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Colorado Leads the Charge: Adopts Affiliate Nexus and New Notice and Reporting Requirements for Sales Tax and "Economic Nexus" Rules for Income Tax

Laura A. Kulwicki
Columbus
1.614.281.3700
lakulwicki@jonesday.com

Allison E. Haedt
Columbus
1.614.281.3972
aehaedt@jonesday.com

The news out of Colorado this legislative session started out badly for taxpayers and just kept getting worse. Like many states, Colorado began 2010 with a significant budget deficit. The General Assembly immediately responded to the state's projected $1.5 billion shortfall by proposing aggressive new legislation focused on closing that gap.[1] These measures swiftly passed. Effective March 1, 2010, House Bill 10-1193 amended §§ 39-26-102 and 39-21-112 of the Colorado Revised Statutes to add an affiliate nexus provision and novel and controversial notice and reporting requirements for retailers that do not have nexus. The Colorado Department of Revenue (the "Department") also wasted no time in enacting emergency regulations with significant new penalties for noncompliance. In addition, the Department amended its definition of "doing business" for income tax purposes to impose "factor presence" nexus standards.[2]

Affiliate Nexus Provision: The Ties That Bind

Section 39-26-102 now provides that an out-of-state retailer that lacks physical presence in Colorado is presumed to be "doing business" in Colorado, and thus is required to collect and remit sales and use tax, if it is part of a group of corporations that has a member with physical presence in Colorado. The presumption can be rebutted through evidence that the member with physical presence in Colorado did not engage in any solicitation in Colorado on behalf of the out-of-state retailer that would satisfy constitutional requirements.[3]

Notice and Reporting Rules: Noncollecting Retailers Must Notify Customers or Face Stiff Penalties

Through its amendment of § 39-21-112, Colorado also has new notice and reporting requirements for retailers that do not collect and remit sales tax to the state. Beginning May 1,

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[1] Steven K. Paulson and Colleen Slevin, *Colorado Budget Gap, Education Reform Dominate First Day of Legislative Session*, The Huffington Post, January 13, 2010.

[2] Col. Code Regs. § 39-22-301.1, effective April 30, 2010.

[3] Colo. Rev. Stat, § 39-26-102(3)(b)(II).

any "non-collecting" retailer that sells to customers in Colorado must do the Department's own "dirty work" by notifying customers twice—once at the time of purchase and then again at the end of each calendar year, beginning in 2010—that the customer is liable for Colorado tax on the purchase; retailers that fail to do so face stiff penalties. Under the new law, the retailer must also file an annual report with the Department, reporting the total amount each Colorado customer paid for its untaxed purchases. Any retailer failing to do so may amass penalties that can quickly rise to as much as $250,000 for the first year and can exceed this cap in later years.

As soon as the new notice and reporting requirements were enacted, there was a flurry of activity at the Department. The Department first issued an emergency regulation addressing the new rules on March 2, 2010. A proposed final regulation soon followed but was withdrawn and replaced with an amended proposed final regulation, which is scheduled for hearing in July 2010.[4] The new law, emergency regulation, and amended proposed final regulation are all summarized below. Until the constitutional issues are fully resolved, however, many retailers face significant new obligations in Colorado or risk penalties for failure to comply.

Customer Notification at the Time of Purchase

Under the new law, retailers that do not collect Colorado sales tax must notify their Colorado customers at the time of purchase that sales or use tax is due on certain purchases made from the retailer.[5] The emergency regulation provides that the notice must appear on each invoice. If no invoice is provided, notice by confirmation email is sufficient. The notice must contain the following information:

- The noncollecting retailer is not obligated to, and does not, collect Colorado sales tax.
- The purchase is subject to Colorado sales tax unless it is specifically exempt from taxation.
- The purchase is not exempt merely because it is made over the internet or by other remote means.
- The State of Colorado requires the taxpayer to file a sales/use tax return at the end of the year reporting all of the purchases that were not taxed and to pay tax on those purchases.
- Retailers that do not collect Colorado sales tax are obligated to provide purchasers an end-of-year summary of their purchases in order to assist them in filing their tax returns.
- Details of how to file this return may be found at the Colorado Department of Revenue's web site, www.taxcolorado.com.
- Retailers that do not collect Colorado sales tax are required by law to provide the Colorado Department of Revenue with a report of the total amount of all of a purchaser's purchases at the end of the year.

[4] Colo. Emergency Reg. 39-21-112.3.5; Colo. Proposed Final Reg. 39-21-112.3.5; Colo. Amended Proposed Final Reg. 39-21-112.3.5.

[5] Colo. Rev. Stat. § 39-21-112.3.5(c)(1).

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The notice must be both legible and prominent. "Please see important sales tax information" must also appear immediately adjacent to the dollar amount of the transaction in bold font that is the same size as the font used on the rest of the invoice.[6]

Annual Customer Notification

Retailers that do not collect Colorado sales tax must also send their Colorado customers notice by first-class mail by January 31 of each year that sales or use tax is due on taxable purchases made from the retailer. The mailing must say "Important Tax Document Enclosed" and must include the name of the retailer. It cannot be sent with any other shipments or deliveries.[7]

The notice must also include the total amount the customer paid to the retailer during the preceding calendar year and "shall include, if available," the dates of the purchases, the amounts of the purchases, and the general category of the purchases.[8] While the statute provides that the retailer must tell the customer whether the purchase is taxable or exempt "if known," the amended proposed final regulation states that the retailer "may also indicate" whether the item is taxable or exempt, but "no non-collecting retailer is required to include such information." [9]

Annual Report to the Department of Revenue

Any retailer that does not collect Colorado sales tax must also file a report with the Department on or before March 1 of each year showing the total amount each of its Colorado customers paid to the retailer during the preceding calendar year.[10] Under the amended proposed final regulation, the report must include the name, billing address, shipping address, and total amount of purchases for each Colorado customer.[11]

[6] Colo. Emergency Reg. 39-21-112.3.5(3). *See also* Colo. Amended Proposed Final Reg. 39-21.112.3.5(2)(b) (requiring substantially similar information to be provided).

[7] Colo. Rev. Stat. § 39-21-112.3.5(d)(I)(A) and (B).

[8] Colo. Rev. Stat. § 39-21-112(3.5)(d)(I)(A).

[9] Colo. Amended Proposed Final Reg. 39-21-112.3.5(3)(a)(v).

[10] Colo. Rev. Stat. § 39-21-112(3.5)(d)(II).

[11] Colo. Amended Proposed Final Reg. 39-21-112.3.5(4)(a).

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De Minimis *Exceptions*

Under the emergency regulation, retailers that had total gross sales in the prior year of less than $100,000 and reasonably expect sales in the current year also to be less than $100,000 are exempt from having to provide notification at the time of purchase.[12] The amended proposed final regulation clarifies that the *de minimis* exception is based upon Colorado sales.[13]

The amended proposed final regulation also provides that retailers that made total gross Colorado sales in the prior year of less than $100,000 and expect sales in the current year also to be less than $100,000 are exempt from having to provide the annual customer reports. An annual customer report need not be sent to any customer whose total Colorado purchases for the prior calendar year amounted to less than $500.[14] Retailers that are not required to send any annual customer notifications need not file an annual report with the Department.[15]

Penalties for Noncompliance

Noncompliance with the notice and reporting rules can lead to significant penalties. Five dollars is imposed for every failure to provide notice at the time of purchase,[16] $10 is imposed for every failure to send an annual customer notification, and an additional $10 is imposed for every failure to provide an annual report to the Department.[17]

The amended proposed final regulation provides some limits to the penalties—at least for the first year. The total amount of $5 penalties issued for failure to provide notice at the time of purchase is limited to $5,000 where the retailer had no actual knowledge of the requirement and began sending the required notices within 60 days of demand by the Department; it is limited to $50,000 where the retailer failed to send the notices for the first calendar year for which they were required.[18] The total amount of $10 penalties issued for failure to send an annual customer notification or annual customer report to the Department is limited to $1,000 where the notification or report was no more than 30 days late, $10,000 where the retailer had no actual knowledge of the requirement and sent the applicable notification or report within 60 days of demand by the Department, and $100,000 where the retailer failed to send the notification or report for the first calendar year for which the notification or report was required.[19] No penalty will be imposed upon a noncollecting retailer that sells goods that are not taxable in Colorado or

[12] Colo. Emergency Reg. 39-21-112.3.5(3)(e).

[13] Colo. Amended Proposed Final Reg. 39-21-112.3.5(2)(e).

[14] Colo. Amended Proposed Final Reg. 39-21-112.3.5(3)(c) and (d).

[15] Colo. Amended Proposed Final Reg. 39-21-112.3.5(4)(d).

[16] Colo. Rev. Stat. § 39-21-112(3.5)(c)(II).

[17] Colo. Rev. Stat. § 39-21-112(3.5)(d)(III).

[18] Colo. Amended Proposed Final Reg. 39-21-112.3.5(2)(f).

[19] Colo. Amended Proposed Final Reg. 39-21-112.3.5(3)(e), (4)(f).

that sells goods only to customers not subject to sales or use tax.[20] Notably, there are no caps on penalties beyond the first year following enactment of the new law.

The Department's Subpoena Power

Retailers that do not collect Colorado sales tax and also refuse to voluntarily furnish information when requested by the Department may be subject to a subpoena issued by the Department's Executive Director to compel such information. If a retailer fails or refuses to respond to the subpoena and give testimony, the Executive Director may ask a state court to issue a contempt order.

Constitutional Red Flags Abound

The new affiliate nexus and notice requirements—which apply to remote sellers that have no physical presence in Colorado and thus clearly have no constitutional obligation to collect tax—raise all kinds of constitutional red flags and are certain to be challenged. Commerce Clause and Due Process Clause concerns abound in this context. Indeed, both the notice and reporting provisions and the "affiliate nexus" provision purport to impose sales tax obligations on retailers that lack any physical presence in Colorado. Clearly, this violates the Commerce Clause as interpreted in *Quill Corp. v. North Dakota*.[21] In contrast to the controversy in the courts as to whether or not *Quill*'s physical-presence Commerce Clause test applies to taxes other than sales and use tax, it is clear that physical presence is still a requirement to support state taxing authority under the Commerce Clause. And while *Quill* took a lot of the "bite" out of Due Process Clause protections in general in this context, Colorado's new amendments, by overreaching so far, trigger due-process concerns as well. While maintaining a market in Colorado may be sufficient for the courts to exercise jurisdiction over a retailer, imposing continuing tax notice and reporting obligations based on nothing more than exploiting the marketplace is something different altogether. Thus, Colorado's aggressive new law is vulnerable to attack as inconsistent under the Due Process Clause as well.

Colorado Adopts MTC's "Factor Presence" Nexus Standard for Corporate Income Taxes

The Department also joined the growing number of states that have adopted the Multistate Tax Commission's "factor presence" nexus standard for income, franchise, or gross receipts tax purposes. Effective April 30, 2010, the Department amended its income tax regulation to impose tax obligations on businesses that have more than $50,000 of property or payroll in the state or generate more than $500,000 in sales attributed to Colorado.[22] A business also meets the new test if 25 percent of its total property, total payroll, or total sales are in Colorado.

[20] Colo. Amended Proposed Final Reg. 39-21-112.3.5(f)(ii)(3); (3)(e)(ii)(4); (4)(f)(ii)(4).

[21] 504 U.S. 298, 305–306 (1992).

[22] Col. Code Regs. § 39-22-301.1.

Colorado's regulation mirrors the move toward "economic nexus" that has gained momentum in recent years. As a practical matter, the new regulation will not affect a company that is protected by P.L. 86-272. However, service-based businesses or any other business that is not protected by P.L. 86-272 may suddenly face income tax obligations in Colorado as a result of this significant regulatory change. Add Colorado to the growing list of states where a significant customer base and economic ties alone are sufficient to create tax liabilities.

Conclusion

Like many states, Colorado has responded to its budget crisis by enacting new nexus laws, specifically an affiliate nexus provision and notice and reporting rules. These new laws have faced significant backlash from the online retailer community and are also vulnerable to constitutional challenge. However, armed with subpoena power and significant penalties—up to $250,000 in 2010 and more in subsequent years—Colorado appears eager and ready to enforce them.

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