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Jurisdiction and Nexus

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NEXUS AND JURISDICTION

When may a State Impose an Obligation to Pay, Or Collect and Remit Taxes, on a Company?

When does a Company have the right to allocate and apportion its income?

How do these concepts influence Virginia and sales and use and corporate income tax planning techniques?

I. Overview

This presentation reviews the powers of the states, including Virginia, to tax, and the corresponding responsibility of taxpayers to pay or collect and remit taxes and file returns. The determination of whether a taxpayer has sufficient contacts or nexus with a state to allow the state to require the taxpayer to pay or collect and remit taxes is a difficult process.

Various federal constitutional and statutory doctrines and constraints as well as those existing at the state level must be considered. The level or degree of contact between a taxpayer and a state necessary to allow imposition of a tax varies not only with regard to the state but also with regard to the type of tax.

Despite these obstacles, it has become increasingly important for taxpayers to determine when sufficient nexus exists for a state to impose an income or franchise tax or a duty to collect and remit sales and use taxes. Many states have increased penalty provisions and enforcement efforts following amnesty programs. A few states require certain corporations to file disclosure spreadsheets detailing where and how returns are filed. These spreadsheets, together with multistate tax compacts designed to assist states in sharing information, enable states to more efficiently determine when corporations should be paying and remitting taxes.

Conversely, determining when Virginia domiciled taxpayers are taxable outside of Virginia may impact the amount of taxes paid or remitted to Virginia. For corporate income tax purpose, taxpayers who are taxable outside of Virginia are not taxed in Virginia on 100% of their income, but instead are allowed to apportion their income among the states in which they are taxable by use of a statutorily prescribed apportionment formula. In certain cases, this may result in more or less than 100% of the corporation's income being taxed, thus presenting planning opportunities and pitfalls.

Further, the operation of other Virginia tax statutes, such as the ability to elect to file separate, combined or consolidated returns for an affiliated group of corporations, depends on the determination of which entities within the affiliated group individually are taxable in Virginia. As a result, it is important that a taxpayer be able to identify its contacts with each state and ascertain whether these
contacts are sufficient to allow that state to subject the taxpayer to its taxing powers.

This outline reviews the states' power to tax corporations in the context of both the states' taxing statutes and the general federal constitutional and statutory limitations on a state's power to tax. However, greatest emphasis will be on the federal limitations on a state's power to tax. As a general rule, states, unless constrained by their constitutions or statutory language, have an unlimited power to tax. Most state statutes have broad, vague definitions of what entities or transactions are subject to its taxing power. Thus, scant guidance is generally given regarding the subjects of such taxing power. The history of the study of state taxation has been one of the federal limitations on such power -- not the state's implicit jurisdiction to tax.

Both corporate income taxes and sales and use tax nexus will be discussed. The integration of these concepts with Virginia's statutory provisions regarding the ability to allocate and apportion income and file separate, combined or consolidated returns and other Virginia income and sales and use tax planning techniques will also be explored.

II. Background

A. What is Nexus?

The term "nexus" is derived from the Latin *nectere*, meaning "to tie." It refers to the connection, link or contacts between a state and a taxpayer. In its broadest sense, nexus refers not only to a state's jurisdiction to tax, but also to the state's ability to assert legal jurisdiction of any kind over a person or a corporation, whether it be the power to require the defense of a lawsuit in the state, the power to regulate or the power to impose taxes. However, for purposes of this presentation, nexus will be used to refer to the level of contacts or connection between a state and a taxpayer sufficient to subject the taxpayer to the taxing jurisdiction of the state.

B. Development of State Taxes

State tax systems developed in colonial times based on the local economy (e.g., in New England where property ownership was more evenly distributed, taxes were imposed on the gross produce of the land, and, in towns, occupational taxes were imposed; in the southern colonies where property ownership was less evenly distributed, property taxes were insignificant and excise taxes predominated).

During the nineteenth century, property taxes predominated. In the north, taxes on banks, insurance companies, railroads and other businesses began
to supplement the property tax. In the South, license and privilege taxes were the main supplements. During the twentieth century, the importance of property taxes has declined (at the state level). Income and sales taxes became the predominant source of state revenue. For 1991, 33.2% of state revenue was from sales taxes; 32% from individual income taxes; and only 6.6% from corporate income taxes.

C. State “Doing Business” Statutes

Most states have “doing business” statutes that impose taxes on corporations having certain contacts with those states. States’ standards for imposing an income tax generally refer to: “doing business,” “earning income from sources in the state,” “employing capital,” or “owning or leasing property,” or some such similar phrase. Generally, state statutes that define doing business require very little in the way of activity in a state for the state to have jurisdiction to impose its tax. Consequently, the doing business statutes generally add little to the U.S. constitutional limitations on the state’s power to impose net income taxes. The term “doing business” also may appear in other contexts, such as a corporate qualification statute or a civil jurisdiction “long-arm” statute. While in some states the term “doing business” carries the same meaning in the tax and non-tax contexts, it should not be assumed that such is the case.

III. General Federal Constitutional Limitations

The principal federal constitutional limitations on a state’s power to tax multistate corporations are independently imposed by the Commerce Clause (U.S. Const., Art. I, Sec. 8, Cl. 3) and the Due Process Clause (U.S. Const., Amend. XIV, Sec. 1). For a state to constitutionally impose a tax on a corporation, there must be “nexus” or some minimum connection between the corporation and the taxing state. If a corporation has no nexus in a state, it is unconstitutional for the state to impose taxes on the corporation.

The history of the application of these constitutional constraints on the ability of a state to tax a nonresident or out-of-state corporation has been one of gradual expansion of the state’s power to tax or regulate the out-of-state person or entity.

A. Commerce Clause

The Commerce Clause provides that Congress has the power “to regulate commerce with foreign nations, and among the several States, and with the Indian tribes.” Taxation may so burden interstate commerce as to amount to a regulation thereof. See, e.g., Case of the State Freight Tax, 82 U.S. (15 Wall.) 232 (1872) (the first decision invalidating a state tax as a

Thus, over the years, the Commerce Clause has been interpreted as not only conferring power on the national government to regulate commerce, but also as limiting the states’ power to interfere with commerce. This restriction on the state’s power often is referred to as the “negative implication of the Commerce Clause” or as the “dormant Commerce Clause” principle. Under the dormant Commerce Clause principle the United States Supreme Court has struck down as unconstitutional a variety of state regulatory and taxation measures as unduly burdening interstate commerce.

1. What is Commerce?

For constitutional purposes, commerce is defined very broadly. As stated in Gibbons v. Ogden, 22 U.S. (9 Wheat.) 1 (1824):

Commerce, undoubtedly, is traffic, but it is something more: it is intercourse. It describes the commercial intercourse between nations, and parts of nations, in all of its branches.

Accordingly, most economic activity is considered commerce. Professional sports, theatrical productions, legal services and the operations of a public utility holding company have all been held to constitute commerce. Insurance, though originally not considered commerce, was later held to constitute commerce subject to federal regulation. Congress later removed this barrier to state regulation of insurance. See McCarran-Ferguson Act, 15 U.S.C. 1011-1015 (1982). The key is determining whether interstate or foreign commerce as opposed to purely intrastate commerce is implicated.

2. Historical Perspective — Free Trade Zone

As early as 1827, the Supreme Court adopted a “free trade” approach to state taxation of interstate commerce, exempting interstate commerce from state taxation. See Brown v. Maryland, 25 U.S. 419 (1827). As stated in Leloup v. Port of Mobile, 127 U.S. 640, 648 (1888):

[No state has the right to lay a tax on interstate commerce in any form, . . . and the reason is that such taxation is a
burden on that commerce, and amounts to a regulation of it, which belongs solely to Congress.

However, the Court recognized that states retained the power to regulate and to tax matters primarily of local concern even if those matters affected interstate commerce. Thus, there were two types of activities, those national in scope subject to exclusive regulation by Congress and those local in scope in which the states had concurrent powers to regulate.

3. **Historical Perspective — Direct and Indirect Burdens**

In the late 1800's, the Court began to increasingly talk about the direct or indirect burdens on interstate commerce in determining the validity of a state tax. A direct burden was impermissible. An indirect burden was allowed.

The touchstone for judicial condemnation was not any actual or probable hampering of interstate commerce but simply its direct bearing or effect on interstate commerce. A state could not tax interstate commerce even if the tax applied equally to local commerce.

For example, in *Freeman v. Hewitt*, 329 U.S. 249 (1946), a state tax on the gross receipts derived from the sale of securities was struck down. The opinion squarely stated that a tax could not be saved by a showing that it applied without discrimination to interstate and intrastate commerce:

It is true that the existence of a tax on its local commerce detracts from the deterrent effect of a tax on interstate commerce to the extent that it removes the temptation to sell the goods locally. But the fact of such a tax, in any event, puts impediments upon the currents of commerce across the State line.

However, a levy on a local activity would be upheld even if the tax were measured by gross receipts from interstate commerce. This was regarded as only an indirect burden on interstate commerce. *See, e.g., American Manufacturing Co. v. St. Louis*, 250 U.S. 459 (1919) (local license tax on manufacturing measured by total gross receipts upheld as subject of tax was the local activity of manufacturing).
It was this formalistic approach to determining which taxes directly impacted interstate commerce and thus were an unconstitutional burden on it that lead many states to adopt a tiered system of taxation: a direct net income tax (for intrastate business) and a franchise tax on the privilege of doing business instate (a local activity even if measured by income from interstate commerce).

The Court began to recognize the mechanical and formalistic nature of this test, noting in a dissenting opinion that the test was “too mechanical, too uncertain in its application, and too remote from actualities to be of value.” *DiSanto v. Pennsylvania*, 273 U.S. 34 (1927). Eleven years later the Court appeared to shift from the direct-indirect test to a more realistic cumulative burdens test in *Western Live Stock v. Bureau of Revenue*, 303 U.S. 250 (1938). In this case involving the imposition of a New Mexico franchise tax measured by gross receipts, the tax on a magazine which was based in New Mexico but received advertising from non-New Mexico persons and had non-New Mexico circulation, was upheld. In the Court’s view:

> [T]he tax assailed here finds support in reason, and in the practical needs of a taxing system which, under constitutional limitations, must accommodate itself to the double demand that interstate business shall pay its way, and that at the same time it shall not be burdened with cumulative exactions which are not similarly laid on local business.

During this period, the Court upheld a number of state taxes imposed on interstate businesses where there were substantial local business activities, the tax imposed did not discriminate against interstate commerce vis-à-vis a local business and the tax was fairly apportioned. See *United States Glue Co. v. Town of Oak Creek*, 247 U.S. 321 (1918); *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113 (1920); and *Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission*, 266 U.S. 271 (1924).

4. **Northwestern States Portland Cement and the Advent of Modern Commerce Clause Jurisprudence**

In *Northwestern States Portland Cement Co. v. Minnesota* and *Williams v. Stockholm Valves & Fittings, Inc.*, 358 U.S. 450 (1959), the Court confirmed that a state may with proper drafting tax exclusively interstate commerce. Northwestern Cement sold cement to Minnesota customers through employee/salespersons out
of a leased office in Minnesota. Stockholm Valves sold valves and fittings in Georgia in a similar manner. The Court observed that:

It is axiomatic that the founders did not intend to immunize such commerce from carrying its fair share of the costs of the state government in return for the benefits it derives from within the state.

It strains reality to say . . . that each of the corporations here was not sufficiently involved in local events to forge 'some definite link, some minimum connection' sufficient to satisfy due process requirements.

The presence of a local office or place of business in the state was regarded as "doing business" in the state sufficient to constitute the conduct of a business locally as opposed to a purely interstate business. In essence, the critical distinction made that a tax on the privilege of engaging in interstate commerce would be invalidated whereas a tax whose subject was the net income derived from such commerce would be upheld. See also Spector Motor Service v. O'Connor, 340 U.S. 602 (1951).

In Colonial Pipeline Co. v. Traigle, 421 U.S. 100 (1975), the Court upheld a Louisiana statute that imposed a franchise tax on the qualification to carry on business or the doing of business in corporate form. An earlier tax on the privilege of doing business instate had been struck down. This decision whittled the exemption of interstate commerce down to a reductio ad absurdum that a tax on a foreign corporation for the privilege of doing an exclusively interstate business is repugnant to the Commerce Clause whereas a tax on foreign corporations for the privilege of doing such a business in the state in the corporate form -- the only form in which corporations can do business -- is permissible.

5. Complete Auto Transit and the Modern Commerce Clause

In Complete Auto Transit v. Brady, 430 U.S. 274 (1977), the Court enunciated the modern Commerce Clause test for determining whether a state tax is unconstitutional. The Court completely repudiated its earlier prohibition on direct taxation of the privilege of doing business in interstate commerce. The Court held that a state tax will survive Commerce Clause scrutiny "when the tax is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate
commerce, and is fairly related to the services provided by the State.”

In other decisions, the Court has weaken the independent significance of two of the prongs of this test. In *Moorman Manufacturing Co. v. Blair*, 437 U.S. 267 (1978), the Court determined that it was beyond its province to invalidate state apportionment methods even though they may result in duplicative taxation. This case involved the imposition of Iowa’s single-factor apportionment formula on an Illinois company which apportioned its income in other states based on the traditional three-factor formula.

The “fairly related to the services provided by the state” test was emasculated in *Commonwealth Edison Co. v. Montana*, 453 U.S. 609 (1981). This case involved the imposition of Montana’s thirty percent coal severance tax on producers of coal. Ninety percent of the coal mined in Montana was shipped out-of-state. The Court observed that general revenue taxes need not be “reasonable related to the value of the service provided to the activity.” The Court viewed the test as not requiring a comparison of the amount of the tax to the cost to the state of the benefits it bestowed on the taxpayer, but whether “the measure . . . [is] reasonably related to the extent of the contact, since it is the activities or presence of the taxpayer in the State that may properly be made to bear a just share of State tax burden.”

In determining whether a tax is fairly apportioned, the Court has examined whether the tax is internally and externally consistent. To be internally consistent, the tax must be structured so that no multiple taxation would result if, hypothetically, each state imposed an identical tax. The external consistency test looks at whether the state taxes only that portion of the taxpayer’s income that reasonably reflects its in-state activities. See, e.g., *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159 (1983); *Goldberg v. Sweet*, 488 U.S. 252 (1989).

Although the U.S. Supreme Court has provided no clear cut test for determining what constitutes discrimination prohibited under the Commerce Clause, the Court has, in recent years, found a number of state taxes to be unconstitutionally discriminatory. The Court often relies on an analysis of relative tax burdens in reviewing the discriminatory impact of a tax. If the state imposes greater state tax burdens on certain taxpayers than on others, discrimination may exist. See, e.g., *Armco v. Hardesty*, 467 U.S. 638 (1987) (state
may not tax transaction or incident more heavily when it crosses state lines than when it occurs entirely within one state). Impermissible discrimination may also exist when the tax interferes with the businessperson’s independent economic decisions regarding the location of his or her business. See, e.g., Maryland v. Louisiana, 451 U.S. 725 (1981) (credit allowed against instate taxes rendered tax discriminatory as it encouraged investment within Louisiana rather than in other states).

For a period of time, many commentators questioned whether the Commerce Clause independently added requirements to those independently imposed by the Due Process Clause. As noted in the following section, it was believed that the Due Process Clause independently required nexus (minimal connection) and apportionment and a fair relationship between the tax and the benefits provided by the state (a rational relationship between the income attributed to the state and the instate value of the enterprise). Thus, the Commerce Clause was seen as only adding the requirement that the tax not discriminate against interstate commerce. However, as more fully described below, the Court’s decision in Quill Corp. v. North Dakota revealed a significant difference in the Commerce Clause’s substantial nexus and the Due Process Clause’s minimal connection nexus standards.

B. Due Process Clause

Unlike the Commerce Clause, which is an affirmative grant of authority to Congress to regulate commerce between the states, the Due Process Clause specifically limits the states’ power to impose taxes. The Due Process clause states that “nor shall any State deprive any person of life, liberty, or property, without due process of law.” The connection between the Due Process clause and the field of state taxation is that the taxation of a person is regarded as the deprivation of that person’s property which, of course, cannot occur without due process of law.


The juridical test of the states’ jurisdiction to tax income accruing to nonresidents is rooted in two cases decided on the same day: Shaffer v. Carter, 252 U.S. 37 (1920) and Travis v. Yale & Towne Manufacturing Co., 252 U.S. 60 (1920).

In Shaffer, the taxpayer was an Illinois resident who owned and operated oil and gas producing properties and leases in Oklahoma.
The taxpayer argued that since he conducted his business in his office in Illinois, Oklahoma was precluded from taxing his income derived from the properties. The Court held that a state could not only tax the income of its residents but also could tax nonresidents on the income generated from property or business conducted within the state. The Court stated that:

We deem it clear, upon principle as well as authority, that just as a State may impose general income taxes upon its own citizens and residents whose persons are subject to its control, it may, as a necessary consequence, levy a duty of like character, and not more onerous in its effect, upon incomes accruing to nonresidents from their property or business within the State, or their occupations carried on therein.

In *Travis*, the taxpayer contended that while New York had the power to tax the property of a nonresident, the state lacked the power to tax the income earned by a nonresident from businesses or occupations conducted within its borders. The Court observed that:

The State, from whose laws property and business and industry derive the protection and security without which production and gainful occupation would be impossible, is debarred from exacting a share of those gains in the form of income taxes for the support of the government, is a proposition so wholly inconsistent with fundamental principles as to be refuted by its mere statement.

The Court's decisions established a standard of fairness in state taxation that continues to the present time. The standard suggests that so long as there is a sufficient contact or nexus between the taxing state and the nonresident taxpayer's instate activities, the tax will be upheld.

The Court's most frequently cited and quoted description of this standard is found in *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435 (1940). This case dealt with the power of a state to subject dividends received by a foreign corporation from property and activities in the state to taxation. In the case, Justice Frankfurter stated:

A state is free to pursue its own fiscal policies, unembarrassed by the Constitution, if by the practical
operation of a tax the state has exerted its power in relation
to opportunities which it has given, to protection which it
has afforded, to benefits which it has conferred by the fact
of being an orderly, civilized society. The test is
whether property was taken without due process of law, or
if paraphrase we must, whether the taxing power exerted
by the state bears fiscal relation to protection, opportunities
and benefits given by the state. The simple but controlling
question is whether the state has given anything for which it
can ask return.

2. Development of the Due Process Minimal Connections
Requirements

In the landmark decision of International Shoe Co. v. Washington,
327 U.S. 310 (1945), the Court held that the Due Process Clause
requires only "minimum contacts" to support a state's assertion of
jurisdiction over a non-resident. The Court expressly adopted a
fairness test, stating that the Due Process Clause requires only that
the non-resident or non-domiciliary corporation have sufficient
contacts with the state that subjecting it to the jurisdiction of the
state does not "offend traditional notions of fair play and substantial
justice."

In International Shoe, which involved both the power of the state
to assert its taxing jurisdiction against a non-domiciliary
corporation and the state's power to subject the corporation to the
jurisdiction of its courts in proceedings to determine such tax
liability, the Court also indicated that no greater contacts were
required to establish the taxing jurisdiction of the state than were
needed to subject the corporation to the jurisdiction of the state's
courts. In fact, the Court affirmatively equated the standards for
the two types of jurisdiction: "The activities which establish its
'presence' subject it alike to taxation by the state and to suit to
recover the tax."

(1957), the Court upheld California's exercise of in personam
jurisdiction over a foreign insurance company whose only contact
with the state consisted of soliciting insurance contracts by mail
from outside the state. Contrast this decision with that in Hanson
v. Denckla, 357 U.S. 235 (1958) in which the Court rejected
Florida's attempt to assert in personam jurisdiction over a
Delaware trustee that did not have an office in the state, transacted
no business in the state and solicited no business in the state. The
Court noted that “it is essential in each case that there be some act by which the defendant purposefully avails itself of the privilege of conducting activities within the forum State, thus invoking the benefits and protections of its laws.”

More recently in a products liability case *World-Wide Volkswagen Corp. v. Woodson*, 444 U.S. 286 (1980), the Court in holding that Oklahoma could not subject a nonresident automobile dealer to *in personam* jurisdiction noted the following factors which would have been sufficient “affiliating circumstances” to allow such jurisdiction to be asserted:

- closing sales instate
- soliciting business instate through salespersons or advertising reasonably calculated to reach the state
- regularly selling cars to Oklahoma residents
- directly or indirectly seeking to serve the Oklahoma market

Finally, in another non-tax Due Process decision *Burger King Corp. v. Rudzewicz*, 471 U.S. 462 (1984), the Court held that a foreign corporation which purposefully avails itself of the benefits of an economic market in a state may be subjected to *in personam* jurisdiction, noting that:

Jurisdiction in these circumstances may not be avoided merely because the defendant did not physically enter the forum State. Although territorial presence frequently will enhance a potential defendant’s affiliation with a State and reinforce the reasonable foreseeability of suit there, it is an inescapable fact of modern commercial life that a substantial amount of business is transacted solely by mail and wire communications across state lines, thus obviating the need for physical presence within a State in which business is conducted. So long as a commercial actor’s efforts are ‘purposefully directed’ toward residents of another State, we have consistently rejected the notion that an absence of physical contacts can defeat personal jurisdiction there.

The Due Process Clause is concerned with fundamental fairness and notice to the individual taxpayer (i.e., it requires a taxpayer be given a “fair warning”). Accordingly, the due process “minimum contacts” nexus test may be satisfied without requiring physical presence in a particular state.
III. U.S. Supreme Court Decisions and Corresponding Factors Constituting Sufficient Nexus

A. In-State Office

The maintenance of an office or other place of business in a state is sufficient to create nexus in that state. See Northwestern States Portland Cement, supra. Moreover, it would generally appear that transactional nexus is not required, i.e., a direct relationship between the non-domiciliary’s in-state office and its in-state selling activities. See Nelson v. Sears, Roebuck and Company, 312 U.S. 359 (1941) (use tax collection); Nelson v. Montgomery Ward & Co., 2312 U.S. 373 (1941) (use tax collection); Standard Pressed Steel Co. v. Dept. of Revenue, 419 U.S. 560 (1975) (gross receipts tax); National Geographic Society v. State Board of Equalization, 430 U.S. 551 (1977) (in-state place of business totally unrelated to mail-order sales made to California customers creates sufficient nexus to impose use tax collection duty); and D.H. Holmes Co. v. McNamara, 486 U.S. 24 (1988) (in-state stores sufficient nexus to allow impose of use tax on catalogues mailed to in-state residents).

B. In-State Employees or Representatives

The first case upholding the imposition of tax on an out-of-state corporation without an in-state office was General Trading Co. v. State Tax Commission of Iowa, 322 U.S. 335 (1944) which imposed a use tax collection duty based solely on instate solicitation of orders by employees with no instate place of business. The following year in International Shoe Co. v. Washington, 326 U.S. 310 (1945), the Court held that the taxpayer who had no offices or other place of business and no stock of goods in the state but had employees who solicited orders for acceptance at and filling by shipment from out-of-state locations had sufficient presence to be subject to the state’s unemployment compensation tax.

After the Northeastern States Portland Cement decision, some have interpreted the Court as indirectly applying the above principle to two cases involving net income taxes. The Court denied certiorari in two Louisiana cases in which the state court had upheld the imposition of a tax on foreign corporations whose only presence instate were employees of the foreign corporation. See Brown-Forman Distillers Corp. v. Collector of Revenue, 101 So.2d 70 (La. 1958), cert. denied 359 U.S. 28 (1959) and International Shoe Co. v. Fontenot, 107 So.2d 640 (La. 1958), cert. denied, 259 U.S. 984 (1959).

More recently, the Court, in Standard Pressed Steel Co. v. Washington Department of Revenue, 419 U.S. 560 (1975), upheld the imposition of
Washington’s business and occupation tax on an out-of-state corporation which had only one employee in Washington who performed non-sales engineering functions instate, stating that the question of whether Due Process nexus existed was a question “in the context of the present case bordering on the frivolous. For appellant’s employee ... with a full-time job within the State, made possible the realization and continuance of valuable contractual relations between appellant and Boeing.”

C. In-State Independent Contractors

In *Scripto, Inc. v. Carson*, 362 U.S. 207 (1960), the Court found the presence of independent contractors in the taxing state gave rise to a use tax collection duty for the out-of-state corporation employing the independent contractors. In the Court’s opinion, the distinction between solicitation by employees and solicitation by independent contractors was without constitutional significance: either method of solicitation was effective in creating and holding a market.

For a period of time, it was thought that this rule only applied to transactional as opposed to operational taxes. However, in *Tyler Pipe Industries, Inc. v. Washington Department of Revenue*, 483 U.S. 232 (1987), *Scripto* was approvingly cited in upholding the constitutionality of Washington’s business and occupation tax as applied to an out-of-state corporation whose only contact with the state was through an independent sales representative. The Court stated that a “showing of sufficient nexus could not be defeated by the argument that the taxpayer’s representative was properly characterized as an independent contractor instead of as an agent.... ‘[T]he crucial factor governing nexus is whether the activities performed ... on behalf of the taxpayer are significantly associated with the taxpayer’s ability to establish and maintain a market ... for the sales.’”

D. In-State Fixed Property

It seems well settled that the presence of real or tangible personal property instate is sufficient to create nexus within the state. *See Heublin, Inc. v. South Carolina Tax Commission*, 409 U.S. 275 (1972); *Consolidated Accessories Corp. v. Franchise Tax Board*, 161 Cal. App. 3d 1036 (Cal. Ct. App. 1984); *Chattanooga Glass Co. v. Strickland*, 261 S.E.2d 599 (Ga. 1974); *Olympia Brewing Co. v. Department of Revenue*, 511 P.2d 837 (Ore. 1973). One key issue is whether consigned inventory represents a true consignment (nexus) or a conditional sale (no nexus). For situations in which the presence of instate property was insufficient to create nexus see *Comptroller of the Treasury v. Matthew Bender & Co., Inc.*, No. 1776, Slip. Op. (Md. Ct. Sp. App. 1989) (property at instate printer did not create nexus) and *Signal Thready v. King*, 435 S.W.2d 468 (Tenn. 1968)
In the sales tax area, the Connecticut superior court ruled that property instate for a "preview" period prior to purchasing the films was not sufficient to create nexus instate. *Cally Curtis Co. v. Groppo*, Case No. 319654 (Conn. Super. Ct. 1989).

### E. In-State Moveable Property

State courts have issued differing opinions on whether the use of moveable tangible personal property by the lessee or licensee of the taxpayer who moved the property instate in interstate commerce was sufficient nexus for taxation of the lessor-licensor. In *American Refrigerator Transit Co. v. State Tax Commission*, 395 P.2d 127 (Ore. 1964), the state imposed its income tax on an out-of-state lessor who had no rental agreement with any railroad operating in Oregon, but whose cars under railroad interchange practices were in Oregon even though the taxpayer had no control over the cars' routing, movement, interchange or use. Arkansas and Oklahoma courts have agreed with this decision. Kentucky and Georgia courts have disagreed.

In *Appeal of U-Haul of Van Nuys*, Cal. St. Tax Rptr. (CCH) Para. 401-489 (S.B.E. 1987), the Board held that Amerco Lease was deriving income from California sources through its regular and systematic channeling of its moveable property into the state through its commonly controlled sister corporation. In *Marx v. Truck Renting and Leasing Association, Inc.*, 520 So.2d 1333 (Miss. 1987), the court struck down imposition of Mississippi tax on out-of-state taxpayer's whose only Mississippi connection was leased trucks domiciled in other states which passed through Mississippi over routes chosen by the lessees, noting that:

> While it is true that the term 'minimal connection' is employed in the test articulated by the Supreme Court, subsequent interpretations have noted that the corporation must "substantially" avail itself to the privilege of doing business in the taxing state. Such language certainly would appear to contemplate greater activities than those present in this case.

Similarly, in *Amerco Lease Co. v. Wisconsin Department of Revenue*, Wisc. St. Tax Rptr. (CCH) Para. 202-952 (Wisc. Cir. Ct. 1988), the Court held that the receipt of income from moveable property instate did not constitute "doing business" in Wisconsin.
F. In-State Intangible Property

In all of the U.S. Supreme Court decisions in which an out-of-state person was found to have nexus for tax purposes, the out-of-state person had some sort of physical presence within the taxing state. However, as discussed below there have been several state court decisions in which physical presence has not apparently been a prerequisite for a finding of taxable nexus.

Part of the recent controversy has arisen as a result of the U.S. Supreme Court’s decision in Quill Corporation v. North Dakota, 112 S.Ct. 1904 (1992). As discussed below, in Quill, the Court found that for sales and use tax purposes, physical presence was required for an out-of-state corporation to be required to collect a state’s sales and use taxes. However, in Quill, the Court stated that “[w]e have not, in our review of other types of taxes, articulated the same physical-presence requirement that Bellas Hess established for sales and use taxes, that silence does not imply repudiation of the Bellas Hess rule.” Some states are narrowly interpreting this seeming dictum in the Quill case as the Court’s acknowledgment of the lack of a physical presence standard for state taxes other than sales and use taxes notwithstanding the lack of any U.S. Supreme Court decisions directly supporting this conclusion.

In Geoffrey, Inc. v. South Carolina Tax Commission, No. 23866 (S.C. S.Ct., July 6, 1993), the South Carolina Supreme Court held that an out-of-state corporation was subject to net income taxation even though the corporation had no physical presence in the state. The court found that the corporation’s licensing of trademark rights to an instate company established nexus under the Due Process and Commerce Clauses of the U.S. Constitution. Even though this case involved a passive investment company (one which generally has no substantive operations and pays little, if any, state tax), the court’s decision was not limited to such passive investment companies or to transactions between out-of-state corporations and instate affiliates.

There is a present danger that this decision may be extended by state departments of revenue to cover any business arrangement in which an economic, but not a physical presence, exists. Financial institutions and other financial service enterprises, passive investors of investment conduits, manufacturers and dealers in computer software, franchisers, telecommunications providers and other enterprises providing or assisting in the transmission and/or dissemination of electronic information, and other arrangements in which a person’s intangible property or services or used by others instate are some of the businesses likely affected by this ruling.
Florida has adopted final regulations that impose income tax on corporations that sell or license intangible property in the state. Fla. Admin. Code Section 2C-1.011(1)(p). Wisconsin has also announced its intention to follow the Geoffrey decision. Wisc. Dept. of Rev., Tax Release 1, I.S.&E. Newsletter 233, 8/11/95. Alabama, Massachusetts, and North Carolina have also made similar announcements. In fact, Alabama has instituted a voluntary compliance program until December 1, giving taxpayers an opportunity to voluntarily come forward and limit liability to three years and avoid imposition of penalties.

*But see B.I. Moyle Associates, Inc. v. Wisconsin Dept. of Revenue, No. 87-S-141 (Wisc. Tax Appeals Com. 1990) (presence of intangible personal property instate in the form of licensed computer programs insufficient to create nexus).*

G. **In-State Economic Exploitation**

Traditionally, the concept of nexus has focused on a taxpayer’s physical presence in the taxing state. Over the past quarter century, this focus appears to be gradually shifting from a physical presence test to an economic presence test. *See Scripto, Inc., supra* and *Tyler Pipe Industries, Inc., supra* ("the crucial factor governing nexus is whether the activities performed in the state on behalf of the taxpayer are significantly associated with the taxpayer’s ability to establish and maintain a market in this state for sales").

This logic follows that of the dissent in the *National Bellas Hess, Inc. v. Department of Revenue*, 386 U.S. 753 (1967), decision in which the Court ruled that a mail-order seller whose only contact with a state was through catalogues and flyers mailed from outside the state and who had no individuals soliciting sales within the state, no property within the state and no local advertising did not have sufficient nexus to require collection of Illinois’ use tax. The dissent stated that:

*There should be no doubt that this large scale, systematic, continuous solicitation and exploitation of the Illinois consumer market is a sufficient “nexus” to require Bellas Hess to collect from Illinois customers and to remit the use tax, especially when coupled with the use of credit resources of residents of Illinois. . . . The difference between the nature of the business conducted by the mail order house and by the local enterprise is not entitled to constitutional significance.*
In the income tax area, the Oregon Supreme Court in the *American Refrigerator Transit Co.* decision stated that:

The connection between the taxing state and the out-of-state taxpayer is essentially an economic rather than a physical relationship.

Nexus may be found even where neither property nor personnel of the taxpayer is employed within the taxing state if it can be said that the state substantially contributes to the production of the taxpayer's income.

Of course, the taxpayer in this case did have property in the state. Therefore, the above language might be regarded as *dicta* nongermane to the rendering of the court's decision.


### H. In-State Agents

Traditionally, the acts of an agent are attributed to its principal. Thus, the presence of an instate agent has been held sufficient to create taxable presence instate for the out-of-state principal. Further, if an instate affiliated corporation is acting as the agent for an out-of-state affiliate, the state courts have found the requisite nexus. *See Western Acceptance Co. v. State of Florida*, 447 So.2d 497 (Fla. Dist. Ct. App. 1985) (instate affiliate collected monies owed out-of-state financing company which was totally dependent on parent to perform necessary activities as it had no employees or property) and *CIT Financial Services Consumer Discount Co. v. Director*, 4 N.J.T.C. 568 (1982) (activities of instate corporation acting as taxpayer's agent and doing business in New Jersey created nexus for out-of-state affiliate).

In the sales tax area see *Reader's Digest Assn., Inc. v. Mahin*, 255 N.E.2d 458 (Ill. 1970), *cert. denied*, 399 U.S. 919 (1970), where an Illinois appellate court found that the instate solicitation of sales on behalf of Reader's Digest by corporate affiliates created nexus for the out-of-state seller due to agency reasons; *Scholastic Book Clubs, Inc. v. State Board of Equalization*, 207 Cal. App. 3d 734 (Cal. St. App. 1989) (teachers...

The Vermont Department of Taxes has ruled that a fulfillment company performing the following activities created nexus for its out-of-state client: duplication of master tapes owned by the client, accounting and revenue processing using Vermont bank accounts held by the client; storage and shipping of the duplicated tapes; processing and filling orders for the client’s inventory which is held in Vermont. These activities were directly attributable to the corporation as the instate company was acting as its agent.

The agency theory has also been used to establish nexus in the state income tax field. The Supreme Court of Minnesota held in \textit{Minnesota Tribune Company v. Commissioner of Taxation}, 37 N.W.2d 737 (Minn. 1949), that an out-of-state parent corporation had income tax nexus in the state because its instate subsidiary was its agent. According to the court:

\begin{quote}
Where a foreign corporation is organized for the purpose of holding the controlling stock in a local corporation and directing its management through the voting power of the stock thus held, or where in addition to such ownership there exist circumstances which render the local corporation merely the agent of the holding corporation and the latter is present and acting in the state through its officers, it may be held to be "doing business" within the state.
\end{quote}

Similarly, in \textit{Amway Corporation v. Director of Revenue}, 794 S.W.2d 666 (Mo. 1990), the Missouri Supreme Court held that Amway was liable for the state’s corporate income tax even though the company had no employees or property in Missouri. The court concluded that Amway’s distributors in the state were acting as the company’s agents.

Although the agency theory of nexus is firmly rooted in the law, it should be noted that the state must show that the instate entity is, in fact, the agent of the out-of-state corporation. If the taxpayer can show that the instate entity is instead independent, attributional nexus will not be upheld. \textit{See}, \textit{e.g.}, \textit{Mississippi State Tax Commission v. Bates}, 567 So.2d 190 (Miss. 1990) (sales tax nexus not present where no agency relationship existed) and \textit{Pledger v. Troll Book Clubs, Inc.}, 871 S.W.2d 389 (Ark. 1994) (out-
of-state book seller not required to collect use tax as instate teachers not
directed or controlled by seller).

I. In-State Partnership, LLC or S Corporation Interest

The majority of states will attribute nexus to an out-of-state corporation
whose only instate contact is through ownership of an interest in a flow-
through entity such as a partnership, limited liability corporation or S
corporation operating instate. For rulings concerning ownership of a
limited partnership interest, see Pennsylvania Board of Finance and
Revenue Docket No. R-13,147 (1990); Florida Technical Assistance
Advisement 88(C)1-004 (1988); Arizona Corporate Tax Ruling 93-9
(1993); Tennessee Revenue Ruling No. 95-15; and Illinois Department of
Revenue Private Letter Ruling 90-278 (1990) among others. A few states
(e.g., Texas, Georgia, Tennessee) may not tax out-of-state corporate
limited partners whose involvement in the partnership is truly as a passive
investor. As a general rule, a general partner would be taxable under
general agency principles. It is expected that the taxation of a limited
liability company would follow that of a limited partnership. The practical
result is the same for S corporations even though a number of states have
instituted agreements that out-of-state shareholders have to sign in order to
receive S corporation treatment instate in case of a challenge to their ability
to tax the out-of-state shareholder based solely on the ownership interest
and activities of the S corporation.

J. In-State Affiliates

The presence of instate affiliates should not per se create any nexus
implications. However, the corporate affiliation does raise questions of
whether the instate affiliate may be acting as agent for the out-of-state
affiliate thereby subjecting the out-of-state affiliate to the state's taxing
power.

A number of cases have arisen in the sales and use tax area in which the
presence of instate affiliates which were not acting as agents for the out-of-
state affiliate did not create a use tax collection duty on behalf of the out-
of-state affiliate. See Bloomingdale's By Mail, Ltd. v. Commonwealth
(occasional return of mail order merchandise to instate affiliate and use of
similar advertising themes and motifs not sufficient to create agency
relationship), SFA Folio Collections, Inc. v. Bannon, No. CV87-0338611S
(Hartford Superior Ct. 1990) ("even as part of a deliberate tax avoidance
strategy, the fact that Folio is incorporated as an entity separate from Saks-
Stamford and Saks & Company does not, standing alone, permit a taxing

In *Current, Inc. v. State Board of Equalization*, No. A061750 (Cal. Ct. App. 1994), a California court of appeal held that Cal. Rev. & Tax. Code Section 6203(g), as applied to the taxpayer, was unconstitutional. This section imposes a use tax collection responsibility on "retailers owned or controlled by the same interest which own or control any retailer engaged in business in the same or similar line of business within the state." Critical to the decision was the fact that neither the parent nor the subsidiary corporation was the alter ego or agent of the other for any purpose. Each owned, operated and maintained its own business assets, conducted its own business transactions, hired and paid its own employees, and maintained its own accounts and records.

In *SFA Folio Collections, Inc. v. Tracy*, Ohio S.Ct., 99 Ohio St. 3d 1 (1995), the Ohio Supreme Court held that the State cannot impute nexus to a company lacking physical presence in Ohio on the basis that a sister company had physical presence in Ohio. The court held that the out-of-state and instate corporations were separate and distinct legal entities. Since SFA itself had no physical presence instate and had no agents operating instate, nexus could not be imputed.

Other states have used similar arguments to the agency theory, instead looking to whether the instate entity is acting as the alter ego of the out-of-state entity in which case the separate corporate existence of the out-of-state entity should be ignored. A series of New York State Tax Commission opinions have subjected out-of-state subsidiaries of parent corporations doing business in New York to use tax collection responsibilities. If the affairs of the subsidiary or the parent are so dominated and controlled by the other entity so that one entity is the alter ego of the other, then the existence of nexus for one will create nexus for the other entity. *See Spencer Gifts, Inc.*, New York Advisory Opinion No. S851028A, TSB-A-86(37)S (N.Y. State Tax Comm'n, Sept. 18, 1986); and *Harfred Operating Corporation*, New York Advisory Opinion No. S850318A, TSB-A-86(28)S (N.Y. State Tax Comm'n, July 19, 1986). *See also CIT Financial Services Consumer Discount Co. v. Director, Division of Taxation*, 4 N.J. Tax Rptr. (CCH) Para. 201-026 (N.J. Tax Ct. 1982) (out-of-state affiliate subject to income tax due to activities of instate affiliates: "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.").
Other states have applied a "unitary theory" to determine whether nexus for affiliates exists. Under a unitary theory of taxation, separate corporate entities engaged in a single (unitary) business may be required to report business income on a combined basis. Thus, an out-of-state affiliate which, standing alone, lacks nexus, effectively can be taxed through inclusion in a combined report with an affiliate which has nexus. A unitary business is generally one where there is a high degree of interrelationship and interdependence among the activities of the related companies. The unitary theory is primarily used in the apportionment area.

Application of the unitary business principle outside its traditional sphere may be considered misplaced. However, a number of states have attempted to assert jurisdiction based on the unitary relationship of an out-of-state company with an instate affiliate. See, e.g., Comptroller of the Treasury v. Armco Export Sales Corp., 572 A.2d 562 (Md. Ct. Sp. App. 1990) (DISC subject to Maryland income taxation based on unitary relationship with instate parent); Ashland Oil, Inc. v. Rose, W.V. Tax Rptr. (CCH) Para. 200-333 (W.V. Cir. Ct. 1988) (five affiliates of instate entity subject to gross receipts taxation due to unitary relationship with instate affiliate). But see SFA Folio Collections, Inc. v. Bannon, supra.

K. Sporadic In-State Presence

In Miller Brothers Co. v. Maryland, 347 U.S. 340 (1954), the Court ruled that Maryland could not constitutionally impose a use tax obligation on a Delaware seller whose only contacts with Maryland was the mailing of circulars to former customers in Maryland, advertising through newspapers and radio and delivery of goods purchased out-of-state through the sellers’ trucks. The Court stated that "there is a wide gulf between [the] type of active and aggressive operation within a taxing state and the occasional delivery of goods sold at an out-of-state store with no solicitation other than the incidental effects of general advertising." But see Good's Furniture House, Inc. v. Iowa State Bd. of Tax Review, 382 N.W.2d 145 (Iowa 1986) (purposefully directed television advertising and regular delivery sufficient to create use tax collection nexus); Cooey-Bentz Co. v. Lindley, 419 N.E.2d 1087 (Ohio 1981) (same result for instate delivery, installation and repair).

In Cole Brothers Circus, Inc. v. Huddleston, No. 01-A-01-9301-CH-00004, 1993 Tenn. App. LEXIS 386 (1993), an assessment against a traveling circus which spent 29 days instate over a four-year period was upheld.
In *Orvis Co. Inc. v. Tax Appeals Tribunal*, 204 A.D.2d 916 (1994), and *Vermont Information Processing v. Tax Appeals*, 206 A.D.2d 764 (1994), the New York Court of Appeals held that anything "demonstrably" more than the slightest presence will provide constitutional nexus. Orvis sold mainly by mail-order but also made approximately four visits a year to as many as 19 New York retailers. Vermont Information also sold mainly by mail-order; however, it also made "troubleshooting" visits to customers to solve installation and other problems (approximately 40 visits over a three-year period were made to New York customers).

The Court of Appeals held that these visits were both systematic and sales related and therefore demonstrably exceeded a slightest presence. Based upon its review of U.S. Supreme Court decisions, the New York court noted that these decisions did not introduce a "substantial" physical presence test. The court viewed such a test as too exacting as it would require a case-by-case examination of the facts in each situation undermining the importance of the "bright line" physical presence test. According to the court, a physical presence exceeding a slightest physical presence is manifested by the presence of property or the conduct of economic affairs by the taxpayer's personnel on its behalf. The decision was not explicitly restricted to sales and use tax and may also apply to other types of taxes.

However, in *Share International, Inc. v. Florida Dept. of Revenue*, Fla. Dist. Ct. App., No. 93-4093 (1995), sufficient nexus was not found where an affiliate of a Texas mail order seller conducted seminars instate for three days per year at which products were sold (tax was collected on the sales actually made in Florida). The court ruled that sporadic physical presence was not sufficient to create the substantial nexus necessary for constitutional nexus to be found.

Also, in *Care Computer Systems, Inc. v. Arizona Department of Revenue*, No. 1049-93-S (Az. Bd. Tax App., April 4, 1995), the Board held that an out-of-state vendor that held title to two personal computers in Arizona, had one salesperson visit per year, and 21 days of customer training by non-resident personnel during the year did not have nexus with Arizona. The Board held that the evidence did not show that the company had significant property in the state or that it intended to establish a business presence.

The Michigan Court of Claims has held that a taxpayer must demonstrate "at least two weeks of solid effort in a state" before the taxpayer can be considered to have substantial nexus in the state to avoid Michigan's sales factor throwback rules. *Magnetek Controls, Inc. v. Michigan Department of Treasury*, No. 93-14739-CM (Sept. 30, 1994). In addition to the
number of days spent in a state, "the totality of the circumstances," including sales volume must be considered. See also Howmet Corp. v. Department of Treasury, No. 161904 (Mich Ct. App., Aug. 18, 1995) (physical presence by itself outside of Michigan not enough to avoid throwback: actual extent of activities must be evaluated).

An Illinois trial court held that a Missouri retailer making regular deliveries into Illinois with its own trucks lack substantial nexus. Brown's Furniture v. Department of Revenue, No. 90-CH-49 (Ill. 7th Jud. Cir., Apr. 20, 1994). The court concluded that the use tax was not uniformly applied to taxpayers in similar situation, it discriminates against interstate commerce and it was not fairly related to services provided by the state.

L. Mail Order Sellers: National Bellas Hess and its Progeny

In National Bellas Hess v. Dept. of Revenue, 386 U.S. 753 (1967), the Court ruled that a state could not require an out-of-state corporation to collect use tax when its only connection with the state was the mailing of product catalogues to instate customers. The Court held that National Bellas Hess lacked the requisite "minimal connections" under the Due Process Clause to allow imposition of Illinois' taxing jurisdiction. The Court also raised two Commerce Clause concerns: that if the thousands of jurisdictions imposing sales and use taxes imposed such taxes, the obligations to which National Bellas Hess would be subject would have no relationship to the benefits provided by the jurisdictions and that the resultant recordkeeping and administrative burdens would violate the purpose of the Commerce Clause -- to "ensure a national economy free from such unjustifiable local entanglements."

M. Quill and its Aftermath

In Quill Corp. v. North Dakota, 112 S.Ct. 1904 (1992), the Court reaffirmed its constitutional prohibition against state taxation of out-of-state mail order sellers. Quill solicited sales by catalog, telephone, and through national advertisements. It delivered merchandise to its customers in North Dakota by mail or common carrier.

The state had assessed Quill under an anti-Bellas Hess statute because it was engaged in the regular solicitation of sales by catalogues or the mail. The North Dakota Supreme Court acknowledged that the statute was inconsistent with Bellas Hess but believed that "the foundational basis of Bellas Hess has been eroded and the Supreme Court would so conclude." The state in effect adopted an economic nexus test.
The Court reversed upholding the traditional physical presence nexus test. The Court differentiated between the nexus standards of the Due Process Clause and that of the Commerce Clause. The Court looked to the differences in the constitutional underpinnings of the two Clauses concluding that “the two standards are animated by different constitutional concerns and policies.” Thus, contacts that might meet Due Process standards concerned with fairness and fair warning might not meet Commerce Clause concerns regarding the effect of state regulation on the national economy.

The Court explicitly overruled the physical presence requirement for Due Process purposes:

[T]o the extent that our decisions have indicated that the Due Process Clause requires physical presence in a state for the imposition of duty to collect use tax, we overrule those holdings as superseded by developments in the law of due process.

However, the Court was unwilling to overturn its Commerce Clause physical presence requirements, at least with respect to use tax collection. The Court found that its holding in Bellas Hess was not inconsistent with Complete Auto Transit and current Commerce Clause jurisprudence. The Court believed that a bright-line test of physical presence which had guided taxpayers and tax administrators for years and had created settled expectations in the area should not be overturned, relying on stare decisis.

The MTC recently released a draft guideline regarding sales and use tax constitutional nexus standards. Although the draft guideline contains commonly accepted notions of activities or contacts constituting nexus for Due Process Clause and Commerce Clause purposes, in certain respects the guideline represents a broad, and possibly unsupported, interpretation of sales and use tax nexus under the U.S. Constitution. Essentially, the guideline largely adopts a nexus interpretation that virtually any contact or activity, other than that which is de minimis, inadvertent, or by way of U.S. mail or common carrier, constitutes substantial nexus under the Commerce Clause. Moreover, the MTC apparently would ignore the brightline physical presence test set forth by the U.S. Supreme Court in Quill, by adding a concept of “deemed physical presence.” For example, advertising directed at instate persons through local media (or “other local means of electronic transmission”) creates nexus under the guidelines, as does granting an interest in or right to use intangible property.

The draft guideline is tentatively projected for MTC adoption in 1995; however, no public hearings have been scheduled. Although impossible to
predict, it is unlikely that a majority of MTC member states will agree to “push the envelope” of nexus as far as the draft guidelines allow.

IV. Public Law 86-272

As noted above, the Commerce Clause provides Congress with the power to regulate interstate commerce. Congress has rarely exercised this power. The major instance in which it did was the passage of Public Law 86-272. This statute provides for a limitation on a state’s power to subject nondomiciliary corporations to the state’s net income tax. In general, the statute provides that a state may not impose a net income tax when a nondomiciliary corporation’s only contact with the state is the solicitation of orders of tangible personal property by its employees if the orders are sent outside the state for approval or rejection and the merchandise is shipped or delivered from a source outside the taxing state.

A. Enactment and Provisions

Public Law 86-272 was a congressional response to the Supreme Court’s suggestion that solicitation of business by a nondomiciliary corporation engaged solely in interstate commerce within a state was sufficient contact to justify taxation. See Brown-Forman Distillers Corp. v. Collector of Revenue and International Shoe Co. v. Fontenot, supra. Public Law 86-272 was intended to be a stop-gap measure until a more detailed study of the states’ taxation of interstate business was made. However, even after the study was complete, no further action was taken and the law has remained on the books.

In general, Public Law 86-272 protects nondomiciliary corporations from being subject to a state’s net income based tax if the corporations only contact with the state is (1) the solicitation of orders for the sale of tangible personal property through employees or representatives where the orders are sent outside the state for approval or rejection and are filled by shipment or delivery from a point outside the state; (2) the solicitation of orders for the sale of tangible personal property through employees or representatives in the name of or for the benefit of a prospective customer of the seller’s customer when the orders are sent outside the state for approval and are filled by shipment or delivery from outside the state; or (3) the solicitation or orders for sale or the actual making of a sale by an independent contractor on behalf of the taxpayer even if the independent contractor maintains an office in the state.

Public Law 86-272 is a limitation on the state’s power to tax ‘foreign’ sellers of tangible personal property. It does not apply to domestic corporations (corporations incorporated in the state).
There has been some disagreement about whether the mere act of qualifying to do business in the state obviates Public Law 86-272. Mass. Letter Ruling 1984-78 and New Jersey State Tax News, Nov./Dec. 1989, ruled that Public Law 86-272 does not apply. However, Letter from Chief Counsel of the Franchise Tax Board; Kelly-Springfield Tire Co. v. Bajorski, 635 A.2d 771 (Conn. 1993); Kelly-Springfield Tire Company v. Commissioner, Docket Nos. 62451-162455, Mass. App. Tax Bd. (1993); and Pomco Graphics v. Director, Division of Taxation, N.J. Tax Ct., Docket No. 04-16-1526-89-CB (1993) have all held that qualification to do business in a state does not remove the taxpayer from the protections of Public Law 86-272. The MTC Guidelines discussed below have also adopted this approach. However, corporations may still be subject to state taxes based on net worth or fixed dollar minimum taxes.

It does not apply to service companies. Thus, service businesses such as trucking and other transportation companies, pipelines, newspapers, broadcasting companies, communication companies and insurance companies are not governed by its limitations. See Pomco Graphics, supra (commercial printer engaged in sale of tangible personal property not the provision of services).

Public Law 86-272 does not generally apply to foreign commerce unless so extended by state administrative decision. Note also that corporations are not the only ones protected by Public Law 86-272. The statute itself refers to “any person.” The facts of at least two cases bear out that out-of-state sole proprietors (and presumably partnerships) are protected. See, e.g., John K. Sjong v. Alaska Department of Revenue, 622 P.2d 967 (Alaska 1981) and Mitchell Sorkin, NYS Advisory Opinion, TSB-A-91(1)I (1991).

Public Law 86-272 only applies to net income taxes. Other taxes such as the Michigan single business tax, Indiana gross income tax and taxes based on net worth are not covered.

There are a number of key questions unanswered by the statutory language: (1) what activities are included within the term “solicitation?”; (2) what activities are included within the term “delivery?”; (3) what is an independent contractor? For years, taxpayers were left to fend for themselves on a state-by-state, court-by-court basis.

B. State Cases Interpreting

Even though Public Law 86-272 is a federal statute, federal courts generally lack jurisdiction to hear cases involving its application by virtue of the federal Anti-Tax Injunction Act. As a result, prior to the Wrigley
case discussed below, the statute was construed and applied almost exclusively in state courts.

Some state courts interpreted solicitation broadly allowing a number of acts which were incidental to the act of asking a customer to purchase a product to be performed instate without creating taxable nexus. Some of these cases interpret solicitation to include those acts which customarily lead to the placing of orders as opposed to those acts which follow as a natural result of the order. More liberal cases overlook the pre-sale/post-sale distinction and focus on whether the activities performed instate are incidental to the sale.

Cases Interpreting Solicitation Broadly:

Coors Porcelain Co. v. State of Colorado, 517 P.2d 838 (Colo. 1973) (taxpayer not allowed to apportion income out of Colorado even though field representatives maintained offices out-of-state and made deliveries)

Muro Pharmaceutical, Inc. v. Crystal, No. 524693 (Conn. Super. Ct. 1994) (indirect solicitation activities (“detailing”) by pharmaceutical company representatives who call upon physicians to ask them to prescribe their products ancillary to solicitation)

Indiana Department of Revenue v. Kimberly-Clark Corp., 416 N.E.2d 1264 (Ind. 1981) (directing displays, shipping coordination, pricing products, coordinating deliveries, checking inventories did not exceed solicitation)

West Publishing Co. v. Indiana Department of Revenue, 524 N.E.2d 1329 (Ind. Tax Ct. 1988) (infrequent acceptance of deposit checks and collecting of past due accounts de minimis and did not exceed solicitation)

A.W. Chesterton Co. v. Commissioner of Revenue, 91-P-764 (Mass. App. Ct. 1994) (activities such as handling customer complaints, providing customer and distributor training ancillary to solicitation; perhaps, only approving orders would exceed protections)

CIBA Pharmaceutical Products, Inc. v. State Tax Commission, 382 S.W.2d 645 (Mo. 1964) (company owned automobile, periodic instate sales meetings and handing out of samples and brochures did not exceed solicitation)

Gillette Co. v. State Tax Commission, 393 N.Y.S.2d 186 (1977) (advice in the displaying of goods did not exceed solicitation)


U.S. Tobacco Co. v. Pennsylvania, 386 A.2d 471, cert. denied, 439 U.S. 880 (1978) (company car, checking of inventory, setting up displays, disbursing of free samples and occasional sale of samples did not exceed solicitation)

John Ownby Co. v. Butler, 365 S.W.2d 33 (Tenn. 1963) (taxpayer not allowed to apportion income even though taxpayer had inventory in public warehouses and with agents out-of-state)

State Court Decisions Interpreting Solicitation Narrowly

Hervey v. AMF Beaird, Inc., 464 S.W.2d 557 (Ark. 1971) (presence of consigned inventory, checking of inventory and accepting of payments exceeded solicitation)

U.S. Tobacco Co. v. Martin, 801 S.W.2d 256 (Ark. 1990) (presence of inventory instate from which retailers’ supplies replenished exceeded solicitation)


In the Matter of Raymond E. Campbell & Associates, Ltd., Iowa St. Tax Rptr. (CCH) Para. 200-483 (Iowa Dept. Rev. 1988) (training seminars, review of design and construction problems and resolving of customer complaints exceeded solicitation)

protected by Public Law 86-272 therefore solicitation sufficient to create nexus)


_Drackett Products Co. v. Conrad_, 370 N.W.2d 723 (N.D. 1985) (replacing damaged merchandise, checking product inventory, pricing items, tracing late shipments, selling displays and monitoring product shelf placement exceeded solicitation)

_National Tires, Inc. v. Lindley_, 426 N.E.2d 73 (Ohio App. Ct. 1980) (reviewing inventories, replacing old inventories, insuring credit, negotiating sales prices and setting up displays exceeded solicitation)

As noted above, the renting of a showroom in a state is generally sufficient to create nexus. As noted by the New York Tax Appeals Tribunal: "In our view, leasing real property in the State, no matter how necessary for the corporation to conduct its solicitation, is an act that is so qualitatively different from solicitation that it cannot be considered merely an aspect of solicitation . . ." _Hugo Bosca Company, Inc.,_ New York Division of Tax Appeals, No. 803558 (1990). See also _In re: Appeal of Hauserman, Inc.,_ Calif. St. Bd. of Equal., No. 93-SBE-103 (1993). Note the MTC Guidelines discussed below would allow rental of showroom in a state for a period not to exceed two weeks without the activity exceeding solicitation.

**Delivery**

Another issue arising from Public Law 86-272 which has not currently received the attention that the scope of solicitation has is the scope of delivery. This issue was addressed in a limited fashion by the U.S. Supreme Court in _Heublein, Inc. v. South Carolina Tax Commission_, 409 U.S. 275 (1972), in which the Court held that delivery of goods to a taxpayer's instate representatives who in turn delivered the product to the taxpayer's customers was taxable. Since this case dealt with the sale of alcoholic beverages which the state could regulate the manner in which products were sold instate, its application appears limited.

In _Olympia Brewing Co. v. Dept. of Revenue_, 516 P.2d 837 (Ore. 1973), _cert. denied_, 415 U.S. 976 (1974), the delivery of goods in containers that were required to remain in the state because of their nature was held to exceed the protections of Public Law 86-272. Also, in _Chattanooga Glass Co. v. Strickland_, 261 S.E.2d 599 (Ga. 1979), the presence of the taxpayer's containers which were used to collect raw materials purchased
in the state were held to exceed the protections of Public Law 86-272. Two decisions discussed above involving the taxpayer’s right to apportion income Coors Porcelain Co. and John Ownby Co. have been criticized as they held that delivery of goods by the taxpayer’s instate representatives did not exceed solicitation.

The MTC has now addressed this issue and there are several state administrative pronouncements which are discussed below.

**Local Taxes**

Also, it is important to note that Public Law 86-272 only applies by its terms to state taxation and not to local taxation. In Philip Morris, Inc. v. Department of Revenue, 11 Ore. Tax Ct. Reports 332 (1990), the Oregon Tax Court held that because the taxpayer had inventory within the state even though not within the locality imposing a local income tax, the taxpayer nevertheless was taxable within the locality due to activities of a sales representative whose activities otherwise did not exceed Public Law 86-272. New York City has issued a similar ruling. New York City Tax Rules, Title 19, Section 11-04(d)(11).

However, at least one court has extended the Commerce Clause’s protections to local commerce notwithstanding an explicit reference to interstate commerce in the Clause. In General Motors Corp. v. City of Los Angeles, No. B073381 (Cal. Ct. App., 2d App. Dist., Div. Four, June 26, 1995), the Los Angeles business tax was held to discriminate on its face and failed the internal consistency Commerce Clause test. Los Angeles imposes an unallocated tax on the gross receipts of an in-city manufacturer (manufacturing tax) and on the in-city receipts of manufacturers located outside the city (selling tax). Under this scheme, goods manufactured and sold within Los Angeles are not subject to the selling tax, but an out-of-city manufacturer who sells into Los Angeles is subject to the selling tax. The court held that this discriminated against interstate commerce since manufacturers selling in Los Angeles are treated differently depending on where the goods were manufactured. Further the court held the unapportioned tax on Los Angeles manufacturers unconstitutional since it could result in multiple taxation.

**Franchise, Net Worth and Minimum Taxes**

Since Public Law 86-272 only applies to net income taxes, the question also arises as to whether a tax is a net income tax. As noted above, in Gillette Company, the Michigan Court of Appeals held that the Michigan Single Business Tax was not a net income tax to which Public Law 86-272 applied despite an earlier administrative ruling to the contrary. Note that
Public Law 86-272 also does not apply to capital or net worth taxes so the protections may extend to the net income component of the dual taxes imposed by Texas and Ohio, but not to the net worth components. Note that the protections would not apply to other taxes such as the Indiana gross income tax. Also, the protections may not apply to minimum taxes or flat taxes (witness New Jersey’s imposition of its $50 minimum tax on corporations which only solicit sales instate, *New Jersey Div. of Taxation, 24 N.J. State Tax News 3, Summer 1995*).

Apparently, a taxpayer may be preparing to challenge the Pennsylvania Supreme Court’s decision in *Clairol, Inc. v. Commonwealth, 518 A.2d 1165* (Pa. 1986) which held that an out-of-state corporation was subject to franchise tax even though its instate activities did not exceed solicitation. The taxpayer will argue that Public Law 86-272 applies to the franchise tax since net income is a major component in computing capital stock value under the fixed formula. Similar challenges apparently are also apparently underway in Texas where the taxpayer has lost at the administrative law judge level. *See Comptroller Decisions No. 31,578, 32,016, 32,017 and 32,018.*

**Independent Contractors**

A final question under Public Law 86-272 is what is the distinction between employees/agents whose maintenance of an instate office and accepting of orders in a state would be sufficient to create taxable presence and independent contractors who could engage in these activities in a state without a finding of taxable nexus. Public Law 86-272 defines an independent contractor as a “commission agent, broker, or other independent contractor who is engaged in the selling, or soliciting of orders for the sale of, tangible personal property for more than one principal and who holds himself out as such in the regular course of this business activities.” However, a representative is defined as not being an independent contractor. Due to this circular definition, the courts have been forced to turn to local case law when faced with this definitional issue.

A reading of case law demonstrates that the key distinction between an independent contractor and a representative is that the taxpayer maintains control over its representatives but not over independent contractors. Thus, in *Herff Jones Co. v. State Tax Comission, 430 P.2d 998* (Ore. 1967), the court held that the agents were not independent contractors, relying on the fact that the agents had to post a fidelity bond and carry auto insurance while the taxpayer controlled the agents’ sales territories, approved hiring and firing and supplied order blanks, sample cases and advertising materials.
Similarly, in *Tonka Corp. v. Commissioner of Taxation*, 169 N.W.2d 589 (Minn. 1969), the court affirmed a lower court’s finding that the taxpayer’s agents were not independent contractors. The pertinent facts: the agents were paid a commission; the agents had exclusive territory and could not sell competing products; all of the orders were sent to the home office for approval; the taxpayer maintained an office for the agents; and the agents assisted in collection and shipments, handled defective merchandise, maintained product displays and helped with advertising.

C. Federal Cases Interpreting Public Law 86-272

The U.S. Supreme Court finally had an opportunity to reach the issue of what activities could be conducted in a state without exceeding the protections afforded by Public Law 86-272 in *Wisconsin Dept. of Revenue v. William Wrigley, Jr., Co.*, 112 S.Ct. 2447 (1992). Wrigley sold chewing gum in Wisconsin through a resident sales force. The instate activities included:

- the supplying of gum to retailers through agency stock checks (the agent supplied the retailer with gum and sent them a bill for the gum later);
- the storage of gum, display racks and promotional materials in Wisconsin;
- the rental of space for the storage of these items
- provision of free display racks for gum which were filled with gum, sometimes from the representatives’ supplies
- the replacement of stale gum by the representative
- the regional manager’s recruitment, training and evaluation of employees; and
- the regional manager’s intervention in particularly sensitive credit disputes.

Wrigley argued for a broad definition of solicitation which would look to the type of business involved and how sales were typically obtained by such businesses and for the adoption of a de minimis standard which would overlook certain minor non-solicitation activities. The state argued for a narrow interpretation of solicitation which would include only pre-sale activities strictly essential to making requests for sales.

The Court rejected both tests and instead drew its line between those activities which were entirely ancillary to requests for purchases (those which served no independent business function apart from their connection to the soliciting of orders) and those activities which the company would have engaged in anyway but chose to allocate to its instate sales force. The Court clearly noted that it was not enough that the activity facilitate sales --
it must facilitate the requesting of sales. The Court also concluded that a
de minimis rule did exist and would apply if the activities in the aggregate
did not establish a "nontrivial additional connection with the taxing State."

The Court held that Wrigley was taxable due to the replacing of stale gum,
the supplying of gum through the agency stock checks and the storage of
such gum in the state. The instate recruitment, training and evaluation of
sales representatives and the use of hotels and homes for sales meetings,
the furnishing of display racks and the intervention in certain credit disputes
were ancillary to solicitation.

Although Wrigley provided more guidance to taxpayers than had
heretofore existed, the standards for both solicitation and de minimis
activities still remain somewhat nebulous. As the states continue to
narrowly interpret the Wrigley decision and Public Law 86-272, taxpayers
should take steps to insure that their activities are entirely ancillary to
requests for orders.

D. Multistate Tax Commission Interpretations of Public Law 86-272

Originally adopted by the signatory states in 1986, the Multistate Tax
Commission's Statement of Information Concerning Practices of the
Multistate Tax Commission and Signatory States Under Public Law 86-
272 lists certain activities that the member states will treat as "immune"
(not creating taxable nexus) and "nonimmune" (creating taxable nexus). The MTC is an organization of approximately 20 states whose purpose is
to promote uniformity of state tax laws.

The Statement was amended after the Wrigley case was decided. After
three public hearings, the so-called Phase I Statement was adopted by 22
states plus the District of Columbia (Alabama, Arkansas, California,
Colorado, Connecticut, District of Columbia, Florida, Hawaii, Idaho,
Illinois, Kansas, Louisiana, Maine, Missouri, Montana, New Jersey, New
Mexico, North Dakota, Oregon, South Dakota, Tennessee, Texas and
Utah). New York, South Carolina and Wisconsin adopted similar versions
of the Statement. The Statement is a good indicator of how states will
interpret "solicitation" in future years.

The Statement indicated that the policy of its member states would be to
impose their net income taxes to the "fullest extent constitutionally
permissible." The Statement makes it clear that Public Law 86-272 only
applies to the sale of tangible personal property. The leasing, renting,
licensing or other disposition of tangible personal property, the sale of
intangible personal property or any other type of property is not covered by
Public Law 86-272.
The Statement defines "solicitation of orders" as speech or conduct that explicitly or implicitly invites an order or activities that neither explicitly or implicitly invite an order, but are entirely ancillary to requests for an order. Ancillary activities are defined as those which "serve no independent business function for the seller apart from their connection to the solicitation of orders." Activities that seek to promote sales rather than orders for sales are not immune.

The Statement, following the Wrigley decision, adopts a de minimis standard. The term "de minimis" is defined as those activities that "when taken together, establish only a trivial additional connection with the taxing State." Any activity conducted on a regular or frequent basis or according to company policy will not normally be considered to be trivial. The term "de minimis," according to the Statement, should be measured on both a qualitative and quantitative basis. The Statement establishes that the fact that the tainted activities only account for a small portion of the business conducted in the taxing state is not determinative of whether a de minimis level of activity exists.

According to the Statement, the following instate activities are considered to exceed solicitation:

- making repairs or providing maintenance
- collecting current or delinquent accounts
- investigating credit worthiness
- installation or supervision of installation
- conducting training courses other than for personnel involved only in solicitation
- providing technical assistance if the purpose is other than the facilitation of orders
- assisting in resolving customer complaints other than for the purpose of ingratiating the sales personnel with the customer
- approving or accepting orders
- repossessing property
- securing deposits on sales
- picking up or replacing damaged or returned property
- hiring, training or supervising personnel, other than personnel involved only in solicitation
- providing shipping information and coordinating deliveries
- maintaining a sample or display room in excess of two weeks
- carrying samples for sale or distribution for value
- owning, leasing or maintaining facilities or property instate such as offices, warehouses, stock of goods, or a telephone answering service
that is formally attributed to the company or its agents in their agency capacity (i.e., listed in a telephone directory under the company name)

- consigning tangible personal property to any person
- maintaining an office or place of business, in home or otherwise that is paid for directly or indirectly by the company and that is formally attributed to the company or to the agent in their agency capacity even if used solely for solicitation
- agency stock checks
- conducting any other nonimmune activities not entirely ancillary to orders

The following activities were listed in the Statement as being immune activities:

- soliciting orders for sales by any type of advertising
- carrying samples for display or distribution without charge
- owning or furnishing autos to sales personnel
- passing inquiries and complaints on to the home office
- missionary sales activities
- checking customers’ inventories without a charge for re-order but not for other purposes such as quality control
- maintaining a sample room for less than two weeks
- recruitment, training or evaluation of sales personnel, including occasional use of homes, hotels or similar places for meetings with sales personnel
- maintaining by any sales employee an in-home office paid directly or indirectly by the company that is not attributed to the company or to the company’s agents in their agency capacity
- mediating direct customer complaints when the purpose thereof is solely for ingratiating the sales personnel with the customer and facilitating requests for orders

The Statement also discusses independent contractors whose activities are afforded greater immunity. However, the maintenance of inventory by an independent contractor under consignment or otherwise (except for purposes of display and solicitation) will cause a taxpayer to lose immunity.

After further study and public hearings, the Statement was further revised with the following issues reconsidered:

- In-home Office: a limited home office exemption exists to the extent the company does not publicly hold itself out as having an instate office and limits its use of the office to those activities permitted under Public Law 86-272. Note that a telephone or other public listing within the state would be considered a public representation not permitted;
whereas the normal distribution of business cards and stationery identifying the employee's name and address, etc. would not be considered a public representation. The Statement makes it clear that it does not matter whether the company directly or indirectly pays for the cost of maintaining the home office.

- Business Equipment: the use of cellular telephones, facsimile machines, personal computers, automobiles, etc. solely in conducting immune activities will be considered immune.
- Delivery in Company Owned Trucks: the Statement recommends that the delivery of goods by other than the U.S. mail or common carrier not qualify for immunity. However, two other alternatives were provided: all deliveries treated as exempt or deliveries by private carrier for which a separate fee not charged treated as exempt. Massachusetts, Florida, Virginia and Delaware had previously adopted similar rules. In Massachusetts, the DOR has established a de minimis rule that a company whose only connection with the state is making no more than 12 pickups, deliveries or trips through Massachusetts during the year does not have nexus.
- Qualification to do Business Instate: the Statement recommends that this not remove the protection of Public Law 86-272 (see earlier discussion).
- Part of Tax Year to Which Immunity Attaches: the Statement recommends that if immunity is lost for any part of the tax year, immunity is lost for the entire tax year.
- Other Practices: Public Law 86-272 should apply to foreign commerce; account collection directly or through third parties is a nonimmune activity; Public Law 86-272 does not apply to service providers; and providing shipping information and delivery information without consideration is an immune activity.

As of July 14, 1995, 14 states have adopted these revised recommendations: Alabama, Arizona, Arkansas, California, Colorado, Hawaii, Idaho, Louisiana, Montana, New Jersey, New Mexico, North Dakota, Oregon and Rhode Island (Oregon and Rhode Island did not adopt the delivery rules). Maine, Maryland and Minnesota have indicated that they will not adopt the statement. Texas is in the process of adopting similar versions of the statement.

IV. Virginia Rulings Concerning Nexus

A. Corporate Income Tax

Virginia imposes its corporate net income tax on every corporation organized under Virginia law and every foreign corporation having income from Virginia sources. Va. Code Section 58.1-400.
Income from Virginia sources is defined as “items of income, gain, loss and deduction attributable to the ownership, sale, exchange or other disposition of any interest in real or tangible personal property in Virginia or attributable to a business, trade, profession or occupation carried on in Virginia or attributable to intangible personal property employed in a business, trade, profession or occupation carried on in Virginia.” Va. Reg. Section 630-3-302.

A foreign corporation whose only connection to Virginia is the receipt of interest on notes secured by deeds of trust on property located in Virginia will have no payroll or property in Virginia. It will also have no receipts in Virginia as no income producing activities occurred in Virginia. Therefore, no Virginia return is required to be filed.

Regulations

Virginia has adopted in regulations the provisions of U.S. Public Law 86-272. Va. Reg. Section 630-3-401.G. provides that:

Virginia is prohibited by federal law from imposing a net income tax on certain foreign corporations which have income clearly derived from Virginia sources but have insufficient activity in Virginia. However, any additional business activities in Virginia which exceed the limitation of federal law may subject the corporation to the imposition of Virginia income tax on all of its income from Virginia sources. Whether or not additional activities are sufficient to subject a foreign corporation to the taxing jurisdiction of Virginia is determined by the facts of each case. Consideration is given to the nature, continuity, frequency and regularity of the activities in Virginia, compared with the [same] elsewhere.

Proposed Regulations

The latest informal draft of proposed regulations provide more detailed guidance regarding Virginia’s rules for determining nexus and application of Public Law 86-272. Va. Prop. Reg. Section 630-3-400.2.A. provides that a tax is imposed on the Virginia taxable income of every domestic corporation and of every foreign corporation having income from Virginia sources.

A foreign corporation with income from Virginia sources is taxable unless its activities in Virginia are limited to solicitation or are de minimis. Registration of a foreign corporation requires such corporation to file a
return even though it may still have zero apportionment factors (i.e., registration does not remove the protections of Public Law 86-272).

A domestic corporation is subject to tax whether or not such corporation has income from Virginia sources and cannot be protected by Public Law 86-272. Although subject to tax, the corporation may still owe no tax if it does not have positive apportionment factors.

**Proposed Regulations — Income from Virginia Sources**

The informal draft of proposed Va. Reg. Section 630-3-302.1 provides further guidance with respect to when a foreign corporation is taxable in Virginia. The regulation provides that “a foreign corporation shall be deemed to have income from Virginia sources if there is sufficient business activity within Virginia to make any of the apportionment factors . . . positive.” Further examples of income from Virginia sources include:

- income associated with Virginia real property
- income associated with inventory for sale or distribution which is maintained in Virginia
- owning or leasing of Virginia tangible personal property (for any portion of the tax year)
- carrying on of a business within Virginia

In this regard, the proposed regulations clearly note that “the presence or absence of physical activity within Virginia is not determinative; an economic presence within Virginia is adequate to create income from Virginia sources.” The regulation provides as an example of an activity creating income from Virginia sources as “exploitation of markets within Virginia.”

There are several instate activities which according to the proposed regulations will not, by themselves, create income from Virginia sources:

- purchasing tangible personal property from a Virginia supplier where the property is shipped outside of Virginia
- leasing property from a Virginia lessor if the property has a non-Virginia situs
- acquiring services from a Virginia service provider where the services are rendered outside of Virginia
- consigning tangible personal property for repairs in Virginia if the property is used outside of Virginia
- receiving interest on notes, bonds, etc. secured by Virginia property
The draft regulations also provide additional guidance on when intangible property creates taxable presence with Virginia. The rules provide that "income from intangible personal property . . . is income from Virginia sources if such property is used in Virginia." Example 2 explicitly provides that an out-of-state corporation which owns tradenames and trademarks which are licensed for use in Virginia is taxable in Virginia. This appears to adopt a Geoffrey argument.

Proposed Regulations -- Financial Corporations

State and national banks, banking associations and trust companies are exempt from income tax to the extent they are subject to the bank franchise tax. Whether or not a foreign bank is subject to the bank franchise tax depends on the bank’s activities in Virginia. Many foreign banks without branches instate may instead be subject to income tax. An out-of-state financial corporation which limits its Virginia activities to the solicitation, acquisition, and collection of loans by mail or electronic communications is not taxable (instate collection in person would render the corporation taxable unless it is de minimis). Holding property via foreclosure or other means and leasing property which is used in Virginia will create nexus (unless the lessor has no knowledge that the property is or will be used in Virginia or such use is de minimis).

Proposed Regulations -- Public Law 86-272 General

With respect to Public Law 86-272, Virginia generally adopts the federal statutory language. However, Virginia adds that “the orders [must be] filled by shipment or delivery by common carrier or contract carrier from a point outside of Virginia.” The regulation notes that Virginia narrowly interprets Public Law 86-272.

The rule revises Virginia’s long standing application of Public Law 86-272 to services, noting specifically that “solicitation of orders for anything other than tangible personal property is not protected activity.” Mixed property/service transactions such as photographic development, fabrication of a customer’s materials, installation of equipment and provision of architectural or engineering services; the sale, lease, rental or license of real or intangible personal property; and the lease of tangible personal property are not covered by Public Law 86-272.
Proposed Regulations -- Public Law 86-272 Immune and Nonimmune Activities

The same general definition as contained in the MTC Statement is adopted for solicitation and activities ancillary to solicitation. Immune activities include those enumerated in the MTC Statement above plus:

- furnishing free display racks of de minimis value; advising on display of the corporation's products; or qualifying to do business in Virginia
- maintaining bank or brokerage accounts in Virginia
- ownership of property in transit through Virginia in possession of a common or contract carrier
- occasionally storing property in a licensed public warehouse in Virginia (unless deliveries are made to customers from such warehouses)
- having property in the custody of an independent contractor who is to repair the property, to perform a step in the manufacturing process or scrap or dispose of the property

Nonimmune activities are generally similar with the following exceptions. The provision of technical services does not contain the exception for assistance if the sole purpose is the facilitation of orders for sales. Additional activities creating nexus include:

- holding meetings of directors, officers or employees
- supervising the operations of a franchisee
- providing display racks if ownership of the racks is not transferred to the customer and the value of the racks is not de minimis
- using a corporation's own vehicles to deliver property unless de minimis (12 or fewer contacts)

The rules contain similar language regarding de minimis provisions and independent contractors. Note that the regulation states that "a foreign corporation will not be subject to tax merely because one or more independent contractors whose activities on behalf of such foreign corporation consist solely of making sales of, or soliciting orders for, tangible personal property, maintains an office in Virginia."

Commissioner's Decisions

Intangible Property. A taxpayer that offered customers access to third-party computer data bases over long distance telephone lines is subject to income tax on account of income attributable to intangible personal property used in a business carried on in Virginia. Ruling of Commissioner, P.D. 94-181 (June 13, 1994). However, the company may be protected from Virginia taxation if the only instate activity is the
solicitation of sales under U.S. Public Law 86-272. Although the federal statute does not apply to protect the solicitation of sales of telecommunications services, the Department noted that its historical policy has been to apply these standards to solicitation of other than tangible property. [Note that the proposed regulation would alter this conclusion.]

**Property.** An out-of-state corporation whose only contact with Virginia was the presence of a corporate aircraft for a period in excess of 60 days was subject to the corporate income tax as the corporation had property in Virginia. It is irrelevant whether the corporation earned any income from the presence of the aircraft instate or did any other instate business. Ruling of Commissioner, P.D. 91-2 (January 11, 1991).

**Property.** An out-of-state corporation did not have sufficient activities in Virginia to subject it to Virginia income tax since its only property in Virginia was imported tobacco which was being held in bonded storage by the United States Customs Service. The tobacco was under the control of the Customs Service and was not processed or handled in any way by the taxpayer. Ruling of Commissioner (July 1, 1983).

**Property.** Storage of manufactured product instate sufficient to create Virginia nexus. Ruling of Commissioner, P.D. 92-125 (July 17, 1992).

**Property.** An out-of-state corporation which leased five aircraft to commercial airlines which fly in and out of Virginia had nexus with Virginia but probably no positive Virginia apportionment factor. Ruling of Commissioner, P.D. 94-291 (September 26, 1994).

**Agency.** DISC income which is commingled with the income of a Virginia based corporation is taxable to that corporation even if the DISC has no nexus with Virginia. Ruling of Commissioner (February 17, 1984). An instate corporation which is the agent of an out-of-state corporation can create nexus for the out-of-state corporation through this agency. *Commonwealth of Virginia v. General Electric Company*, 372 S.E.2d 599 (1988).

**Solicitation.** An out-of-state manufacturing corporation is subject to Virginia income taxation because: perishable products carried by the salesmen to replace out-of-date products on a retailer's display constituted inventory, rather than sales samples, the sales persons were engaged in quality control and management responsibilities and they supplied display stands to retailers. [Note that the last item may be protected under *Wrigley.*] Ruling of Commissioner, P.D. 88-146 (June 20, 1988).
Solicitation. An out-of-state corporation which had instate district managers which solicited sales of tangible personal property and provided technical support and training for its franchisees was subject to Virginia income taxation. Ruling of Commissioner, P.D. 92-64 (May 4, 1992).

Solicitation. Handling of customer complaints sufficient to create Virginia nexus (but see MTC guidelines). Orders subject to home office credit check requirement but not home office approval by themselves not sufficient to create Virginia nexus. Ruling of Commissioner, P.D. 92-150 (August 24, 1992).

Solicitation. Installation, testing and training with respect to computer hardware and software created nexus in Virginia for an out-of-state corporation. Ruling of Commissioner, P.D. 93-75 (March 17, 1993). The ruling notes that Virginia extends protection of Public Law 86-272 to sale of intangible property as well as tangible personal property [apparently overturned by the proposed regulation].

Solicitation. Provision of technical assistance in installation and maintenance sufficient to establish corporate income tax nexus. Ruling of Commissioner (October 8, 1982).

Solicitation. Corporation whose field representatives visited Virginia once or twice a year did not have sufficient nexus for corporate income tax purposes. Ruling of Commissioner (December 20, 1982).

Solicitation. The presence of instate salespersons who advise customers on advertising and display methods, unpack merchandise and place it on shelves, inspect inventory levels, and recommend new dealers did not create nexus as such activities were ancillary to solicitation. However, the inspection of damaged merchandise and investigation of how the merchandise was damaged were not protected activities. The provision of display racks at no cost to retailers could be ancillary to solicitation. However, elaborate displays owned by the taxpayer would generally constitute property in Virginia. Ruling of Commissioner, P.D. 94-111 (April 14, 1994).

Service Companies. An out-of-state corporation which provided operator assistance and direct-dial services outside of Virginia had income from Virginia sources even though it did not direct bill any customer in Virginia or have any Virginia accounts receivable. However, the taxpayer probably did not have positive apportionment factors. The ruling also notes that Virginia applies Public Law 86-272 to the sale of services and intangible property. Ruling of Commissioner, P.D. 94-310 (October 11, 1994).

Delivery. An out-of-state corporation whose only contact with Virginia was the delivery of tangible personal property in its own vehicles was subject to Virginia income taxation. The operation of the taxpayer’s trucks in Virginia, in the Department’s view, clearly exceeded solicitation. Ruling of Commissioner, P.D. 92-230 (November 9, 1992). The policy underlying this ruling apparently is the subject of litigation in National Private Truck Council, Inc. v. Payne. See also Ruling of Commissioner, P.D. 93-59 (March 11, 1993) (same ruling with respect to leased vehicles); and Ruling of Commissioner, P.D. 94-132 (April 26, 1994) (deliveries to single Virginia customer sufficient to create nexus).

Independent Contractor. An out-of-state corporation who was the sole employer of certain instate contractors was taxable in Virginia because they were regarded as agents. To be treated as independent contractors, the contractors must represent more than one principal. Ruling of Commissioner, P.D. 94-113 (April 14, 1994).

B. Income Tax Nexus -- Ownership of Partnership Interests

Virginia requires the pass through of income or loss from both general and limited partnerships to their corporate and individual general and limited partners. See Ruling of Commissioner, P.D. 88-165 (June 29, 1988). Therefore, ownership of an interest in either a general or limited partnership which is conducting a trade or business in Virginia will subject the general or limited partner to Virginia taxation.

Va. Reg. Section 630-3-409.A.2.b. provides that “each item of partnership property shall have the same character for a corporate general partner as if direct corporate ownership of the property existed.” Thus pass-through of the partnership property factors is required for general partners. Further, in Ruling of Commissioner, P.D. 88-226 (July 29, 1988), pass-through of the sales and payroll factors was also required for general partners.

In Ruling of Commissioner, P.D. 88-172 (June 29, 1988) and Ruling of Commissioner, P.D. 88-235 (August 10, 1988), pass-through of the factors to a limited partner was not allowed. There was no mention in either ruling of the percentage interest the corporate limited partner held in the limited partnership.
In Ruling of Commissioner, P.D. 92-60 (May 1, 1992), a corporation held both a general and limited partnership interest in a partnership. The Department ruled that the general partnership interest controlled and that full pass-through of the partnership's factors was allowed. Note that if the partner was acting as a general partner then the limited partnership interest, in effect, should have been treated as a general partnership interest.

In Ruling of Commissioner, P.D. 92-219 (October 30, 1992), the Department did not allow pass through of factors to a limited partner who owned a 15% interest in a limited partnership.

In Ruling of Commissioner, P.D. 95-19 (February 13, 1995), the Department was confronted with a situation where one related party was a 99% limited partner and another a 1% general partner. The Department ruled that it would not allow 99% of the partnership's income to escape Virginia taxation. Therefore, its earlier ruling was modified. The Department arbitrarily issued guidance, pending issuance of regulations, as to when flow-through of a limited partner's factors would not be required: (1) the general partners are unrelated parties; (2) the limited partnership interest held by the taxpayer and all related parties did not exceed 10% of the profits and capital interests of the partnership and (3) the structure of the partnership was not primarily a device to avoid Virginia taxation of the partnership's income.

The informal draft of the proposed regulations state that when a foreign corporation is a general or limited partner in a partnership and the partnership has income from Virginia sources, the partnership's activities will be imputed proportionally to the partners. Draft Va. Reg. Section 630-3-400.D.

Nonresident individual limited partners are subject to tax on the limited partnership's income allocated and apportioned to Virginia if the partnership conducts a trade or business in Virginia. See, e.g., Ruling of Commissioner, P.D. 91-51 (March 28, 1991) and Ruling of Commissioner, P.D. 88-232 (July 29, 1988). In Ruling of Commissioner, P.D. 94-275 (September 16, 1994), limited partners in a "hedge fund" based in Virginia with no property or payroll in Virginia were not viewed to be conducting an active business so no flow-through of income created.

In Ruling of Commissioner, P.D. 94-240 (August 5, 1994), the Department ruled that an S corporation which was a limited partner in a Louisiana manufacturing partnership could flow-through factors to prevent a non-Virginia shareholder in the S corporation from being taxed on 100% of the income from the limited partnership in Virginia without a credit for taxes paid Louisiana being granted.
C. Income Tax Nexus — Ability to Apportion

The same nexus rules used to determine when an out-of-state corporation has to file Virginia income tax returns and pay Virginia tax also apply in determining when Virginia corporations may allocate and apportion their income out of Virginia and thus not pay tax on 100% of their income to Virginia. Under Va. Code Section 58.1-406 a corporation “having income from business activity which is taxable both within and without the Commonwealth shall allocate and apportion its Virginia taxable income.”

The regulations further provide that a corporation “is presumed to be doing business entirely within Virginia unless it is subject to one of the following taxes in another state: a tax imposed on net income; or a franchise tax measured by net income; or a franchise tax for the privilege of doing business.” The term state includes foreign countries. A corporation is subject to one of these taxes if its activities in the state are sufficient to allow the state to impose such a tax whether or not the state actually imposes such a tax. Public Law 86-272 standards are applied (including to foreign countries). Treaty provisions are not considered. See also Ruling of Commissioner (April 5, 1983) (taxpayer had nexus in foreign countries where employees regularly picked up damaged merchandise, inspected inventories, collected delinquent payments, established customer credit terms, arranged local advertising and provided consulting services; no nexus where these services performed infrequently (once a year)).

If a consolidated return is filed the ability to apportion is determined on a consolidated basis. Therefore, if one member of the group is taxable outside of Virginia all members may apportion their income. See Ruling of Commissioner, P.D. 91-293 (November 19, 1991).

A corporation incorporated in Virginia which had no business activities other than ownership of interest in limited partnerships doing business entirely within Virginia not required to apportion loss as corporation was not taxable outside of Virginia. Ruling of Commissioner, P.D. 93-245 (December 28, 1993).

D. Income Tax Nexus — Filing of Consolidated Returns

Virginia regulations provide that:

Every corporation organized under the laws of Virginia and every foreign corporation registered with the State Corporation Commission for the privilege of doing business in Virginia shall file a return with the Department of Taxation under this section. A
return must be filed even if the corporation has no income from Virginia sources and no Virginia income tax is due. Va. Reg. Section 630-3-441.

In the first year two or more members of an affiliated group of corporations . . . are required to file Virginia returns, the group may elect to file separate returns, a consolidated return or a combined return. All returns for subsequent years must be filed on the same basis unless permission to change is granted by the Department of Taxation. The group may elect to file on a basis different from its federal income tax return(s).

A consolidated return is a single return for all eligible members of an affiliated group of corporations. Va. Reg. Section 630-3-442.

_Draft Regulations_

The informal draft of the proposed regulations concerning consolidated returns revise and expand upon the above language. Members eligible to join in the filing of a consolidated return are defined as those who are subject to Virginia income tax, are affiliated, have income from Virginia sources, are not exempt from tax and do not have different tax years. The filing of a separate short year Virginia return upon the organization or acquisition of a new member which creates an affiliated group is not deemed the election of separate returns. The filing of the first return for the tax year beginning on or after the date of organization or acquisition is the filing which controls. See Ruling of Commissioner, P.D. 93-65 (March 17, 1993) (filing for first 12 month period controls) and Ruling of Commissioner, P.D. 95-1 (January 4, 1995).

_Draft Va. Reg. Section 630-3-302.1 provides that:

  a foreign corporation shall be deemed to have income from Virginia sources if there is sufficient business activity within Virginia to make any of the apportionment factors . . . positive even though no portion of its gross or net income may be separately identified as being derived directly from Virginia. A foreign corporation is not deemed to have income from Virginia sources merely because such corporation has received a certificate of authority from the State Corporation Commission to transact business in Virginia.

_Commissioner Decisions_

A foreign parent corporation was excluded from a Virginia consolidated return as it was not taxable in Virginia. The president and
secretary/treasurer of the parent made occasional visits to Virginia (approximately 12 over a two-year period). However, the services they performed instate were regarded as incidental to the services performed out-of-state. The parent had no income from Virginia sources (other than dividends) (no management fee was charged). Therefore, consolidated filing was not allowed. Ruling of Commissioner, P.D. 90-181 (October 9, 1990).

An out-of-state corporation was taxable in Virginia as it sold tangible property instate, provided installation and a one-week training program. Additionally, management services were provided instate. Therefore, the filing of a consolidated return was allowed. Ruling of Commissioner, P.D. 91-33 (March 18, 1991).

Wages paid by a parent company for officers of the parent and subsidiary were treated as wages of the parent not the subsidiary. Therefore, the subsidiary did not have a positive Virginia apportionment factor and thus was not eligible to join in the filing of a Virginia consolidated income tax return. There is a strong presumption that total wages reported to Virginia for unemployment compensation purposes represent compensation paid in Virginia by that entity. Since the wages were reported by the parent, the wages could not be attributed to the subsidiary. Ruling of Commissioner, P.D. 93-116 (April 29, 1993). See also Ruling of Commissioner, P.D. 93-222 (November 16, 1993).

The leasing of property to a related company in Virginia was sufficient to create nexus so that a consolidated Virginia income tax return could be filed. Ruling of Commissioner, P.D. 94-175 (June 8, 1994).

Registration in Virginia and the filing of a separate Virginia income tax return without any activity in Virginia by an affiliate of a company operating in Virginia did not preclude the electing of a consolidated return in a later year when both companies had operations in Virginia. Ruling of Commissioner, P.D. 94-368 (December 12, 1994). See also Ruling of Commissioner, P.D. 94-228 (July 25, 1994) (generally, a corporation must have sufficient business activity in Virginia to make one or more of the applicable apportionment factors positive in order to be eligible to join in the filing of a consolidated return), Ruling of Commissioner, P.D. 92-238 (November 16, 1992), Ruling of Commissioner, P.D. 93-90 (March 29, 1993) (nexus in previous and subsequent year and instate solicitation in the current year not sufficient to create positive apportionment factor) and Ruling of Commissioner, P.D. 94-228 (July 25, 1994).

But see Ruling of Commissioner, P.D. 94-175 (July 29, 1994) (subsidary which leased movable tangible personal property to parent in Virginia
which had nexus in Virginia but did not have positive apportionment factors allowed to file combined return with parent); Ruling of Commissioner, P.D. 92-81 (June 1, 1992) (consolidated group denied permission to file separate returns even though one of two companies was inactive in Virginia and had no income from Virginia sources as it was still subject to Virginia tax and required to file a Virginia income tax return); and Ruling of Commissioner, P.D. 92-238 (November 16, 1992) ("Generally, corporations organized under Virginia law and foreign corporations having income from Virginia sources subject to Virginia tax. A corporation will have income from Virginia sources if there is sufficient business activity within Virginia to make any one or more of the applicable apportionment factors positive.").

The acquisition of an affiliated group of companies doing business in Virginia did not enable the taxpayer to elect to file a consolidated Virginia income tax return. The taxpayer was previously affiliated with companies which also filed separate Virginia returns (note that the Virginia definition of affiliation is broader than the federal definition of those corporations allowed to file a consolidated return). Therefore, an election to file on a separate return basis had been made and permission to change was not granted. Ruling of Commissioner, P.D. 94-212 (July 5, 1994). See also Ruling of Commissioner, P.D. 95-10 (January 18, 1995).

Subsidiary had positive apportionment factors in Virginia due to performance of personal service contract by employees of related entity (i.e., created agency relationship) and thus costs of performance in Virginia and could join in the filing of a consolidated return. Ruling of Commissioner, P.D. 93-89 (March 29, 1993).

Corporation which previously filed consolidated in Virginia but started filing separately when only one corporation was doing business in Virginia allowed to elect consolidated filing when another subsidiary doing business in Virginia organized. Ruling of Commissioner, P.D. 93-72 (March 18, 1993). In this regard, the draft regulations state that:

If, after electing consolidated filing the affiliated group is reduced by reason of sale, merger, liquidation, or withdrawal to a single corporation subject to Virginia income tax, the group is no longer eligible to file a consolidated return and must file a separate return. If another member of the group subsequently becomes subject to Virginia income tax the consolidated election remains in effect and a consolidated return will be required unless two or more separate returns have been filed covering a period of at least 24 months. Va. Draft Reg. Section 630-3-442.1.B.7.
E. Sales and Use Tax Nexus

Under Virginia Code Section 58.1-612.C., a person is deemed to have sufficient activity within Virginia to require registration for sales and use tax purposes (and thus presumably nexus for such purposes) if the taxpayer:

- Maintains or has within this Commonwealth, directly or through an agent or subsidiary, an office, warehouse, or place of business of any nature; [note the potential unconstitutionality of the subsidiary provision]
- Solicits business in this Commonwealth by employees, independent contractors, agents or other representatives;
- Advertises in newspapers or other periodicals printed and published within this Commonwealth, on billboards or posters located in this Commonwealth, or though materials distributed in this Commonwealth by means other than the United States mail; [note that the local advertising issue has not been affirmatively decided by the U.S. Supreme Court -- based upon Quill this may not be enough without some sort of physical presence]
- Makes regular deliveries of tangible personal property within this Commonwealth by means other than common carrier. A person shall be deemed to be making regular deliveries hereunder if vehicles other than those operated by a common carrier enter this Commonwealth more than twelve times during a calendar year to deliver goods sold by him;
- Solicits business in this Commonwealth on a continuous, regular, seasonal, or systematic basis by means of advertising that is broadcast or relayed from a transmitter within this Commonwealth or distributed from a location within this Commonwealth [again the constitutionality of this provision may be in doubt following the Quill decision]
- Solicits business in this Commonwealth by mail, if the solicitations are continuous, regular, seasonal, or systematic and if the dealer benefits from any banking, debt collection, or marketing activities occurring in this Commonwealth or benefits from the location in this Commonwealth of authorized installation, servicing, or repair facilities [again doubts would appear to exist regarding the constitutionality of this provision following the Quill decision];
- Is owned or controlled by the same interests which own or control a business located within this Commonwealth [after the California and Ohio decisions discussed above, this provision clearly appears unconstitutional];
- Has a franchisee or licensee operating under the same trade name in this Commonwealth if the franchisee or licensee is required to obtain a certificate of registration under Section 58.1-613 [it would appear that...
the constitutionality of this provision would turn on whether the franchisee or licensee was an agent or alter ego of the out-of-state franchisor or licensor]; or

- Owns tangible personal property that is rented or leased to a consumer in this Commonwealth or offers tangible personal property, on approval, to consumers in this Commonwealth [the second part may be unconstitutional as the state in *Quill* attempted unsuccessfully to raise the issue that a "return if not satisfied within 30 days for a full refund" was a sale on approval].

**Commissioner Decisions**

**Delivery.** A retail furniture dealer located in another state had taxable nexus in Virginia because it registered with the Department of Taxation for collection of use tax on sales made to Virginia customers, it advertised in the Richmond edition of a national newspaper and it hired a contract carrier to deliver the furniture it sold in Virginia. Ruling of the Commissioner, P.D., 93-141 (June 7, 1993). See also Ruling of Commissioner, P.D. 93-240 (December 28, 1993) (furniture dealer taxable due to directed advertising and deliveries); and Ruling of Commissioner, P.D. 90-49 (March 20, 1990) (out-of-state furniture dealer making more than 12 deliveries a year into state taxable).

**Agency.** An out-of-state corporation that hired subcontractors to install tangible personal property in Virginia was required to register for the collection of sales tax if an agency relationship existed with the subcontractors. Ruling of Commissioner, P.D. 94-10 (January 7, 1994). Under Virginia law, two factors are necessary in order for an agency relationship to be established. First, the agent must be subject to the principal's control, with regard to the work to be done and the manner of performing it. Actual control is not the test: it is the right to control that is determinative. Second, the work has to be done on the business of the principal or for his benefit.

**Services.** In Ruling of Commissioner 94-206 (June 29, 1994), the Department addressed the taxation of a transaction whereby a marketing company assisted Virginia distributors in obtaining vending machines by having an affiliate place an order with an unrelated out-of-state manufacturer. The machines were delivered from the manufacturer to the distributor by common carrier and title passed directly from the manufacturer to the distributor. The marketing company collected a flat fee for its services. The marketing company and its affiliate were not required to collect sales and use tax as they were performing a service -- not selling tangible personal property. The manufacturer was not required
to collect sales and use tax unless the marketing company or its affiliate was acting as the manufacturer's agent.

Property. A Delaware corporation which hangered an aircraft in Virginia for over 60 days was subject to the aircraft use tax regardless of whether a Virginia license for the aircraft was obtained. Ruling of Commissioner, P.D. 91-2 (January 11, 1991).

Agents. An out-of-state corporation which made sales through representatives in Virginia is taxable on sales made by such representatives and on subsequent sales made by telephone. Ruling of Commissioner, P.D. 91-286 (November 8, 1991).

Agency. A subscription agency which made periodical purchases for customers which were delivered directly from the publisher to the customer but which were invoiced to the agency who then reinvoiced the customers with a mark-up was subject to sales tax on the marked-up price of the subscriptions. Ruling of Commissioner, P.D. 92-92 (June 5, 1992). The transaction binds the credit of the agency since the publisher bills the agency and depends on it to remit payment -- not the ultimate customer.

Gifts. A Virginia retailer is required to collect sales tax when a nonresident purchaser orders an item by telephone or mail and directs the seller to send the item directly to another out-of-state resident. The transaction is not an exempt sale in interstate commerce since title and constructive possession are transferred to the purchaser in Virginia when, at the direction of, and for the benefit of the purchaser, the Virginia retailer mails the property or delivers it to a common carrier for distribution as a gift to a recipient outside Virginia. Opinion of Attorney General (February 23, 1991).


F. Withholding Tax Nexus

Presence of employees instate performing services rendered out-of-state corporation subject to requirement to withhold Virginia taxes from the employees' wages. Ruling of Commissioner, P.D. 94-208 (July 5, 1994).
G.  **Other Significant Developments**

*Sales and Use Tax Developments*

The Virginia Department of Taxation has ruled that the electronic transfer of information via telephone lines is a nontaxable service under Virginia Regulation Section 630-10-97.1, but the transfer of information via magnetic tape constitutes a transfer of tangible personal property subject to taxation. Ruling of Commissioner, P.D. 95-68 (Mar. 30, 1995). The taxpayer provided parts price updates to motor vehicle dealers either electronically via telephone lines or through magnetic tapes. In distinguishing the two transactions, the Department noted that the regulation states that a taxable transaction occurs when standard information is conveyed via tangible means (e.g., diskette, computer tape, report, etc.).

*Local Taxes*

Cities and counties in Virginia are empowered to enact local taxes on the sale of food and beverages or meals. Va. Code Section 58.1-3841. In an Attorney General’s ruling dated January 12, 1994, the Attorney General addressed the application of the tax when the meal is prepared in a Virginia locality but delivered or consumed outside of Virginia. The opinion states that:

No state statute expressly authorizes a Virginia locality to exempt the type of interstate transaction you describe or to give the seller a credit against the meals tax due in the Virginia locality for a similar tax paid in another state. The commerce clause of the federal constitution, however, generally prohibits a local tax that subjects interstate commerce to the risk of a double or multiple tax burden to which intrastate commerce is not exposed.

The ruling suggests the adoption of the sales tax rules regarding exemption of interstate sales (i.e., no sale in Virginia if neither title nor possession transferred to purchaser in Virginia).

An earlier Attorney General’s ruling also applied the Commerce Clause to the business license tax. See Opinion of the Attorney General, December 1, 1978. However, in *Short Brothers (USA), Inc. v. Arlington County*, Circuit Court of Arlington County, No. 920083, November 6, 1992, the court sanctioned the imposition of an unapportioned tax on a taxpayer headquartered in Arlington County as there was no evidence that any other taxing jurisdiction actually did subject it to a tax based on gross receipts.
The court stated that the taxpayer produced no evidence of physical presence in another jurisdiction sufficient to allow that jurisdiction to impose a tax on the taxpayer (even though it maintained an inventory of spare parts in Pennsylvania).

In *American Woodmark Corp. v. City of Winchester*, Circuit Court of the City of Winchester, No. 93-291, September 21, 1994, the court held that a corporation whose corporate headquarters was in the City of Winchester qualified as a manufacturer for business license tax purposes even though no manufacturing operations were conducted within the city. Extensive manufacturing operations were conducted outside the city. The court viewed the applicable statute as not one conferring an exemption but one segregating property for taxation by the Commonwealth alone. Thus, the statute was strictly construed against the state. The court ruled that the term "manufacturing" was to be construed liberally and that an integrated manufacturing business could not be segregated into its component parts in order to maximize taxation. This decision has been appealed to the Virginia Supreme Court. There is another case involving the same parties at the circuit court level which appears to revisit the issue presented in *Short Brothers* as to whether the locality in which a company is headquartered can tax the company based upon 100% of its gross receipts.

**Apportionment Rulings**

The Virginia Department of Taxation has ruled that it will permit multistate banks subject to the Virginia bank franchise tax to apportion net capital based upon the ratio of Virginia core deposits to total bank core deposits. *Ruling of Commissioner, P.D. 94-366* (December 8, 1994). Although intrastate apportionment is based on total deposits, the Department of Taxation indicated that interstate apportionment should be based only on core deposits, which would exclude time certificates of deposit of $100,000 or more from both the numerator and denominator of the ratio.

**Passive Investment Companies**

Under Virginia's intragroup transactions regulation, *Va. Reg. Section 630-3-446*, the Department may reattribute items of income or deduction or require consolidated reporting where income from business done in Virginia is distorted. Under the regulation, distortion may exist when there is an arrangement between one or more group members where the consideration does not accurately reflect the income from business done in Virginia and the result is distorting the income reported to Virginia.

Among those factors listed as creating a rebuttable presumption that income is distorted are the existence of significant intragroup lending
transactions where the lending party has no other significant assets and the
source of the funds being lent is dividends or capital contributions.
However, an exception exists is the lending party is a discrete, separate
business enterprise with its own employees, office space and books and
records where the funds are lent at arm’s-length rates and terms.

The Virginia Department of Taxation upheld an audit decision requiring a
parent and its passive investment company subsidiary to file a consolidated
return. Ruling of Commissioner, P.D. 95-86 (Apr. 26, 1995). The
Department concluded that the subsidiary lacked substantial economic
substance, noting that its tax return revealed no payroll expense, payroll
taxes, or similar expenses, and that its only reported assets were cash and a
large receivable from another affiliate. Additionally, there was no evidence
that the royalties were established at an arm’s-length rate. Moreover, the
Department questioned whether an arm’s-length rate would be sufficient to
protect the transaction, noting that the taxpayer would not have transferred
the intangible asset to an unrelated party without consideration and gain
recognition. See also Ruling of Commissioner, P.D. 94-179 (June 8,
1994).

The Department of Taxation has overturned an audit decision that required
a parent and its intellectual property holding company subsidiary to file a consolidated
return. Ruling of Commissioner, P.D. 94-309 (Oct. 11, 1994). The
Department concluded that the subsidiary possessed economic
substance, noting that it managed substantial investments for its own
account; its books reflected actual cash transactions as opposed to paper
intercompany transactions; and it received royalty revenues from third
parties. The subsidiary also employed a part-time general manager to
handle its financial transactions, accounting, and administration; however,
its day-to-day banking and investment activities were outsourced to a non-
Virginia bank. The ruling also emphasized that the subsidiary incurred
routine business expenses and its royalty rates had been accepted by the
IRS and foreign tax authorities. See also Ruling of Commissioner, P.D.
94-66 (March 16, 1994) (royalty respected as royalty company had viable
economic substance (employees, assets and substantial business activity)
and royalties paid by unrelated third parties and sustained by foreign taxing
jurisdictions).

**Individual Income Tax**

The Virginia Supreme Court has ruled that the state must pay refunds to
federal retirees who did not settle the amount owed with the
Commonwealth. Virginia exempted the income of state employees but not
of federal employees. In 1989 in *Davis v. Michigan Department of
Treasury*, 489 U.S. 803 (1989), the U.S. Supreme Court held that a similar
Michigan statute unconstitutionally discriminated against the federal retirees violating the intergovernmental tax immunity embodied in the supremacy clause of the U.S. Constitution. The court held that a refund was required as the statute had expressly provided that one was available: "If the court is satisfied that the applicant is erroneously or improperly assessed with any taxes, the court may order that the assessment be corrected. If the assessment exceeds the proper amount, the court may order that the applicant be exonerated from the payment of so much as is erroneously or improperly charged." The court held that the use of the word "may" did not grant discretion in the ordering of refunds citing previous cases. Even though a pre-deprivation remedy was available, the fact that the taxpayer could have reasonably relied on the existence of a post-deprivation remedy not to have pursued the pre-deprivation remedy was sufficient to invalidate the failure to order refunds.

Virginia Enterprise Zone Revisions

Effective July 1, 1995, Virginia's enterprise zone program has been substantially revised. Previously, up to 25 enterprise zones could exist within the state with four tax incentives: a corporate income tax credit; an individual income tax credit; an unemployment tax credit and a sales and use tax exemption. The legislation increases the number of zones to 50. The income tax credit now provides for a credit of up to 80% of the taxes due Virginia on income attributable to the zone in year one and 60% in years two through ten. The total credits provided by Virginia cannot exceed $5 million annually in the aggregate. The unemployment and sales tax credits are effectively repealed.

To be eligible for the credit, an entity must establish in a zone a new business not previously conducted in Virginia by the taxpayer and 40% or more of the employees must either be residents of the zone or have income below 80% of the median income for the jurisdiction. Alternatively, an existing business in a zone that increases the average number of its full time employees employed within the zone by at least 10% over the lower of the two preceding years' employment numbers with at least 40% of the increased employment either being zone residents or having income below 80% of the median income for the jurisdiction also may qualify for the credit.

Other credits and grants include an enterprise zone property investment credit of up to 30% of qualified zone improvements (not to exceed $125,000 over a five year period per taxpayer); employment grants for the creation of full-time new positions ($1,000 if a zone resident or $500 if not) for businesses located within a zone; discretionary grants to be made
by the legislature and local zone benefits. The zone credits will expire in
the year 2005 unless extended by the General Assembly.