

November 8, 2010

Litigation Challenging New York's Controversial Nexus Statute Continues

On November 4, an appellate court held that the New York affiliate nexus law does not violate the Equal Protection Clause and is facially constitutional under the Due Process and Commerce Clauses. However, the court remanded the case to further explore whether the New York law violates the Due Process and Commerce Clauses as applied to the taxpayer.¹ As summarized in a previous [A Pinch of SALT column](#), New York amended its tax law in 2008 to impose a sales and use tax collection requirement on out-of-state sellers who engage a New York resident to solicit business through an Internet Web site (New York's "click-through nexus statute").² Amazon.com LLC, its affiliate Amazon Services LLC, and Overstock.com, Inc. (Plaintiffs) filed declaratory judgment actions challenging the law. A lower court dismissed the complaints in their entirety, and the Plaintiffs appealed.

Background

The Plaintiffs had entered into agreements with associates located throughout the United States, including New York. These agreements compensated the associates based on a percentage of sales referred to the Plaintiffs. The Plaintiffs filed complaints seeking declaratory and injunctive relief that the click-through nexus statute was unconstitutional, both facially, and as applied to them, under the Commerce, Due Process, and Equal Protection Clauses of the U.S. Constitution.³ A lower court dismissed the complaints in their entirety, and the Plaintiffs appealed. In the interim, Overstock severed its relationships with its New York associates, and Amazon.com began to collect New York sales and use taxes.

Ripeness

As a gateway issue, the court rejected the state's claim that the lawsuit was not ripe because the state had not assessed the Plaintiffs nor had the Plaintiffs exhausted their administrative remedies. Because the state had made clear that it intended to enforce the click-through nexus statute on the Plaintiffs and that the harm of the enforcement was "direct and immediate," the claims, including the as-applied claims, were ripe. Further, the Appellate Division held that when a taxpayer is challenging the constitutionality of a statute, there is not a requirement that the taxpayer exhaust its administrative remedies.

Facial Challenges

The Appellate Division rejected the Plaintiffs' challenges that the click-through nexus statute is facially unconstitutional noting that the Plaintiffs must meet the heavy burden of showing that no set of

¹ *Amazon.com LLC, et al. v. New York State Department of Taxation and Finance, et al & Overstock.com, Inc v. New York State Department of Taxation and Finance, et al.*, 2010 NY Slip Opinion 07823 (1st Dept. App. November 4, 2010)

² N.Y. Tax Law § 1101(b)(8)(vi).

³ The Plaintiffs originally also asserted unconstitutionality under the state constitution, but the denial of those claims was not appealed.

circumstances exist under which the click-through nexus statute would be valid. Moreover, the Plaintiffs would have to prove the invalidity “beyond a reasonable doubt.”

Commerce Clause

The Appellate Division determined that the statute did not violate the Commerce Clause on its face. The court refused to find that the click-through nexus statute facially violated the substantial nexus requirement of the dormant Commerce Clause: “[the click-through nexus statute] imposes a tax collection obligation on an out-of-state vendor only where the vendor enters into a business-referral agreement with a New York State resident, and only when that resident receives a commission based on a sale in New York. The statute does not target the out-of-state vendor’s sales through agents who are not New York residents. Thus, the nexus requirement is satisfied.”

Sutherland Observation: The court draws an interesting, and perhaps challengeable, distinction between solicitation and passive advertising. Further, the court noted that the state will not enforce tax collection if the out-of-state seller puts in place a written agreement with its New York associates that prohibits the associates from “engaging in any solicitation activities in New York State that refer potential customers to the seller.”

The Appellate Division determined that the limited discovery of the Plaintiffs’ relationships with New York affiliates did not satisfy the substantial nexus requirement of the dormant Commerce Clause. Because the record lacked sufficient evidence of the scope of the affiliates’ duties, it was impossible to conclude as a matter of law that the Plaintiffs’ in-state representatives were engaged in activity that was sufficiently meaningful to implicate the state’s taxing powers. Therefore, the Appellate Division found that the Plaintiffs should be given the opportunity to develop a record establishing actually, rather than theoretically, whether their representatives were soliciting business or merely advertising on their behalf.

Furthermore, the Appellate Division determined that it could not rule on whether the in-state representatives were engaged in activities that were “significantly associated” with the out-of-state retailer’s ability to do business in the state. Whether the Plaintiffs could meet their burden, the Appellate Division said, remained to be seen.

Sutherland Observation: The click-through nexus statute imposes a “guilty until proven innocent” burden on taxpayers. The law requires taxpayers to prove that they do not have nexus, rather than forcing the state to prove the taxpayers are taxable. This burden is a heavy one because taxpayers have to prove the absence of activities, or have to get certifications from all of their affiliates that they are not engaged in solicitation, rather than requiring the state to review a sample of those activities to determine if solicitation is occurring.

Due Process

The Appellate Division rejected the claim that the statute was facially unconstitutional under the Due Process Clause. The Plaintiffs asserted that the statute violates due process because it creates an irrebuttable presumption that it had nexus.

The Appellate Division determined that the presumption is not irrebuttable, because: “Both the out-of-state vendor and the in-state representative seek, quite frankly, to make money. It is not irrational to

presume that the in-state representative will engage in various legal methods to enhance earnings. Advertising would be one of those methods, but mere advertising does not implicate the statute. Solicitation, however, in varying forms, is another extremely plausible and likely avenue by which any competent businessperson would seek to improve revenues.”

Sutherland Observation: In ruling that the statute was constitutional, the Appellate Division provided additional guidance about its definition of “solicitation.” The Appellate Division affirmed that any activity that is “geared to the public at large” is not a solicitation, nor is the “maintenance of a Web site which the visitor must reach on his or her own initiative.” However, the Appellate Division stated that an e-mail is no different than a telephone call or a mailing to a customer. “Both constitute active initiatives by a party seeking to generate business by pursuing a sale.”

As Applied

Due Process

The Plaintiffs also argued that the statute was irrational and unfair as it irrebuttably applied to them. The Appellate Division opened the door to further argument on this point. The court did state that the determining factor is whether it would be irrational to conclude that the Plaintiffs’ agreements with New York-based Web sites is sufficient to establish nexus. The court noted that there is strong evidence in favor of this presumption, but remanded for further discovery to give the Plaintiffs an opportunity to develop a record that their in-state representatives limit their activities to advertising on New York-based sites.

Equal Protection Clause

Amazon contended that the statute violated the Equal Protection Clause as applied to them, because it treated them differently from (1) out-of-state retailers who advertise in New York but do not use a mechanism similar to Amazon’s associates program, and (2) out-of-state retailers who do advertise in New York and do utilize a similar program but who compensate their advertisers with a flat fee or on a “pay-per-click” model.

The Appellate Division concluded that Amazon failed to establish a viable equal protection claim. First, it could not claim that it was being exclusively targeted, because it was being treated exactly the same as Overstock. Second, Amazon could not establish that it was treated differently from out-of-state retailers that lack an affiliates program, because those retailers are not similarly situated. Amazon’s first example involved businesses that do not directly solicit but only advertise in media. The second example involved representatives who are paid for results that are less beneficial to the out-of-state vendor (referrals rather than actual sales). Thus, the Appellate Division ruled that there was no proof of an impermissible discriminatory motive.

Conclusion

Sutherland will continue to monitor state nexus challenges aimed at Internet retailers. For more information regarding this Legal Alert, please contact a Sutherland State and Local Tax attorney.



If you have any questions about this development, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

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