SALES AND USE TAXATION OF INTERNET SALES:
The Evolving Case Law

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Technological developments over the past decade have resulted in an explosion in electronic commerce conducted over the internet. However, state sales and use tax statutes, that were built around more traditional notions of commerce, have been slow to catch up with the rapidly-changing technological environment. As a result, businesses engaged in electronic commerce have to navigate a labyrinth of laws that do not fully contemplate purchases from a home computer or sales from a web-based platform. This presentation is designed to give an overview of the laws, constitutional issues and other issues that internet vendors must traverse in order to determine their state sales and use tax obligations.

In broad strokes, businesses engaged in electronic commerce have to make two general inquiries. First, the business must determine if its products or activity it engages in is taxable in any given state or locality. Second, the business must determine if the United States Constitution allows the state to impose sales or use tax obligations on the business. The focus of this paper is on this second inquiry.

1. DOES THE INTERNET VENDOR SELL ITEMS OR ENGAGE IN ACTIVITY THAT IS SUBJECT TO THE DESTINATION STATE'S SALES AND USE TAX?

Sales and use taxes arise from state law and vary from state to state. A few states – such as New Hampshire and Oregon – have chosen not to impose a general sales or use tax at all. Other states have elected to tax not only sales or rentals of tangible personal property, but also virtually every type of business transaction, including services. Other states fall somewhere in the middle.

States that do impose a sales tax fairly universally apply the tax to retail sales of tangible personal property. *See e.g.* Ariz. Rev. Stat. ("ARS") § 42-5061 (imposing a tax on "the business

of selling tangible personal property at retail"); Cal. Rev. and Taxation Code ("CRTC") § 6051 (imposing tax on "the privilege of selling tangible personal property at retail"); Fla. Stat. § 212.05; N.Y. Tax Law § 1105(a). Many states, however, go beyond mere sales of tangible personal property and apply their tax to a myriad of different transactions and activities. These other areas might include rentals of tangible personal property, licenses for use, amusements, lodging (hotel/motel), and transportation.

State sales and use tax classifications also come with many different exemptions, deductions and exclusions. One common and almost universal exemption is a sale for resale. *See e.g.* ARS § 42-5061(V)(3) (explicitly excluding sales for resale); CRTC § 6051 (limiting tax to sales at retail, which excludes resales); Fl. Stat § 212.02(14)(a) (excluding sales for resale from the definition of a retail sale); N.Y. Tax Law § 1105 (excluding sales for resale from definitions of taxable transactions). As a result internet wholesalers, for example, will generally not be subject to sales or use tax in most states.

In addition, some states have addressed electronic commerce by establishing additional rules that can create problem areas for internet vendors. These include the following:

Software: Many states treat computer software differently depending on the nature of the software. For example, sales tax generally applies to sales, license, or rentals of "canned" software (i.e. prewritten software designed for general use and not tailored to the specific needs of a particular client), and the tax base usually includes any licensing fee or royalty paid for the software license. *See e.g.* CRTC § 6010.9; Ariz. Admin. Code Reg. R15-5-154; N.Y Tax Law § 1101(b)(6). At the same time, many states treat "custom" software (i.e. software originally created or written for the specific use of a particular client) as a non-taxable service, rather than a taxable sale, rental or license.

States also come out differently on the property tax treatment of software downloaded from the internet. Some states, such as California, do not impose their sales tax on software downloads, because the property sold was not tangible personal property. Internet vendors must be careful, however, as this rule generally only applies so long as *no transfer whatsoever* of tangible personal property occurs as part of the transaction. For example, states such as California take the position that downloaded software would be taxable if the customer receives backup disks or physical manuals as part of the sale.

Other states, like New York, tax software sales "regardless of the medium by means of which such software is conveyed to a purchaser" be it through a tangible medium such as a disk or downloaded from the internet. N.Y. Tax Law § 1101(b)(6).

Information Services: Some states, such as New York, also tax information services. New York defines an information service as "[t]he furnishing of information by printed, mimeographed or multigraphed matter or by duplicating written or printed matter in any other

manner, including the services of collecting, compiling or analyzing information of any kind or nature and furnishing reports thereof to other persons." N.Y. Tax Law § 1105(c)(1).[1]

New York regulations interpreting this section state that the information may be duplicated in any manner, including through "tapes, discs, [and] *electronic readouts or displays*." N.Y. Reg. 527.3(a) (emphasis added). In short, New York taxes any activity involving "collecting, compiling or analyzing information of any kind or nature and the furnishing reports thereof to other persons." N.Y. Reg. 527.3(b). A few examples of taxable information services include credit reports, tax or stock market advisory reports, and product or marketing surveys. N.Y. Reg. 527.3(c). New York administrative and judicial decisions have frequently applied the sales tax on information services to activity engaged in over the internet.

The rules discussed in this section are meant as a guideline to alert you to the general structure of state sales and use taxes and areas that might affect internet vendors. It is not intended to be all-inclusive, as each of the fifty states has adopted tax laws that differ from the laws of every other state. Thus, when you start engaging in transactions in a state (such as making sales into a state) you will need to determine if that state's sales and use tax applies and if you engage in any taxable transactions.

2. CONSTITUTIONAL LIMITATIONS ON STATES' POWER TO TAX INTERNET VENDORS.

Both the Due Process Clause and the Commerce Clause of the United States Constitution limit the state's power to impose sales taxes or a use tax collection obligation on an out-of-state vendor, including an internet vendor. Both of these constitutional limitations come into play, in the main, when dealing with interstate sale transactions, and limit a state's ability to impose a sales tax or use tax collection duty on an interstate sale transaction.

2.1 The Due Process Clause – Actual Physical Presence Not Needed.

Section 1 of the Fourteenth Amendment to the United States Constitution provides that … "[n]o State shall … deprive any person of life, liberty or property, without due process of law." The Due Process Clause "requires some definite link, some minimum connection between a state and the person, property or transaction it seeks to tax." *Miller Brothers Co. v. Maryland* , 74 S. Ct. 535, 539 (1954). This "definite link," or "minimum connection" is referred to generally as "nexus." The focus of most cases in this area has been to determine what set of factual circumstances satisfies the requirement of that "definite link" or "minimum connection."

The Due Process Clause applies not just to tax cases, but to other situations, as well, and particularly the question of when a state has personal jurisdiction over an out-of-state defendant for purposes of maintaining a suit in that state. One of the leading Due Process Clause cases

[1] New York excludes from its definition of information services, "the furnishing of information which is personal or individual in nature and which is not or may not be substantially incorporated in reports furnished to other persons, and excluding the services of advertising or other agents, or other persons acting in a representative capacity." N.Y. Tax Laws § 1105(c)(1).

arose in this context. In *International Shoe Co. v. Washington*, 326 U.S. 310 (1945), the United States Supreme Court dealt with the question of what contact an out-of-state defendant needed with the state for purposes of the states' asserting personal jurisdiction over that out-of-state defendant. The inquiry as framed by the Supreme Court is whether the defendant had minimum contacts with the jurisdiction "such that the maintenance of the suit does not offend traditional notions of fair play and substantial justice." The test dealing with personal jurisdiction has evolved from requiring the defendant to have a "presence" in the foreign state to a more flexible test of whether a person's contacts with the foreign state make it reasonable to require it to defend a suit there. *See State and Local Taxation Second Edition*, Vol. 1, Pomp and Oldman, page 299.

When it comes to taxation, "the controlling question is whether the state has given anything for which it can ask in return." *Wisconsin v. J. C. Penney Co.*, 311 U.S. 435 (1940).

In *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), the United States Supreme Court was faced with an out-of-state mail order retailer making mail order sales into North Dakota, and the obligation of the out-of-state retailer to collect the destination state's use tax. North Dakota imposed that use tax collection obligation on Quill and Quill challenged the state on both due process and Commerce Clause grounds. On the due process side, the Supreme Court essentially applied its approach to personal jurisdiction cases to the use tax collection obligation. The Court stated "if a foreign corporation purposely avails itself of the benefits of an economic market in the foreign State, it may subject itself to the State's personal jurisdiction even if it has no physical presence in the State." *Id.* at 307. The Court further stated that "it is an escapable fact of modern commercial life that a substantial amount of business is transacted solely by mail and wire communication across the state lines, thus obviating the need for physical presence within a State in which business is conducted." *Id.* at 308, quoting *Burger King Corp. v. Rudzewicz*, 471 U.S. 462, 476 (1985). The Court then went on to conclude that "[c]omparable reasoning justifies the imposition of the collection duty on a mail-order house that is engaged in continuous and widespread solicitation of business within a State." *Id.* at 308.

In so holding, the United States Supreme Court concluded that actual physical presence in a state was not necessary to satisfy Due Process Clause concerns. Rather, the economic exploitation of the market state, by an out-of-state retailer, is sufficient. Thus, under the Due Process Clause alone, an out-of-state mail-order retailer with no physical presence in the destination state, would be required to collect that destination state's use tax, as long as it was "engaged in continuous and widespread solicitation of business within" that state.

As will be noted, the *Quill* court concluded, though, that physical presence, and something more than the "slightest physical presence," is still needed to satisfy the nexus concerns of the Commerce Clause. As a result, the nexus focus for tax cases is now on the Commerce Clause.

2.2 Commerce Clause – Actual Physical Presence Required.

Cl. 3, section 8, article 1 of the United States Constitution provides that "the Congress shall have the power … to regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes." The Commerce Clause focus or concern is on the effects of state regulation on the national economy. The power to regulate commerce between and among the states, was left with the Congress, and not with the individual states. While the Commerce

Clause does not, by its own wording, expressly protect interstate commerce, the United States Supreme Court has held that the Commerce Clause "by its own force prohibits certain state actions that interfere with interstate commerce." *Quill* at 304, *citing South Carolina State Highway Dept. v. Barnwell Brothers, Inc.*, 303 U.S. 177 (1938). This facet of the Commerce Clause is called the "negative" or the "dormant" Commerce Clause.

2.3 The Evolution of the Dormant Commerce Clause.

The dormant Commerce Clause has evolved over the years. There have been three significant tests or evolutions:

(a) No tax on interstate commerce. The initial interpretation of the dormant Commerce Clause was that no state has the right to lay a tax on interstate commerce in any form. *Leloup v. Port of Mobile*, 127 U.S. 640 (1888); *Brown v. Maryland*, 25 U.S. 419 (1827).

(b) No <u>direct</u> tax on interstate commerce. The flat prohibition against a tax in any form on interstate commerce was liberalized and evolved into the interpretation that no state has the right to lay a <u>*direct*</u> tax on interstate commerce. *Spector Motor Service v. O'Connor*, 340 U.S. 602 (1951); *Freeman v. Hewit*, 329 U.S. 249 (1947). This distinction between a direct tax on interstate commerce and a prohibition on a tax in any form allowed an indirect tax such as a franchise tax on interstate sales.

(c) States have the right to tax interstate commerce if four prong test is met. The most recent evolution of the Commerce Clause is found in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977). In that case, the Supreme Court specifically overruled *Spector Motor Service*, and held that all states have the right to lay a tax on interstate commerce so long as the tax:

(1) is applied to an activity with *substantial nexus* with the taxing state,

(2) is fairly apportioned,

(3) does not discriminate against interstate commerce, and

(4) is fairly related to the services provided by the state.

This four prong test is generally referred to as the *Complete Auto* test.

In *Goldberg v. Sweet*, 488 U.S. 252 (1989), the United States Supreme Court applied the four prong *Complete Auto* test to Illinois' imposition of a sales tax on interstate phone calls. The Court went through each prong, analyzed it in view of the interstate telecommunications tax in question, and concluded that the Illinois tax, under the four prong test of *Complete Auto*, did not violate the Commerce Clause. *Goldberg* is one of the more recent and substantial cases dealing with the application of the four part *Complete Auto* test.

2.4 The Nexus Component of the Four Part Complete Auto Test – "Substantial Nexus."

The first prong of the *Complete Auto* test requires "substantial nexus" between the taxing state and the activity being taxed. That substantial nexus test must be satisfied before a tax will be found not to violate the dormant Commerce Clause. Following is the case law development of that "substantial nexus" test in the mail-order retailer and use tax collection context.

(a) *National Bellas Hess* – Physical Presence Required.

In *National Bellas Hess, Inc. v. Department of Revenue*, 386 U.S. 753 (1967), the United States Supreme Court was faced with the issue of what constituted sufficient nexus for a destination state to require an out-of-state mail-order vendor to collect it use tax on mail-order sales made into the state. National Belles Hess was a mail-order company with no offices, warehouses or distribution centers in Illinois. It had no employees, salesmen or agents in the state, either. Neither did National Bellas Hess have any tangible personal property or real property located in the state. It had no telephone listing in Illinois and did not advertise its products on Illinois television, radio, billboards, or in Illinois newspapers. The only contact National Bellas Hess had with Illinois was its mailings of catalogs in advertising fliers into the state through the U.S. mail common carrier.

Illinois imposed the use tax collection duty on National Bellas Hess for its Illinois mail-order sales. National Bellas Hess challenged that tax under both the due process and Commerce Clauses, focusing on the nexus requirement. The Supreme Court relied on the Commerce Clause and held:

> Indeed, it is difficult to conceive of commercial transactions more exclusively interstate in character than the mail-order transactions here involved. And if the power of Illinois to impose use tax burdens upon National were upheld, the resulting impediments upon the free conduct of the interstate business would be neither imaginary nor remote. For if Illinois can impose such burdens, so can every other State, and so, indeed, can every municipality, every school district, and every other political subdivision throughout the Nation with power to impose sales and use taxes. The many variations in rates of tax, in allowable exemptions, and in administrative and record-keeping requirements could entangle National's interstate business in virtual welter of complicated obligations to local jurisdictions with no legitimate claim to impose a fair share of the cost of the local government.

386 U.S. at 759.

With that as background, the court established a bright line, physical presence test:

> In order to uphold the power of Illinois to impose use tax burdens on National in this case, we would have to repudiate totally the sharp

> distinction which these and other decisions have drawn between mail-order sellers with retail outlets, solicitors, or property within a State [physical presence], and those who do no more than communicate with customers in the State by mail or common carrier as part of a general interstate business. But this basic distinction, which until now has been generally recognized by the state taxing authorities, is a valid one, and we decline to obliterate it.

386 U.S. at 758.

The *National Bellas Hess* rule is quite simply that the Commerce Clause prohibits states from imposing the use tax collection duty on an out-of state mail-order retailer that does not have any physical presence in the state.

(b) The *Quill* Case – Upholds *National Bellas Hess* On The Commerce Clause Analysis.

Quill Corp. v. North Dakota, 504 U.S. 298. (1992) was a re-run of *National Bellas Hess.* The facts were essentially the same and both involved mail-order retailers with no physical presence in the destination state, making mail-order sales into that state.

In *Quill*, North Dakota imposed its use tax collection duty on Quill, an out-of-state mail-order of office products. The North Dakota Supreme Court upheld the use tax collection obligation and the U.S. Supreme Court granted certiorari (took review). Both the due process and Commerce Clauses were at issue in *Quill* as they were in *National Bellas Hess*. The *Quill* court distinguished the two clauses, recognizing the distinctions between the two.

For Due Process Clause purposes, the court referred to *Miller Brothers* and reaffirmed that the Due Process Clause requires a definite link or minimum connection between the state and the person it seeks to tax. However, the court observed that its due process analysis in the area of personal jurisdiction had evolved over the recent years and that formalistic tests focusing on a defendant's physical presence in the state had been relaxed in favor of a broader analysis of all of the defendants contacts with the state to determine whether jurisdiction was reasonable under the circumstances. The court held that under the evolution of the Due Process Clause, physical presence was not necessary in order to satisfy the due process nexus requirement:

> Thus, to the extent that our decisions have indicated that the Due Process Clause requires physical presence in a State for the imposition of a duty to collect a use tax, we overrule those holdings as superseded by developments in the law of due process.
>
> In this case, there is no question that *Quill* has purposely directed its activities at North Dakota residents, that the magnitude of those contacts are more than sufficient for due process purposes, and that the use taxes related to the benefits Quill receives from access to the State. We therefore agree with the North Dakota Supreme

> Court's conclusion that the Due Process Clause does not bar enforcement of that state's use tax against Quill.

504 U.S. at 308.

On the Commerce Clause side, the Court reaffirmed the four part test of *Complete Auto*, and that test continues to govern the validity of a state's ability to tax interstate commerce under the Commerce Clause.

As previously noted, the first prong of the *Complete Auto* test is that there be substantial nexus between the activity being taxed and the state. The United States Supreme Court recognized that an out-of-state seller, such as Quill, could satisfy the much lower standard of the Due Process Clause of "minimum contacts", without also satisfying the more rigorous test of the Commerce Clause of "substantial nexus." The Court then reaffirmed the physical presence test for the Commerce Clause:

> In sum, although in our cases subsequent to *Bellas Hess* and concerning other types of taxes we have not adopted a similar bright-line, physical-presence requirement, our reasoning in those cases does not compel that we now reject the rule that *Bellas Hess* established in the area of sales and use taxes. To the contrary, the continuing value of a black line rule in this area and the doctrine and principles of *stare decisis* indicate that the *Bellas Hess* rule remains good law. For these reasons, we disagree with the North Dakota Supreme Court's conclusion that the time has come to renounce the bright-line test of *Bellas Hess*.

504 U.S. at 317-318.

It should be noted that the Supreme Court commented that there is no constitutional bar to congressional legislation in this area, since the Commerce Clause relegates to Congress the power to regulate interstate commerce. Thus, Congress could pass legislation establishing a lower threshold for use tax collection than physical presence. Such congressional legislation has been introduced over the past several years, but there has been no real agreement between the mail-order industry and states over the particulars of such a congressional test. At this juncture, such legislation has not been passed.

2.5 The Physical Presence Test – How Much Is Required.

The focus or inquiry of the cases since *Quill*, is how much physical presence in a state is required for "substantial nexus", and use tax collection. There are two schools of thought on this question.

"Any Physical Presence." The first view is that "any" physical presence in the state, that does not constitute a de minimis connection is sufficient for "substantial nexus." *Quill's* reference to the bright-line test as creating "a safe harbor for vendors whose only connection with customers in the State is by common carrier or the United States mail" (504 U.S. at 315) is

the basis of this view; the converse of such a statement is that *any* physical presence in the state would be sufficient.

"More Than Slightest Physical Presence." The other, and the author believes it the better view, is that "substantial nexus" requires some type of ongoing physical presence in the state, which is more than the "slightest physical presence." *Quill* rejected the "slightest physical presence" standard in *National Geographic Society v. California Board of Equalization*, 430 U.S. 551 (1977). If the "slightest presence" standard was rejected by *Quill*, doesn't physical presence require something more than "slightest physical presence." This view is also supported by the language in *Quill* that "whether or not a state may compel a vendor to collect a sales or use tax may turn on the presence in the taxing state of a small sales force, plant or office." 504 U.S. at 315. Wouldn't this language mean that physical presence requires a plant, office, or a small sales force (perhaps one individual) present in the state. It should. And, as previously mentioned, the post *Quill* litigation, for the most part, involves the interpretation and application of the physical presence test, essentially, how much physical presence in the state is required before the "substantial nexus" requirement of the Commerce Clause is satisfied.

In fact, the court in *Quill* noted that "although title to a few floppy diskettes present in a state might constitute some minimal nexus, in *National Geographic Society v. California Board of Equalization* [citation omitted] we expressly rejected the slightest presence standard of constitutional nexus." *Quill* at footnote 8. So, the in-state presence of computer disks, and perhaps even other types of de minimis property and equipment, would not satisfy the substantial nexus test under *Quill*. This interpretation was applied by the Kansas Supreme Court in *In re Appeal of Intercard, Inc.*, 14 P.3d 1111 (Kan. 2000). It noted that a slightest physical presence was not sufficient to establish substantial nexus, but that some states had found that more than a slight presence is sufficient. Applying this standard, it held that 11 visits by employees of the taxpayer into Kansas to install electronic card readers at photocopy centers was insufficient to establish substantial nexus with the state, when the taxpayer was not incorporated or registered in Kansas, approved all contracts or sales from out-of-state, and had no offices or employees in Kansas.

2.6 Physical Presence and the Relation to the Activity Being Taxed.

The first prong of the *Complete Auto* test requires that the tax be applied to an activity with a substantial nexus with the taxing state. This language suggests that the activity sought to be taxed must have the substantial nexus with the taxing state.

Use Tax – Indirect Relationship is "O.K." However, just a month after the *Complete Auto* decision, the United States Supreme Court issued its decision in *National Geographic*, supra. *Complete Auto* involved a sales tax, while *National Geographic* involved a use tax collection duty. The United States Supreme Court distinguished a use tax from a direct sales tax and concluded that although disassociation between the activity within the state and the activity sought to be taxed is fatal to a direct, sales tax it is not an impediment to the imposition of the use tax collection duty. *National Geographic* involved California's imposition of the use tax collection duty on National Geographic's subscription sales to California residents. California based this duty on the existence in California of two National Geographic sales offices for advertising solicitation. Those advertising sales offices were disassociated from the subscription activities of National Geographic. The Supreme Court concluded, though, that the presence in

the state of a physical activity disassociated from the sales sought to be taxed, is sufficient substantial nexus for the imposition of the use tax collection duty.

Sales Tax – Direct Relationship is Needed. The Supreme Court in *Norton Co. v. Department of Revenue*, 340 U.S. 534 (1951) held that for sales tax purposes, the particular transaction to be taxed must be associated with the taxpayer's in-state activity, and if it is not, that is fatal to a direct tax on the particular transaction. It should be noted, though, that *Norton* was decided in the same year that *Spector Motor Service* laid out the interpretation of the dormant Commerce Clause that no state has the right to lay a direct tax on interstate commerce. It should also be noted that *Quill* made no distinction between a sales and a use tax in this area and we might well expect states to test the distinction between the sales and use tax as laid out in *National Geographic* and *Norton*, with the states arguing that there should be no distinction between the two, and for sales tax purposes, the transaction sought to be taxed can be disassociated from the taxpayer's in-state physical presence.

2.7 Use Tax Collection, Review of Cases.

This portion of the paper will provide an overview of the various United States Supreme Court and state court cases dealing with the use tax collection duty, and particularly the type of in-state physical presence needed to satisfy the substantial nexus requirement.

(a) *Traveling salesmen not sufficient for the imposition of the sales tax. McLeod v. J.E. Dilworth Co.*, 322 U.S. 327 (1944). *Dilworth* involved Tennessee businesses that sold goods into Arkansas. Arkansas attempted to impose its sales tax on these sales. The sellers had no place of business, employees or property in Arkansas. The sellers' only contact with Arkansas was the solicitation of orders by traveling salesmen who resided in Arkansas, with some orders being taken over the telephone or by mail. The orders were accepted in Tennessee, not in Arkansas; the goods were shipped from Tennessee and title passed to the purchaser in Tennessee upon delivery to the carrier. Arkansas attempted to impose its sales tax on those sales. It should be noted that from a sales law standpoint, most of the indicia of the sale took place in Tennessee, with the order being accepted in Tennessee and delivery and title passing in Tennessee. Nevertheless, Arkansas imposed the sales tax and Dilworth objected on Commerce Clause grounds. The United States Supreme Court, in a narrow 5 to 4 decision, struck down the Arkansas sales tax on the transactions:

> [I]n this case the Tennessee seller was through selling in Tennessee. We would have to destroy both business and legal notions to deny that under these circumstances the sale – the transfer of ownership – was made in Tennessee. For Arkansas to impose a tax on such transactions would be to project its powers beyond its boundaries and to tax an interstate transaction.

322 U.S. at 330.

Arkansas argued that it could have levied a use tax on the Arkansas buyers and if it could impose such a use tax, it should be able to impose a sales tax directly on the seller. The Supreme Court made a crucial distinction that it was the Arkansas sales tax at issue and not the use tax:

> Though sales and use taxes may secure the same revenue and serve complementary purposes, they are, as we have indicated, taxes on different transactions and for different opportunities afforded by a state.

322 U.S. at 331.

(b) Traveling salesmen are sufficient for use tax collection. *General Trading Co. v. State Tax Commission, 322 U.S. 335 (1944). General Trading Co*. was a companion case to *Dilworth*. In *General Trading*, Iowa imposed its use tax collection duty on a Minnesota based vendor. General Trading had no place of business, employees or property in Iowa. All of its products were sold by traveling salesmen. The salesmen did not have the power to accept the orders; rather those orders were transmitted to the home office where they were accepted and processed. The key distinction between *Dilworth* and *General Trading* was that while Arkansas attempted to impose its sales tax in *Dilworth*, Iowa attempted to impose its use tax on *General Trading*.

The Supreme Court concluded that the presence of the traveling salesmen was sufficient physical presence in the state for the use tax collection duty to be imposed:

> The tax is what it professes to be – a non-discriminatory excise laid on all personal property consumed in Iowa. That property is enjoyed by an Iowa resident simply because the opportunity is given by Iowa to enjoy property no matter when acquired. The exaction is made against the ultimate consumer – the Iowa resident who is paying taxes to sustain his own state government. *To make the distributor the tax collector for the state is a familiar and sanctioned device.*

322 U.S. at 338 (emphasis added).

The decision was a 7 to 2 decision, with the dissent observing that Iowa could not have imposed its sales tax on the sales in question but that "we are holding that a state has power to make a tax collector of whom it has no power to tax." 322 U.S. at 399.

The *Dilworth – General Trading* distinction still survives – traveling salesmen in a state will not be sufficient for the state to impose its sales tax but is sufficient for the use tax collection duty.

(c) Employees in-state. Full or part time employees living and working in the state is sufficient nexus, for use tax collection. *See General Trading, supra.* (traveling salesmen were employees). *See also Scripto, Inc. v. Carson*¸ 362 U.S. 207, (1960) and *Tyler Pipe Industries, Inc. v. Washington Department of Revenue*, 483 U.S. 232 (1987).

(d) Delivery into the state by the out-of-state retailer. In *Miller Brothers Co. v. Maryland,* 347 U.S. 340, 74 S. Ct. 535 (1954), a department store based in Delaware, sold goods

to Maryland residents that came into the Miller Brothers store in Delaware. When Maryland residents made their purchases, some took the goods with them, other items were delivered to the Maryland purchasers by common carrier and others by the store's own delivery trucks. Maryland sought to impose the use tax collection duty on Miller Brothers on the basis that Miller Brothers made delivery of goods into Maryland by its own vehicles, that Miller Brothers advertising reached Maryland residents (it was not aimed at Maryland residents but Delaware radio stations were also heard in Maryland), and sales from circulars that were mailed to Maryland customers.

The Supreme Court set out the now familiar test that "due process requires some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax." 347 U.S. at 344-345. The Court concluded that such link or connection did not exist between Maryland and Miller Brothers, contrasting the *Miller Brothers* facts with those in *General Trading*:

> "There is a wide gulf between this type of active and aggressive operation within a taxing state [the in-state traveling salesmen in *General Trading*] and the occasional delivery of goods by an out-of-state store with no solicitation other than the incidental effects of general advertising."

347 U. S. at 347.

It should be noted that *Miller Brothers* was decided under the Due Process Clause, with the Commerce Clause not considered.

But see *Brown's Furniture, Inc. v. Wagner,* 171 Ill. 2d 410, 665 N.E. 2d 795 (1996). Brown's Furniture is a retail furniture store located in Palmyra, Missouri and made sales of furniture to Illinois customers, delivering the furniture into Illinois. Palmyra, Missouri is located approximately 15 miles southwest of Quincy, Illinois. Illinois residents frequently patronized Brown's Furniture and their purchases comprised approximately 30% of the store's total sales. On a regular basis, Brown's Furniture delivered items purchased by Illinois residents into Illinois in its own trucks. During the ten month audit period at issue in the case, Brown's Furniture made 942 deliveries of its merchandise, valued at more than $675,000, into Illinois. Brown's Furniture collected neither Illinois nor Missouri sales tax on these sales. The Illinois Supreme Court, on these facts, concluded that the number of trips in the ten month period satisfied the more than "slightest physical presence" test of *Quill*, and upheld Illinois' use tax collection obligation on Brown's Furniture. The Illinois Supreme Court factually distinguished *Miller Brothers* based on the magnitude and frequency of deliveries made by Brown's Furniture on the one hand and the occasional delivery of goods by Miller Brothers, on the other hand.

(e) Presence of independent contractors in the state is sufficient. *Scripto, Inc. v. Carson*, 362 U.S. 207 (1960). Scripto is a Georgia corporation and Florida sought to require Scripto to collect the use tax on pens which Scripto sold and shipped from Atlanta to Florida residents. The facts were essentially the same as those in *Dilworth* and *General Trading*, except that Scripto's traveling salesmen were not employees, but were independent contractors. The Supreme Court held that did not make a difference, and the presence of independent contractors in the state is sufficient nexus for the imposition of the use tax collection duty:

> True, the "salesmen" are not regular employees of appellant devoting full time to its service, but we conclude that such a fine distinction is without constitutional significance. The formal shift and the contractual tagging of the salesmen as "independent" neither results in changing his local function of solicitation nor bears upon its effectiveness in security a substantial flow of goods into Florida. To permit such formal "contractual shifts" to make a constitutional difference would open the gates to a stampede of tax avoidance.

362 U.S. at 211.

It does not matter if the independent contractors also represent other principals.

(f) Courts are split on whether or not in-state volunteers create nexus. Some courts have found that in-state volunteers do not create sufficient nexus. *See Pledger v. Troll Book Clubs, Inc., 871 S.W. 2d 389 (1994); Troll Book Clubs, Inc. v. Tracy*, Ohio BTA, Case No. 92-J-590, 1994 Ohio Tax LEXIS 1374 (August 1994); *Freedom Industries, Inc. v. Tracy*, Ohio BTA Case No. 92-N-597, 1994 Ohio Tax LEXIS 2025 (December 12, 1994); *Scholastic Book Clubs, Inc. v. Commissioner of Revenue Services*, CV 07 4013027 S; CV 07 4013028 S (Conn. Super. Ct., April 9, 2009). Other courts have come out the other way and found that in-state volunteers do create sufficient nexus. *See Scholastic Book Clubs, Inc. v. State Board of Equalization*, 207 Cal. App. 3d 734 (1989) (in-state volunteers do create sufficient nexus); *Appeal of Scholastic Book Clubs, Inc.*, 920 P.2d 947 (Kan. Sup. Ct. 1996). These are all teacher/book club cases. Book clubs normally will have teachers sell books to school children, with the teachers being volunteers and not being paid employees or independent contractors. The cases that have held that the teachers are not agents of the out-of-state book club have found that there is not sufficient nexus. On the other hand, the cases that characterized the teacher as an agent of that out-of-state book club or retailer have held that there is sufficient nexus. So, in the context of these cases, the holding turns on whether the in-state volunteer is an agent or not.

(g) In-state visits by employees of out-of-state retailer.

Orvis Co., Inc. v. Tax Appeals Tribunal of N.Y., 654 N.E. 2d 954 (1995). Orvis was based out-of-state and employees visited up to 19 New York wholesale customers on the average of four times a year. The Court of Appeals found that to be sufficient nexus.

Vermont Information Processing, Inc. v. Tax Appeals Tribunal of N.Y., 654 N.E. 2d 954 (1995). VIP employees visited New York customers some 41 times in three years to resolve computer hardware and software problems. The Court of Appeals held this to be sufficient nexus.

Care Computer Systems, Inc. v. Arizona Department of Revenue, 4 P.3d 469 (Ariz. Ct. App. 2000). A computer and software company had sufficient nexus as a result of visits by out-of-state personnel during twenty-one days per year and one out-of-state traveling salesman making seven one-to-two day visits during a seven year audit period. The business further leased a small amount of property in Arizona that occasionally developed into outright sales when the lease term expired.

(h) Attendance at conventions and trade shows is not sufficient nexus. *See Florida Department of Revenue v. Share International, Inc.*, 667 So. 2d 226. The presence at an in-state convention or trade show does not provide sufficient nexus for use tax collection on mail-order sales into the state. However, any sales made at the trade show were subject to Florida's sales tax.

2.8 Nexus Through Others.

Some states have tried to assert the use tax collection function on an out-of-state retailer with no physical presence in the state through other entities that do have in-state physical presence. There are three theories which are used by states to assert this type of nexus:

1. Agency nexus;

2. Alter ego nexus; and

3. Affiliate nexus.

(a) Agency Nexus. Under this theory, an out-of-state retailer with no physical presence in the state will have nexus if it has an "agent" in the state acting on its behalf. *See, e.g., Scripto, Inc. v. Carson, supra.* (presence of in-state independent contractors acting as Scripto's agents was sufficient nexus). *See also Tyler Pipe Industries, Inc. v. Washington Department of Revenue,* 483 U.S. 232 (1987).

The School Book Club Cases. The agency theory has arisen over the last few years in the school book club cases. In these cases, an out-of-state school book company will make sales of its books to school children enlisting the aid and assistance of in-state teachers. The teachers will generally pass around to their students an order form listing various books that the students might be interested in. The students will then order the books, provide a check or cash for the appropriate amount, and the teacher will assemble all of the orders from her classroom and then send it to the out-of-state club for filling. The books will then be shipped, generally, back to the teacher for distribution to the students. The out-of-state book companies do not have any physical presence in the state and lack the nexus with the state for use tax collection in their own right. However, a number of states have asserted that the teachers are the "agents" of the out-of-state book sellers and their physical presence in the state, soliciting sales, constitutes sufficient nexus to require the out-of-state book company to collect the use tax. The states' position is that the teachers are the equivalent of the independent contractor sales agents in *Scripto*.

The cases have gone both ways, with the focus being on agency law and principals, and whether the in-state teachers can be considered agents for the out-of-state book company under that state's agency law.

<u>No Agency Found</u>. The courts found that the in-state teachers were not agents for the out-of-state book companies in the following cases:

Pledger v. Troll Book Clubs, Inc., 871 S.W. 2d 389 (Ark. 1994) (the Troll Book Club was not required to collect use taxes because two elements of agency, authority and control, were not present).

Troll Book Clubs, Inc. v. Tracy, Ohio BTA Case No. 92-J-590, 1995 Ohio Tax LEXIS 1374 (Ohio 1994) (the Ohio court found no agency, and thus no nexus).

Freedom Industries, Inc. v. Tracy, Ohio BTA Case No. 92-N-597, 1994 Ohio Tax LEXIS 2025 (Ohio 1995) (likewise, the Ohio court did not find in-state teachers that assisted in the sale of school sportswear for the out-of-state retailer to be agents).

Scholastic Book Clubs, Inc. v. Commissioner of Revenue Services, CV 07 4013027 S; CV 07 4013028 S (Conn. Super. Ct., April 9, 2009) (in-state teachers were acting "in loco parentis," or in the place of a parent to assist students in purchasing books. They were not the out-of-state vendor's agents or a sales force in the state).

Agency Found. In *Scholastic Book Clubs, Inc. v. State Board of Equalization*, 207 Cal. App. 3d 734 (Cal. 1989), the California court concluded that there was an "implied" agency between the out-of-state book club and the in-state teachers who took the book orders, and thereby concluded there was sufficient nexus to require the out-of-state book club to collect California use tax on its sales to California students.

Comptroller v. Furnitureland South, Inc., No. C-97-37872-OC, Md. Cir. Ct., Aug. 18, 1999, rev'd on other grounds, 364 Md. 126, 771 A2d 1061 (2001). The Maryland Circuit Court held that an out-of-state furniture vendor delivering its furniture to Maryland residents using an independent delivery company was required to collect use tax on those sales because the delivery company was found to be the agent of the vendor.

Furnitureland South is a large furniture retailer located in North Carolina. It's only showrooms and facilities are in North Carolina. It does not have any offices, showrooms, property or the facilities in other states, including Maryland.

Furnitureland advertised out-of-state using the Internet. Its orders would be accepted and filled from its North Carolina warehouse and then it would use an independent transport company, Royal Transport Inc., to deliver the furniture to its customers, including customers located in Maryland. The delivery company would collect the C.O.D. sales price, set up furniture, repair furniture or pick up damaged furniture for return to and repair at Furnitureland's warehouse in North Carolina.

Maryland imposed the use tax collection obligation on Furnitureland's sales to Maryland residents on the basis that the delivery company was Furnitureland's agent. The delivery company made more than 100 trips into Maryland monthly, providing setup, repair and installation of furniture all on behalf of Furnitureland. The Maryland court first found that substantial nexus exists because of the number of trips the delivery company made into Maryland each month and the services it performed there. Furnitureland relied upon *National Bellas Hess* which held that a state may not impose the use tax collection obligation when an out-of-state vendor uses a common carrier or U.S. mail to deliver its goods into the purchaser's state. The Maryland court reasoned that *National Belles Hess* does not apply because the delivery company's relationship with Furnitureland was more of a personalized delivery service than a common carrier, even though it was a third party common carrier.

(b) Alter Ego Nexus. The "alter ego" theory is very similar to the agency theory. The phrase is defined to mean "a second self" or a "counterpart." *See* Webster's Ninth New Collegiate Dictionary. Under this theory, an out-of-state retailer may be found to have nexus in-state because of the in-state activities of a related entity acting on behalf or in place of the out-of-state entity, as if it were the out-of-state entity. One of the older cases using this theory is *C.I.T. Financial Services Consumer Discount Co. v. Director, Division of Taxation*, 4 N.J. Tax 568, N.J. Tax Rptr. (CCH) ¶ 201-026 (N.J. Tax Court September 17, 1982) ("where the separate corporate entities of related corporations are not preserved in the conduct of their overall business, each corporation is regarded as the agent or alter ego of the other so that the presence of one corporation in a state is the presence of the other"). The court based its holding, not just on the alter ego theory, but also on the fact that the in-state corporation was acting as the agent of the out-of-state corporation. This will generally be the case in most of the alter ego cases, with the agency theory overlapping the alter ego theory.

Conversely, there was no nexus found under the alter ego theory in *Bloomingdale's By Mail Ltd. v. Commonwealth Department of Revenue*, 591 A.2d 1047 (Pa. 1991), *cert. denied*, 112 S. Ct. 2299 (1992). Bloomingdale's had retail department stores located in Pennsylvania. Bloomingdale's by Mail Ltd. is a separate legal entity which conducted Bloomingdale's mail-order business. It had no physical presence in the state. Pennsylvania argued that the presence of a parent's retail stores created sufficient nexus under the alter ego or agency theory. The Pennsylvania Supreme Court, though, held that the in-state presence of the retail stores did not create nexus because there was no proof of the existence of an agency relationship or the piercing of the corporate veil, so that Bloomingdale's retail stores could be viewed as the alter ego of the mail-order business. Again, this case was a mix of both the alter ego and agency theories. It also touched on the issue of whether there can be nexus by affiliation, which is covered below.

(c) Affiliate Nexus. The nexus by affiliation theory is sometimes referred to as "unitary" nexus. The facts of this situation are simple: There will be an out-of-state retailer making mail-order sales into the state, with no physical presence in the taxing state sufficient to satisfy the nexus requirement. However, there will be an affiliated company with physical presence in the state, with that physical presence being more than adequate to satisfy the nexus requirement. The affiliated company will be a parent, subsidiary, or a brother or sister corporation, where there is at least 50% common ownership. Moreover, that affiliated in-state company and the out-of-state mail order vendor will be a part of a "unitary" group for state income tax purposes. A state will attempt to impose the use tax collection duty on the out-of-state mail-order retailer because of the in-state presence of an affiliated member of the unitary group. A summary of the lead cases on this theory follow:

Current, Inc. v. The State Board of Equalization, 29 Cal. Rptr. 2d 407 24 Cal. App. 4th 382 (Cal. App. 1st Dist. 1994). California had a statute which embodied the nexus by affiliation theory. It provided that an out-of-state mail-order retailer would have nexus with California if it had an affiliated member in the state engaged in the same or similar line of business. The California Appellate Court struck down the statute, holding that where a corporation and its parent are organized and operated as separate legal entities, with separate products and separate customers, there is no nexus with the out-of-state retailer.

SFA Folio Collections, Inc. v. Bannon, 585 A.2d 666 *cert. denied* 111 S. Ct. 2039 (Conn. 1991). SFA Collections is the mail-order business of Saks Fifth Avenue. Saks Fifth Avenue had retail stores in Connecticut. SFA Folio Collections was based out-of-state and had no physical presence in the state. Connecticut tried to impose the use tax collection function on SFA Folio Collections because of the in-state presence of its parent, Saks Fifth Avenue. The Court held that there could be no nexus by affiliation and that the unitary concept did not apply in the use tax collection area. The Connecticut Supreme Court rejected affiliate nexus in this case, noting that the management groups for each corporation were separate and operated autonomously. The Court did comment that affiliate nexus would be appropriate in "exceptional circumstances", for example where the in-state corporation was a mere shell or an alter ego of a mail order company.

SFA Folio Collections, Inc. v. Tracy, 652 N.E.2d 693 (Ohio 1995). This is the same set of facts as involved in the Connecticut case, but the taxing state was Ohio. The Ohio court concluded, as the Connecticut court did, that SFA Folio Collections, which had no physical presence in Ohio, could not be deemed to have substantial nexus by virtue of its being a member of an affiliated group where one of the affiliates had physical presence in Ohio.

(d) Amazon Tax. In an attempt to overcome budget shortfalls, New York passed a bill (SB 6807), effective April 23, 2008, which creates a rebuttable presumption that an out-of-state seller is soliciting business in New York through a third-party (and thereby subject to sales or use tax) when the seller enters into an agreement with an in-state party who directly or indirectly refers customers to the out-of-state seller and who receives compensation for doing so. The language of the new statute is as follows:

> [A] person making sales of tangible personal property or services taxable under this article ("seller") shall be presumed to be soliciting business through an independent contractor or other representative if the seller enters into an agreement with a resident of this state under which the resident, for a commission or other consideration, directly or indirectly refers potential customers, whether by a link on an internet website or otherwise, to the seller, if the cumulative gross receipts from sales by the seller to customers in the state who are referred to the seller by all residents with this type of an agreement with the seller is in excess of ten thousand dollars during the preceding four quarterly periods . . . This presumption may be rebutted by proof that the resident with whom The seller has an agreement did not engage in any solicitation in the state on behalf of the seller that would satisfy the nexus requirements of the United States constitution during the four quarterly periods in question.

N.Y. Tax Law § 1101(b)(8)(vi)

The new statute is very broad, as merely having a link on a website counts as referring customers to the out-of-state seller. However, the law contains one significant limitation: a $10,000 threshold for the amount of revenue generated by the in-state affiliate. Any out-of-state vendor satisfying these requirements will be subject to New York sales or use tax. New York's law was essentially designed to target internet vendors from out-of-state, such as Amazon.com and Overstock.com, and requires them to collect sales and use tax without having physical presence in New York. As a result it has been dubbed the "Amazon Tax."

Both Amazon.com and Overstock.com have mounted legal challenges to New York's law. However, to date their challenges have been unsuccessful. In *Amazon.com v. N.Y. St. Dep't of Taxation & Finance*, 877 N.Y.S.2d 842 (N.Y. Sup. Ct., 2009), the New York trial court found that the out-of-state vendors taxed under New York's Amazon Tax law had more than a slightest physical presence in state and therefore satisfied any constitutional nexus standard. It held that in-state affiliates acted as a New York-based salesforce that generated revenue for the out-of-state vendor in-state. Furthermore, their presence in the state on behalf of the out-of-state vendor was substantial because they had to generate a substantial amount of revenue for the out-of-state vendor -- $10,000 -- before the state will impose its sales or use tax obligations on the foreign vendor.

Since New York's passage of this law, many other states have considered adopting a similar law. To date, North Carolina and Rhode Island have passed similar legislation (although Rhode Island's law only contains a $5,000 threshold instead of $10,000). *See* North Carolina Legis. Proposal #5; Rhode Island H.B. 6164. In addition the legislatures of both California and Hawaii have passed similar legislation, however, the governors of those states vetoed the bills and they did not become law. *See* Cal. A.B. 178; Hawaii H.B. 1405. Both states' governors feared that the bills would force small internet businesses that relied on advertising to either go out of business or relocate to another state. Similar legislation was also proposed in Tennessee, Minnesota, Connecticut, and Maryland but never passed or otherwise died in committee. Tenn. S.B. 1741; Minn. S.F. 282, H.F. 401; Conn. S.B. 806; Md. S.B. 1071. Some other states continue to consider legislation similar to New York.

Large internet vendors have responded quickly to the enactment of these laws by the various states. For example, vendors such as Amazon.com and Overstock.com have severed ties with any entities in New York, Rhode Island, or North Carolina that might give rise to a use tax collection obligation in those states. In addition, when Hawaii's Legislature passed its own Amazon Tax, Amazon.com and other internet vendors immediately severed ties with their in-state affiliates. Perhaps this action motivated the governor to veto the Amazon Tax bill before it became law.

2.9 Recent Nexus Developments.

(a) Alabama

(1) <u>Legislation Sets Nexus Standard for Out-of-State Sellers</u>

(i) House Bill 650, enacted 06/16/03, establishes nexus standards for out-of-state vendors that are related to in-state businesses, effective August 1, 2003.

(ii) The legislation provides that an out-of-state vendor has substantial nexus with Alabama for state and local use taxes if the vendor is related to a business maintaining one or more locations in the state, and one or more of the following criteria apply:

- the vendor and in-state business use an identical or similar name, trade name, or trademark to develop, promote, or maintain sales;

- the vendor and in-state business pay for each other's services, contingent upon the volume or value of sales;
- the vendor and in-state business share a common business plan or coordinate their business plans;
- the in-state business provides services that help the vendor develop, promote, and maintain an in-state market.

(iii) In determining whether the out-of-state vendor and in-state business are related parties, the legislation requires that:

- one of the parties own 50 percent of the other's outstanding stock, if one or both of the parties are a corporation;
- one of the parties own 50 percent of the other's profits, capital, stock, or value, if one or both of the parties are a limited liability company, partnership, estate, or trust; or
- an individual stockholder and the members of the stockholder's family own at least 50 percent of the value of both parties' outstanding stock .

(2) Common Ownership Insufficient to Establish Nexus

(i) In Revenue Ruling 03-001, 08/04/03, the Alabama Department of Revenue ruled that the nexus of an in-state retailer cannot be transferred to an affiliated out-of-state company that does not have nexus on a stand-alone basis if the entities are organized and operate independently.

(ii) An out-of-state catalog sales company makes sales to Alabama residents by soliciting orders through the catalog and by delivering merchandise via a common carrier. The company's parent corporation also owns a retail entity ("retailer") that operates retail outlets in several states, not including Alabama, but that is considering opening an Alabama outlet.

(iii) The department explained merely having the retailer and the catalog company formed as distinct legal entities is not enough to prevent the catalog company from having nexus with Alabama. However, if the retailer and catalog company operate as completely separate and distinct businesses, they will be treated for sales tax nexus purposes as separate entities despite their common ownership. The entities must not have any integrated operations or management and cannot be the alter ego, nominee or agent of the other, for any purpose. Thus, if these standards are met, nexus would not be established for the catalog company, the department explained. However, if the entities conduct the same business operation, offer the same items for sale, use the same marketing, or use the same trade name, the department will

consider the "actual facts presented by the situation" when making a nexus determination.

(3) Presence of Rented Property and Representatives In-State Established Nexus

(i) In *Graduate Supply House, Inc. v. Alabama Dep't of Rev.*, Admin. Law Div., No. S05-751, (CCH) [AL-TAXRPTR] ¶201-244 (Nov. 20, 2007), an Administrative Law Judge ("ALJ") found that there was substantial nexus for sales and use tax when an out-of-state company sold or rented graduation equipment to an in-state company, who then rented or sold the equipment to graduating students. The ALJ so found because there was an implied or de facto agency relationship between the in-state and out-of-state companies and because the Taxpayer owned graduation equipment physically present in Alabama.

(ii) Taxpayer was a Mississippi company and had no offices or direct employees in Alabama. However, it had a business relationship with four Alabama residents to assist in renting caps and gowns in Alabama. The four residents were employed by the Balfour Company, which was an Alabama company in the business of selling class rings and paraphernalia. Balfour employees' interaction with Taxpayer was as follows:

a. In a majority of transactions, Balfour employees would measure students for cap and gown size and have students pay them the rental price. Balfour employees would then fill out order forms and send them to the Taxpayer, who would bill Balfour a lower price than Balfour billed the students;

b. In a minority of transactions, Balfour would get cap and gown measurements from school administrators, fill out order forms and send them to the Taxpayer. Then either the Taxpayer would bill the school directly and send a commission fee to Balfour, or the school would pay Balfour, and the Taxpayer would bill Balfour at a lower rate than it received from the school.

(iii) The ALJ found that this arrangement created at least an implied or de facto agency relationship between Balfour employees and the Taxpayer. Balfour employees distributed order forms to students or schools, submitted the completed forms to Taxpayer, and received a commission or other compensation for their services. Thus the ALJ found that there was at least a tacit agreement

between the parties that Balfour would perform these activities on behalf of the Taxpayer. This relationship allowed the Taxpayer to establish and maintain its cap and gown business in Alabama and thus, the ALJ found substantial nexus. For authority, the ALJ analogized to the Book Club cases, above.

(iv) Finally, the ALJ found that even if there was no de facto or implied agency relationship, the Taxpayer would still have substantial nexus with Alabama because it owned caps and gowns that were located in Alabama. Caps and gowns were income producing property of the Taxpayer and were located in Alabama when they were rented in that state. Thus, the Taxpayer was doing business in Alabama, was physically present and had substantial nexus with the state.

(b) California

(1) <u>In-State Store Return Policy Establishes Use Tax Nexus for Online Book Seller</u>

(i) In *Appeal of Borders Online, Inc.*, SC OHA 97-638364, (CCH) [CA-TAXRPTR] ¶ 403-191 (Sept. 26, 2001), the California Board of Equalization ruled that an online retailer that sells into California from an out-of-state location is subject to use tax on its sales to California purchasers as a result of a refund policy that allows online customers to return merchandise to an affiliated entity's in-state retail outlets for a cash refund. California Rev. & Tax Code Sec. 6203 imposes a use tax collection obligation on an out-of-state retailer where three requirements are satisfied. First, the retailer must have a representative. Second, the representative must be operating in California under the authority of the out-of-state retailer. Third, the out-of-state retailer's authorized representative's operations in California must include selling, delivering, installing, assembling, or the taking of orders for tangible personal property. Borders Books & Music's policy of issuing cash refunds to Borders Online customers, while refusing to do the same for other online customers, the Board concluded is sufficient to establish that Borders Books & Music was Online's authorized representative in California. Online expressly stated on its web page that Borders Books was its authorized representative for the purpose of accepting returns. Borders Books' willingness to accept returns established the fact that it was conducting a selling activity in the state on behalf of Online. The taking of returns is an integral part of a retailer's selling efforts, and comports with the common sense understanding that the provision of convenient and trustworthy return procedures is crucial to an out-of-state retailer's ability to make sales. Based on

the above, the Board concluded Online has a substantial physical presence sufficient to satisfy the "substantial nexus" standards specified in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), the Board said.

(ii) The BOE subsequently denied Borders' petition for rehearing, and Borders paid the assessment and filed its refund claim. The California State Board of Equalization on August 1, 2002 accepted its staff's recommendation to deny the refund claim of Borders Online.

(iii) In 2005, the Court of Appeals heard this case and affirmed the ruling of the BOE. *See Borders Online, LLC v. State Board of Equalization*, 129 Ca. App. 4th 1179, 29 Cal. Rptr. 3d 176.

a. The court ruled that Borders Online is subject to use tax on its sales to California purchasers as a result of its online-advertised refund policy that allows online customers to return merchandise to an affiliated entity's in-state retail stores for a cash refund.

b. The court determined that there was an agency relationship between Borders Online and the Borders in-state stores. It so found because the stores accepted returns of the online retailer's merchandise and Border's Online advertised this policy to customers on its website. By accepting returns on behalf of Borders Online, the Borders stores were engaged in selling activity on behalf of Borders Online. The acceptance of returns, the court found, was an integral part of selling activity, and therefore constituted selling in the state. Therefore, the stores were engaged in selling activity on behalf of Borders Online in California.

c. The agency relationship found by the court established sufficient nexus for use tax purposes. First, the online retailer had an agent physically present in the state. Second, the activities of the Borders stores on behalf of Borders Online are significantly associated with the Taxpayer's ability to establish and maintain a market for sales in the state. The ability of customers to easily return or exchange merchandise in person at Borders stores was a crucial factor in Borders Online's ability to develop its very profitable market in California. Therefore the court upheld a finding of substantial nexus and required the online dealer to collect and remit use tax.

d. The court acknowledged that it might have come out differently if the return policy was initiated by the Borders stores as a service to customers, rather than a marketing agreement with Borders Online to enhance the Borders brand.

(2) Out-of-State Online Seller Does Not Have Nexus from the Distribution of Coupon Books by Brick and Mortar Affiliate

(i) In *Barnesandnoble.com LLC v. State Board of Equalization*, No. CGC-06-456465, (CCH) [CA-TAXRPTR] ¶ 404-488 (Ca. Super. Ct. Oct. 12, 2007), the court overturned a State Board of Equalization decision and found that an out-of-state online seller was not subject to sales and use tax in California when a bricks-and-mortar affiliate in the state distributed the online seller's coupons in the shopping bags it gave to customers.

(ii) Taxpayer was an online retailer who made sales only through the internet, delivered products via common carrier, and had no operations, facilities, or personnel in California. It was a separate and distinct entity from the Barnes & Noble entity that operated bricks-and-mortar stores. The two entities shared no common directors or officers.

(iii) The store locations began using shopping bags that contained the online seller's logo and had coupons to barnesandnoble.com pre-inserted into them. The online retailer paid the cost of printing the coupons and paid the incremental cost of placing its logo on the bags.

(iv) By California law, an out-of-state seller is responsible for use tax if it has agents or representatives engaged in selling activities on its behalf in the state. While the Board found that the store locations were agents of the online retailer based on the coupons, the court disagreed, holding that the retail stores did not act as agents of the online seller.

(v) First the court noted that there were no common directors or officers, and that neither had control over the other. The retail stores lacked the power to create coupons for the online retailer, nor did they have authority to change the terms of the coupons in any way. Additionally, they could not accept returns of items purchased with the coupons online and could not solicit sales or accept orders on behalf of the taxpayer. The retail locations merely passively handed the coupons out at the request of the online seller. The fact that both entities benefited from the

increased reputation the coupons created for the Barnes & Noble brand was insufficient to show any kind of agency relationship.

(vi) Because the court found that there was no agency relationship, the tax did not apply under the statute. Since the tax did not apply under state law, the court did not address the constitutional issues. However, the lower decision relied upon the agency relationship in finding physical presence and establishing nexus. The court here specifically found no agency relationship. Thus, there likely was no nexus either.

(3) Legislation Prohibits State from Purchasing from Non-Registered Vendors

(i) During 2003, the California Legislature enacted S.B. 1009 (10/8/03). This law prohibits the state from purchasing tangible personal property from a vendor, contractor, or its affiliates unless the vendor, contractor, and all of its affiliates that make sales for delivery into the state hold a seller's permit or are registered with BOE. Similar legislation has been enacted in other states including Illinois, Pennsylvania, South Dakota, Virginia and Wisconsin.

(c) Connecticut

(1) Independent Contractor's Minimal In-State Repairs Do Not Establish Nexus

(i) In *Dell Catalog Sales, L.P. v. Commissioner of Revenue Services*, 834 A.2d 812 (Conn. S. Ct. 2003), the Connecticut Superior Court ruled that minimal in-state repair services conducted by an independent contractor are insufficient to establish nexus for an out-of-state seller.

(ii) Dell Catalog Sales, L.P., based in Texas, contracted with BancTec, USA, Inc. ("BancTec"), an independent computer service provider incorporated in Delaware, to provide on-site computer repairs for Dell's customers, including those in Connecticut. When a customer purchased a computer service contract, Dell added the charge of the service contract to its customer's invoice. The amount of the charge that was remitted to BancTec was based on BancTec's on-site service calls made during the previous 90-day period. However, Dell retained approximately 90 percent of the contract charge, due to its own technical support activities, while the remainder was remitted to BancTec. The Commissioner of Revenue Services registered Dell as a vendor in the state and issued an assessment based on an estimate of sales made to Connecticut customers. In issuing the

assessment, the Commissioner explained that Dell had the requisite nexus for sales tax purposes based on its contractual relationship with BancTec. The Commissioner sustained the assessment against Dell's challenge and Dell appealed the matter to the Superior Court.

(iii) The fact that BancTec was an independent service provider that performed all of the on-site services and that it was not under Dell's control negates the claim that BancTec was Dell's agent, the court explained. In cases examining whether the use of independent service representatives provide the requisite in-state physical contact, the focus is on the extent of the in-state activities associated with the seller, the court explained, citing *Scripto v. Carson,* 362 U.S. 207 (1960).

(iv) The court acknowledged that BancTec served an important need of Dell to service Dell's Connecticut customers and that Dell's computer sales benefited from the sales of service contracts. However, the court was not presented with facts regarding the extent of BancTec's activities in Connecticut. The court inferred that since Dell retained 90 percent of the price of the service contract and BancTec only received the remaining 10 percent, BancTec's Connecticut operations on Dell's behalf were minimal. As such, the facts are akin to those in *Intercard*, and the court concluded that isolated and sporadic physical contacts are insufficient to establish substantial nexus to Connecticut.

(v) The State has indicated that it will not appeal the decision.

(2) <u>In-State Volunteers do Not Give Rise to Nexus</u>: *Scholastic Book Clubs, Inc. v. Commissioner of Revenue Services,* CV 07 4013027 S; CV 07 4013028 S (Conn. Super. Ct., April 9, 2009).

(i) This case contains the same basic facts as the other School Book Club cases.

(ii) Connecticut held that in-state volunteer teachers that distributed catalogs and order forms to students did not constitute a salesforce or agents of the out-of-state bookseller. Rather, they were acting "in loco parentis," or in the place of a parent, to assist students in purchasing books themselves. As a result the teachers did not create a physical presence in Connecticut for the out-of-state vendor.

(d) Hawaii

(1) Eleven Employee Visits to Hawaii Established Nexus.

(i) In *Baker & Taylor Inc., v. Kawafuchi*, 82 P.3d 804 (Ha. 2004), the State Supreme Court held that an out-of-state company satisfied nexus requirements for sales tax even though title to the property sold passed outside of the state. The court found the following factors determinative: 1) the customer had the right to inspect and reject the goods when they arrived in Hawaii; 2) the company sent employees into Hawaii on at least eleven occasions, each ranging from a day to a month; 3) the company retained ownership of licensed software in the state and 4) the company engaged in ongoing training and services for customers in the state. The court relied heavily upon *Arizona Dep't of Revenue v. Care Computer Sys., Inc.*, 4 P.3d 469 (Ariz. Ct. App. 2000).

(e) Kansas

(1) Use of Independent Sales Force Establishes Nexus.

(i) *In re Family of Eagles, Ltd.*, 66 P.3d 858 (Kan., 2003). An out-of-state corporation that generates in-state sales through a commissioned independent sales force has substantial nexus to justify imposition of use tax collection duties, the Kansas Supreme Court ruled.

(ii) The Taxpayer, Family of Eagles, Ltd., is a Texas corporation that sells coins, jewelry and other products. The taxpayer has no physical presence in the state, other than its commissioned independent sales representatives (ISRs) that use company sales aids and materials to solicit retail orders from customers. The ISRs do not actually purchase products from the taxpayer for resale or maintain an inventory of products. Rather, the taxpayer accepts the orders at its Texas location and ships the goods directly to customers via common carrier. The ISRs do not have assigned territories, can sell to customers outside the state, and are not required to perform any service after-sale activities.

(iii) The court found no constitutionally significant distinction between the ISRs' activities and those in *Scripto v. Carson*, 362 U.S. 207 (1960), where the Court held that Florida could constitutionally tax a Georgia seller for the sale of goods shipped to customers in Florida where the seller employed independent commissioned "jobbers" who solicited orders in Florida, forwarded the orders to Georgia for shipment, and did not collect payment on the order

from the customers. The lack of defined sales territories for the ISR's does not negate a physical presence that otherwise creates substantial nexus, the court explained.

(2) Eleven Employee Visits Insufficient to Establish Substantial Nexus

(i) *In re Appeal of Intercard, Inc*., 14 P.3d 1111 (Kan. 2000), Intercard, Inc. was engaged in the business of manufacturing and selling electronic data cards and card readers for use in photocopy centers. Occasionally, the purchaser requested that Intercard send technicians to the photocopy center to install the card readers. As a result, Intercard sent employees into Kansas eleven times to install card readers – they did not engage in the solicitation of sales.

(ii) The court recognized that a slightest presence is not sufficient to establish a substantial nexus, but that some states had found that more than a slightest presence is sufficient.

(iii) The court determined that eleven incursions into Kansas to install card readers over the 48-month audit period were too sporadic and isolated to establish sufficient nexus with Kansas, especially since Intercard was not incorporated or registered in Kansas, approved all contracts and sales from out-of-state, and had no offices or employees in Kansas.

(f) Louisiana

(1) Preferential In-State Store Return Policy Does Not Establish Nexus for Online Retailer When the Policy Was Implemented By the Bricks-and-Mortar Locations to Generate Goodwill and as a Service to Customers.

(i) In *St. Tammany Parish Tax Collector v. Barnesandnoble.com*, 481 F. Supp. 2d 575 (E.D. La. 2007), a Federal District Court determined that the close corporate relationship between Barnesandnoble.com, an internet retailer, and its sister corporation, a bricks-and-mortar retailer, was insufficient to establish substantial nexus for the internet retailer. The court so held despite the strong relationship between the two entities, which included: 1) the companies offered annual memberships that provided members with discounts from both entities; 2) the bricks-and-mortar locations sold gift cards that included the internet retailer's web address and could be redeemed online; 3) the internet retailer received commissions on merchandise ordered at the store locations but shipped directly to customers;

4) the two engaged in advertising on behalf of each other; and 5) the store locations accepted returns from the internet retailer, and did so in a preferential manner as compared to returns they accepted from non-affiliated dealers. An online purchaser could receive a store credit for the full amount paid, while purchasers from other retailers would only receive a store credit for the amount the store sold the item for.

(ii) The court reasoned that, despite these connections, nexus was not established because the related entities had separate management and directors, did not intermingle assets, were not underfinanced, and did not hold themselves out to be the same entity. In short, they were not alter egos of the same company and attributional nexus cannot apply by virtue of an affiliation between companies alone.

(iii) In addition, the court found the nature and extent of activities the store locations performed on behalf of Barnesandnoble.com were insufficient to treat the store locations as a marketing presence for the internet retailer in Louisiana. For example, the return policy was initiated by the store locations, and not by the online retailer, for the purpose of generating goodwill and to entice customers. Therefore it was not designed to promote a market for the online retailer.

(2) Independent Contractor Performing Repairs In-State Was Sufficient to Establish Nexus.

(i) In *Louisiana v. Dell International, Inc.*, 922 So. 2d 1257 (L.A. Ct. App. 2006), the Louisiana Court of Appeals found substantial nexus when an out-of-state corporation hired a third-party company to perform on-site computer repair services in the state. The test the court applied was whether or not the nature and extent of activities in the state "are significantly associated with the taxpayer's ability to establish and maintain a market in this state."

(ii) Dell sold computers by telephone, internet, and mail order into Louisiana, but had no stores or property in Louisiana. As part of the computer sales, Dell would also sell an on-site repair service. Dell contracted with a third-party, BancTec, to go to a computer purchaser's home or business to perform repairs. Dell remained heavily involved in the on-site repair services: all service requests from purchasers had to come through Dell, Dell trained BancTec technicians, all repair parts came from Dell, and Dell closely monitored BancTec's performance. This activity in Louisiana, the court found, made it possible for Dell to compete with in-state computer vendors. Therefore it was a significant factor in Dell's ability to establish and maintain a market in

Louisiana. As a result, the court overturned the trial court's order of summary judgment in favor of Dell.

(iii) The court found that there was no difference between having an agent or an independent contractor acting on Dell's behalf, as long as the activity performed on Dell's behalf was a significant factor in establishing and maintaining a market in the state.

(3) Presence of Property in Louisiana that was Owned by an Out-of-State Company and Leased to an In-State Company Established Sufficient Nexus.

(i) In *Wabash Power Equipment Co. v. Lindsey*, 897 So.2d 621 (La. Ct. App. 2004), the Louisiana Appellate Court found that substantial nexus existed when an Illinois company leased a boiler to a company in Louisiana because employees of the taxpayer visited the customer in Louisiana, were present during installation, and because the lease allowed employees of the taxpayer access to the boiler for maintenance and repairs. In addition, the taxpayer owned property (the boiler) physically located in Louisiana, and its presence was significantly associated with the taxpayer's ability to establish and maintain a market in the state, because other prospective customers were allowed to visit and inspect the boiler. As a result of these factors, the court found substantial nexus.

(g) Maryland

(1) A Telephone Provider Was an Agent of 900 Number Vendors and Sufficient Nexus to Tax 900 Number Calls.

(i) Lower Court Decision:

a. In *AT&T Communications of Maryland, Inc. v. Comptroller of the Treasury*, 932 A.2d 748 (Md. App. 2007), the Court of Special Appeals found that substantial nexus was created for vendors who sold information through 900 numbers and were located outside of Maryland because AT&T was their agent. The presence of an agent in the state satisfied the nexus requirements.

b. Maryland taxes certain services, including the transmission of information through a 900 number, if the vendor satisfies nexus requirements. The court found that AT&T was an agent of the vendors because it contacted information providers, entered into agreements with them, assigned them phone numbers, reviewed the information before it was received by the public, and provided transportation of

the information over its network. AT&T also provided billing for most of the vendors and received a portion of the revenue produced by the vendors.

c. Because of this involvement, AT&T was found to be more than just a common carrier. It was found to be a representative and agent of the vendors. Because the vendors had an agent representing them in Maryland, they had sufficient nexus to be subject to Maryland's sales tax.

d. It should be noted that Maryland was trying to tax AT&T as a party jointly liable for the tax on the vendors. In order for Maryland to impose a tax on the vendors, which it could then impute to AT&T, it had to establish nexus of the vendors to Maryland.

(ii) Court of Appeals Decision Overturns Lower Court:

a. The court noted that a common carrier is protected from being the agent of a person that uses its service. However, a common carrier may lose this protection if it associates itself too much with the transaction that it carries.

b. In this case, AT&T did not act as anything other than a common carrier, contrary to the lower court's finding:

i. Assigning numbers and carrying information of a third party fit into the definition of a telecommunications common carrier.

ii. Federal law requires common carriers to perform dispute resolution, and further requires it to screen information provided by 900 number vendors to determine if the content violates Federal law or regulations. Therefore this activity could not be treated as going beyond the scope of a common carrier.

iii. AT&T's billing and limited collection services were similar to activities performed by the common carrier in *Bellas Hess*. In that case the common carrier was not treated as an agent and therefore, AT&T should not be treated as an agent based on these factors either.

iv. AT&T, contrary to the lower court's finding, did not receive a share of the total revenue produced by the 900 number vendor. It received funds for the

services it provided regardless of whether the vendor actually collected payments from customers.

c. Since AT&T only acted as a common carrier, it could not be treated as an agent of the vendor and nexus did not exist.

(h) Massachusetts

(1) Sales of Merchandise for Pick-Up Outside State Subject to Tax.

(i) In *Circuit City Stores Inc. v. Commissioner of Revenue*, 439 Mass. 629, 790 N.E.2d 636 (Mass., 2003), the Massachusetts Supreme Judicial Court held that tangible personal property purchased at a Massachusetts store and picked up by a customer at an out-of-state location is subject to Massachusetts sales and use tax, where title passed to the customer in Massachusetts. The Massachusetts definition of "sale" includes any transfer of title or possession of tangible personal property by any means whatsoever, the Supreme Judicial Court noted on appeal. Because the tax statutes provide no explicit definition of the term "title," the Court looked to the Uniform Commercial Code, which provides that title passes to the buyer "at the time and place at which the seller completes his performance with reference to the physical delivery of the goods[,]" unless the parties otherwise explicitly agree.

(ii) Regarding an agreement of the parties, the Court rejected Circuit City's claim that the parties understood that the transaction taking place in Massachusetts constituted an order for merchandise rather than a concluded sale. The Court noted that the sales receipt described the item purchased, as well as, the time and date of the sale and the purchase price reflected on the receipt represented full consideration paid for the merchandise. "From the vantage point of the customer, the sales receipt represents proof of his or her right to the purchased merchandise," the Court concluded.

(iii) Regarding Circuit City's performance "with reference to the physical delivery of the goods," the Court found that the UCC describes, as an acceptable method of seller's tender and delivery, putting and holding conforming goods at the buyer's disposition and giving the buyer reasonable notification "to enable him to take delivery." Likewise, under common law, title may pass although the goods are still in the actual possession of the vendor. "Here, Circuit City performed its obligations with respect to delivery when the sale was entered as an alternative location sale into Circuit City's [inventory computer] system and

the purchased merchandise was 'reserved' for the customer at the designated location," the Court concluded.

(iv) The Court noted that while, under the UCC, title cannot pass prior to the identification of the merchandise under the contract, the reserve notation on the sales receipt sufficiently reflected the merchandise's status of being set aside, or identified, to the particular transaction.

(2) <u>The State Cannot Require a New Hampshire Seller to Collect Use Tax on Sales to Massachusetts Residents Where the Sales Took Place in Massachusetts.</u>

(i) Appellate Tax Board Decision: *Town Fair Tire Centers, Inc. v. Commissioner of Revenue* (CCH) [MA-TAXRPTR] ¶401-171 (Mass. App. Tax Bd. June 9, 2008)

a. The Massachusetts Appellate Tax Board required a seller in New Hampshire to collect use tax on tire sales to Massachusetts residents. Town Fair had store locations in several states, including Massachusetts and New Hampshire. Frequently residents of Massachusetts purchased tires from the locations in New Hampshire, where no sales tax is imposed.

b. The Board found that requiring Town Fair locations in New Hampshire to collect Massachusetts use tax did not violate the Due Process or Commerce Clauses because both the seller and the transaction had sufficient contacts with Massachusetts. Town Fair had nexus because it had physical locations in Massachusetts. The transaction had sufficient contacts because the tires sold were bound for Massachusetts. Furthermore, Town Fair could easily determine which sales it made to Massachusetts residents because it could look at the license plate on the car, and it routinely collected addresses and telephone numbers from customers who came in the door.

(ii) Supreme Judicial Court of Massachusetts Decision Overturns the Board: *Town Fair Tire Centers, Inc. v. Commissioner of Revenue*, 911 N.E.2d 757 (2009).

a. On appeal, the court overturned the Board.

b. Massachusetts law does not impose a use tax until the property sold is stored, used, or otherwise consumed in Massachusetts. In this case, there was no evidence that any of the tires sold were actually stored were used in Massachusetts. In addition, Massachusetts law contains no statutory presumption of use in the state where the property

is sold to a Massachusetts resident outside State, even when attached property registered in Massachusetts. Absent such a presumption (which the Court admits the legislature might be able to enact), the state may not presume the tires sold to a Massachusetts resident in New Hampshire will be used in the state. As a result, Massachusetts may not impose a use tax collection obligation on a New Hampshire business merely because the business sells property to a Massachusetts resident.

(i) New Mexico

(1) Substantial Nexus Found When Third-Party Provided On-Site Computer Repair.

(i) In *Dell Catalog Sales L.P. v. New Mexico Taxation and Revenue Dep't*, No. 26,843 (CCH) [NM-TAXRPTR] ¶ 401-200 (N.M. Ct. App. June 3, 2008) *cert denied* 144 N.M. 593, 189 P.3d 1215 (July 18, 2008), Dell is a Texas-based retailer who sells computers to customers by telephone, internet, and mail order. As a part of its computer sales, Dell frequently sells an on-site repair service. To provide this service, Dell contracts with a third-party, BancTec, to go to a computer purchaser's home or business to perform repairs. Dell remains heavily involved in the on-site repair services: all service requests come through Dell, BancTec technicians are trained by Dell, all repair parts come from Dell, and Dell closely monitors BancTec's performance. Dell retained the majority of the repair service charge to cover its own activities, and remits the rest to BancTec.

(ii) The New Mexico Court of Appeals held that BancTec's activities in-state were sufficient to subject Dell to its gross receipts tax, even though Dell did not have independent physical presence with New Mexico. It specifically addressed "the extent to which a third party, BancTec, can establish a substantial nexus on behalf of the out-of-state business sufficient to satisfy Commerce Clause limitations on state taxation." *Id*. at ¶ 43. The court held that BancTec's activities on behalf of Dell established substantial nexus because of the "reality of the relationship between BancTec and Taxpayer and the critical nature of BancTec's activities to Taxpayer's business." *Id*. at ¶48. Furthermore, BancTec's activities helped the taxpayer establish and maintain a market in New Mexico. *Id*.

(j) New York

(1) In-State Sales Representative Establishes Nexus.

(i) In *TSB-A-03(41)S*, 11/19/03, the New York Department of Taxation and Finance explained that the in-state presence of an independent salesman for an out-of-state business establishes nexus with New York so as to require the collection of sales tax on all of the business's sales to New York customers. The New York Tax Law requires every vendor of tangible personal property to collect the sales and use tax, the Department explained. Under N.Y. Tax Law Sec. 1101(b) and N.Y. Regs. Sec. 526.10, a vendor includes a person who solicits business by independent contractors, agents, or other representatives if such solicitation results in sales in the state of tangible personal property or services. The law also requires every person required to collect the tax to file a certificate of registration with the state. In addition, the law exempts purchases of tangible personal property or services for resale.

(ii) Given the statute and regulations, the Department concluded that the presence of the sales representative in the state establishes New York sales tax nexus for the taxpayer, a New Jersey corporation. The Department also noted that the U.S. Supreme Court has ruled that sales tax nexus is established by the in-state presence of an out-of-state corporation's independent contractor or agent. Thus, the corporation must register with the state and collect and remit the applicable state and local sales and use taxes on all sales, including those not generated by the in-state salesman, to New York customers.

(2) New York Component of Sale of Service to New Jersey Customers Not Sufficient to Establish Tax Collection Requirement.

(i) In *Petition of CWM Chemical Service, Inc.*, N.Y. Tax App. Trib., No. 818757 (CCH) [NY-TAXRPTR] ¶ 404-317 Dec. 11, 2003; aff'g N.Y. Div. Tax App., No. 818757 (CCH) [NY-TAXRPTR] ¶ 404-704, Sept. 12, 2002],

- CWM Chemical Services ("CWM") operates a hazardous waste treatment facility in New York and provides services to customers in and out of the state. When CWM collects waste at a customer's in-state location, CWM collects New York sales tax on the total receipts from the transaction, applying the customer's local rate. However, when CWM collects waste at a customer's out-of-state location and transports the waste to the CWM's New York facility, CWM does not collect or pay any

New York sales tax on any part of the receipts from the transaction.

- On audit, the Division of Taxation asserted that sales taxes were due on the in-state portion of the receipts from these transactions and assessed tax. CWM appealed the assessment to the Division of Tax Appeals ("DTA").

- The Tribunal applied *Jefferson Lines* to the facts at issue and ruled that New York lacks the requisite nexus to impose the sales tax. Nexus lies in the state where the real property is located, the sale is consummated, and the performance is initiated, the Tribunal explained. The Tribunal noted that if the facts were reversed, *i.e.*, the service was initiated in New York and the waste was transported out of state, nexus would be established and New York would be entitled to impose the sales tax on the entire, unapportioned receipt for the service.

(3) Out-of-State Seller Subject to N.Y. Sales Tax When Soliciting Business Through In-State Third-Party.

(i) New York passed SB 6807, effective April 23, 2008, which creates a rebuttable presumption that an out-of-state seller is soliciting business in New York through a third party when the seller enters into an agreement with an in-state party who directly or indirectly refers customers to the out-of-state seller, (including by merely having a link on a website) and who receives compensation for doing so. The agreement must generate at least $10,000 in sales in the previous four quarters.

(ii) A vendor that satisfies these requirements will be subject to New York sales and use tax.

(iii) The law effectively targets internet vendors from out-of-state and requires them to collect and remit sales and use tax without having physical presence in the New York.

(iv) Both Amazon.com and Overstock.com are currently challenging the constitutionality of this law in New York Supreme Court.

(4) New York's Amazon Tax Found Not to Violate the Commerce Clause.

(i) New York's Amazon Tax was found to be constitutional because the out-of-state vendors had more than a slightest physical presence.

(ii) In-state affiliates acted as a New York-based salesforce operating on behalf of the out-of-state vendor.

(iii) This presence was substantial because the in-state affiliates had to generate more than $10,000 in revenue for the out-of-state vendor.

(iv) For additional discussion of this case please see Section 2.8(d) above.

(5) Nexus Established by Employee Visits, Contract Fulfillment In-State, and Real Property Owned In-State.

(i) *In re Krystallos, Inc.*, No. 821739, 821748 (N.Y. Div. Tax App., June 11, 2009)

(ii) The Taxpayer was a designer and installer of holiday displays for real property. On occasion, the taxpayer would enter New York to install its displays, or to view this site of its new York customers prior to installation. Furthermore the taxpayer maintained a warehouse and apartment in New York.

(iii) Given the many contacts the taxpayer had with New York, the judge found sufficient nexus to require collection and remittance of New York sales and use taxes.

(k) Pennsylvania

(1) Legislation Modifies Nexus Standards.

(i) Under H.B. 1848, enacted 6/29/02, sales and use tax nexus standards have been expanded to include:

- having, maintaining, or using an office in Pennsylvania either directly or indirectly through a representative or agent;
- engaging in business activities in the state through a representative or agent;
- entering into Pennsylvania to assemble, service, or repair tangible personal property, either directly or through a subsidiary, representative, or an agent;
- delivery of tangible personal property within the Commonwealth if such delivery includes the unpacking, positioning, placing or assembly of the property;
- having any contact within Pennsylvania under which the state could constitutionally require a person to collect and remit tax.

(l) South Carolina

(1) Employees of Hotels in South Carolina Establish Nexus for a Out-of-State Hotel Looking Service.

(i) *Travelscape, LLC v. South Carolina Dep't of Revenue*, (08-ALJ-17-0076-CC, Feb. 12, 2009)

(ii) Expedia engages in the business of making hotel reservations. It rents hotel rooms in bulk (and at a discount) from hotels across the country, including in South Carolina. It then marks-up and re-rents hotel rooms to hotel guests who use its service (through the internet or a telephone call center).

(iii) South Carolina assessed taxes for Expedia's room rentals, and Expedia argued that it had no physical presence in South Carolina justifying imposing the tax obligation on it under the Commerce Clause of the U.S. Constitution.

(iv) The judge determined that Expedia did have substantial nexus with South Carolina because Expedia derived income from accommodations that were located in South Carolina and because "the services of South Carolinians employed at those commendations were critical to petitioner's ability to produce that income."

(m) Texas

(1) Independent Salespersons Establish Substantial Nexus for a Multilevel Marketing Company.

(i) In *Alpine Industries, Inc. v. Stayhorn*, No. 03-03-00643-CV, 2004 WL 1573159 Tex. App. LEXIS 6242 (Tex. Ct. App. July 15, 2004), the court found substantial nexus when a multilevel marketing company maintained a network of 20,000 independent salespersons in Texas. The salespersons were found to be independent contractors and sufficient to establish nexus.

(ii) The court essentially rubber stamped *Tyler Pipe* and *Scripto*, holding that the presence of a sales force, including a sales force of independent contractors, in the taxing state, established physical presence in the state.

(n) Virginia

(1) Proposed Legislation Would Protect Virginia Businesses From Out of State Sales Tax Assessments - But Legislation Not Passed.

(i) Virginia's SB 668 was introduced in 2004 to define nexus standards in Virginia for companies operating outside the state as well as to provide protection for Virginia businesses against assessments of other states.

(ii) Nexus Safe Harbors. The proposed legislation would amend Title 58.1, Chapter 6 ("Retail Sales and Use Tax") to provide that "[n]o business shall be liable to collect and remit sales and use tax to the Commonwealth unless the business has nexus in the Commonwealth." "Nexus" is defined as "substantial physical presence, such as facilities, plants, distribution centers, offices, property and employees." Under the legislation, the following "economic activities," without more, are insufficient to create nexus in Virginia:

directing business activities toward the Commonwealth by use of telecommunications or common carrier, advertising in the Commonwealth, licensing software in the Commonwealth, deriving income or revenue from customers in the Commonwealth, sending representatives to the Commonwealth to generate business, attending trade shows in the Commonwealth, conducting seminars in the Commonwealth, and assessing competitor's products in the Commonwealth.

(iii) Before final passage of the bill, however, these provisions were all removed and did not become a part of the final law passed.

(o) Washington

(1) <u>Employees Attending a Traveling Horse Show In-State Establishes Nexus for an Out-of-State Company.</u>

(i) In *Priefert Mfg. Co., Inc. v. Washington Dep't of Rev.*, Bd. of Tax App., No. 61969 (CCH) [WA-TAXRPTR] ¶ 202-565 (Nov. 16, 2005) the Board of Tax Appeals found sufficient nexus for business and occupation tax when employees of an out-of-state seller were present in Washington for marketing purposes.

(ii) The Taxpayer was in the business of selling horse, cattle and ranching equipment. It was a Texas based company and sold its products into the state of Washington by placing them on a common carrier FOB place of shipment. The Taxpayer occasionally sent a representative to Washington to meet with retailers that sold its products. The Taxpayer also attended horse shows across the country, including in the state of Washington. The trucks that traveled to the show were owned by the Taxpayer

and contained the Taxpayer's logo. The horse handlers in the shows were employees of the Taxpayer and wore shirts with the company's logo. Taxpayer's horses in the shows used equipment manufactured by Taxpayer and other equipment used at the shows was owned or manufactured by the Taxpayer.

(iii) The Board found that because of these activities, the Taxpayer had employees in the state engaged in marketing activity. The presence of the Taxpayer's products and logos at the show was designed to market its products and trademark. Thus, Taxpayer had substantial nexus with the state because its activity was significantly associated with the seller's ability to establish and maintain a market for its products in Washington.

(p) Wyoming

(1) Out-of-State Company's Previous Holding of a Vendor's License and Voluntary Collection of the Sales Tax Created Substantial Nexus.

(i) In *Buehner Block Co., v. Wyoming Dep't of Revenue.*, 139 P.3d 1150 (Wyo. 2006), the state Supreme Court held that an out-of-state seller of concrete blocks, who had no physical presence in Wyoming but delivered blocks into the state by common carrier, had substantial nexus for sales and use tax. The court found that the company's presence in the state was significantly more than merely shipping blocks into the state by common carrier. Rather, the taxpayer had voluntarily held a sales tax vendor's license and had voluntarily collected the sales tax on many similar transactions. The carrier's past connection with the taxing system in Wyoming, when combined with the company's shipping of goods into the state by common carrier, was enough to satisfy nexus requirements.

2.10 MTC Nexus Bulletin 95-1 and Nexus Discussion Drafts.

MTC Bulletin 95-1. The Multi-State Tax Commission in 1995 issued a Nexus Bulletin, which has been approved by a number of states, including Arizona, taking the position that an out-of-state mail order computer vendor which contracts with a third party to provide in-state warranty repair services for its computers, creates sales and use tax and income tax nexus for the remote computer seller for both corporate income and sales or use tax purposes. MTC Bulletin 95-1 states that "the provision of in-state repair services provided by a direct marketing computer company as part of the company's standard warranty or as an option that can be separately purchased and as an advertised part of the company's sales, contributes to the company's ability to establish and maintain its market for computer hardware sales in the State." The MTC Bulletin did not address other services but its rationale could well apply to services other than repair.

Again, the MTC nexus guideline emphasizes the need, in order not to be saddled with the use tax collection obligation, to avoid any physical presence in the taxing state, including physical presence through independent contractors and agents acting on the out-of-state vendor's behalf.

MTC Discussion Drafts. The MTC has released a number of discussion drafts of possible nexus guidelines covering the sales and use tax collection obligation functions of out-of-state vendors. According to the MTC discussion drafts, the following activities may create nexus for remote Internet or electronic commerce sellers:

- Ownership**,** lease, use or maintenance of computer terminals available for access in the taxing jurisdiction;

- Licensing of proprietary software in the taxing jurisdiction that facilitates use of he on-line service;

- Utilization of a "cybermall" with a computer server in the taxing jurisdiction that performs various administrative and financial functions on behalf of the remote seller;

- Maintaining a telecommunication linkage by private contract in the taxing jurisdiction that permits the on-line service to establish and maintain a market in the taxing jurisdiction;

- Performing or rendering electronic services in the taxing jurisdiction, such as remote computer diagnostics and technical support.

Note: Because of industry opposition to these drafts, the MTC never promulgated the drafts. However, the drafts alert taxpayers to the fairly aggressive nexus positions that states may take.

See Pomp and Oldman, *State and Local Taxation,* 2d ed. – Volume 2, chapter 12, pages 1049-1050.

2.11 MTC Proposed Model Affiliate Sales Tax Nexus Provision.

(a) An out-of-state vendor has substantial nexus with this State for the collection of use tax if both of the following apply:

(1) the out-of-state vendor and an in-state business maintaining one or more location within this State are related parties; and

(2) the out-of-state vendor and the in-state business use an identical or substantially similar name, trade name, trademark or goodwill to develop, promote, or maintain sales, or 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.

(b) Two entities are related parties under this section if they meet any one of the following tests:

(1) both entities are component members of the same controlled group of corporations under section 1563 of the Internal Revenue Code;

(2) one entity is a related taxpayer to the other entity under the provisions of section 267 of the Internal Revenue Code;

(3) one entity is a corporation and the other entity and any party, for which section 318 of the Internal Revenue Code requires an attribution of ownership of stock from that party to the entity, own directly, indirectly, beneficially, or constructively at least 50 percent of the value of the outstanding stock of the corporation; or

(4) one or both entities is a limited liability company, partnership, estate, or trust, none of which is treated as a corporation for federal income tax purposes, and such limited liability company, partnership, estate, or trust and its members, partners or beneficiaries own in the aggregate directly, indirectly, beneficially, or constructively at least 50 percent of the profits, capital, stock, or value of the other entity or both entities.

(c) These provisions of this [statute] [regulation] shall not apply to an out-of-state vendor that had sales in this State in the previous year in an amount of less that $100,000.

2.12 Internet Tax Freedom Act.

The use tax collection cases, for the most part, deal with mail order vendors and not Internet vendors. However, *Quill's* Commerce Clause nexus requirement of more than "slightest physical presence" applies to Internet sales, as well as mail order sales. Thus, all of the cases and concepts discussed above apply equally to Internet sales. In other words, for a remote Internet seller to be required to collect the use tax in the purchaser's state, that Internet seller must have physical presence which is more than "slightest physical presence" in the taxing state. As a result, the author draws no distinction in this analysis between the company store's mail order sales and Internet sales.

Internet Tax Freedom Act. The Omnibus Appropriations Act of October 21, 1998 (P.L. 105-277) includes the Internet Tax Freedom Act, which sets forth the federal policy against state and local government interference with and taxation of interstate commerce on the Internet. The Internet Tax Freedom Act, under Congress' jurisdiction over interstate commerce, establishes a moratorium on the imposition of taxes on the Internet. Specifically, the moratorium provides that "no state or political subdivision thereof shall impose any of the following taxes during the

period beginning on October 1, 1998, and ending three years after the date of the enactment of this Act:

(1) Taxes on Internet access, unless such tax was generally imposed and actually enforced prior to October 1, 1998; and

(2) Multiple or discriminatory taxes on electronic commerce."

The Internet Tax Freedom Act originally prohibited for three years, any new taxes on Internet access or multiple or discriminatory taxes on electronic commerce. The Internet Tax Freedom Act does not impose a moratorium on a state's use tax collection obligation for sales made via the Internet, as long as the Commerce Clause requirement of something more than "slightest physical presence" is met, and such an Internet use tax collection duty is not discriminatory. To be expected, the states will undoubtedly search for some type of physical presence by an Internet seller in the taxing state, in order to impose the state's use tax collection obligation on that remote Internet seller.

Internet Tax Freedom Act Moratorium Extended to November 1, 2003. On October 21, 2001, the federal Internet tax moratorium expired. On November 28, 2001, Congress extended the moratorium to November 1, 2003. The Internet Tax Nondiscrimination Act (Public Law No. 107-75) made no changes to the 1998 legislation that created the moratorium -- it merely extended it as is.

2.13 Moratorium on Internet Access Charges Extended to November 1, 2007.

Congress passed legislation in November 2004 that extends the moratorium on state and local Internet access taxes to November 1, 2007.

The previous moratorium, which was first enacted in October 1998 under the Internet Tax Freedom Act (ITFA), expired on November 1, 2003. The Senate originally approved legislation in April 2004, to expand the ITFA moratorium and reinstate it until 2007. However, the House had refused to concur in this legislation, holding out for a permanent ban. On November 17, 2004, the Senate made two minor amendments to its previously passed legislation, which the House later accepted.

Specifically, the legislation does the following:

- prohibits, beginning November 1, 2003, and ending November 1, 2007, state and local taxes on Internet access, and multiple or discriminatory state and local taxes on electronic commerce (this provision reinstates the ITFA moratorium originally enacted in 1998);

- extends until November 1, 2007, the original ITFA grandfather clause that permits Internet access taxes that were generally imposed and actually enforced prior to October 1, 1998 (however,

the grandfather for the Wisconsin telecommunications service tax is extended only until November 1, 2006);

- expands the definition of exempt Internet access to include telecommunications services "to the extent such services are purchased, used, or sold by a provider of Internet access to provide Internet access" (this provision narrows the moratorium exception for taxes on telecommunications services that had been used by some states to tax digital subscriber line (DSL) service, and it presumably exempts telecommunications services used by Internet service providers over the so-called Internet backbone (i.e. the "middle mile" of access));

- enacts a new grandfather clause to permit, until November 1, 2005, other Internet access taxes that were generally imposed and actually enforced as of November 1, 2003 (this provision permits, for instance, states and localities that have been taxing DSL service to continue to do so for another two years, despite the narrowed exception for taxes on telecommunications services);

- provides that taxation of charges for voice or similar service using Voice Over Internet Protocol (VOIP) are unaffected (this exception for taxation of VOIP services specifically does not apply to services incidental to Internet access, such as voice-capable e-mail or instant messaging);

- amends the ITFA definition of "tax on Internet access" to state specifically that it applies regardless of whether a tax is imposed on a provider of Internet access or a buyer of Internet access, and regardless of the terminology used (the definition, however, would specifically exclude taxes on, or measured by, net income, capital stock, net worth, or property value);

- allows the taxation of otherwise exempt Internet access service that is bundled with taxable services, unless the Internet access provider can reasonably identify the charges for Internet access from its books and records kept in the regular course of business;

- specifies that Texas municipal access line fees are unaffected; and

- directs the Government Accountability Office (GAO) to study the impact of the moratorium on the revenues of state and local governments and assess whether ITFA has had an impact on the deployment or adoption of broadband Internet access services.

Source: CCH NEWS-STATE, 2005 TAXDAY, (Nov. 22, 2004), Item #S.2, All States--Multiple Taxes: Congress Approves Ban on Internet Access Taxes Through 2007.

2.14 Moratorium on Internet Access Charges Further Extended to November 1, 2014.

In October 2007, Congress enacted another extension to the ITFA. Pub. L. 110-108, among other things, extends IFTA's moratorium on state and local taxation of internet access to November 1, 2014.

Specifically, the legislation does the following:

- prohibits, beginning November 1, 2003, and ending November 1, 2014, state and local taxes on Internet access, and multiple or discriminatory state and local taxes on electronic commerce;

- re-defines the term "internet access," effective in certain circumstances retroactively to November 1, 2003, to curb states from overreaching in claiming exemption from the moratorium. The bill, however, pushes back the effective date of the new definition until June 30, 2008 in the case of a tax imposed on internet access that is either: (1) generally and actually imposed on telecommunications services purchased, used or sold by a provider of internet access if the appropriate state or city agency issued a public ruling before July 1, 2007 that was inconsistent with the new definition; OR (2) litigation seeking to enforce such a tax inconsistently with the new definition was instituted in a competent court before July 1, 2007;

- expands "internet access" to include internet-based communication services, such as e-mail and instant messaging. The bill also redefines "telecommunication services," which are exempt to the extent they are purchased, used or sold by a provider to provide internet access, as "telecommunications" and expands the definition to include unregulated, non-utility services such as cable services;

- creates another exemption from the moratorium by adding a specific exception to the definition of "tax on internet access." Taxes that were enacted between June 20, 2005 (with the exception of certain business and occupation taxes enacted earlier) and November 1, 2007, that wholly or partially replace value-added, net income, capital stock or net worth taxes and that expressly levy tax on commercial activity, modified gross receipts, gross income or taxable margin are exempt from the moratorium as long as the tax applies to a broad spectrum of businesses and does not discriminate against internet access, telecommunications or telecommunications service providers;

- prohibits states from taxing under a grandfather provision if the state repealed or nullified its tax on internet access at some point before October 31, 2005.

2.15 Pending Federal Legislation Impacting State Taxes.

(a) Permanent Internet Tax Freedom Act of 2009 - S. 43 and HR 1560

(1) This bill would make the Internet Tax Freedom Act permanent.

(b) Sales Tax Fairness and Simplification Act - H.R. 3396 & S. 34.

(1) Applies only to states that conform their sales/use tax laws/regulations to the SSTA.

(2) Would allow those states to impose tax collection duties on remote sellers (those without physical presence in the state).

(3) Specifies "minimum" simplification requirements that must continue to be met for states to have the authority to impose tax collection obligations on remote sellers.

(4) Creates a small business exception if a seller and its affiliates have less than $5 million gross remote taxable sales nationwide or if the seller itself has less than $100,000 gross remote taxable sales nationwide even if, together with its affiliates, it meets the $5 million threshold.

(5) Vendor compensation would be required.

(6) Sets a limitation that no obligation imposed by the act bears on determining if the seller has nexus with the states for purposes of other taxes.

(7) Court of Federal Claims and U.S. District Courts available for review for certain items.

(8) S. 34 permits a federally recognized Indian tribe that levies a general sales tax to petition and become a member state under the SSTA.

(9) Basically creates a nexus standard that gives states authority to impose a sales tax on any entity with an economic presence in the state, whether they have physical presence or not.

(10) Effectively overturns *Quill.*

(11) **These bills died in committee in 2008 and were not reintroduced in 2009.**

(c) Business Activity Tax Simplification Act - H.R. 5267 & S. 1726.

(1) Modernizes PL 86-272 to protect solicitation activities for all products and services, including news gathering and event coverage.

(2) Updates PL 86-272 to apply to other business activity taxes such as franchise, gross receipts and net worth taxes.

(3) Implements a physical presence standard for all business activity taxes.

(4) Provides quantitative and qualitative *de minimis* standards.

(5) Codifies those situations when attribution of nexus (the agency theory) to other persons is appropriate.

(6) Designed to create clear nexus requirements based on the Commerce Clause and physical presence.

(7) Nexus established only IF physical presence established:

(i) Employees physically present in state, employees assigned to state, exclusive agent in state.

(ii) Owned real or tangible property in the state.

(8) Nexus not established if only *de minimus* physical presence

(i) *De minimus* = less than 15 days in state.

(9) Only applies to net income taxes or taxes measured by the amount of business related activity (i.e. net income, gross receipts, etc.).

(i) Excludes sales and use tax.

(10) Expands PL 86-272 to include sales of items beyond tangible personal property, such as services or intangibles.

(11) **These bills died in committee in 2008 but were reintroduced in 2009 as HR 1083.**

(d) Bill to Regulate Certain State and Local Taxation of Electronic Commerce – SB 3670.

(1) This act, like BATSA, is designed to establish clear guidelines of what constitutes physical presence, but with a focus on electronic commerce. It contains the following provisions:

(i) An entity engaged in electronic commerce must have physical presence in a state in order for the state to require the entity to collect or remit tax resulting from that entity's electronic commerce.

(ii) Physical presence includes:

a. An employee assigned to the state.

b. An exclusive agent that helps to establish and maintain electronic commerce in state.

i. Comment – this provision is aimed at eliminating or significantly reducing states' ability to asses tax based on affiliate nexus.

c. Leasing/owning real or tangible property in state.

(iii) Physical presence does not include:

a. De minimus presence of fewer than 15 days.

b. Presence in state for limited or transient business activity.

c. A revenue sharing agreement for e-commerce with an entity that has physical presence in the state.

(2) This bill does not affect businesses or individuals domiciled in the taxing state.

(3) **This bill died in committee in 2008 and was not reintroduced in 2009.**