receive revenues of \$10,000 or more from the referrals.⁵⁵

When assessing Amazon’s other argument, the New York Supreme Court noted that Amazon has contracts with thousands of New York residents through its affiliate program and that these associates “are free to

49. See N.Y. TAX LAW § 1101(b)(8)(vi).

50. *Id.*

51. *Amazon.com*, 877 N.Y.S.2d at 845 (representing the subsequent suit Amazon brought in response to the passage of the affiliate tax in New York).

52. *Id.* (“Amazon has hundreds of thousands of Associates. Thousands ‘of them have provided Amazon with addresses in New York.’”).

53. See *id.* (“The Operating Agreement further sets forth that Associates will be paid through a ‘referral fee’ and can elect between the ‘Classic Fee Structure’ (generally 4% of qualifying revenues from sales of products sold through special links) or the ‘Performance Fee Structure’ (a percentage of qualifying revenues set forth in a table that varies with the number of total items shipped).”). See generally *Make Money Advertising Amazon Products*, AMAZONASSOCIATES, <https://affiliate-program.amazon.com/> (last visited Oct. 30, 2011) (listing all affiliate-program information).

54. *Amazon.com*, 877 N.Y.S.2d at 846. Amazon alleged that the law “violates the Commerce Clause of the United States Constitution, both facially and as applied to Amazon, because it imposes tax collection obligations on out-of-state entities who have no substantial nexus with New York.” *Id.* (internal quotation marks omitted).

55. *Id.* at 848 (“All of these requirements make clear that a tax-collection obligation will only be imposed based on an out-of-state seller’s conscious decision to contract with in-state residents who collectively refer more than \$10,000 of New York based business.”). The court also makes clear that the \$10,000 minimum revenue provision ensures that there is more than a mere “slight[] presence” within the state. *Id.* (internal quotation marks omitted).

target New Yorkers and encourage Amazon sales.”⁵⁶ Given these facts, the court determined Amazon was prohibited from arguing it had not explicitly instructed the New York associates to solicit New York business since there was no contractual agreement not to do so.⁵⁷ Therefore, the court dismissed Amazon’s complaint on the grounds that it failed to state a cause of action.⁵⁸ As a result of the dismissal, Amazon began collecting sales tax on all sales to New York residents.⁵⁹

IV. PROBLEMS WITH THE AFFILIATE TAX

A. IMPUTING SUBSTANTIAL NEXUS

The affiliate tax presumes a substantial nexus exists between an out-of-state retailer and the state whenever a retailer earns \$10,000 or more in revenue through its affiliates residing within the state. The New York court held that this presumption met the Commerce Clause substantial-nexus test established in *Quill* due to the out-of-state retailer’s contractual relationships with affiliates in the state.⁶⁰ This finding was contrary to what most courts and scholars believed the *Quill* standard required—an actual physical presence within the state.⁶¹ In fact, at the time of the law’s passage and the corresponding legal action brought by Amazon, many commentators and politicians agreed that it had serious “questionable constitutional validity and [an] undesirable impact on e-commerce,” and many predicted that

56. *Id.* at 849. The court also noted that “Amazon emphasizes that its Associates ‘are mere advertisers who do not solicit sales at Amazon’s behest’ and that they are not ‘traveling salesmen’—they do not necessarily personally solicit sales from New York residents.” *Id.*

57. *Id.* (stating that it does not matter that Amazon did not instruct its New York associates to target New York business since such associates are free to solicit such business). The court noted this arrangement was possible because “Amazon authorizes Associates to place different types of links from their websites to its own. . . . which ‘when clicked will allow visitors [of the Associate’s site] to add products to their shopping cart and/or purchase products via [Amazon’s] 1-Click feature.’” *Id.* at 845.

58. *Id.* at 851 (“The neutral statute simply obligates out-of-state sellers to shoulder their fair-share of the tax-collection burden when using New Yorkers to earn profit from other New Yorkers.”). Many commentators have taken issue with the outcome of this case and question the constitutional basis of the court’s decision. *See, e.g.,* Cowan, *supra* note 16, at 1446–47 (“The New York trial court’s decision in *Amazon.com* exaggerated the passive role Amazon’s associates play in New York and failed to give necessary weight to the Supreme Court’s decision in *Quill*.”). On appeal, the New York Supreme Court, Appellate Division affirmed the decision to dismiss Amazon’s Commerce-Clause-based facial challenge but remanded the case for further discovery to determine whether the statute violated the Commerce Clause as applied. *Amazon.com, LLC v. N.Y. State Dep’t of Taxation & Fin.*, 913 N.Y.S.2d 129, 137–39, 145–46 (App. Div. 2010). The case has yet to be heard on remand.

59. *Sales Tax Requirements*, AMAZON.COM, <http://www.amazon.com/gp/help/customer/display.html?nodeId=468512#which> (last visited Oct. 30, 2011) (stating that sales tax is collected for all sales to residents of New York).

60. *See supra* Part III.

61. *Amazon.com*, 877 N.Y.S.2d at 849; *see supra* note 44 and accompanying text.

Amazon would win its case.⁶² Scholars who have analyzed the affiliate tax argue that imputing the requisite substantial nexus through a retailer's contractual relationship with affiliates in the taxing state does not meet the *Quill* standard.⁶³ In addition, the Supreme Court has never directly imputed a substantial nexus via an out-of-state retailer's contractual relationship with residents in a taxing state.⁶⁴

However, *Quill* also did not completely foreclose the possibility that an out-of-state retailer's contractual relationship with in-state citizens could create the requisite substantial nexus.⁶⁵ Whether a retailer's contractual relationship with in-state residents meets the substantial-nexus standard has yet to be definitively decided, but *Quill* made clear that physical presence is required in order to satisfy the Commerce Clause requirement.⁶⁶ Since the

62. Amazon's Memorandum of Law in Support of Its Cross-Motion for Summary Judgment and in Opposition to the State's Motion to Dismiss at 9, *Amazon.com*, 877 N.Y.S.2d 842 (No. 601247/08), 2008 WL 5592585 [hereinafter Amazon Memorandum]. A New York Senator and two of New York's U.S. Representatives proposed a bill to retract the Amazon Tax due to its "unprecedented and unlawful effort to interfere with interstate commerce." *Id.* Additionally,

[T]he California Board of Equalization (the agency charged with administering sales taxation in that State) recently expressed its view—contrary to New York State's position here—that the advertising affiliations that out-of-state Internet retailers have with in-state websites *do not* create a substantial nexus between that State and the retailer, even where, as here, the out-of-state retailer pays the in-state website commissions on sales resulting from referrals.

Id. at 10.

63. *Id.* at 8 n.10 ("Roy J. Girasa, chairman of the Department of Legal Studies and Taxation at the Lubin School of Business of Pace University and author of a textbook on cyberlaw, said New York is on shaky legal ground. . . . 'Trying to establish presence by using affiliates is extremely questionable,' he said." (quoting Julie Moran Alterio, *Amazon Fights N.Y. on Sales Tax*, J. NEWS, June 15, 2008, at 1D) (internal quotation marks omitted)).

64. In *Quill*, the Court found "that a vendor whose only contacts with the taxing State are by mail or common carrier lacks the 'substantial nexus' required by the Commerce Clause." *Quill Corp. v. North Dakota*, 504 U.S. 298, 311 (1992). In other words, an out-of-state retailer's contractual relationship with contractors that provide a service (mail delivery) is not sufficient to create the required substantial nexus. *Id. Scripto*, although decided prior to the Court's announcement of the substantial-nexus test for Commerce Clause claims, held that a retailer's contractual relationship with residents of the taxing state could substantiate the state's decision to impose sales tax. *Scripto, Inc. v. Carson*, 362 U.S. 207, 211–12 (1960). Reconciling *Scripto* with the rule established in *Quill* presents an argument that the Court in *Scripto* indirectly imputed a substantial nexus between the state and retailer through contractual relationships. *Compare Quill*, 504 U.S. at 311, *with Scripto*, 362 U.S. at 211–12.

65. *Quill*'s holding specifically finds that contact with a state solely via mail carrier is not sufficient to create a substantial nexus. *Quill*, 504 U.S. at 311. The Court's narrow holding therefore leaves open the possibility that other contractual relationships with the taxing state could be sufficient to meet the substantial-nexus requirement.

66. Cowan, *supra* note 16, at 1433 (interpreting *Quill* to require a physical presence). *Quill*'s holding specifically rejected overruling *Bellas Hess*'s "stringent physical presence test in favor of a more flexible substantive approach." *Quill*, 504 U.S. at 314 (internal quotation marks omitted).

New York affiliate tax is reliant on imputing the necessary physical presence of the out-of-state retailer through its contractual relationships with in-state citizens, the law is susceptible to being declared invalid if the New York Supreme Court misinterpreted the *Quill* standard and the standard actually requires something more to establish a physical presence.

*B. ADVERTISING CONTRACTS WITH NON-EXCLUSIVE INDEPENDENT CONTRACTORS
ARE THE SOLE BASIS OF TAX LIABILITY*

Alternatively, the Court may eventually find that imputing physical presence from a retailer's contractual relationship with residents of the taxing state is appropriate, but that affiliate contracts are not sufficient to meet the test.⁶⁷ For purposes of complying with the New York affiliate tax, the retailer's only source of determining who is or is not a New York affiliate is the address provided to it from the affiliate.⁶⁸ This creates the potential that non-New York citizens who provided New York addresses will be incorrectly classified as New York affiliates and vice versa.⁶⁹

Additionally, New York's basis for imposing the collection of sales tax is based primarily on the retailer's contracts with those New York affiliates whose advertisements are not exclusively or specifically directed at consumers in the state.⁷⁰ The New York court did not find this problematic since the language of the statute provided retailers the opportunity to rebut the presumption that they had a substantial nexus by showing they did not collect \$10,000 or more in sales from New York customers.⁷¹ However, other courts could disagree with New York's finding and hold that the affiliate-tax statute "imposes tax collection obligations based on activities that are insufficient to create a substantial nexus under the dormant Commerce

67. Amazon Memorandum, *supra* note 62, at 10–12 (arguing against finding that the substantial nexus is met through Amazon's relationship with affiliates in New York).

68. See *Amazon.com LLC v. N.Y. State Dep't of Taxation & Fin.*, 877 N.Y.S.2d 842, 849 (Sup. Ct. 2009) ("Amazon contracts with thousands of Associates that provided it with a New York address."), *aff'd as modified sub nom.* *Amazon.com, LLC v. N.Y. State Dep't of Taxation & Fin.*, 913 N.Y.S.2d 129 (App. Div. 2010).

69. Amazon Memorandum, *supra* note 62, at 11 ("Amazon, however, has no way of knowing whether these [affiliates] who provide addresses in other States, are legal residents of New York.").

70. *Amazon.com*, 877 N.Y.S.2d at 848–49 ("All of the[] requirements [of the affiliate tax] make clear that a tax-collection obligation will only be imposed based on an out-of-state seller's conscious decision to contract with in-state residents who collectively refer more than \$10,000 of New York based business. . . . [T]he[] [affiliates] do not necessarily personally solicit sales from New York residents.").

71. *Id.* at 848 ("The Commission-Agreement Provision is carefully crafted to ensure that there is a sufficient basis for requiring collection of New York taxes and, if such a basis does not exist, it gives the seller an out.").

Clause.”⁷² Even though New York has found that the contractual relationships between a retailer and in-state residents meet the substantial-nexus test, other courts may find advertising contracts not directed solely at the taxing state as insufficient for meeting this test.

C. AMAZON AND OTHER RETAILERS CAN STILL AVOID THE TAX

The largest problem associated with the affiliate tax is the ease with which retailers can avoid it. Although New York’s affiliate tax has resulted in Amazon collecting sales tax in New York, no other state with an affiliate tax has been successful in collecting sales tax.⁷³ Amazon has cancelled its affiliate program in all states that implemented the affiliate tax besides New York.⁷⁴ Whenever a state implements an affiliate tax, Amazon must determine if the revenue from the affiliate program justifies incurring the burden of collecting sales tax on all sales to residents of that state. Since Amazon has never disclosed sales figures by state, it is not abundantly clear why Amazon has decided to continue its affiliate program in New York and not in other states.⁷⁵ However, a reasonable presumption is that the revenue generated from New York affiliates was substantial enough that it was more costly to end the program than to collect sales tax on sales to New York residents.⁷⁶ Given New York’s large population, it is likely that Amazon employed a large number of affiliates in the state who generated substantial revenue. Amazon has dropped its affiliate program in all states with populations smaller than New York including North Carolina, Rhode Island, and Colorado.⁷⁷ Looking at that list, Iowa has a smaller population than

72. Amazon Memorandum, *supra* note 62, at 15; *see id.* at 10–12 (arguing a number of facts regarding Amazon’s affiliate program that work against finding a substantial nexus between it and New York).

73. *See* W. David Gardner, *Amazon Drops More Affiliates Over Online Tax Issue*, INFO. WEEK (June 30, 2009, 5:13 PM), <http://www.informationweek.com/news/government/state-local/218102135> (stating that Amazon dropped its affiliate program in North Carolina, Rhode Island, and Hawaii due to the state legislatures passing their own version of the affiliate tax). *See generally Associates Program Operating Agreement*, AMAZONASSOCIATES, <https://affiliate-program.amazon.com/gp/associates/help/operating> (last updated Sept. 23, 2011) (stating that residents of “Colorado . . . North Carolina, [or] Rhode Island [are] ineligible to participate in the Program”).

74. *See supra* note 73 and accompanying text.

75. *Amazon.com*, 877 N.Y.S.2d at 845 (“Sales to New York customers originating from New York-based Associate referrals constitute less than 1.5% of Amazon’s New York sales. Without disclosing the dollar amount of those sales, Amazon simply acknowledges that its ‘Associates Program generates more than \$10,000 per year in sales to customers located in New York.’”).

76. Amazon stated that its New York affiliates resulted in less than 1.5% of all Amazon sales in the state of New York. Amazon Memorandum, *supra* note 62, at 12.

77. New York had a population of approximately 19.5 million citizens in the year 2009. U.S. CENSUS BUREAU, ANNUAL ESTIMATES OF THE POPULATION FOR THE UNITED STATES, REGIONS, STATES, AND PUERTO RICO: APRIL 1, 2000 TO JULY 1, 2009 (2009), *available at* <http://www.census.gov/popest/states/NST-ann-est.html> (providing estimated populations by state). In 2009, North Carolina had a population of nearly 9.4 million citizens, Colorado had a

both North Carolina and Colorado.⁷⁸ Therefore, if Iowa enacted its own affiliate tax, it would likely result in the same outcome—cancellation of Amazon’s affiliate program in Iowa. Such a result is not only ineffective at collecting additional sales tax, but actually results in lowering the state’s tax revenue further. When Amazon cancels its affiliate program in a state as a result of the affiliate tax, that state’s affiliates will no longer earn commissions on sales through the program. This results in these affiliates having less income to report to the state and thus paying less income tax. These results are contrary to the very purpose of enacting the affiliate tax.

V. PROPOSAL FOR THE INTERMEDIARY TAX

The Iowa Legislature recently passed an amendment to update its tax code to mirror the New York affiliate tax.⁷⁹ The language of the proposed law is identical in most respects to the New York law, and thus is susceptible to the same defects as the New York affiliate tax.⁸⁰ However, given the serious issues associated with the affiliate tax, Iowa should consider potential alternatives before enacting its own iteration of the affiliate tax.

A possible alternative to the affiliate tax is a tax that bases tax-collection liability on whether a retailer acts as an intermediary for in-state residents to sell their goods. Many online retailers act as intermediaries when they provide customers with forums to sell their merchandise through the retailer’s website. For instance, Amazon has the Amazon Marketplace, which allows individuals and retailers to sell goods through Amazon’s website in exchange for a commission on the sale price.⁸¹ Another example is www.ebay.com (“eBay”), which is an online auction site whose sole business is providing a service that facilitates the online sale and purchase of goods.⁸²

Amazon and eBay can act as a potential sales-tax shield. First, both sites create an opportunity for Iowa retailers to avoid collecting state-imposed sales tax on sales made to Iowa residents, since the sales are made through the intermediary retailer and not through the Iowa retailer itself.⁸³ Second,

population of approximately 5 million citizens, and Rhode Island had a population of approximately 1 million citizens. *Id.*

78. Iowa’s population is approximately 3 million. *Id.* Amazon dropped its affiliate program in both North Carolina and Colorado, both of which have larger populations than Iowa. *Id.*; see also *supra* note 73 and accompanying text.

79. See H. File 2510, 83d Gen. Assemb., Reg. Sess. (Iowa 2010).

80. The language of both statutes operate in a similar manner using the same structure—substantial nexus is assumed if contractual relationships with in-state advertisers resulted in \$10,000 or more in revenue from the taxing state. Compare *id.*, with N.Y. TAX LAW § 1101(b)(8)(vi) (McKinney 2011).

81. *Sell on Amazon.com*, AMAZONSERVICES, <http://www.amazonservices.com/content/sell-on-amazon.htm?ld=AZEnumSearch#how-it-works> (last visited Oct. 30, 2011).

82. EBAY.COM, <http://www.ebay.com> (last visited Oct. 30, 2011).

83. If these retailers created their own website for e-commerce, they would be required to ensure full collection of sales tax on all sales to Iowa residents. See IOWA CODE ANN. § 423.2(1)

many of these intermediary sites are not required to collect the sales tax. This occurs when the intermediary retailer does not have the necessary substantial nexus with Iowa, and therefore the intermediary has no duty to collect sales tax.⁸⁴ Many online retailers that act as intermediaries, such as Amazon, disclaim any potential duty they may have to collect sales tax for sales made by sellers on their sites by shifting the burden of collection to the sellers.⁸⁵ Yet these intermediaries have no safeguards in place to ensure that sellers using their services actually collect the requisite sales tax.⁸⁶ Therefore, Iowa retailers using an intermediary for sales are left to their own devices with respect to charging, collecting, and reporting the appropriate sales tax from sales to Iowa residents. Thus, the use of intermediaries creates opportunities for Iowa retailers to avoid or under-report sales tax owed to the state.

The intermediary tax proposed in this Note applies the same logic and structure of the affiliate tax while avoiding some of its defects. Like the affiliate tax, the intermediary tax would impute the necessary physical presence to retailers based on the retailers' contractual relationships with residents in the state.⁸⁷ There are two major components to establishing the intermediary tax.⁸⁸ Subpart A defines an intermediary for tax purposes, and Subpart B establishes a rebuttable presumption for when a sufficient substantial nexus exists between the state and the intermediary to allow the state to impose collection of sales tax on the intermediary.

A. DEFINING AN INTERMEDIARY

The first requirement of implementing a tax based on a retailer's status as an intermediary is to define what qualifies as an intermediary. The definition of an intermediary should include any business that enters into agreements with residents of the state to provide a forum or service that allows in-state residents to sell their goods or merchandise in exchange for compensation. In addition, to qualify as an intermediary, the retailer's

(West 2011) ("There is imposed a tax of six percent upon the sales price of all sales of tangible personal property, consisting of goods . . . sold at retail in the state to consumers or users except as otherwise provided . . .").

84. See *supra* Part III.

85. See, e.g., *Sales Tax Requirements*, *supra* note 59 ("Marketplace sellers are responsible for the sales tax on any items sold on Amazon.com, and if necessary, they generally add this cost into the price of their items. Therefore, you will not be charged any additional sales tax for Marketplace purchases. If you have further questions about a particular Marketplace seller's tax practices, feel free to contact the seller directly.").

86. See *id.*

87. See *supra* Part III.

88. See *supra* Part III. Like the affiliate tax, the intermediary tax is dependent on both a contractual relationship, which creates the entity (intermediary), and a rebuttable presumption that the substantial-nexus requirement is satisfied if revenue from such contracts exceeds a dollar threshold.

forum or service must allow for the seller to sell its goods to residents of the state in which the seller is located.

B. A REBUTTABLE PRESUMPTION THAT THE SUBSTANTIAL-NEXUS REQUIREMENT IS MET

The second aspect of implementing this proposal is to create a rebuttable presumption of an adequate substantial nexus between the state and the intermediary when a certain revenue threshold is met. Similar to the affiliate tax, this presumption should take effect once the intermediary retailer obtains a minimum amount of cumulative revenue from its relationships with Iowa citizens.⁸⁹ If this presumption is met, the intermediary tax would require the intermediary to collect sales tax on all of the intermediary's sales transactions to residents of the taxing state. Iowa could use the \$10,000 revenue threshold from the affiliate tax for the intermediary tax, which would require most national online marketplaces, such as Amazon and eBay, to collect sales tax on all pertinent transactions when that threshold is met.⁹⁰

Ultimately, the intermediary tax operates in a similar manner as the affiliate tax.⁹¹ However, the differences between the two are what will ensure the effective collection of the implemented tax. A state basing its imposition of sales-tax collection on an intermediary's contractual agreement to provide a forum for in-state residents to sell goods online has distinct benefits over basing the tax on the retailer's affiliate contracts with in-state residents.

VI. ADVANTAGES OF THE INTERMEDIARY TAX

A. A STRONGER SUBSTANTIAL NEXUS IS ESTABLISHED

As mentioned previously, it is not clear whether contractual relationships are sufficient to satisfy the substantial-nexus test established in *Quill*.⁹² However, Iowa would have a stronger argument for imputing the requisite physical presence necessary to satisfy the substantial-nexus standard if it relied on the retailer's contractual agreements with residents of the state to provide a forum for the sale of their goods, as opposed to contracts involving advertising of the retailer's goods.

The first advantage of the intermediary tax over the affiliate tax is the substantial increase in the number of contracts between Amazon and Iowa

89. See N.Y. TAX LAW § 1101(b)(8)(vi) (McKinney 2011) (stating that the law presumes that the required substantial nexus is met when revenue from such contracts exceed \$10,000 or more); see also *Amazon.com LLC v. N.Y. State Dep't of Taxation & Fin.*, 877 N.Y.S.2d 842, 846 (Sup. Ct. 2009), *aff'd as modified sub nom. Amazon.com, LLC v. N.Y. State Dep't of Taxation & Fin.*, 913 N.Y.S.2d 129 (App. Div. 2010).

90. See N.Y. TAX LAW § 1101(b)(8)(vi).

91. See *supra* note 88 and accompanying text.

92. See *supra* note 64 and accompanying text.

residents.⁹³ To participate in a retailer's affiliate program, participants must own a website that can advertise. Given this hurdle, very few residents are capable of participating in the affiliate program. However, selling goods online through the Amazon Marketplace only requires access to a computer.⁹⁴ An agricultural state, such as Iowa, is likely to have much fewer affiliates than it does online sellers of goods.⁹⁵ Additionally, the revenue generated from intermediary contracts is likely to be much more significant than the revenue generated from affiliates in the state.⁹⁶ Sales on the Amazon Marketplace accounted for thirty percent of total units sold on Amazon.⁹⁷ In light of this figure, a state like Iowa would likely have a much stronger argument for the existence of a substantial nexus between it and an online retailer based on the intermediary tax than through the affiliate tax.

The second distinct advantage of the intermediary tax is the link between the activity contracted for and the imposition of tax liability. The activity contracted to be performed in an intermediary contract—selling goods online—creates a corresponding tax liability, either sales or use tax.⁹⁸ This is not present in the affiliate tax since its contracts relate to advertising services, which are not activities that produce a taxable event.⁹⁹ Hypothetically, an affiliate may perform its contracted obligations and not generate any taxable activity.¹⁰⁰ A state attempting to impute physical presence through a retailer's contractual relationships with state residents presumably has a stronger argument for such an imputation when the activity contracted for creates tax liabilities, rather than contracts that generate no tax activity, such as affiliate contracts.¹⁰¹

The increase in the number of contracts covered, the corresponding tax duties generated from selling goods online, and the substantially greater amount of revenue generated from these contracts will help Iowa build a strong case for imputing a physical presence to out-of-state retailers. *Quill's*

93. In 2009, Amazon reported that thirty percent of its total unit sales on its website were the result of sales on its Marketplace. Amazon.com, Inc., Annual Report (Form 10-K) at 26 (Jan. 28, 2010), available at <http://phx.corporate-ir.net/External.File?item=UGFyZW50SUQ9Mzc2NjQyfENoaWxkSUQ9Mzc1Mjc3fFR5cGU9MQ==&t=1> [hereinafter Amazon 2009 FR]. Sales on the Marketplace account for less revenue than sales of Amazon goods, but sales on the Marketplace result in a higher gross margin for Amazon per unit sold. *Id.*

94. Amazon did not disclose the number of contracts associated with its affiliate program. *See id.*

95. Likewise, no disclosure is made regarding the number of contracts with sellers associated with Amazon's Marketplace. *See id.*

96. *See supra* note 93 and accompanying text.

97. *See* Amazon 2009 FR, *supra* note 93, at 26.

98. *E.g.*, IOWA CODE ANN. § 423.2 (West 2011) (sales tax); *id.* § 423.5 (use tax).

99. *See id.* §§ 423.2, 423.5.

100. This occurs if an affiliate posts advertisements on its webpage and no purchases result. This is in contrast to a seller that performs under an intermediary contract, which always creates a taxable event.

101. *See* IOWA CODE ANN. §§ 423.2, 423.5.

substantial-nexus test would more likely be satisfied with the intermediary tax as opposed to the affiliate tax.

B. RETAILERS' ABILITY TO AVOID COLLECTING THE TAX IS REDUCED

A large part of Amazon's profits come from sales made through its Marketplace.¹⁰² According to Amazon's 2009 financial reports, the gross margin¹⁰³ Amazon earned per unit sold by sellers on its Marketplace was either the same or greater than that earned from goods sold by Amazon itself.¹⁰⁴ The biggest problem associated with the affiliate tax is that Amazon would rather cancel its affiliate program in any given state than bear the burden of collecting sales tax.¹⁰⁵ Due to the significant impact sales through Amazon's Marketplace have on Amazon's bottom line, the decision to stop such activity would have a substantial financial impact. Amazon could likely cancel contracts in one state, but each state dropped would have a significant impact on Amazon's overall profitability. Other retailers, such as eBay, whose sole business is selling other people's goods, would not be able to cancel this activity without ceasing to do business entirely. Therefore, the intermediary tax presents vendors with a much more difficult decision—one that is much more likely to result in states collecting sales tax rather than losing tax revenue from cancelled affiliate programs.

C. THE NUMBER OF RETAILERS REQUIRED TO COLLECT SALES TAX IS EXPANDED

One of Amazon's arguments when fighting the New York affiliate tax was that the tax was unduly directed specifically at Amazon.¹⁰⁶ This argument did not prove persuasive, but other state courts may disagree with the New York court.¹⁰⁷ Only a small number of vendors utilize the affiliate-marketing program used as the basis for the affiliate tax, so the application of the program is thus limited.¹⁰⁸ The intermediary tax expands tax liability

102. Amazon 2009 FR, *supra* note 93, at 26; *see also supra* note 93 and accompanying text.

103. Gross margin is also commonly referred to as gross profit. *Gross Margin*, ANSWERS.COM, <http://www.answers.com/topic/gross-income> (last visited Oct. 30, 2011). Gross margin is the leftover revenue after the costs associated have been subtracted. *Id.*

104. *See supra* note 93 and accompanying text.

105. *See supra* Part IV.C.

106. Amazon Memorandum, *supra* note 62, at 6 ("State officials made clear that the Statute's target was Amazon. Press reports also acknowledged that State officials and others had dubbed the proposal the 'Amazon tax.'") (footnote omitted).

107. *Amazon.com LLC v. N.Y. State Dep't of Taxation & Fin.*, 877 N.Y.S.2d 842, 851 (Sup. Ct. 2009) (noting that "Amazon allege[d] that it has been denied equal protection because the statute" focused unduly on Amazon), *aff'd as modified sub nom. Amazon.com, LLC v. N.Y. State Dep't of Taxation & Fin.*, 913 N.Y.S.2d 129 (App. Div. 2010). The court was unpersuaded by Amazon's argument since Amazon failed to assert "that the State has actually treated it any differently from others that are similarly situated." *Id.*

108. The affiliate tax was enacted with the express purpose of requiring Amazon to collect sales tax. *See supra* note 106 and accompanying text.

to a larger group of vendors. For instance, eBay has an affiliate program, yet it incurred no additional tax liability as a result of the affiliate tax since eBay itself does not sell any goods.¹⁰⁹ The intermediary tax would shift the tax-collection burden from the eBay sellers to the intermediary—eBay itself.¹¹⁰ eBay would have an affirmative duty to ensure it collected sales tax on all appropriate transactions and could no longer assume that sellers are collecting it.¹¹¹ This is advantageous for the state since it would ensure full collection of the taxes owed on all sales transactions through eBay and other similar retailers.

D. THE CONTRACTUAL RELATIONSHIPS USED TO IMPOSE THE COLLECTION OF SALES TAX ARE MORE DIRECTLY RELATED TO THE ACTIVITY PRODUCING THE TAX

Under the intermediary tax, Iowa can argue that a key motivation for enacting the intermediary tax is to ensure full collection of the existing sales-tax liability from retailers that already had the affirmative duty to collect sales tax prior to the law's enactment.¹¹² In essence, the intermediary tax closes an existing tax loophole and its sole purpose is not to collect additional tax revenue that the state was not entitled to collect prior to its enactment. Currently, Iowa sellers and retailers can use intermediaries, such as Amazon, to sell their goods to Iowa residents, thus creating sales-tax liability. These Iowa retailers are responsible for reporting the corresponding sales tax from sales through the intermediary—similar to the state's reliance on individuals to report corresponding use tax.¹¹³ However, such sales tax often goes unreported by the in-state retailers. The intermediary tax would not only guarantee that the state collects the tax already owed by shifting the burden of collection to the intermediary, but it would also have the effect of collecting sales tax on sales made by the intermediary itself as a result of its relationship with Iowa residents. Both would be beneficial to the state.

109. *How eBay Partner Network Works*, EBAY.COM, <https://publisher.ebaypartnernetwork.com/files/hub/en-US/index.html> (last visited Oct. 30, 2011) (affiliate program); eBay Inc., Annual Report (Form 10-K) at 1 (Feb. 17, 2010), available at http://files.shareholder.com/downloads/ebay/1053363633xox361552/b45137ee-aa41-4c2c-94ca-d72d5bo844be/eBay_77655_BANNERLESS.pdf ("We provide online marketplaces for the sale of goods and services as well as other online commerce, or ecommerce, platforms and online payment solutions to a diverse community of individuals and businesses.").

110. *See supra* Part V.

111. *See supra* Part V.

112. *See supra* Part V.

113. To test this theory, this author, an Iowa resident with a shipping address in Iowa, went onto Amazon and placed an order from an Iowa vendor selling goods on the Amazon Marketplace. Upon completing the order, no sales tax was charged at the time of checkout. Amazon's policy allows sellers to not charge a separate amount for sales tax and instead may elect to take the sales tax out of the price paid for the item. *See supra* note 85 and accompanying text. Therefore, it is difficult to determine whether any sales tax will actually be reported to the state.

VII. POTENTIAL CHALLENGES TO THE INTERMEDIARY TAX

A potential issue with implementing the intermediary tax is that the intermediary tax cannot rely as heavily on *Scripto* for constitutional support.¹¹⁴ The imposition of sales tax through the affiliate tax is based heavily on the Supreme Court decision in *Scripto*.¹¹⁵ Like *Scripto*, the affiliate tax imposes sales-tax collection on those retailers that enter into contracts with affiliates in the taxing state to advertise for the company, both in and out of the state, in an attempt to solicit sales for the retailer.¹¹⁶

In contrast, the intermediary tax involves residents of the state entering into contracts with Amazon for Amazon to provide a forum for the resident to sell their goods. Unlike both *Scripto* and the affiliate tax, the intermediary tax involves state residents seeking vendors' services; it is Amazon, not the state resident, receiving compensation for those services.¹¹⁷

However, just because the intermediary tax cannot rely solely on *Scripto* for support does not mean the substantial-nexus requirement is not met. Amazon actively pursues sellers in the same manner that it acquires affiliates. Amazon writes the mandatory sales agreement that all Amazon sellers must agree to, and it stipulates Amazon's compensation from such sales.¹¹⁸ All of these facts demonstrate that Amazon actively solicits contractual agreements with residents of every state to sell their merchandise, as it does when acquiring affiliates. Therefore, the subtle differences between affiliate and

114. The facts are different when applying the intermediary tax since the contracts at issue involve residents who seek the services of the retailer rather than the retailer hiring the residents to perform some service for it. Both the intermediary tax and *Scripto* are similar in that both involve the use of contractual relationships between a vendor and in-state residents to establish the state's right to impose the collection of sales tax. See *Scripto, Inc. v. Carson*, 362 U.S. 207, 210–11 (1960). The contracts used in *Scripto* are retailer-initiated advertising contracts, *id.* at 211, and the intermediary tax relies on consumer-initiated service contracts with the retailer. Although the nature of the contracts differ, the holding in *Scripto* is not limited only to contracts where the retailer initiated the contractual relationship, nor is the holding limited to advertising contracts. See *id.* at 211–12.

115. *Amazon.com LLC v. N.Y. State Dep't of Taxation & Fin.*, 877 N.Y.S.2d 842, 847 (Sup. Ct. 2009) (“[T]he United States Supreme Court held that a State could require tax collection by an out-of-state company that had contracts with 10 in-state residents—deemed ‘independent contractors’—who solicited orders for products on its behalf.”), *aff'd as modified sub nom. Amazon.com, LLC v. N.Y. State Dep't of Taxation & Fin.*, 913 N.Y.S.2d 129 (App. Div. 2010).

116. *Id.*

117. See N.Y. TAX LAW § 1101(b)(8)(vi) (McKinney 2011) (stating that the affiliate tax is based on the presumption that the substantial nexus is met through the retailer's contracts with individuals in the state to conduct advertising for the retailer); *Scripto*, 362 U.S. at 210–12 (stating that the fact that the retailer sought out and hired independent contractors to solicit orders for it was enough to support the state in imposing its sales tax on the retailer).

118. See *Amazon.com*, *supra* note 81 (providing information regarding how to sell goods on Amazon). There is no mention that the commission rates are negotiable, nor does the site request participants to submit their own contracts. *Id.* The only means of utilizing Amazon's Marketplace is to agree to Amazon's standard terms and conditions. *Id.*

seller contracts would not likely have a significant impact on the state's case of establishing a substantial nexus through the intermediary tax.

VIII. CONCLUSION

The affiliate tax is too easy to circumvent and, more often than not, results in states losing tax revenue rather than collecting it. The creation and implementation of an intermediary tax would address this issue by making it much more difficult for retailers, such as Amazon, to avoid collecting sales tax through cancellation of its contracts with in-state residents because cancellation of the intermediary contract would directly impact the profitability of the company. Additionally, the intermediary tax more directly aligns the duty to collect sales tax with the contractual relationships creating such a tax liability. Although the intermediary tax, like the affiliate tax, is reliant on imputing a physical presence through contractual relationships, there is a much stronger argument for imputing such a presence. If the proposed intermediary tax is implemented in the state of Iowa, it is much more likely the state will achieve its long-term goal of increasing sales-tax revenue.