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The *Amazon* Decision: A New Nexus Standard for the Internet Age?

by Timothy P. Noonan, Christopher L. Doyle, and Daniel P. Kelly

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At long last, New York's highest appellate court has closed the book on the state's "Amazon" tax. On March 28, in *Amazon.com, LLC v. New York State Department of Taxation and Finance*, the Court of Appeals found New York's Amazon tax constitutional, ending (at least for now) a multiyear challenge from two of the Internet's biggest names: Amazon.com and Overstock.com.[1] The importance of the court of appeals' decision is magnified because since New York enacted Tax Law section 1101(b)(8)(vi) in 2008, at least eight other states passed their own iterations, and many more have proposed similar laws. And the decision could pave the way for an overhaul of the physical-presence nexus standard altogether. This article will serve as an overview of the court of appeals' decision and some of the other major decisions in this area, with an eye toward the practical implications of the court's opinion.

Background

Under the commerce clause of the U.S. Constitution, if a state wants to force an out-of-state seller to collect and remit the state's sales and use tax, the seller must have "substantial nexus," among other criteria, with the taxing state.[2] As all our readers know, in *Quill v. North Dakota*,[3] the U.S. Supreme Court determined that substantial nexus required an out-of-state seller to have a physical presence in the taxing state before the taxing state could require the seller to collect and remit its use tax. If a seller's only connection with a state were through a common carrier or the U.S. Postal Service, that contact wouldn't be enough. New York courts have said that physical presence can be met with "demonstrably more than a 'slightest presence.'"[4]

In New York every seller who is a vendor under the Tax Law must register with the state for sales tax purposes and is required to collect and remit the state's sales tax on the vendor's taxable sales in the state. A vendor includes, among other things, "a person who regularly or systematically solicits business in [New York] if such solicitation satisfies the nexus requirement of the United States constitution."[5] Tax Law section 1101(b)(8)(vi), the provision challenged in *Amazon*, expanded the definition of vendor for sales tax purposes, essentially creating a presumption of vendor status for certain out-of-state

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[1]2013 N.Y. Lexis 542, 2013 N.Y. Slip. Op. 2102 (2013).

[2]*Moran Towing Corp. v. Urbach*, 99 N.Y.2d 443, 449 (2003), quoting *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977).

[3]*See Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

[4]*See Orvis Co. v. Tax Appeals Tribunal*, 86 N.Y.2d 165, (1995) ("While a physical presence of the vendor is required, it need not be substantial. Rather, it must be demonstrably more than a 'slightest presence' [citation omitted]. And it may be manifested by the presence in the taxing State of the vendor's property or the conduct of economic activities in the taxing State performed by the vendor's personnel or on its behalf."); *cf. Scripto, Inc. v. Carson*, 362 U.S. 207 (1960) (in-state solicitation on behalf of an out-of-state seller by independent contractors constituted sufficient nexus to require the out-of-state seller to collect and remit Florida use tax).

[5]Tax Law section 1101(b)(8)(i)(E). Although that particular section of the Tax Law seems unconstitutionally vague, the plaintiffs did not argue the point.

sellers. That section provides that a seller of taxable tangible personal property or services shall be *presumed* to be soliciting business through an independent contractor or other representative (that is, that the seller has nexus in New York) if:

- the seller 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; and
- the cumulative gross receipts from sales by the seller to customers in the state who are referred to the seller by those residents with that type of an agreement exceeds $10,000 during the preceding four sales tax calendar quarters.

That statutory presumption of solicitation may, however, be rebutted. Rebuttal requires the seller to prove "that the resident with whom the seller has an agreement did not engage in any solicitation in the state on behalf of the seller that would satisfy the nexus requirement of the United States Constitution during the four quarterly periods in question."[6]

Shortly after the enactment of section 1101(8)(b)(vi), the New York State Department of Taxation and Finance issued two Technical Service Bureau memoranda, advising taxpayers on the state's application of the new amendment. First, in TSB-M-08(3)(S) (May 8, 2008), the department clarified that *mere advertising* would not trigger the statutory presumption, and provided some detail on how the out-of-state sellers could rebut the presumption. The department noted, however:

> For this purpose, placing an advertisement does *not* include the placement of a link on a Web site that, directly or indirectly, links to the Web site of a seller, where the consideration for placing the link on the Web site is based on the volume of completed sales generated by the link.

Next, in TSB-M-08(3.1)S (June 30, 2008), the department elaborated on the procedure for an out-of-state seller to rebut the presumption, but only if two conditions are met: (1) there was a contractual prohibition forbidding the New York representatives of the out-of-state seller from engaging in solicitation in New York, and (2) every year the seller must collect from each of its New York representatives a statement of compliance that the representative has not engaged in the prohibited solicitation during the past year.

With the law and corresponding guidance in place, the stage was set for the consideration of what constitutes physical presence in the digital age.

[6]Tax Law section 1101(b)(8)(vi).

The Players

As detailed by the court of appeals in its opinion, Amazon.com and Overstock.com are both online retailers that don't maintain an office, pay employees, or own property in New York. Before 2008 neither of those companies had the required substantial nexus with New York, so that New York could require them to collect and remit New York's use tax.

As part of its business model, though, Amazon fostered a network of third parties that participated as independent contractors in its associates program. Those participants placed links on their own websites; when clicked, the links directed potential customers to Amazon. When the traffic directed by the associates resulted in sales, Amazon compensated the associates with a commission. Overstock has a similar affiliates program.

The History of the Case

In 2008 Amazon and Overstock initially posited that Tax Law section 1101(8)(b)(vi) was facially unconstitutional because it violated the physical presence standard for substantial nexus, as mandated by the commerce clause, and it was unconstitutional "as applied" to both Amazon and Overstock. Also, the parties argued that the amendment violated their due process rights because the presumption of solicitation imposed by the amendment was both irrational and irrebuttable.

The New York Supreme Court granted the tax department's motions to dismiss, at the same time rejecting all of the plaintiff's constitutional arguments against section 1101(8)(b)(vi).[7] On appeal, the Appellate Division, First Department, affirmed the lower court on the facial constitutional challenges, but reinstated the as-applied challenges, refusing to dismiss them without a fuller development of the facts.[8] Instead of going back down to the trial court for a hearing on the merits of the as-applied question, however, the plaintiffs abandoned the as-applied challenges and went straight to New York's high court on only the facial constitutionality matters. Perhaps some observers are left to wonder why Amazon and Overstock left their as-applied challenges to section 1101(8)(b)(vi) on the table. It's certainly possible the parties realized an as-applied error is easier for the State Legislature to cure than a facial constitutional challenge to the law. Or it's possible that the taxpayers' as-applied facts really weren't all that good. And of course, since New York created this so-called Amazon tax, many states have jumped on the bandwagon. Getting this question

[7]*See Amazon.com, LLC v. New York State Dep't of Taxation and Fin.*, 23 Misc. 3d 418 (Sup. Ct. N.Y. County 2009).

[8]*Amazon.com, LLC v. New York State Dep't of Taxation and Fin.*, 81 A.D.3d 183 (1st Dep't 2010).

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and case in front of the U.S. Supreme Court quickly may have been viewed as a more favorable solution for Amazon and Overstock than an ephemeral victory through an as-applied challenge.[9]

The Decision

Regarding the plaintiffs' facial challenge of section 1101(8)(b)(vi) based on its violation of the commerce clause's substantial nexus requirement, the court of appeals majority opinion stated that "the statute plainly satisfies the substantial nexus requirement. Active, in-state solicitation that produces a significant amount of revenue qualifies as 'demonstrably more than a slightest presence' under *Orvis.*" The court of appeals noted how the Amazon Associates and Overstock affiliates — even if they were only local religious groups, radio stations, or schools — had essentially become local sales forces at work in New York, actively soliciting business (and creating the proper grounds for tax nexus) on behalf of the Internet sellers.

The plaintiffs also argued that section 1101(8)(b)(vi) was facially invalid on due process grounds because (1) the presumption of solicitation the statute creates is essentially irrebuttable and (2) section 1101(8)(b)(vi)'s presumption of solicitation lacks a rational basis.[10] The court of appeals applied the standard for constitutional validity that "there must be 'a rational connection between the facts proven and the fact presumed, and . . . a fair opportunity for the opposing party to make [a] defense.'"[11]

As the court of appeals pointed out, the "fact proved" is that the New York resident is compensated for referrals to Amazon or Overstock (or any online retailer that met the requirements of the law), and the "fact presumed" is that at least some of the compensated residents will actively solicit referrals from other New Yorkers, which will increase their own compensation.[12] In finding section 1101(8)(b)(vi)'s presumption constitutional, the majority concluded that there indeed was a rational connection between those two facts:

> More specifically, it is not unreasonable to presume that affiliated website owners residing in New York State will reach out to their New York friends, relatives and other local individuals in order to accomplish [the increase of referrals, and therefore compensation].[13]

And although the court conceded that advertising alone does not rise to the level of substantial nexus required by the commerce clause for a state to require a remote seller to collect and remit its sales taxes, the court seemed to accept the Legislature's supposition that commission-compensated activities were more likely to be solicitation than advertising: "the presumption would appear decidedly less rational if it were applied to those who receive some types of 'other consideration' — *i.e.*, those whose compensation is unrelated to actual sales."[14] The plaintiffs also argued the presumption was irrebuttable because it was so difficult — and bordered on impossible — to prove that none of their New York affiliates were soliciting business on their behalf. But the court noted that the tax department had set up, as discussed above, a method for rebutting the presumption. And even if the method was an inconvenience, it was enough to block the plaintiffs' argument.[15]

Amazon and Overstock could have also made a void-for-vagueness constitutional argument centering on the statutory rebuttal of the nexus presumption. The law allows a seller to rebut the presumption of nexus by having an agreement with the in-state affiliate to not engage in any solicitation in the state on behalf of the seller "that would satisfy the nexus requirement of the United States constitution." If the Legislature can't describe the required proof more precisely, how can taxpayers conform their behavior to follow it? Is it fair and reasonable to require Internet retailers to apply a highly nuanced constitutional law analysis to the actions of everyone who provides a link to their websites?

Whatever the case, the majority opinion also includes an interesting "invitation" to the U.S. Supreme Court:

> The world has changed dramatically [since *Quill*] and it may be that the physical presence test is outdated. An entity may now have a profound impact upon a foreign jurisdiction solely through its virtual projection via the Internet. That question, however, would be for the United States Supreme Court to consider.

So the court of appeals explicitly acknowledged that a decision to get rid of the physical presence test was above its pay grade. That could set up another *Quill*-type challenge at the Supreme Court. Of course, it's also possible that Congress could jump to the front of the line and spoil all the fun for everybody. Indeed, only a few days before the court of

[9]And, of course, as-applied questions may often be cured through minor changes to the statute. It is logical to assume that the plaintiffs wanted the concept of those laws invalidated, and a successful as-applied challenge would not have accomplished that result.

[10]*Amazon, supra note* 1.

[11]*Id.* at *13, *supra* note 1, quoting *Matter of Casse v. New York State Racing & Wagering Bd.*, 70 N.Y.2d 589, 595 (1987).

[12]*Id.* at *13-*14.

[13]*Id.* at *14.

[14]*Id.*

[15]*Id.* at *15.

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appeals issued its decision, 75 U.S. senators announced their support for the Marketplace Fairness Act of 2013, a bill that would provide a federal solution to the state substantial nexus problem.[16]

The Dissent

Dissenting Justice Robert S. Smith agreed with the majority's cited legal standards, but took issue with their conclusions. Smith posited that the presumption established by section 1101(8)(b)(vi) "tries to turn advertising media into an in-state sales force."[17] The dissent raises several valid points, including that the website links in question are not soliciting sales like a local sales agent would be but are more akin to an advertisement that an out-of-state seller would place in a local newspaper. The dissent also notes that although the associates and affiliates are paid on a commission and not a flat fee (and therefore appear more like sales agents), the practicalities of the modern Internet and the efficiencies allowed through results-based compensation for advertising mean that the associates and affiliates should be able to receive a commission based on results, while still viewing the link as "only an ad."[18]

Conclusion

New York's highest court has found the country's first Amazon tax to be facially constitutional. The effect, of course, is not limited to New York, given the prevalence of Amazon laws around the nation. The court of appeals' opinion will certainly be persuasive authority for states hoping to defend their own nexus-creating laws when the out-of-state retailer's only physical presence in the taxing state is through associates and affiliates like those used by Amazon and Overstock. And of course, with the court explicitly inviting the U.S. Supreme Court to revisit the physical presence test, this case could have even broader implications, and change the way nexus is viewed in the new Internet-fueled economy. So stay tuned. The final resolution of this case and its nexus implications may still be on the horizon. ✰

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[16] *See generally*, press release of Sen. Richard J. Durbin: "Marketplace Fairness Act Receives Overwhelming Bipartisan Support in Senate Vote."

[17] *Amazon*, at *19.

[18] *Amazon*, at *20.

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