

**Where California Went Wrong
With the Amazon Tax:
Application of Due Process and Commerce
Clause Jurisprudence to State Use Tax
Collection Requirements Imposed on Out-Of-
State Internet Retailers**

by ANDREW T. CANNON*

Introduction

The worst recession since the 1930's is encouraging state lawmakers to find alternative ways to bridge budget deficits and obtain income for their respective states. A budget shortfall exists when state revenues are exceeded by the cost of providing state services.¹ In 2010, state tax revenue declined by over eleven percent.² Without a corresponding decline in state services, budget shortfalls will continue into the conceivable future. Budget shortfalls for 2011 totaled over one hundred and thirty billion dollars.³ The shortfall was offset by over fifty-nine billion in Federal Recovery Act assistance.⁴ Already, states are reporting budget shortfalls of over one hundred and twelve billion for fiscal year 2012.⁵ Unfortunately, only six billion in Federal Recovery Act dollars remain available.⁶

* Juris Doctor Candidate 2012, University of California, Hastings College of the Law; Bachelor of Science 2002, California State University, Monterey Bay.

1. Elizabeth McNichol, Phil Oliff & Nicholas Johnson, *States Continue to Feel Recession's Impact*, CTR. ON BUDGET & POL'Y PRIORITIES 2 (2011), <http://www.cbpp.org/files/9-8-08sfp.pdf>.

2. *Id.* at 1.

3. *Id.* at 3 (These are the largest budget shortfalls ever recorded in California.).

4. *Id.*

5. *Id.*

6. *Id.* at 4.

This Note analyzes California's attempts to find a new source of revenue, collecting use taxes from online out-of-state retailers without a classic physical presence in state. The idea builds on other states' laws that require retailers such as Amazon to collect state use taxes for in-state customers. Specifically, the Note points out a huge problem with California's recently enacted use tax collection law which exempts out-of-state online retailers doing business with Google, Inc., an internet solicitor which clearly has California nexus. This Note analyzes historic precedent, new case law, and recent legislative action to suggest new ways in which California can achieve its use tax collection goals.

Part I of this Note answers questions about the use tax including the following: What is it, why do we have it, and what problems are encountered when states enforce use tax collection requirements on out-of-state internet retailers. Part II focuses on the historical developments of Due Process and Commerce Clause jurisprudence in the area of state use tax collection. Part III explains the application of this jurisprudence in *Scripto v. Carson*, and recent state court decisions upholding use tax collection requirements where in-state independent contractors actively solicit sales for out-of-state retailers.⁷ Part IV explains the Google, Inc. ("Google") advertising model, and details the relationship between internet retailers and Google. Lastly, Part V argues that California made a mistake when exempting internet retailers doing business with Google from collecting use taxes on California sales.

I. What is a Use Tax, Why do we Have it, and What are the Problems with Collecting it?

Use taxes are an excise tax levied by a state against in-state consumers.⁸ The tax is assessed for the use, storage, or consumption of goods in state that are purchased out-of-state and that are not subject to sales tax.⁹ Most states attempt to collect use taxes from consumers themselves.¹⁰ States primarily rely on consumers to report on their state tax returns the total amount of any tax that should have

7. See *Scripto v. Carson*, 362 U.S. 207, 211 (1960).

8. See *California Use Tax Information*, CAL. STATE BD. OF EQUALIZATION, <http://www.boe.ca.gov/taxprograms/usetax/index.html> (last visited Mar. 27, 2010).

9. *Id.*

10. *Id.*

been paid on out-of-state purchases.¹¹ Most people are unaware that they have to pay this amount, or they simply fail to do so.¹²

California first enacted a use tax on July 1, 1935.¹³ The use tax was initially designed to eliminate the tax advantage that out-of-state retailers enjoyed against California businesses.¹⁴ Today, California requires taxpayers to fill out a line item on their California resident tax return and report use tax amounts for all qualified out-of-state purchases.¹⁵ In the latest Board of Equalization (BOE) Annual Report, the failure of consumers to report and pay use taxes is the most frequent and costly area of taxpayer non-compliance.¹⁶ According to the BOE, failure of consumers to pay use taxes in 2008 resulted in more than seventy-eight million dollars in unpaid tax.¹⁷

Recently, the California legislature imposed use tax collection requirements on out-of-state internet retailers that conduct business inside the state of California.¹⁸ According to Assemblywoman Nancy Skinner, California can collect over three hundred million dollars in use tax revenue under the new law.¹⁹ This bill attempts to return California and out-of-state retailers to a level playing field. By collecting use tax from California customers, online retailers will no longer enjoy a competitive advantage over California businesses that are required to collect a state sales tax.²⁰

Unfortunately for the California legislature, forcing online retailers such as Amazon to collect use taxes presents many problems. First and foremost, the constitutionality of forcing online retailers to

11. *Id.*

12. See 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, 923 (2006).

13. CAL. REV. & TAX. CODE § 6201 (West 2010).

14. *Bank of Am. Nat'l Trust & Sav. Ass'n v. State Bd. of Equalization*, 209 Cal. App. 2d 780, 791 (1st Dist. 1962) (court specifically stated that the use tax was enacted to put allow in-state retailers, that are subject to the sales tax, compete on equal footing with their out-of-state competitors).

15. See *California Resident Income Tax Return 2010, Form 540*, CAL. FRANCHISE TAX BD. 2 (2010), available at http://www.ftb.ca.gov/forms/2010/10_540.pdf (line 95).

16. See *2007-2008 Annual Report*, STATE BD. OF EQUALIZATION 29 (June 2009), <http://www.boe.ca.gov/annual/pdf/2008/4-sales08.pdf>.

17. *Id.*

18. CAL. REV. & TAX. CODE § 6203 (West 2011).

19. See Marc Lifsher, *California Lawmaker Pushes to Tax Online Sales*, L.A. Times (Jan. 20, 2011), <http://www.latimes.com/business/la-fi-internet-tax-20110120,0,2567343.story>.

20. *Id.*

collect use taxes in a state where they have no definitive physical presence is unclear. Supreme Court jurisprudence in this area requires a state to establish that an out-of-state retailer has some physical presence in the state before imposing a use tax collection requirement.²¹ Furthermore, Amazon has threatened to pull business interests from states that enact these laws, thus reducing the overall tax base for the taxing state.²² According to Amazon, states will actually lose tax revenue by imposing use tax collection requirements on internet retailers.²³

Following through on its threats, Amazon has decided to end associate marketing programs in any state that imposes use tax collection requirements on internet retailers.²⁴ This has effectively ended the impact of the use tax legislation and reduced the overall amount of revenue previously received from internet retailers.²⁵ Because of Amazon's defensive actions, California will not only lose out on sales tax revenue, but will also lose out on state income tax payments from over 25,000 Amazon Associates residing inside its borders.²⁶

II. Historical Development of Commerce Clause Jurisprudence in the Area of State Tax Collection Requirements

The Commerce Clause of the United States Constitution provides that "Congress shall have Power . . . [t]o regulate Commerce . . . among the several States."²⁷ Yet the Commerce Clause is more than this; it also has a "negative sweep."²⁸ As Justice

21. See *Nat'l Bellas Hess v. Dep't of Revenue*, 386 U.S. 753 (1967) (states cannot impose use tax collection requirements on mail order retailers without a physical presence in the taxing state); see also *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992) (despite economic changes since *National Bellas Hess*, Court reiterated the need for physical presence in the taxing state before a state can impose a use tax collection requirement on an out of state retailer).

22. See Lifsher, *supra* note 19.

23. *Id.*

24. Jan Norman, *Amazon Terminates Deal with 25,000 Calif. Affiliates*, ORANGE COUNTY REGISTER (June 29, 2011), <http://jan.ocregister.com/2011/06/29/amazon-terminates-deal-with-25000-calif-affiliates/60971/>.

25. See Mark Binker, *Amazon Cuts Relationships with N.C. Affiliates*, NEWS & RECORD (June 26, 2009), http://www.news-record.com/content/2009/06/26/article/amazon_cuts_relationships_with_affiliates, and Lifsher, *supra* note 19.

26. See Lifsher, *supra* note 19.

27. U.S. CONST. art. I, § 8, cl. 3.

28. *Quill Corp. v. North Dakota*, 504 U.S. 298, 309 (1992).

Stone stated in *South Carolina State Highway Dep't v. Barnwell Bros.*, the Commerce Clause, “by its own force,” denies the states from engaging in any activity that interferes with interstate commerce.²⁹ This so-called “Dormant Commerce Clause” allows the Supreme Court to invalidate any state law that unnecessarily interferes with interstate commerce.

The first notable constitutional challenge to use tax collection requirements occurred in *National Bellas Hess v. Dep't of Revenue*.³⁰ In *Bellas Hess*, the Illinois Use Tax Act required mail order retailers to collect and pay use taxes to the state of Illinois on sales to Illinois customers.³¹ *Bellas Hess* argued that it had no presence in Illinois. Specifically, *Bellas Hess* stated that the Illinois use tax collection requirements were violative of the Due Process and Commerce Clause of the Fourteenth Amendment.³² The Court, in an opinion by Justice Stewart, held that a state tax complied with Due Process and the Commerce Clause if the retailer had a minimum connection with the state (state has given some benefit to the retailer), and maintained a physical presence inside state borders.³³

Ten years after *Bellas Hess*, the Supreme Court again addressed the area of state taxation of out-of-state retailers. In *Complete Auto Transit, Inc. v. Brady*, a Mississippi state law required that any business transporting persons or property for hire within Mississippi must pay a tax equal to five percent of the gross income of the business.³⁴ *Complete Auto* argued that any privilege tax violates the Commerce Clause by inhibiting interstate commerce.³⁵ In deciding the constitutionality of Mississippi's privilege tax, the Court held that state taxes have sustained Commerce Clause challenges when “[1] the tax is applied to an activity with a substantial nexus within the taxing State, [2] is fairly apportioned, [3] does not discriminate against interstate commerce, and [4] is fairly related to the services provided by the State.”³⁶

29. *Id.* (quoting *S.C. State Highway Dep't v. Barnwell Bros*, 303 U.S. 177 (1938)).

30. *See generally* *Nat'l Bellas Hess v. Dep't of Revenue*, 386 U.S. 753 (1967).

31. *Id.* at 753–54.

32. *Id.* at 756.

33. *Id.* at 756–60.

34. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 275 (1977).

35. *Id.* at 277.

36. *Id.* at 279.

Most importantly, the Court in *Complete Auto* repudiated the free trade approach of previous Commerce Clause jurisprudence.³⁷ Before this case, the Court took a formalistic approach and upheld any state tax that expressly taxed intrastate activity.³⁸ Alternatively, the Court rejected any state tax approach that simply taxed an interstate business for the privilege of doing business in a state.³⁹ *Complete Auto* rejected any formalistic distinctions.⁴⁰ Today, the Court looks at all the facts and circumstances to determine if a tax reaches the intrastate business of an entity.⁴¹ If a state tax meets the four-part test outlined above, the state tax will not run afoul of the Commerce or Due Process Clauses.⁴²

In 1992, twenty-five years after *Bellas Hess*, the Court again decided the limits on use tax collection by out-of-state retailers.⁴³ In *Quill Corp. v. North Dakota*, North Dakota imposed a use tax collection requirement on any out-of-state retailer that regularly and systematically solicited sales within the state.⁴⁴ Quill, an out-of-state mail order furniture retailer, conducted substantial mail order business in North Dakota, but had no physical presence inside North Dakota's borders.⁴⁵ Quill argued that the collection requirement violated the Due Process Clause of the Fourteenth Amendment and unjustifiably burdened interstate commerce.⁴⁶ More specifically, Quill

37. *Id.* at 279–89.

38. See *Freeman v. Hewit*, 329 U.S. 249 (1946) (Indiana's gross income tax could not be applied to the proceeds of a sale of securities made by a resident of Indiana through a local broker on the New York Stock Exchange. Court struck down the tax as a direct imposition on the flow of free trade), and *Spector Motor Serv., v. O'Connor*, 340 U.S. 602 (1951) (Connecticut levied a tax on the privilege of doing business measured by net income apportioned to the state. Court held that states are precluded from taxing the privilege of doing an exclusively interstate business even when the tax is measured by net income fairly apportioned to the state.). Cf. *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959) (Court found no Commerce Clause barrier to the imposition of a nondiscriminatory, fairly apportioned, direct net income tax on a foreign corporation carrying on an exclusively interstate business within the taxing state. Yet, decision did not expressly overrule *Freeman* and *Spector*.).

39. *Freeman*, 329 U.S. 249.

40. *Complete Auto Transit*, 430 U.S. at 279.

41. *Id.*

42. *Id.*

43. See generally *Quill Corp. v. North Dakota*, 504 U.S. 298, 303 (1992).

44. *Id.* at 303–04 (North Dakota determined that regular or systematic solicitation meant three or more advertisements within a twelve-month period).

45. *Id.* at 302.

46. See, e.g., *id.* at 303.

argued that the North Dakota law violated the physical presence requirement established in *Bellas Hess*.⁴⁷ The North Dakota Supreme Court had previously upheld the tax by relying on the fact that there had been wholesale changes in the law and economy since *Bellas Hess* was decided.⁴⁸

As to the legal changes since *Bellas Hess*, the North Dakota Supreme Court opined that when *Complete Auto* was decided, substantial nexus only required a finding of minimum connection under the Due Process Clause.⁴⁹ To satisfy the minimum connection requirement, a taxing state simply had to prove that it provided any benefit for which it could expect a return.⁵⁰ Because North Dakota had established an “economic climate that fostered demand for Quill’s products, maintained a legal infrastructure that protected that market, and disposed of twenty-four tons of catalogs mailed by Quill into the state every year”, Quill had a sufficient economic presence in the state of North Dakota to establish the minimum contact necessary to justify imposition of use tax collection.⁵¹

Along with legal changes, the North Dakota Supreme Court also relied on changes in the economic climate to ignore the physical presence requirement set forth by the Supreme Court in *Bellas Hess*.⁵² The Supreme Court of North Dakota noted the explosive growth in the mail order business since *Bellas Hess* was decided, stating that mail order businesses had changed “from a relatively inconsequential market niche in 1967 to a goliath with annual sales that reached the staggering figure of 183.3 billion in 1989.”⁵³ Because the Supreme Court of the United States set forth the *Complete Auto* test of substantial nexus in 1977, and because of the corresponding changes in the national economy, North Dakota felt it was time to require out-of-state retailers to collect use taxes from in-state customers.⁵⁴

Although the Supreme Court sympathized with North Dakota’s claim and the reasoning of the North Dakota Supreme Court, the

47. *Id.*

48. *See id.*

49. *Id.* at 304.

50. *Id.* (The North Dakota Supreme Court argued that only minimum contacts with the state is all that is required under the nexus prong of the *Complete Auto* test.).

51. *Id.*

52. *Id.*

53. *Id.* at 303.

54. *See generally id.*

Court nonetheless disagreed with North Dakota's approach and reiterated that a physical presence is needed to justify a use tax collection requirement.⁵⁵ First, the Court held that changes in the law, including the decision in *Complete Auto*, were not inconsistent with the ruling in *Bellas Hess*.⁵⁶ The Court stated that the due process requirement of minimum connection and the physical presence requirement of the Commerce Clause are completely distinct and separate tests.⁵⁷ This meant that just meeting the due process minimum connection prong is not enough; physical presence must also exist in order to find substantial nexus.⁵⁸ Additionally, the Court held that both tests are encapsulated in the substantial nexus prong of the *Complete Auto* test.⁵⁹ Since the Court upheld the physical presence requirement, North Dakota's use tax collection requirement did not have the requisite substantial nexus to pass constitutional muster under the Dormant Commerce Clause.⁶⁰

After *Quill*, any state use tax collection requirement must still meet the four-prong test set forth by Justice Jackson in *Complete Auto*.⁶¹ Most pertinent to state requirements of use tax collection is the first prong of the *Complete Auto* test—"substantial nexus."⁶² To satisfy substantial nexus, a state must prove that an out-of-state retailer not only has a minimum connection with the state, but also a physical presence within the state.⁶³

Substantial nexus first requires a finding of minimum connection to ensure that the collection law does not violate the Due Process Clause of the Fourteenth Amendment. Minimum connection is fairly easy for a state to prove; it requires only a showing that the state has

55. *Id.* at 310–11 ("While contemporary Commerce Clause jurisprudence might not dictate the same result were the issue to arise for the first time today, *Bellas Hess* is not inconsistent with *Complete Auto* and our recent cases.").

56. *Id.*

57. *Id.* at 305–06.

58. *Id.* at 310–14.

59. *Id.* at 313–14.

60. *See generally id.*

61. *Id.*

62. A state use tax will always be fairly apportioned (prong 2) because it is levied at a rate similar to the state sales tax. Any use tax is nondiscriminatory (prong 3) because it is complementary to the state sales tax and thus does not discriminate against interstate commerce. Lastly, if substantial presence is found (prong 1), the tax will most likely be fairly related (prong 4) to the benefits conferred. *See id.* at 310–14 (Substantial nexus (prong 1) encapsulates minimum connection and physical presence.).

63. *Id.*

provided benefits where it could seek a return.⁶⁴ In *Quill*, the Court found a minimum connection through Quill's economic presence in the state.⁶⁵ The Court reasoned that *Quill* depended on the services and benefits provided by the state in conducting business.⁶⁶

In contrast, the physical presence requirement (encapsulated in the substantial nexus prong of the *Complete Auto* test) is much more difficult for states to prove in validating a use tax collection requirement. In *Quill*, the Court illustrated examples of establishing physical presence, including the following: Presence of sales personnel in state (including independent contractors), and maintenance of local retail stores.⁶⁷ In *Quill*, the Court required a legitimate presence, stating that a "slight presence" is not sufficient to find nexus.⁶⁸ Absent some sort of legitimate physical presence, state use tax collection requirements will remain unconstitutional burdens on interstate commerce.

In *Quill*, the Supreme Court cited *Scripto v. Carson* to show that physical presence could turn on a small sales force of independent contractors in the taxing state.⁶⁹ In *Scripto*, the Court found a minimum connection to the taxing state because Scripto voluntarily entered the Florida market to sell mechanical pencils and pens to Florida residents.⁷⁰ The Court also held that Scripto established a physical presence in Florida by employing ten independent contractors that solicited sales inside Florida.⁷¹ Scripto furnished the independent contractors with catalogs, samples, and advertising materials to assist in Florida solicitation.⁷² Furthermore, the

64. *See id.* at 307.

65. *Id.*

66. *Id.* at 308 (Court found a minimum connection because Quill Corporation purposefully directed activities toward North Dakota residents, and because the use tax requirement is directly related to the benefits that Quill Corporation receives from North Dakota).

67. *Id.* at 306 (citing *Felt & Tarrant Mfg. Co. v. Gallagher*, 306 U.S. 62 (1939) (sales personnel in state gave required physical presence.), *Nelson v. Sears, Roebuck & Co.*, 312 U.S. 359 (1941) (maintenance of local retail stores gave required physical presence), and *Scripto v. Carson*, 362 U.S. 207 (1960) (in-state solicitation by independent contractors is enough to give physical presence)).

68. *See Quill*, 504 U.S. at 315 n.8 (finding that Quill having title to licensed software (floppy diskettes) in North Dakota was not enough to prove a substantial nexus).

69. *Id.* at 315.

70. *See Scripto*, 362 U.S. at 211.

71. *Id.*

72. *Id.* at 209.

independent contractors initiated orders in Florida and sent them back to Scripto in Atlanta to accept and deliver.⁷³ Scripto then sent a commission check to the individual independent contractor after completion of the sale.⁷⁴ Other than the ten independent contractors, Scripto had no other presence in Florida.⁷⁵ The Court declined to make any “fine constitutional distinction” about the independent contractors in holding that substantial nexus occurred because of the level of activity inside the state.⁷⁶

III. Recent State Court State Court Developments Allowing Imposition of Use Tax Collection Requirements on Out-of-State Internet Retailers

In a 2008 amendment to New York state’s tax law, New York required internet retailers with a physical presence in New York to collect use taxes on the sale of tangible personal property exceeding ten thousand dollars in the aggregate.⁷⁷ Specifically, the New York statute found physical presence when an internet retailer entered into commission-based agreements with New York internet advertisers.⁷⁸ The New York state law treats any New York company that forwards website traffic based on consumer “clicks” as a local sales associate working on behalf of an out-of-state retailer. In 2009, New York state targeted online retailer Amazon.com and the Amazon Associate network under the New York state use tax collection requirement.⁷⁹

Amazon.com, through the Amazon Associate Program, partners with web advertisers to drive business to Amazon.com.⁸⁰ Under Amazon’s Associate model, Amazon.com allows website administrators to post links or advertisements for specific products on Amazon.com.⁸¹ If a customer clicks on the link to an Amazon.com

73. *Id.*

74. *Id.*

75. *Id.* at 208–09 (Appellant does not own any physical property in Florida. The only physical presence consisted of ten independent salesmen who resided in Florida.).

76. *Id.* at 211.

77. N.Y. TAX LAW § 1101(b)(8)(vi) (McKinney 2010).

78. *Id.*

79. *See generally* Amazon.com LLC v. N.Y. State Dep’t of Taxation & Fin., 877 N.Y.S.2d 842 (N.Y. Sup. Ct. 2009).

80. *See generally* ‘Make Money Advertising Amazon Products, AMAZON.COM, <https://affiliate-program.amazon.com/> (last visited Mar. 27, 2010).

81. *Id.*

product and purchases the product, Amazon.com will pay a commission of between four percent and fifteen percent on any customer purchase.⁸² Additionally, Amazon.com pays any website associate a commission of twelve dollars for driving traffic to Amazon.com that culminates in the customer signing up for Amazon.com's Prime program.⁸³

Amazon.com has numerous web pages to help any website administrator sign up for and advertise for Amazon products through the Associate program.⁸⁴ Specifically, Amazon.com gives help for any associate who wants to build links and banners and advertise specific products.⁸⁵ Amazon does this by publishing how-to guides on their website for hosting specific products and establishing online stores.⁸⁶ Any associate that establishes an online store is essentially creating a more specific version of the Amazon.com marketplace. In establishing an online store, the associate will advertise products for users to click on; the user is then forwarded to Amazon.com to complete the sale.

New York applied the New York state tax law to Amazon.com, by finding that Amazon entered into agreements with New York website advertisers to drive sales to Amazon.com.⁸⁷ Amazon acknowledged that in New York alone, there are thousands of associates participating in the program.⁸⁸ Although Amazon did not disclose the exact amount of revenue paid to New York Associates through the program, Amazon indicated that it totals over ten thousand dollars annually.⁸⁹ The amount is most likely an understatement of the sales generated through the associate program. But, taken at its word, this means that Amazon generates over two hundred fifty thousand dollars in sales annually driven by the Amazon associate program in New York. According to New York

82. See *Associates Compensation Overview*, AMAZON.COM, <https://affiliate-program.amazon.com/gp/associates/join/compensation.html> (last visited Mar. 27, 2010).

83. Amazon.com, 877 N.Y.S.2d at 845.

84. See, e.g., *Make Money Advertising Amazon Products*, *supra* note 80; *Links & Banners*, AMAZON.COM, <https://affiliate-program.amazon.com/gp/associates/promo/build-links.html> (last visited Mar. 27, 2010); *aStore*, AMAZON.COM, <https://affiliate-program.amazon.com/gp/associates/astore/main.html> (last visited Mar. 27, 2010).

85. *Links & Banners*, *supra* note 84.

86. See *Links & Banners*, *supra* note 84; *aStore*, *supra* note 84.

87. See generally *Amazon*, 877 N.Y.S.2d 842.

88. *Id.* at 849.

89. *Id.*

state, the Amazon.com Associate program imputed substantial nexus under New York state law.⁹⁰ Substantial nexus in New York requires Amazon to collect use taxes on all sales to New York state customers.⁹¹

As expected, Amazon challenged the application of New York state's use tax collection requirement in New York state court.⁹² Among other things, Amazon argued that the rule violated the Commerce Clause, both facially and as applied.⁹³ Specifically, Amazon argued that the collection requirement resulted in collection obligations on out-of-state entities with no substantial nexus in New York state.⁹⁴

The New York supreme court held the New York state use tax collection requirement facially valid under current Due Process and Commerce Clause jurisprudence.⁹⁵ Because the use tax collection obligation is only imposed on retailers that make a conscious decision to solicit in New York's market, the New York statute met the minimum connection requirement under the Due Process Clause of the Fourteenth Amendment.⁹⁶ Furthermore, because the New York statute requires an out-of-state retailer to pay commissions to New York independent contractors before the use tax is valid, the use tax obligation met the physical presence requirement under the Commerce Clause.⁹⁷ Since both the Commerce and Due Process requirements were met under the *Complete Auto* test, the law finds a substantial nexus in New York before justifying a use tax collection requirement.

The New York supreme court also held that New York had shown that Amazon.com exhibited a substantial nexus in the state, and the law as applied to Amazon did not unjustifiably inhibit interstate commerce.⁹⁸ In the decision, the New York court relied on *Scripto*, which held that ten in-state independent contractors soliciting business for an out-of-state entity is enough to qualify under the

90. *See generally id.*

91. N.Y. TAX LAW § 1101(b)(8)(vi) (McKinney 2010).

92. *See generally Amazon*, 877 N.Y.S.2d 842.

93. *Id.* at 846.

94. *Id.*

95. *Id.* at 848.

96. *Id.*

97. *Id.*

98. *Id.* at 848–49.

substantial nexus prong of the *Complete Auto* test.⁹⁹ In applying *Scripto*, the New York court found that the Amazon associate program, which provided for in-state independent contractors, met the physical presence requirement under *Quill* and established a substantial nexus in the state of New York.¹⁰⁰ Furthermore, the New York court found that because the New York state tax law required any solicitation by in-state marketers to exceed ten thousand dollars annually before substantial nexus is found, the law required more than the minimal nexus disallowed in *Quill*.¹⁰¹ In reasoning similar to that used in *Scripto*, the New York court stated that Amazon.com would be liable for the New York state collection requirements if it had simply hired employees to solicit in New York state.¹⁰² The New York court refused to make distinctions between independent website contractors and employees hired to solicit for New York state business.¹⁰³ As such, the New York supreme court granted New York state's motion to dismiss Amazon's claim.¹⁰⁴

In 2009, New York's Supreme Court Appellate Division, First Department, heard Amazon.com's appeal of the prior decision of the New York supreme court.¹⁰⁵ In the appeal, Amazon dropped the facial challenge to the Commerce Clause, but reiterated the claim that the New York state tax law as applied to Amazon is unconstitutional for lack of substantial nexus.¹⁰⁶ Following the New York supreme court decision, the appellate branch held that New York state, under New York state law, could reasonably assume that Amazon.com exhibited a substantial nexus under New York law.¹⁰⁷ According to the court, passive solicitation is not enough for finding physical presence.¹⁰⁸ The appellate court specified that advertisers had to actively solicit for the out-of-state business to find physical

99. *Id.* at 847.

100. *See id.* at 849.

101. *Id.*

102. *Id.*

103. *Id.* (Language in this case is very similar to that used in *Scripto*. In *Scripto*, the Court refused to make fine constitutional distinctions on differences between independent contractors and employees.)

104. *Id.*

105. *See Amazon.com, LLC v. N.Y. State Dep't of Taxation & Fin.*, 913 N.Y.S.2d 129 (N.Y. App. Div. 2010).

106. *Id.* at 136.

107. *Id.* at 138-39.

108. *See id.* at 138.

presence.¹⁰⁹ Specifically, the court looked to the language of Amazon's associate agreement which states in part "[o]ur compensation philosophy is simple: reward Associates for their contributions to our business in unit volume and growth," to find that Amazon's program is not designed for the passive advertiser.¹¹⁰ Amazon's program clearly seeks to grow Amazon's online retail business by agreements with online solicitors in the Associate program.

Amazon argued that as applied, the finding violated the Commerce and Due Process Clauses of the Constitution.¹¹¹ Amazon stated that their representatives do nothing more than advertise on New York based websites.¹¹² Although the court doubted that Amazon Associates in New York merely advertise rather than solicit business, the court remanded the case for further proceedings.¹¹³ Amazon had the burden to prove that Associates in New York simply advertised for each respective internet client rather than actively solicit sales.¹¹⁴

Following the initial New York decision in Amazon, other states have enacted legislation to impute physical presence on out-of-state internet retailers.¹¹⁵ California has followed this trend by enacting legislation that imposes a use tax collection requirement on out-of-state retailers that have a physical presence in the state.¹¹⁶ Like New York, California imputes physical presence on out-of-state retailers that use affiliate advertising similar to Amazon.com's commission-based associate program.¹¹⁷ However, California stopped short from establishing a physical presence through advertising with any California company (i.e., Google, Inc.).

IV. The Google Model

Google, Inc., an American multinational corporation that specializes in internet search engine technology, cloud computing,

109. *Id.*

110. *Id.* at 139.

111. *Id.* at 143.

112. *Id.*

113. *Id.* at 143–44.

114. *Id.*

115. See N.C. GEN. STAT. § 105-164.8(b)(3) (2010); R.I. GEN. LAWS § 44-18-15 (2010).

116. See CAL. REV. & TAX. CODE § 6203 (West 2011).

117. CAL. REV. & TAX. CODE § 6203(c)(5)(A) (West 2011).

and advertising technologies, was incorporated in California in 1998.¹¹⁸ Google's main source of revenue is through advertising, particularly through the Google Adwords program.¹¹⁹ Google's Adwords program helped Google make over twenty-eight billion dollars in total advertising revenue in 2010.¹²⁰ The Adwords program is used by companies through a pay-per-click, cost-per-impression, and site-targeted advertising.¹²¹ In each case, vendors purchase internet advertising through Google's content network.

In the pay-per-click method, vendors select adwords that will trigger their ads during a Google search.¹²² When a user searches for relevant words on Google, a list of sponsored links shows up on the right hand of the screen or above the main search result.¹²³ These sponsored links appear because companies have entered a bid with Google for how much a user click is worth to them.¹²⁴ The order of results in the Google search is determined by which companies pay the most per user click (and other relevant factors determined by Google).¹²⁵ An example of this is seen when typing in the phrase "shoes" in a Google search. The results that come up include a link to Zappos.com, a website that specializes in shoe sales. If a user happens to click on the Zappos result, and is thus transferred to the Zappos.com website, Zappos will pay Google a set amount for a user clicking on the Zappos link.¹²⁶

Under site-targeted advertising, Google allows vendors to enter specific keywords, domain names, topics, and demographic targeting

118. *Google History*, GOOGLE, <http://www.google.com/intl/en/corporate/history.html> (last visited Mar. 27, 2010).

119. See David A. Vise, *Online Ads Give Google Huge Gain in Profit*, WASH. POST (Oct. 21, 2005), <http://www.highbeam.com/doc/1P2-78242.html>.

120. *Google Investor Relations—2010 Financial Tables*, GOOGLE, <http://investor.google.com/financial/tables.html> (last visited Mar. 27, 2010).

121. See *AdWords*, WIKIPEDIA, <http://en.wikipedia.org/wiki/AdWords> (last visited Mar. 27, 2010).

122. See *id.*; *'Growing Your Business with AdWords*, GOOGLE (2000), http://static.googleusercontent.com/external_content/untrusted_dlcp/www.google.com/en/us/adwords/pdf/hc/growing_adwords_en.pdf; *AdWords Help—Get Started*, GOOGLE, <http://support.google.com/adwords/bin/topic.py?hl=en&topic=1713937&from=21899&rd=1> (last visited Mar. 27, 2010).

123. See *supra* note 122.

124. *Id.*

125. *Id.*

126. Notice that typing in "shoes" in the Google.com search window results in a featured link at the top of the page for Zappos.com in the yellow highlighted area ("Shoes at Zappos.com").

preferences.¹²⁷ Google will then place vendor ads on relevant sites in their display network.¹²⁸ Google's display network includes thousands of sites throughout the internet, including Netscape, AOL, and Ask.com.¹²⁹ Essentially, the display network is made up of sites that are not search engines.¹³⁰ This allows a vendor much more visibility on particular websites. A vendor can have Google place many different types of ads throughout the Google display network, including text ads, image ads, mobile text ads, and video ads.¹³¹ This gives vendors flexibility in marketing. An individual vendor can target specific segments of the population according to internet search habits provided by Google.

In the cost-per-impression method, a vendor is basically trying to reduce costs per click.¹³² In the cost-per-impression scheme, a vendor will target specific websites, and pays Google a set amount every time the vendor ad is displayed on a given website.¹³³ Normally, the cost per impression is much less than the price of cost per click.¹³⁴ This is because the impression on a Google content website is targeted to a specific website, while a search result is returned directly on Google's own search website and a vendor is only charged when a user directly clicks on the vendor's own link. Statistics have shown that a user clicking through to a vendor website is more likely to buy a product on that website than if the same user simply sees an ad impression on a Google content site.¹³⁵

Because of the complexity of the Google Adwords program, and the importance of online advertising, many vendors have sought out outside search engine marketing agencies and consultants to manage their Google Adwords account.¹³⁶ Search engine marketing specialists

127. See *AdWords*, *supra* note 121, and *Google Display Network*, GOOGLE, <http://www.google.com/adwords/displaynetwork/> (last visited Mar. 27, 2010).

128. See *supra* note 127.

129. *Id.*

130. *Id.*

131. *Id.*

132. See *supra* note 122.

133. *Id.*

134. *Id.*

135. See *AdWords*, *supra* note 121.

136. See *supra* note 122; *AdWords Help—What is My Client Center?*, GOOGLE, <http://adwords.google.com/support/aw/?hl=en> (last visited Mar. 27, 2010); *AdWords Help—My Client Center (MCC)*, GOOGLE, <http://support.google.com/adwords/bin/topic.py?hl=en&topic=22064> (last visited Mar. 27, 2010).

and individual website administrators can log in to a special area of Google's website to optimize search keywords and to bid on search terms.¹³⁷ Google allows access to a robust tracking tool called My Client Center. My Client Center allows website administrators to see breakdowns of daily visits of their website, page views, and trends.¹³⁸ My Client Center also allows an administrator to see if a website visitor is new or returning, referrals (who sends traffic to a site), geographic location of visitors, browser version of visitors, and connection speed.¹³⁹ All of this information can be condensed and exported to a spreadsheet for further analysis.¹⁴⁰ My Client Center is an essential research tool for any online advertiser to focus on target audiences and to tailor advertising towards trends and other factors.

Google's Adwords program has revolutionized internet marketing and has allowed vendors from all over the world to get information about their respective products and services to a huge audience. Through tools such as My Client Center, Google offers vendors the ability to optimize search engine results on Google.com and place targeted advertisements on the Google content network. Google's efforts through internet advertising have opened up entirely new markets to vendors and service providers alike. Because of the close relationship Google has with its content providers and Adwords clients, Google is able to drive traffic and promote sales exclusively through the internet. Because Google.com is the most widely used search engine on the World Wide Web today, advertising with Google is imperative in driving sales to any online business.¹⁴¹

As stated above, advertising through Google is essential to the long-term health of any online business. Since Google, Inc. is located in California, and actively solicits customers for online retailers, any non-California internet retailer that uses Google's advertising model has a physical presence in California.

V. Applying Current Due Process and Commerce Clause

137. See *supra* note 136.

138. *Id.*

139. *Id.*

140. *Id.*

141. See DJ, *Search Engine Market Share July 2009*, TECHWYSE INTERNET MARKETING (Aug. 4, 2009), <http://www.techwyse.com/blog/internet-marketing/search-engine-market-share-july-2009> (Google.com has almost 80% of the search engine market share followed by Baidu.com with almost 9%, Yahoo.com with a little over 7%, and Bing.com with more than 3%. All numbers are from 2009.).

Jurisprudence to Internet Retailers Advertising with Google, Inc.

The state of California must take the right action to create new state tax revenue and level the playing field between in-state retailers and out-of-state internet websites. For years, in-state retailers have been at a comparative disadvantage to out-of-state internet websites because of sales tax collection requirements. The comparative advantage is evidenced by a simple hypothetical scenario. Imagine that you are in the market for a new flat screen television. If you get in your car and drive to the local California retailer, you will notice that the exact brand you want is priced at \$1,000. When the salesperson rings you up, the grand total with sales taxes is 1,082.50.¹⁴² Now, say that you are savvy on the internet and find the same exact model on Amazon.com for the exact same price. In the alternative scenario, the \$1,000 price tag comes without tax, saving you \$82.50. Although you are supposed to report this amount to the state of California on your resident tax return, you either forget or fail to do so.¹⁴³ California's loss is your gain.¹⁴⁴

To remedy this inequity, California has implemented new use tax collection requirements similar to those established in New York, Rhode Island, and North Carolina.¹⁴⁵ In 2012, California will require any out-of-state retailer (like Amazon.com) to collect use taxes on California sales if the retailer uses in-state independent website advertisers to drive business to their sites. California, however, has enacted a substantial exception to this requirement. The California legislature has exempted retailers that only have a physical connection to California through a non-commission agreement with an internet advertiser.¹⁴⁶ Specifically, an out-of-state internet retailer

142. Assume a hypothetical California local jurisdiction with an 8.25% sales tax rate.

143. See *California Resident Income Tax Return 2010, Form 540*, *supra* note 15; *2007-2008 Annual Report*, *supra* note 16.

144. See Scott Gaylord & Andrew J. Haile, *Constitutional Threats in the E-Commerce Jungle: First Amendment and Dormant Commerce Clause Limits on Amazon Laws and Use Tax Reporting Statutes* (Elon Univ. Law Legal Studies Research, Paper No. 2011-01, 2011), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1773685 (Gaylord and Haile provided a similar hypothetical to show the comparative disadvantage that in-state retailers have with out-of-state internet retailers.).

145. See CAL. REV. & TAX. CODE § 6203 (West 2011).

146. CAL. REV. & TAX. CODE § 6203(c)(5)(B) (West 2011).

will not have physical presence in California simply through participation in Google, Inc.'s pay-per-click program.¹⁴⁷

California, through the Google exemption, has given out-of-state retailers such as Amazon.com the ability to opt out of use tax collection requirements by discontinuing associate programs. Not only does this allow internet retailers like Amazon.com to keep their competitive advantage by not collecting sales tax, but it also causes California to lose valuable jobs and income tax revenue. The Google exemption is a lose-lose scenario. The only way for California to meet specific goals of collecting revenue and leveling the playing field between out-of-state internet retailers and in-state businesses is to delete the Google exemption. Although imputing physical presence on an out-of-state internet retailer through Google seems tenuous, it will likely pass constitutional muster.

Any state tax must meet the four-prong *Complete Auto* test to pass constitutional muster.¹⁴⁸ Prong one, substantial nexus, is the only factor in contention in most state use tax collection disputes.¹⁴⁹ Substantial nexus requires a finding of minimum connection and physical presence within the taxing state.¹⁵⁰ Minimum connection with a taxing state is easily satisfied. Any retailer that purposefully enters into a state market, enjoying benefits of state markets and laws, has the requisite minimum connection.¹⁵¹ The alternative, physical presence standard is a much higher threshold. According to the *Quill* Court, physical presence must be more than minimal.¹⁵²

If California applied its use tax collection statute on internet retailers partnering with Google, finding a minimum connection with the state is simple. Every large internet retailer in the United States purposefully wants to enter every possible market. Because these

147. *Id.*

148. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977) (*Complete Auto*'s four factor test: "[1] the tax is applied to an activity with a substantial nexus within the taxing State, [2] is fairly apportioned, [3] does not discriminate against interstate commerce, and [4] is fairly related to the services provided by the State.").

149. *See Quill Corp. v. North Dakota*, 504 U.S. 298 (1992); *Scripto v. Carson*, 362 U.S. 207 (1960).

150. *Quill*, 504 U.S. at 305–06 (The *Quill* Court stated that the Due Process requirement of minimum contact and the physical presence requirement of the Commerce Clause were completely distinct and separate tests and encapsulated within the substantial nexus prong (prong 1) of the *Complete Auto* test.).

151. *See id.* at 307.

152. *See id.* at 315 n.8 (finding that *Quill* having title to licensed software (floppy diskettes) in North Dakota was not enough to prove a substantial nexus).

retailers purposefully want to sell products in every state, the retailers are taking advantage of the markets and laws provided by each respective state. To be sure that small retailer's are not unfairly burdened by a collection requirement, the California legislature has set a minimum level of sales that must be met before use tax collection is required.¹⁵³ This ensures that new laws do not unfairly burden small businesses in California.¹⁵⁴

However, finding physical presence in California is much harder. In *Scripto*, the Court held that an out-of-state retailer without any physical property or employees in state, nonetheless had physical presence because of ten commission-based independent contractor salesmen.¹⁵⁵ Google, like the *Scripto* salesmen, actively solicits for companies with whom they have agreements. In the Google pay-per-click approach, Google solicits consumers by displaying links to customer website's based on Google.com search criteria.¹⁵⁶ Google also places text ads, banners, and video ads throughout its network, targeting specific audiences and demographics for Google customers.¹⁵⁷ Similar to the salesmen in *Scripto*, Google is told how and where to solicit products. Google customers determine how they will pay Google for each advertisement on the Google Content Network.¹⁵⁸ Customers either pay per impression, per click, or even on the culmination of the sale.¹⁵⁹ Customers also determine exactly the type of advertisement they want to run on the Google Content Network, including advertising of specific products.¹⁶⁰ Lastly, like the salesmen in *Scripto*, Google does not make any final sales. Google simply forwards a user who clicks on a Google.com-generated link to the customer website to complete a sale.

The Court in *Scripto* specifically held that if *Scripto* would have physical presence by employing salesmen in the taxing state, *Scripto* certainly had physical presence by paying commissions to

153. See CAL. REV. & TAX. CODE § 6203(c)(5)(A)(i) (West 2011). An internet retailer must have total cumulative sales of tangible personal property of more than \$10,000 in any given year. *Id.*

154. See *id.*; N.Y. TAX LAW § 1101(b)(8)(vi) (McKinney 2010).

155. *Scripto v. Carson*, 362 U.S. 207, 211 (1960).

156. See *supra* note 122.

157. *Id.*

158. *Id.*

159. *Id.*

160. *Id.*

independent salesmen.¹⁶¹ Any court applying the *Scripto* decision to an internet retailer partnering with Google would find no difference between advertising with Google and hiring employees to solicit internet sales in the taxing jurisdiction.

In the *Amazon.com* decision, the New York court highlighted the fact that in finding a physical presence, advertisers had to actively solicit for out-of-state businesses.¹⁶² The court explained that passive solicitation is not enough.¹⁶³ Applying the Google advertising model to Commerce and Due Process jurisprudence shows the strength of the New York court's decision. The New York court relied on *Scripto* to find that the Amazon Associate program in New York imputed substantial nexus to Amazon, LLC.¹⁶⁴ Similarly, if Google were incorporated in New York, it is easy to see that any solicitation agreement with Google would produce the same result.

Lastly, the New York appellate court remanded the previous New York *Amazon* case to allow Amazon to prove that website associates did not actually solicit sales in New York.¹⁶⁵ Under the Google approach, it is unlikely that the appellate court would allow the same leeway. Because Google gives vendors multiple approaches for actively soliciting sales through the internet (Content Network, Search Engine, etc.), any state court would find that hiring Google to produce internet sales gives the vendor substantial nexus in the taxing state of Google's incorporation.

CONCLUSION

California has taken the first step in enacting a fair use tax law. Unfortunately for brick-and-mortar businesses, and the citizens of California, the new laws do absolutely nothing. Why give out-of-state retailers a way out? The new California laws have done nothing but put California in a deeper hole. Now, not only does California lose out on sales tax on any Amazon.com purchase, but they also lose out on income tax collection from 25,000 Amazon.com Associates. If the California legislature wants to effectively raise revenue and take away

161. *Scripto v. Carson*, 362 U.S. 207, 211 (1960).

162. *Amazon.com, LLC v. N.Y. State Dep't of Taxation & Fin.*, 913 N.Y.S.2d 129, 138 (N.Y. App. Div. 2010).

163. *Id.*

164. *See generally Amazon.com LLC v. N.Y. State Dep't of Taxation & Fin.*, 877 N.Y.S.2d 842 (N.Y. Sup. Ct. 2009).

165. *See Amazon.com*, 913 N.Y.S.2d at 143-44.

the comparative advantage that out-of-state internet retailers currently enjoy, the legislature would tie physical presence to any California advertiser. Most importantly, California should take advantage of the fact that the biggest internet advertiser, Google, Inc., resides within its borders.

California will benefit greatly from addressing constitutional due process and Commerce Clause concerns by establishing a minimum connection through market participation and a physical presence through Google, Inc. Any internet retailer partnering with Google will have substantial nexus in California. With substantial nexus, California can rightfully impose use tax collection requirements on any sale to California customers.

Of course there is the concern that Amazon or other internet retailers will simply pull out of agreements with Google to get around physical presence and skirt the use tax collection requirement.¹⁶⁶ Yet, with twenty-eight billion dollars in sales in 2010, there is absolutely no chance that any internet retailer will refuse to do business with Google.¹⁶⁷ Thus, finding a physical presence through Google will allow California to achieve two important goals: 1) To raise revenue, and 2) to level the playing field between California businesses and out-of-state internet retailers.

166. See Lifsher, *supra* note 19.

167. See *Google Investor Relations—2010 Financial Tables*, *supra* note 120.