

Nos. 13-252, 13-259

IN THE
Supreme Court of the United States

OVERSTOCK.COM, INC.,
Petitioner,

AND

AMAZON.COM LLC AND AMAZON SERVICES LLC,
Petitioners,

v.

NEW YORK STATE DEPARTMENT OF TAXATION
AND FINANCE, ET AL.,

Respondents.

**ON PETITIONS FOR A WRIT OF CERTIORARI
TO THE NEW YORK COURT OF APPEALS**

**BRIEF OF SCRAPBOOK.COM, ASSISTED
LIVING STORE, INC., CHEF'S RESOURCE,
GARAGE FLOORING LLC, PERFECT CORNERS
COLLECTIBLES, PUGET SOUND
INSTRUMENT, AND STRINGS AND BEYOND,
AS *AMICI CURIAE* IN SUPPORT OF
PETITIONERS**

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BRIEF OF AMICI CURIAE¹

Amici curiae Scrapbook.com, Assisted Living Store, Inc., Chef's Resource, Garage Flooring LLC, Perfect Corners Collectibles, Puget Sound Instrument, and Strings and Beyond, respectfully submit this brief in support of petitioners Overstock.com, Inc., and Amazon.com, LLC, and urge that the writs for certiorari be granted.

INTEREST OF THE AMICI

Amici curiae are small businesses engaged in e-commerce in the United States. Like petitioners, *amici* do not have any physical presence in New York, but most utilize affiliate marketing strategies whereby third party website operators—who are not agents of *amici*—display hyperlinked ads for *amici's* websites and products.² These affiliates receive a portion of any sales generated by users who click through the ads and subsequently purchase from *amici*. Like petitioners, therefore, *amici* are subject to (or potentially subject to) sales tax collection

¹ Pursuant to Rule 37.6, *amici* certify that no party's counsel authored this brief in whole or in part and that no person or entity other than *amici* or their counsel has made a monetary contribution to the preparation or submission of this brief. All counsel received timely notice of the filing of this brief. Petitioners have filed blanket consents with the Court, and counsel for respondent consented to this brief via e-mail.

² Some of the *amici* do not yet utilize affiliate marketing, but have been attempting to implement such programs. As explained in further detail below, the uncertainty surrounding affiliate nexus taxes presently deters them from pursuing this approach.

obligations in New York and other jurisdictions that treat the activities of third-party affiliates as a basis for imposing tax collection obligations on e-commerce businesses.

Because these obligations impose massive compliance costs, they have a weighty effect on a small business's marketing decisions. The absence of definitive guidance by this Court regarding the constitutionality of sales taxes on e-commerce clouds the decision making environment and makes it even more challenging for struggling small businesses to plan for their futures. *Amici* thus have a strong interest in a clear resolution to this issue.

SUMMARY OF ARGUMENT

Affiliate nexus taxes like New York's expose businesses to tax collection obligations in far-flung jurisdictions where the business has no physical presence or even agents with physical presence. Such laws constitute the primary means by which small online businesses become subject to sales tax collection obligations outside of their home states. The constitutionality of affiliate nexus taxes has been hotly debated, and courts have reached conflicting results. *See* Overstock Pet. 11-18 (describing cases). If the decision below is permitted to stand, it will encourage other jurisdictions to likewise require businesses with local affiliates to collect sales taxes.

These obligations impose substantial compliance costs on all e-commerce businesses—large and small. But for small businesses like *amici*, these costs are prohibitive. Almost all *amici* generate annual revenues of less than \$10 million (some generate closer to \$1 million), in a retail industry where profit

margins are exceedingly tight. Many small businesses simply cannot afford to erect the necessary technical infrastructure to ensure compliance with the complex tax rules of myriad states and localities, including the necessary upgrades to accounting software systems, the recurring costs of licensing and maintaining those systems, and the training required to utilize them correctly. Nor can they afford to bear the systemic risk of a tax audit in every remote jurisdiction where their customers or affiliates reside.

If businesses cannot afford to make the necessary investments in compliance, they will instead be forced to terminate their affiliate marketing arrangements (or to refrain from initiating them in the first instance). This Court should grant review to determine whether affiliate nexus laws are constitutional. Unless it does so, small businesses face a climate of uncertainty that discourages investment and hinders growth.

ARGUMENT

1. Begin with the following fact: If the decision below upholding affiliate nexus taxes is permitted to stand, then other jurisdictions are likely to follow New York's example and enact similar laws. States and localities perceive the taxation of online sales as a significant opportunity to generate additional revenue in a challenging economic climate. They are searching for ways to augment their tax base without increasing tax rates. Thirteen states (including New York) have already enacted affiliate nexus tax laws,

and more are considering them.³ If this Court denies certiorari, it will signal to these jurisdictions that they are free to pursue affiliate nexus taxation on Internet sales.

Affiliate marketing is a ubiquitous form of Internet advertising. It permits retailers to spread the word about their products through a broad range of channels by solving one of the principal challenges associated with Internet marketing: information asymmetry. The Internet is teeming with blogs and websites offering information to the public. But except in the case of a small number of highly popular websites and blogs, it is extremely difficult for a retailer to ascertain whether advertising on any particular site is likely to be profitable. Affiliate contracts—which typically compensate the affiliate when sales are made—solve that problem by ensuring that a website operator is only paid to the extent that the ads are effective. Affiliate contracts also preserve the affiliate’s independence from the retailer: the retailer does not obtain any control over the affiliate’s content, and the affiliate can make the retailer’s ads as prominent (or not) as it wishes.

³ The other states are Arkansas, California, Connecticut, Georgia, Illinois, Kansas, Maine, Missouri, Minnesota, North Carolina, Pennsylvania, and Rhode Island. West Virginia recently enacted similar legislation that will take effect on January 1, 2014. *See* W. Va. Code § 11-15A-1(b)(8)(B) (2013). Similar laws have been proposed in other states as well. *See* Jack Stewart, “*Click-Through*” and “*Affiliate*” Nexus – *What Does It All Mean?*, Schneider Downs Insights (Apr. 15, 2013), <http://www.schneiderdowns.com/click-through-affiliate-nexus>.

Because affiliate marketing is such a common approach to Internet advertising, it is an obvious target for taxing jurisdictions seeking to expand their ability to collect taxes. If the decision below is not reversed, then the Court should expect that other jurisdictions will move to enact affiliate nexus taxes of their own. For the reasons that follow, this would be disastrous for small and mid-sized Internet retailers.

2. Multistate sales tax compliance—especially for Internet businesses—is extremely complex and tremendously costly. This is so because there are literally thousands of potential taxing jurisdictions, including states, counties, and cities, often with overlapping jurisdiction and conflicting rules. *See* PriceWaterhouseCoopers, Retail Sales Tax Compliance Costs: A National Estimate E-1 (Apr. 7, 2006), *available at* <http://netchoice.org/wp-content/uploads/cost-of-collection-study-sstp.pdf> (“State or local retail sales taxes are imposed by 46 states, the District of Columbia, and approximately 7,400 local jurisdictions in the United States.”).⁴

⁴ It is an open question whether nexus with a state is sufficient to create nexus with the state’s localities. “The general rule is that once you have established nexus with the state, then you are required to collect the appropriate tax in all localities administered by the state. Alternately, if you establish nexus in a home rule locality then you have a tax collection responsibility for that home rule locality as well as any higher level home rule authorities that share the boundaries.” *Sales Tax Nexus*, SalesTaxSupport.com, <http://www.salestaxsupport.com/sales-tax-information/sales-tax-help-questions/nexus/> (last visited Sept. 23, 2013). This

To comply with tax collection obligations in each of these jurisdictions, an Internet business must typically first register with the taxing jurisdiction. Then, every time the business transacts with a consumer, it must determine where a purchase is being made with a high level of granularity. It must then calculate the applicable tax rate for the product, the purchaser, and the jurisdiction. Then, it must charge the consumer the appropriate rate. And finally, the business must remit the tax to the proper authority.

Some examples illustrate just how complex sales tax compliance can be. The first challenge is to determine exactly where a sale occurs, and therefore which tax rates apply. Difficulties arise because a single ZIP code may straddle multiple counties, or a city and a county, which apply different tax rates in addition to the applicable state rate—which means that a business cannot rely on the purchaser’s state, or even her ZIP code, to determine the tax rate.

Consider, for example, Greenwood Village in Colorado, population approximately 13,925. U.S. Census Bureau, *Greenwood Village QuickFacts*, <http://quickfacts.census.gov/qfd/states/08/0833035.ht>

statement is consistent with guidance recently issued by the Colorado Department of Revenue, a state that administers some local taxes and leaves others to home rule. *See* Colo. Dep’t of Revenue, *Re: Affiliate Nexus*, GIL-12-016, at 5-7 (Dec. 31, 2012). Thus, it is entirely possible that localities will seek to take advantage of state-level nexus in order to charge local taxes, or will create their own local nexus laws that would apply if an affiliate is present in the locality.

ml (last visited Sept. 23, 2013). Greenwood Village, like many small towns, shares a ZIP code with its surroundings. In fact, many mailing addresses in Greenwood Village state that the property is in “Englewood,” a separate taxing jurisdiction with a higher sales tax rate. As a result of this confusion, the city government reports that “Greenwood Village businesses and residents often pay a higher, incorrect Sales Tax,” and provides instructions for residents to obtain relief. See City of Greenwood Village, *Tax Information* 1-2, <http://www.greenwoodvillage.com/DocumentCenter/Home/View/94> (last visited Sept. 23, 2013). The city advises vendors that in order to determine the correct tax rate, they ought to consult a street boundary guide, which explains exactly which address numbers on which street are within Greenwood Village. See City of Greenwood Village, *Street Boundary Guide*, <http://www.greenwoodvillage.com/DocumentCenter/Home/View/64> (last visited Sept. 23, 2013). The city also notes that it conducts its own audits, so that any noncompliant vendor faces enforcement risk.

Greenwood Village is not unique in this regard. There are literally thousands of localities that have their own special tax rates and rules. Several such localities might share a single ZIP code, and determining the tax rate that applies at the exact location of a sale is therefore no mean feat. A business must somehow obtain access to street-address-level sales tax rate data, and then find a way to connect that data to its sales and accounting systems.

Once a business determines where a sale takes place, it must then determine which products in the

sale are taxable. For example, in Massachusetts, sales of apparel items are exempt from taxes up to \$175. See Mass. Dep't of Revenue, *A Guide to Sales & Use Tax*, <http://www.mass.gov/dor/individuals/taxpayer-help-and-resources/tax-guides/salesuse-tax-guide.html> (last visited Sept. 23, 2013). This includes items to be sewn on to apparel, such as buttons. *Id.* *Amicus* Scrapbook.com, which sells craft supplies, sells a variety of buttons on its website (a search for the word "button" on the site yields 621 results). Some of these buttons are identical to buttons sold by other vendors for apparel, while others likely could not be sewn onto apparel. In order to determine whether a button falls within the apparel exemption from Massachusetts sales tax, Scrapbook.com would have to categorize each button as taxable-in-Massachusetts or not, and collect sales taxes on taxable buttons.

Again, that is just one example from one jurisdiction. Similarly fine distinctions abound elsewhere. For example, several states exempt sales of their own state flag from taxes, but do not exempt sales of the flags of other states. See Joseph Henchman & Steven Pahunkin, *Happy Flag Day! 14 States Exempt Flags from Their Sales Taxes*, TaxFoundation.org (June 14, 2011), <http://taxfoundation.org/blog/happy-flag-day-14-states-exempt-flags-their-sales-taxes-0> (last visited Sept. 23, 2012). In Connecticut, diapers for babies are taxable, but diapers for adults are not. See Conn. Dep't of Revenue Servs., *Taxability of Children's & Adult Diapers*, AN 2012(8) (Aug. 23, 2012). In Illinois, candies that contain flour are taxed at a low rate for "food," while other candies are taxed at a

higher “general merchandise” rate. Thus, “yogurt . . . covered fruit or nuts” are taxed as candy, but “yogurt covered pretzels” are taxed as food. See Ill. Dep’t of Revenue, *Recent Sales & Use Tax Changes Affecting Candy, Personal Grooming & Hygiene Products, & Soft Drinks*, FY2010-01 (July 2009). If a small business had to categorize each of its products in dozens, or hundreds, or thousands of jurisdictions, the cost would be tremendous, as would be the risk that it would err. This is especially the case because the tax treatment of many particular products is not clear from statutes or regulations, but instead buried in caselaw or informal guidance documents.

Moreover, classifying products presents an ongoing challenge. Tax laws change to reflect shifting policy priorities, and businesses also add products to their inventory, which means that they must constantly update their tax designations. This means that even if the process was simplified so that affiliate nexus taxes were only levied at the state level (and so businesses only had to consider the rules of 47 jurisdictions), there would still be so much complexity that no small business could reasonably be expected to navigate the system.

In addition to checking the taxability of products, a business must also determine whether a purchaser is exempt from the relevant tax. In many taxing jurisdictions, government departments and certain not-for-profit organizations are not required to pay sales taxes. But the exemptions hardly stop there. Many states issue certificates of exemption to eligible purchasers, and those purchasers are instructed to present their certificates at the time of purchase so that they can avoid paying taxes at the point of sale.

Retailers must collect and file those certificates and apply the proper tax rate for each purchaser. Other states hold sales tax “holidays” where on a particular day, taxes are not levied on certain products. A business must track all of these variables to ensure that it is charging the proper rates.

Finally, once the taxes are collected, the business must remit them to the correct jurisdiction. Local taxes must go to localities, while state taxes from the same purchase must go to the state. That part of the transaction thankfully does not require difficult judgment calls. But it does require highly refined reporting capabilities. Most taxing jurisdictions have their own forms to accompany remittances, and the sheer logistical challenge of timely sending funds to the right place is a tremendous undertaking.

3. For Internet retailers attempting to comply with affiliate-nexus taxes like New York’s—and especially for small or family-run businesses that simply do not have the resources to shoulder these burdens—outsourcing is the only option. Vendors have emerged to shoulder some of the compliance function. For example, some vendors are capable of using geolocation to determine exactly where a sale takes place, and to then perform a rate lookup that yields an accurate tax rate. But such services cost thousands of dollars to set up, and thousands of dollars more every year to use—at least.

The software costs go beyond the tax service itself. Most small Internet businesses use relatively simple software packages to meet their basic needs. These include basic online “shopping carts”—which is software on a server that permits customers to accumulate a list of items and then purchase those

items securely—and basic accounting software packages that allow the retailer to produce simple reports for compliance and internal control purposes. But this software is incapable of dealing with the complexity of multistate sales tax compliance.

In order to satisfy their compliance burdens, many small and medium sized businesses will be forced to implement transaction, accounting, and reporting systems that are much better suited to large multistate businesses, but without the revenues to support either the up-front costs or the ongoing service and maintenance of those systems. Not only are these new software systems expensive, but the process of transitioning an entire system—whether it be a shopping cart or a back-end accounting system—is a massive undertaking. Data must be exported and converted; personnel must be trained; and hundreds of hours will likely be spent working out the kinks. For the owners and operators of small businesses, the time commitments associated with these transitions can be even more taxing than the financial ones.

Critically, these upgrades are fixed costs that businesses must incur even if only a few jurisdictions begin to impose sales tax compliance obligations on them. The issue is that the basic back-end systems that most small businesses use are simply not designed to integrate with third-party sales tax software at all. So once it becomes necessary to take that step—whether to comply with the rules of five jurisdictions or five hundred—these businesses must incur expenses in the tens of thousands of dollars.

The net effect of all of these expensive changes is that the companies' systems will become capable of

compliance, but also substantially more complex. And it is a truism that systems with more moving parts are more prone to failure and more difficult to repair. Consider the following example: in order to collect the proper amount of sales tax, an online shopping cart must take as an input the customer's address, and then send a query to a third-party server to determine all of the applicable tax rates (local and state) based on that address. Sometimes, the query will run first through an intermediary server that acts as a "connector" between the shopping cart company's server and the sales tax compliance company's server. The third-party server must then send the result back to the shopping cart software, which applies the rates to the relevant products. If, for some reason, the connector or the sales tax company's site is down or not responsive, then the shopping cart has only two options: either it can collect zero taxes (or some default amount), which will expose the company to sanctions for noncompliance or complaints from the customer (depending on whether the software collects too little or too much tax); or the system will simply not permit the transaction to go through, which means that the customer will likely go elsewhere. These added steps, referred to in the industry as "friction," all result in fewer sales. And that hypothetical involves a relatively benign scenario. It is likely that many businesses will experience far more significant hiccups as they transition to new systems.

Importantly, the costs of sales tax compliance are not limited to software and systems. People must then use those systems on a daily basis. Employees must classify products so that the software can

determine whether they are taxable or not (*e.g.*, adult diapers vs. baby diapers). They must collect tax exemption certificates from exempt buyers outside of their home states. They must conduct regular checks to ensure that the software is collecting taxes properly. And then they must find a way to remit those taxes to the proper taxing authorities. These tasks add up. In large businesses, sizeable compliance departments deal with them. In small businesses, they fall upon employees who already shoulder a host of other responsibilities. Many small businesses may need to hire additional staff simply to deal with the compliance burden.

Another important potential cost associated with affiliate nexus taxes is the systemic risk of an out-of-state tax audit. Taxing jurisdictions—from the State of New York to Greenwood Village—all have the power to conduct intrusive audits of retail vendors. Presently, there is no uniform procedure for such audits, and so a business subjected to such audits is forced to hire expensive attorneys and advisors to ensure that it complies fully with a regulator's requests. Even if an audit does not reveal any evidence of wrongdoing, the cost of responding alone can be enough to drive a small business from the black to the red.

Finally, and critically, the burdens of the affiliate nexus taxes impose a disproportionate and unconstitutional competitive burden on *Internet* retailers that will again be felt most acutely by small businesses. Internet sales, like the mail-order sales at issue in *Quill Corp. v. North Dakota ex rel. Heitkamp*, 504 U.S. 298, 315-16 (1992), entail costs that brick-and-mortar sales do not—most

particularly shipping costs. By adding unlawful sales tax collection obligations to the already high costs of e-commerce, states like New York will assuredly drive sales away from Internet businesses. And small online businesses will be disproportionately affected because they have less capacity to absorb losses or use economies of scale to cut their own costs.

4. For all of the foregoing reasons, this Court's prompt review of the question presented is of vital importance to small businesses across the country. Until the controversy over the constitutionality of affiliate nexus taxes is resolved, the most likely outcome is that retailers that do not have affiliate marketing programs will not initiate them, and retailers that have them will curtail them in states that adopt affiliate nexus taxation. The alternative would be to make substantial investments of time and money in upgraded technical infrastructure and training, without knowing whether those investments are even necessary.

In today's challenging business environment, these are investments that small businesses simply cannot afford to make. Indeed, the Performance Marketing Association, the lead trade group for affiliate marketers, reports that "over 200 merchants terminated their affiliate programs in New York, to avoid the expense and unfairness of collecting sales tax for purchases made in New York." Performance Marketing Association, *Affiliate Nexus Tax Basics*, <http://performancemarketingassociation.com/advocacy/legislation/the-advertising-tax> (last visited Sept. 23,

2013). Those 200 merchants include some of the *amici*.⁵

This is thus a textbook case in which legal uncertainty threatens to chill beneficial economic activity. Unless and until this Court takes up the constitutionality of affiliate nexus taxes, retail businesses, their affiliates, and consumers are all likely to suffer as a result of continued uncertainty.

⁵ The fact that tax collection obligations will not apply if a business shifts its advertising from an affiliate model to more traditional advertising reveals the absurdity of focusing on affiliates in the first instance. By enacting affiliate nexus taxes, states like New York have embraced the fiction that affiliates are “soliciting” on behalf of the retailers, as opposed to simply posting advertisements. That blinks reality, and the fact that small businesses are likely to simply reallocate their advertising budgets to other forms of ads demonstrates how flimsy the states’ “hook” for taxation truly is.

CONCLUSION

For the foregoing reasons, the petitions for a writ of certiorari should be granted.

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