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Amazon: Data Analysis Reveals an Estimated $1.9B in Unpaid State Sales Tax from FBA Sales in 2016 Alone; States Targeting Amazon and Sellers in Mounting Legislative and Enforcement Efforts

State Sales Tax Compliance Update

A source provided The Capitol Forum with a trove of data showing that Amazon third-party sellers who use fulfillment by Amazon (FBA) failed to pay an estimated $1.9 billion in state sales tax in 2016 alone. Taking into account extremely low tax compliance rates by FBA sellers, states are owed several billions of dollars of back sales taxes.

After fighting the states for years, Amazon now pays sales tax for its own direct sales in 42 states. Regarding FBA sales, Amazon takes the position that sales tax is the seller's own obligation. At the same time, however, Amazon creates sales tax liability for sellers by moving their inventory from state to state without clear notice. By quickly moving inventory around 22 states that have Amazon fulfillment centers, Amazon creates sales tax nexus and triggers the obligations of sellers to collect state sales tax. One recent study showed that sellers on average have their stock in seven fulfillment centers within their first month of using FBA and more than fifteen centers by the end of a year.

In 18 of the states where Amazon has fulfillment centers, nexus is created as soon as an Amazon seller's item passes through a fulfillment center in that state. From that point forward, that seller is liable to pay sales tax not only on their Amazon sales into the state but also on all sales into the state from any channel, whether a different e-commerce marketplace or their own website. The $1.9 billion figure does not take into account 2016 taxes owed on non-Amazon channels.

States are beginning to take action on e-commerce tax compliance, with several states passing or proposing laws in recent months, some of which give states the ability to go after marketplaces like Amazon for uncollected tax on third party sales. Several other states are bulking up their tax collection and auditing efforts. In light of legislative and enforcement action by the states, neither Amazon nor FBA sellers can ignore state sales taxes going forward without potential consequences. For FBA sellers, back taxes owed plus penalties and interest can be a huge liability that could put sellers out of business, say a number of Amazon experts and sellers.

In-Depth Look at the Compliance Data

We spoke with an industry expert who had previously set out to quantify the extent to which FBA sellers were charging state sales tax. Surveys have shown that if sellers are not collecting sales tax, they are also not paying sales tax. The estimated nearly $2 billion in unpaid 2016 state sales tax from FBA sellers was calculated through an exhaustive study based on hundreds of thousands of bits of data pulled from Amazon's API plus actual sales tax compliance census data. California takes the biggest hit, with an estimated $431 million in uncollected tax from FBA sales in 2016. Next is Texas with $264 million and then Florida with $186 million.

With states becoming more active on collecting back taxes, and average compliance rates for the top 5,000 FBA sellers estimated at a mere 5.5%, FBA sellers face daunting tax liability. Unpaid 2016 sales tax amount to an average of one-third of FBA sellers' net profit margins at an average of $49,000 in sales tax liability for every $1 million sold (based on state sales tax rates and an average FBA seller margin of 15%). Historic liability from unpaid taxes plus penalties and interest would eat up much more of those margins.

The industry expert who provided us the data worked with a team of software engineers to check thousands of items and determine for a given SKU sold by a given FBA seller, shipping to a specific state, whether or not that seller would charge sales tax to the customer. The study was conducted in October of 2016 and focused on only the 18 states where a mature FBA seller would have nexus by nature of the presence of an Amazon fulfillment center and the likely fact that their product had passed through each and every fulfillment center at some point (AZ, CA, CT, FL, IL, IN, KS, KY, MD, NJ, NV, OH, PA, SC, TN, TX, WA, WI).

Looking at the top 5,000 FBA sellers as compiled by Marketplace Pulse, and across all states, they found that sales tax was charged in just 5.5% of state-seller combos. Making the reasonable assumption that all these sellers should be collecting sales tax in all 18 States, this number should be thought of as a compliance rate and should be 100%. The observed compliance rate varied from state to state with California (20.8%), Florida (8.0%) and New Jersey (7.6%) having the highest rates and Ohio (6.0%), Kansas (2.6%) and Connecticut (2.0%) having the lowest. (FBA warehouses only opened in Ohio and Illinois in mid-2016, so that may explain the low rate of compliance there). When they repeated the analysis using a sample of 16,000 sellers outside of the top 5,000, the overall compliance rate fell to 2.2%.

Though we could not replicate the study, we did perform a similar analysis to check the reasonableness of the results. We took 147 of the top 150 FBA sellers at the time of the original analysis (we could not access three of these FBA sellers' sites on Amazon). We then went through the process of going to a seller's Amazon site, adding an item to our cart on Amazon, designating a shipping address in a state, and proceeding to the final step to see if sales tax was added. We did this for each of the 147 sellers and each of the 18 states in question for a total of 2,646 data points.

In the original analysis, these 147 sellers had an overall sales tax compliance rate of 16.3%. The overall higher compliance rate in this subset is not surprising—larger sellers are more likely to have a better understanding of sales tax law than smaller sellers. In our analysis, these 147 sellers had an overall sales tax compliance rate of 20.3%. The increase from 16.3% to 20.3% could be explained by sellers getting into compliance over time.

In our sample of 147 sellers, 64 did not charge sales tax in any of the 18 states, and 43 sellers only charged sales tax in one state. At the other end of the spectrum, only eight sellers charged sales tax in all 18 states; six charged sales tax in 17 of the 18 states; and an additional six charged sales tax in 16 of the 18 states.

In-Depth Discussion of the Sales Tax Issue

States are taking action to collect FBA sales tax, to lessen requirements for sales tax nexus, and to put Amazon on the hook for non-compliance. As e-commerce captures a larger share of the retail pie, and brick-and-mortar sales decline, states are feeling the budgetary pressure to take action on uncollected sales tax. Faced with the choice between raising tax rates on brick-and-mortar retailers who are paying their taxes and going after e-commerce retailers who are not, states naturally prefer the latter. Moreover, collecting from non-residents is a politically safe option. States have also given up on Congress and have started taking matters into their own hands because The Marketplace Fairness Act that has been proposed every year since 1992 continues to elude passage.

Richard Cram, Director of the National Nexus Program at the Multistate Tax Commission, spoke to us about the wave of recent state action related to ecommerce tax collection efforts. "The pressure is going to build on Amazon to automatically collect on behalf of the seller," said Cram. The objective of some of the states' legislation is to "go after one collector," given the difficulties of collecting tax from each individual seller, he said. Although Amazon is now paying state sales tax on its own first party sales, "states started realizing they aren't getting tax from third party sellers," said Cram.

Five or six states have introduced legislation this year requiring the marketplace "facilitator"—which would include not just Amazon but companies like EBay—to collect tax, explained Cram. The proposed legislation does not let individual sellers off the hook, however, and makes clear states also can go after sellers for unpaid taxes.

Technically, states with fulfillment centers and sortation centers do not need legislation because they can collect sales tax under the *Quill* Supreme Court case, which requires a physical presence in the state for sales tax collection. But the legislation makes tax liability "crystal clear," and "puts the onus on Amazon to collect," said Cram. Minnesota, Mississippi, New Mexico, New York, Rhode Island, and Washington have all introduced legislation this year, according to Cram. Michael Fleming, a Director at Peisner Johnson & Company, a multi-state tax practice that offers nexus and taxability consulting, added Arizona to the list of states seeking to collect directly from Amazon.

Other states are enacting legislation that takes away the physical presence requirement of *Quill*, so that sales taxes can be collected solely on the basis of sales into the state. Fleming pointed out a 2015 concurring opinion by Justice Kennedy in which he essentially requested a case that the Court could use to overturn *Quill's* physical presence requirement. Wrote Kennedy: "There is a powerful case to be made that a retailer doing extensive business within a state has a sufficiently 'substantial nexus' to justify imposing some minor tax-collection duty, even if that business is done through mail or the Internet."

"A number of states responded," to Kennedy's call, said Fleming. In January of last year, Alabama passed a law saying no connection to the state is required for state sales tax liability as long as a seller has $250,000 in sales, explained Fleming. And South Dakota requires only $100,000 in sales or 200 transactions for sales tax nexus. Twelve states currently have laws mimicking the South Dakota legislation right now, according to Richard Cram. There is currently an injunction against the South Dakota law, said Fleming, but Alabama is "going full steam ahead and pursuing people actively."

States are not just proposing legislation but also beefing up their enforcement efforts. Fleming said 80 people contacted him in 2016 about being audited, whereas in 2015 that number was one. Moreover, states like New York and Florida have "bounty" programs, where anyone can turn in a seller they believe is not remitting sales tax, said one expert.

With Amazon having a hands-off approach and not eagerly warning sellers about tax nexus issues, most sellers are surprised and angry when they receive an audit. Collection of back taxes could put a large share of sellers out of business, say several experts to whom we spoke, given the small margins most sellers earn.

How Amazon creates sales tax nexus without clear disclosure to sellers. One FBA seller told us about his ordeal of being audited. "No one was collecting sales tax so we kept going without thinking about it," he said, noting, "you're at a pretty big disadvantage if you collect sales tax," vis-a-vis other sellers. When the audit came, the seller said he was “terrified by what we found.” “Nobody is complying, and this liability is enormous,” he said. He felt the consequences were “deeply unfair.”

In his view, “Amazon is complicit” because they “purposely make it difficult,” to figure out where your inventory is. As a seller, you “send them your inventory,” and then Amazon “distributes it across all their fulfillment centers without your knowledge.” He added that third party merchants do not know who the customer is or their email or mailing address. “Amazon is creating the sales tax nexus without your control,” he said.

“Anything that’s been held in a warehouse and not sold counts as nexus,” and the volume of sales to create tax nexus in states is “incredibly low.” It’s “very hard to understand where the inventory has been,” he added, pointing to Amazon’s complicated inventory reports that make use of fulfillment center codes confusing to sellers. Another seller, however, said he did not think Amazon was being deliberate in making sales tax nexus information confusing.

Regardless of Amazon’s intentions regarding inventory reporting, one expert insists Amazon is “looking the other way” on FBA state sales tax. Amazon knows which sellers are using FBA, it knows where FBA sellers have had inventory, and it knows if FBA sellers are collecting tax, he said.

Amazon does make inventory location information available, just not in a particularly user-friendly way. A seller can get a snapshot from Amazon of where their inventory is today, but the snapshot does not provide historical information, said an expert. A snapshot is somewhat unhelpful because Amazon moves product around so quickly, he added, and even inventory passing through a state’s fulfillment center can trigger nexus.

To get historical information, Fleming explains that “inside of Amazon there’s an inventory event detail report,” and sellers “can pull it back until the day they started doing business,” to try to figure out when they first had nexus in a state. It’s “a lot of data,” that the seller must download as a text file and convert into a spreadsheet. But Amazon does not tell sellers what states their inventory is in and instead provides a code that consists of the airport code plus some numbers, he explained. A seller then can do a web search of the airport codes that Amazon uses to identify its fulfillment centers.

Furthermore, inventory is not the only way to trigger state sales tax nexus. Fleming pointed to two Supreme Court cases, *Scripto* and *Tyler Pipe*, which hold the activities of third parties can create nexus for a merchant. “If a company is helping you to establish or maintain a marketplace, that becomes a nexus-creating activity,” says Fleming, as does activities like customer service or accepting returns.

“Amazon has started doing something fairly recently that brings this to the forefront even more,” says Fleming, which is “making deliveries in their own trucks or through Amazon Flex.” An agent making a delivery for a seller in a state creates nexus, says Fleming, and Amazon delivery does not fit in the common carrier exception applied to UPS and FedEx under the law. Amazon is now doing its own deliveries in 30 cities, says Fleming.

“In three states, there are not any fulfillment centers but there are sortation centers: Colorado, Michigan, and North Carolina,” explained Fleming. “There are fulfillment centers in 22 states and Amazon is adding more every year.” Hence, “our opinion is if you are a seller of any size, you need to take a conservative route and look at all 25 states,” said Fleming.

Software services have sprung up to help FBA sellers with the task of identifying sales tax nexus. For instance, TaxJar will tell sellers how much tax they should have paid based on what states their inventory is being shipped out of and from when. It starts at $19/month and offers a free trial. Similarly, for a one-time fee of $29, WhereStock provides a report on when Amazon first put stock into each state (but does not tell sellers their total tax in that state and how much taxes they owe). The availability of these services raises the question as to why Amazon does not make such reports available, but it also shows that FBA sellers have options for figuring out their tax liability.

The challenges of compliance and the risks of noncompliance. One Amazon expert told us that just registering in each tax jurisdiction would run a FBA seller $2,500 in fees plus $6,000 per year in administrative fees for tax filing. Plus, it creates hours of work of preparing the filings. "It's a nightmare to do all this paperwork," said one FBA seller. Moreover, many businesses from outside of the U.S. send stock to Amazon and do not even understand U.S. sales tax, much less know how to go about registering in 25 states.

However, "the longer people wait the worst it is going to get," said the seller. "If you start collecting the tax right now, it's a pass-through expense and customers pay it," emphasized one expert. But "if you don't collect it, it's a liability on the books." Moreover, explained Richard Cram, states can go after a seller personally and can collect a judgment lien through foreclosure. States have to jump through a few more hoops if the seller is set up as a corporation, but eventually they can pursue the principals for personal liability, said Cram.

To go about collecting tax on Amazon, an FBA seller has to first get registered for sales tax in each state. Next the seller can request that Amazon collect taxes, a service for which sellers must pay Amazon a fee of 2.9% of the taxes paid. Then, for each individual product, sellers have to indicate to Amazon whether the product is taxable.

For the estimated 94.5% of FBA sellers who are not properly collecting and remitting taxes, however, the issue of back taxes owed is not an easy one. One expert told us about a seller having $15 million of tax liability that it cannot pay. Sellers can either participate in state voluntary disclosure programs and hope the states forgive a good share of back taxes, or they can register to pay taxes moving forward to reduce their odds of getting audited and penalized for back taxes.

If states continue to ramp up their collection efforts, sellers "are going to go out of business," said one seller. If the top 1,000 sellers have to close their doors, said one expert, "Amazon has a really big problem." Regardless of whether that extreme outcome occurs, the wave of state legislation and enforcement indicates the issue of billions of dollars of unpaid state sales tax is likely to come to a head.