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Internet Companies Immediately Object to New York's "Gotcha!" Theory of Nexus

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Our column in the March-April edition¹ reported on the aggressive new nexus proposals contained in New York's 2008-2009 budget bill.² On April 9, 2008, the New York Legislature enacted these budget proposals, which included a novel and far-reaching approach to sales tax nexus based on Web site linking arrangements (sometimes called "affiliation agreements"). Under this new law, an out-of-state Internet seller is presumed to have nexus with New York—and thus will be required to collect and remit use tax on all sales to New York residents—if it pays a commission to New York residents in exchange for displaying an Internet link that allows prospective customers to "click through" to the out-of-state seller's Web site. The controversial statute conflicts with basic principles of commerce clause nexus and has already generated at least two lawsuits challenging its constitutionality.

New York's New Statutory Nexus Presumption

Section 1101(b)(8)(vi) of the New York Tax Law creates a presumption of nexus for any seller that:

enters into an agreement with a resident of [New York] under which the resident, for a commission or other consideration, directly or indirectly refers potential customers, whether by a link on an internet website or otherwise, to the seller, if the cumulative gross receipts from sales by the seller to customers in the state who are referred to the seller by all residents with this type of an agreement with the seller is in excess of ten thousand dollars during the preceding four quarterly periods ...

Thus, an out-of-state seller is presumed to have nexus in New York if it (1) enters into agreements with New York residents for Web site referrals or links; (2) pays commissions or fees for such referrals based on sales; and (3) the total gross receipts from sales made as a result of all such arrangements is at least \$10,000 during the preceding four quarterly periods.

The statute purports to apply concepts of agency or third-party nexus. On its face, the statute provides that a seller meeting the conditions specified in the statute “shall be presumed to be soliciting business through an independent contractor or other representative” as a result of entering into Web site linking agreements with New York residents. Thus, the Department’s rationale is based on the notion that the individual displaying a link on his or her Web site in some way qualifies as a “representative” sufficient to create nexus under the traditional third-party nexus rules established by the Supreme Court in *Scripto, Inc. v. Carson*³ and *Tyler Pipe Industries v. Washington Dep’t of Revenue*.⁴ As the following discussion will show, however, there are a number of problems with the state’s approach.

The Department’s Guidance

On May 8, 2008, the New York Department of Taxation and Finance’s Office of Tax Policy Analysis/Taxpayer Guidance Division issued a Taxpayer Memorandum (the “Memorandum”) containing guidelines regarding its application of the new statute.⁵ The Memorandum attempts to “clarify” the new rules by way of explanation and example.

In order to trigger the presumption, the seller must enter into agreements with New York “residents” and pay a commission or other consideration based on sales in exchange for the referral. First, the Department’s Taxpayer Memorandum defines a “resident” as any individual who maintains a permanent place of abode in New York, or any entity that is doing business or maintaining a place of business in New York.

Next, it instructs that the seller’s agreement with a New York resident need not be direct. That is, the presumption applies, even if the Internet seller uses a third-party provider to manage and contract with those that display the seller’s link. Since there are a number of companies engaged exclusively in the business of managing and facilitating online linking arrangements between Internet companies and their “Web site affiliates” (independent third-party Website operators), this catch-all interpretation ensures that the presumption applies to even those sellers that do not directly contract with the third parties that are displaying their Web site link.

Finally, the Memorandum clarifies that a commission or “other consideration” must be based on volume of completed sales. Merely paying a set fee based on the number of clicks on the link to the out-of-state seller’s Web site will not trigger the presumption. A linking arrangement of that kind will be viewed as an agreement to place advertising on the resident’s Website. By contrast, paying a commission or fee based on sales made as a result of “clicking through” to the seller’s Web site will not be viewed as mere advertising and will trigger the presumption, if such sales exceed the statutory threshold.

Rebutting the Presumption

Theoretically, any presumption of nexus that arises by application of the statute may be rebutted. According to the Memorandum, the seller can rebut the presumption of nexus if it can establish that the only in-state activity is a Web site link maintained by

a New York resident and that “none of the resident representatives engage in any solicitation activity in the state targeted at potential New York State customers on behalf of the seller.” As a practical matter, however, the nature of most Web site linking arrangements makes the presumption effectively impossible to rebut under this standard.

For example, once the presumption arises, the seller can avoid nexus only by proving a negative. That is, the seller would be required to introduce evidence—to the satisfaction of the Department—that the Web site affiliate does nothing more than display a Web site link. Yet, the independent Web site affiliate functions completely independent of the online seller, and is not subject to the seller’s supervision or control. The online seller has no means to track or control what the third party does, and would not have access to detailed information regarding the activities of every third-party Web site affiliate that displays a link to its Web site. In many cases (particularly where the online seller uses a third-party company to manage and facilitate its relationships with third-party Web site affiliates), the seller does not even have a direct contractual relationship with such third parties. And disproving the presumption becomes even more complicated due to the fact that the nexus presumption arises even if the Web site referral is “indirect.”⁶ In short, the difficulties inherent in rebutting the presumption effectively foreclose any meaningful way for an out-of-state seller to disprove nexus once the presumption arises. As a result, many out-of-state sellers that engage in this form of advertising will find themselves subject to tax, despite the fact that they lack physical presence nexus as required by *Quill*.

Statutory and Constitutional Problems

As a threshold matter, the statute conflicts with existing provisions of New York law. Section 12(c) of the New York Tax Law—which has been on the books since 1998—expressly provides that advertising on the Internet *via* a server in New York or using a service provider having nexus in New York does not create tax nexus. Displaying a Web site link certainly should qualify as Internet “advertising” subject to the existing safe harbor,⁷ yet the Department expressly notes that this exception will not apply in the case of Web site links. Although the Department acknowledges that “a business is not considered a vendor” under the new statute “merely because the business stores advertising on a server or other computer equipment located in New York State, or has advertising disseminated or displayed on the Internet,” it goes on to note that entering into agreements for Website linking as described by statute does not qualify as a protected “advertisement.” It is difficult to see how the Department’s application and interpretation of the new statutory presumption squares with this corresponding provision of tax law.

More importantly, however, a presumption of nexus based solely on Internet-based activities also conflicts with longstanding constitutional law. Indeed, the U.S. Supreme Court has repeatedly held that advertising alone is insufficient to create nexus.⁸ Yet the New York law purports to impose tax obligations on companies based solely on Internet-based activities, even though it is well-established that advertising fails to create “substantial nexus” under the Commerce Clause.

One additional point to consider in this context relates to the very nature of Internet communications. Third-party nexus exists under the tests established in *Scripto* and *Tyler Pipe* only if an in-state representative acts on behalf of the out-of-state seller to establish and maintain a market in the taxing state. However, Web sites are not geographically specific and the Internet is a protected form of interstate communication. In fact, the defining characteristic of the Internet is its decidedly unboundaried nature. Thus, a link posted on a New York resident's Web site is not necessarily targeted to the New York marketplace and may do nothing to "establish and maintain a market" in New York State. In fact, such an advertisement is no more likely to reach New York customers than customers located in any other state or location worldwide. Although the statute presumes that all New York-based Web site affiliates are targeting or creating a market in New York State, this assumption is unfounded. Thus, the statutory presumption fails this constitutional hurdle as well.

Some Immediate Responses—Amazon.Com and Overstock.com Sue

The response to the new statute from the business community was immediate and forceful. Just two weeks after the statute was enacted, Amazon.com filed suit in New York state court on April 25, 2008, seeking to declare it unconstitutional both on its face and as applied.⁹

A second online seller also filed suit several weeks later, but only after it had terminated all of its relationships with Web site affiliates that provided New York addresses. On May 15, Overstock.com notified its New York-based Web site affiliates that, based on the new law, it could no longer provide advertising. Thereafter, Overstock.com also sued the New York Department of Taxation, challenging the statute on constitutional grounds and seeking a permanent injunction prohibiting the Department from enforcing it.¹⁰

The facts and legal challenges presented in both suits are very similar. Neither Amazon.com nor Overstock.com has any property, employees, agents or other traditional physical presence in New York. Amazon.com, LLC is a Washington-based company that sells merchandise exclusively online. It has no physical presence in New York, no affiliated retail stores in New York, and no other contacts with New York other than Web site linking arrangements as described by the statute. Overstock.com, Inc. is a Utah-based company that likewise sells merchandise exclusively over the Internet but has no physical ties to New York state.

Each company, however, allows independent third parties to post Web site advertisements with links to their respective Web sites. Some of these Web site affiliates are located in New York State. Both online companies pay commissions to the third party Web site affiliates based on any sales to customers who accessed the Web site using the affiliate's link.¹¹ The independent Web site affiliate does not solicit or consummate sales on behalf of either Amazon.com or Overstock.com, and neither company authorizes the Web site affiliate to act as an agent or representative on its behalf. In each case, the online seller alleged that the statute violates the Commerce Clause of the U.S. Constitution because it imposes tax obligations on companies that

lack “substantial nexus” in New York. Both sellers also challenged the statute on Due Process grounds, alleging that the presumption is functionally irrefutable and that the statute is unconstitutionally vague and overbroad. Factual allegations regarding the ability to rebut the statutory presumption are also similar. Each complaint alleges that once established, there is not an effective way to overcome the nexus presumption. Neither Amazon.com nor Overstock.com track the legal residence of Web site affiliates in their program. Although the Web site affiliates do provide contact information, including an address, each online seller asserts that it has no way of knowing whether the affiliates are legal residents of New York, as defined in the Department’s Memorandum. More importantly, each complaint asserts that, because Web sites are not location specific and because the presumption extends to “indirect” solicitation as well, it is impossible to determine whether New York Web site affiliates are, in fact, soliciting New York customers.

Conclusion

All eyes will be on New York as these cases unfold. In the meantime, Internet sellers with similar Web site linking arrangements should be prepared for enforcement efforts if they are not registered and collecting tax in New York.

Addendum

Update on Web Site Linking: New York Issues Additional Information for Rebutting Statutory Presumption

Developments involving the New York nexus presumption just keep unfolding! On June 30, 2008, the New York Department of Taxation and Finance’s Office of Tax Policy Analysis, Taxpayer Guidance Division, issued a second memorandum designed to provide additional information as to how sellers can rebut the new nexus presumption. See, TSB-M-08(3.1)S (N.Y. Dept. of Tax. June 30, 2008). The memorandum sets forth the specific steps that Internet sellers must take in order to properly rebut the presumption of nexus based on Web site linking arrangements.

According to the Department’s initial Taxpayer Guidance Memorandum, New York residents that merely display a Web site link to the seller’s Web site will not create nexus for the out-of-state Internet seller, so long as the resident does not engage in any solicitation targeted to New York residents. Due to the operation of the new statutory presumption, however, a seller that has linking arrangements with New York residents and that meets the \$10,000 sales threshold will be presumed to have nexus, even if its only contact is the Web site link. In order to avoid nexus, therefore, the seller must rebut the presumption by proving—to the Department’s satisfaction—that its Web site affiliates do not engage in any solicitation on its behalf.

The new memorandum, TSB-M-08(3.1)S, Additional Information on How Sellers May Rebut the New Presumption Applicable to the Definition of Sales Tax Vendor as Described in TSB-M-08(3)S, lists the steps that such sellers must take to successfully

rebut nexus. These conditions include:

- (1) Contractual language prohibiting the New York Web site affiliate from engaging in any solicitation on the Internet seller's behalf; and
- (2) Proof of compliance in the form of a "signed certification" annually from each New York resident that displays a Web site link, certifying that the New York resident has done nothing other than display the Web site link.

Prohibited "solicitation" activities are very broad in scope and include any kind of activity in New York that refers potential customers to the out-of-state seller. The Department's listing includes, but is not limited to, distributing flyers, coupons, newsletters, etc., sending e-mails, initiating telephone calls or making in-person referrals, or distributing any printed promotional materials or electronic equivalents. To comply with the new standards, Internet sellers who have linking arrangements with New York residents must ensure that their contract specifically prohibits any additional promotional activities directed to New York customers. Clubs or other organizations that display Web site links must go even further—the organization's Web site must specifically indicate that members are prohibited from engaging in any solicitation or referral activities.

However, the contractual prohibition is not enough to rebut a presumption of nexus. The Internet seller must obtain and file a certificate *for each New York resident* that displays a Web site link, certifying that the Web site affiliate has not engaged in any promotional activities for the seller. The seller must file a new certificate annually and must alert its Web site affiliate that the information is subject to audit by the Department.

Once again, the Department's guidelines raise more questions than they answer. In addition to the overall constitutional problems that the presumption and its interpretation raises, this new interpretation raises some additional questions—How will this be upheld and enforced? Do these reporting requirements, standing alone, unduly burden interstate commerce? What about First Amendment issues?

Stay tuned ...

ENDNOTES

¹ Maryann B. Gall and Laura A. Kulwicki, Nexus News, *New York Proposes Aggressive New Steps to Expand Nexus*, J. STATE TAX'N, Mar.-Apr. 2008, at 5.

² New York S.B. 6807C, A.B. 9807C (Laws 2008) contained the legislation ultimately adopted in furtherance of the Fiscal Year 2008-09 Budget for the State of New York.

³ *Scripto, Inc. v. Carson*, SCt, 362 US 207 (1960).

⁴ *Tyler Pipe Industries v. Washington Dep't of Revenue*, SCt, 483 US 232 (1987).

⁵ TSB-M-08(3)S (May 8, 2008).

⁶ For example, nexus exists under the Department's interpretation if a New York resident directs customers to his or her own Web site (or another third-party Web site), if that Web site includes a link to the out-of-state seller's Web site.

⁷ For example, if the Internet seller's Web site address was disseminated in a nationally circulated magazine or via direct mail, such advertising would not be sufficient to create nexus.

⁸ See, e.g., *Quill Corp. v. North Dakota*, SCt, 504 US 298 (1992); *National Bellas Hess, Inc. v. Illinois Dep't of Revenue*, SCt, 386 US 753 (1967).

⁹ *Amazon.com, LLC, et. al v. New York State Dep't of Taxation and Finance*, No. 08601247 (N.Y. Sup. Ct., N.Y. County) (complaint filed April 25, 2008).

¹⁰ *Overstock.com, Inc. v. New York State Dep't of Taxation and Finance*, No. 107581 (N.Y. Sup. Ct., N.Y. County) (complaint filed May 30, 2008).

¹¹ Amazon.com has a traditional Web site affiliation program in which it directly contracts with, and administers, its relationship with third-party Web site affiliates. However, the application process, subsequent communications and resulting relationship takes place exclusively over the Internet.

Overstock.com's Web site affiliate program is managed by an independent third party called LinkShare. The third-party Web site affiliates enter into a relationship with LinkShare. LinkShare then facilitates the arrangement between Overstock.com and third-party Web site affiliates.

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