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States Go After Small Businesses on Amazon - and Sometimes Amazon - for Millions in Back Sales Taxes

The Supreme Court in 2018 gave states the power to make new rules for collecting sales taxes online. But back taxes on products sold by small businesses on Amazon's marketplace are still a major point of dispute.

Amazon is one of the nation's largest retailers in part because of its rapidly growing online marketplace, which allows small business owners to sell their products to a vastly larger group of consumers. In fact, Amazon's marketplace sales more than doubled in just three years, climbing to about \$230 billion in 2019, accounting for more than half of the online giant's business.

But up until last year, many of those sales weren't taxed because the legal requirement to do so was murky. Now, some state governments are trying to recoup those taxes. But whether they're going after Amazon or small business owners themselves for that money depends upon the state.

In California, a state agency is trying to collect back taxes from Fulfilled-By-Amazon (FBA) sellers from as far back as 2012, when Amazon first opened warehouses and fulfillment centers there.

Earlier this year, Philadelphia-based FBA seller Brian Freifelder received a notice from the California Department of Tax & Fee Administration (CDTFA) warning that he could owe California up to \$1.6 million in back sales tax, plus penalties and interest. (After the story made national news, the CDTFA admitted the \$1.6 million estimate was "higher than it should have been," but did not let Freifelder off the hook.)

The CDTFA argues that a business owner's inventory stored for sale in California amounts to having a physical presence there, and therefore triggered the eligibility for those sales to be taxed. The action by the agency has sparked at least two lawsuits, the most recent one filed in September by the trade organization Online Merchants Guild. The guild, which represents FBA sellers, says those sales taxes should have been collected by Amazon in the first place because Amazon was the retailer. In the marketplace format, it argues, merchants are the equivalent of suppliers because they don't have control over where their products are shipped or sold.

"They [the CDTFA] have no more discretion to go after Amazon sellers than they do Black & Decker for their sales within Home Depot," said Paul Rafelson, executive director of the guild.

But California isn't alone in trying to directly collect from sellers, with Massachusetts, Minnesota, Washington and Wisconsin also sending demands for back taxes in recent years.

In South Carolina, however, the state is targeting Amazon itself. It sued the company for \$12.5 million in unpaid sales tax, interest, and penalties for the first quarter of 2016 alone. An administrative law judge sided with South Carolina, but that ruling is under appeal. The state says Amazon is liable for remitting sales tax for third-party marketplace sales because customers are using Amazon's website and fulfillment services for the purchase.

Amazon said last year the ruling was without merit and hinted at the scale of the potential financial hit if other states followed this tack. “If South Carolina or other states were successfully to seek additional adjustments of a similar nature, we could be subject to significant additional tax liabilities.”

Most states sought to clarify the responsibility for collecting taxes after the landmark 2018 Supreme Court ruling that allowed states to collect sales taxes from online sellers, no matter where those merchants are located. In enacting their own sales tax laws, many governments made a distinction between businesses doing direct sales to in-state consumers and those done via online marketplaces such as Amazon or Ebay.

These marketplace facilitator laws, which have been passed in 33 of the 45 sales tax states, make clear that the marketplace platform is responsible for collecting sales taxes—not the merchant who is providing the product. The intent was to keep in place protections for small business owners for whom it may be cost prohibitive to comply with dozens of different sales tax laws. For example, California’s law that took effect in 2019 says that remote retailers must register to collect and remit sales tax once their annual sales into the state exceed \$500,000.

But far from clearing things up, those facilitator laws have in some cases added to the confusion. In California, State Treasurer Fiona Ma criticized the CDFTA’s approach, calling it “a wrong-headed and retroactive administration of the state’s tax law.” She argued in a letter to Gov. Gavin Newsom that the state’s policy was unfair to small businesses without the ability to comply, while possibly forcing them out of business. Since then, the legislature passed another law that limited the state’s look-back period to 2016 for collecting marketplace sales taxes, but that still targets sellers.

Scott Peterson, Avalara’s vice president of U.S. tax policy, said that state legislatures can potentially step in to protect marketplace sellers from past tax liability. But in California, that ship has likely sailed.

“They could have let the past be the past,” he said. “But instead they doubled down.”

Route Fifty

By Liz Farmer

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