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Going Big: Update on States Seeking to Expand Tax Jurisdiction, Tax Base and Enforcement

Jeffrey A. Friedman

Richard Pomp

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Jeffrey A. Friedman, Partner, Sutherland
Richard Pomp, University of Connecticut School of Law

Going Big: Update on States Seeking to Expand Tax Jurisdiction, Tax Base and Enforcement

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Agenda

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- Overview
 - Sales Tax Nexus
 - Attributional Nexus
 - Affiliate Nexus
 - Physical Presence Nexus
 - Income Tax Nexus
 - Economic Nexus
 - Physical Presence Nexus

Sales Tax Nexus

Constitutional Nexus Requirements

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- *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).
 - The Supreme Court reconsidered and reaffirmed the continued vitality of the National Bellas Hess v. Illinois Dep't of Revenue, 386 U.S. 753, 18 L. Ed. 2d 505, 87 S. Ct. 1389 (1967), bright line rule of physical presence.
 - Commerce Clause prohibits states from imposing sales or use tax obligations upon out-of-state sellers unless there is a "substantial nexus" with the taxing state.
 - Court ruled that licensing of computer software to customers in the state was not "substantial nexus," and expressly rejected a "slightest presence" standard of constitutional nexus.
- *Scripto, Inc. v. Carson*, 362 U.S. 207 (1960).
 - Ten independent contractors "conducting continuous local solicitation in [the state] and forwarding the resulting orders..." to the taxpayer created nexus.
 - The Supreme Court later described Scripto as representing "the furthest constitutional reach to date of a State's power to deputize an out-of-state retailer as its collection agent for a use tax." National Bellas Hess v. Illinois Dep't of Revenue, 386 U.S. at 757.
- *Tyler Pipe Industries, Inc. v. Washington Dep't of Revenue*, 483 U.S. 232 (1987).
 - In-state sales representative/independent contractor supplied requisite nexus.
 - Taxpayer's representative resided in Washington and "acted daily on behalf of Tyler Pipe in calling on its customers and soliciting orders."
 - Physical presence could be characterized as continuous.

Attributional Nexus

Attributional Nexus – Colorado

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- *The Direct Marketing Association v. Roxy Huber*, Civil Case No. 10-cv-01546-REB-CBS, Order Granting Motion for Preliminary Injunction (U.S. Dist. Ct. Colorado, January 26, 2011)
 - U.S. District Court granted the Direct Marketing Association's (DMA) motion for a preliminary injunction. Colorado was enjoined from enforcing the reporting provisions
 - The Court determined that the reporting provisions could be discriminatory because the burden only fell on out-of-state retailers, not in-state retailers
 - The Court determined that the burden of the provisions could run afoul of Quill

Attributional Nexus – Colorado

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- Reporting legislation was enacted in Colorado, South Dakota, and Oklahoma
- Similar legislation has been under consideration in California, Tennessee, South Carolina, and has been discussed in many other states
- The MTC has discussed drafting model reporting legislation

Attributional Nexus – New Mexico

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- *Dell Marketing LP v. Taxation and Revenue Department of the State of New Mexico*, cert. denied March 23, 2009
 - Dell had no physical presence in New Mexico
 - Dell contracted with a third-party company to provide computer repair services for Dell products
 - The computer repair company did not solicit or promote sales of Dell products
 - Lower court held that an unrelated third-party repair company that offered service contracts for computers sold by Dell created New Mexico gross receipts tax nexus
 - Dell has litigated this issue in other states (e.g. Connecticut) and won

Attributional Nexus – Connecticut

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- *Scholastic Book Clubs, Inc. v. Comm’r of Revenue Services*, 47 Conn. L. Rptr. 698 (Conn. Super. Ct. 2009), cert. granted Conn. Sup. Ct.
 - Connecticut Supreme Court set to determine whether Scholastic Book Club’s use of teachers to distribute catalogs, collect orders and payments, and distribute books to their students results in sales/use tax collection obligation
 - Scholastic had no property, employees or business locations in Connecticut
 - Superior Court held that Scholastic was not engaged in business because the teachers were not “representatives” of Scholastic
 - Court concluded a representative is “a person who participates in an in-state ‘sales force,’ to sell, deliver or take orders to generate revenue.”

Click - Through Nexus

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Click-Through Nexus Authority Asserted Without Specific Legislation¹

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Click-Through Nexus

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- Click-through nexus is a type of attributional nexus
 - Nexus is asserted on the out-of-state retailer on the basis of the retailer's relationship with an entity doing business in the state – not based on common ownership or control
- Click-through nexus statutes look to an out-of-state retailer's relationship with in-state persons, often third parties
- These statutes generally provide that a seller is presumed to be soliciting business through an independent contractor or other representative if:
 - The seller enters into an agreement with an in-state resident to, directly or indirectly, through a link on an internet website or otherwise, refer potential customers to the seller in exchange for consideration
 - The presumption applies only if the seller has cumulative gross receipts in excess of a certain amount (typically \$10,000) from sales to in-state customers resulting from such agreements during the preceding four quarterly periods
 - E.g., the threshold is \$10,000 in New York and North Carolina and \$5,000 in Rhode Island
 - In most states the presumption can be rebutted if the seller demonstrates that the in-state resident did not engage in any solicitation activities on behalf of the seller that would satisfy the nexus requirements of the U.S. Constitution during the time period in question

Click-Through Nexus

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- Rebutting the presumption in New York
 - For example, in New York, there is a presumption that an entity “solicits” business in the state if any in-state entity is compensated, directly or indirectly, for referring customers to the person “by a link on an internet website or otherwise” and person generates more than \$10,000 in sales during the previous four quarters
 - See Tax Law Sec. 1101(b)(8)(vi)
 - Taxpayers can rebut presumption of solicitation by:
 - Proving that the resident with whom the taxpayer has an agreement did not engage in any solicitation on behalf of the taxpayer that would satisfy the nexus requirements of the Constitution
 - See N.Y. Dept. Tax'n & Fin., TSB-M-08(3)S, 05/08/08.
 - Or by meeting the safe harbor's conditions:
 - Out-of-state entity and affiliate must enter into a contract by which the affiliate agrees not to engage in any solicitation activities in New York that refer potential customers to the retailer
 - The affiliate must provide annual signed certifications to the out-of-state seller that the affiliate did not actually engage in such solicitation activities in New York during the previous year
 - See N.Y. Dept. Tax'n & Fin., TSB-M-08(3.1)S, 06/30/08

Click-Through Nexus – New York

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- *Amazon.com LLC v. New York State Dep't of Taxation and Finance, et al. and Overstock.com, Inc. v. New York State Dep't of Taxation and Finance, et al.*, 0210 NY Slip Opinion 07823 (1st Dept. App. 11/4/10)
 - Amazon.com and Overstock.com filed suit challenging New York's sales tax nexus statute
 - Internet retailers asserted that statute was facially unconstitutional and unconstitutional "as applied"
 - Internet retailers argued that the statute is impermissibly overbroad because it assumes all New York resident affiliates are targeting New York customers
 - Trial court dismissed complaints, and Internet retailers appealed

Click-Through Nexus – New York

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- Court rejected retailer's facial challenge because heavy burden of showing no set of circumstances under which the statute would be valid
 - Statute failed to facially violate substantial nexus requirement of Commerce Clause
 - Only applies if have New York residents receiving commissions
 - Distinguished between "passive advertising" and "soliciting."
- Court remanded to factually address "as applied" challenge and to determine if affiliates engaged in solicitation or advertising
 - Court found that statute was not irrational or unfair because the presumption of substantial nexus applied to retailers
 - Retailers could include safe harbor language in contracts to avoid presumption
 - Amazon claimed that it was being treated differently than out-of state retailers that advertise in New York without an Associate's program those that use a flat fee or on a "pay-per-click" compensation model
 - Court found that Amazon could not claim that it was exclusively targeted and that other retailers were not "similarly situated."

Click-Through Nexus – New York

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- Amazon.com filed an appeal on Dec. 6, claiming that:
 - The Nov. 4 decision upheld the constitutionality of an “irrational and effectively irrebuttable evidentiary presumption” for requiring the collection of sales tax
 - This presumption violates the Commerce Clause and “leaves Amazon and other online retailers without the meaningful guidance they need concerning the constitutionality of the challenged statute.”
 - The court should either resolve the constitutional issues or allow the case to move forward to the Court of Appeals

Click-Through Nexus – Who does it apply to?

| California | Illinois | North Carolina | Rhode Island |
|---|--|--|--|
| Any retailer who enters into an agreement under which a person in California, for a commission or other consideration, refers <u>potential purchasers of tangible personal property</u> to the retailer, whether by an Internet-based link, an Internet website, or otherwise, provided both of the following conditions are met: | Retailer maintaining a place of business in the state includes a retailer having a contract with a person located in this State under which the person, for a commission or other consideration based upon the sale of tangible personal property by the retailer, directly or indirectly refers potential customers to the retailer by a link on the person's Internet website, provided: | A retailer is presumed to be soliciting or transacting business by an independent contractor, agent, or other representative if the retailer enters into an agreement with a resident of this State under which the resident, for a commission or other consideration, <u>directly or indirectly refers potential customers</u> , whether by a link on an Internet Web site or otherwise, to the retailer. | "Retailer" includes every person making sales of tangible personal property through an independent contractor or other representative, if the retailer enters into an agreement with a resident of this state, under which the resident, for a commission or other consideration, <u>directly or indirectly refers potential customers</u> , whether by a link on an Internet website or otherwise, to the retailer, provided: |

Click-Through Nexus – Activity Thresholds

| California | Illinois | North Carolina | Rhode Island |
|---|---|---|---|
| <p>The total cumulative sales price from all of the retailer's sales, within the preceding 12 months, of tangible personal property to purchasers in this state that are referred pursuant to all of those agreements with a person or persons in this state, is in excess of ten thousand dollars (\$10,000).</p> <p>The retailer, within the preceding 12 months, has total cumulative sales of tangible personal property to purchasers in this state in excess of five hundred thousand dollars (\$500,000).</p> | <p>The cumulative gross receipts from sales of tangible personal property by the retailer to customers who are referred to the retailer by all persons in this State under such contracts exceed \$10,000 during the preceding 4 quarterly periods ending on the last day of March, June, September, and December.</p> | <p>This presumption applies only if the cumulative gross receipts from sales by the retailer to purchasers in this State who are referred to the retailer by all residents with this type of agreement with the retailer is in excess of \$10,000 during the preceding four quarterly periods.</p> | <p>The cumulative gross receipts from sales by the retailer to customers in the state who are referred to the retailer by all residents with this type of an agreement with the retailer, is in excess of \$5,000 during the preceding four (4) quarterly periods ending on the last day of March, June, September and December.</p> |

Click-Through Nexus – Defining Resident or Person

| California | Illinois | North Carolina | Rhode Island |
|--|---|---|---|
| <p>"Person" is defined as Person" includes "any individual, firm, partnership, joint venture, limited liability company, association, social club, fraternal organization, corporation, estate, trust, business trust, receiver, assignee for the benefit of creditors, trustee, trustee in bankruptcy, syndicate, the United States, this State, any county, city and county, municipality, district, or other political subdivision of the state, or any other group or combination acting as a unit."</p> | <p>"Person" is defined for Illinois sales and use tax purposes as "any natural individual, firm, partnership, association, joint stock company, joint adventure, public or private corporation, limited liability company, or a receiver, executor, trustee, guardian or other representative appointed by order of any court."</p> | <p>"Resident" is not defined for North Carolina sales and use tax purposes.</p> | <p>"Resident" is not defined for North Carolina sales and use tax purposes.</p> |

Click-Through Nexus - MTC

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- Beginning in March 2011, the MTC Sales and Use Tax Subcommittee began work on an associate nexus model.
 - Using the New York click-through statute, the Subcommittee is considering the following policy choices:
 - Should a model be developed now, before litigation is final in New York?
 - Should the statute take the form of a presumption that, assuming all requirements are met, the seller is obligated to collect sales and use tax?
 - What gross receipts threshold should trigger the obligation to collect?
 - Should the presumption be rebuttable?

Affiliate Nexus

Affiliate Nexus

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- States that have recently proposed or enacted affiliate nexus legislation have enacted presumptive affiliate nexus sales tax statutes
- These statutes provide that an out-of-state company with no other physical presence will be presumed to have sales tax nexus if it has an affiliate doing business in the state
- Statutes generally require that out-of-state company and in-state affiliate both be retailers

Affiliate Nexus - General

- The sole presence of a subsidiary in a state does not ordinarily establish nexus over the out-of-state parent for state tax purposes (e.g. Current)
- However, states are becoming more aggressive in pursuing nexus based on the physical presence or activities of affiliate entities, employees, or other representatives in the state
- Outside of the activities defined in *Tyler Pipe* and *Scripto*, states are enacting legislation that imposes nexus based on affiliate activity unrelated to taxable sales
 - A number of states already have “affiliate nexus” statutes, including Florida, Georgia, New Jersey, New York, Utah, and Virginia
- The affiliate nexus concept can apply to both sales and income tax nexus

Affiliate Nexus - General

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- Affiliate vs. Attributional Nexus
 - Affiliate nexus generally requires the existence of common ownership or control between an in-state taxpayer and an out-of-state company in order to create nexus for the out-of-state company
 - Many states have looked to activities that establish that the in-state company is creating or maintaining a market in the state for the out-of-state company (e.g. advertising, accepts returns of product, sales solicitation, marketing, etc.)
 - Attributional nexus is broader and consists of a state's ability to assert nexus over an out-of-state taxpayer based on the activities of a related or unrelated entity engaging in in-state activities on behalf of the out-of-state retailer

Affiliate Nexus - General

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- Standard/Traditional affiliate nexus statutes
 - Affiliate nexus is legislatively defined in various states and often includes situations where (1) an out-of-state entity sells to in-state customers, (2) has an in-state affiliate, and:
 - The in-state affiliate uses identical or substantially similar business names, trademark, or goodwill, or sells similar products; or
 - A number of states have provisions whereby nexus is deemed or presumed to exist for an out-of-state retailer if the retailer is affiliated with an in-state entity that uses the same trademarks or does business under the same or substantially similar name, or both these conditions exist.

Affiliate Nexus – Similar Name/Products

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- Alabama - Code of Ala. § 40-23-190(a):
 - “An out-of-state vendor has substantial nexus with this state . . . if . . . the out-of-state vendor and an in-state business maintaining one or more locations within this state are related parties; and the out-of-state vendor and the in-state business use an identical or substantially similar name, tradename, trademark, or goodwill, to develop, promote, or maintain sales”
- Illinois - 35 Ill. Comp. Stat. Sec.105/2:
 - “Retailer maintaining a place of business in this State means the retailer sells the same or substantially similar line of products as the person located in this State and does so using an identical or substantially similar name, trade name, or trademark as the person located in this State

Affiliate Nexus – Constitutional?

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- Connecticut - Conn. Gen. Stat. § 12-407(a)(12)(H), (I)
 - Retailer has nexus if it is in the similar line of business of retailer doing business in Connecticut and is under common control with retailer doing business in Connecticut
- Missouri - Mo. Rev. Stat. § 144.605(2), (3)
 - “Engages in business activities within this state” includes:
Being owned or controlled by the same interests which own or control any seller engaged in the same or similar line of business in this state
- Vermont - Vt. Stat. Ann. 32 § 9701
 - “Vendor” includes: Owns or controls a person engaged in the same manner or similar line of business in this state

Affiliate Nexus – In-State Services

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- Georgia – Ga. Code Ann. § 48-8-2(3)(J)
 - A "dealer" includes an affiliate that sells at retail, offers for sale at retail in this state, or engages in the regular or systematic solicitation of a consumer market in this state through a related dealer located in this state unless:
 - The in-state dealer to which the affiliate is related does not engage in any of the following activities on behalf of the affiliate:
 - Advertising; Marketing; Sales; or Other services; and the in-state dealer to which the affiliate is related accepts the return of tangible personal property sold by the affiliate and also accepts the return of tangible personal property sold by any person or dealer that is not an affiliate on the same terms and conditions as an affiliate's return
- Utah - Utah Code Ann. § 59-12-107(f)
 - Related to a seller that is required to pay or collect and remit sales and use taxes under Subsection (1)(a) as part of an affiliated group or because of common ownership;
 - (B) if the seller to which the related seller is related does not engage in any of the following activities on behalf of the related seller:
 - (I) advertising; (II) marketing; (III) sales; or (IV) other services; and
 - (C) if the seller to which the related seller is related accepts the return of an item sold by the related seller, the seller to which the related seller is related accepts the return of that item:
 - (I) sold by a seller that is not a related seller; and (II) on the same terms as the return of an item sold by that seller to which the related seller is related

Affiliate Nexus - In-State Sub

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- District of Columbia - D.C. Code Ann. § 47-2201(h)
 - “Engaging in business in the District” means
 - The maintaining, occupying or using, permanently or temporarily, directly or indirectly, or through a subsidiary or agent, by whatever name called, of any office, place of distribution, sales or sample room or place, warehouse or storage place, or other place of business; and The having of any representative, agent, salesman, canvasser, or solicitor operating in the District for the purpose of making sales at retail as defined herein, or the taking of orders for such sales
- Indiana - Ind. Code § 6-2.5-3-1(c)(1)
 - “A retail merchant engaged in business in Indiana” includes any retail merchant who maintains an office, place of distribution, sales location, sample location, warehouse, storage place, or other place of business which is located in Indiana and which the retail merchant maintains, occupies, or uses, either permanently or temporarily, either directly or indirectly, and either by the retail merchant or through a representative, agent, or subsidiary

Affiliate Nexus – Controlled Group

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- The in-state affiliate is a member of the out-of-state entity's controlled group and certain in-state activity is performed related to TPP
- Certain states have adopted legislation that presumes nexus exists for an out-of-state retailer that is part of a controlled group of corporations with a component member retailer engaged in business in the state
- The terms “controlled group” and “component member” are generally defined with reference to Sec 1563(b) of the Internal Revenue Code

Affiliate Nexus – Controlled Group

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- Presumption of Nexus if Part of Controlled Group
 - See, e.g., Colo. Rev. Stat. Sec. 39-26-102(3)(b)(II):
 - “. . . if a retailer that does not collect Colorado sales tax is part of a controlled group of corporations, and that controlled group has a component member that is a retailer with physical presence in this state, the retailer that does not collect Colorado sales tax is presumed to be doing business in this state.”
 - See, e.g., South Dakota S.B. 147 Sec. 4 (signed into law on March 10, 2011) (providing that a taxpayer is presumed to be engaged in business in South Dakota if it is part of a South Dakota controlled group that contains a member that is engaged in business in the state)

Affiliate Nexus – Controlled Group

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- California recently enacted, then put on hold, a bill that would have created controlled-group nexus (and click-through nexus)
- First California Bill:
 - AB X1 28, effective June 29, 2011, attempted to impose a collection requirement on retailers who were members of the same commonly controlled group as another member that, pursuant to an agreement or in cooperation with the retailer, performed services in California in connection with tangible personal property sold by the retailer
 - The services include, but are not limited to “design and development of tangible personal property sold by the retailer, or the solicitation of sales of tangible personal property on behalf of the retailer.”
 - Defines “retailer engaged in business in this state” as a retailer that has “substantial nexus with this state for purposes of the Commerce Clause” and upon whom federal law permits the states to impose a use tax collection duty

Affiliate Nexus – Controlled Group

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- Second California Bill:
 - AB 155, approved by the governor on September 23, 2011, was passed in response to a potential referendum on the first bill, reinstated the law as it existed prior to AB X1 28, and stayed the effectiveness of AB X1 28 until September of 2012
 - Amazon agreed to support a federal bill that would allow states to collect sales tax from out-of-state retailers

Affiliate Nexus – Engaged in Business

| Colorado | New York | Oklahoma & South Dakota | Texas |
|--|--|---|---|
| <p>If a retailer that does not collect Colorado sales tax is part of a controlled group of corporations, and that controlled group has a component member that is a retailer with physical presence in this state, the retailer that does not collect Colorado sales tax is presumed to be doing business in this state.</p> | <p>If either: An affiliated person that is a vendor as otherwise defined in this paragraph uses in the state trademarks, service marks, or trade names that are the same as those the seller uses; or</p> | <p>The retailer holds a substantial ownership interest in, or is owned in whole or in substantial part by, a retailer maintaining a place of business within this state; and The retailer sells the same or a substantially similar line of products as the related retailer in this state and does so under the same or a substantially similar business name, or</p> | <p>Effective January 1, 2012, "retailer engaged in business in this state" will also include anyone who: holds a substantial ownership interest in, or is owned in whole or substantial part by, a person who maintains a location in Texas from which business is conducted and if: (a) the retailer sells the same or a substantially similar line of products as the person with the location in Texas and sells those products under a business name that is the same as or substantially similar to the business name of the person with the location in Texas; or (b) the facilities or employees of the person with the location in Texas are used to:</p> |

Affiliate Nexus – Engaged in Business

| Colorado | New York | Oklahoma & South Dakota | Texas |
|----------|---|---|--|
| | <p>An affiliated person engages in activities in the state that inure to the benefit of the seller, in its development or maintenance of a market for its goods or services in the state, to the extent that those activities of the affiliate are sufficient to satisfy the nexus requirement of the United States constitution.</p> | <p>the instate facility or instate employee of the related retailer is used to advertise, promote, or facilitate sales by the retailer to a consumer; or The retailer holds a substantial ownership interest in, or is owned in whole or in substantial part by, a business that maintains a distribution house, sales house, warehouse, or similar place of business in this state that delivers property sold by the retailer to consumers.</p> | <p>advertise, promote, or facilitate sales by the retailer to consumers; or perform any other activity on behalf of the retailer that is intended to establish or maintain a marketplace for the retailer in Texas, including receiving or exchanging returned merchandise. Tex. Tax Code Ann. § 151.107(a)(7) (effective 01/01/2012) holds a substantial ownership interest in, or is owned in whole or substantial part by, a person that: maintains a distribution center, warehouse, or similar location in Texas; and delivers property sold by the retailer to consumers. Tex. Tax Code Ann. § 151.107(a)(8) (effective 01/01/2012).</p> |

Affiliate Nexus – Rebutting the Presumption

| Colorado | Oklahoma |
|---|--|
| <p>The presumption of doing business in the state may be rebutted by proof that during the calendar year in question, the component member that is a retailer with physical presence in this state did not engage in any constitutionally sufficient solicitation in this state on behalf of the retailer that does not collect Colorado sales tax.</p> | <p>The presumption of being engaged in business may be rebutted by evidence that during the calendar year at issue the component member that is a retailer engaged in business in Oklahoma did not engage in any of the activities described in this subparagraph on behalf of the retailer.</p> |

Affiliate Nexus Litigation – Texas

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Amazon.com, Inc. et al v. Texas Comptroller of Public Accounts,
No. D-1-GN-11-000164, Filed January 14, 2011

- Amazon has received an assessment for unpaid sales taxes in Texas
- Amazon asked for documentation and workpapers from the Department, and the Department declined to produce some of the documents citing attorney-client privilege
- Amazon subsequently filed a lawsuit seeking to obtain the documentation
- The Department based its assessment on the presence in the state of a distribution center operated by a subsidiary of Amazon.com, Inc. and has indicated in the press that this distribution center created nexus for the entity that sells products to Texas customers

Physical Presence Nexus

Physical Presence Nexus – Sales Tax

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- *Quill*'s physical presence nexus standard is still the law
- Some types of physical presence may be permitted without creating nexus
- Some states allow certain types of physical presence or certain activities to be conducted in the state without creating nexus (e.g., tradeshow attendance, recruiting activities, conferences/seminars, etc.)
- These activities are often not viewed as establishing or maintaining a market in the state and therefore not nexus creating

Physical Presence Nexus – South Carolina

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Travelscape, LLC v. South Carolina Department of Revenue, Opinion No. 26913 (Jan. 18, 2011)

- Online travel company that facilitates hotel reservations was audited by South Carolina
- South Carolina asserted that Travelscape was required to pay sales tax on gross proceeds from furnishing hotel accommodations in South Carolina
- Travelscape had no physical presence in South Carolina and asserted it was not engaged in business in the state
- Court held that Travelscape was engaged in business in South Carolina because it entered into contracts with hotels in the state to accept reservations, sent employees to the state to negotiate the agreement and booked reservations in exchange for compensation at hotels in South Carolina

Physical Presence Nexus – West Virginia

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West Virginia Technical Assistance Advisory 11-002 (April 1, 2011)

- Out-of-state commercial printer acquired plant site in West Virginia to construct and operate a commercial printing facility. Print facility included an off-line co-mail network to serve clients and the plants. The co-mail network served as a consolidation site where print jobs can be consolidated – including print jobs from outside of West Virginia
- Customers had raw materials, work in process and finished print goods at the printer's plant. In addition, the commercial printer mailed customer's printed materials to its customers from West Virginia
- Customer's also visited the West Virginia facility to review and approve tasks on items being printed
- Mere ownership of out-of-state customers raw materials in West Virginia and occasional visits to Printer's facilities is not sufficient to impose sales and use tax or an income tax filing requirement on the out-of-state customers

Physical Presence Nexus – Texas

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Texas Policy Letter Ruling, No. 201103016L (March 24, 2011)

- On July 11, 2010, Texas issued a revised version of a regulation, Texas Administrative Code Rule 3.286(a)(2)(E), that indicated that an out of state company using a server in the state would be engaged in business in the state
- The Department issued a ruling clarifying that the regulation was not intended to extend nexus over out-of-state companies using a server for any reason in Texas, but rather to ensure that use of digital content stored on a server in Texas for sale later would be nexus creating

Physical Presence Nexus – Texas

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Texas Policy Letter Ruling

- In the ruling, the Department states that “having ONLY a website on a third party server in Texas (upon which the third-party provide provides all the functionality)” does not create nexus. However, elsewhere, the Department states that storing digital content on a server in Texas does create nexus
- The Department states that further clarification will be forthcoming. The Department may explain the difference between “storing digital content” on a server, and “having a website” (which is created through digital content) on a server
- One fundamental question remains: if a company stores digital content for a taxpayer on servers across the country, including Texas, and the taxpayer has no idea where the content is stored, does the taxpayer have nexus in Texas?

Federal Legislation

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- Caveat –
 - At the time this presentation was prepared, the Main Street Fairness Act had been introduced in the Senate in July of 2011 and the Sales and Use Tax Collection and Simplification Act of 2011 had been introduced in October in the House. Both Acts would allow states to require remote sellers to collect sales & use tax
 - Federal legislation would result in a significant change to the sales tax nexus landscape

Economic Nexus

Economic Nexus

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- States have continued to expand application of economic nexus principles
- Economic nexus is no longer limited to deriving revenue from the licensing of intangibles in the state (e.g., *Geoffrey*)
- Economic nexus can be created through franchisees use of intangibles
- Economic nexus can be created by significant economic presence through revenue earned from customers in the state
- Economic presence can be created by having sales of tangible personal property to customers in the state (e.g. MTC Factor Presence Nexus)

Economic Nexus – Washington

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- For B&O tax purposes, persons engaging in service activities and the activity of receiving royalty income will have substantial nexus with the state if of the following requirements is met:
 - (1) An individual is a resident or domiciled in the state;
 - (2) a business entity is organized or commercially domiciled in this state; or
 - (3) the individual or business is organized or domiciled outside the state but has more than \$50,000 of property in the state, more than \$50,000 of payroll in the state, more than \$250,000 of receipts from this state, or at least 25 percent of the individual's or business's total property, total payroll, or total receipts in this state.

Economic Nexus – Washington

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- The nexus standard only applies to service activities and the activity of receiving royalty income
- Physical presence still applies for retail sales, wholesale sales, radio and television broadcasting and other activities
- A business or individual with substantial nexus in any tax year is deemed to have substantial nexus with the state for the following tax year

Economic Nexus – Colorado

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- Colorado adopted the MTC's factor presence nexus standard via regulation
- An out-of-state corporation will be considered doing business in Colorado if it has substantial nexus
- Substantial nexus is established if any of the following thresholds is exceeded during the tax period:
 - a dollar amount of \$50,000 of property; or
 - a dollar amount of \$50,000 of payroll; or
 - a dollar amount of \$500,000 of sales; or
 - twenty-five percent of total property, total payroll or total sales

Economic Nexus – California

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- California adopted MTC's factor presence nexus standard
- An out-of-state corporation will be considered doing business in California if it has:
 - \$500,000 in sales;
 - \$50,000 in property; or
 - \$50,000 in payroll in the state.
- Effective for tax years beginning on or after January 1, 2011

Economic Nexus – What we know?

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- Financing/Credit card activities = substantial nexus (Capital One, MBNA)
- Licensing intangibles = substantial nexus (Geoffrey, Lanco)
- What's next?

MBNA America Bank, N.A. & Affiliates v. Indiana Department of State Revenue, Case No. 49T10-0506-TA-53 (Ind. Tax Ct., 10/20/2008)

- MBNA, a national bank out-of-state bank, issued Visa and MasterCard credit cards to consumers in Indiana
- MBNA did not maintain a place of business within Indiana, nor did its employees enter Indiana on business – it acquired its Indiana customers through telephone and mail solicitation
- Indiana Tax Court held that MBNA was subject to the state's Financial Institutions Tax
- Court held that bank's economic presence in Indiana satisfied the substantial nexus requirement of the Commerce Clause

Economic Nexus

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KFC Corporation v. Iowa Department of Revenue, 792 N.W. 2d 308
(Dec. 30, 2010)

- KFC is out-of-state corp. with principal place of business in Louisville, KY
- Its primary business is the ownership and licensing of KFC trademarks to independent franchisees who own approximately 3400 restaurants throughout the U.S. including some affiliates
- KFC owns no restaurants or properties in Iowa and has no employees in the state
- Iowa audited KFC and issued an assessment asserting that KFC had Iowa nexus because of its receipt of income from franchisees in the state.
- ALJ and lower court held that KFC had nexus in Iowa as a result of its licensing of intangibles in the state
- Supreme Court held that presence of transactions within the state that give rise to KFC's revenue provide sufficient nexus under established Supreme Court precedent
- Appeal to U.S. Supreme Court filed on April 28, 2011, cert. denied Oct. 3, 2011

Physical Presence

Physical Presence – New York

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Matter of Shell Gas Gather Corp. & Shell Gas Pipeline Corp., N.Y. Tax App. Trib., No. 821569 et al. (Sept. 23, 2010)

- Foreign corporations without physical presence in the state but holding membership interests in entities doing business in the state had sufficient nexus with New York and were thus subject to New York's corporate franchise tax
- Court focused on the NY activities of the wholly owned entity that was directly and indirectly owned by the foreign corporations, not the NY activities of the foreign corporations themselves

Physical Presence – Illinois

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Illinois Dept. of Rev. General Information Letter IT 11-0006-GIL (March 11, 2011)

- A registered service agent sought a ruling on whether it had income tax nexus in Illinois. The agent does not have any employees or property in Illinois, and contracts with local lawyers that accept documents on behalf of the service agent
- Illinois determined that the service agent did not have PL 86-272 protection, not because it wasn't engaged in the business of selling tangible personal property, but because coordinating deliveries for payment is not a protected activity
- The Department then concluded that in order to determine whether the service agent had nexus, it would have to do a factual inquiry to determine if the activities in the state were de minimis, and the Department declined to do so, stating that it does not issue final determinations on nexus

Physical Presence – Washington

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Lamtec Corp. v. Dept. of Rev., State of Wash., Docket No. 83579-9, en banc (Wash. Sup. Ct. Jan. 20, 2011)

- Washington Supreme Court held that Lamtec had nexus for Washington B&O tax purposes based solely on employees' irregular visits to customers
- Court stated, "[w]e conclude that to the extent there is a physical presence requirement, it can be satisfied by the presence of activities within the state."
- Lamtec argued *Bellas Hess*
 - Bright-line physical presence
- Department of Revenue argued *Tyler Pipe*
 - Activities significantly associated with the taxpayer's ability to establish and maintain a market in this state for the sales
- Court's language provides uncertainty as to whether Washington requires physical presence in determining nexus
- Petition for certiorari filed to U.S. Supreme Court on April 19, 2011, cert. denied Oct. 3, 2011

Physical Presence – New Jersey

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Telebright Corp., Inc. v. Director, Division of Taxation, No. 011066-2008 (N.J. Tax Ct. Mar. 24, 2010)

- Telebright's employee telecommuted from her home in New Jersey, was expected to report for work, regularly received and carried out her assignments, was supervised by Telebright, began and ended her work day, and delivered her finished work product in New Jersey. Furthermore, Telebright employed property in the state by providing her with a laptop
- Based on the above-mentioned contacts through its employee, Telebright was found to be "doing business" in the state under N.J.A.C. 18:7-1.9(b)
- Telebright's tax liability under the CBT did not violate the Due Process Clause because the corporation had sufficient minimum contacts with New Jersey and also had fair warning that its employment relationship could subject it to the laws of the state
- The employee's daily presence in the state for purposes of carrying out responsibilities for Telebright satisfied the substantial nexus requirement of the Commerce Clause because the corporation enjoyed the benefits of the state's labor market. Just because Telebright did not further take advantage of New Jersey's markets by hiring additional employees or soliciting customers did not substantiate its constitutional claims

Questions?

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Jeffrey A. Friedman

202.383.0178

jeff.friedman@sutherland.com

Richard Pomp

(860) 570-5251

Richard.Pomp@law.uconn.edu

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