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NEXUS: UPDATE ON RECENT DEVELOPMENTS

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We keep track of nexus developments on a regular basis – legislation, administrative interpretations, the passage of rules and regulations, and court cases. This issue of our newsletter updates important nexus developments during the First Quarter, 2007. It is organized by the kind of activity that tends to give out-of-state entities nexus planning and litigation difficulties, such as trade show attendance, in-state personnel, affiliate nexus, and "doing business" in various states. We hope you find it helpful in your planning and compliance work.

I. SUBSTANTIAL NEXUS" LITIGATION IN THE STATE COURTS

A. Trade Shows

The Texas Comptroller takes an extremely aggressive enforcement position. If an out-of-state company attends a trade show in Texas, even for one day, the Comptroller asserts that it creates sales tax nexus for the entire year. The following Comptroller decision is one in a series of administrative determinations finding nexus for trade show attendance.

1. TEXAS

a. In Re: ***, Texas Comptroller Decision Hearing No. 46,628, CCH ¶403-228 (Tex. Cmptr. Pub. Acct. Aug. 28, 2006)

i. Taxpayer was an out-of-state seller of dental equipment. Taxpayer attended trade shows in Texas annually where its products were introduced and demonstrated for sale. Taxpayer argued that it did not have substantial nexus with Texas for sales and use tax purposes because it merely demonstrated products at the trade shows and all its orders were filled, billed and shipped from out-of-state.

ii. The ALJ held that the taxpayer was engaged in business in Texas by virtue of attending trade shows in Texas and therefore was required to collected Texas sales and use tax on sales to Texas purchasers even if orders were received and filled outside Texas. The ALJ found that the trade shows had allowed the taxpayer to maintain continuous solicitation throughout the audit period. Such activity provided the requisite physical presence to establish substantial nexus with Texas under the Commerce Clause. The ALJ further stated that P.L. 86-272 did not apply here as the case involved sales and use tax.

B. In-State Personnel

The majority opinion in this important case determined that economic activity of a credit card bank was sufficient to establish nexus. After the majority decision, Justices of the West Virginia Supreme Court issued separate dissenting and concurring opinions which you should review if you are interested in this issue. MBNA has filed a petition for certiorari to the United States Supreme Court where it is still pending.

1. WEST VIRGINIA

a. *Steager v. MBNA American Bank, N.A.*, No. 04-AA-157 (W.Va. Cir. Ct. June 27, 2005), *aff'd*, No. 33049, 2006 W.Va. LEXIS 132 (W.Va. Nov. 21, 2006).

i. Justices of the West Virginia Supreme Court issued separate dissenting and concurring opinions. The dissent criticized that the majority's economic nexus approach merges Due Process and Commerce Clause nexus requirements. The dissent also contended that the majority's position in differentiating *Quill*'s substantial nexus standard based upon tax types and differences in the complexity of collection obligations is too speculative.

ii. The concurrence emphasized that the majority had correctly recognized the legal differences between the Due Process Clause and Commerce Clause as well as the distinctions between the application of sales and use taxes as opposed to business franchise and corporation net income taxes. According to the concurrence, the majority had taken into account the "realism of today's world," in which a business does not need a physical presence anywhere. The concurrence thus found that MBNA's significant economic presence in the state meets the substantial nexus standard.

iii. On March 8, 2007, MBNA filed a petition for certiorari with the United States Supreme Court. The question presented in the

petition is whether the Commerce Clause permits states to impose income and franchise taxes on an out-of-state company with no in-state physical presence, simply because that company has customers in the taxing state.

C. Incidental Ownership of Property

A traditional nexus test is ownership of real property in a state, so this regulation is important.

1. OREGON

a. Or. Admin. R. 150-318.020(2)

i. The Oregon Department of Revenue has amended the regulation to provide that an isolated sale of real property in Oregon may satisfy the nexus requirements of the Due Process Clause for corporate income tax purposes.

D. Affiliate Nexus

Two determinations have been issued on affiliate nexus. The Illinois Department of Revenue took a very sensible position in analyzing facts related to affiliated companies in order to reach a "no nexus" determination. In Louisiana, the Federal Court found in favor of barnesandnoble.com, which had lost its case in California. Here, on identical facts, the District Court Judge decided that the in-state retail affiliate did not create nexus for the on-line company. This is a very important decision and should be watched by all retailers that have three sales channels – retail stores, catalogs, and internet.

1. ILLINOIS

a. Private Letter Ruling No. ST 06-0073-GIL**,** 2006 Ill. PLR LEXIS 81 (Ill. Dept. of Rev. Apr. 19, 2006)

i. Taxpayer, a wholly-owned subsidiary of Parent Company, sold unrelated third-party vendors' footwear directly to end users via the internet. Parent Company also had several other affiliates that each sold their own branded merchandise ("sister companies"). Taxpayer was an online business that had no physical stores and was headquartered in California. Taxpayer's warehouse, storage space and order fulfillment were in Ohio separate from the other sister companies. Taxpayer also had an Ohio call center located in a shared space with the other sister companies. Taxpayer did not have any physical presence in Illinois, nor did it send employees, independent contractors, or perform any other in-state activities in Illinois. The sister companies, however, did have nexus in Illinois.

ii. The issue in the ruling was whether the activities of the sister companies in Illinois could be attributed to the taxpayer for the purpose of sales and use tax nexus.

iii. The Department ruled that the nexus of the sister companies could not be attributed to the taxpayer merely due to ownership by a common parent company. The Department reasoned that the sister companies would not be establishing and maintaining a market for the taxpayer, as they were in a separate business of designing, manufacturing, marketing and selling their own private label clothing. Moreover, the taxpayer had a written policy requiring all returns to be made directly to the taxpayer's warehouse in Ohio, and the sister companies would not accept returns of any merchandise sold by the taxpayer. Thus, the Department ruled that nexus could not be attributed to the taxpayer via common ownership by the parent company.

iv. The Department also determined that other activities of the taxpayer did not create nexus. Specifically, the taxpayer's sale of some of the sister companies' merchandise on its website did not create nexus because (i) the taxpayer and the sister companies were conducting dissimilar businesses; (ii) such merchandise sale was only a small amount; and (iii) neither the sister companies nor the taxpayer could control the conduct of the other with respect to any matter related to the merchandise sale.

v. The fact that customers could use the private label cards of the sister companies at the taxpayer's website also did not create nexus because (1) an independent third party managed the private label cards; and (ii) the Ohio call center would not answer any questions regarding these cards.

vi. The link on the sister companies website to the taxpayer's website did not create nexus because the taxpayer paid the sister companies a fair price, negotiated at arm's-length, for this link to be accessible from the sister companies. Also, any emails by the sister companies directing customers to the taxpayer's website did not create nexus because (i) all technological infrastructure were located outside Illinois; and (ii) the taxpayer paid the sister companies an arm's-length price to send emails.

vii. The taxpayer's placement of stuffers in shipping boxes advertising the private label credit cards of the sister companies did not create nexus because the taxpayer was not purposefully availing itself of the Illinois market with this action.

viii. Also, the fact the taxpayer will purchase certain administrative services from its parent company that supplied the same types of services to the sister companies did not create nexus because (i) the transaction was conducted on arm's-length basis; (ii) the transaction was no different than any other third party outsourcing arrangement; and (iii) none of the services were performed in Illinois.

ix. Sharing space with the sister companies within a call center located outside of Illinois also did not create nexus. The call center was entirely bifurcated for the taxpayer's operations. The taxpayer's own employees performed all vital tasks, and the sister companies' representatives at the call center were not be acting on behalf of the taxpayer.

x. Lastly, possession of a similar infrastructure system as the sister companies did not create nexus. The Department reasoned that the mere similarity of operational functions was a normal consequence of shared ownership as well as best practices. The Department stated that all of the above activities, taken together and viewed as a whole, did not create nexus for the taxpayer in Illinois.

2. LOUISIANA

a. *St. Tammany Parish Tax Collector v. Barnesandnoble.com***,** No. 05-5695, 2007 U.S. Dist. LEXIS 20823 (E.D. La. Mar. 22, 2007)

i. Barnesandnoble.com, LLC ("Online") was an internet retailer of books, movies, and music. Online accepted orders from customers across the country, including St. Tammany Parish ("Parish"), and used common carriers to deliver the out-of-state merchandise ordered online to customers in Louisiana. Online had no employees in Louisiana nor did it own any tangible property within the state.

ii. Online was a subsidiary of Barnes & Noble, Inc. ("Parent"). Parent also wholly owned Barnes & Noble Booksellers, Inc. ("Booksellers"), which owned and operated retail stores throughout the country, including one in Parish, under the brand name "Barnes and Noble." Although Booksellers and Online were both owned, in whole or in part, by Parent, Booksellers and Online did not share management, employees, offices, and other important elements of their businesses.

iii. The St. Tammany Parish Tax Collector ("Tax Collector") sued Online in Louisiana state court for sales and use tax that Online

allegedly failed to collect. Online subsequently removed the case to the federal court. The Tax Collector cited five aspects of the business relationships between Online and Booksellers as evidence that substantial nexus existed during the relevant period: (1) both of the companies offered a membership program, which Online derived revenue from customers who paid an annual fee and received discounts on merchandise purchased from either companies; (2) Booksellers sold gift cards that were redeemable with Online and included Online's web address; (3) Online received commissions on merchandise ordered at Booksellers' retail stores but shipped directly to the customer from Online's distribution centers; (4) the two companies engaged in advertising on behalf of each other; and (5) Booksellers' stores gave preferential treatment to returns of merchandise purchased from Online.

iv. The U.S. District Court held that Online did not have a substantial nexus with Parish. The court concluded that attributional nexus was not established merely by virtue of the affiliation between the companies. The court found that Online and Booksellers were formally separate corporate entities. Although the two companies shared a common name and brand identity, there was no overlap between the companies' management or directors. In particular, no allegations of asset commingling had been made, and it was not independently significant that the companies had shared financial or market data. Moreover, the companies did not represent themselves as the same entity. Consequently, attributional nexus did not apply merely by virtue of the affiliation between the companies.

v. The court also found that the nature and extent of Bookseller's activities performed on behalf of Online within Parish were insufficient to treat Booksellers as Online's marketing presence in Parish. According to the court, Booksellers had never taken or solicited orders on behalf of Online and had not provided facilities to place orders with Online. Furthermore, the Tax Collector had failed to demonstrate that participation in the gift card and membership programs, in which revenue is divided on a pro rata basis among all participating retailers, could constitute a sufficient nexus with Parish. Neither of these programs produced revenue to Online by virtue of sales made or orders taken by the entity that was physically present in Parish. Accordingly, it was insufficient to impute Booksellers' physical presence to Online simply because Online may have derived a benefit from Booksellers' advertising of the programs.

vi. The court also rejected the Tax Collector's argument that nexus was established because Online received commissions from

merchandise ordered at Booksellers' retail stores but delivered directly to customers from Online's distribution centers. The court reasoned that Online was only one of many wholesalers, including its competitors, from whom Booksellers sourced items that it did not have in stock. Booksellers had treated Online on an arm's-length basis, just like with other third-party wholesalers in its systems. Moreover, Booksellers treated such sales as its own sales and collected any applicable sales and local taxes.

vii. The court also rejected the Tax Collector's preferential return policy argument. According to the court, Booksellers' return policy was preferential to Online in that Booksellers accepted Online's merchandise as if it were its own, whereas with other retailers, Booksellers' policy was to provide store credit in the amount of the price of the item in Booksellers' store at that time. Booksellers had accepted returns for the purpose of generating goodwill, serving its customers, encouraging customer satisfaction and enticing new customers. Although Booksellers' policy to accept returns of items purchased from Online was slightly more generous than the one extended to other retailers, it was not comparable to an independent contractor making sales on behalf of the out-of-state retailer. Nor was it comparable to the level of sales or sales support activity undertaken by in-state agents in those cases in which courts have found nexus. Accordingly, a substantial nexus did not exist with Parish.

E. Michigan Single Business Tax

While the SBT is going to disappear, Michigan taxpayers with refund claims or assessments are still interested in the retroactive application of P.L. 86-272 standards. Unfortunately for SBT taxpayers, this decision found that the Department was not bound by its prior administrative interpretation upon which many taxpayers had justifiably relied.

a. *Int'l Home Foods, Inc. v. Michigan Dep't of Treasury*, 708 N.W.2d 711 (Mich. Ct. App. Oct. 4, 2005), rev'd, 725 N.W.2d 458 (Mich. Jan. 5, 2007).

i. Taxpayers were businesses based outside of Michigan which maintained a sales force that called upon Michigan businesses. The sales force, who worked out of their individual homes, encouraged businesses to place orders for the taxpayers' products at the taxpayers' out-of-state offices. Those orders were then processed and shipped to Michigan customers from outside the state.

ii. The Department assessed SBT liability against the taxpayers. The dispute in the case was whether the Department could retroactively apply a court decision and impose the SBT for the tax years during which there was an interpretive ruling issued by the Department that was favorable to the taxpayers' position.

iii. In 1989, the Department in RAB 1989-46 held that P.L. 86-272 prohibited Michigan from imposing the SBT on a business whose sole contact with the state were merely solicitation activities conducted by an independent contractor of the business. Four years later, in *Gillette*, the Michigan Appellate Court held that P.L. 86-272 did not apply to the SBT because it is a value-added tax rather than an income tax. *Gillette Co. v. Dept. of Treasury*, 519 N.W.2d 156 (Mich. App. Ct. 1993). The Department in this case argued that it could retroactively apply *Gillette* and that the taxpayers therefore did not have the protection of P.L. 86-272 for tax years prior to 1993.

iv. The trial court ruled in favor of the Department. On appeal, the appellate court reversed the decision and held that the Department could not retroactively apply *Gillette*. The appellate court concluded that the Department was bound by its earlier RAB 1989-46 and accordingly "cannot apply a different position to the detriment of a taxpayer for activity before March 1, 1993, the date of the release of this Court's opinion in *Gillette*."

v. On further appeal, the Michigan Supreme Court reversed the appellate court's decision and held that the *Gillette* decision can be retroactively applied. In a one-sentence opinion, the Michigan Supreme Court reinstated the trial court's decision and expressly adopted the reasoning in the appellate court's dissent. In the appellate court, the dissent stated that the same issue had previously been decided in *Rayovac Corp. v. Dep't of Treasury*, 691 N.W.2d 57 (Mich. Ct. App. 2004), which held that the retroactive application of the new nexus standards for SBT under *Gillette* did not violate the Commerce Clause. The Department was not prevented from retroactively applying such new standards created by case law simply because it had issued RABs advising taxpayers of the then-applicable rule. Because the issue was already decided previously, such precedent must thus be followed.

vi. Accordingly, in determining whether a taxpayer has sufficient nexus with the state for tax years before *Gillette* in 1993, the Department may retroactively apply *Gillette* under which the protection of P.L. 86-272 would not apply to the SBT. The Department is not bound by its prior RAB 1989-46 (under which P.L. 86-272 would apply to the SBT) because such RAB did not have the force of law. It

should be noted that the SBT has been repealed by the Michigan legislature for tax years beginning after December 31, 2007. H.B. 5743 (Mar. 31, 2006); Senate Journal No. 73 and House Journal No. 71 (Aug. 9, 2006).

F. "Intangible" Nexus

a. *Lanco, Inc. v. Director, Division of Taxation*, 21 N.J. Tax 200 (N.J. Tax Ct. 2003), rev'd, 879 A.2d 1234 (N.J. Sup. Ct. App. Div. 2005), aff'd 908 A.2d 176 (N.J. 2006), petition for cert. filed, No. 06-1236 (U.S. Mar. 9, 2007).

i. On March 9, 2007, Lanco petitioned the United States Supreme Court for a writ of certiorari. The question presented in the petition is whether the New Jersey Supreme Court erred when it concluded that the Commerce Clause permits a state to impose an income tax on an out-of-state corporation that has no physical presence in the taxing state.

G. Doing Business In The State

It doesn't take much to do business in California, according to the Destino case. A Nevada LLC was determined to have California nexus because it received rent checks in California from a rental house in Nevada. In North Carolina, the Department of Revenue applied traditional standards to find that an out-of-state retailer had nexus because she delivered her product and installed it in customers' residences in the state. Finally, the Pennsylvania Commonwealth Court correctly concluded that many in-state activities created franchise tax nexus.

1. CALIFORNIA

a. *In re Destino Properties, LLC*, No. 339961, CCH ¶404-212 (Cal. Bd. of Equalization Feb. 1, 2007).

i. Taxpayer was a Limited Liability Company ("LLC") organized in Nevada. Taxpayer's sole asset was a single-family home located in Nevada, from which it received rental income. Three of Taxpayer's four members had residences in California. Taxpayer argued that it did not owe the annual LLC tax because it was not doing business in California. Specifically, the taxpayer argued that it was organized in Nevada, it had never registered to do business in California, its only asset was located in Nevada, and it conducted most of its management activities outside of California.

ii. The Franchise Tax Board ("FTB"), however, contended that the taxpayer was doing business in California. Specifically, the FTB argued that any action that the taxpayer's managing members took

on behalf of the taxpayer for financial gain is attributable to the taxpayer; thus, if any such action was taken in California, then the taxpayer was doing business in California. According to the FTB, because the managing member performed managerial functions in California on behalf of the taxpayer, the taxpayer was therefore considered to be doing business in the state.

iii. The Board of Equalization ("Board') upheld the franchise tax assessment. The Board stated that the term "doing business" has been construed broadly and the "doing business" test is met if there is any active participation in any transaction for pecuniary gain or profit. The Board held that the taxpayer, through one of its members, had actively participated in managing the Nevada property. In holding so, the Board looked to the following activities conducted in California by the taxpayer's member: (i) receipt of rental checks from Nevada tenants at the California address, endorsement of the checks and mailing of such checks to a bank; (ii) authorization of repairs; (iii) receipt of mail, and (iv) hiring of a California tax preparer. As a result of such activities, the taxpayer was therefore "doing business" in California.

2. NORTH CAROLINA

a. Department of Revenue, Docket No. 2006-177, CCH ¶202-368 (N.C. Jan. 16, 2007).

i. Taxpayer was an out-of-state retailer who sold, delivered and installed window shutters at customers' residences in North Carolina. Taxpayer used her own trucks to deliver the shutters to North Carolina and her own employees to install the shutters in North Carolina. The Department issued an assessment for sales tax on the sales of window shutters delivered and installed at customers' residences in North Carolina during the audit period.

ii. The Department upheld the sales tax assessment, holding that the taxpayer was engaged in business as a retailer in North Carolina. The Department justified its holding on the ground that the taxpayer had used company vehicles to deliver the window shutters and that its employees had entered the state to deliver and install such window shutters. Such activities thus brought the taxpayer within the definition of "engaged in business" in North Carolina.

3. PENNSYLVANIA

a. *Cruise Int'l Corp. v. Commonwealth,* No. 667 F.R. 2004, CCH ¶203-643 (Pa. Commw. Ct. Jan. 18, 2007).

i. Taxpayer was an out-of-state corporation engaged in business as a broker. Taxpayer contracted with independent truck drivers to make deliveries of goods and supplies in Pennsylvania and elsewhere for third party vendors with interstate customers. The truck drivers were independent contractors who owned the trucks used to make the deliveries. Taxpayer did not have any employees, officers, customers, or property in Pennsylvania. In addition, Taxpayer did not generate any sales in Pennsylvania, nor did it bill or pay any Pennsylvania business. During each of the tax years at issue, the independent truck drivers made over 200 trips back and forth and through Pennsylvania, totaling over 15,000 miles respectively.

ii. The Department issued franchise tax assessments against the taxpayer for the tax years at issue on the basis that the taxpayer was "doing business" in Pennsylvania by virtue of leasing trucks from the truck drivers for the purpose of making deliveries into Pennsylvania. Taxpayer argued that it was not "doing business" in Pennsylvania, relying largely on a Department ruling which provides that, where a foreign corporation delivers its products into Pennsylvania via a common carrier, that activity is insufficient to create nexus for franchise tax purposes.

iii. The court upheld the franchise tax assessments, finding that the taxpayer was doing business in and employing capital in Pennsylvania. According to the court, Taxpayer was engaged in the transportation of property in and through Pennsylvania. Specifically, through its lease agreements with the truck drivers, Taxpayer was using and employing property in Pennsylvania to accomplish its corporate purposes. The court also noted that the Department ruling cited by the taxpayer was distinguishable in that instant case did not involve common carrier. Accordingly, the taxpayer had sufficient nexus with the state to be subject to the Pennsylvania franchise tax.■

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