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Merchants and Affiliates Struggle to Navigate New York's 'Amazon Law'

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The pages of this magazine have been abuzz of late over New York's controversial "Amazon law" and its implications, as the new affiliate-nexus concept spreads from New York onto the national stage. But as the academic issues of constitutionality and policy move their way through the forest canopy above, the more immediate ramifications of the Amazon tax are playing themselves out at ground level. With the rules effective in New York for nearly a year, online merchants and their New York affiliates struggling to cope within the new regime are finding themselves in uncharted territory -- as forbidding as the Amazon itself.

In our practice over the past year, we've had a chance to witness, firsthand, the practical consequences of the Amazon tax — from the perspective not only of the out-of-state retailers now potentially liable for New York sales tax, but also of New York's affiliate business community, whose livelihood depends on those retailers.

The most dramatic result has been an unmistakable exodus of merchants away from their dealings with New York affiliates. One respected online discussion forum for the New York affiliate community has kept an ongoing list — a requiem of sorts — of each out-of-state merchant that has severed all ties with New York affiliates since the tax policy was initiated. Those merchants that have not simply dropped their New York affiliates outright are confronting many legal and practical difficulties in continuing their affiliate programs in New York. Affiliates themselves, meanwhile, are fighting to stay afloat.

The Affiliate Industry — Caught in the Net

But before delving deeper into the issue, perhaps it would help to describe the industry we're talking about. Who are these affiliates? Many of us were not familiar with that industry in November 2007, when the New York State Department of Taxation and Finance first announced its policy that "remote sellers" will be presumed to have the requisite physical presence (and thus sales tax nexus) if they paid commissions to in-state affiliates that provided links from their Web sites to the sellers' Web sites.[1] The initial policy memorandum gave several examples of the type of relationship covered by the policy:

- A ski club in New York provides a link on its website to the website of an out-of-state, Internet-based sporting goods retailer, allowing club members to purchase skiing equipment there. In exchange, the ski club receives a commission for any sale ultimately made by use of that link.

- A New York-based author of a kayaking guidebook provides a link on his website to an Internet-based bookseller, allowing potential readers to purchase his book online. In exchange, the author is paid a commission on any sales generated through use of the link.

Although quaint, those examples don't really capture the true essence of the affiliate-marketing industry. In reality, the industry is composed in large part of persons who create and maintain Web sites with the overriding purpose of tapping into the stream of revenue created by affiliate marketing. For example, I, Tim Noonan, have eight kids (no kidding, I really do), so I know a thing or two about toys, diapers, and other kid-related stuff. Suppose I decided to start NoonansNursery.com, a Web site with some content, like parenting tips and helpful links to other parenting-related sites. I probably wouldn't be able to persuade Amazon.com to buy advertising on my fledgling site (that is, a "banner ad" linking to its own site). However, Amazon.com could place the same banner ad on my site and have to pay me only when and if sales result from people using the link. Once I have a viable Web site, I can fill it with as many of those links

as there are merchants willing to sign me up. Large nationwide affiliate networks specialize in linking merchants with appropriate affiliates. And because it costs merchants nothing other than a percentage of sales to use those affiliates, it's an alluring prospect for both parties.

In that context, it isn't hard to see why New York state might adopt a presumption that those affiliates, motivated by the desire to earn commissions, might engage in additional promotional activities on behalf of a remote retailer on its site. It's the commission arrangement that distinguishes the affiliate relationship from mere advertising, which normally would not trigger nexus for an out-of-state company. And that's what the Amazon tax is -- a rebuttable *presumption* that a merchant who enters into commission-based arrangements with New York affiliates is "soliciting business through independent contractors or other representatives."[2]

Rebutting the Nexus Presumption

"Rebuttable" is the crucial word for those merchants that haven't given up on the prospects of marketing through New York affiliates. In a policy memorandum released shortly after the adoption of the Amazon tax legislation, the tax department clarified that the department:

will deem the presumption rebutted where the seller is able to establish that the only activity of its resident representatives in New York State on behalf of the seller is a link provided on the representative's web sites to the seller's Web site and none of its resident representatives engage in any solicitation activity in the state targeted at potential New York State customers on behalf of the seller.[3]

Tax Law section 1101(b)(8)(vi) states that what merchants need to prove is that they did not engage in any solicitation in the state on behalf of the seller "that would satisfy the nexus requirements of the United States Constitution." Thus, by its own terms, the Amazon law concedes that providing a Web site link for commission-based consideration is not a nexus-producing activity in and of itself.

In sum, if affiliates treat a merchant's link as equivalent to advertising space and merchants can prove to the tax department that their New York affiliates did not engage in any additional solicitation activities on behalf of the merchant, no harm, no foul, and no nexus. Indeed, the tax department in May 2008 issued what is essentially a safe harbor for merchants and affiliates to follow to effectively rebut the presumption of nexus. The memorandum is titled, appropriately enough, "Additional Information on How Sellers May Rebut the New Presumption Applicable to the Definition of Sales Tax Vendor."[4]

Safe Harbor -- How Safe?

That gesture, however, has not reversed online retailers' exodus away from New York affiliate relationships, and at least one large affiliate *network* has already closed its doors to participation by affiliates residing in New York. New York affiliate groups have been working exhaustively to show the tax department guidance to merchants in hopes of luring them back with the promise of what, on its face, looks like a fairly simple two-step process by which merchants can protect themselves from sales tax liability. The memorandum, TSB-M-08(3.1)S, sets forth two requirements for merchants to prove that their relationships with affiliates, or "resident representatives," did not amount to nexus-producing solicitation activity.

First, the contract or agreement between merchant and affiliate must include language prohibiting the affiliate from: engaging in any solicitation activities in New York State that refer potential customers to the seller including, but not limited to: distributing flyers, coupons, newsletters and other printed materials or electronic equivalents; verbal solicitation (e.g., in-person referrals); initiating telephone calls; and sending e-mails.

Affiliates that are clubs or organizations with members (like a ski club, for example) must post language on their Web sites warning members themselves not to engage in any of the prohibited activities.

But having that contractual prohibition is insufficient, by itself, to rebut the presumption. The second requirement is that the merchant obtain and keep signed certifications annually from each and every New York resident affiliate, saying that the affiliate has not engaged in any "prohibited" solicitation activities in New York on behalf of the merchant. So rebutting the presumption, according to New York state, is really just a matter of meeting a contractual condition and a proof-of-compliance condition.

But for retail behemoths like Amazon.com and Overstock.com that risk millions of dollars in tax liability to New York, not to mention a loss of their competitive advantage, placing their entire tax status at the mercy of individual affiliates is still tough to swallow. That is why the affiliate industry's efforts to make merchants aware of the safe harbor have failed to win back many of the retailers that have severed their ties with their New York affiliates. Other merchants, however, have been willing to continue (or at least consider continuing) their affiliate programs in New York. Our office has fielded a stream of calls from out-of-state merchants, wondering, among other things, "Just how safe is this safe harbor?"
In working with retailers and affiliate groups within the confines of the Amazon law, we've encountered many legal and logistical difficulties with what otherwise would seem like a simple framework. Here in the trenches, the focus is on how to comply with TSB-M-08(3.1)S. Although a contractual provision prohibiting solicitation is easy enough to insert into an affiliate agreement or contract, satisfying the proof-of-compliance prong is not as simple. The following are some of the questions that have emerged in our work with merchants on the Amazon tax and the state's guidance on avoiding nexus.

What Constitutes 'Solicitation' for a Web Site Operator?

The guidance makes it clear that distributing flyers or coupons to draw people to the merchant's link constitutes solicitation. The same goes for soliciting by phone, e-mail, or in person. Obviously, any promotions appearing on the affiliate's Web site itself beckoning visitors to link to a merchant would also be problematic. But would merely posting some text below the link describing the merchant be considered solicitation on behalf of that merchant? And what about the affiliate's ability to actively promote its own Web site? Would the affiliate inadvertently expose a merchant to nexus if it ran aggressive rampant promotions to draw visitors to its own Web site, even if it did so without reference to specific links or merchants? Since this is still uncharted territory, the answers are unclear.

What if Affiliates Provide the Required Certification of Compliance but Lie About Their Promotional Activities During the Year?

To prove affiliates have complied with the requisite prohibitions against solicitation, merchants are required to obtain and keep signed certifications from all New York resident affiliates. TSB-M-08(3.1)S says that a merchant will have satisfied the proof-of-compliance condition if it accepts completed certificates from all resident affiliates in "good faith (that is, the seller does not know of or have reason to know that any of the certifications are false or fraudulent)." That is similar to the good-faith-acceptance standard applicable to sales-tax exemption certificates (that is, resale certificates). Presumably, a retailer having no knowledge that one or more of its associates has "gone rogue" would be protected. But what happens when a merchant discovers an affiliate's solicitation activities during the middle of the tax year? Is it sufficient to drop the affiliate immediately, or has the damage been done? More importantly, are the activities of one noncompliant affiliate sufficient to create nexus for a merchant, despite scores of compliant ones? We've already seen from the statute that a mere $10,000 in cumulative sales is sufficient to create nexus under the presumption,[5] so it wouldn't be out of line to suspect a similar threshold for affiliate activity. Again, that type of uncertainty only exacerbates the anxiety for out-of-state merchants seeking a way to do business through affiliates.

What Happens if Some Affiliates Fail to Return Their Compliance Certificates?

The tax department acknowledges that a merchant may be unable to obtain a certification from each and every affiliate, but the guidance is vague on the consequences. TSB-M-08(3.1)S says that "In weighing the significance of the seller's reliance on certifications from fewer than all its New York resident representatives, the Tax Department will apply the standards for constitutional nexus set forth in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992) and *Orvis Co. v. Tax Appeals Tribunal*, 86 N.Y.2d 165 (1995)." Translation? It would appear that if the seller lacks certifications from all its New York resident affiliates, goodbye safe harbor. The nexus standard emerging from the *Quill* and *Orvis* cases is, of

course, that an out-of-state merchant must have at least some physical presence in New York state to be subject to sales tax liability. But New York has already deemed affiliate arrangements as presumably meeting the standard for an out-of-state retailer; thus the guidance is not very helpful here.

What Happens if an Affiliate Misrepresents Being a 'Resident' of New York?

This issue is critical for two reasons. For one, if an affiliate represents to a merchant that it is not a resident of New York, it may not be asked to sign a contractual prohibition against solicitation. Secondly, even if the merchant's contract or agreement for all affiliates contains the New York prohibition, the "nonresident" affiliate will presumably not complete a compliance certificate for the merchant's records as proof it did not engage in prohibited solicitation in New York.

That situation is not limited to cases in which the affiliate has lied about its residency: The definition of a "resident" in the sales-and-use-tax context can be difficult to understand in the context of the affiliate industry. For example, an individual is a resident for use tax purposes if he maintains a permanent place of abode in New York.[6] However, a corporation or other business entity need not maintain a place of business in New York to be a resident; rather, it can be deemed a resident merely by being "engaged in any manner in carrying on . . . any employment, trade, business or profession in New York."[7] Thus, an affiliate based in Portland, Ore., could technically be a New York "resident" affiliate by virtue of carrying on some form of business in New York but not realize it for the purposes of signing an affiliate agreement. Specific contractual provisions are necessary to protect merchants from such scenarios.

Finally, merchants are on their own when it comes to what form those all-important compliance certificates take. Although TSB-M- 08(3.1)S provides what they must contain, the memorandum also says that the tax department would provide an appropriate form for those purposes. It has yet to do so.

Conclusion

The Amazon tax law has turned what was previously an innocuous marketing arrangement between online merchants and their New York affiliates into a high-stakes game for out-of-state retailers. Those merchants who have opted to remain in the game and work with affiliates in New York are finding that the road map provided by the tax department in the form of TSB-M-08(3.1)S is not a sure way out of the thicket the state has created. As we've seen in practice, navigating the Amazon law involves more than following the two steps offered by the department for rebutting the presumption of nexus. Merchants must take extra precautions not only in their agreements with New York affiliates, but also in their selection of affiliates to work with.

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FOOTNOTES

[1] The policy was first broached by the Tax Department in Technical Services Bureau Memorandum, TSB-M-07(6), Nov. 9, 2007. A week later the memorandum (and thus the policy) was withdrawn at the orders of then-Gov. Eliot Spitzer, only to resurface as proposed legislation in the 2008-2009 New York State budget. The law is now codified in N.Y. Tax Code section 1101(b)(8)(vi).
[2] Tax Law section 1101(b)(8)(vi). A "vendor" for general sales tax purposes includes a "person who solicits business by employees, independent contractors, agents or other representatives." Tax Law section 1101(b)(8)(i)(C).
[3] New York Technical Service Bureau Memorandum No. TSB-M-08(3)S, May 5, 2008.
[4] New York Technical Service Bureau Memorandum No. TSB-M-08(3.1)S, June. 30, 2008.
[5] See Tax Law section 1101(b)(8)(vi).
[6] 20 NYCRR section 526.15(a).
[7] 20 NYCRR section 526.15(b).

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