



# Armatus

Technology & Intellectual Property Update



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## Internet Sales Have Become a More Taxing Issue

**S**elling over the Internet, an everyday money-making practice for many companies, may now become increasingly complicated as states pass more aggressive sales and use tax laws.

Generally, companies must withhold and remit sales/use tax to the state where their customer is located if the business itself has a physical presence there. The definition of “physical presence,” however, can mean many things including an office, a storefront or salespersons. If the seller has no physical presence, the state is relegated to collecting use tax from each individual customer – a practically impossible task.

The physical presence requirement is primarily based on the Commerce Clause of the Constitution. However, the New York state legislature recently passed a tax law that attempts to sidestep the Commerce Clause and shift the use tax collection burden to out-of-state retailers.

This new state tax law requires out-of-state Internet retailers to collect and remit sales tax on sales to New York customers linked or brought over to the retailer website from a separate, New York-based website. For example, if the customer accesses the Internet retailer’s site by clicking through the site of the Internet retailer’s authorized New York reseller, New York state sales tax must be collected by the Internet retailer. This could be a tremendous tax compliance burden for Internet retailers, particularly if other states follow suit.

This new law applies even to Internet retailers that have no physical presence or employees in New York. Amazon.com and Overstock.com have already filed suit to have the New York

tax declared unconstitutional pursuant to the Commerce Clause, and several more Internet retailers are likely to follow. But millions of dollars are at stake, and New York has some case law on its side, so this is not shaping up to be a quick or easy battle.

### The New York Law

The New York law clearly targets Internet retailers, who are now subject to New York sales tax collection responsibility if:

1. the retailer enters into an agreement with a New York resident (entity or individual) whereby the resident receives a commission on the number of sales directly or indirectly attributable to the resident’s customer referrals whether such referrals are by link on a website or otherwise, and
2. the cumulative gross receipts from sales by the retailer to customers in New York State as a result of referrals to the retailer by residents exceed \$10,000 during the preceding year.

To further complicate matters, the new law also states that an Internet retailer does, in fact, have an agreement with a New York resident even when the retailer enters into an agreement with an out-of-state third party that has a New York resident act as the seller’s representative.

### The Argument

Internet retailers are challenging this new law, claiming that because they do not have a physical presence in the state, the imposition

**A**rmatus is the Latin word for “armor.” This newsletter addresses intellectual property issues and suggests ways to protect your intellectual property.

of state tax violates the U.S. Constitution's Commerce Clause. New York contends, however, that by contracting with a New York resident, a physical sales presence in New York has actually been established. The U.S. Supreme Court has, in the past, agreed that the physical presence requirement is met by having salespersons in-state, even if there is no building or office in the state. This analysis has been extended to cover not only employees, but also independent contractors of the out-of-state company.

But is a website that offers products or directs customers to the main ordering site the same as a sales force consisting of people soliciting orders? New York, and presumably other states, contend the answer is yes, while most Internet retailers very much hope the answer is no. Internet retailers will argue that the websites run by state residents are not shielding taxes that otherwise would be paid to the state. The resident will pay state income tax (on its referral or other fees generated from the Internet retailer), but the sale of the products would not be consummated in that state, and therefore no state sales tax is owed.

### The Near Future

It seems likely that other states and their political subdivisions, looking for quick cash in a down

economy, may adopt the New York sales tax model. Importantly, other taxing jurisdictions at the county, city, and even school district level could theoretically adopt New York's model. This would be disastrous for Internet retailers who could be forced to comply with the tax collection and remittance laws of over 7,000 different jurisdictions.

Internet retailers should expect other jurisdictions to be emboldened by New York's new law. Until a case is litigated to the Supreme Court and the court reaches a final and clear decision, Internet retailers will be required to observe and uphold the various state laws or risk the penalties associated with tax avoidance.

Internet sales make the global marketplace possible. Internet retailers should quickly assess their out-of-state sales and referral practices and take immediate steps to minimize their exposure to states' increasingly onerous sales tax obligations.

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