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Taxing Ad Affiliate Internet Sales Would Be Maryland's Mistake

by

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In a November 14 editorial, the Baltimore Sun urged the state of Maryland to send the taxman after out-of-state retailers that do business on the Internet. Its editorial called on Maryland to rewrite state law to impose sales tax collection obligations on remote online retailers that have website ad commission sales arrangements with Maryland residents.

So-called "affiliate-nexus" sales taxes are a constitutionally dubious tax on interstate e-commerce. Current U.S. Supreme Court jurisprudence recognizes Congress as the authority to address interstate e-commerce and state taxation matters. And in practice, affiliate-nexus taxes will backfire by generating little to no revenue and by effectively eliminating web ad affiliate agreements with Maryland residents. Instead of trying to find new ways to expand its tax powers beyond its borders, Maryland should instead find more measured approaches to obtaining tax revenue. These may include ensuring businesses are in compliance with use tax requirements on goods purchased from out-of-state sellers not subject to sales tax, and considering taxing sales of digital goods on par with tangible goods.

The occasion for the Baltimore Sun's editorial is the "Maryland Remote Sales Tax Loss Study." The study was just released by the office of Maryland Comptroller Peter
Franchot. According to the study, Maryland lost "an estimated $198.4 million in sales and use tax revenue from the sale of tangible goods by remote sellers" in 2010, including "an estimated $97.2 million from e-commerce remote sales." It estimates that state revenues could increase by approximately $21 million or more annually if the Maryland legislature enacts an affiliate-nexus bill. Of course, "lost" revenue is a loaded term in this instance, since it assumes that remote online retailers are subject to Maryland's taxing jurisdiction. That estimate is also an optimistic extrapolation from New York tax revenues paid under protest and pursuant to pending litigation. Thus, the Comptroller qualified his tax revenue recovery estimate this way: "However, given that Amazon, the largest online retailer, has ended its affiliate relationships in most states with such provisions, there is no certainty of a substantial revenue increase under such a bill."

The *Baltimore Sun* editorial takes the Comptroller to task for his pessimism about the prospects of Maryland increasing revenue by adopting an affiliate-nexus bill. The editorial assumes that Maryland has the constitutional authority to so extend the reach of its taxing power to remote sellers. It therefore urges the Maryland legislature to aggressively assert its taxing powers extraterritorially, claiming that the state's existing tax policy is unfair and somehow subsidizes in-state brick-and-mortar retailers. The editorial also calls for aggressive taxation of remote online sellers despite acknowledging that it would have detrimental near-term effects on Maryland sales tax revenue and e-commerce.

While the *Baltimore Sun*’s editorial is called "Franchot's Mistake," there are plenty of reasons to think that the *Baltimore Sun* is mistaken.

In the last few years, five states have adopted "affiliate-nexus" or "Amazon tax" laws that impose sales tax collection obligations on retail business that have no property, stores, or employees in the taxing state. Such legislation attaches tax collection obligations to remote online sellers that have web advertising affiliate agreements with in-state residents. Under those agreements, online affiliates typically place ad banners on their websites for goods sold by retailers like Amazon and Overstock.com. The affiliates receive a small commission when buyers click on the ads and purchase such goods.

But the U.S. Supreme Court's jurisprudence recognizes constitutional limits on state taxation of interstate commerce. The Supreme Court has ruled that states can only impose sales and use tax collection obligations on retailers that have a sufficient "nexus" with the taxing state. Here "nexus" generally means the retailer has a "substantial physical presence" in the taxing state by virtue of its operation of retail stores or the in-state presence of employees. The Supreme Court has also ruled that the issue of state taxation of remote sellers is an issue that Congress has the ultimate power to resolve.

By treating online ad affiliates as the trigger for sales tax collection obligations, affiliate-nexus bills appear to run contrary to the standards set by the Supreme Court. Such a
bold assertion of extraterritorial tax authority over interstate commerce has instead triggered a lawsuit in New York, the first state to adopt such legislation. Although New York's intermediate appellate court upheld that state's tax, the litigation is still ongoing.

Aside from the legalities, policy problems also beset affiliate-nexus bills. The editorial's claim that remote online retailers with ad affiliate agreements are being subsidized by in-state bricks-and-mortar retailers ignores the fact that remote sellers do not directly benefit from state and local services such as police, fire, utilities, and roads. Bricks-and-mortar business storefronts, particularly small businesses, can also serve as warehouses for fulfilling their own e-commercial transactions with out-of-state customers. Maryland businesses that sell to customers in other states need not collect and remit sales taxes to states where they have no substantial physical presence. Online remote sales can be a friend to main street businesses.

For that matter, a nexus-affiliate law would likely have deleterious effects on Maryland sales tax revenue and e-commerce. As the Comptroller's study states, "[r]eportedly over 200 companies including Overstock.com and Backcountry.com have terminated their affiliates in one or more states that have enacted affiliate-nexus laws." Should Maryland adopt an affiliate-nexus law, state residents who place ad banners for remote retailers on their websites would also find their ad affiliate agreements cancelled. And in such instances the state would lose its trigger for imposing sales tax collection obligations on online remote sellers.

The *Baltimore Sun* editorial also acknowledges that a Maryland affiliate-nexus tax would have harmful consequences. But strangely enough, it still urges legislative action, writing:

> In the short term, such an aggressive effort by the state (assuming the industry responds in its customary fashion) could actually cost Maryland not only millions in sales tax collections but put Maryland-based affiliates out of business. That's regrettable. But unless states are willing to take such harsh steps, it's unlikely this grossly unfair situation is going to change.

Just because no immediate Congressional action regarding interstate e-commerce and state taxation is expected doesn't mean that rash extraterritorial exercises of state taxing power are a good idea, especially given the likely negative consequences of a nexus-affiliate law. There are also close-to-home measures that the state can take to shore up its tax revenue shortfalls. Yet the *Baltimore Sun* editorial overlooks a couple other tax policy reforms that do not call for Maryland to engage in interstate tax aggression.

First, the state can make more earnest efforts to enforce its use tax revenue from Maryland businesses. The Comptroller's report points to the state of Washington's estimated 77% voluntary use tax compliance rate in 2006. Maryland could take steps to
ascertain how high its own business use tax compliance level is and follow up with additional measures to boost that rate further.

Second, Maryland's legislature can bring digital goods within the scope of its sales tax, giving digital goods tax parity with tangible goods. As the Comptroller's report explains:

Maryland can choose to make the sale of digital goods taxable. If that were done, sellers would still have to have nexus with the State. Since digital goods are not currently subject to the Maryland sales and use tax, sales of digital goods do not lead to foregone revenues in the same sense as the remote sales of tangible goods.

Digitally downloaded computer software is currently taxed by 33 of 46 states that have sales taxes, and at least 24 states tax sales of digital books, music, and movies. The Comptroller estimated that if Maryland were to subject digital goods to sales tax, "revenues could increase by an estimated $4.7 million in fiscal year 2013." That may not cover the Comptroller's estimate of $91 million in "lost" tax revenue from remote e-commerce, or his estimate of $79 million from e-commerce transactions that are business-to-customer. But remember: calling such revenue "lost" assumes the dubious proposition that remote online retailers are subject to Maryland's taxing jurisdiction.

Affiliate-nexus sales taxes won't guarantee Maryland any significant increase in tax revenue, whether one feels the state is entitled to it or not. It will, however, guarantee that web ad affiliate agreements with Maryland residents will come to an abrupt end. And any Maryland affiliate-nexus law could be halted and overturned by the courts. Unless or until Congress acts, Maryland should consider alternative tax reform proposals that don't involve extraterritorial tax adventurism. But legislation adopting an affiliate-nexus approach would be the real mistake.

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