COMPETITIVE ENTERPRISE INSTITUTE

From *Overstock* to Overtaxed:

The Dubious Legality of State Click-Through Nexus Taxes

NOVEMBER 2014

Ryan Radia[*] & Hans Bader[†]

I. SUMMARY

As online shopping has boomed in recent years, several states have enacted legislation aimed at collecting sales taxes on their residents' purchases from out-of-state Internet retailers. Over a dozen states' tax laws now require out-of-state sellers that use "affiliates"—in-state Internet advertising partners—to collect sales taxes whenever one of their residents makes a purchase by clicking a link on an affiliate's website.

The push for "click-through" Internet sales taxes received a major boost in March 2013, when New York State's high court upheld that state's law in a split decision that the U.S. Supreme Court declined to review. States have since continued to enact similar tax laws, bolstered by the New York ruling. Most recently, in June 2014, New Jersey enacted its own click-through nexus tax modeled on the New York law.

However, the U.S. Supreme Court has held that the Constitution forbids states from taxing out-of-state businesses that lacks a "physical presence" in the taxing state. As this paper will show, affiliates do not meet this requirement. Therefore, Internet retailers and affiliate marketers who are burdened by these taxes should sue to enjoin their enforcement—and courts should invalidate state laws that tax out-of-state Internet retailers merely because they maintain in-state affiliates.

II. BACKGROUND

Among the many taxes levied in the United States, few pervade everyday life as much as sales taxes, which are typically collected whenever a consumer buys a taxable good or service. In 2013, state governments collected a combined $254 billion in sales tax revenue, amounting to 30 percent of total state tax collections.[1] Currently, 45 states tax the sales of most goods and some services.[2] Sales tax rates range from 5 to 9 percent of the sale price, with many states permitting local governments to impose additional sales taxes.[3]

The vast majority of goods consumed in each state are typically purchased in that state by its residents.[4] But as Americans have grown more mobile thanks to

---

* Associate Director of Technology Studies, Competitive Enterprise Institute, Washington, D.C.

† Senior Attorney, Competitive Enterprise Institute.

1. U.S. CENSUS BUREAU, STATE GOVERNMENT TAX COLLECTIONS SUMMARY REPORT: 2013, at 2-3 (2014), *available at* http://www2.census.gov/govs/statetax/2013stcreport.pdf. The data cover the fiscal year that ended in 2013; most states' fiscal years end on June 30. *Id.* at 1.

2. Scott Drenkard, *State and Local Sales Tax Rates in 2014* 1 (Tax Found. Fiscal Fact No. 420, Mar. 2014), *available at* http://taxfoundation.org/sites/taxfoundation.org/files/docs/FF420.pdf.

3. *Id.* at 2.

4. *See* Ward Hanson, *Discovering a Role Online: Brick-and-Mortar Retailers and the Internet*, in THE

cars and planes—and companies have increasingly availed themselves of interstate shipping and the Internet—an expanding share of goods are purchased and consumed in different states.[5] If individuals faithfully adhered to their respective states' tax laws, whether they purchased goods from a seller based locally or out-of-state would not affect how much each state collected in taxes.[6]

However, sales taxes are not always collected at the point of sale. If a resident of a state with a sales tax buys a taxable item from another state—or another country—to consume in her home state, she may be required to pay a similar tax, known as a "use tax," to her state's taxing authority.[7] Taxpayers are supposed to periodically report and pay use taxes for any eligible out-of-state purchases to their state.[8] To avoid so-called "double taxation" that discriminates against out-of-state sellers, states must allow individuals to offset their use tax by any amount paid in sales tax to another state.[9]

In reality, whether individuals comply with a tax depends in large part on the government's ability to enforce the tax. Because sales taxes are calculated, recorded, and collected by vendors each time they sell a taxable good,[10] individuals cannot evade the tax on a purchase unless the seller is a willing participant in the evasion, and large firms rarely flout their duty to collect sales taxes on eligible purchases.[11] After all, evading the tax runs the risk of a sting operation whereby the state taxing authority surreptitiously makes a large purchase and subsequently examines the company's financial records.[12]

INTERNET AND AMERICAN BUSINESS 235 (William Aspray & Paul E. Ceruzzi eds., 2008) (consumers spend significantly more at physical retail stores than on Internet shops).

5. *Id.*

6. Because most states collect use taxes on an annual basis, the timing of sales tax and use tax receipts often differs. *See* Jaime Klima, *Mom & Pop v. Dot-Com: A Disparity in Taxation Based on How You Shop?*, 2002 DUKE L. & TECH. R. 28, 34 (2002).

7. Charles E. McLure, Jr., *Taxation of Electronic Commerce: Economic Objectives, Technological Constraints, and Tax Laws*, 52 TAX L. REV. 269, 322 (1997) ("Fearing loss of revenue from out-of-state purchasing, which they could not tax for constitutional reasons, in the 1930s, states began imposing complementary use taxes (typically on the use, consumption, or storage of goods within the state).").

8. Klima, *supra* note 6, at 34.

9. *See* Reid S. Okimoto, *Close but No Cigar: Is a Use Tax Valid in a Gross Receipts Tax State Under the Supreme Court's Compensating Tax Doctrine?*, 62 TAX LAW. 1113, 1120 (2009) (citing Halliburton Oil Well Cementing Co. v. Reily, 373 U.S. 64, 70 (1963) (noting that "equal treatment for in-state and out-of-state taxpayers similarly situated is the condition precedent for a valid use tax on goods imported from out-of-state.")).

10. *See* JEROME HELLERSTEIN & WALTER HELLERSTEIN, STATE TAXATION ¶ 12.02 (3d ed. 1998 & Cum. Supp. 2014).

11. *See* Nathaniel T. Trelease, *Taxing Internet Sales: Bringing the Old Economy to the New Economy*, 32 COLO. LAW. 11, 12 (2003).

12. *See id.* at 13–14 (businesses that violate sales tax laws may face audits or shareholder lawsuits,

However, when a seller located in one state sells and ships goods to consumers in another state, the latter state cannot easily ascertain which of its residents purchased those goods—or how much each of them bought.[13] The onus to report and pay use taxes rests with individual consumers, and companies rarely volunteer customer information to faraway states. As a result, Americans routinely fail to pay the use taxes they owe.[14] In fact, many consumers do not even realize they are legally required to keep track of purchases from out-of-state sellers,[15] while states have generally shied away from conducting invasive audits of their residents that may uncover a few hundred—or a few thousand—dollars in missing tax revenues at most.[16] In the aggregate, states' inability to collect use taxes—and their reticence toward policing residents' online purchases—results in over $11 billion dollars annually in lost tax revenue, according to one estimate.[17]

Dismayed by this sizable and growing "tax gap,"[18] states are increasingly advocating laws that require online retailers to collect and remit sales taxes pursuant to the laws of each buyer's state of residence—regardless of whether the seller has offices or personnel in the state.[19] By requiring sellers to collect sales taxes in this manner, states will no longer need to rely on their residents' compliance to tax goods sold by out-of-state vendors for in-state consumption.

But states cannot simply impose this mandate on businesses nationwide without Congress' permission, for the U.S. Constitution confers upon Congress the

---

while responsible officers may face personal liability for back taxes.)

13. *See* Michael J. Payne, *Selling the Main Street Fairness Act: A Viable Solution to the Internet Sales Tax Problem*, 44 ARIZ. ST. L.J. 927, 950–51 (2012) (discussing burdens of requiring consumers to track each online purchase and the amount, if any, collected in sales tax for each purchase).

14. *See, e.g.*, Scott W. Gaylord & Andrew J. Haile, *Constitutional Threats in the E-Commerce Jungle: First Amendment and Dormant Commerce Clause Limits on Amazon Laws and Use Tax Reporting Statutes*, 89 N.C. L. REV. 2011, 2022 (2011) ("[I]n 2008, only 2.5% of North Carolinians who filed state income tax returns reported owing any use tax.").

15. H.R. REP. No. 107-240, at 37 (2001) (statement of Rep. Sensenbrenner), *available at* http://beta.congress.gov/107/crpt/hrpt240/CRPT-107hrpt240.pdf. ("[T]he use tax … is probably the most ignored tax on the books.")

16. *Id.*

17. *See* DONALD BRUCE ET AL., STATE AND LOCAL GOVERNMENT SALES TAX REVENUE LOSSES FROM ELECTRONIC COMMERCE 7 (2009), *available at* http://cber.utk.edu/ecomm/ecom0409.pdf.

18. The "tax gap" refers to the difference between the amount of taxes legally owned to the government, and the amount the government actually collects in taxes. *See* Maricel P. Montano, *Can Widening the Scope of Information Reporting to Include Income Derived from Online Sales Help to Narrow the Expanding Tax Gap?*, 83 S. CAL. L. REV. 379, 381–82 (2010).

19. Scott T. Allen, *Adapting to the Internet: Why Legislation Is Needed to Address the Preference for Online Sales That Deprives States of Tax Revenue*, 66 TAX LAW. 939, 939–42 (2013) (a coalition that includes groups representing "state and local governments and large brick-and-mortar retailers" is advocating federal legislation "to allow states to require that all Internet sellers charge sales and use taxes to customers and remit taxes owed to the respective states").

power to regulate interstate commerce.[20] If a state levies taxes—or the burden of collecting taxes on its behalf—on interstate sales, it can do so only if there exists "some definite link … between a state and the person, property or transaction it seeks to tax."[21]

Over the past several years, states and several large retailers have aggressively lobbied Congress to pass legislation to allow states to collect sales taxes from remote vendors.[22] One prominent legislative proposal to this end, the Marketplace Fairness Act (MFA), passed the U.S. Senate in May 2013.[23] The bill has stalled in committee in the House of Representatives,[24] where the House Judiciary Committee is taking its time deliberating on the bill since unveiling a list of "basic principles" regarding Internet sales taxes in September 2013.[25]

MFA would overcome the Commerce Clause's limits on state action by giving states Congress' permission to collect taxes from remote sellers. As the Supreme Court has held:

> If Congress ordains that the States may freely regulate an aspect of interstate commerce, any action taken by a State within the scope of the congressional authorization is rendered invulnerable to Commerce Clause challenge.[26]

Thus, MFA would approve an interstate compact—the Streamlined Sales and Use Tax Agreement (SSUTA)—that any state could join if it wished to collect taxes from out-of-state retailers.[27] MFA would also authorize a state that is not

---

20. U.S. CONST. art. I, § 8, cl. 3. As the Supreme Court has long recognized, it follows from this clause that the "power to regulate [interstate] commerce … is exclusively vested in Congress, and no part of it can be exercised by a State." Gibbons v. Ogden, 22 U.S. 1, 3 (1824).

21. Miller Bros. Co. v. Maryland, 347 U.S. 340, 344–45 (1954).

22. *See, e.g.*, Gregory Korte, *Sales Tax Legislation on Retailers' Shopping List*, USA TODAY (Nov. 28, 2013, 1:34 PM), http://www.usatoday.com/story/news/politics/2013/11/28/marketplace-fairness-act-holiday-shopping/3680835/.

23. Marketplace Fairness Act, S. 743, 113th Cong. (as passed by Senate, May 6, 2013), *available at* http://thomas.loc.gov/cgi-bin/query/z?c113:S.743.ES:/.

24. H.R. 684, 113th Cong. (2013); *see also* Daniel Rothberg, *House Panel Considers Internet Sales Tax Compromise*, L.A. TIMES (Mar. 12, 2014), http://www.latimes.com/business/la-fi-house-internet-sales-tax-20140313-story.html.

25. The seven principles are (1) tax relief, (2) tech neutrality, (3) no regulation without representation, (4) simplicity, (5) tax competition, (6) states' rights, and (7) privacy Rights. H. Comm. on the Judiciary, *Basic Principles on Internet Sales Tax* (Sept. 18, 2013), *available at* http://judiciary.house.gov/index.cfm/basic-principles-of-on-internet-sales-tax.

26. W. & S. Life Ins. Co. v. State Bd. of Equalization of California, 451 U.S. 648, 652–53 (1981).

27. S. 743, *supra* note 23, § 2(a); *see also* Streamlined Sales and Use Tax Agreement (as amended through Oct. 8, 2014), *available at* http://www.streamlinedsalestax.org/uploads/downloads/Archive/SSUTA/SSUTA%20as%20Amended%20Through%20October%208,%202014.pdf.

party to SSUTA to collect taxes from remote sellers if it meets the Act's "minimum [tax] simplification requirements."[28]

Although MFA may be constitutional, it would be unwise public policy in its current form. First, requiring Internet retailers to collect and remit taxes on sales to residents of the roughly 9,600 U.S. sales tax jurisdictions—most of which are municipalities and counties[29]—would create substantial compliance costs, especially in the many states that assess differing tax rates on various types of goods.[30] Second, MFA would undermine healthy tax competition among states by eliminating the incentive for Internet retailers to consider state and local sales tax rates when deciding where to locate offices and warehouses.[31] Finally, MFA would effectuate a significant de facto tax increase on much of the U.S. population, as states are unlikely to reduce tax rates in response to the increased revenue that they would enjoy if MFA passed.[32]

Meanwhile, frustrated by congressional inaction, 13 states have enacted legislation that purports to satisfy the Commerce Clause's limitation on states' power to impose tax burdens on out-of-state Internet vendors.[33] These laws, known as "click-through nexus taxes," extend far beyond companies with a "physical presence" in the taxing state, as the concept has traditionally been defined.[34] Such taxes run contrary to the Supreme Court's 1992 decision in *Quill Corporation v. North Dakota* that states cannot tax out-of-state businesses that have no "physical

---

28. S. 743, § 2(b).

29. *See* Joseph Henchman, *Marketplace Fairness Act Introduced: Expands State Internet Sales Tax Authority with Some Simplifications*, TAX FOUND. BLOG (Feb. 28, 2013), *available at* http://taxfoundation.org/blog/marketplace-fairness-act-introduced-expands-state-internet-sales-tax-authority-some-simplifications.

30. *See* Jessica Melugin, *The Marketplace Fairness Act Would Create a State Sales Tax Cartel and Hurt Consumers* 3–4 (Competitive Enter. Inst. OnPoint No. 180, July 30, 2012), *available at* http://cei.org/sites/default/files/Jessica%20Melugin%20-%20The%20Marketplace%20Fairness%20Act%20Would%20Create%20a%20State%20Sales%20Tax%20Cartel.pdf; *see also* Michael S. Greve, *The Internet Sales Tax Reveals Its Foolish Head Yet Again*, FORBES (Apr. 25, 2013, 8:00 AM), http://www.forbes.com/sites/realspin/2013/04/25/the-internet-sales-tax-reveals-its-foolish-head-yet-again/.

31. *See* MICHAEL S. GREVE, SELL GLOBALLY, TAX LOCALLY 26–28 (2003), *available at* http://www.aei.org/wp-content/uploads/2011/10/20040218_book449.pdf (tax competition is minimized when sellers are indifferent to local tax rates).

32. *See, e.g.*, Bernie Becker, *Congress to Push Internet Sales Tax After Midterm Elections*, THE HILL (Sept. 23, 2014, 6:00 AM), http://thehill.com/policy/finance/domestic-taxes/218576-congress-to-push-internet-sales-tax-after-midterms.

33. *See supra* note 58 and accompanying discussion. Note that one

34. *See, e.g.*, Nat'l Geographic Soc. v. California Bd. of Equalization, 430 U.S. 551, 559 (1977) (emphasizing the "'sharp distinction … between mail order sellers with [a physical presence] within (the taxing) State, and those … who do no more than communicate with customers in the State by mail or common carrier as part of a general interstate business.'" (quoting Nat'l Bellas Hess, Inc. v. Dep't of Revenue of State of Ill., 386 U.S. 753, 758 (1967))).

presence in the taxing State."[35] Nevertheless, some state courts have upheld the constitutionality of click-through nexus laws, all but disregarding the Supreme Court's still-binding holding in *Quill*, as the following sections show. Until Congress acts, however, it is only a matter of time before the Supreme Court reviews state click-through nexus taxes. When that happens, these expansive tax laws are unlikely to survive the high court's review.

III. The Constitution Limits States' Authority to Tax Out-of-State Companies

A. The Dormant Commerce Clause Bars States from Taxing Out-of-State Businesses with No Physical Presence in the State

Under a constitutional doctrine known as the Dormant Commerce Clause,[36] states cannot impose an undue burden on interstate commerce or discriminate against out-of-state producers or consumers.[37] This principle is implied by the text of the Commerce Clause, which vests in Congress—and Congress alone—the power to "regulate Commerce … among the several states."[38] In 1824, the Supreme Court employed this doctrine to invalidate a New York law that regulated out-of-state steamboat operators, holding that the "power to regulate [interstate] commerce … is exclusively vested in Congress, and no part of it can be exercised by a State."[39] In 1945, the Court expounded upon "a hundred years" of its Dormant Commerce Clause precedents:

> [T]he commerce clause … affords some protection from state legislation inimical to the national commerce, and … where Congress has not acted, this Court, and not the state legislature, is under the commerce clause the final arbiter of the competing demands of state and national interests.[40]

---

35. Quill Corp. v. North Dakota *ex rel.* Heitkamp, 504 U.S. 298 (1992).

36. Chief Justice John Marshall explained the "dormant" nature of the Congress' power under the Commerce Clause in *Gibbons v. Ogden*, writing that the power to regulate interstate commerce "is an investment of power for the general advantage, in the hands of agents selected for that purpose; which power can never be exercised by the people themselves, but must be placed in the hands of agents, or lie dormant." 22 U.S. 1, 189 (1824).

37. *See* RICHARD EPSTEIN, THE CLASSICAL LIBERAL CONSTITUTION ch. 15 (2014) (tracing history of dormant Commerce Clause and praising it as a "welcome departure from the rules of strict constitutional construction"); *but see* Martin H. Redish & Shane V. Nugent, *The Dormant Commerce Clause and the Constitutional Balance of Federalism*, 1987 DUKE L.J. 569, 571 (1987) (arguing that "there is no dormant commerce clause to be found within the text or textual structure of the Constitution").

38. U.S. CONST. art. I, § 8, cl. 18.

39. Gibbons v. Ogden, 22 U.S. 1, 3 (1824).

40. S. Pac. Co. v. State of Ariz. *ex rel.* Sullivan, 325 U.S. 761, 769 (1945) (citations omitted).

Courts have long held that the Dormant Commerce Clause limits the power of states to tax out-of-state businesses that sell goods to residents of the taxing state.[41] For a state to "impose a tax on such transactions," the Supreme Court has held, "would be to project its powers beyond its boundaries and to tax an interstate transaction."[42] Thus, a state cannot impose tax collection requirements or other burdens on an out-of-state business merely because it advertises within the state.[43] This applies even when an out-of-state business pervasively advertises or ships merchandise into the state for consumption by its residents.[44]

In 1992, following decades of litigation over state tax laws, the U.S. Supreme Court adopted a bright-line rule in *Quill Corporation v. North Dakota*: a state cannot exercise its taxing authority over out-of-state businesses that "lack[] a physical presence in the taxing State."[45] The state of North Dakota had sought to force Quill Corporation—a major mail-order vendor of office supplies that engaged in "continuous and widespread solicitation of business within" North Dakota—to collect use taxes on purchases shipped to North Dakotans.[46] The North Dakota Supreme Court ruled that the company had a substantial presence within the state because it continuously and purposefully directed its advertising and business activities at North Dakotans.[47]

The U.S. Supreme Court reversed, squarely rejecting the state of North Dakota's argument that a company's economic nexus with the state can suffice to constitute the "substantial nexus" whereby an out-of-state seller becomes subject to North Dakota's taxing power.[48] Instead, the Court held that a seller without "a

41. *E.g.*, McLeod v. J. E. Dilworth Co., 322 U.S. 327, 330 (1944); Nat'l Bellas Hess, Inc. v. Dep't of Revenue of State of Ill., 386 U.S. 753, 760 (1967).

42. *McLeod*, 322 U.S. at 330.

43. *E.g.*, *Nat'l Bellas Hess, Inc.*, 386 U.S. at 754 (state could not compel out-of-state mail order firm to collect use taxes even though firm regularly mailed catalogues and advertising flyers to past and potential in-state customers).

44. *See* Quill Corp. v. North Dakota *ex rel.* Heitkamp, 504 U.S. 298 (1992); *rev'g sub nom.* State *ex rel.* Heitkamp v. Quill Corp., 470 N.W.2d 203, 204-05 (N.D. 1991) (state could not require out-of-state retailer to collect state use tax even though firm solicited business from thousands of in-state residents through "numerous catalogs and flyers, advertisements in nationally distributed 'card packs,' advertisements in national periodicals and trade journals, and telephone solicitation of current customers").

45. 504 U.S. at 312.

46. *Id.* at 308; *see id.* at 302 (Quill "solicit[ed] business through catalogs and flyers, advertisements in national periodicals, and telephone calls").

47. State *ex rel.* Heitkamp v. Quill Corp., 470 N.W.2d 203, 216 (N.D. 1991).

48. *Quill*, 504 U.S. at 312.

physical presence in the taxing State"—no matter how extensive its *economic* contacts with the state—lacks the substantial nexus within the state that the Commerce Clause requires.[49]

Quill reaffirmed the bright-line physical presence test that the Court had adopted in its earlier cases, reasoning that a "clear rule" will "reduce[] litigation" and "foster[] investment."[50] To satisfy *Quill*'s bright-line requirement, therefore, a seller must have some physical presence in the taxing state.[51]

B. State Click-Through Nexus Taxes Threaten the Vitality of E-Commerce

The World Wide Web went public in August 1991, a mere nine months before the Court handed down its *Quill* opinion (the Court did not consider online retailers in its ruling).[52] Since then, Internet retailers have typically collected sales and use taxes only as required by the state or states in which the seller maintains a physical presence.[53] Thus, major Internet businesses that are part of brick-and-mortar retail chains—such as Target, Walmart, and Home Depot—that have stores throughout the nation regularly collect taxes on all, or nearly all, domestic online sales.[54] Online-only retailers, by contrast, must collect taxes only on sales shipped to residents of states where the retailer maintains a presence—such as its headquarters, a regional office, or a company-owned warehouse.[55]

Since 2008, a handful of states, eager to capture additional tax revenue without increasing taxes on their own residents, have adopted laws that presume an out-of-state retailer has a local presence if its sales to residents referred to it by in-state affiliates exceed a modest threshold.[56] Most recently, in June 2014, New Jersey enacted a click-through nexus law,[57] joining Arkansas, California, Connecticut, Georgia, Kansas, Maine, Minnesota, Missouri, New York, North Carolina,

---

49. *Id.* (emphasis added).

50. *Id.* at 315–16; *see also* Nat'l Bellas Hess, Inc. v. Dep't of Revenue of State of Ill., 386 U.S. 753, 758 (1967).

51. *Id.* at 317.

52. Tony Long, *Aug. 7, 1991: Ladies and Gentlemen, the World Wide Web*, WIRED (Aug. 7, 2012), http://www.wired.com/2012/08/aug-7-1991-ladies-and-gentlemen-the-world-wide-web/.

53. *See* Emily L. Patch, *Online Retailers Battle with Sales Tax: A Physical Rule Living in A Digital World*, 46 SUFFOLK U. L. REV. 673, 685 (2013).

54. *Id.* at 677 n.39 (after observing Amazon's success in Internet sales, many brick-and-mortar stores opened their own online retailers).

55. *Id.* at 686 (discussing how online retailers' employed "entity isolation"—contracting with subsidiary or third party entities—to avoid maintaining a physical presence in a state).

56. *See infra* note 58.

57. A.B. 3486, 216th Leg. (N.J. 2014) (enacted June 30, 2014) (amending N.J. REV. STAT. § 54:32B-2(i)(1)(C)).

and Rhode Island.[58] Although these laws are similar in most respects, two states—Connecticut and Texas—have especially draconian laws: whereas most states' click-through nexus laws theoretically permit a seller to rebut the presumption that its in-state sales are attributable to its in-state affiliates, Connecticut and Texas do not.[59]

1. New York's High Court Upholds Click-Through Nexus Statute

In March 2013, New York's highest court issued a major challenge to *Quill* in *Overstock.com v. New York State Department of Taxation & Finance*.[60] In *Overstock*, the online retailer challenged a 2008 New York state law requiring out-of-state online vendors with New York-based affiliates to collect use taxes on sales shipped to New York addresses.[61] Amazon, another major online retailer, filed a separate lawsuit challenging the New York law on essentially the same grounds as Overstock; the state's high court resolved both retailers' challenges in a single opinion.[62]

Both Overstock and Amazon engage in affiliate marketing, a common Internet advertising model whereby an online retailer contracts with independent website owners to advertise that retailer's products.[63] These affiliates place on their websites "click-through" advertising links that direct viewers to the retailer's site.[64] Each time a user clicks on such an affiliate link and goes on to make a purchase, the retailer pays the affiliate an agreed upon share of the resulting revenue.[65] The companies argued that the law was facially unconstitutional because

---

58. ARK. CODE § 26-52-117 (2013); CAL. REV. & TAX. CODE § 6203(c)(5) (2012); CONN. GEN. STAT. § 12-407(a)(12)(L) (2013); GA. CODE § 48-8-2(8)(M) (2014); KAN. STAT. § 79-3702(h)(2)(C) (2013); ME. REV. STAT. tit. 36, § 1754-B(1-A)(C) (2014); MINN. STAT. § 297A.66 subd. 4a (2014); MO. STAT. § 144.605(2)(e) (2013); N.Y. TAX LAW § 1101(b)(8)(vi) (2013); N.C. GEN. STAT. § 105-164.8(b)(3) (2009); R.I. GEN. LAWS § 44-18-15(a)(2) (2012).

59. *See* Joseph Henchman, *The Marketplace Fairness Act: A Primer* 13 & nn. 41–45 (Tax Found. Background Paper No. 69, July 2014), *available at* http://taxfoundation.org/sites/taxfoundation.org/files/docs/TF%20BP69%20The%20Marketplace%20Fairness%20Act.pdf.

60. Overstock.com, Inc. v. New York State Dep't of Taxation & Fin., 987 N.E.2d 621, 624 (N.Y. 2013), *cert. denied*, 134 S.Ct. 682 (2013).

61. The retailers challenged N.Y. TAX LAW § 1101(b)(8)(vi) (2013). The law states, in part, that "a person making sales of tangible personal property or services taxable under this article … shall be presumed to be soliciting business through an independent contractor or other representative 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." *Id.*

62. *Overstock*, 987 N.E.2d at 624.

63. *Id.* at 622–23.

64. *Id.*

65. *Id*.

it presumes an out-of-state retailer is subject to New York's taxing authority if it conducts "affiliate marketing" in concert with in-state affiliates.[66]

The New York Court of Appeals upheld the state law by a 4 to 1 vote.[67] It ruled that although a state cannot tax out-of-state sellers that advertise in the state using traditional media,[68] such as print ads, sellers who partner with in-state websites to offer "click-through" online advertising may be presumed to be subject to the state's taxing authority.[69]

While it acknowledged that neither Overstock nor Amazon had any property or employees in New York, the court focused on the retailers' affiliate programs, in which numerous New York-based website owners participated.[70] The court held that the statute does not exceed New York's state's taxing power, notwithstanding *Quill*'s physical presence requirement.[71] Although the majority recognized that the statute targets online retailers who "conduct their operations without maintaining a physical presence" in New York, the court nonetheless found the Commerce Clause physical presence requirement was satisfied by the "physical presence" within the state of the "resident website owner[s]" whom the retailers paid as affiliates for marketing purposes.[72]

Yet the court did not find that the affiliated website owners' presence in New York could be attributed to the retailers in an ordinary legal sense.[73] Instead, the court deemed the affiliated website owners' presence within New York sufficient to establish a state nexus, as the affiliates might encourage New York residents to "mak[e] purchases" from the retailers "through their [advertising] links."[74] The New York Court of Appeals likened affiliate marketing to a retailer maintaining a "local sales force" in a state, an activity that the Supreme Court has held sufficient to satisfy the nexus requirement for a business with no other in-state presence.[75]

---

66. *Id.* at 626–27.

67. *Id.* at 626.

68. The New York Court of Appeals is the court of last resort in the State of New York. *See Court System Outline*, COURT OF APPEALS OF THE STATE OF NEW YORK, https://www.nycourts.gov/ctapps/outline.htm (last visited May 30, 2014).

69. *Overstock*, 987 N.E.2d at 623.

70. *Id.* at 627.

71. *Id.*

72. *Id.*

73. *Id.* at 626 (finding that through affiliation agreements, "a vendor is deemed to have established an in-state sales force"); *see also* RESTATEMENT (THIRD) OF AGENCY § 2.01–.07 (2006) (summarizing common law doctrine regarding the attribution of agents to principals).

74. *Overstock*, 987 N.E.2d at 626.

75. *See, e.g.*, Scripto, Inc. v. Carson, 362 U.S. 207, 212 (1960); Tyler Pipe Indus., Inc. v. Washington

For instance, in *Scripto, Inc. v. Carson*, the Supreme Court held that the state of Florida did not violate the Commerce Clause when it levied a use tax on an out-of-state vendor that contracted with in-state sales associates to "conduct[] continuous local solicitation" of Floridians,[76] even though the salesmen were independent contractors not directly employed by the vendor.[77]

Examining the "nature and extent of the activities of the [vendor] in Florida,"[78] the Court observed that the company had a "written contract" with 10 brokers in Florida, each assigned a "specific territory" and working on a "commission basis."[79] Based on these factors, the Court concluded that the vendor's operations in Florida formed a sufficient nexus to subject it to the state's taxing authority.[80]

Similarly, in *Tyler Pipe Industries, Inc. v. Washington State Department of Revenue*, the Court held that the seller—which had no offices, property, or employees in Washington State[81]—nevertheless had a sufficient nexus with the state because of its contracting with sales representatives in Washington who "perform[ed] … local activities necessary for maintenance of [the seller's] market and protection of its interests" in the state.[82]

2. The *Overstock* Court Wrongly Conflated Passive Internet Affiliates with Active Local Sales Representatives

The *Overstock* court, in concluding that affiliates were analogous to the sales agents described in *Scripto* and *Tyler Pipe*, overlooked several important differences between the two types of arrangements. As Judge Robert S. Smith wrote in his dissenting opinion in *Overstock*:

> The Overstock and Amazon links that appear on websites owned by New York proprietors serve essentially the same function as advertising that a more traditional out-of-state retailer might place in local newspapers. The websites are not soliciting customers for Overstock and Amazon in the fashion of a local sales agent. Of course the website owners solicit business for themselves; they encourage people to visit their websites, just as a newspaper owner would

State Dep't of Revenue, 483 U.S. 232, 250–51 (1987).

76. *Scripto*, 362 U.S. at 211.

77. *Id.* at 209.

78. *Id.* at 211.

79. *Id.* at 209.

80. *Id.* at 208.

81. Tyler Pipe Indus., Inc. v. Washington State Dep't of Revenue, 483 U.S. 232, 249 (1987).

82. *Id.* at 251 (quoting Tyler Pipe Indus., Inc. v. State Dep't of Revenue, 715 P.2d 123, 125 (Wash. 1986)) (internal quotation marks omitted).

seek to boost circulation. But there is no basis for inferring that they are actively soliciting for the out-of-state retailers.[83]

Indeed, a sales representative takes a far more active role in hawking the products she is selling than a typical website affiliate, who merely hosts click-through ads linking to the retailer's site. Unlike the brokers in *Scripto*, who were "actively engaged in Florida *as a representative of Scripto* for the purpose of attracting, soliciting and obtaining Florida customers,"[84] and the "in-state sales representatives" in *Tyler Pipe* who "acted daily *on behalf of Tyler Pipe* in calling on its customers and soliciting orders" such that they were effectively its agents,[85] the website operators at issue in *Overstock* neither acted as agents nor actively solicited customers on behalf of the affiliated online retailer.

Instead, affiliates take a passive role in generating sales for their retail partners. Most retailers significantly restrict how their affiliates may display marketing links[86] and require affiliate websites to produce their own original content.[87] And when an affiliate marketing link appears on an affiliate's website, it is typically easily distinguishable from the website's own content.[88] If a user selects an affiliate market link, it will redirect her to the retailer's independent shopping site, such as Amazon.com. Unlike traditional salesmen, who are notorious for traveling door-to-door and calling private homes at inopportune times,[89] Internet affiliates do not initiate contact with prospective customers. Instead, a potential buyer must voluntarily navigate to an affiliate's website before she will encounter a click-through advertisement, which the user must also click on to navigate on to the retailer's website. Affiliates are thus a 21st century analogue of newspapers, radio stations, and billboards—not traveling salesmen.

Internet affiliates do resemble salesmen in one sense: They typically earn a fee based on how many sales they make. Meanwhile, advertisers typically base their rates on metrics such as the size of the audience they reach. One of the oldest challenges in marketing is assessing how many sales a particular advertisement

---

83. Overstock.com, Inc. v. New York State Dep't of Taxation & Fin., 987 N.E.2d 621, 628 (N.Y. 2013) (Smith, J., dissenting).

84. *Scripto*, 362 U.S. at 209 (emphasis added).

85. *Tyler Pipe*, 483 U.S. at 249–50 (emphasis added).

86. *See, e.g.*, Amazon Associates Program Participation Requirements, §§ 2–5, *available at* https://affiliate-program.amazon.com/gp/associates/help/operating/participation/ (last visited June 16, 2014).

87. *See, e.g.*, *Earn Passive Blog Income with Infolinks and Amazon Associates Easily*, SEOChat.com (Nov. 3, 2010), http://www.seochat.com/c/a/search-engine-optimization-help/earn-passive-blog-income-with-infolinks-and-amazon-associates-easily/.

88. *See* Amazon Associates Program Participation Requirements, *supra* note 86, § 30.

89. *See generally* DAVID MAMET, GLENGARRY GLEN ROSS (1983), *available at* http://www.dailyscript.com/scripts/glengarry.html.

generates. As the prominent retailer John Wanamaker famously quipped: "Half the money I spend on advertising is wasted; the trouble is I don't know which half."[90] Thanks to the Internet, it is now possible to know how well each advertisement performs, and compensate affiliates accordingly.[91]

This earnings model is not enough to transform passive advertisers into active sales agents.[92] By the same logic, the shift from flat fee advertising to a commission-based model cannot allow states to tax otherwise unreachable entities, as it would open the gates to a stampede of burdensome, complex interstate taxation requirements.

Yet the *Overstock* majority offered no serious discussion of these factors. In fact, even as the majority purported to follow the Supreme Court's physical presence test, it criticized the test's reasoning, writing:

> The world has changed dramatically in the last two decades, 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.[93]

As Judge Smith noted in his dissent, the majority's decision nullifies *Quill*'s "rule that advertising in in-state media is not the equivalent of physical presence."[94] Allowing a state to exercise its taxing authority over out-of-state sellers based on the activities of third party affiliates, he argued, functionally abrogates the physical presence requirement.[95]

If other states enact legislation similar to the New York statute—and other courts adopt the *Overstock* court's flawed reasoning—they will force retailers to make a tough choice: Either forego click-through-based Internet advertising or face a

---

90. *See* ADVERTISING AGE, *John Wanamaker*, Mar. 29, 1999, *available at* http://adage.com/article/special-report-the-advertising-century/john-wanamaker/140185/.

91. By contrast, print advertising revenue for newspapers fell by more than half between 2003 and 2012, even as online advertising revenue grew substantially. *See* RICK EDMONDS ET. AL, PEW RESEARCH CENTER PROJECT FOR EXCELLENCE IN JOURNALISM, NEWSPAPERS: STABILIZING, BUT STILL THREATENED (2013), *available at* http://stateofthemedia.org/2013/newspapers-stabilizing-but-still-threatened/ (print revenue fell from $46 billion in 2003 to $22 billion in 2012).

92. Indeed, the *Scripto* Court, confronted with the question whether a retailer's independent contractors were meaningfully different from its employees, wrote: "To permit such formal 'contractual shifts' to make a constitutional difference would open the gates to a stampede of tax avoidance." 362 U.S. at 211 (citations omitted).

93. Overstock.com, Inc. v. New York State Dep't of Taxation & Fin., 987 N.E.2d 621, 625 (N.Y. 2013) (Smith, J., dissenting).

94. *Id.* at 629.

95. *Cf. id.* at 628 (Smith, J., dissenting). The court's decision essentially adopted the very reasoning that *Quill* rejected—namely, that a state can exercise its taxing authority over an out-of-state seller based on the economic effects of the seller's conduct. *See also* Amazon.com, LLC v. New York State Dep't of Taxation & Fin., 81 A.D.3d 183, 195 (2010).

morass of potential liability from innumerable taxing jurisdictions. Nevertheless, at least 12 states have adopted tax laws similar to the one upheld in *Overstock*, with four states enacting such laws in the months immediately following the New York Court of Appeals' March 2013 decision.[96] But these states may not realize the revenues they anticipate these laws will bring. Shortly after New York enacted its 2008 tax law, Overstock pulled out of its affiliate business in the state.[97] Similarly, in the years following North Carolina's adoption of a click-through nexus tax, the state reportedly lost revenue, as "many retailers cut ties with affiliate marketers in the state."[98]

IV. THE INTERNET TAX FREEDOM ACT PREEMPTS STATE CLICK-THROUGH NEXUS TAXES

Even if the Constitution permitted states to tax remote Internet retailers merely because they partnered with in-state affiliate marketers, the discriminatory nature of such taxes may run afoul of the federal Internet Tax Freedom Act (ITFA).[99] Enacted in 1998 as a temporary Internet tax moratorium and renewed by Congress four times since, ITFA bars states from imposing "[m]ultiple or discriminatory taxes on electronic commerce."[100] According to a 2001 House Judiciary Committee report accompanying a bill that renewed ITFA, a state tax is discriminatory if it is "levied specifically on electronic transactions or taxes that single out electronic transactions for higher rates of taxation."[101] Under this standard, some state laws that target out-of-state Internet retailers may discriminate against online transactions, in violation of ITFA.

In 2013, the Illinois Supreme Court invalidated that state's click-through nexus tax law on these grounds.[102] The Illinois law, enacted in 2011, expanded the def-

---

96. *See* note 58 *supra* and accompanying text.

97. Geoffrey A. Fowler & Erica Alini, *States Plot New Path to Tax Online Retailers*, WALL ST. J., July 3, 2009, *available at* http://online.wsj.com/news/articles/SB124657597066189059.

98. Laura Mahoney et al., *States See Little Revenue From Online Sales Tax Laws, Keep Pressure on Congress*, BLOOMBERG LAW (Jan. 8, 2014), *available at* http://www.bna.com/states-see-little-revenue-from-online-sales-tax-laws-keep-pressure-on-congress/.

99. Internet Tax Freedom Act, Pub. L. No. 105-277, div. C, title XI, 112 Stat. 2681–2719 (1998), as amended by Pub. L. No. 107–75, § 2, 115 Stat. 703 (2001); Pub. L. No. 108–435, §§ 2–6A, 118 Stat. 2615–18 (2004); Pub. L. No. 110–108, §§ 2–6, 121 Stat. 1024–26 (2007); Pub. L. No. 113–164, § 126, 128 Stat. 1867 (2014) (codified as amended at 47 U.S.C. § 151 note) [hereinafter ITFA]. The law is set to expire on December 11, 2014, although many in Congress wish to make it permanent. *See, e.g.*, Permanent Internet Tax Freedom Act, H.R. 3086, 113th Cong. (as passed by House, July 15, 2014).

100. ITFA § 1101(a)(2).

101. H.R. REP. 107-240, at 6 (2001).

102. *See* Performance Mktg. Ass'n, Inc. v. Hamer, 2013 IL 114496, ¶ 5, 998 N.E.2d 54, 56 (Ill. 2013).

inition of what it means for a business to "maintain[] a place of business in [Illinois]" to include any retailer "having a contract with a person located in this State under which the person, for a commission or other consideration based upon the sale of tangible personal property by the retailer, directly or indirectly refers potential customers to the retailer by a link of the person's Internet website."[103] A trade association representing Internet retailers brought suit against the law, alleging that it violated both the U.S. Constitution and ITFA.[104]

The Illinois Supreme Court did not reach the constitutional claims. Instead, the Court held that the statute was preempted by section 1101(a)(2) of ITFA, which bars states from imposing discriminatory taxes on electronic commerce.[105] ITFA defines a discriminatory tax, in part, as "any tax imposed by a State or political subdivision thereof on electronic commerce that … imposes an obligation to collect or pay tax on a different person or entity than in the case of transactions involving similar property, goods, services, or information accomplished through other means."[106]

Whether the Illinois Supreme Court's holding in *Performance Marketing Association* applies to other state laws that seek to tax remote Internet sellers remains unclear. The Illinois law expressly targeted only Internet sellers, referring explicitly to sales driven by a "link" on a "person's Internet website"—whereas New York's law, which that state's high court upheld, applies to affiliates regardless of whether they "refer[] potential customers … by a link on an internet website *or otherwise*."[107] As the Illinois court noted, under the state's click-through nexus tax law, "national, or international, performance marketing by an out-of-state retailer which appears in print or on over-the-air broadcasting in Illinois, and which reaches the same dollar threshold, will *not* trigger an Illinois use tax collection obligation."[108] But in states with click-through nexus taxes modeled after

---

103. 2010 Ill. Legis. Serv. P.A. 96-1544, § 5 (H.B. 3659) (West) (eff. Mar. 10, 2011) (codified at 35 ILL. COMP. STAT. 105/2(1.1) (2011).

104. *Performance Mktg. Ass'n*, 2013 IL 114496 at ¶ 35.

105. *Id.* ¶¶ 15–23, 998 N.E.2d at 57–60 (citing ITFA § 1105(2)(A)(iii)).

106. ITFA, *supra* note 99, § 1105(2)(A)(iii).

107. N.Y. TAX LAW § 1101(b)(8)(vi) (2013) (emphasis added). The law provides that "a person making sales of tangible personal property or services taxable under this article ('seller') shall be presumed to be soliciting business through an independent contractor or other representative if the seller enters into an agreement with a resident of this state 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 … ." *Id.* This statutory presumption can theoretically "be rebutted by proof 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." *Id.*

108. *Performance Mktg. Ass'n*, 2013 IL 114496 at ¶ 23, 998 N.E.2d at 59.

New York's law—such as that recently enacted in New Jersey[109]—even retailers with *offline* in-state affiliates that refer customers to them must collect and remit applicable sales taxes.[110]

Nevertheless, in practical terms, both the Illinois and New York laws target online retailers, who are far more likely to engage in affiliate marketing than brick-and-mortar retailers. Moreover, the New York law, like the Illinois tax, exempts traditional advertising models—which brick-and-mortar retailers typically rely on for marketing.[111] Although the Illinois court held that ITFA preempted the state's facially discriminatory tax, ITFA may also preempt facially neutral taxes—such as the New York law—insofar as their incidence falls largely on Internet retailers. Indeed, ITFA bars taxes that discriminate not only among sellers of identical "property, goods, [and] services," but also sellers of "similar" products, suggesting that the law reaches state taxes that are discriminatory in practice yet generally applicable in formal terms.[112]

Courts have adopted this reasoning in Dormant Commerce Clause cases, invalidating state laws that were not facially discriminatory but would nonetheless in "practical operation work discrimination against interstate commerce."[113] Tax laws such as New York's should fall on similar grounds, whether under ITFA or the Constitution, because the burdens they impose on affiliate-based marketing fall almost entirely on Internet retailers in practical terms.

V. CONCLUSION

As more states consider enacting click-through nexus taxes, Internet retailers and affiliates should avail themselves of the Constitution's limits on state regulation of interstate commerce. Litigation serves as an important check on government, especially when the political branches violate constitutional principles. Eventually, the U.S. Supreme Court will probably agree to hear such a challenge—especially if state courts follow New York's example and seek to upend the well-established doctrine that a state may tax only entities with a physical presence in the state.

---

109. A.B. 3486, 216th Leg. (N.J. 2014) (enacted June 30, 2014) (amending N.J. REV. STAT. § 54:32B-2(i)(1)(C)).

110. *See supra* text accompanying note 107.

111. *See* N.Y. State Dept. of Taxation and Fin., Off. of Tax Pol'y Analysis, Taxpayer Guidance Div., TSB-M-08(3)-S, *New Presumption Applicable to Definition of Sales Tax Vendor* 2 (May 8, 2008), *available at* http://www.tax.ny.gov/pdf/memos/sales/m08_3s.pdf.

112. *See* ITFA, *supra* note 99, § 1105(2)(A)(iii).

113. *E.g.*, W. Lynn Creamery, Inc. v. Healy, 512 U.S. 186, 201 (1994); *cf.* Hunter v. Underwood, 471 U.S. 222 (1985) (facially-neutral felony disenfranchisement statute violated Constitution's equal protection clause where it was designed to disenfranchise blacks more than whites).

States should resist the temptation to extract additional revenue from online retailers by enacting new taxes of dubious constitutionality. Any benefit the states accrue from these laws will likely be short-lived, as most retailers are quick to end their affiliate partnerships in states that enact click-through nexus taxes. Instead, states that genuinely need to raise revenue should do so within the confines of the law, and in a manner that respects the uniquely interstate nature of e-commerce.

Meanwhile, Congress should reject the Marketplace Fairness Act, a bill that would increase compliance costs, undermine tax competition, and effectuate a large de facto tax hike on the American people. Instead, if lawmakers in Washington, D.C., wish to serve their constituents, they should pass legislation that expressly bans state click-through nexus taxes.

The Competitive Enterprise Institute promotes the institutions of liberty and works to remove government-created barriers to economic freedom, innovation, and prosperity through timely analysis, effective advocacy, inclusive coalition-building, and strategic litigation.

COMPETITIVE ENTERPRISE INSTITUTE

1899 L Street NW, 12th Floor

Washington, DC 20036

202-331-1010

cei.org