Interstate Commerce Initiative

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Issue Brief

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"Backdoor Retroactivity:" How California Finds Itself In Court Over a Dubious Tax Grab

Once again, California is flouting limitations on the Commerce Clause's prohibition against undue burdens on interstate commerce with little regard for the impact on small businesses. This time, the state is targeting smaller out-of-state retailers that utilize Fulfillment By Amazon (FBA) services, saying they should have collected California sales taxes going back to 2012. This overreach has led a group of small businesses called the Online Merchants Guild to sue the state in federal court.

California is no stranger to questionable tax enforcement. Last year, the National Taxpayers Union Foundation recommended to the U.S. Supreme Court that it take up the state of Arizona's case against California for unconstitutional enforcement of its "doing business" tax against out-of-state passive investors in California LLCs. Though the Supreme Court ultimately did not take the case, it represented a clear-cut example of California unfairly targeting out-of-state residents with no nexus to the state with tax penalties and even financial seizures that could not be effectively challenged in court.

Key Facts:

California, a state with a history of aggressively pursuing taxes from out-of-state entities, is attempting to enforce retroactive collection of sales taxes from small businesses that use Amazon's "Fulfilled By Amazon" services going back as far as 2012.

California's questionable approach constitutes a kind of "backdoor retroactivity," which is arguably at odds with state law and with Supreme Court precedent established in the 2018 case of *South Dakota v. Wayfair*.

A new lawsuit brought by a group of small businesses argues that California's tax scheme is unconstitutional and could strike a significant blow to the state's tax aggression if successful.

Unfortunately, this case further illustrates a general trend of California carelessly assessing tax liabilities on out-of-state residents with little regard for either limits on its legal authority to do so or the impact on small businesses. Should judicial action fail to rein in the Golden State, taxpayers can surely expect more of the same in the future.

Background: Fulfillment By Amazon and Small Sellers

Prior to June 2018, when the Supreme Court overturned decades of precedent with its decision in *South Dakota v. Wayfair*, a state could only require sales tax collection and remittance by out-of-state businesses if the company had some form of physical presence within the state. In *Wayfair*, the Court dispensed with this precedent by effectively validating a South Dakota law that assessed tax based on an out-of-state company's "economic nexus" with the state.

Wayfair ushered in a massive shift to the tax landscape, but even before that decision states found ways to collect plenty of revenue from out-of-state businesses. Large sellers with nationwide operations, such as Amazon, often entered into voluntary collection and remittance agreements with many states before the *Wayfair* decision happened.

Amazon entered into one such agreement with California in 2011, beginning to voluntarily collect and remit sales tax to the state in September of 2012. At the time, it was clear that this agreement applied only to products sold by Amazon itself, not the third-party sellers that used Amazon's platform.

That's where Amazon's FBA services come in. Fulfillment by Amazon allowed for third-party sellers to benefit from Amazon's delivery infrastructure to facilitate faster, cheaper shipping than they could achieve on their own. Unfortunately for these sellers, this convenience also exposed them, in California's interpretation, to Golden State sales tax law. Because Amazon had fulfillment centers located in California, the California Department of Tax and Fee Administration (CDTFA) considered this as constituting physical presence for FBA retailers, much as a warehouse would.

However, this does not accurately reflect the relationship that FBA retailers have with fulfillment centers. FBA retailers ship their inventory to fulfillment centers, but Amazon handles everything from there. FBA retailers are not aware of the details of individual orders, such as who purchases their products, how much they purchase, or where their products are delivered. As far as FBA retailers are concerned, the final step of the transaction that they have any active role in is the process of shipping their inventory to the fulfillment center.

The California Department of Tax and Fee Administration (CDTFA) has taken to arguing that the existence of Amazon fulfillment centers in the state necessarily confers nexus on a third-party FBA seller. If upheld, this interpretation by the state would give it the power to impose tax collection obligations on businesses that lack both a bona fide physical presence *and* an economic presence as defined in California's post-*Wayfair* remote sales tax law, with its premise of taxability resting entirely on the transit of a good through a warehouse that it does not own or control.

California State Treasurer Fiona Ma, who has urged the CDTFA to reconsider its interpretation of FBA nexus exposure, compares the relationship between FBA retailers and Amazon fulfillment centers to that of consignment stores. Just like with businesses that send inventory to consignment stores, the business is not responsible for the collection of sales tax from the consumer — rather, the consignee, as the party that consummates the transaction with the final customer, is responsible.

California's Latest Cash Grab

Nevertheless, because of its faulty reasoning, the CDTFA is pursuing unremitted sales taxes from FBA retailers going back as much as eight years. Because FBA retailers never collected this sales tax from consumers in the first place (having never been involved in the final transaction with the Amazon customer), businesses caught in the CDTFA's scheme would be on the hook for paying these sales taxes themselves.

The National Taxpayers Union Foundation has repeatedly documented the many ways in which the *Wayfair* decision has created new burdens and hurdles for small businesses to jump through. From the compliance burden of filing taxes in many new states to navigating states with unnecessarily complex sales tax structures to states failing to institute adequate (or any) safe harbors for small businesses, the challenges for small businesses are numerous and significant. However, this action by the CDTFA represents an entirely different kind of threat.

As several businesses testified to Congress in a hearing on the topic, paying the taxes that California demands would threaten their ability to stay operational. After all, sales taxes are collected by retailers but actually paid by the consumers who purchase the items. If a business is required to pay sales taxes years after the transaction occurred, it will come straight out of the businesses' bottom lines. And few businesses enjoy the kinds of profit margins to absorb an extra 7.25 percent (the California sales tax rate) on years' worth of sales.

"Backdoor Retroactivity?"

When *Wayfair* was first decided, a major fear was that states, particularly those with dormant legislation that was on the books but unenforceable before *Wayfair*, would attempt to enforce these rules retroactively, going back before the June 2018 *Wayfair* decision that gave them legal force. Fortunately, despite brief flirtations with the idea by Florida, Hawaii, and Alabama, no state went forward with a comprehensive retroactive enforcement of economic nexus rules.

However, California is not the only state to engage in a form of "backdoor retroactivity," asserting retroactive tax collection obligations not for all online retailers but rather for those with voluntary collection agreements hammered out years ago. Like California, South Carolina has also pursued backdoor retroactivity claims based on a prior agreement with Amazon.

In 2011, South Carolina agreed to defer tax collection and remittance obligations for Amazon for five years in return for Amazon investments in the state. When 2016 came along, Amazon began collecting and remitting sales taxes to the state on sales made by Amazon, but *not* for third-party marketplace sales. South Carolina began claiming that Amazon was responsible for collecting and remitting sales taxes for these sales as well.

South Carolina's position is different from California's, as it is pursuing the uncollected sales taxes from Amazon itself rather than third parties using its platform. Likewise, South Carolina attempted to enforce these tax burdens even before *Wayfair*, arguing that the case wasn't needed to justify its claim. California, however, made no attempts to enforce tax collection obligations on FBA sellers until after the *Wayfair* decision emboldened the state to do so.

Yet at the same time, the legal landscape has shifted dramatically since 2016. When Amazon first argued to South Carolina that it had no legal responsibility to collect these taxes, physical presence was

still the law of the land, and no state had enacted a marketplace facilitator law. Now, 39 of the 45 states with a statewide sales tax have done so. But those laws did not exist when Amazon first disputed the collection of taxes for third-party sellers back in 2016. Businesses should not be expected to predict future court decisions in order to comply with the law.

Conclusion

With California's interpretation set to be challenged in federal court, judges would do well to consider the deleterious impact that California's aggressive tax enforcement has had on interstate commerce. Put simply, the state has shown no ability to restrain itself from stretching its authority beyond its borders. Time will tell if this new lawsuit can successfully push back on the state's long history of aggressive tax enforcement.

About the Authors

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