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# State Tax Return

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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 Third and Fourth Quarters of 2008. It is organized by the kind of activity that tends to give out-of-state entities nexus planning and litigation difficulties. This issue includes recent decisions in Missouri, New York and Virginia regarding sales personnel who travel in and out of the state, a new development about website nexus in New York, a discussion of the decisions of Oklahoma and Texas courts that reached opposite conclusions on the nexus implications of stored natural gas, affiliate nexus developments in California, Kentucky, Massachusetts and Virginia, a New Mexico case on agency nexus, "economic nexus" cases in Iowa, Maryland and Massachusetts and administrative rulings in Texas and Virginia regarding the type of activities that exceed the protection of P.L. 86-272.**

## EMPLOYEE VISITS

***It's no surprise that the Virginia Tax Commissioner found that the presence of the Taxpayer's sales representatives in Virginia creates use tax collection responsibility. Representatives soliciting sales in a state on behalf of a company always create use tax nexus.***

### VIRGINIA

***Ruling of Commissioner, P.D. 08-167, CCH ¶ 204-892 (Va. Dep't of Tax., Sept. 11, 2008).***

1. An out-of-state corporation (the "Taxpayer") was a provider of broadcast computer equipment (servers) and software used to transmit data via television. In connection with its server sales, the Taxpayer provided installation, customer support, training services,

and repair and maintenance services. The taxpayer did not maintain a home office in Virginia and did not employ Virginia residents for sales or active solicitation. Instead, the Taxpayer used traveling sales representatives that solicited sales to Virginia based customers and provided installation and maintenance services to these customers. The Taxpayer sought a ruling that its sales of broadcasting equipment and services were exempt from the Virginia retail sales and use tax.

2. The court found that pursuant to Va. Code § 58.1-612A, the sales tax was collectible from all persons who are dealers. "Dealers" was defined to include every person who "imports or causes to be imported into this Commonwealth tangible personal property from any state or foreign country, for sale at retail, for use, consumption, or distribution, or for storage to be used or consumed in this Commonwealth." The statute further provided that a dealer will be deemed to have sufficient activity or nexus in Virginia if the dealer solicits business in Virginia by employees, independent contractors, agents or other representatives. The court held that the Taxpayer satisfied this requirement through its use of traveling sales representatives that solicit sales to Virginia based customers and provide installation and maintenance services to these customers. Therefore the Taxpayer was subject to the registration and collection requirements of the Virginia retail sales and use tax. In reaching this conclusion, the court also noted the United States Supreme Court case *General Trading Co. v. State Tax Commission of Iowa,* in which the presence of traveling salesman in a state constituted sufficient nexus to impose use tax collection responsibilities. *See* 322 U.S. 335 (1944). In that case the requirement to collect Iowa's use tax was upheld regardless of the fact that the taxpayer did not maintain a branch, office, or warehouse in Iowa.

## NEW YORK

***Here's another case in which the New York Tax Appeals Tribunal found that the physical presence of an employee in the state created substantial nexus.***

***In re J.C. Newman Cigar Company, DTA NO. 820885, New York Division of Tax Appeals, Tax Appeals Tribunal, (Nov. 06, 2008), CCH ¶406-219.***

1. Petitioner, J.C. Newman Cigar Company, manufactured cigars at its facility in Tampa, Florida. In addition to manufacturing, it also imported cigars from various countries for sale to customers in the United States. Petitioner's only office was in Tampa. Petitioner sold

tobacco products to customers (tobacconists, tobacco outlets, and chain stores; not individuals) in New York State and shipped the products via a common carrier. Petitioner was not registered in New York State as a distributor or wholesaler of tobacco products and did not file tobacco products tax returns in New York State.

2. Petitioner mails catalogs or informational brochures from its Tampa office to promote the sale of its cigars. Petitioner employed a salesperson whose territory consisted of New York and portions of New Jersey and North Carolina. The salesperson visited existing accounts in his designated sales territory from once every six weeks to once every four months. Petitioner filed New York State withholding tax returns and paid New York State withholding tax on this employee. Petitioner argued that its activities in New York were insufficient to satisfy the Commerce Clause and that it should not be subject to tobacco products tax on products sold to customers in New York.

3. Consistent with its prior decisions, the Tax Appeals Tribunal found that the constitutional standard is met if "an out-of-state manufacturer engage[s] independent nonexclusive in-state representatives on a commission basis to seek out and maintain business through repeated visits to potential and current retailers to market products, inspect retail displays and inquire about problems with the products." Such regular marketing efforts satisfy the requirements of the Commerce Clause.

## TEMPORARY IN-STATE PRESENCE

### INDIANA

***The Indiana Department of Revenue found that a related company's handling of customer complaints and providing on-site technical assistance were solicitation activities protected by P.L. 86-272. However, the Department found that the storage of inventory in Indiana was significantly associated with the Taxpayer's ability to establish and maintain a market and created income tax nexus.***

***Letter of Findings 07-0330, CCH ¶ 20081002025 (Ind. Dep't of Rev. Oct. 1, 2008)***

1. Taxpayer corporation was headquartered outside but domiciled in Indiana. It filed a consolidated adjusted gross income tax return which included several related companies. After an audit, the Indiana Department of Revenue issued proposed assessments for additional adjusted gross income tax which added two related

companies to the consolidated group. Taxpayer protested claiming that these two related companies did not have nexus with Indiana.

2. The first related company ("Related 1") had sales staff in Indiana which would occasionally pick up out-dated or malfunctioning equipment, help with paperwork regarding damaged goods, provide on-site technical assistance, conduct in-state training seminars, and supervise the installation or usage of products. It also owned property in Indiana -- molds and dies -- which it provided to unrelated manufacturers that used the molds and dies to produce containers for Related 1's products.

3. The Department acknowledged that P.L. 86-272 precludes Indiana from imposing an income tax on a company that only solicits orders in Indiana, and that the Indiana Supreme Court held that acts of courtesy to accommodate a customer do not exceed solicitation.

4. The Department applied *Tyler Pipe Industries, Inc. v. Washington State Department of Revenue*, 483 U.S. 232 (1987) and asked if "the activities performed in [Indiana] on behalf of the taxpayer are significantly associated with the taxpayer's ability to establish and maintain a market in [Indiana] for the sales."

5. Under this standard, the Department found that Related 1's sales staff's activities were acts of courtesy and, therefore, insufficient to establish nexus. In addition, the molds and dies used by third-party contractors, the Department found, did not contribute to Related 1's ability to maintain a market in Indiana and did not establish nexus.

6. The second related company ("Related 2") had sales staff in Indiana and also had inventory at several Indiana hospitals. The hospitals purchased and removed the goods from the inventory on an as-needed basis.

7. Despite Related 2's argument that its inventory in the state should not establish nexus because the goods were held on consignment at the hospital, the Department found that Related 2 had a substantial nexus with Indiana because it held property in Indiana for later distribution. Related 2's actions on behalf of Taxpayer were significantly associated with the taxpayer's ability to establish and maintain a market in Indiana for sales of its goods, so those activities established nexus.

8. Taxpayer also protested the Department's decision to apply Indiana adjusted gross income tax to Taxpayer's sales to foreign countries under a "throwback rule." Taxpayer supplied documentation to show that it retained title to its goods until the goods were delivered

to customers in foreign countries. The Department originally found that Taxpayer did not have nexus in the foreign countries, so its sales should be taxed in Indiana. Upon protest, the Department found that, because delivery occurred after entry into those countries, Taxpayer had inventory in those countries and therefore had adequate nexus with them. Thus, its income from those sales was not subject to the throwback rule.

## INDIANA

***In this Letter of Findings, the Department again found nexus based on the presence of the taxpayer's products in Indiana. Here, the taxpayer claimed nexus in other states to circumvent the Department's attempt to throw back sales.***

***Dept. of Revenue, Letter of Findings Nos. 07-0527, 07-0537, 07-0538 (Oct. 1, 2008).***

1. Taxpayer sold replacement parts for recreational vehicles and commercial trucks. Taxpayer often sent parts to repair shops in other states near stranded drivers' locations. The Department determined that Taxpayer's income from other states was subject to a "throwback rule" because Taxpayer lacked nexus with those other states. Similarly, the Department determined that Taxpayer's shareholder owed additional Indiana adjusted gross income tax due to additional income attributable to the corporation.

2. Taxpayer and Taxpayer's shareholder protested the imposition of the Indiana adjusted gross income tax, arguing that the corporation did have substantial nexus with the other states. Taxpayer submitted letters from the various states' Departments of Revenue in which the departments found that Taxpayer had sufficient nexus with those states. In addition, Taxpayer explained that it did pay income taxes to those states.

3. The Board read *Tyler Pipe Industries, Inc. v. Washington State Department of Revenue*, 483 U.S. 232 (1987) and *Wisconsin Dept. of Revenue v. William Wrigley, Jr., Co.*, 505 U.S. 214 (1992) together to "provide that an independent contractor's actions may be considered when determining nexus for a taxpayer which has no employees of its own in a state and that the contractor's actions are to be considered with all other activities by the taxpayer in determining whether or not those actions and activities are de minimis."

4. The Department found that Taxpayer was dependent on repair shops' activities in other states to maintain sales in those states

where it does not have repair shops. Taxpayer also had inventory in those states when it shipped the parts to the repair shops and the shops did not install the parts immediately, since the shops never took title to the parts. In addition, because the Taxpayer proved other states' departments had determined it had sufficient nexus and, indeed, Taxpayer had filed income tax returns with all of the states in question, the Department sustained the Taxpayer's protest.

***This Letter of Findings demonstrates the nexus danger of delivering merchandise in your own vehicles and sending employees into a state to install your products. The Department easily concluded that nexus was present.***

***Letter of Findings 08-0079, CCH ¶ 401-336 (Ind. Dep't of Rev. October 29, 2008)***

1. Taxpayer sold boat docks and lifts to Indiana residents. After an audit, the Indiana Department of Revenue determined that Taxpayer had failed to remit sales tax on the sales of boat docks and lifts to Indiana residents. Taxpayer protested the imposition of sales tax.

2. Department ruled that taxpayer's contact was "more than the mere solicitation of business or delivery by a third-party carrier," because (1) taxpayer sold and delivered products to Indiana residents using its own vehicles to transport the items; (2) taxpayer's employees helped install the items; and (3) at times, terms of payment such as "cash on delivery" were fulfilled in Indiana.

***Two state courts recently reached different conclusions on whether the assessment of ad valorem tax on stored natural gas violates the Commerce Clause. The Oklahoma Supreme Court said NO, and affirmed the assessment. The Texas Court of Appeals said YES, and reversed the assessment on stored natural gas.***

## OKLAHOMA

***In the Matter of the Assessment of Personal Property Taxes, 2008 OK 94 (Oct. 21, 2008), 2008 Okla. LEXIS 98.***

1. The Woods County Assessor (the "Assessor") issued an omitted property tax assessment against Missouri Gas Energy ("Energy") for natural gas held in an underground storage facility in Woods County, Oklahoma (the "County"). Energy appealed to the trial court which ruled in favor of Energy. Assessor appealed to the Supreme Court.

2. Energy was a local gas distribution company with a principal place of business in Kansas City, Missouri. It purchased natural gas from suppliers in Texas, Kansas and Oklahoma and contracted with Panhandle Eastern Pipeline Company ("Panhandle"), an interstate carrier of natural gas, to transport the gas to Missouri. Energy did not sell gas in Oklahoma and did not have facilities or employees in the state.

3. During transport, some of the natural gas was stored at a site in the County. Panhandle offered a storage service to its shippers, whereby the shippers nominated gas into storage. While the shippers made an election to store gas, they could not specify which storage facility was to receive the gas nominated for storage. In addition, the molecules of gas that went into a storage facility were very unlikely to be the same molecules that the shipper purchased. It was not possible to trace the stored molecules of gas. Assessor argued that the gas stored in the County was subject to ad valorem taxation by the County.

4. Upon review, the Court found that (1) the tax was levied upon gas stored in the County and not upon an intangible interest in that gas, (2) the gas stored in the County had a taxable situs in the County, (3) the gas in the County was owned in common by all shippers with storage volume on the Panhandle Pipeline system, (4) the tax was not barred by the Commerce Clause and (5)Energy's stored gas was not covered by the Freeport Exemption.

5. In analyzing the Commerce Clause issue, the Court used the four-part test from *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977). The Court stated that "[u]nderlying the *Brady* analysis and contemporary Commerce Clause jurisprudence in general is the conviction that those engaged in interstate commerce must expect to pay their just share of state tax burdens." The Court rejected the use of an analysis that would focus on whether a tax was proper based on an interruption in transit that took the goods out of interstate commerce (the analysis used by Peoples Gas).

6. The first prong of the *Brady* test is whether there is substantial nexus between the property taxed and the taxing state. The Court found that Energy had substantial nexus in the County. Energy argued that its only contact with Oklahoma was its contractual relationship with Panhandle and regardless of how long the gas was present in the County, it was "merely passing through the state" and therefore could not have nexus in Oklahoma. The Court found that, because some portion of the gas was stored in the state at all times, it was not merely passing through. Although Energy had no control over the gas in storage or the timing of its return,

Energy elected and intended to have the gas stored and because it contracted with Panhandle, Energy knew the gas would be stored in either the County or a facility in Kansas. The Court based its finding on the fact that Panhandle stored gas on behalf of Energy and a certain amount was stored in the County at all times during the year. The stored gas created nexus in Oklahoma.

7. The Court also found that the remaining prongs of the *Brady* test were met. First, the tax was fairly apportioned to activities carried on by Energy within the state because the County was seeking to tax gas located in the County and nowhere else. Second, the Court found that the tax was not discriminatory because it falls on anyone owning property located in the state on the assessment date. Third, the tax was reasonably related to the services provided by the state to the taxpayer. Energy argued that because it had no offices or employees in Oklahoma, did not use the states' infrastructure and did not benefit from police or fire protection (because any loss would fall on Panhandle) it was not benefiting from the state's services. The Court found that the analysis is not whether the tax was proportionate to the amount of benefit Energy received from the state, but rather whether the tax was reasonably related to Energy's contact with the state. Energy's gas is taxed to the same extent as all other personal property in the state.

8. Using the *Brady* test, the Court found nothing in the record to show that the taxation by the County of Energy's gas stored in the County violated the Commerce Clause.

**<u>TEXAS</u>**

***The Peoples Gas, Light, and Coke Company v. Harrison Central Appraisal District, No. 06-07-00103-CV, 6<sup>th</sup> App. Dist. of Texas at Texarkana (Sept. 24, 2008).***

a. The Harrison Central Appraisal District (the "District") assessed a large ad valorem tax bill against a portion of natural gas owned by Peoples Gas, Light and Coke Company ("Peoples"). Peoples appealed a judgment favoring the District.

b. Peoples was a Chicago distribution company that purchased natural gas from suppliers and delivered it to customers in Chicago, Illinois. Peoples bought gas that was already on an interstate pipeline owned and operated by Natural Gas Pipeline Company of America ("Pipeline"). The gas was also stored on the pipeline. Peoples had no employees, representatives, physical facilities or offices in Texas. It had no presence in Texas other than the stored gas which was the subject of the case.

c. A portion of gas was stored at the North Lansing storage facility in Harrison County, Texas in order to provide pressure and balance necessary to facilitate the safe and efficient operation of the pipeline. Pipeline paid ad valorem taxes on this portion of stored gas. The District also assessed ad valorem tax against Peoples.

d. Peoples contended that it did not own, for ad valorem tax purposes, any of the natural gas lying beneath Harrison County and, even if it did, the Commerce Clause shielded it from taxation by the District because the gas was in interstate commerce. The court found that Peoples did own a portion of the gas, but the District did not have authority to tax Peoples.

e. Congress protects interstate business activity by restricting state regulation of interstate commerce. Here, the natural gas entered the stream of interstate commerce when it was placed with the common carrier, Pipeline. In addition, the court found that the gas stored at the North Lansing center was also in interstate commerce because, although there was a stoppage in transit, Peoples had no control over the operations of the pipeline and did not control where the natural gas was stored. Because the stoppage of natural gas in North Lansing did not serve the business purpose of Peoples, storage, in this case, was part of interstate transportation.

f. Since the gas was part of interstate commerce, in order to tax the gas, there must have been “some definite link, some minimum connection, between [the] state and the person, property, or transaction it [sought] to tax.” Peoples did not have a physical presence in Texas and there was no evidence that the gas was delivered to customers in Texas. The only connection that Peoples had to Texas was through the structure and location of Pipeline’s pipeline and Pipeline’s decision to store the gas in North Lansing. The connection was not sufficient to subject Peoples to ad valorem taxes. The District contended that nexus existed between the natural gas and the state since much of the gas was Texas-produced. However, since there was no way to ascertain the location from which Peoples’ allocation of gas originated, the storage of the gas in North Lansing was insufficient to create nexus.

g. The court relied on an out-moded theory of taxation regarding movement in interstate commerce to conclude that the taxation of gas owned by Peoples violated the Commerce Clause. For a similar case with a different conclusion, see In the Matter of the Assessment of Personal Property Taxes, 2008 OK 94 (October 21, 2008).

## IN-STATE PERSONNEL

### INDEPENDENT CONTRACTORS, SALES REPRESENTATIVES, AND MANUFACTURING REPRESENTATIVES

### MISSOURI

***It's not surprising that Missouri found in-state representatives soliciting orders on a company's behalf created use tax nexus. In-state personnel, if working on a company's behalf, always create use tax nexus.***

***Letter Ruling No. LR4724, CCH ¶202-908 (Mo. Dep't of Revenue, May 5, 2008).***

1. Applicant is an out-of-state business that sells coffee, hot chocolate, tea, coffee mugs, and t-shirts to schools, churches, and other Missouri nonprofit organizations. Applicant has two sales representatives who live in Missouri and work out of their homes.

2. Applicant asked whether it has nexus with Missouri for use tax purposes and the Department of Revenue said yes. Under 12 CSR 10-114.100(1), "sufficient nexus exists when the vendor has a physical presence in Missouri." Applicant's two sales representatives who live and sell products in Missouri establish nexus. Therefore, the Department found that Applicant must collect use tax unless an exemption applies to the sales.

### NEW YORK

***As reported in our September, 2008 nexus update, New York's much publicized new law creates "website nexus" for out-of-state companies if the company has an agreement with a New York resident to refer customers. Here's another lawsuit challenging this law.***

***Overstock.com, Inc. v. New York Dep't of Taxation and Finance, No. 107581/2008, (N.Y. Supreme Ct. May 30, 2008).***

1. Overstock.com has filed a lawsuit challenging the constitutionality of New York Senate Bill 6708.

2. Overstock alleges that because some independently operated, New York-based websites post advertisements with links to Overstock.com and are compensated for these advertisements, Overstock is presumed to be engaged in "solicitation" under the statute. As a result, Overstock contends that the statute requires it to collect and pay New York sales and use taxes on receipts from sales to New York customers despite the fact that it lacks any physical presence in New York and does not actively solicit business there.

3. Overstock seeks a declaratory judgment that the new statute is invalid and unconstitutional on the grounds that it violates both the Commerce Clause and the Due Process Clauses. Overstock also seeks a permanent injunction that prohibits the Department from enforcing the new statute.

**VIRGINIA**

***Warranty services performed by unrelated distributors, retailers, and contractors were purchases of services by Taxpayer and did not exceed the protection of P.L. 86-272.***

***Ruling of Commissioner, P.D. 08-184, CCH ¶ 204-908 (Va. Dep't of Tax., Oct. 17, 2008).***

1. The Taxpayer was commercially domiciled outside Virginia and maintained no property or employees in Virginia. Sales solicitation activities by the Taxpayer were limited to those permitted under P.L. 86-272. Taxpayer sold two distinct products. Commercial products were sold directly to contractors that installed the products. Residential products were sold to distributors that, in turn, sold to retailers and contractors for sale to residential customers.

2. Both commercial and residential products carried a parts and labor warranty. Commercial warranties were fulfilled by the contractor that did the installation. In contrast, residential warranties claims were handled by the distributor, retailer or contractor. In both cases, the Taxpayer shipped parts to the entity providing the warranty work and reimbursed the entity for the cost of repairs or replacements. The Taxpayer had no ownership interest in any of the distributors, retailers, or contractors operating in Virginia. The Taxpayer sought a ruling as to whether the warranty services provided by a third party entity in Virginia subjected the Taxpayer to Virginia income tax.

3. In a previous ruling, the Department of Taxation affirmed that warranty services carried on in Virginia are not an activity protected

by P.L. 86-272 (and are therefore subject to Virginia income tax). *See* P.D. 99-278, 1999 WL 1286061 (Va. Dep't of Tax., Oct. 14, 1999). However, that ruling further stated that the provision of services in Virginia by an independent contractor on behalf of a taxpayer was the purchase by the taxpayer of services from a vendor that were then resold to the taxpayer's customers. Accordingly, such activity would not create nexus for the taxpayer purchasing the services.

4. In this case, warranty services were not purchased from a warranty company. Rather, the services were provided by unrelated distributors, retailers, and contractors. The Taxpayer reimbursed these independent contractors for providing the warranty services. Therefore, in accordance with P.D. 99-278, the performance of warranty services by the distributors, retailers, and contractors in Virginia were purchases of services by the Taxpayer and did not exceed the protection afforded under P.L. 86-272. Thus, the Taxpayer was not subject to Virginia income tax.

## AFFILIATE NEXUS

***States continue to be active in the area of affiliate nexus. The California Board of Equalization reached a settlement with barnesandnoble.com.***

### CALIFORNIA

***barnesandnoble.com LLC v. State Bd. of Equalization*, Case No. CGC-06-456465 (Cal. Super. Ct Sept. 7 2007).**

1. On May 29, 2008, the Board and barnesandnoble.com agreed to settle the tax determinations totaling approximately $17.7 million for $9 million. The settlement was for sales and use taxes, interest and penalties through November 1, 2005 -- the date on which barnesandnoble.com voluntarily began collecting and remitting sales and use taxes.

### KENTUCKY

***In this case, the Circuit Court found that the Department of Revenue's inclusion of subsidiaries with no physical presence in Kentucky in a consolidated income tax return violated the Commerce Clause. The Circuit Court also rejected the Department's claim that AT&T waived its constitutional rights by voluntarily filing a consolidated return.***

***AT&T Corp. v. Kentucky Dep't of Rev., No. 08-CI-01272, CCH ¶202-850 (Jefferson Cty. Circ. Ct. Sept. 9, 2008)***

1. AT&T is organized under laws of New York and has hundreds of subsidiaries across the nation. Approximately 20 of the subsidiaries were located in Kentucky during the tax period at issue. AT&T filed a consolidated income tax return in Kentucky. AT&T included all of its subsidiaries, including those with no physical presence in the state, and then sought refunds for excess income taxes paid due to the inclusion of those subsidiaries. The Department of Revenue denied AT&T's claims, finding that all of the subsidiaries nationwide comprise an "affiliated group" for taxation purposes and are thus treated as a single corporation. The Board of Tax Appeals affirmed, reasoning that AT&T elected to be treated as a single corporation by filing a single consolidated return, instead of individual returns for each corporate subsidiary. AT&T appealed.

2. The Court held that the income tax imposed upon AT&T violated the Commerce Clause because the "great majority of AT&T's subsidiaries that essentially have nothing to do with the state of Kentucky have been forced to pay taxes" to Kentucky. The Court noted that out-of-state corporations were forced to pay taxes to Kentucky without enjoying the benefits in-state corporations receive. The Court also rejected the Department's argument that AT&T's voluntary election to file a consolidated return, constituted waiver of its constitutional rights. Because the tax disproportionately favored in-state interests while burdening foreign corporations, the court found that it violated the Commerce Clause due to a lack of nexus between the state and the entity it sought to tax.

## MASSACHUSETTS

***The Massachusetts Appellate Tax Board found "substantial nexus" here because the taxpayer's intrastate and out-of-state activities constitute a "unitary business" enterprise.***

***NES Group, Inc. & Tomsich v. Commissioner of Revenue, 2008 WL 4427500 (Mass. App. Tax. Bd. Sept. 30, 2008).***

1. Appellant NES Group was incorporated in Delaware and has its principal place of business in Ohio. NES, at all relevant times, acted primarily as a holding company (either as the general or limited partner) in multiple entities, including several entities that either sold tangible personal property, performed services, or had offices in Massachusetts.

2. In Massachusetts, S-corporations with receipts that meet or exceed $6 million are taxable as an entity.

3. A corporate excise deficiency was assessed against Appellant, based on the Commissioner's reclassification of NES Group as a manufacturing corporation. The Commissioner's reclassification of Appellant took into account the activities of six pass-through entities (limited partnerships and qualified subchapter S subsidiaries) engaged in manufacturing outside the Commonwealth of Massachusetts.

    a. NES was either a 99-percent limited partner or 100-percent owner in each of these six manufacturing entities.

    b. None of these six entities owned, rented, or used any real or personal property in Massachusetts. None rendered any personal services or paid any compensation in Massachusetts. However, three of these entities sold tangible personal property in Massachusetts.

    c. These entities either manufactured industrial equipment, printing equipment, trade show displays, or conveyors.

4. Appellant contended that "the inclusion of entities that have no connection to Massachusetts in considering manufacturing classification is unconstitutional." In essence, Appellant asserted that Massachusetts cannot tax value earned outside its borders.

5. The Appellate Tax Board stated that "substantial nexus is present where the taxpayer's intrastate and out-of-state activities constitute a "unitary business" enterprise." Since Appellants offered no evidence to establish that the various operating entities under common NES Group Control constituted "discrete business enterprises" the Appellate Tax Board affirmed the assessment.

***These Rulings of the Virginia Tax Commissioner offer guidance on the types of affiliation that create nexus for corporation income tax and a nonresident's obligation to pay individual income tax on income received from a Virginia limited partnership that owns land in Virginia.***

**VIRGINIA**

***Ruling of Commissioner, P.D. 08-123, Virginia Dep't of Taxation, June 26, 2008.***

1. Type of Tax: Individual Income Tax.

2. Taxpayer was not a resident of Virginia, but owned a 13% limited partnership interest in a Virginia limited partnership ("VLP"). The first issue was whether the VLP's income was taxable and the second issue was whether the tax could be assessed against Taxpayer.

3. VLP's primary asset holdings included various investments, holdings in publicly traded partnerships as a limited partner, two plots of unimproved land, coins and a minority interest in two limited liability companies that owned unimproved land in Virginia. Taxpayer claimed that VLP was not engaged in business in Virginia because VLP had no employees and no property for conducting business and the undeveloped land and coins were not employed in a business carried on in Virginia because they did not generate income.

4. Taxpayer relied on Tax Bulletin 05-6 which stated that pass-through entities that are established solely to invest in intangible personal property and that have no employees and no real or tangible property are not considered to be carrying on a trade or business. However, because VLP owned land, tangible assets and a minority interest in two limited liability companies that owned land in Virginia, VLP did not qualify as an *investment* pass-through entity. All of VLP's income resulted from a business and was taxable in Virginia.

5. Taxpayer further claimed that the Due Process Clause prohibited her from being taxed because she lacked sufficient contacts with Virginia. However, because the Department had the authority to tax the income of VLP, it had the authority to assess the tax against the Taxpayer as a partner of VLP. It was not a matter of whether the income was subject to tax, but who was to pay the tax.

***Ruling of Commissioner, P.D. 08-139, Virginia Dep't of Taxation, July 30, 2008.***

1. Type of Tax: Corporation Income Tax.

2. Corporation A was a corporation not domiciled in Virginia, but subject to Virginia corporate income tax. Corporation A produced and sold tangible personal property nationwide. It wholly owned Corporation B, which wholly owned Corporation C. The issue was whether Corporation B or Corporation C were subject to Virginia income tax. The Commissioner found that only Corporation C had nexus in Virginia, but was not subject to income tax because it was not clear that it had source income or a positive sales factor.

3. Corporation A generated accounts receivables from the sale of the property. It sold the receivables to Corporation B for a discount and Corporation B sold them to Corporation C. Corporation A serviced the receivables on behalf of Corporation C, traveling to Virginia to do so. While in Virginia, Corporation A's collection officers engaged in sales promotion on behalf of Corporation A, the periodic review of existing customers' creditworthiness, and the discussion of delinquent accounts.

4. Corporation B did not have nexus because its income was limited to the net proceeds from the resale of the receivables to Corporation C, so it did not have any connections with Virginia that created nexus.

5. Corporation C did have nexus in Virginia because Corporation A's employees serviced its receivables in Virginia. Although an independent contractor's services in the same situation would not have created nexus for Corporation C, because Corporation C was indirectly owned entirely by Corporation A, Corporation A's services were imputed to Corporation C for nexus purposes.

***The following ruling illustrates the nexus consequences of a related brick-and-mortar store accepting returns of merchandise purchased from a related out-of-state mail-order seller. It also demonstrates that nexus risk may result from an unrelated third-party's set-up and installation of merchandise.***

***Ruling of Commissioner, P.D. 08-168, CCH ¶ 204-893 (Va. Dep't of Tax., September 11, 2008).***

1. The Taxpayer was an out-of-state corporation that sold its products to Virginia customers through mail order and via the Internet. Its products were delivered by unrelated third party contract carriers.

2. The Taxpayer was related to an entity (Stores) that had retail stores located in Virginia that sold many of the same products as the Taxpayer. As a service to their customers, the retail stores accepted returns of merchandise purchased from the Taxpayer. The Taxpayer's website did not advertise that returns were accepted at retail stores, but instead instructed customers to ship merchandise directly to its distribution center located outside Virginia. Taxpayer requested a ruling that it did not have nexus with Virginia for purposes of corporate income tax.

3. <u>Delivery</u>. In this case, delivery services were provided by unrelated third party contract carriers. The Taxpayer argued that its use of carriers that were independent contractors was protected by P.L.

86-272. However, the delivery companies unpacked merchandise, provided minor setup services, inspected purchased property for quality and damage, and removed packaging materials. The Tax Commissioner concluded that depending on the manner in which these activities were carried out, they could exceed the solicitation of sales in Virginia. If the activities of the contract carriers went beyond the solicitation of sales, such activities would not be protected by P.L. 86-272. The Tax Commissioner stated that she did have enough information about the activities of the contract carriers to resolve this issue.

4. <u>Merchandise Returns</u>. Stores operated retail stores and its activities were separate from the Taxpayer. However, the Taxpayer's relationship with Stores was such that there was direct or indirect common ownership so that the two entities were included in the same corporate family. Under such circumstances, the Tax Commissioner found the issue to be whether the agent (Stores) was independent from the principal (the Taxpayer) it represented. According to the Tax Commissioner, the mere potential of an entity to control an agent disqualifies the agent as an independent contractor, even if the agent is an unrelated corporation. In a case where a corporation is performing services for a related entity, there is a strong presumption that the right or potential of control is present at minimum, and that actual control likely exists as well.

5. The facts indicated that Stores accepted returns of merchandise from customers who purchased items through the mail or over the Internet. The Tax Commissioner held that because customers' regard for the mail order or Internet seller is enhanced by the availability of a place to return merchandise locally, the Taxpayer benefited from Stores' policy even if its website did not advertise that merchandise may be returned to Stores' locations. Moreover, Stores provided an additional service not provided to unrelated third parties. Stores provided a local shipping point for the Taxpayer's returned merchandise not carried in the retail store; Stores did not provide similar services to unrelated third parties. Again, this illustrated that more services were provided to related entities than to unrelated third parties.

6. The Tax Commissioner has typically found that such internal business policies and accounting practices are a function of a corporate family of business acting in its own best interest and the desirability of portraying the public image of a seamless entity. As such, the Tax Commissioner concluded that Stores' return policy, when conducted in Virginia on behalf of the Taxpayer, constitutes sufficient nexus to the state for taxation.

## UNRELATED IN-STATE PRESENCE

***States continue to assert nexus based on the in-state activities of unrelated third parties. The New Mexico Court of Appeals found nexus here based on its finding that the unrelated third-party's in-state activities helped the taxpayer establish and maintain a market in New Mexico.***

### NEW MEXICO

***Dell Catalog Sales L.P. v. New Mexico Taxation and Revenue Dep't, No. 26,843, 189 P.3d 1215 (N.M. Ct. App. 2008).***

1. Dell Catalog Sales L.P. (Taxpayer) is a limited partnership with its principal place of business in Texas. Taxpayer does not own or lease property in New Mexico, has no retail stores in the state, and has no sales agents or employees there. The Taxpayer also does not franchise or license its trade name in New Mexico. Instead, Taxpayer, uses a "direct to the customer" sales model, to sell computers to individual customers. The individual customers contact Taxpayer in Texas to place orders directly by phone, mail, fax, or over the internet. Taxpayer also advertises by mailing catalogs to potential customers in New Mexico. Taxpayer makes all shipments to New Mexico customers by common carrier.

2. Taxpayer's limited warranty is a return to factory. Customers who want at-home repair services are offered service contracts provided by an unrelated third-party service provider, BancTec U.S.A., Inc. When customers need repair, they contact Taxpayer. About 75% of New Mexico customers purchased the additional service contract.

3. In July, 1999, the Taxation and Revenue Department audited Taxpayer and determined that it had not reported or paid gross receipts taxes on computer sales to New Mexico customers or compensating taxes on the value of advertising materials distributed in New Mexico. Taxpayer protested the assessment, but the hearing officer found that taxpayer was liable for gross receipts tax. Taxpayer appealed, arguing in part that the imposition of gross receipts tax and compensating tax violates the Commerce Clause.

4. The court noted at the outset that it had to address the extent to which a third party can establish substantial nexus on behalf of an out-of-state business sufficient to satisfy Commerce Clause limitations on state taxation. In such cases, "the crucial factor governing nexus is whether the activities performed in this state on behalf of a taxpayer are significantly associated with the taxpayer's ability to establish and maintain a market [in the taxing state] for the

sales." *Tyler Pipe Indus., Inc. v. Wash. State Dep't of Revenue*, 483 U.S. 232, 250 (1987).

5. The court found that BancTec's activities helped Taxpayer "establish and maintain a market," which is the crucial factor in establishing nexus. Taxpayer, through its relationship with BancTec, had substantial nexus with New Mexico and was subject to gross receipts and compensating tax.

## IN-STATE ADVERTISING/SOLICITATION

***Local advertising can create nexus risks. In an advisory ruling, the New York Tax Commissioner stated that advertising via satellite or cable television alone does not create nexus. Likewise, in a letter ruling, the Missouri Department of Revenue found that magazine advertising alone does not create nexus.***

***Administrative Ruling, CCH ¶406-143 (N.Y. Comm'r of Taxation and Finance, Aug. 6, 2008).***

1. Petitioner, Gems TV USA Limited, a Delaware Corporation, is a retailer of gemstone jewelry. Petitioner has no locations or employees in New York and does not maintain a place of distribution, sales, storage, or a warehouse in the state. All products are warehoused in Nevada and are shipped from a location outside New York to New York customers via UPS. Petitioner's shopping programs are filmed in its studio located outside New York. Petitioner has an agreement with a satellite television provider (STP) that provides that STP will broadcast its shopping programs via satellite. Petitioner's products are available through a dedicated television home shopping channel owned by STP. Petitioner also has an agreement with a procurer to purchase airtime and distribute petitioner's programming on various cable television networks. All orders are sent to petitioner via internet or toll-free numbers. Petitioner also maintains a sales website.

2. In response to a request for an advisory opinion, the Commissioner found that an out-of-state seller that merely advertises via satellite and cable television stations in New York does not have nexus with New York. In addition, contractual relationships for the purchase of airtime or advertising of the kind described with STP, the procurer, and cable operators do not provide an out-of-state seller the physical presence needed for nexus.

***Letter Ruling No. LR4991, CCH ¶202-976 (Mo. Dept. of Revenue, Aug. 19, 2008).***

1. Applicant is an out-of-state company that sells diabetic testing supplies to Missouri residents who have a prescription. Applicant does not have any relationship with physicians. Applicant ships the supplies to the Missouri residents via UPS or the USPS. Applicant does not have any physical presence in Missouri. Specifically, it has no sales representatives and no storage facility in the state. Its only advertisements appear in magazines. Applicant does have a website. Missouri residents may contact Applicant directly to place an order, but Applicant does not make sales calls to Missouri.

2. The Department found that, based on the facts presented, Applicant did not have nexus with Missouri and was not required to collect and remit use tax on the retail sale of its supplies.

***Texas and Virginia issued rulings providing guidance on the type of activities that exceed the protection of P.L. 86-272.***

***Texas Comptroller of Public Accounts, Hearing Nos. 46,233 and 47,108 (April 9, 2008).***

1. Type of Tax: Texas Former Franchise Tax

2. Claimant, a Delaware limited liability company, sought a refund of franchise tax paid for the 2002 tax year. Claimant argued that, under the former Texas franchise tax, it did not have nexus in Texas for the earned surplus portion of the tax because it was protected under P.L. 86-272. Claimant had one employee in the state who solicited orders that were subject to approval at the New Jersey home office.

3. First, the Comptroller established that Claimant had the burden of proof to establish that it did not have nexus. The Tax Division generally bears the burden of proof for imposition of a tax; however, because Claimant elected to file a report for the year in question and reported tax for the earned surplus component, it bore the burden of proof to show that it did not have the required nexus.

4. P.L. 86-272 prohibits a state from imposing a tax measured by net income on a foreign corporation when the only business activity within the state is solicitation of orders for sales of tangible personal property where orders are sent outside the state for approval or rejection. To be protected, the business activity must be limited to solicitation of orders and activities that are ancillary to such solicitation, with the exception of certain *de minimus* activities that only amount to a trivial connection with the state.

5. Claimant's principal evidence was an affidavit from its Texas salesperson stating that all sales solicited by him required approval from the New Jersey office. The Comptroller found that the affidavit alone was not sufficient evidence to meet Claimant's burden of proof. The Comptroller noted that, even if the affidavit was accepted, it contained nothing excluding other activities that may have established nexus, such as performing repairs, maintenance or installation, collecting accounts or securing deposits.

6. The imposition of the tax was upheld because Claimant could not establish lack of nexus.

***Texas Comptroller of Public Accounts, Hearing No. 41,102 (June 6, 2008).***

1. Type of Tax: Texas Former Franchise Tax

2. Taxpayer argued that it did not have nexus in Texas under the earned surplus portion of the former Texas franchise tax because it only solicited business in Texas, did not have any permanent employees in Texas, did not own or lease real or personal property in Texas and did not maintain a place of business in Texas.

3. The Taxpayer had representatives that made at least seven visits to Texas during each year in question for client visits, marketing, client maintenance, customer calls, business entertainment and training. During the visits, the representatives met with specific customers either at their offices or at a third party establishment to promote Taxpayer's products.

4. The Comptroller found that solicitation is defined as "activities that neither explicitly nor implicitly invite an order, but are entirely ancillary to requests for an order." The Comptroller found that it was reasonable to conclude that the visits were to "promote or induce sales" and thus constituted doing business in Texas for purposes of the former franchise tax.

***Ruling of Commissioner, P.D. 08-142, Virginia Dep't of Taxation, July 30, 2008.***

1. Type of Tax: Corporation Income Tax.

2. Taxpayer was a foreign corporation that manufactured and sold medications for animals. Taxpayer employed several sales representatives, a district manager and a veterinarian, all of whom resided and worked out of their homes in Virginia. The issue was whether the employees' activities exceeded the solicitation of sales in order to create nexus in Virginia. The Commissioner found that

the activities of the district manager and the veterinarian did create nexus.

3. Taxpayer argued that all of the employees' activities were either directly related to the solicitation of sales or were ancillary to the solicitation process and had no independent purpose apart from their connection to the solicitation of orders. As such, Taxpayer argued that the activities did not create nexus.

4. The sales representatives solicited sales of the Taxpayer's medications at veterinary clinics and distributed samples to customers within the state. These activities did not create nexus.

5. The district manager recruited, hired, trained and defined responsibilities of the sales representatives and forecasted and evaluated costs and pricing. The district manager was also a tactical coordinator between the regional office and district sales team. The Commissioner found that, although the activities may have served the solicitation function, they were managerial and administrative in nature and therefore did create nexus.

6. The veterinarian conducted product demonstrations and provided technical training to veterinary customers regarding proper use of the products. The Commissioner found that the training created nexus. In so finding, the Commissioner recognized that training provided to customers that is limited to reselling a taxpayer's product, may be ancillary to solicitation and therefore not create nexus. However, training provided for the purpose of enabling customers to use a taxpayer's product in their business is considered a business function separate and apart from the solicitation of sales and does create nexus.

**<u>TEMPORARY NEXUS</u>**

***In this Letter of Findings, the Department found that the Taxpayer's physical presence in Indiana during January, 2006 required it to file a withholding tax return and withhold tax for nonresident shareholders for the whole year.***

***Letter of Findings No. 07-0337P, 08-0347P, CCH ¶20081002007 (Ind. Dep't of Rev. Oct. 1, 2008)***

1. Taxpayer was a limited partnership based in Indiana which sold its partnership in January 2006. It did not pay its Indiana Withholding Tax for Nonresident Shareholders, Partners, or Beneficiaries of Trusts and Estates for 2006. It argued that Indiana lacked the requisite substantial nexus with Taxpayer to impose any continuing tax filing obligation after January of 2006.

2. The Indiana Department of Revenue rejected this argument, proclaiming that the fact that Taxpayer's nexus with Indiana terminated sometime in 2006 does not erase its previous nexus status. It maintained a place of business in Indiana and had sufficient contacts with the state to have a substantial nexus. Because Taxpayer had a nexus with Indiana during 2006, it had a statutory duty to file its return and it failed to do so, so the Board denied the Taxpayer's protest.

## MICHIGAN BUSINESS TAX

***The Michigan Department of Treasury recently released Revenue Administrative Bulletin 2008-4 which provides guidance regarding the Department's nexus standard for the Michigan Business Tax. The nexus standard in this Bulletin is effective retroactively to January 1, 2008. The Bulletin adopts two alternative theories of nexus—physical presence OR economic presence.***

***Michigan Department of Treasury, Revenue Administrative Bulletin 2008-4, CCH ¶401-392 (Oct. 21, 2008).***

1. Persons have nexus with Michigan and are subject to the Michigan Business Tax (MBT) if "the taxpayer has a physical presence in [Michigan] for a period of more than 1 day during the tax year **OR** if the taxpayer actively solicits sales in [Michigan] and has gross receipts of $350,000 or more sourced to [Michigan]."

2. For most companies, the MBT has two components—a business income tax and a modified gross receipts tax. P.L. 86-272 protects a company only from the business income tax portion of the MBT, and only if the company's activities in Michigan are limited to solicitation. A company with nexus may be subject to the modified gross receipts portion even if its only activities in Michigan are solicitation.

3. Physical presence is established for one day if the company is physically present in Michigan for any part of a day.

4. However, the following activities, if conducted for less than 10 days, do not create physical presence nexus: meeting with in-state suppliers; in-state meeting with government representatives in their official capacity; attending occasional meetings; holding recruiting or hiring events; advertising; renting to or from an in-state entity customer list; and attending/participating at a trade show at which no sales are solicited or made.

## <u>“INTANGIBLE” NEXUS</u>

***States continue to assert economic nexus over companies with no physical presence in the state. Iowa rejected the taxpayer’s claim that physical presence was needed for income tax nexus. Instead, it found economic nexus based on the franchise agreements with Iowa restaurants. Not surprisingly, the Maryland Tax Court found that the activities of out-of-state companies formed to hold trademarks were attributable to the parent company because the subsidiaries did not act independently.***

### <u>IOWA</u>

***KFC Corporation v. Department of Revenue, Iowa Dep’t of Inspections and Appeals, Admin. Hearings Div., No. 07DORFC016 (August 8, 2008).***

1. Taxpayer was a fast food corporation with franchisee restaurants in Iowa, and derived royalty and license income from the franchisee’s use of the corporation's trademarks, trade names, service marks, and unique system of preparing and marketing fried chicken. In Iowa, income tax is imposed on corporations doing business in the state, as well as corporations that are deriving income from sources within the state.

2. The taxpayer was determined to be deriving income from sources inside Iowa by receiving royalty and license income from the franchised restaurants in Iowa. Additionally, the nature of the franchise agreements required the taxpayer to rely on the services and jurisdiction of Iowa in order to benefit from the agreements, regardless of the taxpayer’s physical situs in the state.

3. Iowa’s taxation of the taxpayer's income did not violate the Commerce Clause of the United States Constitution because the standard for imposing income tax does not require physical presence. Although the United States Supreme Court has held that physical presence was necessary for nexus concerning sales and use tax, this position was determined to be inapplicable here. Instead, the taxpayer was found to have created nexus with Iowa, despite a lack of property or employees in the state. The Department noted that franchise rights are intangible property that have become an integral part of a business activity occurring regularly in Iowa (citing *Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E.2d 13 (S.C. 1993)).

4. With every Iowa purchase by an Iowan at a franchisee’s location, the franchisee was obligated to pay the taxpayer based on the gross revenue. Additionally, the tax could be fairly apportioned

and/or deducted in the computation of other taxes, did not discriminate against interstate commerce, helped level the field with other foreign corporations doing business in the state, and was related to the governmental functions that all Iowa businesses enjoy.

## MARYLAND

***Nordstrom, Inc. et al. v. Comptroller of the Treasury, 2008 WL 4754842 (Md. Tax Ct., Oct. 24, 2008).***

1. N2HC is a wholly owned subsidiary of Nordstrom. NIHC is a wholly owned subsidiary of N2HC. Neither subsidiary had property or did business in Maryland. Nordstrom incorporated these entities to own and license valuable Nordstrom trademarks (the Marks). The parent company, Nordstrom does business in Maryland.

2. The Tax Court said that the issue was whether there is sufficient nexus between Maryland and the subsidiaries to impose income tax on the subs.

3. Income

    a. The income in question for NIHC arose from the 1999 transfer by NIHC of the right to license the Marks to its parent, N2HC, resulting in a gain.

    b. The income in question for N2HC arose from a license to use the Marks granted to Nordstrom in exchange for an arm's length royalty fee. Additionally, N2HC loaned back to Nordstrom substantial sums of money (approximately 2/3 of the year's royalties) which was being paid back with interest.

4. The Tax Court stated that the test to use to determine nexus is whether the out-of-state affiliates had "real economic substance as separate business entities." The Tax Court, therefore, examined the economic substance of the subsidiaries, as well as the legitimate business activities (other than tax avoidance) of the subsidiaries and their parent.

5. Nordstrom contended that:

    a. N2HC should not be subject to Maryland income tax because it (i) maintained an office in Portland staffed by a specialist who interfaced with outside counsel; (ii) was actively engaged in maintaining, managing, enforcing, and protecting the Marks; and (iii) employed a full-time paralegal. AND

b. NIHC should not be subject to Maryland income tax because the income arising from the 1999 transaction bears no relation to Nordstrom's use of the Marks in its Maryland stores or any other activity conducted in Maryland.

6. The Tax Court held that NIHC and N2HC lacked real economic substance as separate business entities. It stated that, fundamentally, the subsidiaries did not act independently, although the financial structure creates an illusion of substance. The Court further held that the activities of NIHC and N2HC must be considered the activities of their parent, Nordstrom, and, as such, there were substantial activities in Maryland. Nordstrom has constitutional nexus with Maryland, and therefore the assessments were affirmed.

**MASSACHUSETTS**

***Capital One Bank v. Commissioner of Revenue, Docket Nos. C262391 & C262598, CCH ¶ 401-080 (Mass. Appellate Tax Bd. June 22, 2007), Massachusetts Supreme Judicial Court No. SJC-10105 (Mass. 2007).***

1. Capital One has appealed to the Massachusetts State Supreme Judicial Court, arguing that the tax is unconstitutional under the Commerce Clause. Arguments are expected on October 7, 2008.

**VERMONT**

***Applying economic substance doctrine, the Vermont Supreme Court found that holding companies were not separate taxable entities but instead were "nothing more than a vehicle for tax avoidance."***

***TD Banknorth, N.A. v. Dep't of Taxes, 2008 VT 120 (Sept. 19, 2008).***

1. Type of Tax: Bank Franchise Tax (BFT).

2. Commissioner assessed a BFT on Taxpayer. The tax was upheld by the superior court and Taxpayer appealed to the Vermont Supreme Court.

3. Taxpayer was a parent company to three banks. Each of the banks established a wholly owned holding company. Each holding company was a Vermont corporation. The banks capitalized their respective holding companies by assigning certain assets to the holding companies and also by entering into "participation agreements" whereby the holding company received 100% of the economic interest in the assets. However, the Taxpayer retained full management of the assets. Prior to the existence of the holding companies, the banks reported income from the assets. After the

loans were transferred to the holding companies, the income stream from the assets was reassigned to the holding companies, resulting in a loss to the bank for purposes of federal income tax. By reporting the loss, the bank could almost eliminate any payment of the Vermont BFT, which is generally capped not to exceed the bank's federal taxable income. Meanwhile, the holding companies paid virtually no tax on the income based on a carve-out in the Vermont law for corporations whose activities are confined to maintenance and management of certain intangible investments (the "Carve Out").

4. Upon audit, the Department found that the holding companies "had no economic substance or legitimate business purpose and were formed merely to evade the [BFT]." The Department assessed additional BFT, attributing the holding companies' income to its parent company and also imposed a penalty.

5. On appeal, Taxpayer claimed, among other things, that the Commissioner erred in concluding that the holding companies lacked sufficient business purpose and independent economic substance. Taxpayer asserted that the transfer of income-producing assets to a corporation was sufficient to shift the taxability of the income to that corporation. Further, the taxpayer argued that the holding companies engaged in sufficient business activity to be distinct from their parent for purposes of the BFT.

6. The Court applied the economic substance doctrine and found that the holding companies were not taxable entities separate from Taxpayer. The doctrine uses a two prong approach, looking at both the motivation in creating the entity and the economic activities of the entity. Because the holding companies failed both prongs of the analysis, the Court declined to decide whether the two prongs were conjunctive or disjunctive.

7. The Court found that the sole motivation for forming the holding companies was to avoid paying taxes because the Taxpayer's accountant advised Taxpayer that the formation of the holding companies was a "slam dunk strategy" for achieving substantial BFT savings. The Court found that the holding companies conducted insufficient independent business activity to qualify as a taxable entity separate from the Taxpayer because (i) the Taxpayer operated the holding companies out of its back office, without any independent property, tangible assets or staff, (ii) through the use of the participation agreements, the holding companies received a 100% undivided interest in the loan while the banks maintained control, (iii) the holding companies carried no economic risk and (iv)

the holding companies did not engage in meaningful business with third parties.

8. Although the holding companies met the literal requirements for the Carve Out, they are disregarded under the economic substance doctrine because they are nothing more than a vehicle for tax avoidance. The Court upheld the assessment of the BFT against Taxpayer.

## VIRGINIA

***The Commissioner found that a nonresident taxpayer had nexus with Virginia based on the taxpayer's interest in an S corporation that owned real property in Virginia.***

***Ruling of Commissioner, P.D. 08-143, Virginia Dep't of Taxation, July 30, 2008.***

1. Type of Tax: Individual Income Tax

2. Taxpayer was not domiciled in Virginia, but owned a 50% share of an S Corporation incorporated in Virginia. The Corporation held cash, investment securities and a 25% interest in an out-of-state limited partnership that held one parcel of undeveloped real estate in Virginia.

3. The Department concluded that the Corporation's income was Virginia source income to Taxpayer. Taxpayer contended that the Corporation's income was not source income subject to tax of nonresidents.

4. Virginia treats S corporations similar to the Internal Revenue Service. The corporation itself is not subject to taxation but the shareholders will be taxed as individuals on their pro rata share of S corporation income. Even so, the Taxpayer contended that the corporation was a pass-through entity established solely to invest in intangible personal property and because the corporation had no employees and no tangible personal property it was not carrying on a trade or a business. Taxpayer argued that the corporation did not own the property in Virginia, but rather, owned a 25% limited partnership interest, which was intangible personal property.

5. The Department considers a taxpayer to be the owner of a share of the pass-through entity's assets and liabilities. Here, the attributes of the real property ownership flowed through the limited partnership to the corporation and ultimately to the Taxpayer. Having real property in Virginia created nexus to the corporation

and established authority for the taxation of an appropriate portion of the Taxpayer's income.

6. Although the Commissioner found nexus for the Taxpayer, the corporation had no income from Virginia sources during the taxable years, so the Taxpayer was not subject to Virginia income tax.

## DOING BUSINESS IN THE STATE

### ARIZONA

***The Arizona Department of Revenue issued a ruling clarifying the imposition of transaction privilege tax on sales of tangible personal property by out-of-state mail order or internet-based (remote) vendors and the responsibility for use tax collection by such vendors.***

***Transaction Privilege Tax Ruling TPR 08-1, Arizona Dep't of Revenue (July 30, 2008).***

1. Ascertaining whether a remote vendor is liable for transaction privilege tax, is responsible for collecting use tax, or has no liability for either tax requires a determination of the vendor's nexus with the state.

2. After a review of federal and state case law, Arizona provided this guidance:

   Generally, in circumstances involving an out-of-state vendor, certain factors may increase the likelihood that the vendor will be considered a retailer due to substantial nexus with Arizona, such that it becomes subject to Arizona transaction privilege tax liability. An overarching attempt to create a "unified face" or singular "brand recognition" among consumers, despite the actual separate corporate existences of subsidiaries, suggests an effort to maintain and improve the name recognition, market share, goodwill, and individual customer relationships of the subsidiaries. The lack of separation between the retail operations and promotional activities of the bricks-and-mortar store and remote vendor subsidiaries would be distinguishable from cases in which the activities of the in-state and out-of-state entities were more clearly separated.

3. While neither exhaustive nor intended to suggest that any one factor would necessarily lead to a finding of substantial nexus, the Department also created a list providing some guidance regarding practices that it would examine in determining whether any vendor liability or responsibility exists:

a. Cross-promotion and advertising of remote subsidiary ( e.g., a "dotcom" or mail-order subsidiary) and in-state subsidiary ( e.g., retail) locations, catalogs, and websites by in-state subsidiaries, excluding the availability of a remote subsidiary's catalogs at a retail location to use for reference purposes or to provide to a retail customer at the customer's request.

b. The ability to return and exchange merchandise acquired through different subsidiaries at in-state retail store locations and to receive credit for the return or exchange that can be applied to new transactions across subsidiaries.

c. In-state telephone or internet kiosks that allow customers to access inventories and purchase merchandise from remote subsidiaries.

d. The acceptance of remote subsidiary orders by a retail subsidiary at in-state locations when a product is unavailable at the in-state location.

e. The order fulfillment of merchandise ordered by customers from a remote subsidiary through in-state retail or marketing subsidiaries.

f. Other activities that suggest that an in-state retail or marketing subsidiary is acting as a salesperson or independent contractor for remote subsidiaries ( e.g., in-state subsidiary employees and agents soliciting names and addresses of customers for a remote subsidiary's catalog mailing list, distribution of discount coupons specifically for use with remote subsidiaries).

g. Other in-state sales and marketing efforts that promote the operations of remote subsidiaries to in-state retail customers as part of a single business (e.g., by emphasizing a common company name), although they are actually separately organized business entities.

h. Arizona case law has held that transaction privilege tax imposed under the retail classification does not require a higher level of nexus with the taxing state than use tax. *Ariz. Dep't of Revenue v. Care Computer Sys., Inc.*, 197 Ariz. at 416, 4 P.3d at 471 (Ct. App. 2000). If a taxpayer's retail business maintains the required degree of nexus with Arizona, the taxpayer will be subject to transaction privilege tax rather than a use tax collection obligation, unless otherwise provided by statute.

i. Arizona use tax functions as a complement to transaction privilege tax: if transaction privilege tax applies, use tax does not. Consequently, if an out-of-state vendor is liable for transaction privilege tax on gross receipts derived from a given transaction, the Department cannot opt to impose use tax instead on the in-state purchaser in the transaction.

j. Even if the remote vendor, based on the above factors, does not have sufficient nexus for the imposition of the transaction privilege tax, it could still have sufficient nexus to be subject to Arizona use tax collection requirements for sales to Arizona customers if it has an Arizona presence unrelated to its retail activity.

## INDIANA

***The Indiana Tax Court found economic presence enough to subject a credit card issuer to the Indiana Financial Institutions Tax. In so holding, the Tax Court rejected a "mechanical application of [Quill's] physical presence standard to franchise and income taxes . . . ."***

***MBNA America Bank v. Indiana Dep't of State Rev., 895 N.E.2d 140, 2008 Ind. Tax LEXIS 27 (Oct. 20, 2008).***

1. MBNA was denied a refund of the Indiana Financial Institutions Tax ("FIT"), and challenged the decision on the basis that MBNA did not have a place of business or employees in Indiana. It did, however, issue credit cards to Indiana customers.

2. The FIT is an excise tax on "the corporate privilege of transacting the business of a financial institution in Indiana." Ind. Code Ann. § 6-5.5-2-1(a). MBNA did not dispute that it was engaging in the business of a financial institute, but it argued that mere economic presence in a state does not satisfy the requirement of substantial nexus.

3. The Indiana Tax Court held that the United States Supreme Court has not extended the physical presence requirement for substantial nexus beyond the realm of sales and use taxes. Thus, the court determined whether economic presence can satisfy substantial nexus for purposes of the FIT as a matter of first impression.

4. The Tax Court analogized the situation to that of the "intangible nexus" cases, as well as those cases where a credit card company was subjected to income tax in a state where it issued credit cards,

but in which it had no physical presence. In each set of cases, the Indiana Tax Court found the arguments for finding nexus persuasive.

5. Citing to a West Virginia Supreme Court income tax case involving MBNA, the Indiana court noted that sales and use taxes impose different burdens on a collecting entity than franchise or income taxes. Furthermore, "mechanical application of a physical-presence standard to franchise and income taxes is a poor measuring stick of an entity's true nexus with a state in today's world." Thus, the Tax Court held economic presence is sufficient to establish substantial nexus in such a case.

## MARYLAND

***Court of Appeals found that a provider of "900" number service was not the agent of an out-of-state vendor for purposes of creating nexus and permitting state taxation of an interstate sale.***

***AT&T Commc'ns of Md. v. Comptroller of Treasurer, No. 24-C-05-000945, 950 A.2d 86 (Md. Ct. App. June 12, 2008).***

1. This case involves a sales and use tax assessment on AT&T's provision of "900" number service to Maryland consumers. The Comptroller found that AT&T was the agent of the out-of-state information providers ("Providers") and created nexus between Maryland and the Providers. In essence, Maryland sought to tax the in-state consumption of information services provided by out-of-state companies by making AT&T their agent.

2. AT&T appealed, arguing that a common carrier cannot be deemed the agent of an out-of-state seller for the purposes of creating nexus and permitting state taxation of an interstate sale.

3. The court agreed, but found that two additional issues had to be addressed: 1) Is a telecommunications provider a common carrier under *Bellas Hess* and *Quill*? and 2) Did AT&T act in a manner that took it beyond the role of common carrier?

4. A&T argued that it was a common carrier because it publicly offered to provide "900" number carriage. The court agreed. However, the court went on to determine whether AT&T had transcended the common carrier classification. AT&T did contract with the information providers, review the information providers' advertisements and preamble messages, transport the messages over its networks, provide billing and collection services, provide dispute resolution services, and receive funds for the services provided. However, the court found that all of those functions were

typically provided by common carriers in analogous contexts. Some functions were also required by the Telephone Disclosure and Dispute Resolution Act (TDDRA).

5. The court found there can be no nexus if a common carrier delivers a service provided by an out-of-state company. The assessment could stand only if AT&T was more than a common carrier, i.e., a co-vendor or agent of the Providers. Since AT&T did not promote or have a vested interest in the success of the Providers, it was not the Providers' agent or co-vendor. Thus, under *Bellas Hess* and *Quill*, AT&T was not responsible for sales or use tax on transactions between Maryland customers and the "900" information service vendors.

***The Maryland Comptroller recently updated his administrative release regarding the nexus standards for corporate income tax.***

***Administrative Release No. 2, CCH ¶201-822, Maryland Comptroller of the Treasury (Sept. 1, 2008).***

1. The Maryland Comptroller of the Treasury recently updated his Administrative Release regarding the nexus standards applicable to corporate income tax.

2. This release includes a definition of "business location" and "representative."

3. It also includes a list of activities that the Comptroller considers protected under P.L. 86-272. These activities do not cause an entity to be taxable:

   a. Employees or representatives soliciting orders for tangible personal property.

   b. Solicitation activity by nonemployee, independent contractors, conducted through their own office in Maryland.

   c. Delivery of goods to customers by the corporation in its own or leased vehicles from a point outside Maryland.

4. Finally, the Comptroller provided the following nonexclusive list of in-state activities that generally create nexus:

   a. Maintaining a business location in Maryland.

   b. Ownership or use of property in Maryland, real or personal.

   c. Employees soliciting and accepting orders in Maryland.

d. Installation or assembly of the corporation's product.

e. Maintaining a stock of inventory in a public warehouse or placement of inventory in the hands of a distributor.

f. Sales persons making collections on regular or delinquent accounts.

g. Technical assistance and training with Maryland offered by corporate personnel to purchasers or users of corporate products after the sale.

h. Corporate personnel repairing or replacing faulty or damaged goods.

i. Mobile stores in Maryland from which direct sales are made.

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