



Volume 12 Number 12

December 2005

State Tax Return

Massachusetts DOR Issues Letter Ruling On Affiliate Nexus-Let's Split Some Hairs!

Laura A. Kulwicki
Columbus
(330) 656-0416

The Massachusetts Department of Revenue (the "DOR") outlined its approach to sales/use tax nexus for remote sellers with in-state retail affiliates in a comprehensive letter ruling issued last month. In *Massachusetts Dept. of Revenue Letter Ruling No. 05-7* (Nov. 8, 2005), the DOR examined the business relationships between an in-state retailer and its internet and catalog affiliates and concluded that the retail store's planned activities in Massachusetts will not create nexus for the affiliated remote sellers. In doing so, the DOR described its overall analytical approach to nexus in this context. Although the DOR ultimately concluded that the facts would not create nexus, this outcome was highly fact-dependent and turned on a very nuanced approach to the issues.

The Applicable Facts

The companies at issue were all separately formed and wholly-owned by a common parent. None of these companies currently had any physical presence in Massachusetts. The retail store entity, however, intended to open a retail store in Massachusetts. Two other related entities, an internet seller and a catalog seller, also sold similar merchandise using common logos and similar trade names. The DOR considered whether the relationship with the in-state retail store would create sales/use tax nexus for the affiliated catalog and internet sellers.

While there was certainly some overlap in the way these three affiliated retailers planned to conduct their business operations, the relationship was structured so as to respect the independent status of each business. Cross-marketing between the entities will be kept to a minimum. For example, the retail store will not display its dot.com affiliate's website address on customer receipts or in the retail store, nor will it display the affiliate's contact information or logo on shopping bags or other materials in the retail store. Although the store planned to purchase catalogs from its affiliate for reference guides and merchandise education, these catalogs will be kept under the counter and will not be prominently displayed in the store. They will be available to customers upon request, but this fact will not be affirmatively promoted.

As is common among many multi-channel retail affiliates, gift certificates will be available for purchase from all three companies. Customers can redeem the gift

certificate at any of the affiliated companies, irrespective of where the certificate was purchased. The companies also plan to participate in co-branded credit card and rewards program, with similar cross-redemption options.

Catalog or internet orders cannot be placed directly by customers from the retail store, and the store will not place orders on behalf of the remote sellers. On some occasions, the store may phone in an order to the catalog company, but this order will be treated as a store sale and applicable tax charged and collected.

Finally, neither the catalog company nor the internet seller will direct customers to the retail store for returns or customer service. However, the store will accept returns of merchandise purchased from the remote sellers if the item is also sold in the retail store. The store characterized this policy as a “repurchase” policy. That is, the store will accept a “return” of merchandise purchased from any source (whether from the catalog or internet affiliates, or from a wholly-unrelated retailer), so long as the merchandise is sold by the retail store. No charge-backs or accounting will be made to the affiliates with respect to items “repurchased” from customers of its internet or catalog affiliates.

The DOR’s Legal Analysis

The DOR began its analysis by recognizing *Quill’s* physical presence rule and the third-party nexus principles established by the United States Supreme Court in *Scripto, Inc. v. Carson*.¹ It then reviewed the body of case law specific to affiliate nexus and rejected the notion that affiliation alone, coupled with the sale of common merchandise and the use of common trademarks and tradenames, creates nexus:

Although it could reasonably be argued that the activities of a retail store in one corporation could be attributed to the other commonly-owned corporations engaged in remote retail sales of similar inventory under related company names, there is significant authority to the contrary.

Based on this analysis, therefore, something more than affiliation alone creates nexus. The California Court of Appeal’s decision in *Borders Online, LLC v. State Board of Equalization*, 129 Cal. App. 4th 1179 (2005) illustrates the “something more” that, in the DOR’s analysis, would be sufficient to create nexus. In particular, the remote seller’s return policy (directing its customers to the retail store), the store’s policy of referring its customers to the online affiliate, and the website address on store receipts all tipped the balance in favor of nexus in that case.

The DOR’s Nexus Test

The DOR applied a “functional” analysis and concluded that affiliate nexus exists if the function of the store’s activities is to “establish and maintain a market” for the remote seller in the state. Common ownership is not determinative. Instead, the test is whether

¹ See, *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992); *Scripto, Inc. v. Carson*, 362 U.S. 207 (1960).

the retail store is engaging in a particular activity for the benefit of its remote affiliate, or is instead conducting its own business operations with only an incidental impact on the remote seller.

Whether or not the store acts as a legal “agent” for the remote seller is not relevant to the DOR’s analysis. In fact, the DOR was careful to emphasize that legal agency was *not* the test. If the retail store’s activities establish and maintain a market in the state, then nexus will be established, regardless of agency principles.

The DOR stated its view of the nexus test as follows:

[T]here must be some additional connection between related corporations beyond a related company name and similar inventory of merchandise to constitutionally require an out-of-state affiliate with no physical presence in Massachusetts to collect sales or use tax. However, the connection need not rise to the level of the in-state store acting as agent for the out-of-state affiliate under common law principles, nor must any physical presence be substantial to meet the substantial nexus requirement of *Quill*.

The DOR Finds No Nexus

In the facts at hand, the DOR found that the retail store will engage in its own business. According to the DOR, the retail store’s activities in Massachusetts will have “at most, an incidental impact on the market of the remote retailers in Massachusetts.” Central to this finding was the fact that the return policy will not expressly encourage store returns and was designed primarily for the convenience of the store’s customers. Similarly, the DOR found it significant that there was no direct promotion of the catalog and internet businesses in the retail store, expressly finding that the catalogs only incidentally benefited the remote sellers.

The DOR was most persuaded, however, by the companies’ assertion that, based on past experiences in other states, catalog and internet sales in a particular state actually went down after a retail store was opened in that state. The DOR found this to be a “compelling factor, as it shows that the store is not growing or maintaining a market in the state.”

The DOR was careful to caution, however, that any change in actual operations could alter its nexus findings. For example, advertising that catalogs were readily available in the stores could tip the balance in favor of nexus.

Conclusion

The DOR’s position reflects an interesting synthesis of applicable nexus principles in the affiliate nexus context. It’s “no nexus” findings, coupled with its refusal to find nexus based on mere affiliation and common merchandising, is an encouraging sign to taxpayers and a proper application of controlling legal principles.

However, the DOR's "functionality" test departs from long-standing legal principles in other ways. The United States Supreme Court has never held that a third party can create nexus for a remote seller, unless that third party acts on behalf of the out-of-state seller as its agent or legal representative. The DOR's new test dispenses with this critical element of Supreme Court jurisprudence.

Without the principles of legal agency that have guided courts for over a decade, the DOR's new "functionality" test will also present administrative challenges. Indeed, the DOR's new test offers very few practical guidelines. Although the nexus analysis is inherently fact-sensitive, the DOR's analysis does nothing to promote clarity and certainty. By eliminating certain longstanding legal guideposts, nexus determinations in Massachusetts will become extremely nuanced and uncertain. ■



This article is reprinted from the *State Tax Return*, a Jones Day monthly newsletter reporting on recent developments in state and local tax. Requests for a subscription to the *State Tax Return* or permission to reproduce this publication, in whole or in part, or comments and suggestions should be sent to Christine Rhodes (614/281-3911 or crhodes@jonesday.com) in Jones Day's Columbus Office, P.O. Box 165017, Columbus, Ohio 43216-5017.

©Jones Day 2005. All Rights Reserved. No portion of the article may be reproduced or used without express permission. Because of its generality, the information contained herein should not be construed as legal advice on any specific facts and circumstances. The contents are intended for general information purposes only.