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State Tax Return

Nexus Update

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This is our end-of-the-summer nexus update -- new rulings and cases as well as updates on matters we've reported about in earlier articles. Its been 13 years since *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992) and the area is still one of great controversy and disagreement between taxpayers and states tax officials.

In-State Personnel

Use of in-state personnel is always problematic for nexus purposes. However, when the out-of-state entity has no personnel in a state, and no other physical presence, there is no tax nexus.

WEST VIRGINIA: Steager v. MBNA America Bank, N.A., No. 04-AA-157 (W. Va. Cir. Ct. Jun 27, 2005).

On appeal by the Commissioner, the Circuit Court reversed the ALJ's decision, holding that MBNA had substantial nexus with West Virginia despite the lack of physical presence in the state. First, the court concluded that the physical presence test under Quill did not apply because the taxes at issue were not sales and use taxes. Therefore, MBNA's lack of physical presence in West Virginia was not determinative. Second, the court found a statutory presumption of a substantial nexus based on the substantial revenue that MBNA generated from West Virginia citizens. Third, the extension of credit to West Virginia residents, who provided payment to MBNA from West Virginia, also supported the finding of substantial nexus. Lastly, the court found that the State extended substantial benefits to MBNA by providing banking and consumer credit laws as well as access to its courts which supported the generation of income by MBNA, particularly so since MBNA's extension of credit was unsecured. Based on these factors, the Court held that there was substantial nexus for the imposition of corporate net income and business franchise taxes.

MISSOURI: Mo. Code Regs. Ann. tit. 12 § 10-114.100 (2005).

(a) The new regulation, effective June 30, 2005, determines when a vendor has sufficient nexus requiring the vendor to register with the Department and collect and

remit use tax on sales to Missouri purchasers. Under the new regulation, an out-of-state vendor must register with the Department, and collect and remit use tax, when the vendor has a physical presence in Missouri. Physical presence is defined as: (1) owning or leasing real or tangible personal property within Missouri; or (2) having employees, agents, representatives, independent contractors, brokers, or others that reside in, or regularly and systematically enter into, Missouri on behalf of the vendor. Mo. Code Regs. Ann. tit. 12 § 10-114.100(1)(B).

(b) The regulation also provides that a vendor does not have sufficient nexus if the only contact with the state is delivery of goods by common carrier or mail, advertising in the state through media, or occasionally attending trade shows at which no orders for goods are taken and no sales are made. Mo. Code Regs. Ann. tit. 12 § 10-114.100(3)(B). Once nexus has been established, it will continue to exist for a reasonable period of time after the vendor no longer has a physical presence in the state.

Affiliate Nexus

The issue of "affiliate nexus" has been litigated for twenty years. In almost every case, the out-of-state retailer, either mail-order or internet, has prevailed. This California decision is one of the very few in which there was in-state activity sufficient to create tax nexus.

CALIFORNIA: Borders Online, LLC v. State Board of Equalization, 2005 Cal. App. LEXIS 875 (Cal. Ct. App. May 31, 2005).

(a) The trial court, on summary judgment, ruled in favor of the Board. On further appeal, the court of appeals affirmed the trial court's determination, finding that Borders Online had sufficient nexus with California by virtue of the fact that Borders Online referred its customers to Borders Inc.'s local retail stores in California for returns and customer service. The court held that, through the agreement to accept returns of merchandise for Borders Online, Borders Inc. acted on behalf of Borders Online as its authorized representative in California. According to the court, these merchandise return activities supplied the physical presence necessary to satisfy the Commerce Clause.

(b) The court also found that the return activities undertaken on behalf of Borders Online by Borders, Inc. constituted "selling" under the California statute, a requisite finding before California can impose tax in this case. In doing so, the court accepted the Board's interpretation of the term "selling" to broadly include anything that is an integral part of making sales. The court found that Borders Online's return policy satisfied this test because it "undoubtedly made purchasing merchandise on its website more attractive to California customers, as they would know that returning or exchanging any unwanted items would be far simpler than if they purchased items from an e-commerce retailer with no presence in California." According to the court, the return policy aided and was an integral part of Borders Online's sales efforts in California.

(c) The court further found that the cross-marketing and brand activities between Borders Online and Borders Inc. created nexus. Some of the factors noted by the court included: (1) the fact that both Borders Online and Borders Inc. sold comparable goods and had similar logos; (2) store receipts stated "Visit us online at www.borders.com," the website address for Borders Online; (3) store employees were encouraged to refer customers to such website; (4) Borders Online's website contained a link to the Borders Inc.'s website; and (5) the companies shared market and financial data. According to the court, these facts demonstrated a "cross selling synergy" which supported the conclusion that Borders Online's relationship with the affiliated Border Inc. created substantial nexus with California.

(d) Among other arguments, the court rejected Borders Online's argument that its in-state representative (i.e., Borders Inc. stores) did not actually make sales and therefore did not have third-party nexus. Importantly, the court found that making sales is not the test; rather, the test for whether or not a third party representative can constitutionally create nexus is whether the activities of the in-state representative are "significantly associated with the [seller's] ability to establish and maintain a market in the state for the sales." Based on this test, the court concluded that the in-state activities performed by Borders Inc. on behalf of Borders Online with regard to the return policy and cross-marketing was part of Borders Online's strategy to build a market in California. Borders Online therefore had substantial nexus with California.

KANSAS: Private Letter Ruling, No. P-2005-016 (Dep't of Revenue, Jun. 20, 2005).

(a) An out-of-state company sold security locks and equipment to businesses in Kansas. The company had no property, employees, solicitors, or places of business in Kansas. The company contracted with third-party installers to install the security locks and equipment in Kansas. The locks and equipment were drop shipped from outside Kansas to the customer or third-party installer. The company paid the third-party contractor and then re-billed its customers for the services.

(b) The Department determined that the company's out-of-state sales of services to customers in Kansas through third-party contractors created nexus between the company and Kansas. In determining that the company was a retailer doing business in Kansas, the Department reasoned that the third-party installer was an agent under the company's authority for the purpose of installing the locks and equipment. The third-party installer was thus, according to the Department, someone who effected the performance of the contract between the company and its Kansas customer. Since there was substantial nexus with Kansas, the company must register with Kansas and collect use tax on interstate sales made to customers in Kansas.

Sales Representatives

The U.S. Supreme Court has held that in-state sales personnel creates nexus. Texas has had no trouble applying this rule in many situations, including the new case noted below.

TEXAS: INOVA Diagnostics, Inc. v. Strayhorn, No. 03-04-00503-CV (Tex. App. May 26, 2005).

(a) Taxpayer was a California corporation which developed and manufactured products used in medical testing. Taxpayer had one salesperson who worked an average of seven to ten days per month in Texas. The salesperson's activities in Texas were visiting existing and prospective customers, providing promotional materials, and demonstrating Taxpayer's products. All orders were placed directly with Taxpayer in California and delivered via mail or common carrier. The Comptroller determined that Taxpayer was required to pay Texas franchise tax because the salesperson's activities created substantial nexus with the state. Taxpayer argued that the salesperson's presence in Texas was de minimus and thus exempt under P.L. 86-272.

(b) The court ruled against Taxpayer, holding that the employment of the salesperson in Texas created a physical presence in the State and thus supplied the necessary substantial nexus for the imposition of the Texas franchise tax. Specifically, the court found that Taxpayer had permanent sales presence in Texas since the salesperson lived in Texas, worked from his home in Texas, and systemically solicited orders from customers in Texas. According to the court, the salesperson's presence in seven to ten days a month in Texas was not *de minimus*, and Taxpayer was therefore not exempt under P.L. 86-272.

Trade Shows

Generally, attendance at a trade show, in which tangible personal property is not sold, does not create nexus (except in Texas which has different rules). The *Share International* case in Florida established this general rule, amplified by state legislation in a number of states. Connecticut has now created a trade show exception by statute.

CONNECTICUT: S.B. 1232 (Conn. 2005).

(a) Effective July 13, 2005, and applicable to taxable years commencing on or after January 1, 2005, the new law provides that a retailer, not otherwise engaged in business in the state, that participates in a trade show at the Connecticut Convention Center located in Hartford shall not be deemed to be engaged in business in the state for Connecticut sales and use tax purposes. Conn. Gen. Stat. § 12-407(15)(D). Similarly, a company that participates in a trade show at such convention center shall also not be deemed to be carrying on or doing business in the state. Conn. Gen. State § 12-213(20)(C).

(b) In addition, under the new law, such a retailer or company is not subject to the state taxes regardless of whether it has employees or other staff present at the trade shows provided: (1) the retailer or company's activity at such trade shows is limited to the display of goods or the promotion of services; (2) no sales are made; (3) any orders received are sent outside Connecticut for acceptance or rejection; (4) the orders are filled outside Connecticut; and (5) the retailer or company's participation in the trade shows is not more than 14 days, or part thereof, in the aggregate, during the retailer or

company's income year for federal income tax purposes. Conn. Gen. Stat. §§ 12-407(15)(D) and 12-213(20)(C).

"Intangible" Nexus

Case law is developing across the country on this issue, often adverse to the intellectual property holding company. The Indiana Department of State Revenue has ruled that intangibles create nexus.

INDIANA: Letter of Findings No. 04-0251 (Dep't of Revenue, May 1, 2005).

(a) Taxpayer was a Delaware company in the business of licensing intellectual property consisting of trademarks and service marks. Taxpayer was owned by a retail chain store which conducted business nationwide including Indiana. Prior to entering into a licensing agreement with Taxpayer, the retail chain store had transferred its intellectual property to Taxpayer in exchange of Taxpayer's stock. Thereafter, under the agreement, the retail chain store paid Taxpayer a certain percentage of their net sales for the right to use the intellectual property. Taxpayer subsequently loaned the royalty payments back to the retail chain store. Taxpayer did not have any employees or tangible property located in Indiana. Taxpayer did not file Indiana corporate income tax returns during the period at issue. Upon audit, the Department issued proposed assessment on the royalty income that Taxpayer received from licensing the intellectual property for use in Indiana. Taxpayer protested the proposed assessments on the basis that it did not have substantial nexus with Indiana.

(b) The Department ruled that Taxpayer had substantial nexus with Indiana as a result of its "contractual relationship" with the Indiana retail chain store in the licensing of its intellectual property. Specifically, the Department reasoned that "[b]y virtue of that licensing agreement, the retail chain store uses the intellectual property to enhance the value of the products sold within the state and to generate the sales which form the basis upon which the taxpayer receives a stream of royalty income." Based on this reasoning, the Department found that Taxpayer had substantial nexus with Indiana.

(c) The Department further disagreed with Taxpayer's argument that there must be physical presence in Indiana before the Department can impose tax on Taxpayer. The Department refused to follow *Lanco, Inc. v. Dir., Div. of Taxation*, 21 N.J. Tax 200 (N.J. Tax Ct. Oct. 23, 2003, appeal pending). In doing so, the Department stated that "Taxpayer is paid millions of dollars in royalties by retail chain store for no apparent purpose. There is no indication that taxpayer does anything to earn these royalties. Taxpayer loans the royalties back to retail chain store with no apparent expectation of repayment. The stock exchange agreement, the licensing agreement, the Delaware incorporation, the royalty payments, and the on-going "loans" of the royalties, constitute no more than an elaborate ruse intended to minimize the retail chain store's state tax liability…." Based on this reasoning, the Department held that Taxpayer had substantial nexus with Indiana despite the lack of physical presence in Indiana, and was subject to Indiana adjusted gross income tax.

INDIANA: Letter of Findings No. 03-0369 (Dep't of Revenue, Jun. 1, 2005).

(a) Taxpayer was a successor chemical and manufacturing company that was assigned rights to certain specified intellectual property following restructuring of its predecessor company. Taxpayer, including three other related entities (i.e., Delaware Company, Fiber Company, and Compounds Company) were owned by the same shareholders. Taxpayer admitted that it had an Indiana nexus, since it had an Indiana business situs, had Indiana employees, sold products to Indiana customers, and received income from doing business in Indiana. Taxpayer assigned its intellectual property to Delaware Company and then paid substantial royalties to Delaware Company for the right to use such intellectual property. Fiber Company and Compounds Company also paid substantial royalties to Delaware Company for the right to use its intellectual property. Upon audit, the Department concluded that Taxpayer was required to file a combined adjusted gross income tax report with the three related entities. Taxpayer argued that the three related entities did not have the requisite Indiana nexus and should not be subject to the Indiana tax.

(b) The Department determined that a combined report of Taxpayer and all the three related entities were required because Taxpayer's use of the royalty/licensing agreement was "primarily intended as an artifice to minimize tax liability." According to the Department, the collective business structure among the four entities were ambiguous, particularly how the intellectual property came to be owned by Delaware Company and why Taxpayer was paying substantial royalties to Delaware Company. The Department was unable to discern a correlation between the substantial royalties paid to Delaware Company under the licensing agreement and the services provided by Delaware Company. Furthermore, the Department noted that all the entities were owned by the same shareholders. Based on these facts, the Department concluded that there was a lack of economic substance or a business purpose for the licensing agreement and that such agreement was effectuated for tax avoidance purposes. Taxpayer and the other three entities must thus be included in a combined report.

NORTH CAROLINA: A&F Trademark, Inc. v. Tolson, 605 S.E.2d 187 (N.C. Ct. App. 2004), appeal dismissed, 611 S.E.2d 168 (N.C. Mar. 3, 2005), petition for cert. filed, Dkt. 04-1625 (U.S. Jun. 2, 2005).

On June 2, 2005, the taxpayers filed a petition for certiorari with the U.S. Supreme Court. The question presented in the petition was whether Quill's Commerce Clause nexus test forbidding taxation in the absence of physical presence applies to all state taxes, as held by decisions in Michigan, New Jersey, New York, Tennessee, Texas, and West Virginia - or - as the North Carolina decision held, and as also concluded by decisions in Illinois, Kentucky, Maryland, Massachusetts, New Mexico, Ohio, South Carolina, and Washington - whether the rule applies only to state sales and use taxes.

VIRGINIA: Ruling of Commissioner, P.D. 05-90 (Dep't of Taxation, Jun. 9, 2005).

(a) Taxpayer, an out-of-state corporation, was a parent holding corporation of one wholly owned subsidiary. Taxpayer's sole source of income was interest on loans made

to the subsidiary. Taxpayer had no office, employees, or tangible assets. Taxpayer, however, had officers who routinely performed management, finance, administrative and marketing activities in Virginia and out-of-state. The subsidiary, headquartered out-of-state, operated in multiple states including Virginia. The Virginia operations included an administrative office that kept the accounting records for Taxpayer and paid the salaries of the officers of Taxpayer.

(b) The Department determined that Taxpayer had nexus with Virginia because Taxpayer's commercial domicile was in Virginia. Specifically, the Department found Virginia to be the commercial domicile of Taxpayer, even though Taxpayer had no office or tangible assets, because Taxpayer's affairs were conducted primarily by officers located at the subsidiary's office in Virginia. Accordingly, Taxpayer had nexus with Virginia and was subject to Virginia corporate income tax.

Michigan Single Business Tax

Nexus litigation continues in Michigan concerning the SBT. Since this tax is not a tax measured by, or assessed upon, "net income," P.L. 86-272 does not apply.

MICHIGAN: Fluor Enterprises, Inc., v. Dep't of Treasury, No. 02-000027-MT (Mich. Ct. App. Apr. 14, 2005).

(a) Fluor Enterprises, Inc. ("Fluor") was a California corporation that provided engineering, construction, and technical services. It also performed architectural and engineering services at its out-of-state offices for real estate improvement projects that were constructed in Michigan. Fluor filed SBT returns for the years at issue, but did not report the receipts from the services performed out-of-state as Michigan receipts. Upon audit, the Department issued three intents to assess SBT on such receipts. Following an informal conference with the Department, the Department denied Fluor's claims and issued final assessments. Fluor subsequently paid the assessments under protest and filed an action with the Court of Claims to recover the SBT. The Court of Claims issued judgment for Fluor and the Department appealed to the Court of Appeals.

(b) Fluor and the Department disagreed on the meaning of the statutory apportionment provision in Mich. Comp. Law § 208.53(c) which states: "Receipts derived from services performed for planning, design, or construction activities within this state shall be deemed Michigan receipts." The Court of Appeals agreed with the Department's interpretation of the statute, finding that "within this state" modified "activities" (rather than modified "performed" as what Fluor had argued). Based on this interpretation, Fluor's receipts must be apportioned to Michigan because the construction activities occurred in Michigan. The fact that the services were performed outside of Michigan did not matter under the Court's interpretation.

(c) Fluor also argued that the imposition of SBT on the receipts violated the Commerce Clause because the receipts were for engineering and architectural services rendered outside Michigan. Specifically, Fluor contended that to satisfy the "substantial nexus" prong, a state must have a connection, not only to the taxpayer, but also to the

specific activities it seeks to tax. The Court disagreed with Fluor's argument, concluding that the "substantial nexus" prong does not depend on whether the particular activity may be geographically assigned to Michigan. The Court stated that so long as Fluor had a physical presence in Michigan, which it did, Michigan would have the authority to tax Fluor. The Court further stated that if Fluor had wanted to exclude the receipts from apportionability and being taxed, Fluor would have to show that the income was earned in the course of activities unrelated to those carried out in Michigan.

(d) Finally, while the Court agreed with the Department's statutory analysis, the Court ultimately held that Mich. Comp. Law § 208.53(c) violated the internal consistency requirement of the fair apportionment prong of the Commerce Clause analysis set forth in *Complete Auto Transit v. Brady*, 430 U.S. 274 (1977). According to the Court, the statute was not internally consistent because "if another state had the same apportionment formula, the receipts could be subject to more than one state's income tax." The Court thus found the statute unconstitutional.

Fulfillment Centers: Safe Harbor

In order to encourage in-state business development, some states have "carved out" exceptions to physical presence nexus. South Carolina now allows a distribution facility in the state without creating nexus for the out-of-state's owner/operator. Ohio and New York have similar provisions.

SOUTH CAROLINA: H.B. 3006 (S.C. 2005).

(a) Effective June 10, 2005 and applicable to taxable years beginning January 1, 2006, the new law provides that the ownership or utilization of a distribution facility within South Carolina does not constitute physical presence in the state for purposes of establishing sales and use tax nexus. S.C. Code Ann. § 12-36-2690.

(b) The new law further provides that a distribution facility is not considered to be a fixed place of business in South Carolina for corporate income tax and corporation license fee purposes. In addition, a person's nexus with South Carolina for corporate income tax and corporation license fee purposes is determined without regard to whether the person owns or utilizes a distribution facility within the state, owns or leases property that is used at or distributed from a distribution facility in the state, or sells property shipped or distributed from a distribution facility in the state. S.C. Code Ann. § 12-6-60.

Public Contracting Nexus

A number of states have passed statutes providing that an out-of-state vendor and all of its affiliates must be registered for tax collection purposes as a precondition to doing business with state and local governments. For example, Georgia, California, and New York have passed statutes like this. Alabama has a bill pending to add such a provision to its law.

ALABAMA: H.B. 738 (Ala. 2005).

(a) On April 6, 2005, the Alabama legislators introduced House Bill 738 to amend the Alabama Code to add a new Section 41-4-116. The new provision would prohibit a state agency or department from purchasing goods from a vendor unless that vendor and all of its affiliates that make sales for delivery into Alabama or leases for use in Alabama are properly registered, collecting and remitting Alabama sales, use, and lease tax. Ala. H.B. 738, proposing new Ala. Code § 41-4-116(b). The bill also requires each vendor to certify that it satisfies these conditions before selling to the state.

(b) In addition, the bill presumes nexus for all affiliates of a contracting vendor, stating that "each affiliate of that vendor or contractor that makes sales for delivery into Alabama shall be regarded as an entity engaged in business in this state and shall be required to collect and remit Alabama sales, use, or lease tax on all its sales and leases into the state." Ala. H.B. 738, proposing new Ala. Code § 41-4-116(e).

(c) The bill is currently pending.

In-State Advertising/Solicitation

Generally, P.L. 86-272 protects in-state selling activities. Here, Texas found that most of the sales in question were of intangibles and were not immune under P.L. 86-272.

TEXAS: Texas Comptroller of Public Accounts, Hearing No. 44,735 (Tex. Apr. 6, 2005).

(a) Taxpayer was a direct sales and network marketing company that sold a variety of products and services to marketing professionals, including training videos and web hosting services. Taxpayer's offices were located in Florida and maintained no offices or employees in Texas. Taxpayer also did not manufacture, or store product or equipment in Texas. In order to purchase Taxpayer's marketing services, a Texas customer had to apply for "membership" and pay a fee, thereby becoming a member. Taxpayer also offered such Texas members with affiliate status financial incentives if they referred new customers to Taxpayer. Taxpayer did not file Texas franchise tax returns. Upon audit, the Comptroller determined that Taxpayer was liable for Texas franchise tax because Taxpayer had substantial nexus with Texas.

(b) The ALJ agreed with the Comptroller, holding that Taxpayer's activities were sufficient to establish nexus for the taxable capital component of Texas franchise tax. Specifically, the ALJ found that the members-affiliates acted as independent contractors of Taxpayer as they were authorized to solicit sales of company memberships, goods, and services in Texas. According to the ALJ, such solicitation of business by Taxpayer through independent contractors was sufficient to establish substantial nexus for purposes of Texas franchise tax.

(c) The ALJ further rejected Taxpayer's argument that because their activities were mere solicitations of orders for tangible goods or *de minimus* independent business

functions, they were protected by P.L. 86-272. The ALJ determined that while Taxpayer sold a small amount of tangible personal property, most of Taxpayer's activities were related to the sale of intangibles and, thus, were not immune from tax under P.L. 86-272. Specifically, the ALJ found that the Texas members received valuable intangible benefits, such as access to Taxpayer's telephone and web-based services, and customer leads resulting from Taxpayer's advertising. Furthermore, the ALJ found that Taxpayer also offered its Texas affiliates financial incentives in the form of bonuses and commissions. According to the ALJ, these activities exceeded the mere solicitation of orders for tangible goods, and therefore were not immune under P.L. 86-272.

Home Court Advantage

In order to make sure that home-state retailers are given every advantage, New Hampshire has tried to pass a statute giving its state courts authority to determine if a New Hampshire business has nexus in another state, like California or Ohio. This is new and different!

NEW HAMPSHIRE: S.B. 210-FN (N.H. 2005) (pending).

(a) On March 31, 2005, the New Hampshire Senate passed a bill granting its own state superior courts authority to determine whether New Hampshire-based businesses have nexus with another state. Under the proposed new section 546-C:1, a business organized in New Hampshire or authorized to do business in New Hampshire could file a declaratory judgment action in New Hampshire Superior Court against a tax official of another state on the subject of nexus. The court would have the authority to determine if the New Hampshire business could constitutionally be required to collect tax in the other state.

(b) The bill has passed the Senate and is currently pending before the New Hampshire House of Representatives. On May 4, 2005, the House Judiciary Committee voted the bill as "ought not to pass." The bill remains, however, under consideration.■