Illinois enacts Web sales tax; online retailers threaten to leave

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Illinois Gov. Pat Quinn stepped into the Internet tax fray this week, signing into law a bill designed to collect a sales tax for certain online purchases, a move that Amazon.com Inc. said it would blunt by severing ties with Illinois affiliates.

The controversial law makes it tougher for online merchants such as Amazon and Overstock.com Inc. to claim they have no physical presence in a state - something they must do in order to avoid charging their customers sales tax.

"Amazon has basically a 10 percent pricing advantage, and they're fighting like the dickens to keep it," said Fiona Dias, executive vice president of strategy at GSI Commerce, a Pennsylvania-based digital marketing firm.

The law, which took effect immediately after it was signed Thursday, is expected to have little effect on consumers but deals a blow to small Web businesses that count Internet retail giant Amazon and other online merchants as a major source of ad revenue.

Under the new law, called the Main Street Fairness Act, online retailers must collect and remit sales taxes on purchases made by Illinois residents if the online retailer has a physical presence in the state. The new law expands the meaning of "physical presence" beyond a warehouse, factory or office to include affiliate companies, typically deal and coupon website operators that earn commissions for directing shopping

traffic to an online store.

The average combined sales tax on goods purchased in the U.S. jumped to a record high of 9.64 percent in 2010, from 8.63 percent in 2009, according to Vertex Inc., as cash-strapped city, county and state governments sought new revenue. The average state sales tax rose to 5.52 percent in 2010 from 5.48 percent in 2009. The state sales tax in Illinois is 6.25 percent.

Amazon and Overstock said they would avoid the sales-tax issue by dropping their affiliates in Illinois. Amazon declined to disclose how many of its affiliates are in Illinois, but Overstock said it did business with "well over 100." Amazon and Overstock have relationships with thousands of affiliates across the country.

Illinois is among a handful of states - including New York, Rhode Island and North Carolina - that have instituted similar laws to extract sales taxes from online merchants and boost depleted state coffers.

"Illinois' Main Street businesses are critical to ensuring our long-term economic stability, which is why they must be able to compete with every company doing business online in Illinois," Quinn said. "This law will put Illinois-based businesses on a level playing field, protect and create jobs, and help us continue to grow in the global marketplace."

The Illinois Department of Revenue estimates it misses out on $153 million to $170 million in uncollected sales taxes each year from online purchases. The uncollected taxes of goods sold online and through catalogs totaled $8.6 billion in 2010 nationwide, according to a Wall Street Journal report citing the National Conference of State Legislatures.

The U.S. Supreme Court ruled in 1992 that companies without a

physical presence in a state aren't required to collect state sales taxes.

Amazon, based in Seattle, sent a letter to its affiliates in Illinois on Thursday telling them that the company will terminate their contracts April 15. Its affiliates will no longer receive advertising fees for sales referred to Amazon.com, Endless.com or SmallParts.com, the letter said.

Overstock also sent a letter to its Illinois affiliates Thursday, saying it will sever its ties with them as of May 1 unless the law is repealed or the affiliates move to another state where no such law exists.

"We think that states that do this are making a mistake," said Jonathan E. Johnson, president of Salt Lake City-based Overstock. "We think this kind of law doesn't really hurt Overstock that much. The affiliate business can be borderless. If a Web shopper is looking for a coupon, they don't care if they get it from an Illinois-based affiliate or an Indiana-based affiliate."

Scott Kluth, founder and CEO of Chicago-based CouponCabin.com, called the new law "deeply disappointing" and said his company is "actively exploring" moving to Indiana.

"It's a shame we have to consider leaving our longtime home in Illinois, but we will do what is best for our business," Kluth said.

Brad Wilson, founder of BradsDeals.com, is staying in Chicago for now but predicted the new law will stunt the growth of the deal-site industry that has sprouted in Illinois.

"Chicago doesn't lead on the Internet in many things, but this space is one of the things that we do, and the state should cherish that and foster that," Wilson said. "These are modern business models. They don't require factories or fixed investments. They require smart people. And

you can find smart people anywhere. They're legislating (this industry) out of the state."

Rival retailers saddled with brick-and-mortar stores, for their part, cheered the new law.

As the biggest online retail company, Amazon's ability to avoid collecting and remitting state sales taxes has been the envy of brick-and-mortar retailers. Retail margins are so slim, typically less than 5 percent, that not charging sales tax amounts to a price advantage.

In the past few weeks, Sears Holdings Corp., Best Buy Co., Barnes & Noble and Wal-Mart Stores Inc., among others, launched an effort to poach disgruntled Amazon affiliates in states the online retailer has threatened to leave.

Wal-Mart said in a statement Thursday that the new law "will help create a level playing field between online-only retailers and brick-and-mortar retailers."