Chapter 1

Interstate Activity and Nexus

Learning objectives

- Identify nexus issues.
- Distinguish between income tax and sales tax nexus.
- Recognize the constitutional issues that drive nexus decisions.
- Identify the limitations of Public Law 86-272.

COPYRIGHTED MATERIAL

Introduction

Nexus is the beginning issue in any multistate activity. Unless you are doing business in, or have nexus with, a political jurisdiction, there is no obligation to file a return with that jurisdiction.

The word *nexus* comes from the Latin word *nexum* referring to obligations between contracting parties. More simply, in the state and local tax context it refers to both the quantity and quality of contacts, links, or connections between a taxpayer and a political jurisdiction sufficient enough to subject the taxpayer to the jurisdiction of the state. Or to put it even more simply, are you doing business in ___________ (fill in the blank: town, county, or state)?

The nexus issue is becoming increasingly volatile and complex in light of the states' attempts to broaden their tax base and increase their tax collections. States are pressing out-of-state companies, with the most slender of connections to the state, to file returns and pay sales tax and income tax. The rapid

© 2019 Association of International Certified Professional Accountants. All rights reserved.

growth of e-commerce and the internet has added to this complexity, making proper tax planning in this area more critical than ever. Even though this is a class on multistate corporate income tax, we discuss both sales tax nexus and income tax nexus in this chapter. The principles behind nexus for both taxes overlap and, as a consequence, there is a lot of confusion over the distinction between sales tax and income tax nexus. It is critical to understand both nexuses and the differences between the two.

Knowledge check

1. The volatility of the nexus issue for purposes of state income taxes has

    a. Lessened.
    b. Become less complex.
    c. Increased.
    d. Stopped completely.

© 2019 Association of International Certified Professional Accountants. All rights reserved.

Nexus defined

Nexus is the contact that must be established with a taxing jurisdiction before that jurisdiction can require a business to collect its tax, or otherwise subject it to its taxing authority. Generally, states extend their taxing authority as far as constitutionally possible. Consequently, it is with the U.S. Constitution that we must begin our discussion of nexus.

Please note, however, that nexus may be different for different taxes. In analyzing income tax issues, be careful not to confuse nexus for sales and use tax purposes with nexus for income tax purposes. For instance, most businesses are concerned with three types of nexus when doing business in surrounding states or states outside their domicile's taxing jurisdiction. Most common are nexus for sales and use tax purposes, nexus for income and franchise tax purposes (if this tax applies in a state), and nexus for purposes of registering or qualifying with the Secretary of State's office to do business in a state. Nexus conditions for all three of these are generally different.

The two clauses of most importance in the U.S. Constitution for defining the taxing jurisdiction of states are the Due Process and Commerce Clauses.

Due process

The Fourteenth Amendment to the Constitution prohibits states from denying any person "life, liberty, or property, without due process of law." Because taxation is regarded as depriving someone of their property, a state cannot exact such tolls without due process of law.

Due process relates essentially to questions of fundamental fairness, to "traditional notions of fair play and substantial justice." "That test is whether property was taken without due process of law, or if we must paraphrase, whether the taxing power exerted by the state bears fiscal relation to protection, opportunities and benefits given by the state. The simple but controlling question is whether the state has given anything for which it can ask return." (*Wisconsin v. J.C. Penney Co*., 311 U.S. 435)

The Due Process Clause of the Fourteenth Amendment imposes four hurdles a state must overcome before it can impose a tax.

- There must be a minimum connection between the taxpayer and the state.
- There must be "some definite link, some minimum connection, between a state and the person, property, or transaction it seeks to tax." *Quill v. North Dakota*, citing *Miller Brothers v. Maryland*, 347 U.S. 340, 344-345 (1954).
- There must be some rational relationship requirement between the taxpayer and the state.
- The "income attributed to the State for tax purposes must be rationally related to 'values connected with the taxing State.'" *Quill* at 306, citing *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 273 (1978). If property is taken, or responsibilities are imposed on the taxpayer, the government must have sufficient jurisdiction over the taxpayer, or due process is not served (*Wisconsin v. J.C. Penney,* 311 U.S. 435 (1940); *National Bellas Hess v. Illinois Dept. of Revenue,* 386 U.S. 753

© 2019 Association of International Certified Professional Accountants. All rights reserved.

(1967)). (The *National Bellas Hess* decision seemed to combine both the Commerce Clause and the Due Process Clause analyses.)

For many years, it has been fairly clear that the Due Process Clause is not really a serious hurdle. Why? Because the Supreme Court has ruled that the due process hurdle is cleared whenever a company purposefully directs it business activity or solicitation toward a state's residents. The minimum connection for a company need be no more than "purposefully avail[ing] itself of the benefits of an economic market in the forum State," or engaging "in continuous and widespread solicitation of business within a State." In other words, the Due Process Clause does not require physical presence. Thus, a mail-order company, whose only contacts with a state were catalogs and goods sent through the U.S. mail, satisfied the nexus standard for due process (see *Quill Corp. v. North Dakota*, 504 U.S. 298,306 (1992)).

Commerce clause

The second applicable constitutional provision is the Commerce Clause, which provides for congressional regulation of interstate commerce. The Commerce Clause of the Constitution provides that "Congress shall have the power to regulate Commerce with foreign Nations, and among the several states, and with the Indian tribes." (*U.S. Constitution, Art. I, Section 8, Cl. 3*)

The Commerce Clause has been interpreted as not only conferring power on the national government to regulate commerce, but also as limiting the states' power to interfere with commerce even where Congress has not acted. Under this dormant Commerce Clause principle, taxes that have been found to unduly burden interstate commerce have been declared unconstitutional. However, the crux of the Commerce Clause analysis is not necessarily that states are prohibited from imposing any burden on interstate commerce, but rather whether the tax discriminates against interstate commerce, either by providing a direct commercial advantage to local businesses, or by creating multiple taxation on interstate commerce. In short, states can tax interstate commerce so long as they meet the four-prong test of *Complete Auto Transit*.

In *Complete Auto Transit*, the Supreme Court provided a four-prong test for determining whether a state tax on interstate commerce is constitutional. A state tax will be deemed constitutional if

- the tax is applied to an activity with substantial nexus with the taxing state.

For sales and use tax purposes, substantial nexus has historically been defined as requiring at least a minimal physical presence. See *Quill v. North Dakota*, 504 U.S. 298 (1992). However, the recent *Wayfair* decision has added economic thresholds as a means of creating nexus. See *South Dakota v. Wayfair*, 585 U.S. (2018).

- The tax is fairly apportioned.

The Supreme Court has stated that fair apportionment requires that the tax meets both an internal and external consistency test. "Internal consistency is preserved when the imposition of a tax identical to the

© 2019 Association of International Certified Professional Accountants. All rights reserved.

one in question by every other State would add no burden to interstate commerce that intrastate commerce would not also bear." *Oklahoma Tax Comm'n v. Jefferson Lines*, 514 U.S. 175, 185 (1995).

In short, if every state adopted the same test as the one before the court, and the income tax would be no more than 100%, then the internal consistency test is met.

External consistency is "the economic justification for the State's claim upon the value taxed, to discover whether a State's tax reaches beyond that portion of value that is fairly attributable to economic activity within the taxing State." *Oklahoma Tax Comm'n v. Jefferson Lines*, 514 U.S. 175, 185 (1995). In short, external consistency requires that the formula or methodology used be a fair or reasonable reflection of how the income is earned in the state.

Most of the debate over the fair apportionment test has been over the formulas used by states in apportioning and allocating the income of a multistate business.

- The tax does not discriminate against interstate commerce.

A state may not "impose a tax which discriminates against interstate commerce . . . by providing a direct commercial advantage to local business." *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 458 (1959).

- The tax must be fairly related to services provided by the taxing state.

The "fourth criterion asks only that the measure of the tax be reasonably related to the taxpayer's presence or activities in the State." *Complete Auto Transit, Inc., v. Brady*, 430 U.S. 274 (1977). Generally, if the sale takes place in the state and is measured by its purchase price, there will be no violation of this fourth test.

In sum, state taxes may be imposed on interstate commerce, but they will be justified only if the taxes are designed so that the interstate business bears a fair share of the cost of the government entity whose protection it enjoys [*Complete Auto Transit, Inc.* U.S. 274 (1977); *Western Livestock v. Bureau of Revenue,* 303 U.S. 250 (1938); *McGoldrick v. Berwind-White Coal Mining Co.,* 309 U.S. 33 (1940); *Northwestern States Portland Cement Company v. State of Minnesota,* 358 U.S. 450 (1959)].

It is important to note that the nexus requirements for the two constitutional hurdles, Due Process and the Commerce Clause, are not the same; a point emphasized by the U.S. Supreme Court in *Quill*. "[North Dakota] contends that the nexus requirements imposed by the Due Process and Commerce Clauses are equivalent and that if, as we concluded previously, a mail-order house that lacks a physical presence in the taxing State nonetheless satisfies the due process 'minimum contacts' test, then that corporation also meets the Commerce Clause 'substantial nexus' test. We disagree. Despite the similarity in phrasing, the nexus requirements of the Due Process and Commerce Clauses are not identical." (*Quill Corp. v. North Dakota*, 504 U.S. 298 (1992))

© 2019 Association of International Certified Professional Accountants. All rights reserved.

Knowledge check

2. The right to impose tax on an out-of-state business rests upon

    a. The U.S. Constitution.
    b. State law.
    c. Local taxing authority.
    d. The Supreme Court.

3. The Due Process Clause defines nexus as ___________, and the Commerce Clause definition requires ___________.

    a. Fair apportionment; rational relationship.
    b. Substantial nexus; minimal contacts.
    c. Minimal contacts; substantial nexus.
    d. Fair apportionment, minimal contacts.

4. The Commerce Clause requires all but

    a. Minimal nexus
    b. Nondiscrimination
    c. Fair apportionment
    d. Some relation to services provided

In summary, the Due Process Clause requires only (1) minimum contacts (physical presence not necessary), and (2) a rational relationship between the income and the state. The Commerce Clause requires (1) substantial nexus, (2) nondiscrimination, (3) fair apportionment, and (4) some relation to the services provided.

We can look at an example to see how the preceding case law and rules work in practice.

For example, Crystal City Computers has one small store in Denver, Colorado, but sells most of its computers and peripherals over the internet and through catalogs. It has no employees, sales representatives, or facilities other than the Denver store. A farm girl from Kansas, named Dorothy, orders one of the company's computers over the internet. Crystal City ships a computer to Dorothy by common carrier. Crystal City does not exceed any economic nexus threshold in Kansas. Crystal City does not have any obligation to collect sales or use tax from Dorothy on the sale because it does not have nexus with the state of Kansas. Nor does Crystal City have any obligation to file an income tax return with Kansas.

Would our answer be any different if Crystal City has maintenance agreements with several Kansas computer service repair shops that provide warranty repair in case Dorothy's computer fails? Perhaps. Many states have adopted a rule asserting that warranty repair services provided by third-party independent contractors will create nexus for a remote vendor. Suppose Crystal City delivers the computer in its own truck rather than using a common carrier. Would that create nexus? If the deliveries were infrequent and sporadic, the seller might not have nexus. However, if the deliveries are significant in number, most states will claim that sales tax (but not income tax) nexus has been created between itself and the remote seller.

Suppose Crystal City had one sales person who made only two trips into Kansas during the past 18 months. Would the physical presence of the salesperson create a filing obligation on the part of

© 2019 Association of International Certified Professional Accountants. All rights reserved.

Crystal City? Perhaps not. It is not enough physical presence for some states. However, Washington recently held that two visits to the state were sufficient to create a filing obligation (see *Lamtec Corp. v. Washington*, 246 P.3d 788 (Wash. 2011)).

The questions about deliveries, the extent of physical presence, and the actions of agents are part of the continuing debate over nexus. But before we look at those issues, it is important to stop for a moment and distinguish sales tax nexus from income tax nexus. People often confuse the two.

Sales tax nexus

There are three key U.S. Supreme Court cases that define the test for sales tax nexus: *National Bellas Hess, Inc. v. Illinois*, 386 U.S. 753 (1967), *Quill v. North Dakota*, 504 U.S. 298 (1992), and *South Dakota v. Wayfair, Inc*. In the first two instances the Court ruled that physical presence is the bright-line test for sales tax nexus, and subsequently added an additional economic presence standard that could be met with the third.

National Bellas Hess was a landmark decision in the sales and use tax nexus area. In this 1967 case, the seller was a Missouri mail-order house with no presence or activity in Illinois, except for catalogs and flyers that were mailed to its customers twice a year. Any products sold in Illinois were delivered by common carrier. Illinois required that National Bellas Hess register to collect sales and use tax, asserting it had nexus with the State of Illinois. Illinois believed that Bellas Hess was doing business in the state because its "large-scale, systematic, continuous solicitation and exploitation is a sufficient 'nexus' to require Bellas Hess to collect" Illinois use tax. The U.S. Supreme Court held that Bellas Hess did not have a filing obligation with Illinois. In fact, the court held that a taxpayer must have physical presence in a state before incurring a sales or use tax filing obligation. The court was sensitive to the fact that the thousands of sales taxing jurisdictions in the United States posed a considerable impediment to interstate commerce.

The court decided that the activities of National Bellas Hess in Illinois were strictly in interstate commerce. Accordingly, there was not sufficient nexus for National Bellas Hess to be liable for Illinois use tax on sales to Illinois residents. The court determined that requiring the seller to collect sales and use tax in Illinois would violate the company's rights under both the Due Process and Commerce Clause of the U.S. Constitution. In short, the sales were clearly a matter of interstate commerce; the company did not have any physical presence in the state and, thus, had no obligation to collect the state's tax.

Given the significant changes in technology, including computers, fax machines, mobile phones, and the internet, since the Bellas Hess decision in 1967, it was no surprise that state tax administrators believed the physical presence test to be archaic and wanted to revisit the issue. North Dakota did just that in Quill in 1992.

The *Quill* case was similar factually to the *National Bellas Hess* decision. Quill Corporation, a non-North Dakota business, had no physical presence or employees in North Dakota. Quill sold business equipment and supplies in North Dakota only through catalogs, flyers, and by telephone. The post office or common carriers delivered all sales in North Dakota.

© 2019 Association of International Certified Professional Accountants. All rights reserved.

The opinions of the lower courts involved in the *Quill* cases were varied. The North Dakota trial court found *Quill* indistinguishable from *National Bellas Hess* and, accordingly, ruled in favor of Quill. The North Dakota Supreme Court, however, overruled the trial court in favor of the state citing that changes in the economy and the law, in essence, outdated *National Bellas Hess.* The North Dakota Supreme Court embraced an economic presence test versus a physical presence test and held that Quill's economic presence in the state was sufficient nexus to require Quill to collect the use tax. After all, reasoned the court and its supporters, with fax machines, mobile phones, satellite transmissions, and the beginning of the internet, a company no longer had to be physically present in a state to do business there.

Nevertheless, the U.S. Supreme Court reversed the decision of the North Dakota Supreme Court, but agreed with it on some grounds. With respect to the due process analysis, the court held that a physical presence was not required. The court's due process analysis was based on whether a multistate business's contacts with a state made it reasonable to require it to defend a lawsuit in the state. The Supreme Court reasoned that Quill's continuous and widespread activity within North Dakota was sufficient warning that its activities may subject it to the taxing jurisdiction of the state. It is important to note that this finding differed from the court's position in *National Bellas Hess*. One of the Supreme Court justices indicated that in the 25 years between the *National Bellas Hess* ruling and the *Quill* ruling, there were enough changes in law and in technology that the due process analysis of *National Bellas Hess* was no longer applicable.

The U.S. Supreme Court held that while requiring *Quill* to collect North Dakota's sales or use tax was not a due process violation, it would still place an unconstitutional burden on interstate commerce. The court found that the physical presence requirement is still a valid requirement under the Commerce Clause analysis and, in that regard, it refused to overrule *National Bellas Hess*'s reasoning. It also reaffirmed that the Complete Auto Transit four-part test was an adequate test under the Commerce Clause. In essence, the decision maintained the status quo, yet sent a strong message to Congress that Congress is not only better qualified to resolve this issue, but that it also has the ultimate power to do so.

In summary, the *Quill* decision holds that a taxpayer has established nexus for sales and use tax under the Due Process Clause where the taxpayer's activity is limited to purposefully directing its economic activities to the state's residents. Thus, a retailer whose only activity in a state is limited to the mailing of catalogs has probably created nexus for purposes of the Due Process Clause. In other words, a company need not be physically present in a state to create a filing obligation for purposes of the Due Process Clause.

The Commerce Clause, however, still offers significant protection to remote sellers. First, a state cannot interfere with the regulation of the national economy. Second, a state can only assert jurisdiction over businesses where there is substantial nexus with the state. The U.S. Supreme Court disagreed with the North Dakota Supreme Court's assertion that the technological and economic business changes since *Bellas Hess* would justify totally overruling that decision. Physical presence is still one of the easier means to identify if nexus has been created. But, nexus has been greatly expanded by the recently decided *South Dakota v. Wayfair, Inc.* case.

Forget Nexus. Let's try "notice and reporting."

© 2019 Association of International Certified Professional Accountants. All rights reserved.

There is another trend happening now that could have great impact. Even with the *Wayfair* decision, notice and reporting is still alive and well. Failure to comply with what some call the “Notice and Reporting” rules have some egregious penalties.

Colorado was the first state to enact this new “Amazon law.” Their approach was to say, “Okay, if we can’t force out-of-state sellers to collect our use tax because of *Quill*, what if we can make it really expensive not to collect it by imposing very expensive record-keeping and onerous reporting requirements? If we do that maybe we can ‘convince’ sellers to ‘choose’ to collect the tax.”

It was enacted in 2010 but immediately challenged. As enacted, Colorado’s use tax notification requirement applies to out-of-state businesses that sell taxable goods to Colorado residents but don’t collect Colorado sales or use tax. It requires noncollecting businesses making at least $100,000 in total gross annual sales to

1. inform Colorado customers they may be subject to Colorado use tax;
2. send an annual purchase summary to Colorado customers who purchase more than $500 in taxable goods in one year, along with a reminder of their use tax obligation; and
3. provide the Colorado Department of Revenue with annual customer information (names, addresses, and amount of purchases).

The Direct Marketing Association (DMA) immediately challenged the policy because it discriminates against interstate commerce and unduly burdens out-of-state businesses. The DMAs lawsuit in *Direct Marketing Association v. Brohl* is what prompted the opinion by Justice Kennedy mentioned previously.

DMA lost

The original DMA case created a stir because of the comments by Kennedy as have already been discussed. After the original case was remanded back to the state court for a rehearing on the merits, the state court upheld the legality of the notice and reporting requirements. That was a shame for businesses because those requirements are so onerous. When that second State court ruling was then re-appealed to the U.S. Supreme Court, they declined the case, letting the lower court’s ruling and the onerous Colorado laws stand.

Penalty for not reporting

The taxpayer might be tempted to just ignore this requirement in Colorado. Do so at your peril though, because the penalties could be devastating:

- There is a $5-per-transaction penalty for each failure to inform Colorado customers that they may be subject to Colorado use tax.
- There is a $10 penalty per each failure to send an annual purchase summary to Colorado customers who purchase more than $500 in taxable goods in one year, along with a reminder of their use tax obligation.

That’s how Colorado decided to bully out-of-state sellers to comply. These requirements may seem like an unconscionable burden on retailers, but this is the current law of the land in Colorado. Colorado’s success in the courts prompted Louisiana and Vermont to pass similar notice and reporting laws. More

© 2019 Association of International Certified Professional Accountants. All rights reserved.

states are likely to follow. In fact, the state of Washington recently passed its own version, effective January 1, 2018.

Before *Wayfair*, this approach seemed like the easiest path for a state to take to make people register to collect tax. If a client is selling in Colorado and facing these penalties, they will quickly realize it is way more expensive to comply with the notifications rules and file these reports than just to get registered in Colorado and collect the tax. That is exactly what Colorado was hoping for, and pre-*Wayfair* it seemed likely many more states would adopt the same approach. In fact many other states did pass similar legislation including Louisiana, Pennsylvania, Rhode Island, Vermont, and Washington, and others are expected to jump in. Each state has its own version of the law. The following are the sales thresholds in each state that would subject a taxpayer to these new laws:

State	Threshold
Colorado	$100,000
Louisiana	$100,000
Oklahoma	$10,000
Pennsylvania	$10,000
Rhode Island	$100,000 or 200 transactions
Vermont	None mentioned
Washington	$10,000

The penalties are onerous. Here's what they are in each of the preceding states:

State	Penalty
Colorado	$5 to $10 per item missed
Louisiana	Unknown
Oklahoma	Lesser of $20,000 or 20% of sales
Pennsylvania	Lesser of $20,000 or 20% of sales
Rhode Island	None stated
Vermont	$5 to $10 per item missed
Washington	$20,000 maximum

Because of *Wayfair*, economic nexus is now in force, but physical presence also creates nexus. The question around physical presence has always been "How much physical presence is necessary?" In brief, the physical presence standard since *Quill* has generally revolved around three questions:

- How much physical presence is sufficient to create substantial nexus? (Or is physical presence in and of itself substantial nexus?)
- Can nexus be attributed to the seller through the physical presence of the seller's agent or affiliate?
- Is there a physical presence test for income tax?
- How much physical presence?

© 2019 Association of International Certified Professional Accountants. All rights reserved.

The U.S. Supreme Court has stated (and this statement has not been changed by the *Wayfair* case) that physical presence must be more than the slightest presence to rise to a standard of constitutional nexus. *National Geographic Soc'y v. California Bd. of Equalization*, 430 U.S. 551, 556 (1977). For example, in *Quill* the court held that Quill's ownership of some floppy disks and the licensing of the accompanying software in North Dakota did not create sales and use tax nexus in the state. The disks, while owned by Quill, were software used by its customers to place orders and check current inventories and prices. Despite the court's reference to a slightest presence and Quill's software in the state, it is not uncommon for auditors to take the position that any physical presence is, by definition, substantial nexus.

That said, it is difficult to say with certainty how much physical presence will create the necessary substantial nexus to satisfy the Commerce Clause. Prior to *Quill*, in *Miller Bros. Co. v. Maryland*, 347 U.S. 340 (1954), the U.S. Supreme Court ruled that occasional deliveries, in its own trucks by a Delaware retailer into Maryland, did not create nexus for sales and use tax. After *Quill*, the court had an opportunity to revisit the delivery issue in *Brown's Furniture, Inc. v. Wagner*, 171 Ill. 2d 410, cert. denied, 519 U.S. 866 (1996) but declined. The Illinois Supreme Court held that Brown's Furniture had nexus in Illinois by virtue of its advertising in the state coupled with 942 deliveries in its own trucks over a 10-month period. Such activity created nexus, the court said, because it was more than incidental, occasional, or sporadic, but instead it was regular and frequent. More recently, the Illinois Appellate Court ruled that 30 furniture deliveries over a 26-month period was enough physical presence to be substantial nexus for sales and use tax (*Town Crier, Inc. v. Illinois*, 315 Ill. App. 3d 286, 733 N.E.2d 780 (2000)). In Maine, a company whose advertising and solicitation were specifically directed toward the state, and who made 180 deliveries in its own trucks into Maine, had sufficient physical presence to constitute the substantial nexus necessary to create a filing obligation to the state (*John Swenson Granite v. State Tax Assessor*, 685 A.2d 425 (Me. 1996)).

The trend initiated by Illinois continues today. In 2014, Colorado ruled that using a contract carrier rather than a common carrier triggers a filing obligation because the contract carrier "is an agent of the shipper." (Colo. Information Letter GIL-14-015 (5/29/2014)) Texas ruled that a Louisiana retailer delivering furniture in its own trucks into Texas established nexus in the state (Texas Comptroller Decision No. 107,751 (7/23/2014)). Finally, and not surprisingly, Washington held that an Oregon fuel distributor who made 1,675 deliveries to 40 different customers in Washington during the three-year audit period established nexus in the state (*Space Age Fuels, Inc. v. Washington*, 315 P.3d 604 (Wash. Ct. App. 2013)). On the other hand, a Washington County Superior Court held that an out-of-state taxpayer who regularly shipped goods to a single customer in the state using leased railcars did not have a filing obligation with the state (*Washington v. Sage V Foods*, Dkt. No. 12-2-01893-3 (8/20/2013)). It is uncertain, but the difference between the two cases seems to depend on the fact that the latter's activities did not help to create and maintain a market for its goods in the state.

State courts have also differed on whether occasional or sporadic visits by employees are sufficient physical presence to constitute substantial nexus. New York has held that visits by an out-of-state retailer's employees exceeded the state's slightest physical presence test, thereby creating nexus. In one case, the visits were to 19 wholesalers, four times a year, and in another, there were 41 visits over a three-year period. According to the New York court, an out-of-state company's presence need not be substantial; it need only be more than the slightest presence. *Orvis Co. v. Tax Appeals Tribunal*, 86 N.Y.2d

© 2019 Association of International Certified Professional Accountants. All rights reserved.

165, 654 N.E.2d 954, *cert. denied,* and *Vermont Info. Processing, Inc. v. Tax Appeals Tribunal*, 86 N.Y.2d 165, 654 N.E.2d 954, *cert. denied,* 516 U.S. 989 (1995). In a holding to the contrary, the Kansas Supreme Court ruled that 11 visits by an out-of-state seller to install card readers did not create nexus, because the visits were isolated and sporadic [*In re Appeal of Intercard, Inc*., 270 Kan. 346, 14 P.3d 1111 (2000)]. The Arizona Court of Appeals held that a company had nexus with the state whose only activity during a three-year period was one visit per year by a salesperson, coupled with 21 days of customer training (*Care Computer Systems v. Arizona*, 4 P.3d 469 (Ariz. 2000)).

More recently, the Washington Supreme Court held that two or three visits per year were sufficient to trigger a filing obligation for the state's B&O tax. The court added that the physical presence test in *Quill* was irrelevant because that case was limited to a sales tax, and the issue before the court was a gross receipts tax (*Lamtec Corp. v. Washington*, 246 P.3d 788 (Wash. 2011)). Furthermore, P.L. 86-272 was not applicable because the B&O is not an income tax, but a gross receipts tax. (See the discussion of P.L. 86-272 that follows.)

The harsh result in *Lamtec* should be compared to a Utah private letter ruling that held that an out-of-state entertainment company's annual presence at a 10-day film festival did not trigger an income tax filing obligation with the state. [See Utah Private Letter Ruling 08-013, (05/04/2009).] Inconsistency between jurisdictions continues to abound. The Oregon Tax Court recently held that a franchisor did not have an income tax filing obligation with the state because it found in-state inspections of the company's seven franchisees coupled with a three- to five-day training did not rise to the level of substantial nexus (*Rent-A-Center, Inc. v. Oregon*, Dkt. No. 111031D (Ore. Tax Ct., 2014)).

The physical presence need not be that of an employee or independent contractor. North Carolina attempted to hold a company responsible for sales, corporate income, and franchise taxes, whose only connection with the state is the selling and renting of VHS videotapes through the mail. Educational Resources, Inc. (ERI), a South Carolina company, sells and rents videotapes about workplace safety. Between 1990 and 1995 it made 219 sales and 906 rentals into North Carolina totaling $201,304 and $99,521, respectively. ERI did not have any employees in North Carolina or any other contacts with the state except for the tapes that it sold and rented to North Carolina customers through the mail. The tapes rented for $150 to $200. Customers would keep rented tapes between 5 and 30 days before mailing them back to ERI.

The North Carolina Department of Revenue audited ERI and assessed them for sales, income, and franchise taxes. North Carolina argued that the presence of the rented tapes, which were ERI's property, created nexus with the state. The Superior Court ruled in favor of ERI stating that "the Court finds and concludes that, under the Commerce Clause of the United States Constitution as interpreted in *Quill* . . . , and other cases, there is not a 'substantial nexus' justifying the state's attempts to collect the use tax, corporate income tax, and franchise tax in these cases." (*Educational Resources, Inc. v. Tolson*, Nos. 00CVS14723 and 14724, Wake County, (North Carolina Superior Court, Feb. 20, 2003)) As the reader may recall, the U.S. Supreme Court ruled in *Quill* that the licensing of its software in the state along with the presence of a few floppy disks did not constitute substantial nexus. Compare North Carolina's actions with a recent decision in Alabama. In Alabama, an administrative law judge has ruled that an out-of-state leasing company was not doing business in the state despite the fact that the company's lessee was

© 2019 Association of International Certified Professional Accountants. All rights reserved.

using the company's property in the state (*Union Tank Car Co. v. Alabama Dep't of Revenue*, Admin. Law Div., Dkt. No. Corp. 04-247 (1/11/05)).

The most disconcerting ruling of 2014 was issued by Texas. The court ruled that the licensing of software downloaded over the internet established nexus for sales and use tax. A Utah taxpayer sold computer programs and digital content online. The taxpayer retained all rights in title to and ownership of the downloaded software. Because it did so, and because the state contends that computer software downloaded electronically is tangible personal property, the taxpayer had a sales and use tax filing obligation with Texas (Texas Comptroller's Decision No. 106,632 (9/19/2014)). This ruling seems inconsistent with the *Quill* decision in which the Supreme Court dismissed the fact that Quill licensed software to its customers in North Dakota. The court held that while the presence of a few floppy disks in the state "might constitute some minimal nexus," it did not rise to the level of substantial nexus as required under the Commerce Clause. Texas acknowledged this in its decision, but held that in *Quill* it was unclear as to what rights Quill retained to the software, and that in any case, the record established that the taxpayer's software in Texas "generated fees [that] cannot be dismissed as not establishing a substantial physical presence in Texas." This is a bold ruling, but fortunately it is only an administrative level decision, carrying no precedential authority and is likely to be overruled if a similar case ever goes to court.

Sporadic visits and trade show nexus

The landmark case with respect to trade shows is *Share International, Inc. v. Florida*, 676 So.2d 1362 (Fla. 1996); *cert denied*, 117 S.Ct. 685 (1997). Share International was a Texas corporation in the business of manufacturing and distributing chiropractic supplies primarily through direct mail solicitation. It did not have any offices or employees in Florida. However, the company did attend a three-day seminar in Florida every year at which it displayed and sold some of its products. Share registered with Florida and collected and remitted sales tax on the seminar sales, but not on its mail order sales. Florida argued that the seminar presentation and sales created the sufficient nexus with the state that obligated Share to collect and remit sales tax on all of its Florida sales, including its mail order sales. The Florida Supreme Court disagreed, holding that Share's physical presence at the seminars was not sufficient to rise to the standard of substantial nexus.

In light of the Share decision and coupled with pressure from business and economic development groups, several states have backed away from asserting trade show nexus. For example, California regulations provide that out-of-state retailers may receive up to $100,000 in sales at up to 15 days of trade shows, seminars, or conventions without incurring any sales or use tax collection responsibilities for the retailer's remote sales (Sales tax must be remitted, however, on any sales made at the trade show) (Cal. Code Regs. tit. 18, Section 1684). Connecticut's trade show legislation is restricted to 14 days per year and trade show activities are limited to displays and promotion. No sales are allowed (see SB 1232, Laws 2005.) Connecticut's exemption also appears to be limited to trade shows within its designated convention centers (see Sec. 12-407(a)(15)(D).) Minnesota also provides a similar, but more restrictive safe harbor of 3 days over 12 months (Minnesota Revenue Notice 00-10). Maine's law is simpler — merely attending trade shows or conventions does "not constitute a substantial physical presence." (36 MRS Section 1754-B(1)(G)(2).) Many states, however, do not provide such exemptions or

© 2019 Association of International Certified Professional Accountants. All rights reserved.

safe harbors and aggressively pursue taxpayers for use tax collection with any physical presence in the state. For example, Alaska, Georgia, Indiana, Iowa, and Ohio have indicated that trade show attendance for fewer than even 14 days a year may create a tax filing obligation. Other states such as Illinois have provided mixed signals. Some of Illinois' early letter rulings indicated that any participation in a trade show triggered nexus. Illinois retracted that position in the mid-90s, but recently seemed to have reversed themselves (see ST 94-0126-GIL; PLR 87-003; PLR 86-0170; ST 95-0089-GIL; ST00-0089-GIL; and ST01-0049-GIL). Kansas holds that any trade-show participation where sales orders are taken triggers nexus, while Colorado, which initially held that participation did create nexus (Colo. DOR InforEmail June 27, 2008), reversed that position in May 2014. (Colo. Information Letter, GIL -14-015 (5/29/2014); see Kansas Dept. of Opinion Letter No. 0-2009-011.) Massachusetts provides for three-day trade show protection. New Mexico held in 1997 that attending a trade show and exhibiting or promoting triggers a filing obligation (Rev. Rul. 480-97-01) as has Tennessee in 1996 (PLR No. 96-16) and Texas (PLR 200006394L). Washington recently held that attending a trade show four times a year over a seven-year period triggers nexus for both sales and use tax and the state's Business and Occupation tax (Washington Tax Determination No. 13-0213, 33 WTD 64 (7/15/2014)). However, a recent safe harbor was enacted to allow for a single day of attendance per year at a trade show if sales were not made there (Sec. 82.32.531, Rev Code of Wa.)

Arguments continue between tax practitioners, revenue officials, and other commentators over whether the substantial nexus test for purposes of the Commerce Clause means substantial physical presence.

Printer's nexus

A company may trigger nexus with a state in which it contracts with a printer, particularly if the company stores printed material at the printer's warehouse or makes frequent or routine visits to the printer to supervise or inspect the printed material. It may be that the visits would be de minimis, but the threat is real enough that many states, at the behest of local printers, have passed safe harbor laws exempting such activity from triggering any filing obligations. States that have passed such legislation include Connecticut, Florida, Georgia, Illinois, Indiana, Kentucky, Maine, Ohio, Oklahoma, Pennsylvania, South Carolina, Tennessee, Utah, Virginia, and Wisconsin. Some of the state provisions provide a safe harbor for both sales and income tax, but several states limit their provisions to only sales tax or income tax, but not both.

Fulfillment centers, public warehouses, and distribution centers

Printers have not been the only industry to successfully lobby for nexus safe harbor provisions. Because engaging a fulfillment center to take orders or engage in telemarketing and storing inventory at a public warehouse may often provide the substantial nexus to trigger a filing obligation, several states have passed protective legislation in these areas as well. Some of the states that exclude contractual arrangements with fulfillment service providers from nexus include Connecticut, New Mexico, New York, Ohio, and South Carolina. Unfortunately, most of these states limit the safe harbor to sales tax nexus. Even among those states, the varying qualifications, the activities covered, the time involved, and the specific nuances of each state's statute make generalizations nearly impossible. Nevertheless, like

© 2019 Association of International Certified Professional Accountants. All rights reserved.

printers nexus legislation, it is important to note that it may be available and, therefore, specific state research is in order.

Servers and websites

Advertising via the internet through a website should be no different than advertising on national television or providing 1-800 numbers. Absent any other activity, it is an interstate communication activity protected by the Commerce Clause. It should not trigger nexus. Nevertheless, there is no specific prohibition blocking states from trying to tax a company that maintains a website on a server in the state. The state may argue that the server itself is sufficient property to trigger nexus, or it may argue that the service provider hosting the website is an agent acting on behalf of the out-of-state company. As with printers and fulfillment centers, some states have specifically provided, either through statute or rule, that owning or operating an in-state server will not create nexus. That said, given the ever-evolving technology of the internet, states have begun to closely study the various types of marketing appearing online, such as eBay, craigslist, and so on. For example, do website linking arrangements constitute a physical presence, local solicitation, or intangible property in the state? Maybe they do, according to New York (who, in 2008 began requiring online retailers, who pay commissions or other compensation to New York businesses for customer referrals, whether by a link on an internet website or other manner, and who generate sales into the state over $10,000 for the past four quarters, to register with the state and begin collecting state and local taxes on all the retailer's sales into the state). Rhode Island, North Carolina, California, and a large number of other states have also passed similar legislation, and it is being considered in other states. Some states, like Pennsylvania, have reinterpreted existing statutes to cover compensated customer referrals. Each state that has passed these statutes has a slightly different tweak to it, so that a program that forms nexus in one state may not in another.

Several states have issued policy positions, revenue determinations, and letter rulings addressing this issue, but the rulings are often inconsistent and so factually specific that it is difficult to ascertain the underlying rule. In fairness to state tax administrators, the rapid technological changes have made defining nexus in these circumstances akin to flying your plane while building it.

Affiliation, attribution, and agency

In addition to the continuing debate over physical presence, there is a question as to whether the physical presence of a third party will create substantial nexus for an out-of-state taxpayer. The fact that the third party is an independent contractor is usually irrelevant. What is at issue is the nature of the contractor's activities. As long ago as 1960, the U.S. Supreme Court held that independent contractors could create sales tax nexus for an out-of-state retailer. According to the Supreme Court: "The test is simply the nature and extent of the activities" in the state. Where there is "continuous local solicitation," and the independent contractors are performing the same role and function as sales employees by establishing and maintaining a market in the state for the remote seller, the out-of-state seller has nexus with the state. (See *Scripto v. Carson*, 362 U.S. 207, 208 (1960) and *Tyler Pipe Industries, Inc. v. Washington Dept. of Revenue*, 483 U.S. 232 (1987)). Often, the key problem is in defining an agency relationship.

© 2019 Association of International Certified Professional Accountants. All rights reserved.

If a third party acts as an agent for an out-of-state seller, that agency relationship may create nexus for the seller. A series of cases involving high school book club sales is illustrative: *Scholastic Book Clubs v. State Board of Equalization,* 207 Cal. App. 2d 734 (1st Dist. 1989) (out-of-state book club is deemed to have nexus because teachers collected money from the schoolchildren); *Pledger v. Troll Book Clubs Inc.,* 871 S.W.2d 389 (Ark. 1994) (teachers are not agents for the out-of-state bookseller); *Scholastic Book Clubs v. Michigan Department of Treasury,* 567 N.W.2d 692 (Mich. Ct. App. 1997) (taxpayer does not have nexus, because teachers, lacking the authority to bind Scholastic, are not agents of Scholastic); and *In re Scholastic Book Clubs, Inc.,* 920 P.2d 947 (Kan. 1996) (Kansas Supreme Court holds that Scholastic has nexus, because an agency relationship exists with the schoolteachers); *Scholastic Book Clubs, Inc. v. Farr, Tenn. Ct. of App.*, No. M2011-01443-COA-R3-CV (January 27, 2012) (Scholastic's connections with Tennessee are sufficient to establish nexus because the taxpayer has created a de facto marketing and distribution network through Tennessee teachers and schools); *Scholastic Book Clubs, Inc. v. Alabama Department of Revenue*, Alabama Tax Tribunal, No. S. 14-374, Mar. 25, 2016.) In an eminently more reasonable opinion, the Connecticut Superior Court recently ruled that the teachers were simply not representatives of the book seller because they were not in the same class as salesmen, canvassers, or solicitors. Although their administrative functions were important to Scholastic, those functions did not rise to the level of a sales force (*Scholastic Book Clubs Inc. v. Commissioner of Revenue*, Dkt. Nos. CV 07 4013027 S; CV 07 4013028 S, Superior Court of Connecticut Judicial District of New Britain, (April 9, 2009)). Although the differing conclusions of these cases sometimes indicate the importance of a state's specific interpretation of its laws on agency, the cases remain troubling because substantial nexus can be created by a third party in absence of a formal contract or compensation.

In any event, Scholastic eventually failed in both Connecticut and Tennessee. The Connecticut Supreme Court overturned the lower Superior Court's decision holding that because the teachers acted as representatives for Scholastic, the company had nexus and a sales tax filing obligation in the state. Scholastic appealed both the Connecticut and Tennessee decisions to the United States Supreme Court who declined to review them. (See *Scholastic Book Clubs v. Farr*, Tenn. Ct. App. at Nashville, Dkt. No. M2011-01443-COA-R3-CV, 01/27/2012, *petition for cert denied,* U.S. S.Ct., Dkt. No. 12-374, 11/26/2012.) and *Scholastic Book Clubs, Inc. v. Commissioner of Revenue Services*, Conn. S. Ct., Dkt. No. SC 18425, 03/27/2012, 304 Conn 204, 38 A3d 1183 (2012), *petition for cert. denied*, U.S. S.Ct., Dkt. No. 11-1532, 10/09/2012.))

A secondary issue related to the use of independent contractors and the law of agency is whether activities unrelated to sales or solicitation will also constitute substantial nexus. For example, will the performance of post-sale services by independent contractors create nexus for an out-of-state seller? The Multistate Tax Commission's Nexus Program Bulletin 95-1 (MTC 95-1) generated considerable discussion when it was issued, because it asserted that warranty repair services provided by third-party independent contractors created sales tax nexus for an out-of-state seller (remember, services are not protected by P.L. 86-272; so, arguably, warranty work triggers income tax nexus as well). More than 20 states have adopted the Bulletin. New York has held that an independent third party engaged by an out-of-state seller to diagnose and repair computers sold in-state by the seller created nexus for the seller (TSB-A-00 (42) S (N.Y. Dep't of Taxation Fin. Oct. 13, 2000)).

© 2019 Association of International Certified Professional Accountants. All rights reserved.

Dell Computer has litigated the issue of whether sales tax nexus is created by a third-party independent contractor, performing warranty repair services in Connecticut, Louisiana, and New Mexico. In all three states, Dell contracts with BancTec, an independent contractor, to perform repairs and warranty work with respect to the company's catalog and internet computer sales. Dell won its case in Connecticut and at the District Court level in Louisiana [*Dell Catalog Sales v. Commissioner*, 834 A2d 812 (Super. Ct. 2003) and *Louisiana Dep't of Revenue v. Dell Catalog Sales*, LP, No. 456,807 (La. Dist. Ct., May 25, 2004)]. However, Louisiana's Court of Appeal has rejected the District Court's decision to grant summary judgment and has instructed the lower court to determine if there existed an agency relationship between Dell and BancTec, and whether the latter helped to establish and maintain a market for Dell's computers in the state (*Louisiana v. Dell International Inc*., Dkt No. 2004 CA 1702 (Feb. 15, 2006)). Dell suffered another setback in New Mexico when the state Court of Appeals ruled that the company had nexus in the state because BancTec helped to "establish and maintain a market" in the state for Dell's computers. (See *Dell Catalog Sales, LP. v. New Mexico*, 189 P.3d 1215 (N.M. Ct. App. 2008)). In short, BancTec's relationship with Dell was sufficient substantial nexus to subject Dell to New Mexico's gross receipts and compensating tax. Because BancTec provides similar services to other computer retailers such as Toshiba and Compaq, these cases were closely watched.

MTC 95-1 is typical of many states' approach to agency. In brief, the states are extending the agency argument from one of true agency to a "but for" argument, such as; but for some unrelated party, the taxpayer could not do business in the state, and therefore by helping the taxpayer to create and maintain a market for its goods in the state, that relationship is a nexus-creating activity. The use of the "but for" argument is misleading if not clearly a logical fallacy, but nevertheless difficult to contest.

Most states have been routinely unsuccessful in arguing that the physical presence of an out-of-state seller's affiliate creates nexus for the out-of-state taxpayer. Generally, the states have tried to argue that the affiliate had an agency relationship with the out-of-state vendor, because the two entities shared the same business names, trademarks, and logos, engaged in cross advertising, or were in similar lines of business. For example, Bloomingdale's had different affiliated corporate entities conducting sales in Pennsylvania: one through in-state retail stores, the other through mail-order catalog. Pennsylvania argued that the mail-order company had nexus, because its corporate affiliate's in-state stores sold many of the same goods, shared advertising campaigns, and on two occasions accepted merchandise returns of items purchased by catalog. The Pennsylvania Commonwealth Court found for the taxpayer, rejecting the state's argument that nexus existed because of an agency relationship between the affiliated corporations (*Bloomingdale's By Mail, Ltd. v. Department of Revenue*, 567 A.2d 773 (Pa. Commw. Ct. 1989), *aff'd without opinion,* 591 A.2d 1047 (Pa. 1991)). The courts came to similar conclusions in two cases with Saks Fifth Avenue. *SFA Folio Collections Inc. v. Bannon*, 217 Conn. 220 (1990), 585 A.2d 666 (Conn. 1991); *SFA Folio Collections Inc. v. Tracy*, 652 N.E.2d 693 (Ohio 1995). The Ohio case is of particular interest because the state attempted to use the income tax unitary doctrine to assert substantial nexus for sales tax.

California is one of the state leaders in asserting nexus through agency and affiliation, and where an agency relationship can be established, the state has been successful in asserting nexus.

© 2019 Association of International Certified Professional Accountants. All rights reserved.

Borders Online Inc. operated a website through which it sold primarily books, CDs, and DVDs. It is a separate corporate entity affiliated with the traditional bricks and mortar Borders Inc. bookstores. Borders Inc. bookstores routinely accepted returns from its patrons, regardless of whether the item was purchased at Borders Inc., Borders Online Inc., or one of Border's competitors. If the item was purchased from a competitor, Borders Inc. would give the purchaser store credit. If the item was purchased from Borders Online, the store would provide a cash refund.

The SBE determined that the refunding of cash for returned goods made Borders Inc. the authorized representative of Borders Online. In addition, the SBE held that the refunding of cash for returns was a key element of the selling process and, in and of itself, constituted selling in California under California Revenue & Taxation Code (CRTC) Section 6203.

The decision was roundly criticized at the time by the tax community, who argued that Borders's return policy was nothing more than good customer service, rather than an action taken as a representative on behalf of Border's Online. Furthermore, critics said, the SBE decision did not adequately address the principle articulated in *Scripto* and *Tyler Pipe* that an in-state representative creates nexus only through actions that purposefully establish and maintain a market in the state for the remote seller (*Scripto Inc. v. Carson*, 362 U.S. 207 (1960) and *Tyler Pipe Industries Inc. v. Washington*, 483 U.S. 232 (1987)). The key to the court's decision may be that Borders Online directed customers on its website to return online purchases to its local brick and mortar stores for returns or exchanges. This policy, according to the court, indicated that the stores were acting on behalf of the online affiliate.

One year after its ruling in Borders Online, the SBE held that the online subsidiary of Barnes & Noble Booksellers, Inc. (B&N) had nexus in California because B&N distributed discount coupons that could be redeemed with its online affiliate Barnes & Noble.Com (B&N.C). As in the Borders decision, the SBE determined that B&N acted as B&N.C's representative, through their joint marketing effort whereby B&N.C, paid to have printed coupons inserted into the shopping bags of B&N customers. The SBE rejected the taxpayer's argument that the discount coupons inserted into shopper's bags were simply advertising akin to coupon inserts in magazines and newspapers (*Barnes & Noble.com*, No. 89872 (Cal. State Bd. Equal., Sept. 12, 2002)).

On September 7, 2007, the California Superior Court overruled the SBE holding that B&N.C did have nexus through its brick and mortar sister corporation, B&N. According to the Court, B&N did not act as B&N.C's agent or representative. Distributing coupons or bags with advertising logos, the court said, was akin to somebody on the street corner passing out flyers or coupons. Agency requires much more, and because the state did not provide a useful definition of agency, the Court looked to general principles. The essential principle of agency is that the agent must have authority to bind the principal and B&N did not have that authority. In addition, there was no evidence that common management or control existed between the two companies. For example, neither company had any common directors or officers. (See *barnesandnoble.com, LLC. v. SBE*, Calif. Super. Ct. (San Francisco County), Case No. CGC-06-456465, 9/7/2007.) Despite the win at Superior Court, on May 29, 2008, Barnes & Noble agreed to a settlement with the SBE, paying $9 million of the original assessment of $17.7 million. The settlement covered all taxes, penalties, and interest through November 1, 2005: the date barnesandnoble.com began voluntarily collecting the state's sales and use taxes.

© 2019 Association of International Certified Professional Accountants. All rights reserved.

Louisiana has also argued that barnesandnoble.com had nexus in that state as well. Unlike California, however, Louisiana focused its argument on certain key facts; arguing that those facts alone met the substantial nexus hurdle required of states under the Commerce Clause. (See St. Tammany Parish Tax Collector v. barnesandnoble.com, U.S. Dist. Ct., Eastern District, LA, Dkt. No. 05-5695 (3/22/2007)). The facts included a common membership program, gift card exchange, advertising, preferential treatment on returns, and commissions. The federal district court found the facts were either misplaced or insufficient to create substantial nexus. The common advertising was limited and the commissions, membership program, and gift cards were common to all booksellers, including competitors. Although the return policy was a bit more generous for barnesandnoble.com than others, it was not sufficiently so. In brief, Louisiana's argument was reduced to holding that the close corporate relationship between the companies, similar company names, and brand identity itself was sufficient to establish substantial nexus. The court simply disagreed.

The New Mexico Supreme Court upheld the appellate court's decision that an online bookseller had nexus because the many intercompany activities, such as gift card promotions, sharing of customer data, common loyalty programs, and shared use of trademarks and logos were significantly associated with the online bookseller's ability to establish and maintain a market in the state for its goods (New Mexico Taxation & Revenue Department v. Barnesandnoble.com LLC,2012-NMCA-063, 283 P3d 298 (2012)).

Other states followed California and Louisiana's lead, and in April 2005, the Multistate Tax Commission proposed a new affiliate nexus standard, entitled "Proposed Model Affiliate Sales Tax Nexus Proposal." The proposed standard provides that an out-of-state business has nexus with an in-state business if they (1) are related (members of the same federal controlled group, or there exists a 50% ownership), and (2) they use "an identical or substantially similar name, trade name, trademark or goodwill to develop, promote, or maintain sales," or (3) the in-state business "provides services to, or that inure to the benefit of, the out-of-state business related to developing, promoting, or maintaining the in-state market."

Instead of litigation, other states have simply passed legislation providing that companies are taxable in the state for sales and use tax through affiliation. Effective January 1, 2002, a remote seller affiliated with an Arkansas retailer has nexus with the state for the purposes of sales and use tax. The out-of-state or remote seller will have to collect and remit Arkansas use tax on sales into the state, if the seller is affiliated with an Arkansas retailer and "the vendor sells the same or substantially similar line of products . . . under the same or substantially similar business name, or the facilities or employees of the Arkansas retailer are used to advertise or promote sales by the vendor to Arkansas purchasers." (Ark. Code Ann. Section 26-52-117 (2011)).

Like Arkansas, Minnesota has amended its statutes to require that an affiliated remote seller of an in-state retailer must collect the state's use tax. An out-of-state retailer or remote seller is an affiliate of an in-state entity if "the entity uses its facilities or employees in this state to advertise, promote, or facilitate the establishment or maintenance of a market for sales of items by the retailer to purchasers in this state or for the provision of services to the retailer's purchasers in this state, such as accepting returns of purchases for the retailer, providing assistance in resolving customer complaints of the retailer, or providing other services." (Minn. Stat. Section 297A.66(4)). Other states to enact attributional or affiliate

© 2019 Association of International Certified Professional Accountants. All rights reserved.

nexus statutes include Alabama (Ala. Code Section 40-23-190); Colorado (C.R.S. Section 39-26-102(3)); Georgia (Ga. Code Section 48-8-2(3)); Idaho (Idaho Code Section 63-3611); Illinois (35 ILCS 105/2 and 35 ILCS 110/2); Indiana (Ind. P.L. 81-2004 (H.B. 1365, effective July 1, 2004)); Kansas (Kan. Stat. Section 79-3702); Kentucky (Kentucky Rev. Stat. Section 139.340); New Jersey (N.J. Stat. Section 54:32B-2); New York (N.Y. Tax Law Section 1101(b)(8)(i)(l)); Oklahoma (Okla. Stat. Section 1401(9); South Dakota (see S.B. 147 effective July 1, 2010); Texas (Tex. Tax Code Section 151.107(a)(4)); Utah (Utah Code Section 59-12-107)); and Wisconsin (Wis. Stat. Section 77.51(13g)(d)).

Yet another approach states have taken recently to encourage remote sellers to charge and collect the state's use tax is to require that any vendors doing business with any state or local agencies register and collect the state's sales and use tax. California initiated such a requirement effective January 1, 2004. Other states with similar requirements include Connecticut, Hawaii, Illinois, Missouri, North Carolina, Oklahoma, South Dakota, Virginia, and Wisconsin. Critics have charged that the practice is illegal and a violation of the Commerce Clause. They claim that while states may have the right to establish their purchasing requirements, such requirements violate the Constitution when their participation in the market becomes an attempt to regulate the interstate market.

Federal legislation

The Multistate Tax Commission (MTC) and state supporters have continued each year to introduce the Commission's single standard nexus proposal. In brief, the proposal provides that any company whose activity in a state exceeds (1) owning $50,000 of property; or (2) $50,000 of payroll; or (3) $500,000 of sales has nexus for both income and sales tax. Under the proposal, a remote seller whose only contacts with the state are either through the internet or catalog sales would have nexus in the state if those sales exceeded $500,000. With the *Wayfair* decision having been issued now approving lower economic thresholds than the MTC and its member states had been requesting, we do not expect the MTC to continue to ask for these higher thresholds any more.

The Amazon wars and click-through nexus

One of the triggering developments in sales tax nexus for online sellers (and ultimately leading to the *Wayfair* decision) was ignited by legislation passed by New York in spring 2008 that required online retailers, who paid commissions or other compensation to New York businesses for customer referrals, whether by a link on an internet website or other manner, and who generated sales into the state over $10,000 for the past four quarters, to register with the state and begin collecting state and local taxes on all the retailer's sales into the state (New York Senate Bill 6807, Chapter 57, N.Y. Laws of 2008).

The New York legislation was particularly significant at the time because it said that a taxpayer need not have had physical presence in New York to be subject to the state's sales tax. This was clearly contrary to the U.S. Supreme Court's decisions in both *National Bellas Hess* and *Quill* discussed previously. Thus, it was no surprise that Amazon.com and Overstock.com filed suits immediately after the New York law was passed, challenging the legislation as invalid, illegal, and unconstitutional because it violated the Commerce, Due Process, and Equal Protection Clauses of the U.S. and New York constitutions. In 2013, New York's highest court, the New York Court of Appeals found that the state's click-through nexus

© 2019 Association of International Certified Professional Accountants. All rights reserved.

statute did not facially violate the Due Process and Commerce Clauses of the U.S. Constitution. (Whether the law violated the Constitution in practice was not addressed by the court.) The two businesses appealed the decision to the U.S. Supreme Court, but in December 2013, the Court denied review. (The two cases were combined early in appeal.)

The importance of New York's legislation and the constitutional challenges it raised were pivotal in getting us to where we are today and cannot be overemphasized. Several other states attempted to follow New York's lead by adopting similar legislation. The legislation initially failed in Connecticut, Maryland, and Tennessee. However, it passed in California, Hawaii, and Minnesota, only to be vetoed by the governors of those states, partly in fear that the legislation was unconstitutional. Twenty-one states quickly enacted their own click-through nexus provisions.

Initially Amazon fought the state's assertion that they should be collecting tax quite vigorously. When they found very little success, they reversed their position entirely and as of this writing now collect tax on their own sales in every state in the United States. And today Amazon has become a vocal supporter of legislation requiring remote sellers to collect sales tax in other states. Such was the power of the New York decision.

Colorado's "notice and reporting" legislation in 2010 (discussed earlier) was inspired by New York's move. The Colorado legislation prompted the Direct Marketing Association, an association of businesses that uses catalogs, newspapers, and the internet to market products to consumers, to litigate the issue at both the federal district and Colorado district state courts. The U.S. Court of Appeals initially ruled that the federal courts did not have jurisdiction over the case because the federal Tax Injunction Act (TIA) prohibited federal courts jurisdiction over state tax controversies. (*Direct Marketing Association v. Brohl*, CA-10, 735 F.3d 904 (2013)). However, the U.S. Supreme Court unanimously reversed the Tenth Circuit's decision on March 3, 2015, holding that the TIA did not bar Direct Marketing's suit (*Direct Marketing Ass'n v. Brohl*, 135 S.Ct. 1124 (2015)). Justice Kennedy, in a concurring opinion, wrote that it was time to revisit the *Quill* decision, noting that with mobile phones and laptop computers, a taxpayer can be present in a state in a "meaningful way without that presence being physical." He went on to say that he viewed the *Quill* decision as "tenuous" and that given the increase in online sales, it was "inflicting extreme harm and unfairness on the States." The case has since been resolved. The Tenth Circuit Court of Appeals found that Colorado's notice and reporting requirements did not burden interstate commerce. In doing so, they declined to expand the holdings in *Quill* to nontax matters. The Supreme Court subsequently declined to review the case, establishing it as law in Colorado and precedent in the rest of the 10th circuit. Although this precedent is not binding on states residing in the other circuits, it will still tend to embolden other states to pass similar legislation (*Direct Marketing Association v. Brohl,* Dkt. 12-1175, 10th Cir 2016).

The ultimate challenge

Not surprisingly, states reacted quickly to Justice Kennedy's invitation to challenge the *Quill* decision. Alabama's Governor Robert Bentley issued Proposed Rule 810-6-2-.90.03 providing that remote sellers with no physical presence in the state will have nexus in Alabama if their sales in the state exceed $250,000 per year. The rule is effective January 1, 2016, and the governor made it quite clear that he welcomed Amazon.com or some other remote seller to challenge the law.

© 2019 Association of International Certified Professional Accountants. All rights reserved.

Tennessee also joined the fray early on. The Tennessee Department of Revenue promulgated Rule 1320-05-01-.129, effective January 1, 2017. The rule required out-of-state sellers to register with the state if they have substantial nexus with the state. The rule defines substantial nexus as being established through the regular and systematic solicitation of sales from Tennessee customers that result in more than $500,000 in gross sales during the prior 12-month period. Starting March 1, 2017, taxpayers meeting that threshold are required to register with the state and collect sales tax. However, this requirement was put on hold pending the outcome of a lawsuit ([see *Am. Catalog Mailers Ass'n v. Tenn. Dep't of Revenue*, Tenn. Ch. Ct., No. 17-307-IV (complaint filed March 30, 2017)] and further action from the Tennessee legislature.

South Dakota also answered the challenge with its own economic nexus statute. It passed Senate Bill 106, which added a new nexus standard. Any out-of-state business that does not otherwise have nexus with the state will acquire nexus if they either sell $100,000 of taxable goods, services, or electronically transferred goods into South Dakota, or sold taxable goods or services in 200 or more separate transactions (91st Session, S.D. Legis. (2016)). However, this act came with a unique twist. The act allowed South Dakota to file suit against any sellers who do not comply with the new ordinance. Although the first of these cases is pending, the act requires the state to file an injunction against itself that bars the Department of Revenue and other agencies from collecting or administering the tax in regard to remote sellers until a final resolution is made on the suit. The act specifically states that it is in direct contradiction of the *Quill* holding, and that a final holding by the courts (specifically, the U.S. Supreme Court) is required. This law is what generated the *Wayfair* court case that was decided on June 21, 2018 (*South Dakota v. Wayfair, Inc. et al.*, 585 U.S. ______(2018)).

Wayfair v. South Dakota — Economic nexus rising

By the nature of its design, the South Dakota law was accelerated through the state court system and landed at the U.S. Supreme Court. Both parties filed briefs, and over 40 interested parties filed amicus curiae briefs with the court on the matter. South Dakota pinned its argument on the meteoric growth in e-commerce, the increasing gap of uncollected sales tax, and the increasing ease with which software can provide solutions to tax rate and filing issues in the 45 states plus D.C. that impose a sales tax. They presented facts showing cheap compliance and steep tax losses. In addition, the state also argued that e-commerce has changed the landscape so much that stare decisis was no longer sufficient to keep the holdings in *Quill* and *National Bellas Hess*.

Wayfair and the other defendants, on the other hand, argued that tax filing was just a small portion of the cost. The company argued that taxability and legions of hungry sales tax auditors presented a grave threat to online sellers who in many cases tend to be small businesses. They presented a picture of expensive compliance costs, massive filing headaches, and a treacherous landscape for small businesses. In addition, the defendants also pointed out that the tax gap was already closing with Amazon, Inc. now collecting tax on its sales in every state.

During oral arguments, it was clear that the justices had read the litany of briefs presented and were well prepared with questions. In addition to the aforementioned arguments, the U.S. Solicitor General decided to join in and argue in favor of South Dakota.

© 2019 Association of International Certified Professional Accountants. All rights reserved.

After considering the arguments the Court voted 5–4 to overturn the limitations of *Quill* and *National Bellas Hess*. Justice Anthony Kennedy wrote the majority opinion, joined by Ginsburg, Thomas, Alito, and Gorsuch. The court reverted to the older Complete Auto Transit test (see *Complete Auto Transit v. Brady*, 430 U.S. 274 (1977)). In *Complete Auto*, a four-prong test was applied to determine if a tax was imposed in violation of the Commerce Clause. The *Wayfair* case specifically focuses on the first prong, whether or not there is a sufficient nexus with the taxing state. In its analysis, the Court found that continuous economic activity from an online seller could create a sufficient connection with the state. In an interesting twist, the court also found that the *Quill* decision was flawed from the outset, and did not comply with modern-day Commerce Clause jurisprudence.

After overturning *Quill*, the South Dakota law was then evaluated on its merits to see if it complied with *Complete Auto*. In analyzing the South Dakota statute, the court specifically noted some factors that aided in its finding of sufficiency. The South Dakota law included a minimum threshold of $100,000 in gross sales, or 200 individual transactions in a 12-month period. These figures could not be reached " . . . unless the seller availed itself of the substantial privilege of carrying on business in South Dakota" (see Wayfair, pp. 23). Specific mention was also made of the fact that South Dakota was a full member of the Streamlined Sales and Use Tax Agreement and had a single state taxing authority. This last part raises interesting questions as to the applicability of *Wayfair* to the so-called "Home Rule" states of Alabama, Arizona, Colorado, and Louisiana where the local governments can self-administer their own taxing schemes.

It is worth noting that the dissenting opinion in the case, written by Chief Justice Roberts, would not have upheld *Quill* on its merits. Instead, it would have held that the arguments were insufficient to overcome stare decisis in the face of a declining tax gap. The dissent felt that Congress was better suited to resolve the issue, and that the lessening tax gap of uncollected taxes had to be balanced against the added burdens to small businesses on the internet. This shows that none of the justices were in favor of the original logic behind *Quill*.

As of this writing, there are economic nexus provisions active or announced in Alabama, California (effective 4/1), Colorado, Connecticut, Washington, DC, Georgia, Hawaii, Illinois, Indiana, Iowa, Kentucky, Maine, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Nebraska, Nevada, New Jersey, New York, North Carolina, North Dakota, Ohio (cookie nexus), South Carolina, Tennessee (pending legislative action), Texas (effective 10/2019), Utah, Vermont, Washington, West Virginia, Wisconsin, and Wyoming.

Physical presence — not dead yet

In the wake of *Wayfair*, it is important to remember that physical presence is still enshrined in most states' nexus laws. Although economic nexus can create a sales/use tax responsibility, the old physical presence standard can do it just as easily. The new *Wayfair*-inspired laws do not replace physical presence as the doorway to nexus; they merely add a second doorway that can be used. Always be mindful of both factors when determining whether your business has nexus in a given state.

© 2019 Association of International Certified Professional Accountants. All rights reserved.

Knowledge check

5. In the *Wayfair* decision, the following 12-month sales dollar figure was approved as establishing nexus:

   a. $50,000.
   b. $100,000.
   c. $500,000.
   d. $200,000.

6. In the *Wayfair* decision, the following 12-month sales transaction amount was approved as establishing nexus:

   a. 1 transaction.
   b. 200 transactions.
   c. 500 transactions.
   d. 1,000 transactions

Income tax nexus

Although physical presence is the bright-line test for sales tax nexus, it does not determine income tax nexus. In fact, a company can have numerous employees in a state creating physical presence aplenty and yet not have an income tax filing obligation. That is because a federal law, Public Law 86-272, creates a safe harbor from income tax nexus, even where there is physical presence.

Public Law 86-272

Due process and interstate commerce are the constitutional hurdles. But there is also a bit of federal legislation, which adds yet another hurdle to establishing nexus, but only for income tax nexus. That legislation is Public Law (P.L.) 86-272.

Public Law 86-272 states that "No state . . . shall have the power to impose (an) income tax . . . if the only business activities within such state (are) the solicitation of orders . . . for sales of tangible personal property, which . . . are sent outside the State for approval or rejection, and, if approved, are filled by shipment or delivery from outside the State . . . "

In brief, P. L. 86-272 provides a safe harbor for certain activities with respect to income tax nexus. Essentially, physical presence alone will create a filing obligation for *sales tax*. So if your company has employees, property, even independent contractors in a state, it is likely that the company will have a sales tax filing obligation to that state. Note, however, that under P.L. 86-272 a company can have employees busy soliciting sales in the state and not create nexus for income tax. In the earlier Crystal City Computers example, the company could hire employees to sell their computers in Kansas (in fact, the employees could live in Kansas), and so long as those employees restricted their activities to the solicitation of sales of tangible personal property, and those sales orders were sent back to Colorado for acceptance and fulfillment, Crystal City would not have to file income tax returns with Kansas. New York

© 2019 Association of International Certified Professional Accountants. All rights reserved.

recently ruled that the presence of an in-state representative working out of his office-in-the home, and provided with a company laptop, constituted protected activities under P.L. 86-272 (see NYS Dep't of Tax'n and Fin., TSB-A-05(7)(C) (4/4/05)).

Please pay particular attention to the fact that P.L. 86-272 applies only to net income taxes and the sales of tangible personal property. Some states (for example, Tennessee) impose combined franchise and excise taxes upon income and property, and the taxpayer may have to pay tax upon both calculations. These states have taken the position that P.L. 86-272 only applies to their *income base*, not their *capital base*. Thus, a taxpayer who may have only salespeople soliciting in the state would still be required to pay the state's franchise tax based on capital, but not income. The Texas Court of Appeals specifically ruled that the net worth component of the state's old franchise tax did not fall under the safe harbor provision of P.L 86-272 (see *INOVA Diagnostics, Inc. v. Compt'r*, 166 SW3d 394 (Tx Ct. of App. 2005)). Texas has since replaced its corporate franchise tax with a modified gross receipts tax called the Texas Margin Tax that the Texas legislature specifically stated did not fall under the safe harbor provisions offered by P.L. 86-272. Taxes measured by gross income or receipts are not covered by P.L. 86-272. As a consequence, there are different nexus standards for the state of Washington's B&O Tax and New Mexico's Gross Receipts Tax.

Knowledge check

7. Under federal law (P.L. 86-272), a business may be able to avoid

    a. Both income and franchise taxes.
    b. Income taxes, but not franchise taxes.
    c. Franchise taxes, but not income taxes.
    d. Neither income or franchise taxes.

Please note also that P.L. 86-272 applies only to the solicitation of sales of tangible personal property. Sales of services, for example, are not protected. Thus, if Crystal City Computers were to offer training seminars or computer classes in Kansas, these activities would not be protected and Crystal City Computers would have to begin filing Kansas income tax returns.

Finally, P.L. 86-272 leaves undefined what constitutes solicitation. The Supreme Court addressed the term in its decision in *Wisconsin Dept. of Revenue v. William Wrigley, Jr. Co*., 112 S. Ct. 2447 (1992). Wrigley's activities within Wisconsin included the in-state recruitment, training, and evaluation of sales reps who solicited sales using company cars, and carried gum samples, display racks, and promotional literature with them. The court ruled these activities were protected under 86-272. The sales reps also supplied gum for a charge to retailers who installed new display racks and occasionally replaced stale gum. Despite the fact that the replacement of stale gum only represented 0.00007% of the company's total sales in Wisconsin, the court ruled that these activities went beyond solicitation. In brief, because one would have reason to replace stale gum apart from solicitation, it is not the volume, but the company practice itself that exceeds the safe harbor provisions of P.L. 86-272. The court wrote that the demarcation between protected solicitation and other activities is the "clear line . . . between those activities that are entirely ancillary to requests for purchase — those that serve no independent business

© 2019 Association of International Certified Professional Accountants. All rights reserved.

function apart from their connection to the soliciting of orders — and those activities that the company would have reason to engage in any way but chooses to allocate to its in-state sales force."

There is one exception to the preceding rule: "Even if engaged in exclusively to facilitate requests for purchases, the maintenance of an office within the State, by the company or on its behalf, would go beyond the 'solicitation of orders.'" That said, for purposes of P.L. 86-272, the one key difference between an employee and an independent contractor is that the latter can have an office in the state.

The MTC offered its interpretation and an elaboration of the term solicitation in its "Statement of Information Concerning Practices of Multistate Tax Commission and Signatory States under Public Law 86-272" issued in January 1986. The statement has been revised and reissued in January 1993, July 1994, and July 2001. According to the MTC, the term solicitation includes (1) speech or conduct that explicitly or implicitly invites an order; and (2) activities that neither explicitly nor implicitly invite an order, but are entirely ancillary to requests for an order. "Ancillary activities are those that serve no independent business function for the seller apart from their connection to the solicitation of orders." If the seller would engage in an activity apart from soliciting orders, the activity is not ancillary. Even if the activity is not ancillary, it will still qualify for immunity if it is *de minimis*. "*De minimis* activities are those that, when taken together, establish only a trivial connection with the taxing state." Both the quantitative and qualitative nature of the activity will be considered, but not its economic importance. If the activity is conducted on a regular or continuous basis, it will not normally be considered trivial or *de minimis*.

The statement provides examples of minimal activities within a state that could establish nexus for income tax purposes, including the following:

- Repairs and maintenance
- Collections on accounts
- Credit investigations
- Installation and supervision of installation
- Nonsolicitation training
- Nonsolicitation technical advice
- Handling or processing customer complaints (except mediating customer complaints when the sole purpose is to ingratiate sales personnel with the customer)
- Approving or accepting orders
- Repossessing property
- Securing deposits on sales
- Picking up or replacing damaged or returned property
- Hiring, training, or supervising personnel other than those involved only in solicitation
- Using agency stock checks or any other instrument by which sales are made in the state by sales personnel
- Maintaining a sample or display room in excess of 14 days at any one location within the state during the tax year
- Carrying samples for sale, exchange, or distribution in any manner for value
- Owning, leasing, using, or maintaining a repair shop; parts department; warehouse; meeting place for directors, officers, or employees; stock of goods (other than samples for sales personnel or that are used entirely ancillary to solicitation); telephone answering service that is publicly attributed to the company or to the employee(s) or agent(s) of the company in their representative status; mobile stores; real property or fixtures of any kind; or any other office (other than a protected in-home office described subsequently)

© 2019 Association of International Certified Professional Accountants. All rights reserved.

- Consigning tangible personal property to any person
- Maintaining by any employee or other representative, an office or place of business of any kind (other than an in-home office located within the residence of the employee or representative that (i) is not publicly attributed to the company or the employee or representative in an employee or representative capacity, and (ii) so long as the use of such office is limited to soliciting and receiving orders from customers; for transmitting orders outside the state for acceptance or rejection; or for such other activities that are protected under P.L. 86-272)
- Any indication through advertising or business literature that the company or its employee or representative can be contacted at a specific address within the state, or a telephone or other public listing within the state for the company or its employee or representative in a representative capacity is normally considered an in-state office or place of business. However, the normal distribution and use of business cards and stationery that identify the employee's or representative's name, address, telephone and fax numbers, and affiliation with the company is not, itself, considered as advertising or otherwise publicly attributing an office to the company, its employee, or representative.
- The maintenance of any office or other place of business that does not qualify as an in-home office described previously will, itself, cause the loss of protection under P.L. 86-272. It is not relevant whether the company pays directly, indirectly, or not at all for the maintenance of such in-home office.
- Entering into or selling franchises or licenses; selling tangible personal property pursuant to such franchise or license agreements to in-state franchisees and licensees
- Any other nonprotected, nonancillary activity (even if such activity helps to increase purchases)

Activities that the MTC deems protected include the following:

- Soliciting orders for sales by any type of advertising
- Carrying samples and promotional materials for display only or for distribution without charge or other consideration
- Furnishing or setting up display racks and advising customers on display of products without charge or other consideration
- Providing autos to sales personnel for use in protected activities
- Passing orders, inquiries, and complaints to the home office
- Checking customers' inventories without charge (for reorder only)
- Maintaining a sample or display room for 14 days or less at any one location within the state during the tax year
- Soliciting orders for sales by an in-state resident employee or representative of the company, provided such person does not maintain an in-state sales office or place of business other than a protected in-home office
- Missionary sales activities (such as, the solicitation of indirect customers for the company's goods. For example, a manufacturer's solicitation of retailers to buy the manufacturer's goods from the manufacturer's wholesale customers would be protected if such solicitation activities are otherwise immune)
- Recruiting, training, or evaluation of sales personnel, including the occasional use of homes, hotels, or similar places for meetings of sales personnel
- Mediating direct customer complaints when the purpose is solely for ingratiating the sales personnel with the customer and facilitating requests for orders
- Coordinating shipment or delivery without payment and providing related information prior to or subsequent to placement of order
- Owning, leasing, using, or maintaining personal property for use in an in-home office or car that is used solely for protected activities

© 2019 Association of International Certified Professional Accountants. All rights reserved.

Physical presence and income tax

As the preceding discussion indicates, a taxpayer can have physical presence in a state and still avoid an income tax filing obligation if that presence is protected by P.L. 86-272. Please note, however, that any services are not protected under P.L. 86-272. As a consequence, employees that telecommute can trigger an income tax filing obligation. For example, the state of New Jersey successfully taxed TeleBright, a Maryland software company that allowed one of its employees to telecommute from her home in New Jersey. The employee, a software developer, moved from Maryland to New Jersey because her spouse changed jobs. Because she was a highly regarded and skilled employee, TeleBright proposed she work from home. According to the court, because the employee regularly received and carried out her assignments, began and ended her workday by checking in, and routinely received assignments from her supervisor either by email or phone, the corporation was doing business in the state under N.J.A.C. 18:7-1.9(b). (*Telebright Corp. v. New Jersey*, No. A-5096-09T2, N. J. Super. Ct. (March 2, 2012). See also Appeal of Warwick McKinley Inc., No. 489090, California State Board of Equalization, (January 11, 2012)).

However, the current debate over income tax nexus has focused not so much on P.L. 86-272, but on whether a taxpayer's economic presence in a state can create income tax nexus.

The U.S. Supreme Court has never addressed whether there exists a physical presence requirement for income tax nexus. In fact, more than one state Supreme Court has ruled that physical presence is not necessary for income tax nexus. The South Carolina Supreme Court ruled that a Delaware holding company, whose only presence in the state was the licensing of its trademarks, was subject to South Carolina's income tax. In brief, the state's argument was that physical presence is unnecessary for income tax nexus, due process is satisfied by the purposeful direction of business activity, and that P.L. 86-272 does not protect the licensing of intangibles: only the solicitation of the sale of tangible personal property. The South Carolina Supreme Court ruled in favor of the state and the U.S. Supreme Court denied cert. (*Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E.2d 13, *cert. denied*, 114 S. Ct. 550 (1993)).

The *Lanco* decision, like the Geoffrey cases, involved an intangible holding company, a tax planning structure that is considered by some state tax administrators to be little more than a tax scam. That cannot be said, however, of the *MBNA American Bank* case. (See *West Virginia v. MBNA,* 640 S.E.2d 226 (W.Va. 2006)).

MBNA America did not have any employees, property, or other physical presence in West Virginia. Nonetheless, the company had $8 to $10 million in gross receipts from the state through the issuance and servicing of credit cards. The only contacts MBNA had with West Virginia were through mail and telephone solicitation. Nevertheless, the West Virginia Supreme Court ruled that the bank's "systematic and continuous business activity in [the State] produced significant gross receipts attributable to its West Virginia customers which indicate a significant economic presence sufficient to meet the substantial nexus prong of *Complete Auto*." In addition, an income tax imposition, unlike that of sales and use tax, imposed little burden on interstate commerce. In any case, the technological changes in commerce made "the application of a physical presence standard . . . a poor measuring stick of an entity's true nexus with the state." On March 9, 2007, MBNA filed a petition for certiorari with the U.S. Supreme Court. It was denied on June 18, 2007.

© 2019 Association of International Certified Professional Accountants. All rights reserved.

Not surprisingly, other states followed West Virginia's lead in targeting financial institutions via economic nexus. The Indiana Tax Court followed the reasoning of the West Virginia court in ruling that MBNA had substantial nexus in the state without physical presence (*MBNA America Bank v. Indiana Department of State Revenue*, Ind. Tax Ct., No. 49T10-0506-TA-53, Oct. 20, 2008). The Massachusetts Supreme Judicial Court came to the same conclusion based on the same reasoning as the West Virginia and Indiana courts (*Capital One Bank v. Massachusetts*, 899 NE2d 76 (Mass. 2009)). However, the New Jersey Tax Court recently rebuffed the state's attempt to adopt a significant economic presence test in determining nexus, for the simple reason that it had not been adopted by the state legislature. (See *AccuZIP, Inc. v. Director*, N.J. Tax, Dkt. No. 005744-2003, (08/13/2009) (unpublished)). Nevertheless, several other states, including California, Connecticut, Hawaii, Minnesota, and Tennessee, have indicated that they expect to adopt the economic nexus standard articulated in these recent cases. The decisions are unsettling, because given the basis for the courts' holdings in West Virginia, Indiana, and Massachusetts, there is no reason why such reasoning cannot be extended to any business whose presence in a state is limited to solicitation through the mail or over the internet. It is no exaggeration to say that the implications of *MBNA* and *Capital One* are enormous.

Financial institutions, however, are not the only industry that has been targeted by state tax administrators. Franchising has also become a primary target. On December 30, 2010, the Iowa Supreme Court ruled that Kentucky Fried Chicken's (KFC) licensing of intangibles in the state to its franchisees, was the "functional equivalent of 'physical presence' under *Quill*." Consequently, despite having no employees, property or other presence in the state, KFC had to pay tax on the royalties it received from its franchisees in the state. The court went on to say that even if the intangibles were not the functional equivalence of physical presence, it didn't really matter because *Quill* was limited to sales tax and inapplicable to income tax. (*KFC Corporation v. Iowa*, 792 N.W.2d 308 (Ia. 2010)). KFC appealed to the U.S. Supreme Court but their appeal was denied (*KFC Corp. v. Iowa Dept. of Rev*., Iowa S. Ct., Dkt. No. 09-1032, 12/30/2010, 792 NW2d 308 (2010), *cert denied*, U.S. S. Ct., Dkt. No. 10-1340, 10/03/2011)). Iowa has continued to go after taxpayers whose only connection with the state is franchising fees. (*See Jack Daniels Properties, Inc. v. Department of Revenue*, Iowa Department of Inspections and Appeals, Dkt. No. 09DORFC002, (July 28, 2011)).

The state pursuit of nexus through intangibles has not always been wins for the states. In 2012 the West Virginia Supreme Court (yes, the same court that ruled in *MBNA*) held that an out-of-state subsidiary was not liable for corporation income tax on its royalty income, where it did no business in the state and was not created for tax avoidance purposes (*Griffith v. ConAgra Brands, Inc*., 728 S.E.2d 74 (W. Va. 2012)). The Oklahoma Supreme Court came to a similar decision regarding an insurance company's receipts from intellectual property licensed to a related party's restaurant chain (*Scioto Insurance Co. v. Oklahoma Tax Commission*, 279 P.3d 782 (Okla. 2012)).

Nevertheless, the pattern seems clear. First, the states have targeted intangible holding companies, then banks, and now franchisors. With economic nexus tests now explicitly blessed by the Supreme Court in the wake of *Wayfair*, other taxes are open to a more expansive nexus setup. What will be next?

© 2019 Association of International Certified Professional Accountants. All rights reserved.

What we know and where to go from here

In brief, here is where we are. We know that physical presence and economic nexus are tests for sales tax nexus, but it is not clear how much physical presence must be involved, or under just what circumstances the physical presence of a third party can be attributed to the out-of-state taxpayer. Finally, we know that many states are using economic nexus in the wake of the *Wayfair* decision. Physical presence still creates nexus, but with *Wayfair* it is no longer the primary concern.

For income tax, we know that physical presence does not trigger an income tax filing obligation if the activities fall within the safe harbor provisions of P.L. 86-272. However, if a taxpayer's activities include services, or the licensing of intangibles, or any other activities not protected under 86-272, we know that several states have successfully asserted that the taxpayer has nexus, absent any physical presence. What isn't clear is whether economic presence in a state will necessarily trigger an income tax filing obligation in those states that have not specifically addressed the issue.

Nevertheless, what is certain is that states will continue to pursue a broad interpretation of what constitutes nexus.

Marketplace facilitator

Some states have gone the route of requiring large retailers who have platforms that facilitate commerce to collect and remit the sales and use taxes. Washington led the way, and has been joined by a number of states. Although some states may allow vendors selling only through facilitator channels to not register, others still require registration and filing. It is important to note that this facilitator may not cover all taxes, and nexus and a filing obligation may still exist. Washington's B&O tax is a prime example of this as those using the facilitator's service still need to file and pay this tax.

Offers in compromise (voluntary disclosures)

Many states provide for a formal offer-in-compromise program. Some companies may have had nexus for quite some time, but have refrained from filing because of ignorance or misunderstanding of the law, or have simply postponed fulfilling this obligation because of administrative constraints, or even because they "didn't want to bother."

Those companies may be willing to file prospectively, but fear that doing so would cause the taxing jurisdiction(s) to look back after receiving the application, and then propose a substantial (if not staggering) assessment. Note that, even where activity was rather limited, assessments could still be very significant, because the statute of limitations does not start running until a return is filed. Theoretically, states could go back indefinitely, although they usually will not do so. In fact, many states go back 7 to 10 years. In addition, the assessment would include significant penalties and interest.

© 2019 Association of International Certified Professional Accountants. All rights reserved.

These are the ideal circumstances in which an offer-in-compromise or voluntary disclosure agreement (VDA) may be appropriate. There are two primary advantages to a VDA. First, most states will waive penalties and some will even waive part of the interest due. Second, and perhaps more importantly, the state will limit the look-back period, usually to three or four years. Generally, the VDAs are proposed anonymously through the use of a tax professional. For effecting a satisfactory compromise, it may be best to ask an expert tax professional to contact the state(s) and determine whether a lump-sum settlement would be agreeable to bring the taxpayer current, or alternatively, whether the state might be willing to limit its review to just a few years (for example, three to five). VDAs are particularly useful in those situations where the nexus determination is ambiguous or in a particularly gray area of the law. For companies facing a FIN 48 issue, a VDA can be very helpful.

Making an offer could also be considered in conjunction with state amnesty programs. However, even if there is such a program, the taxpayer should act very cautiously, because the program might specifically limit the amnesty to specified periods or types of taxes. State amnesty programs should also be regarded with a healthy dose of skepticism for several reasons. Amnesty programs will usually offer a waiver of penalties, and often a partial waiver of interest. This can make them seem more appealing than the state's VDA program, which usually only waives penalties. However, most amnesty programs lack the ability to limit the lookback period that is the hallmark of VDA programs. When these amnesty programs are being considered, they should be compared to the applicable VDA program to see which is a better fit to a particular set of facts for a given taxpayer.

In addition to specific state programs, the MTC has a formal offer-in-compromise program through which taxpayers and their representatives can approach multiple states through a voluntary disclosure process. For more information, see the MTC website at www.mtc.gov.

© 2019 Association of International Certified Professional Accountants. All rights reserved.

© 2019 Association of International Certified Professional Accountants. All rights reserved.