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NEXUS: FIRST QUARTER 2011 DEVELOPMENTS—STATES CONTINUE TO ADOPT A NARROW INTERPRETATION OF *QUILL*

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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 of 2011. It is organized by state and types of activity that tend to give out-of-state entities nexus-planning and litigation difficulties, such as sales personnel who travel in and out of states, affiliate nexus, intangible nexus, web nexus, and in-state advertising or solicitation. It also highlights the aggressive use tax-reporting regime recently enacted in South Dakota, as well as the latest developments related to the Direct Marketing Association's challenges to a similar regime adopted in Colorado.

Decisions from Iowa and Washington deserve particular attention. The Iowa Supreme Court concluded that an out-of-state taxpayer with no physical presence in the state was subject to tax on the basis of revenues received from licensing intangibles to third-party franchisees in the state, while the Supreme Court of Washington found that the presence of employees in the state to visit customers was sufficient to create nexus for Washington business and occupation tax purposes, regardless of whether those employees were soliciting sales or selling product. Notably, both courts noted the large number of states that have refused to apply the physical presence test set forth in *Quill* to taxes other than sales and use taxes.

ALABAMA

Nonbusiness Income From Extraordinary Transaction

Kimberly-Clark Corp. v. Ala. Dep't of Rev., No. 2061117 (Ala. Civ. App., Mar. 21, 2008), *rev'd and remanded, Ex Parte Ala. Dep't of Rev.*, No. 1070925 (Ala., Feb. 26, 2010).

i. At issue was whether income from the 1998 sale of the Coosa pulp/paper mill and approximately 375,000 acres of timberland (the "Coosa Sale") was "nonbusiness" income for the purposes of Alabama corporate income tax. Kimberly-Clark Corporation and Kimberly-Clark Worldwide, Inc. ("KC"), argued that the income received was business income from an incidental or occasional sale and therefore should be excluded from their sales factors pursuant to an Alabama Department of Revenue rule. In support, KC asserted that the income was reinvested in business activities, KC had previously filed tax returns that classified such receipts as business income in states other than Alabama, and the sale did not liquidate the companies. Alternatively, KC argued that the gross receipts were nonbusiness income and should therefore be allocated to their domicile, Texas, instead of Alabama.

ii. The Alabama Department of Revenue ruled that the income from the Coosa Sale was nonbusiness income allocated entirely to Alabama. The administrative law judge ("ALJ") disagreed, ruling that the income was apportionable business income. The ALJ decision was reversed by the Alabama circuit court. The circuit court decision was reversed by the Court of Civil Appeals of Alabama. The Alabama Supreme Court, in the fourth consecutive reversal in the case, affirmed the trial court's decision that such gross receipts are nonbusiness income.

iii. In remanding the case to the Court of Civil Appeals, the Alabama Supreme Court concluded that the receipts did not constitute business income because the sale of the properties was an extraordinary transaction that represented a divestiture by the parent of part of its business, rather than a transaction conducted in the regular course of KC's business. The Alabama Supreme Court noted that the sale of the properties was KC's largest during the audit years and that KC had bought or sold parcels of timberland of a similar size on only two other occasions throughout the 1990s. Furthermore, the reason for the sale was to reduce KC's pulp production to focus on other aspects of the business, which was a significant shift in strategy from other transactions.

iv. This case has limited future authority because, as noted by the Alabama Supreme Court, the Alabama legislature in 2001 adopted a new definition of "business income," which applies to years beginning after 2001. The current law incorporates an alternative "operationally related" test that treats gain or loss from the sale of property as apportionable "if the property while owned by the taxpayer was operationally related to the taxpayer's trade or business carried on in Alabama."

CALIFORNIA

Factor Presence

Cal. Rev. & Tax Code § 23101(b)(2009).

i. Effective January 1, 2011, the definition of "doing business" for purposes of determining nexus under the corporation franchise and income tax law has been revised. The California Franchise Tax Board issued guidance on its web site discussing the new rules. The web site addresses, among other issues, how the rules are applied. Under the new law, a taxpayer will be considered to be doing business in California if it satisfies one of the following:

(a) The taxpayer is organized or commercially domiciled in California;

(b) The taxpayer's California sales, including sales by an agent or independent contractor, exceed the lesser of $500,000 or 25 percent of the taxpayer's total sales;

(c) The taxpayer's California real property and tangible personal property exceed the lesser of $50,000 or 25 percent of the taxpayer's total real property and tangible personal property; or

(d) The amount paid in California by the taxpayer for compensation exceeds the lesser of $50,000 or 25 percent of the total compensation paid by the employer.

COLORADO

Use Tax Reporting

Direct Mktg. Assoc. v. Huber, No. 10-cv-01546-REB-CBS (D.C. Colo., 2011).

i. The plaintiff, the Direct Marketing Association ("DMA"), asserted that the Colorado District Court should enjoin the enforcement of a Colorado law, Colo. Rev. Stat. § 39-21-112(3.5) (2010), and regulations, 1 Colo. Code Regs. § 201-1:39-21-112.3.5 (2010), which require many out-of-state retailers to fulfill reporting and notice obligations. The law and regulations require retailers that do not collect sales tax on sales to Colorado consumers to report certain information regarding the purchases to customers and the Colorado Department of Revenue (the "Department"). The law's requirements do not apply to retailers with less than $100,000 in gross annual sales in the state.

ii. DMA argued that the law and regulations are unconstitutional under the Commerce Clause. In granting a preliminary injunction, the court held that DMA showed a substantial likelihood that it is likely to prevail on its claim that Colorado discriminated against out-of-state retailers under the Dormant Commerce Clause, in part because the notice and reporting burden is not imposed on in-state entities unless such entities defy sales tax requirements. Furthermore, because DMA showed that nondiscriminatory alternatives are available, the court held that the defendant is not likely to be able to show a lack of such alternatives.

iii. The district court also held that DMA showed a substantial likelihood of success on its undue-burden claim under the Dormant Commerce Clause. Articulating the *Complete Auto* test and citing *Quill*, the court concluded the reporting and notice "requirements likely impose on out-of-state retailers use tax-related responsibilities that trigger the safe-harbor provisions of *Quill*." The only reason for the burdens, the court noted, is to collect "use taxes when sales taxes cannot be collected." Furthermore, the law and regulations burden out-of-state entities with no connection to customers in the state except through mail or common carrier.

iv. The Department appealed the court's grant of the preliminary injunction to the Tenth Circuit Court of Appeals but voluntarily dismissed the appeal after district court judge Robert Blackburn entered a stipulated order under which the parties agreed to submit cross-motions for summary judgment on the Commerce Clause issues without further discovery. The Department and DMA filed their respective summary judgment motions on May 6, 2011.

CONNECTICUT

Doing Business in the State

Informational Publication 2010(29.1), Connecticut Dep't of Rev. Servs., Dec. 28, 2010, CCH ¶401-489.

i. The Connecticut Department of Revenue Services revised a guidance regarding the state's business tax nexus standard. Partnerships, companies, and S corporations deriving "income from Connecticut or hav[ing] a substantial economic presence within" the state, "in either case attributable to the purposeful direction of business activities toward Connecticut," are subject to Connecticut tax.

ii. One of the guideposts in the publication is that the "purposeful direction of business activities" will be evaluated through the "frequency, quantity, and systematic nature" of the business contacts. Entities are not deemed to fall within this category if their receipts attributable to the state are less than $500,000 during the taxable year.

GEORGIA

Streamlined Sales Tax

Reg. Sec. 560-12-1-0.20-.37, Ga. Dep't of Rev. (effective Feb. 21, 2011).

i. The Georgia Department of Revenue adopted an emergency rule relating to the multistate Streamlined Sales and Use Tax Agreement. The rule covers a number of areas, including nexus. According to the rule, if Georgia withdraws or is removed from the Streamlined Sales and Use Tax Agreement, the state will not use "the seller's registration with the central registration system and collection of taxes in member states" to determine whether a seller has nexus with Georgia.

ii. The rule will remain in effect for 120 days or until the state adopts subsequent rules, whichever occurs earlier.

HAWAII

Affiliate Nexus

State of Haw. Multi-Level Mktg. Co. Excise Tax Agreement, Haw. Dep't of Taxation (Mar. 2011).

i. The Hawaii Department of Taxation posted a sample agreement on its web site pursuant to which a "multi-level marketing company" can contract with Hawaii to collect taxes on behalf of its direct sellers.

ii. With regard to nexus, the agreement provides that a company which is not engaged in activities that create nexus may agree to be licensed solely for the purpose of collecting tax on behalf of its direct sellers. If the company's activities change so that nexus is established, the company must "immediately change its license status and pay the general excise and use taxes that have accrued" from the company's activities in Hawaii. The company would then maintain two general excise licenses: one for collecting and remitting taxes on behalf of direct sellers, and one for remitting taxes due "on its own business activities."

iii. The agreement also provides that if the state first agrees that the company does not have nexus but later determines nexus has been established, the state may not assess certain general excise or use tax penalties.

Doing Business in the State

CompUSA Stores LP v. Haw. Dep't of Taxation, No. SCWC-29597 (Haw., Feb. 14, 2011).

i. The Hawaii Supreme Court held that chapter 238 of the Hawaii Revised Statutes requires the assessment of use taxes against CompUSA for goods that CompUSA shipped from the mainland to its Hawaii stores. Citing the statute's plain language, the court reasoned that CompUSA is a licensed "retailer" in Hawaii and that CompUSA used the merchandise "for purposes of resale" in Hawaii after purchasing and importing it.

ii. CompUSA argued that the use tax did not apply to it under the Hawaii Supreme Court's decision in *Baker & Taylor, Inc. v. Kawafuchi*, 82 P.3d 804 (Haw. 2004). *Baker & Taylor* held that the tax did not apply to a seller from the mainland that shipped and sold books FOB point of shipment to the state library in Hawaii. The court rejected CompUSA's argument, reasoning that unlike CompUSA, the taxpayer in *Baker & Taylor* did not use the books in Hawaii after they were sold to the library; when such a sale occurred, title passed to the library. The *Baker & Taylor* taxpayer "had no presence in [Hawaii] to make any use of them." CompUSA, however, was held to use the goods in the state "by keeping them for resale."

ILLINOIS

Web Nexus

35 Ill. Comp. Stat. 105/2, 110/2 (2011).

i. Effective July 1, 2011, Illinois deems out-of-state retailers to be retailers "maintaining a place of business" in Illinois if they have contracts that fall into certain categories. Such retailers must collect use or service use tax, as applicable.

ii. Under the new law, an out-of-state retailer or serviceman will be deemed to be maintaining a business in Illinois if the retailer or serviceman has a contract with a person located within Illinois, under which the person, for a commission or other type of consideration, directly or indirectly refers potential customers to the retailer or serviceman by a link on the person's internet web site. The law applies only if the gross receipts from the sales to Illinois customers total more than $10,000 during the previous four quarterly periods.

iii. An out-of-state retailer or serviceman will also be deemed to be maintaining a business in Illinois if the retailer or serviceman has a contract with a person in Illinois under which the retailer or serviceman sells the same or substantially similar products or services as the Illinois resident "using an identical or substantially similar name, trade name, or trademark" as the Illinois resident, and the retailer or serviceman provides a commission or other consideration to the Illinois resident. Such a law applies, however, only if the gross receipts from the sales to Illinois customers are more than $10,000 over the previous four quarterly periods.

INDIANA

Public Law 86-272

Revenue Ruling No. 2010-02 IT, CCH ¶401-634 (Ind. Dep't of Revenue, Nov. 18, 2010).

i. The Indiana Department of Revenue ruled that a taxpayer's activities in Indiana were insufficient for nexus and therefore the taxpayer was not subject to income tax.

ii. The company's business involved sending gifts to customers' employees when those employees reached certain milestones. Usually, the customer agreed to buy products from the company, and dates and milestones of the customer's employees were maintained and tracked by the company.

Upon each occurrence of a milestone, the company automatically sent a packet or gift to the employee, who then selected a gift from the packet by following certain ordering instructions.

iii. The Department applied Public Law 86-272, which prohibits states from requiring an out-of-state taxpayer to pay net income tax if the entity's business within the state is limited to soliciting sales. A state regulation establishes a "minimum threshold of activity" in which a taxpayer must engage for nexus to be established under Public Law 86-272. The entity's business activities in the state did not include any of those listed in the regulation, such as maintaining a place of business, accepting orders, or providing services to customers in the state.

IOWA

"Intangible" Nexus

KFC Corp. v. Iowa Dep't of Revenue, No. 09-1032 (Iowa, 2010).

i. The Iowa Supreme Court held that the Iowa Department of Revenue (the "Department") properly imposed an income tax on an out-of-state corporation that has no tangible physical presence in the state but receives revenues from the use of its intangible property in Iowa.

ii. KFC Corporation ("KFC Corp") is a Delaware corporation with its principal place of business in Kentucky. KFC Corp's primary business is the ownership and licensing of the KFC trademark and related system to independent franchisees throughout the United States, including Iowa. KFC Corp owns no properties and has no employees in the state.

iii. KFC Corp argued that *Quill* stands for the proposition that a foreign corporation with no physical contact with the state cannot be subject to tax. KFC Corp noted that *Quill* did not limit this holding to use taxes. KFC Corp also argued it was not subject to the tax because the Iowa statute required the foreign corporation to have property "located or having a situs" in Iowa.

iv. The court identified two questions that needed to be answered in order to resolve the constitutional issues presented in the case. The first inquiry was whether the activities of KFC Corp in Iowa satisfy the physical presence test articulated in *Quill*. The second inquiry is whether the physical presence test set forth in *Quill* applies to cases involving state income taxation.

v. The court found that KFC Corp had a physical presence in Iowa for two reasons. First, the court adopted a "functional equivalent" test concluding that the licensing of intangibles to "its franchisees that are firmly anchored within the state, would be regarded as having a sufficient connection to

Iowa to amount to the functional equivalent of 'physical presence' under *Quill*." Second, the court found that revenue-generating transactions in Iowa provide nexus. According to the court, "[T]he fact that the transactions that produced the revenue were based upon use of the intangibles in Iowa" supports taxation.

vi. The court further concluded that physical presence was not required because the Commerce Clause concerns related to the use tax in *Quill* were not a factor for KFC Corp. After examining rulings in other states, the court stated, "We also doubt that the Supreme Court would extend the 'physical presence' rule outside the sales and use tax context of *Quill*." According to the court, " '[P]hysical presence' in today's world is not a meaningful surrogate for the economic presence sufficient to make a seller the subject of state taxation."

vii. The court sought to apply a substance-over-form approach that, according to the court, has been embraced by the United States Supreme Court. The court stated that a company which earns hundreds of thousands of dollars from sales to Iowa customers arising from the licensing of intangibles associated with the fast-food business should be required to pay its fair share of taxes without violating the Dormant Commerce Clause. The court held that "by licensing franchises within Iowa, KFC has received the benefit of an orderly society within the state and, as a result, is subject to the payment of income taxes."

viii. In response to the taxpayer's arguments regarding the Iowa statute, the court pointed to Iowa Code § 422.33(1)'s reference to "*intangible property* located or having a situs in the state" to conclude that the tax at issue fell within the statute.

Economic Nexus

Policy Letter 10240041, CCH ¶201-295 (Iowa Dep't of Revenue, Dec. 16, 2010).

i. A policy letter issued December 16, 2010, by the Iowa Department of Revenue (the "Department") ruled that physical presence is not a requirement for Iowa nexus. The Department cited several state court cases that have stood for this proposition, pointing out that the U.S. Supreme Court has denied review of many of those decisions.

ii. The company at issue serviced clients in all states. The services included supplying an address to clients for the purpose of a process server's delivery of a lawsuit on behalf of the company's clients. The company subcontracted with an Iowa law firm, which scanned documents if needed.

iii. The Department noted that the company was exploiting Iowa's market and that receipts should be considered Iowa receipts when the service benefits are received in the state.

KANSAS

In-State Personnel

Opinion Letter No. O-2011-002 (Kan., Jan. 24, 2011).

i. The Kansas Department of Revenue opined on January 24, 2011, that a company performing oil well services in the state must register for the purposes of sales tax and withholding tax. Physical presence was established by sending employees to Kansas to service oil and gas wells.

ii. Kansas sales tax is imposed on labor services performed at oil and gas wells. Kansas exempts these services performed at oil or gas wells from sales tax when the services are performed during the well's first construction or initial construction.

MICHIGAN

Public Law 86-272

Lane Co. Inc. v. Michigan Dep't of Treasury, No. 294456, CCH ¶401-557 (Mich. Ct. App., Jan. 25, 2011).

i. The Lane Company Incorporated ("Lane"), a Virginia corporation with no Michigan employees or property, contracted with independent contractors to solicit requests for sales of its products. The requests were considered and approved in Virginia. In 1988, Lane sought information from the Michigan Department of Treasury (the "Department") about its obligations under the now-repealed Single Business Tax Act ("SBTA"). The Department sent Lane a letter stating that "[a] manufacturer receiving orders for its products, whose orders are sent outside the state for approval or rejection and if approved, are filled by shipment or delivery from a point outside the state, is afforded immunity from SBT under Public Law 86-272" and attached a list of nonimmune activities. Lane informed the Department that, according to the list attached to the letter, it was not conducting business in Michigan.

ii. In 1993, the Michigan Court of Appeals decided *Gillette Co. v. Dep't of Treasury*, 198 Mich. App. 303, 497 N.W.2d 595 (1993), holding that Public Law 86-272 did not apply to the SBTA. On February 24, 1998, the Department issued Revenue Administrative Bulletin ("RAB") 1998-1, setting forth the standard for "substantial nexus," which includes an out-of-state company "regularly and systematically conduct[ing] in-state business activity through … independent contractors."

iii. The Department assessed a penalty against Lane under the SBTA for failure to make payments for tax years 1998 and 1999. Lane claimed that it was not aware of RAB 1998-1 until after the time for remitting

iv. Affirming the court of claims, the court of appeals reasoned that Lane had a minimal but genuine basis for believing that it had no SBTA liability. In doing so, it distinguished its prior opinion in *Hobbs Corp. v. Dep't of Treasury*, 268 Mich. App. 38, 706 N.W.2d 460 (2005), in which it held that a taxpayer may not obtain a penalty waiver for failing to file on the basis of the changes to the nexus standard. The court stated that the key distinction between this case and *Hobbs Corp.* was that in *Hobbs Corp.* the taxpayer was actually aware of RAB 1998-1.

NEW JERSEY

In-State Advertising/Solicitation

New Jersey Division of Taxation Technical Advisory Memorandum TAM-6, Jan. 10, 2011.

i. The New Jersey Division of Taxation (the "Division") issued a notice, which it intends to codify in a regulation, that under the Business Tax Reform Act, P.L. 2002, c.40, enacted July 2, 2002, taxpayers performing services and domiciled outside the state who solicit business within the state or derive receipts from sources within the state must file a Corporation Business Tax return and pay the applicable tax to New Jersey. This applies to all corporations, including financial business corporations, banking corporations, and credit card companies.

ii. The notice is applicable retroactively to privilege periods beginning on or after January 1, 2002, when the Corporation Business Tax became effective.

SOUTH CAROLINA

Affiliate Nexus

Travelscape, LLC v. S.C. Dep't of Revenue, No. 26913 (S.C., Jan. 18, 2011).

i. Taxpayer, Travelscape, LLC ("Travelscape"), is an online travel company doing business through the web site Expedia.com. Travelscape appealed a final order of the administrative law court assessing sales and accommodations taxes against the company for the period July 1, 2001, through June 30, 2006. At issue in this case was: (1) whether the gross proceeds received by Taxpayer from customers who rented South Carolina hotel rooms are subject to sales tax under S.C. Code Ann. §12-36-920

(2000 & Supp. 2007); and (2) whether imposition of sales tax on the taxpayer violates the Commerce Clause of the United States Constitution. The Supreme Court of South Carolina affirmed the order of the administrative law court that Travelscape's proceeds were subject to the South Carolina sales and accommodations tax and that the imposition of such tax on the taxpayer was constitutional.

ii. Travelscape charged customers a discounted rate for hotel accommodations to which it added state sales tax calculated on the basis of the discounted rate, along with service and facilitation fees. The court held that the service and facilitation fees were subject to the sales tax imposed by S.C. Code Ann. § 12-36-920 according to the plain language of the statute. The court reasoned that because the South Carolina statute imposes a sales tax on the "gross proceeds" derived from the room rentals, the cost of services should be included in the definition of "gross proceeds."

iii. The court noted that in *Tyler Pipe Indus. v. Wash. State Dep't of Revenue*, 483 U.S. 232 (1987), the United States Supreme Court held that a corporation had a physical presence in Washington based upon the activities of nonemployee, in-state sales representatives who provided services that were essential to the corporation's ability to make sales in the state. Under somewhat concerning reasoning that seems to slide down a slippery slope of "one-step-removed" nexus, the court found that the services provided by the hotels in this case met the *Tyler Pipe* test, because they were significantly associated with Travelscape's ability to establish and maintain a market in South Carolina for its sales. Travelscape had entered into contracts with South Carolina hotels for the right to offer reservations at hotels. The fact that Travelscape had disclaimed any agency relationship with the hotels with which it contracted was viewed by the court as irrelevant for Commerce Clause purposes.

iv. Travelscape argued, on the basis of *McLeod v. J.E. Dilworth Co.*, 322 U.S. 327 (1944), that it did not meet the nexus requirement of the Commerce Clause. The court rejected this argument, distinguishing this case from *Tyler Pipe* and *Scripto, Inc. v. Carson*, 362 U.S. 207 (1960), because of the fact that the corporation at issue in *McLeod* had relied very little on the services of Arkansas to facilitate the sale of its goods to Arkansas residents.

SOUTH DAKOTA

Affiliate Nexus

Legislative Action – S.B. 147, 86th Leg. Assemb. (Mar. 2011) (enacted).

i. On March 14, 2011, South Dakota enacted a bill (the "Act") providing that certain companies shall be deemed "retailers" which must collect the state's sales and use tax. The bill will be codified at Chapter 10-45 of the South Dakota codified laws.

ii. To be considered a "retailer" under the first prong of the Act, a business must be affiliated with a retailer maintaining a place of business in South Dakota (the "related retailer"). In addition, the business must either: (1) sell the same or a substantially similar line of products as the related retailer in South Dakota under the same or a substantially similar business name; or (2) use an in-state facility or in-state employee of the related retailer to advertise, promote, or facilitate sales to consumers in South Dakota.

iii. A business will also be considered a "retailer" if it is affiliated with a company maintaining a distribution house, sales house, warehouse, or similar place of business in South Dakota that delivers property sold by the retailer to consumers.

iv. The new law creates a rebuttable presumption that any entity belonging to a "controlled group" is presumed to be a "retailer" engaged in business in South Dakota if any of the group's component members engages in business described in the Act.

v. For the purposes of the Act, a business is affiliated if it "holds a substantial ownership interest in, or is owned in whole or in substantial part by" its related retailer. "Ownership" includes both direct ownership as well as indirect ownership, through a parent, subsidiary, or affiliate.

vi. Furthermore, a business making sales to consumers in South Dakota by mail, telephone, internet, or other media will be classified as a "retailer" under South Dakota law if it has a contractual relationship with an entity performing installation, maintenance, or repair services for the retailer's purchasers within the state.

Use Tax Reporting

Legislative Action – S.B. 146, 86th Leg. Assemb. (Mar. 2011) (enacted), *to be codified at* S.D. Codified Laws § 10-45.

i. A new law requires out-of-state businesses that are not required to collect sales and use tax in South Dakota to provide conspicuous notice to South

Dakota purchasers that, unless exempt, their purchases are subject to the state's use tax.

ii. This conspicuous notice is to be printed on invoices mailed into the state with products and on web sites selling products to South Dakota consumers. Any implication that no tax is due on such purchases—including "a summary of the transaction includ[ing] a line designated 'sales tax' and show[ing] the amount of sales tax as zero"—must be accompanied by the notice described in the Act.

iii. The Act creates a safe harbor for businesses and web sites making less than $100,000 in total gross sales to South Dakota purchasers, exempting these businesses from its requirements.

TEXAS

In-State Personnel

In Re: ***, Texas Comptroller Decision Hearing No. 102,402, Tex. Tax Reporter (CCH) ¶ 403-655 (Tex. Cmptr. Pub. Acct., Sept. 21, 2010).

i. Taxpayer was a Colorado corporation headquartered in Colorado. The Texas Comptroller of Public Accounts had determined that Taxpayer was subject to the Texas franchise tax and had assessed this tax for tax years 2005 and 2006. Taxpayer requested a redetermination. An administrative law judge recommended that the franchise tax assessment be upheld without change, and the Comptroller followed this recommendation.

ii. The Comptroller found that Taxpayer was doing business in Texas. Taxpayer had two employees who were Texas residents during the years 2005 and 2006. One of these employees worked from his home in Texas, performing services for a Texas business. Such services may have included performing clerical work, providing labor, handling funds, keeping records, obtaining permits, and performing other services.

iii. In addition, the Comptroller found that Taxpayer was part of a corporate group that performed contracts in Texas.

iv. The Comptroller concluded that its staff had presented a prima facie case that the franchise tax was due and that Taxpayer had not met its burden of proving by a preponderance of the evidence that it was not doing business in Texas. Therefore, the Comptroller upheld the assessment without change.

Texas Comptroller of Public Accounts, Hearing No. 100,984, Tex. Tax Reporter (CCH) ¶403-672 (Tex. Cmptr. Pub. Acct., Dec. 9, 2010).

i. Taxpayer was an Illinois corporation selling medical and general-use scales through retailers in Texas and directly, through its online retailer. The Texas Comptroller of Public Accounts determined that Taxpayer had established nexus for the purposes of the sales and use tax on the basis of two independent grounds.

ii. First, Taxpayer issued a Form 1099 to every entity engaged in medical sales in Texas and to one individual who worked as a sales representative. The Comptroller held that engaging an agent to sell, deliver, or take orders for taxable items or using an independent salesperson to direct sales of taxable items amounted to doing business in the state.

iii. Second, Taxpayer's web site instructed consumers who had purchased its products at retail stores in Texas to return those products to the Texas stores for warranty services. The Comptroller concluded that the provision of warranty or repair services was sufficient to establish Taxpayer's nexus to the state.

iv. An undisclosed amount of taxes, penalties, and interest was assessed against Taxpayer for the time period during which it was selling its products directly in the state through online sales.

Temporary In-State Presence

Editor's Note: This case is a good example of the dual requirement that states have both (i) nexus with the taxpayer and (ii) nexus with the particular transaction or property sought to be taxed.

Midland Cent. Appraisal Dist. v. BP Amer. Prod. Co., 282 S.W.3d 215 (Tex. App.—Eastland 2009, pet. denied), *petition for cert. filed* __ U.S.L.W. __ (U.S., Dec. 30, 2010) (No. 10-890).

i. Midland Central Appraisal District ("MCAD") appealed the judgment of the trial court holding that an *ad valorem* tax was improperly imposed on crude oil located in a tank farm that is part of an interstate, common-carrier pipeline system. The oil at issue is produced in Texas and New Mexico, pumped into the Midland Pipe System (an interstate, common-carrier pipeline system), and transported to refineries located in Texas and other states. During its journey, a large part of the oil passes through the tank farm in Midland that exists to facilitate the transport, not the storage, of the oil. Oil is constantly present in the tanks, but the tanks are not used for storage. Upon arrival at a refinery, the oil is assessed and listed for taxation by the local appraisal authorities.

ii. Tangible personal property in Texas is taxable if it is located in Texas for longer than a temporary period, is temporarily located outside Texas but owned by one residing in Texas, or is used continuously in Texas. Tex. Tax Code Ann. §§ 11.01, 21.02 (Vernon 2008).

iii. MCAD argued that nexus was present because the oil had a constant presence in the tank, even though individual units were never present for more than short periods of time. For this reason, the oil should not be viewed as moving in interstate commerce. MCAD also argued that imposition of the tax on the oil did not violate the Commerce Clause of the United States Constitution.

iv. MCAD asserted that the oil should be viewed as a massive, constant presence of oil in the tank farm and that, if so viewed, it could not be concluded that the oil was in interstate commerce or that it was only temporarily in Midland County. The appellate court rejected this argument, distinguishing this case from *Diamond Shamrock Ref. & Mktg. Co. v. Nueces County Appraisal Dist.*, 876 S.W.2d 298 (Tex. 1994), and *Exxon Corp. v. San Patricio County Appraisal Dist.*, 822 S.W.2d 269 (Tex. App.—Corpus Christi 1991, writ denied), in that Texas was the final destination of the oil at issue in those cases. The court found that the facts of this case were more similar to those of *Va. Indonesia Co. v. Harris County Appraisal Dist.*, 910 S.W.2d 905 (Tex. 1995), because any disruption in the transit of the oil was due not to the business purposes of the owner, but rather to the necessity to meet federal safety and emissions standards.

v. Next, the appellate court considered the trial court's holding that the tax violated the Commerce Clause because it did not satisfy the "substantial nexus" requirement. MCAD urged the appellate court to follow *In re Assessment of Pers. Prop. Taxes Against Mo. Gas Energy, a Div. of S. Union Co.*, No. 103,355, 2008 WL 4648330 (Okla. Oct. 21, 2008), an Oklahoma Supreme Court decision that upheld an *ad valorem* tax on gas held in an underground storage facility owned and operated by an interstate, common-carrier pipeline. The Texas appellate court distinguished the facts of this case, though, noting that the gas at issue in the Oklahoma case was temporarily stored in Oklahoma while the oil in this case was not temporarily stored in the tank farm. To comply with the substantial nexus requirement, the appellate court held, the *ad valorem* tax must have applied to an *activity* with a substantial nexus to Texas. The court held that the activity at issue—the ownership of oil that was in interstate transit—did not have a substantial nexus to the state even if the oil itself did. The court pointed out that if it upheld the *ad valorem* tax at issue in this case, then *ad valorem* taxes could potentially be levied by any taxing authority on oil in transit but located, at the time of assessment, in the portion of an interstate pipeline system within the boundaries of that local taxing authority. The result would be impermissible multiple burdens on interstate commerce, the court concluded.

VIRGINIA

"Intangible" Nexus

Ruling of Commissioner, P.D. 10-279 (Va. Dep't. of Tax, Dec. 22, 2010).

i. Taxpayer, a corporation domiciled outside Virginia, sought a ruling that the activities of its corporate family in Virginia were insufficient to create a nexus to Virginia for corporate income tax purposes.

ii. Taxpayer has no property or employees in Virginia. It owns and manages intangible assets, such as intellectual property, used by members of its corporate family. It licenses these intangible assets to S1, one of its four subsidiaries, for an arm's length royalty fee, and S1 uses the intangible assets in connection with the packaging, marketing, and sales of its products. S1 is domiciled outside Virginia, but it sells its products in Virginia and has two employees that solicit orders for its products in the state, which orders are then submitted for approval at an office outside Virginia.

iii. The activities of S1 are protected under Public Law 86-272, which prohibits a state from imposing an income tax where the only contacts with the state are a narrowly defined set of activities constituting solicitation of orders for sales of tangible personal property. The Commission further stated that the Department of Taxation's policy has been to extend the solicitation test to situations involving sales other than tangible personal property.

iv. The Tax Commissioner noted that some states have held that a holding corporation which licenses the use of intellectual property to a related corporation authorized and doing business in the state may be taxed on royalty income it earns from such licensing. *See Geoffrey, Inc. v. South Carolina Tax Comm'n*, 437 S.E.2d 13 (S.C. Sup. Ct. 1993). The Commissioner noted, however, that in Virginia even if nexus were created, it is unclear whether the taxpayer would have any Virginia source income.

v. The Tax Commissioner also noted that the Department of Taxation (the "Department") has the authority to adjust the taxable income of two or more corporations, or even to consolidate the accounts of two or more corporations, in the event that transactions between commonly owned businesses improperly reflect Virginia taxable income from business done in Virginia. Va. Code § 58.1-446. This authority extends to the situation where two commonly owned corporations structure an arrangement in such a manner as to reflect improperly, inaccurately, or incorrectly the business done in Virginia or the Virginia taxable income. *See Commonwealth v. General Electric Co.,* 236 Va. 54 (Va. 1988). The Commissioner stated that generally the Department will exercise such authority only if it finds that a transaction lacks economic substance or is not at arm's length.

vi. The Tax Commissioner ruled that neither Taxpayer nor its subsidiary, S1, is subject to Virginia income tax because neither entity had established a nexus with Virginia for income tax purposes.

WASHINGTON

Employee Visits

Lamtec Corp. v. Dep't of Revenue, No. 83579-9 (Wash., Jan. 20, 2011) (en banc).

i. Washington imposes a gross receipts tax, the Business and Occupation ("B&O") tax, "for the act or privilege of engaging in business activities" on every person that has a substantial nexus with the state. Wash. Rev. Code § 82.04.220 (2010); *see also Ford Motor Co. v. City of Seattle*, 156 P.3d 185 (2007). Section 82.04.220 was revised in 2010 (*see* Laws of 2010, 1st Special Sess., ch. 23, § 201), but because this case concerned tax years 1997 to 2003, the Supreme Court of Washington decided the case on the basis of the B&O tax provision in effect at that time and did not consider the impact, if any, of the revision to the statute.

ii. The Supreme Court of Washington held that Washington's imposition of B&O tax on New Jersey-based Lamtec Corporation passed constitutional muster despite the fact that the company had no offices or employees in Washington. The court held that, to the extent there is a physical presence requirement for the imposition of the B&O tax, the physical presence requirement can be satisfied by the presence of activities within the state as long as the activities are: (1) substantial; and (2) associated with the company's ability to establish and maintain its market within the state. In addition, the court stated that its analysis would apply regardless of whether the activities were performed by staff permanently employed within the state, independent contractors, or persons traveling into the state from without.

iii. Lamtec Corporation is a New Jersey-based manufacturer of insulation and vapor barriers. The company has no offices in Washington and no employees stationed in Washington. During the audit period in question, from 1997 to 2003, it sold more than $9 million worth of products to Washington customers through orders placed over the phone. During the same period, Lamtec employees visited major customers in Washington approximately 50 to 70 times in order to answer questions and provide information about Lamtec products. The purpose of the visits was to maintain Lamtec's Washington market, but employees did not solicit sales during these visits.

iv. Lamtec argued that *Quill Corp. v. North Dakota*, 504 U.S. 274, 315 (1977), required a "brick and mortar" presence or at least an established sales force within the taxing state in order to establish the requisite nexus for taxation. The court rejected this argument, instead adopting the Department of Revenue's view, based upon *Tyler Pipe Indus., Inc. v. Wash. Dep't of Revenue*, 483 U.S. 232 (1987), that a business is subject to Washington's B&O tax if "the activities performed in [Washington] on behalf of the taxpayer are significantly associated with the taxpayer's ability to establish and maintain a market in this state for the sales." *Id.* at 250. The court went on to state that "a physical presence in the taxing jurisdiction for the purposes of B&O tax can be based on periodic visits."

v. The Department of Revenue also argued that *Quill* applies only to state sales and use taxes. The court, noting that some states have refused to apply the *Quill* physical presence test to other kinds of taxes, agreed that the great weight of authority concurs with the Department, but it declined the opportunity to decide this issue on these facts.

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