

Taxing E-Commerce Affiliates: The Potential Impact Of New York State’s “Amazon Tax”

Ross A. Malaga, Montclair State University, USA

ABSTRACT

On June 1, 2008 New York State imposed a new law, called the “Amazon tax”, that requires online retailers who receive more than \$10,000 per year in revenue from New York affiliates to collect New York sales tax. While a number of major online retailers have challenged the law in court, it has already had a significant impact on affiliate marketers. If the law is upheld other states will enact similar laws. This paper details the impact of the law on affiliate marketers, online retailers, and affiliate networks. It provides specific short and long range recommendations to each of these types of companies.

Keywords: E-commerce, Sales Tax, Online Retail

1. INTRODUCTION

In April 2008 New York State passed a new law requiring online retailers who receive more than \$10,000 per year in revenue from New York affiliates to collect New York sales tax (New York State, 2008). The law went into effect on June 1, 2008. It is estimated that the new law will provide approximately \$50 million to the state’s \$122 billion budget.

The law, dubbed the “Amazon tax”, represents a major shift in how states handle sales tax from online retailers. Amazon.com and other major online retailers have challenged the constitutionality of the law. In January 2009, the New York Supreme Court upheld the law. However, Amazon.com and the other plaintiffs have indicated they will appeal. If the law is upheld, it is likely that other states will implement similar legislation.

The goal of this paper is twofold. First, it aims to examine the impact of this law on affiliate marketers, online retailers, and affiliate networks. Second, it provides specific suggestions on how online retailers, affiliate marketers, and affiliate networks should respond to the new law. The next section provides background on sales tax laws, affiliate marketing, and the “Amazon tax”. Following that, the impact of the law is examined. Section four discusses the decisions that need to be made by online retailers, affiliates and affiliate networks and specific recommendations are detailed. Finally, conclusions are discussed.

2. BACKGROUND

In order to understand the New York law and its potential impact, a general understanding of sales tax law is required. In addition, the affiliate marketing model is discussed and the “Amazon tax” is examined.

2.1 Sales Tax

Merchants with a physical presence in a jurisdiction are required to collect sales tax on certain items they sell. A person from one state who makes a non-taxable purchase in another, may be required to pay a use tax to their own state. For example, if a person in New Jersey travels to New York to purchase a product that is not taxed

in New York, but is taxed in New Jersey, that person would pay a use tax in New Jersey. In order to simplify this discussion, we use sales tax throughout this paper, but use taxes may also apply.

One of the major difficulties for online retailers in terms of sales tax is, each state and local jurisdiction may set its own sales tax rate. For example, in Chicago the sales tax rate is 9%. This tax is made up of a number of sales taxes imposed by numerous jurisdictions – 6.25% IL sales tax, 1.25% city sales tax, 0.75% county sales tax, 0.75% transportation authority tax.

The proliferation of sales tax rates (over 7500 by some counts) led to the 1992 *Quill vs. North Dakota* Supreme Court ruling (Stevens, 1992). In that case the state of North Dakota attempted to collect sales taxes from Quill (a catalog office supply company) for purchases made by North Dakota residence. The Supreme Court ruled that since Quill did not have nexus in North Dakota, no sales taxes were due. According to the Court, nexus is a physical presence (such as an office, warehouse, or employees) in a state. This is opposed to an economic presence (customers).

Another Supreme Court ruling that must be considered is the 1960 case *Scripto vs. Carson* (Clark, 1960). Scripto was a maker of pens located in Georgia. The company used commissioned brokers in Florida to solicit business from Florida customers. Florida attempted to collect taxes on these sales. Scripto argued that it did not have a physical presence in Florida as the brokers were independent contractors. The Court ruled with Florida in this case. Justice Clark, writing for the Court, ruled that the difference between employees and independent contractors was “without constitutional significance.”

2.2 Affiliate Marketing

According to Malaga (2007) affiliate marketing is an e-commerce business model in which an online retailer agrees to pay a commission to Web site owners who send it traffic that leads to an action (usually a sale). Thus the affiliate model is often referred to as cost-per-action (CPA). Commissions are usually paid on a sale, but some merchants will also pay for each lead. In addition, commission rates vary widely. For example, commissions for physical products typically range from 5-20%. However, commissions for information goods (e-books and software) are normally in the 40-60% range.

The exact size of affiliate marketing activity is difficult to determine. However, according to MarketingSherpa (Holland, 2006) affiliates earned more than \$6.5 billion in commissions in 2006. The total amount of revenue online retailers received through their affiliates cannot easily be determined. Many public online retailers, such as Amazon.com, include payouts to affiliates as part of their overall marketing expenses.

There are two main ways in which affiliate programs are run. The first is for the merchant to run the affiliate program in house. The merchant adds code to their checkout process to track which affiliates have provided the traffic for a purchase. Amazon.com uses this approach.

The second method is to use a third party provider (affiliate network), such as Commission Junction, LinkShare, or ShareASale. These sites serve as a trusted intermediary between the merchant and the affiliate. Merchants register with the affiliate network and provide links, banner ads, data feeds, and other advertising. Affiliates register with specific merchants on the network. The affiliate uses the advertising provided by the merchant, or its own advertising to send the merchant traffic. The affiliate network tracks traffic and sales, collects commissions from merchants, and pays affiliates.

2.3 The New York State Law

The New York State law applies to only to online retailers that collect more than \$10,000 per year in revenue from affiliates that live in New York State. The base sales tax rate in New York State is 4%. However, many local jurisdictions have higher rates. For example, the sales tax rate in New York City is 8.375%. According to (Kennedy, 2008) there are 78 different sales tax jurisdictions in the state. The law went into effect on June 1,

2008 despite a legal challenge from major online retailers such as Amazon.com and Overstock.com (Zarrol, 2008). These companies have argued that using affiliates do not constitute nexus in New York State.

3. IMPACT OF THE “AMAZON TAX”

The “Amazon tax” has already had an impact with online retailers. One major impact is a host of online retailers that have dropped their New York based affiliates. For example, on May 15, 2008 Overstock.com told its approximately 3,400 New York state affiliates that they could no longer participate in the company’s affiliate program. Other online retailers that have taken similar action include (but are not limited to) – Bodybuilding.com, eToys.com, Geeks.com, LampsPlus.com, Luggage.com, Ritz Camera, and uBid.com (Kevin, 2008). The dropping of New York affiliates potentially impacts tens of thousands of residents who rely on these programs for their livelihood or to simply supplement their incomes.

Another major impact is that some online retailers, such as Amazon.com, have decided to keep their affiliates and charge New York state customers applicable sales tax. This obviously puts the retailer at a competitive disadvantage as they now have to charge both sales tax and shipping. In addition, the retailer must invest in the technology needed to determine the proper tax rate in the customer’s local jurisdiction. It is too soon to determine the financial impact of this approach.

If the “Amazon tax” in New York is upheld by the courts many other states are likely to follow suit. According to (Kennedy, 2008) California is already considering similar legislation. If other large states enact similar laws, the impact on affiliate marketing is likely to be disastrous as many online retailers drop their affiliate programs.

Finally, the “Amazon tax” has had an impact on the affiliate networks. For example, ShareASale.com has recommended that their merchants do not drop their New York affiliates. In addition, they have added a link on their merchant control panel to enable merchants to track their revenue from New York based affiliates. If the law is upheld and other states follow suit, the negative impact on the affiliate networks is likely to be substantial.

4. DECISION MAKING FOR ONLINE RETAILERS, AFFILIATES, AND AFFILIATE NETWORKS

Given the uncertainty in the current situation it is difficult for online retailers, affiliates, and affiliate networks to determine how to respond to the “Amazon tax”. However, there are a number of practical steps that each can take.

4.1 Online Retailers

First, online retailers need to determine how much of their revenue comes from New York based affiliates. These retailers should keep in mind that the law only applies to those companies that have more than \$10,000 in revenue from New York affiliates. Companies that are close to that figure need to monitor their situation closely.

Second, online merchants need to evaluate their affiliate programs. Some of these programs are highly successful, representing a significant percentage of the merchants total revenue. Other programs bring in little or no revenue. Obviously, the unsuccessful programs can easily drop their New York affiliates with little or no business impact.

Third, those merchants with a successful affiliate program that is impacted by the “Amazon tax” may decide to drop their New York affiliates. However, this decision has significant long term consequences. The legal situation will have one of two possible outcomes. Either the courts will rule in favor of New York or in favor of Amazon (and the other online retailers that have sued).

If the courts rule in favor of the online retailers then those companies that have dropped their New York affiliates may have a difficult time winning them back. Losing their relationship with their New York affiliates

might put a company at a competitive disadvantage going forward. However, online retailers in this situation need to decide how to react in the interim as the matter moves through the legal system.

If the courts rule in favor of New York then other states are likely to enact similar laws. At this point the online merchant would need to either discontinue its affiliate program entirely or implement the technology to begin collecting sales tax. Online retailers need to think about their decision in this circumstance. If the company decides it would eliminate its affiliate program, then it should proceed with dropping the New York affiliates immediately. However, if the company decides it would collect sales tax it should begin analyzing the technology needed to implement such a solution.

4.2 Affiliates

Some affiliates have developed successful and highly profitable businesses using the affiliate model. In fact, the top affiliates regularly generate multi-million dollar revenues every year. Those businesses based in New York are clearly threatened by the “Amazon tax”. Those affiliates who are dropped (or may soon be dropped) by their main online merchant have a number of options.

First, the affiliate can attempt to shift to using a merchant who collects New York sales tax. However, for those affiliates who have a long standing relationship with their merchant this might prove difficult. Many merchants provide incentives and higher payouts for their best affiliates. This tends to lock in affiliates with a specific merchant and makes it difficult for the affiliate to start over. Clearly, given the current legal situation, all affiliates should consider diversifying their merchant base.

Second, affiliates can shift their business operations out of New York state. In fact, many New York based affiliates have already done this. It should be noted that this approach may have negative legal repercussions. Given the nature of electronic commerce shifting business operations to another state is typically an easy solution. As merchants and affiliate networks use the mailing address of the affiliate to determine location, affiliates can simply setup in another state. Those affiliates who do not have a corporate entity may choose to rent a post office box in a neighboring state. Affiliates who have a corporate entity can establish that entity in another state and use a registered agent in that state for mail forwarding.

4.3 Affiliate Networks

The affiliate networks earn money by charging online merchants a commission every time they process a transaction from an affiliate. Clearly, fewer affiliates will negatively affect these companies revenues. All of the affiliate networks should help their merchants determine if they are impacted by the “Amazon tax”. This is the course of action taken by ShareASale. Other affiliate networks have been more circumspect. For example, the leading affiliate network, Commission Junction, sent the following e-mail to their merchants and affiliates:

“As you may already know, the State of New York recently enacted new legislation that addresses tax registration, collection, and other time-sensitive obligations. As with all laws, this law may or may not apply to you and your business. We are actively monitoring the law and will use reasonable efforts to protect ourselves and our publishers as we deem appropriate.

The application of the law is dependent on particular business and factual circumstances, and Commission Junction is not in a position to provide legal and tax advice regarding this law. However, we encourage you to perform the appropriate due diligence as it relates to your business.

For your convenience, we have provided a link to a memo from the New York State Department of Taxation and Finance, Office of Tax Policy Analysis, Taxpayer Guidance Division that addresses the new legislation: http://www.tax.state.ny.us/pdf/memos/sales/m08_3s.pdf.”

Affiliate networks might also consider trying to provide technical solutions for their merchants. Some examples include:

- automatically removing non-performing and low performing New York based affiliates from merchant programs,
- monitoring New York based affiliate revenues and slowing or stopping traffic from those affiliates as the \$10,000 threshold is approached, and
- helping merchants setup the technical solutions required to collect the appropriate sales tax.

5. CONCLUSIONS

Affiliate marketing is a multi-billion dollar industry. The New York State “Amazon tax” is a major threat to that industry. While online merchants fight the law in court, they, along with affiliates and affiliate networks must find interim solutions and begin thinking about how to proceed should the courts uphold the law.

This paper discusses the impact of the law on affiliates, online merchants, and affiliate networks. It details specific actions each constituency can take in the short run, as well as when the courts finally decide the underlying legal questions.

One area that was not addressed in the paper, but is a topic for future research is the impact of the law on New York state. If a large number of online merchants drop their affiliates then the state will likely be worse off, as they will lose income taxes from the affiliates and not gain any new sales tax revenues.

AUTHOR INFORMATION

Ross A. Malaga is an Associate Professor of Management and Information Systems at the School of Business, Montclair State University. He received his Ph.D. from George Mason University. Dr. Malaga has published extensively in the area of electronic commerce in *Communications of the ACM*, *Electronic Commerce Research*, and the *Journal of Organization Computing and Electronic Commerce*. He serves on the editorial review boards of *Information Resources Management Journal* and the *Journal of Electronic Commerce in Organizations*.

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