NEXUS – JUST PASSING THROUGH

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by

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I. INTRODUCTION

This paper discusses the use tax collection duties of a retailer making sales of tangible personal property from outside the taxing state to consumers in that state, and after a discussion of the United States Constitution, will focus on the situation in California. The question that arises in these circumstances is whether the out-of-state retailer has sufficient nexus with the taxing state to permit that state to impose a use tax collection duty on the retailer.

If a person does not have nexus with a state for a particular purpose, then the state cannot impose its jurisdiction on that person, at least not for the particular purpose for which nexus is lacking. As relates to use tax collection duties, the first question is whether the state's own laws extend those duties to a person. If so, the next question is whether the state's laws doing so withstand constitutional scrutiny.

II. BACKGROUND

A. California

California imposes use tax on the use of property purchased from a retailer for use in California, unless the use is specifically exempt from tax by statute. (Rev. & Tax. Code § 6201.) The use tax is imposed on the purchaser. (Rev. & Tax. Code § 6202.) However, if the retailer is engaged in business in California, then the retailer is required to collect the applicable use tax from the purchaser and remit it to the state. (Rev. & Tax. Code § 6203.) The tax that a retailer engaged in business in this state is required to collect from its purchasers constitutes a debt owed by the retailer to the state. (Rev. & Tax. Code § 6204.) The purchaser's liability for the use tax, however, is not extinguished until the tax has been paid to the state or has been paid to a retailer engaged in business in this state who gives the purchaser a receipt in the form set forth in Regulation 1686 showing that the tax has been paid. (Rev. & Tax. Code § 6202; Reg. 1686.)

With certain exceptions,[1] California does not currently have an effective enforcement mechanism to require persons making extax purchases from unregistered out-of-state retailers to pay the applicable use tax. Thus, for these purchases, the inability of the state to require the retailer to collect use tax from the purchaser is virtually equivalent to an exemption, so much so that it is not an uncommon belief, though not supported by the law, that purchases from outside California are exempt from tax.

When a retailer is engaged in business in this state within the meaning of Revenue and Taxation Code section 6203, that retailer has nexus with California for purposes of state law. I will return to the question of when a retailer is regarded as engaged in business in California under section 6203 after a discussion of federal law.

[1] The exceptions include purchases of certain big ticket items, purchases of cigarettes shipped to the purchaser in California, and purchases by persons who hold California seller's permits.

B. Decisions of the United States Supreme Court

It is a basic tenet of constitutional law that a state cannot impose its jurisdiction over a person located in another state unless that person has at least some contact with the state. In the use tax arena (as in others), the question that arises is how much contact need there be? The continual advances of technology and marketing acumen have led to an increasing "economic presence" by retailers in states other than their own. Is an economic presence sufficient? During much of the last half of the twentieth century, this question of the sufficiency of an economic presence has festered as part of the greater question of just when a state has use tax collection nexus over an out-of-state retailer.

In *Miller Bros. Co. v. Maryland* (1954) 347 U.S. 340, a Delaware retailer occasionally delivered property to purchasers in Maryland. Sometimes those deliveries were by common carrier and sometimes by the retailer's own facilities. The retailer had no locations in Maryland, sent no solicitors into Maryland, and did not "target" Maryland residents with advertising (catalogs sent to residents of Maryland were sent to them because they had visited the retailer's store in Delaware). It took orders for all sales at its store in Delaware, and it took no orders by mail or telephone. Maryland sought to impose a use tax collection duty on Miller Brothers for all sales to Maryland purchasers, even for those sales where the purchasers took delivery and possession at the Delaware store. The Court held that "the occasional delivery of goods sold at an out-of-state store with no solicitation other than the incidental effects of general advertising" was insufficient to constitute the nexus necessary to impose a use tax collection duty on the retailer. (*Id.* at 347.)[2]

In *Scripto v. Carson* (1960) 362 U.S. 207, a Georgia retailer sold and shipped tangible personal property to Florida consumers. Scripto had no business locations in Florida nor, as relevant to Florida's statute in question, any regular employees or agents in that state. During the period in question, however, Scripto did use ten Florida residents known as "jobbers." It was

[2] Shortly after *Miller Bros.*, the California State Board of Equalization ("Board") concluded that two or more deliveries into California per week were regular deliveries and were not merely "occasional" deliveries. Thus, if a retailer makes two or more deliveries per week into California in its own facilities, California does not regard *Miller Bros.* as preventing it from imposing its use tax collection duties on the out-of-state retailer. (If the person making the delivery also makes collections, then the required number of deliveries into California would be far smaller.) However, this would only determine whether the retailer is engaged in business in this state under section 6203. Even if a retailer is engaged in business in this state under section 6203, California would not impose a use tax collection duty on the retailer with respect to sales where the transaction is entered into, and consummated, fully outside California and the purchaser takes delivery and possession at the time of purchase at the out-of-state location of the retailer. (*Montgomery Ward & Co. v. State Board of Equalization* (1969) 272 Cal.App.2d 728 (retailer with clear nexus with California not required to collect use tax from persons who purchase, and take delivery, of property at retailer's out-of-state location).) If, however, there was California contact with the transaction, such as the parties entering into the contract of sale of a vehicle inside California, with the vehicle then delivered to the purchaser at an out-of-state point, the provisions of Revenue and Taxation Code section 6247 would be fully applicable, and the retailer would have a use tax collection obligation except as provided therein.

through these jobbers that the sales to residents of Florida occurred. Each jobber had a contract with Scripto and a specific territory. The contract specifically provided that the parties intended to create the relationship of "independent contractor." The jobbers had no authority to make collections nor to incur debts for Scripto. Each was furnished catalogs, samples, and advertising material, and operated in Florida as a representative of Scripto for the purpose of obtaining Florida customers. No money passed between the customers and the jobbers (if a jobber received a check, it would be forwarded to Scripto with the order). The Court noted that the jobbers were not regular employees of Scripto, but it concluded that such a fine distinction was without constitutional significance. (*Id.* at 211.) The Court was also not persuaded by the fact that a jobber could work for several principals. (*Id.*) The tax collection duty of Scripto was upheld.[3]

The Court in *Miller Brothers Co.* analyzed the issue under its rule "that due process requires some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax," (347 U.S. at 344-45), and in light of its conclusion that this test was not satisfied, did not consider whether there was also a Commerce Clause violation (*Id.* at 347).[4] The Court in *Miller Brothers Co.* thus seems to indicate that it would have proceeded to a Commerce Clause analysis if the facts had satisfied due process concerns. However, in *Scripto*, the Court appears to have treated the analysis as one of due process alone. Quoting from *General Trading Co. v. State Tax Com.* (1944) 322 U.S. 335, 338, the Court in *Scripto* noted that "no State can tax the privilege of doing interstate business [unless Congress permits it]" (*Scripto, supra,* 362 U.S. at 212), and then concluded "that the 'minimum connections' not present in *Miller* are more than sufficient here." (*Id.* at 213.)

Then came *National Bellas Hess, Inc. v. Department of Revenue of Illinois* (1967) 386 U.S. 753. Bellas Hess had no physical presence in Illinois. It had no locations or sales representatives in Illinois, did not have a telephone listing in the state, and did not advertise in newspapers, on billboards, or by radio or television in Illinois. Its only contacts with Illinois were by mail or common carrier. Bellas Hess argued that imposing a use tax collection duty on

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[3] *Scripto* was cited approvingly in *Tyler Pipe Industries, Inc. v. Washington Department of Revenue* (1987) 483 U.S. 232. Tyler had no presence in Washington except for a sales representative who acted on its behalf. The Court held that the activities performed by the representative in Washington were significantly associated with Tyler's ability to establish and maintain a market in that state. The Court held that Tyler had nexus with Washington sufficient to support the state's imposition of its business and occupation (B & O) tax on Tyler, stating that the characterization of Tyler's representative as an independent contractor or as an agent was irrelevant. (*Id*. at 249-52. See also *Standard Pressed Steel Co. v. State of Washington Department of Revenue* (1974) 419 U.S. 560 (single employee of out-of-state retailer who worked out of his home and who consulted with customer on retailer's behalf was sufficient for the imposition of Washington's B & O tax on the out-of-state retailer, even though the employee took no orders).)

[4] Under the Commerce Clause in Article 1, section 8, Congress has the power to regulate commerce among the states. This provision has been interpreted as giving Congress the exclusive authority to regulate commerce among the states, and the Court has further interpreted this exclusive Congressional authority as prohibiting the states from passing laws which would interfere with interstate commerce. This latter interpretation is sometimes called the "negative" or "dormant" Commerce Clause.

it was a violation of due process as well as an unconstitutional burden on interstate commerce. The Court indicated that these two claims were closely related, stating:

> "In order to uphold the power of Illinois to impose use tax burdens on National in this case, we would have to repudiate totally the sharp distinction which these and other decisions have drawn between mail order sellers with retail outlets, solicitors, or property within a State, and those who do no more than communicate with customers in the State by mail or common carrier as part of a general interstate business. But this basic distinction … is a valid one, and we decline to obliterate it." (*Id.* at 758.)

This decision recognized a safe harbor for those retailers whose *only* contact with the taxing state is by mail or common carrier (which would include contact by telephone and, most agree, by Internet). The Court's final statement was a reliance on the Commerce Clause with the comment that "this is a domain where Congress alone has the power of regulation ...." (*Id.* at 760.)

Although the Court in *Bellas Hess* seemed to indicate that Congress had the power to overturn that decision, after the decision there were discussions, analyses, and arguments regarding whether Congress did have the power to overturn the decision and permit states to impose a use tax collection duty on out-of-state retailers who did not have a physical presence in the taxing state. If the conclusion in *Bellas Hess* that the retailer must have some contact with the state other than by mail or common carrier was based on the Due Process Clause as well as on the Commerce Clause, then no action by Congress could overturn it since Congress has no power to authorize a violation of due process.

While this question simmered, the Court provided further guidance as to what constituted the physical presence necessary to impose a use tax collection duty in *National Geographic Society v. California Board of Equalization* (1977) 430 U.S. 551. National Geographic made mail order sales of tangible personal property to California purchasers. Its physical presence in California consisted of two offices whose function was to solicit advertising copy for the Society's monthly magazine.[5] The California Supreme Court held that the Society was engaged in business in California under section 6203 based on the Society's two offices in this state, stating that the "the slightest presence within such taxing state independent of any connection through interstate commerce" established sufficient nexus to constitutionally support the imposition of the use tax collection duty. (*National Geographic Society v. State Board of Equalization* (1976) 16 Cal.3d 637, 644.)

The United States Supreme Court affirmed the California Supreme Court's decision, but noted that its decision was "not to be understood as implying agreement with [the California

[5] The offices made some over-the-counter sales of tangible personal property for about one month of the six-month audit period. (*National Geographic Society v. State Board of Equalization* (1976) 16 Cal.3d 637, 640.) However, both the California Supreme Court (*Id.* at 641, fn. 6) and the United States Supreme Court (430 U.S. at 554-55, fn. 2) found it unnecessary to consider these sales in reaching their conclusions.

Supreme Court's] 'slightest presence' standard" (430 U.S. at 556). In any event, the Court found nexus aplenty on the facts presented. In doing so, it regarded as instructive its then recent decision in *Standard Pressed Steel Co. v. Washington Rev. Dept.* (1975) 419 U.S. 560, which involved a direct tax on the seller, measured by sales to Washington purchasers, rather than a use tax collection duty. The Court upheld that tax based on the presence of a single employee in Washington even though the employee was not involved in direct sales (the employee consulted with the retailer's Washington customer and clearly facilitated sales), stating that the answer to the question "whether the state has given anything for which it can ask return" in the context of the case before it "verges on the frivolous." (*Id.* at 562.) In *National Geographic Society*, the Court explained that "[t]he case for the validity of the imposition upon the out-of-state seller enjoying such services of a duty to collect a use tax is even stronger." (*National Geographic Society v. California Board of Equalization*, 430 U.S. at 558.)

The Court in *National Geographic* made it clear that the retailer's presence in the taxing state need not be related to its sales activities in order to impose a use tax collection duty. Rather, applying (and quoting) the due process terminology from *Miller Brothers*, the Court held that all that is required is "some definite link, some minimum connection between [the State and] the *person* … it seeks to tax." (*Id.* at 561 (quoted as written in *National Geographic*).) The Court further held that "the Society's continuous presence in California in offices that solicit advertising for its magazine provides a sufficient nexus to justify that State's imposition upon the Society of the duty to act as collector of the use tax." (*Id.* at 562.)

A review of these cases shows that when a retailer has a definite continuous physical presence in the state, such as a business location, the Court has found such presence sufficient to support the imposition of a use tax collection duty on the retailer even if that location is unrelated to the sale of tangible personal property. However, when the physical presence in the taxing state is directly connected with the sales activities for which the state seeks to impose the tax or duty to collect the tax, the Court has upheld the tax or tax collection duty based on a lesser physical presence in the taxing state.[6] In this line of cases, the Court has relied on the presence of the seller's representatives in the taxing state for purposes that are significantly associated with the seller's ability to establish and maintain a market in the taxing state. (See, e.g., *Tyler Pipe Industries, Inc. v. Washington Department of Revenue* (1987) 483 U.S. 232, 250-51.)

During the same term as it decided *National Geographic*, the Court issued its seminal ruling in *Complete Auto Transit Inc. v. Brady* (1977) 430 U.S. 274. Although concerning a tax other than use tax, this case is the starting point when analyzing the challenge to any tax as a violation of the Commerce Clause. The Court held that a tax is valid against a Commerce Clause challenge so long as the tax 1) is applied to an activity with a substantial nexus with the

[6] E.g., *Scripto* (10 jobbers who acted as independent contractors); *Standard Pressed Steel* (1 employee connected with sales but not selling). See also *Tyler Pipe Industries, Inc. v. Washington Department of Revenue* (1987) 483 U.S. 232, 248-51 (no physical presence in the taxing state except for an independent contractor acting as a sales representative).

taxing State, 2) is fairly apportioned, 3) does not discriminate against interstate commerce, and 4) is fairly related to the services provided by the State. (*Id.* at 279.)

The decisions up to this point make it clear that a retailer can be required to collect a state's use tax if: 1) the retailer has a business location in the taxing state, even if wholly unrelated to sales of tangible personal property; or 2) if the retailer has any representative in the taxing state for the purpose of furthering the retailer's market for sales of tangible personal property in the taxing state, regardless of how the parties characterize the relationship between the retailer and the representative. What if the retailer has an *economic* presence in the taxing state such that the retailer is, for all intents and purposes, present in the taxing state? Is that not the substantial nexus with the taxing state necessary to support a use tax collection duty?

With the march of technology and the ability of out-of-state retailers to have virtually the same economic presence as retailers physically present in the state, some states, including California, believed that economic presence was sufficient. Part of the states' concern was the loss of revenue, but the most significant concern was the same as the original genesis of use tax laws: if out-of-state retailers could continue to avoid use tax collection duties, in-state retailers would be substantially harmed because of the tax savings that could be offered by the out-of-state retailers.[7]

In light of these facts, many states amended their use tax collection statutes to extend to persons "economically present" in the taxing state. California did so during 1987 and 1988 in amendments to Revenue and Taxation Code section 6203 which became effective during 1988. In 1987, North Dakota also amended its use tax collection statute to extend that statute's reach. Quill, a retailer located outside North Dakota, challenged this provision, resulting in the eagerly anticipated case of *Quill Corporation v. North Dakota* (1992) 504 U.S. 298. Quill had no locations or employees in North Dakota; it solicited its business in that state through catalogs and flyers, advertisements in national periodicals, and by telephone. All property sold to residents of North Dakota was delivered to them by mail or common carrier.

The Court in *Quill* noted that its decision in *Bellas Hess* relied on both the Due Process Clause and the Commerce Clause, regarding claims under them as closely related. (*Id.* at 305.) However, the *Quill* Court clarified that the analyses of the two are, in fact, different. The Court commented that its due process jurisprudence had evolved substantially in the prior 25 years, and held that for purposes of requiring a retailer to collect a state's use tax, due process is satisfied when the retailer has purposely directed its activities at the state's residents, without regard to

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[7] Some commentators claim that the tax savings enjoyed by purchasers from non-registered out-of-state retailers is offset by the shipping charges they must pay for shipment of their goods. However, these same commentators do not factor into the equation the savings enjoyed by these mail-order retailers, such as avoiding the costs of shipping to retail locations in the state and then stocking the retail stores' shelves. These savings permit mail order sellers, in many or most cases, to compete on equal pricing terms with retail outlets, even *after* adding the shipping and handling charges For these mail order retailers, as far as price goes, the tax may be the difference.

the retailer's physical presence in the taxing state. (*Id.* at 307-8 (when a retailer engages in continuous and widespread solicitation of business within the state, the retailer has fair warning that its activity may subject it to that state's jurisdiction).) Accordingly, the Court overruled prior opinions to the contrary. The issue of the Commerce Clause, however, remained.

North Dakota argued that since the nexus requirements of the Due Process Clause and those of the Commerce Clause are equivalent and the nexus requirements of due process do not require physical presence, neither should the nexus requirements of the Commerce Clause require a physical presence. While the Court intimated that it would have reached a different result had this issue then been one of first impression, it concluded that *Bellas Hess* was not inconsistent with *Complete Auto Transit* and other recent cases. (504 U.S. at 311.) The Court essentially acknowledged the aberration of the rigidity of the *Bellas Hess* bright-line test compared to the modern more flexible analysis, but decided that it would not overrule that bright line. Thus, the Court held that some physical presence in the taxing state is required before a retailer can be required to collect that state's use tax, even though the "rule appears artificial at its edges ...." (*Id.* at 315.) An important factor in this conclusion was that, since the Court "put [the Due Process] problem to rest," Congress became "free to decide whether, when, and to what extent the States may burden interstate mail-order concerns with a duty to collect use taxes." (*Id.* at 318.)

Thus, the *same* physical presence that would have been required under *Bellas Hess* is still required under *Quill*.[8] What *Quill* did in terms of the power of the states to impose use tax collection duties on out-of-state retailers in comparison to *Bellas Hess* can be summed up in a single word: nothing. As before *Quill*, the one thing that is certain is that there is a safe harbor for those out-of-state retailers whose only contacts with the taxing State are by mail or common carrier. Once a retailer's activities bring it outside that safe harbor, the uncertainty that existed before *Quill* remains with us.[9]

III. AFTER *QUILL*

[8] The Court's decision in *Quill* lowered the bar to imposition of a duty to collect use tax as against a due process challenge, and kept the bar where it was with respect to a Commerce Clause challenge (though actually criticizing the *Bellas Hess* analysis while explaining why it remained good law). Thus, it is hard to understand how anyone would think that *Quill* raised the bar as to a state's imposition of a use tax collection duty since one need only read the decision to discover otherwise. Nevertheless, some did, in fact make this argument, at least in the period shortly following the issuance of the opinion. Hopefully, these arguments, perhaps made mostly as part of vociferous advocacy as litigators, have subsided so that the discourse can better focus on the opinions as written, not as persons with one viewpoint or another wish they were written.

[9] The Court's rejection of the "slightest presence" test, at least by the time of *Quill*, resolves little if anything. An out-of-state retailer seeking to avoid the duty to collect use tax and a state tax administrator are likely to have entirely different views of what constitutes a slight presence if the retailer physically enters the state (e.g., through a representative) for any business purpose, especially a purpose related to sales of tangible personal property or furthering the retailer's market for sales of tangible personal property.

A. Substantial Nexus

Some commentators have misunderstood just what "substantial" means in the phrase "substantial nexus." For example, in 1995 the New York Court of Appeals considered the imposition of a use tax collection duty on a Vermont company whose employees occasionally visited customers in New York. The Court of Appeals held that *Quill* cannot be read as equating a substantial physical presence of the vendor in the taxing state with the substantial nexus prong of the *Complete Auto* test. (*Orvis v. Tax Appeals Tribunal* (1995) 86 N.Y.2d 165, 176.) Despite the wording of the opinion, it has been claimed that the New York Court of Appeals "rejected the substantial nexus requirement."[10]

These commentators overlook the very meaning of "nexus," which is "a means of connection" or a "link." In determining whether a person has nexus with a state such that the state can impose its jurisdiction over that person, whether there is nexus depends on the means of connection among the state, the person, and *the activity for which jurisdiction is sought.* This, in fact, is discerned from the very wording of the first prong of the *Complete Auto* test, that the "tax is applied to an *activity with a substantial nexus* with the taxing State." (*Complete Auto Transit*, *supra*, 430 U.S. at 279 (emphasis added); see also *Quill*, *supra*, 504 U.S. at 311.) The commentators with the flawed view just noted[11] forget to factor into the analysis this connection between the activity in question and the activity for which jurisdiction is sought, preferring to see the term "substantial physical presence" where the term used by the Court was "substantial nexus."[12]

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[10] W. Ray Williams, *Electronic Commerce in the 21st Century* (2001) 27 Wm. Mitchell L. Rev. 1703, 1720. Mr. Williams apparently declined to focus on the actual words used by the court in *Orvis* which in no way "rejected" the substantial nexus requirement *Quill* mandates. *Quill* does mandate the finding of substantial nexus prior to imposing a use tax collection duty, and the New York Court of Appeals *applied* the substantial nexus requirement in reaching its decision. Substantial nexus is not always equal to substantial physical presence when there the retailer has a physical presence in the state directly related to the retailer's sales activities.

[11] It is not clear whether Mr. Williams actually read *Orvis* or just relied on other commentators' reading of it. For example, he states that the "court found that the level of nexus required by both the Due Process Clause and the Commerce Clause was 'indistinguishable.'" (27 Wm. Mitchell L. Rev. at 1720-21.) Although not attributing this conclusion to another commentator, this is the identical statement made by law student Megan Groves in *Where There's a Will, There's a Way: State Sales and Use Taxation of Electronic Commerce* (1998) 74 Ind.L.J. 293, 302 (Mr. Williams does cite to this source elsewhere in his paper). In any event, the characterizations of *Orvis* by both Mr. Williams and Ms. Groves are simply wrong. Rather than finding that even *after* the decision in *Quill* the level of nexus required by these clauses *was* indistinguishable, as asserted by these commentators, the court stated: "*Until Quill Corp. v. North Dakota*, the constitutionally required nexus … was applied indistinguishably for purposes of both Due Process and Commerce Clause analysis …." (*Orvis,* 86 N.Y.2d at 956 (emphasis added).)

[12] I believe that the thought processes of these commentators is also reflected in Mr. Williams' comment that one can infer from the United States Supreme Court's refusal to grant review in *Orvis* that the Court did not want to overturn the decision by the New York Court of Appeals because either the Court was unhappy with *Quill* or was trying to force the hand of Congress. (27 Wm. Mitchell L. Rev. at 1721.) Mr. Williams overlooked the distinct possibility that the Court did not grant review of *Orvis* because it viewed the decision as correct.

B. *Current v. State Board of Equalization* and the terminology of Representative Nexus and Attributional or Affiliate Nexus

Subdivision (c)(2) of California Revenue and Taxation Code section 6203[13] is an example of representative nexus, as are the cases of *Scripto*, *Standard Pressed Steel*, and the like. The out-of-state retailer is regarded as having nexus in the taxing state because of the physical presence in the state of its representative making sales on its behalf, or otherwise acting to further the retailer's market in that state. That is, the retailer is literally physically present in the taxing state: the representative is in the taxing state, and the retailer acts in the taxing state through that physically present representative.

An example of affiliate nexus was contained in former subdivision (g) of section 6203. In the late 1980s when California expanded the provisions of section 6203 to test the limits of *Bellas Hess*, subdivision (g) was added to provide that a retailer was engaged in business in this state if it was "owned or controlled by the same interests which own or control any retailer engaged in business in the same or similar line of business in this state." That is, without regard to any physical presence of the out-of-state retailer in California, the nexus of the California affiliate would be attributed to the out-of-state retailer based on the common ownership and the out-of-state retailer's sales of the same or similar products as the in-state retailer. This would be true without regard to whether the in-state retailer ever acted on the out-of-state retailer's behalf in California, and without regard to whether the out-of-state retailer had any physical presence in this state except for the presence of its corporate relative in this state.

Subdivision (g) was tested in *Current, Inc. v. State Board of Equalization* (1994) 24 Cal.App.4th 382. During the relevant period, Current had no nexus with California, unless subdivision (g) applied. The Court explained the business of Current as follows:

> "Current is engaged in the concept development, artwork design, production, and retail sale through the mail of greeting cards, gift-wrapping paper and spin-off novelty items, including novelty checks incorporating scenes from successful greeting card promotions. Most of Current's sales consisted of greeting cards and gift-wrapping paper….
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> "During the taxable period, 7.9 percent of Current's revenue arose from its sale of checks. Current had begun the production and sale of checks in 1986 as a spin-off from its traditional stationery products. Approximately 97 percent of Current's revenue was derived during the taxable period from the sale of its products at retail to individuals. The remaining 3 percent was derived from the sale of its products to churches and other fund-raising groups for resale." (*Current*, 24 Cal.App.4th 386.)

[13] See next section for the text of section 6203.

Current was acquired by Deluxe prior to the audit period. Deluxe had clear physical nexus with this state and held a California seller's permit. The court explained the business of Deluxe as follows:

> "During the taxable period, 96.3 percent of the sales of Deluxe to California customers were sales of checks to financial institutions and their depositors. Deluxe billed the financial institutions for the checks, and received payment for them from the financial institutions, either weekly or monthly, following the shipment of checks to the financial institutions or their depositors. The noncheck sales to California customers during the taxable period, representing 3.7 percent of the sale of Deluxe to California customers, involved sales of financial forms to banks for their own use and mail-order sales of business forms, preinked hand stamps and checkbook calculators. The mail-order sales by Deluxe of all products (checks and nonchecks) to California customers during the taxable period represented approximately 4 percent of its total sales to California customers."

The facts in *Current* were not the facts that subdivision (g) was designed to cover. It was designed to cover the classic situation where an in-state retailer who makes mail-order sales decides to create an out-of-state subsidiary to take over the mail order business, selling the same items by mail as the original company sells over the counter. Quite simply, *Current* is an excellent example of a very poor case selection for purposes of testing subdivision (g). There were other cases in the pipeline that were on all fours with the facts that subdivision (g) was adopted to cover.[14] Nevertheless, it was the Current situation under which subdivision (g) was examined.

The Board's position was that both Current and Deluxe were in the business of printing, and thus in the same line of business. If one were to look at the businesses that broadly, then the Board's position would have been correct. However, looking at the statement of facts for Current and for Deluxe as quoted above, it is difficult, at least for me, to see them as in the same line of business. A least in hindsight, the facts in *Current* do not appear to even come within the provisions of subdivision (g), meaning that the constitutional question was not really presented. The court, however, dealt with the constitutional question first, noting that the parties had stipulated that "Current and Deluxe 'did not have integrated operations or management,' 'were organized and operated as separate and distinct corporate entities,' and, 'neither ... was the alter ego or agent of the other for any purpose.'" (*Id.* at 391.) For these reasons, the court held that subdivision (g) was unconstitutional *as applied to Current*.[15] The court then proceeded to also

[14] This is not to say that the result would have been different had one of these cases been selected as the lead case. However, the analysis of the court would have at least been more on point with the goal of subdivision (g), and would have had to squarely address that goal, regardless of the Court's ultimate conclusion.

[15] The court in *Current* did not come right out and hold that subdivision (g) was unconstitutional, but rather that it was unconstitutional as applied to the facts before it. Nevertheless, the Board concluded that, based on the court's analysis, there would be no facts under which imposition of a use tax collection duty based only on subdivision (g) would pass constitutional muster. Thus, the Board sponsored repeal of subdivision (g).

conclude that Deluxe and Current were *not* in the same line of business for purposes of subdivision (g).

The *Current* court cited approvingly cases from other jurisdictions (*Id.* at 390), explaining two of them as follows:

> "In Bloomingdale's v. Dept. of Revenue (1991) 527 Pa. 347 [591 A.2d 1047] (Bloomingdale's), affirming 130 Pa. Commw. 190 [567 A.2d 773], certiorari denied _____ U.S. _____ [119 L.Ed.2d 223, 112 S.Ct. 2299], the court found that a sufficient nexus was not established between an out-of-state mail-order company, 'Bloomingdale's By Mail,' with no physical presence in the state and its parent company which owned retail stores within the taxing state. The court found the issue to turn on whether the parent company acted as an agent for the mail-order company.
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> "The court in Reader's Digest Association v. Mahin (1970) 44 Ill.2d 354 [255 N.E.2d 458] (Reader's Digest), certiorari denied 399 U.S. 919 [26 L.Ed.2d 786, 90 S.Ct. 2237], also found the agency relationship critical to the nexus analysis in a case involving affiliated entities. Hence, a sufficient nexus was established because the mail-order's subsidiary which was present in the state also acted as its agent in the solicitation of advertising. (255 N.E.2d at p. 458.)"

As this discussion shows, the court accepted the distinction between simply attributing the nexus of one corporate relative to another based solely on the corporate relationship and the finding of nexus based on an agency relationship between an out-of-state retailer and its in-state representative (who happens to be a corporate relative). Some commentators have used the term "attributional nexus" to include both affiliate nexus and representative nexus. In the latter circumstance, these commentators would argue that the nexus of the representative is being attributed to the retailer. I disagree.

Representatives and agents literally act on behalf of the retailer. They are standing in the shoes of the retailer, on the retailer's behalf: for purposes of their representation of the retailer, they *are* the retailer. In such circumstances, the retailer is physically present in the taxing state, through its representative, and the finding of nexus is based on the actions of the authorized representative doing the retailer's bidding in the taxing state. This is the very reason that the United States Supreme Court has held that such retailers do have nexus with the taxing state *based on their own physical presence* through their representatives. In the case of affiliate nexus based solely on common ownership, the finding of nexus of the out-of-state retailer is based on attributing the nexus of the corporate relative to the out-of-state retailer, even though neither the corporate relative, nor anyone else, acts on behalf of the out-of-state retailer in the taxing state. Hence, the term "attributional nexus" is an entirely appropriate alternative to what I believe is the more specific term "affiliate nexus."

C. California Today

As indicated above, if a retailer is not engaged in business in California within the meaning of Revenue and Taxation Code section 6203, no question arises under the United States Constitution because California would not impose a use tax collection duty. Since the decision in *Quill* and certain other decisions (including *Current*, discussed above), the Legislature has amended section 6203 to repeal some subdivisions and to provide a limited exemption for specified trade show activities, so that section 6203 now states:

> "(a) Except as provided by Sections 6292 and 6293, every retailer engaged in business in this state and making sales of tangible personal property for storage, use, or other consumption in this state, not exempted under Chapter 3.5 (commencing with Section 6271) or Chapter 4 (commencing with Section 6351), shall, at the time of making the sales or, if the storage, use, or other consumption of the tangible personal property is not then taxable hereunder, at the time the storage, use, or other consumption becomes taxable, collect the tax from the purchaser and give to the purchaser a receipt therefor in the manner and form prescribed by the board.
>
> "(b) As respects leases constituting sales of tangible personal property, the tax shall be collected from the lessee at the time amounts are paid by the lessee under the lease.
>
> "(c) 'Retailer engaged in business in this state' as used in this section and Section 6202 means and includes any of the following:
>
> > (1) Any retailer maintaining, occupying, or using, permanently or temporarily, directly or indirectly, or through a subsidiary, or agent, by whatever name called, an office, place of distribution, sales or sample room or place, warehouse or storage place, or other place of business.
> >
> > (2) Any retailer having any representative, agent, salesperson, canvasser, independent contractor, or solicitor operating in this state under the authority of the retailer or its subsidiary for the purpose of selling, delivering, installing, assembling, or the taking of orders for any tangible personal property.
> >
> > (3) As respects a lease, any retailer deriving rentals from a lease of tangible personal property situated in this state.
> >
> > (4) (A) Any retailer soliciting orders for tangible personal property by mail if the solicitations are substantial and recurring

and if the retailer benefits from any banking, financing, debt collection, telecommunication, or marketing activities occurring in this state or benefits from the location in this state of authorized installation, servicing, or repair facilities.

(B) This paragraph shall become operative upon the enactment of any congressional act that authorizes states to compel the collection of state sales and use taxes by out-of-state retailers.

(5) Notwithstanding Section 7262, a retailer specified in paragraph (4) above, and not specified in paragraph (1), (2), or (3) above, is a 'retailer engaged in business in this state' for the purposes of this part and Part 1.5 (commencing with Section 7200) only.

"(d)

(1) For purposes of this section, 'engaged in business in this state' does not include the taking of orders from customers in this state through a computer telecommunications network located in this state which is not directly or indirectly owned by the retailer when the orders result from the electronic display of products on that same network. The exclusion provided by this subdivision shall apply only to a computer telecommunications network that consists substantially of online communications services other than the displaying and taking of orders for products.

(2) This subdivision shall become inoperative upon the operative date of provisions of a congressional act that authorize states to compel the collection of state sales and use taxes by out-of-state retailers.

"(e) Except as provided in this subdivision, a retailer is not a 'retailer engaged in business in this state' under paragraph (2) of subdivision (c) if that retailer's sole physical presence in this state is to engage in convention and trade show activities as described in Section 513(d)(3)(A) of the Internal Revenue Code, and if the retailer, including any of his or her representatives, agents, salespersons, canvassers, independent contractors, or solicitors, does not engage in those convention and trade show activities for more than 15 days, in whole or in part, in this state during any 12-month period and did not derive more than one hundred thousand dollars ($100,000) of net income from those activities in this state during the prior calendar year. Notwithstanding the preceding sentence, a retailer engaging in convention and trade show activities, as described in Section 513(d)(3)(A) of the Internal Revenue Code, is a 'retailer engaged in business in

> this state,' and is liable for collection of the applicable use tax, with respect to any sale of tangible personal property occurring at the convention and trade show activities and with respect to any sale of tangible personal property made pursuant to an order taken at or during those convention and trade show activities.
>
> "(f) Any limitations created by this section upon the definition of 'retailer engaged in business in this state' shall only apply for purposes of tax liability under this code. Nothing in this section is intended to affect or limit, in any way, civil liability or jurisdiction under Section 410.10 of the Code of Civil Procedure."

Subdivisions (c)(1), (c)(2), and (c)(3) existed as part of section 6203 prior to its expansion in 1988.[16] None of these provisions has been successfully challenged.

1. Subdivision (c)(1) of section 6203

Subdivision (c)(1) imposes a use tax collection duty on a retailer with a place of business in California. Its predecessor provision was upheld by the United States Supreme Court over sixty years ago in *Felt & Tarrant Mfg. Co. v. Gallagher* (1939) 306 U.S. 62.[17] The current version of subdivision (c)(1) was specifically upheld in *National Geographic Society*, *supra*. If the retailer has "an office, place of distribution, sales or sample room or place, warehouse or storage place, or other place of business" in this state, it is engaged in business in this state and must collect the applicable use tax from its California purchasers. This is true *even if the retailer's place of business in California is unrelated to its sales of tangible personal property*.

2. Subdivision (c)(2) of section 6203

Circumstances similar to those in which subdivision (c)(2) applies were considered by the United States Supreme Court in *Scripto*, *Tyler Pipe*, and *Standard Pressed Steel*, all discussed above. Under the first prong of the *Complete Auto* test, the presence in the taxing state of an agent or representative of the retailer, even if not an employee, constitutes substantial nexus for purposes of use tax collection when that person's presence in the taxing state is related to the activity for which the tax is imposed, that is, sales of tangible personal property. These are the circumstances in which subdivision (c)(2) applies.

It should be noted that the mere presence of a retailer's agent or representative in this state, in the absence of any business location of the retailer in this state, is not alone sufficient

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[16] Until amendments to section 6203 made in 1998, these were subdivisions (a), (b), and (c), respectively.

[17] The retailer had two general agents in this state whose entire time and attention were devoted to soliciting orders for the retailer. The retailer paid for the agents' office space, and all shipments were sent from outside California. The statute required the retailer to have a place of business in this state, and the Court apparently found that such was the case.

under section 6203 for the imposition of a use tax collection duty on the retailer. If that presence does not relate to the activity for which California seeks to impose a use tax collection duty, that is, sales of tangible personal property, then the retailer would not come within subdivision (c)(2) of section 6203 (and would likely lack the substantial nexus required by the Commerce Clause). However, it is sufficient if an agent or representative operates in this state for the purpose of selling, delivering, installing, assembling, or taking of orders for tangible personal property sold by the retailer. In other words, once the physical presence of the retailer's agent or representative in this state is connected with (also known as having a nexus with) *sales* of tangible personal property, the retailer is engaged in business in this state and must collect California's use tax.

Subdivision (c)(2) was one of the issues considered in *Scholastic Book Clubs, Inc. v. State Board of Equalization* (1989) 207 Cal.App.3d 734. Scholastic had no employees or locations in California. It sold its wares by distributing catalogs by mail, to teachers and school librarians. The teachers and librarians distributed order sheets to their students, collected the completed orders, compiled the orders and payments, and sent the order and payment to Scholastic. There were two possibilities: 1) the teachers and librarians purchased the goods from Scholastic for resale and were the retailers of those goods (in which case they owed sales tax on their sales); or 2) the teachers and librarians were acting as the agents of Scholastic for purposes of making sales of tangible personal property, and Scholastic was the retailer making the sales. The court held that the teachers and librarians were the agents of Scholastic, and that Scholastic was the retailer making the retail sales.

Since Scholastic was the retailer, it was required to collect the applicable use tax if it was engaged in business in this state. The court recognized that when an out-of-state retailer's only connection with the taxing state is through the mail, there is insufficient nexus to uphold a use tax collection duty. The court concluded, however, that Scholastic had sufficient nexus with California to impose on it a use tax collection duty since its use of agents, the teachers and librarians, was similar to the retailer's use of jobbers in *Scripto*, *supra*. Unlike the customers in *Bellas Hess* who were solicited directly by mail, the only way a student could order books from Scholastic was through its local intermediaries, the teachers and librarians. (*Id.* at 739-40.) The use tax collection duty under section 6203 was upheld.

Since *Scholastic* was decided prior to *Quill*, some argued that the result would have been different if it had been decided after *Quill*. Of course, given the court's conclusion that the teachers and librarians were the agents of Scholastic, that is, the representatives of Scholastic in California, the statutory and constitutional requirements for imposing a use tax collection duty were satisfied. Nevertheless, the issue was tested by Troll Book Clubs under virtually identical facts as in *Scholastic*. In an unpublished opinion, the First Appellate District of the Court of Appeal upheld the use tax collection duty of Troll Books. (*Troll Book Clubs, Inc. v. State Board of Equalization* (1/1/95) A64306.) Presumably, the Court of Appeal declined to publish the opinion because it really said nothing new: the decision in *Scholastic* is unaffected by *Quill*.

3. Subdivision (c)(3) of section 6203

Subdivision (c)(3) of section 6203 imposes a use tax collection duty on a retailer who derives rentals from leases of tangible personal property in this state. The use tax collection duty with respect to such leases extends to the use tax due on those leases, and not to the retailers' other sales into California if there is no other basis for imposing the use tax collection duty for those other sales. It would be hard for a retailer to argue that it does not receive sufficient benefits of state service to justify imposing a collection duty with respect to these leases when the rentals on which tax is imposed is from the lease of property physically present in this state. Since the use tax collection duty under this provision does not extend beyond that leased property, there is not much to argue about.

4. Subdivision (c)(4) of section 6203

The former version of subdivision (c)(4) imposed a use tax collection duty on any retailer who solicited orders by mail if the solicitations were substantial and recurring and if the retailer benefited from banking, financing, debt collection, telecommunication, or marketing activities occurring in California or from authorized installation, servicing, or repair facilities located in California. In a challenge by out-of-state retailers, the federal courts reviewed that version of subdivision (c)(4), and found it constitutionally infirm unless Congress authorizes the states to compel collection of the tax by out-of-state retailers. (*Direct Marketing Association, Inc. v. State Board of Equalization* (E.D. 1992) Civ. No. S-88-1067 MLS.) The addition of subdivision (c)(4)(B), operative January 1, 1996, conformed subdivision (c)(4) to that ruling. Subdivision (c)(4)(B) states that subdivision (c)(4) becomes operative upon enactment by Congress of authorization for states to compel the collection of state sales and use taxes by out-of-state retailers. Thus, the subdivision is not enforced at this time.

5. Subdivision (d) of section 6203

This provision was originally adopted as subdivision (k) in 1994, with a five-year sunset date. At the time, it was known as the "Apple Bill" since Apple lobbied for the bill so that it could start an online service similar to CompuServe and America Online without worrying about its potential customers having nexus with California based on Apple's servers being located in this state. Apple created the company, eWorld, and the bill was passed. Then the Internet happened and eWorld was gone, but this provision remains.

As the use of the Internet spread, the Board considered the question of whether a web page on a California server could be the basis for concluding that a retailer was engaged in business in this state. In 1997, the Board adopted an amendment to Regulation 1684 which provides:

> "The use of a computer server on the Internet to create or maintain a World Wide Web page or site by an out-of-state retailer will not be considered a factor in determining whether the retailer has a substantial nexus with California. No Internet Service Provider, On-line Service Provider, internetwork

> communication service provider, or other Internet access service provider, or World Wide Web hosting services shall be deemed the agent or representative of any out-of-state retailer as a result of the service provider maintaining or taking orders via a web page or site on a computer server that is physically located in this state."

This provision made it clear that, for purposes of determining whether an out-of-state retailer is engaged in business in California within the meaning of section 6203, the retailer's use of the Internet is effectively ignored, just as the retailer's use of mail and telephone from outside California to contact California residents is ignored.

In 1998, as part of the bill that adopted the California Internet Tax Freedom Act, the Legislature eliminated the sunset date from what is today subdivision (d). Initial analyses from the legislative staff indicated that the Board's amendment to Regulation 1684 was an expansion of subdivision (d), and the bill originally included language that would codify this expansion. Later, the Legislature settled on simply deleting the sunset date; the intent of the deletion was, I have been told, to serve as the codification of the Regulation 1684 amendment.

6. Subdivision (e) of section 6203

As discussed above, subdivision (c)(2) applies to an out-of-state retailer who has *any* representative in this state for a selling activity. This applies, for example, to a retailer entering the state for a trade show. Even though the retailer may be in the state for a short period, the purpose of that presence in California is to create or further the retailer's market for sales of tangible personal property to California purchasers. As such, this presence, which comes squarely within the provisions of subdivision (c)(2) of section 6203, is also the substantial nexus required to satisfy constitutional requirements. In 1997, the California Legislature decided to permit limited entries into the state for trade show purposes without triggering a use tax collection duty for other sales (i.e., sales other than those made at the trade show). Thus, subdivision (e) was adopted to exclude retailers from the otherwise applicable definition of retailer engaged in business in this state under subdivision (c)(2) if the sole basis for such a conclusion is the retailer's qualified trade show activities. Originally, the exclusion permitted trade show activities of no more than seven days per year, which resulted in no more than $10,000 of income. In 2000, the Legislature increased these figures to fifteen days, and $100,000 net income, respectively.

7. Duration of Nexus

When a retailer has come within the provisions of section 6203 and thereafter ceases all its physical connection with California, the question necessarily arises as to how long that retailer's use tax collection duty remains. Surprisingly enough, the answer is: it depends.

A person cannot escape all obligations under California's Sales and Use Tax Law for periods that it is outside California's boundaries. For example, a person who has a

representative soliciting sales in California only on the first day of each month is regarded as continuously engaged in business in this state. Such a retailer must collect and remit use taxes with respect to all its sales to California consumers, rather than only with respect to those sales made on the first day of each month or those generated from the in-state solicitations. On the other hand, when a retailer completely removes itself from California, there is an end point to its use tax collection obligations in this state.

Each such circumstance is examined on a case-by-case basis. *At a minimum*, the retailer is regarded as engaged in business in California through at least the quarter following the quarter in which its termination of business activities in California occurs. Obviously, some of the sales business generated during that quarter will have been a direct result of the retailer's activities while physically present in California. Of course, it is also true that some of the sales generated far in the future may still be a direct result of the retailer's activities while physically present in California. Nevertheless, California has concluded that there is a certain de minimus benefit from having previously been physically present in California beyond which a conclusion that the retailer is subject to the use tax jurisdiction of this state is no longer supported. Beyond the quarter following the quarter in which the retailer withdraws from all physical activities in this state, the burden is on the retailer to establish that its future sales fall below this de minimus benefit from its previous California presence.

Notwithstanding the discussion above, when a retailer is registered to collect California's use tax, whether voluntarily or otherwise, as long it remains registered with this state, even if after it would have been entitled to terminate its registration, the retailer remains subject to the same duties of collecting and remitting use tax as a retailer who is required to be registered as a retailer engaged in business in this state. (Reg. 1684(b).) This is explained in the Board's memorandum decision in *B & D Litho, Inc.* (5/31/2001), a copy of which is attached.

IV. THE INTERNET

At indicated above, at least in California, an out-of-state retailer making sales to California consumers through the Internet is treated no differently than a traditional mail order retailer. The Internet is effectively treated the same as a telephone call between the out-of-state retailer and the California purchaser. If the retailer never physically enters California, through representatives or otherwise, and its only contact with California is over the Internet or by mail, telephone, or common carrier, then the retailer is not regarded as engaged in business in this state for purposes of use tax collection.

Nevertheless, while the advent and evolution of the Internet has not changed the legal landscape of the nexus issue, it has certainly changed the dynamics. The business of out-of-state sellers has continued to rapidly expand, and the Internet has played a significant role in that expansion. States imposing sales and use taxes are concerned about the potential in lost revenues and harm to in-state retailers. This concern is heightened when state and federal legislators indicate a desire to make the Internet a wholly tax-free zone. Even though legislators

have not adopted such legislation (at least at the federal level and in California), the legislation they do adopt can cause consumers to believe that such is the case.

In 1998, Congress passed the Internet Tax Freedom Act. The incorrect belief of some that purchases from out of state are exempt from tax (because of the lack of enforcement) was compounded by the adoption of this Act. Many persons came to believe that their purchases over the Internet are exempt from tax, even when the retailer and purchaser reside in the same state. What else could Internet tax freedom mean? In fact, however, the federal Internet Tax Freedom Act as currently written does not affect the imposition of California's use tax collection statute, and certainly does not create any exemption from the otherwise applicable sales or use tax for purchases made over the Internet. Similarly, the California Internet Tax Freedom Act, also adopted in 1998, does not create a tax-free zone for Internet sales. Like the federal Act, the state Act prohibited state and local taxes on Internet access fees. Before and after the adoption of these acts, the application of California's sales and use tax remains the same.

There has been a flurry of activity in Congress and in the states. Several states, for example, have been working to develop a process for tax simplification under which a sufficient number of states would participate, and that this would convince Congress to permit them to mandate collection of use tax beyond that now permitted under the Court decisions discussed above. There have been discussions of a Congressionally authorized compact among the states.

The wide-spread acceptance of the Internet as a reliable marketplace has further exacerbated the use tax collection problem of the states. As discussed above, California ignores the retailer's use of the Internet in determining whether the retailer is engaged in business in this state. However, that California ignores the Internet does not mean that California ignores all activities of a retailer, just because it happens to conduct its business primarily online.

In 1999, a group of local booksellers argued that the Board was not enforcing the provisions of section 6203 against online sellers such as Borders Online (also known as Borders.com or Borders dot-com). Board staff explained its interpretation of how the section applied. For example, the Board staff clearly stated its view that the acceptance of returns by in-state stores on behalf of out-of-state retailers was sufficient to bring the out-of-state retailer within the provisions of subdivision (c)(2) of section 6203 in Business Taxes Law Guide Annotation 220.0002 (6/22/99):

> "Company B is an out-of-state retailer located solely outside California. It sells products through its website with all orders processed out of state. The products are shipped directly to the customers from the retailer's out-of-state warehouse. Customers may return unwanted merchandise previously ordered from the out-of-state retailer to Company A's in-state stores. Company A then returns the products to Company B's out-of-state warehouse. Company B will issue a credit or refund to the customer and will compensate Company A for its services on its behalf.

> "Company A is acting as Company B's representative in this state for acceptance of returns of items sold. The ability of Company B's customers to return unwanted items to local stores of Company A on Company B's behalf as an alternative to packing them up and shipping them back to Company B is sufficient to bring Company B within the definition of retailer engaged in business in this state."

Although the booksellers were assured that the law was being enforced, they were also advised that the confidentiality law precluded disclosure to them of the particulars of any investigation. (See Rev. & Tax. Code § 7056.) The booksellers took their concerns to the Legislature, and Assemblywomen Carole Migden and Dion Aroner introduced AB 2412 in February 2000.

AB 2412 built on prior subdivision (g) of section 6203, and would have defined a retailer to be engaged in business in this state if: 1) it shares common ownership with a bricks and mortar retailer in California; 2) the out-of-state retailer sells the same or substantially similar line of products as the related California retailer; and 3) the in-state and out-of-state retailers shared the same or substantially similar business name, or facilities or employees of the related California retailer located in this state are used to advertise or promote sales by the out-of-state retailer to California purchasers. AB 2412 was not merely an affiliate nexus provision as was former subdivision (g).[18] Rather than attributing the nexus of an in-state retailer based solely on common ownership and similar lines of business as in former subdivision (g), AB 2412 would have added the requirement that either : 1) the retailers share the same or substantially similar business name, or 2) facilities or employees of the related California retailer are used to advertise or promote sales by the out-of-state retailer to California purchasers. The Legislature passed the bill; however, the governor vetoed it, stating:

> "This bill would impose sales tax collection obligations on retailers who process orders electronically, by fax, telephone, the Internet, or other electronic ordering process, if the retailer is engaged in business in this state.
>
> "In order for the Internet to reach its full potential as a marketing medium and job creator it must be given time to mature. At present, it is less than 10 years old. Imposing sales taxes on Internet transactions at this point in its young life would send the wrong signal about California's international role as the incubator of the dot-com community.
>
> "Moreover, the Internet must be subject to a stable and non-discriminatory legal environment, particularly in the area of taxation. Unfortunately, AB 2412

[18] As discussed previously, an out-of-state retailer came within former subdivision (g) if it shared common ownership with an in-state retailer and the two entities sold substantially similar lines of products, even if no one, not even its corporate relative, did anything in California to further the out-of-state retailer's business. Rather, the nexus of the in-state company was attributed to the out-of-state company based solely on their corporate relationship and similarity of product lines.

> does not provide such a stable environment: it singles out companies that are conducting transactions electronically and attempts to impose tax collection obligations on them to which, according to California courts, they are not subject. Furthermore, AB 2412 re-enacts provisions that the Legislature has recently repealed due to court decisions.
>
> "In the next 3 to 5 years, however, I believe we should review this matter. Therefore I am signing SB 1933, which creates the California Commission on Tax Policy in the New Economy. The Commission will examine sales tax issues in relation to technology and consumer behavior and make recommendations." [19]

Early in 2001, Assemblywomen Migden and Aroner introduced AB 81, which was substantially identical to AB 2412. Later in the session, the provisions in AB 81 related to the Sales and Use Tax Law were gutted, and replaced by unrelated property tax provisions. My understanding is that the authors concluded that the Governor would not change his view in the year since his veto of AB 2412. There will be no expansion in California's nexus provisions this year.

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[19] With all due respect to the Governor, his veto statement includes some inaccuracies. California's sales tax is imposed on the retailer, while the use tax is imposed on the purchaser, with the retailer required to collect it. Contrary to the statement in the first paragraph, AB 2412 would have imposed a *use* tax collection duty on certain retailers not required to do so under section 6203 as currently written. Furthermore, the first paragraph implies that the bill would add a requirement for certain retailers who are engaged in business in this state to collect use tax when they process orders electronically. In fact, when a retailer is engaged in business in this state, that retailer must collect the applicable California use tax without regard to the manner of making the sale, whether by mail, telephone, Internet, or whatever. This has always been the rule. The issue presented by AB 2412 was when a retailer would be regarded as engaged in business in this state, not which sales of such a retailer would be covered by a use tax collection duty.

The second paragraph of the statement implies that all Internet transactions are exempt from tax, a common fallacy. In fact, tax applies to purchases over the Internet in the same manner as tax applies to any other purchase, whether by mail, telephone, or in person. So, for example, if the sale is made over the Internet and the retailer ships the property from a California location to a California consumer, the retailer will owe sales tax on the sale unless there is some exemption, just as if the retailer sold the same property to the purchaser over the counter at the retailer's California location. The question with Internet sales made from outside this state is whether the retailer is engaged in business in California such that it is responsible for collecting the applicable use tax. The purchaser, of course, owes the tax whether the retailer collects it or not.

The statement in the third paragraph is also misleading at best. California courts have not held that retailers coming within the provisions of AB 2412 are not required to collect use tax. To the extent that AB 2412 stated that an out-of-state retailer would have been regarded as engaged in business in this state if the in-state relative acted on its behalf in a selling activity, the statute would have simply restated existing law. To the extent that AB 2412 would have expanded section 6203 to cover prior subdivision (g) with the additional requirement of similar names, that would not have been declaratory of existing law; however, it also would not have simply been a restatement of former subdivision (g) or any other provision that a California court has ruled to be unconstitutional. If AB 2412 had become law, upon challenge a court might very well have concluded that the similarity of names along with the other requirements was tantamount to the in-state person's acting on behalf of the out-of-state retailer in California by seeking to confuse potential customers as to the separate identity of the two retailers. In any event, AB 2412 added something that has not yet been tested in California courts.

While AB 2412 was being passed and vetoed and AB 81 introduced, the Board continued its enforcement investigations and actions. The Board issued a deficiency assessment against one retailer, who filed a Petition for Redetermination and had an Appeals Conference resulting in a Decision and Recommendation adverse to the retailer. During this process, confidentiality rules prevented the public disclosure of these proceedings. The retailer then proceeded to a hearing before the Members of the Board of Equalization. The hearings of the Board are public, so once the hearing was held, the fact of the investigation and all other facts disclosed during the hearing may now be publicly disclosed: the retailer is Borders Online.

During a portion of the audit period, Borders Online had a notice on its web site stating that if customers wanted to return merchandise purchased from Borders Online, the customers had several choices, including returning the merchandise to a local Borders store. When Borders Online was advised that this was sufficient to bring it within the definition of "retailer engaged in business in this state," it removed the notice from its web site. It did not, however, change its policy. There was no dispute that during the audit period, Borders stores would take returns from anyone (presumably if the returned goods were in like-new condition) and would provide a store credit. Borders would even accept returns on this basis from its competitors. When it did so, it clearly was doing so on its own behalf (good will, bringing customers in, etc.), and not on behalf of its competitors. Just like a purchaser of a book from any other retailer, a person purchasing a book from Borders Online could return it to any Borders store for a store credit. However, Borders provided preferential returns, not offered to customers of any other retailer, for its own customers and for customers of Borders Online. Customers from either Borders entity could, with a proper receipt, obtain a cash refund of the purchase price.

The Board concluded that this preferential treatment for the customers of Borders Online was done to further the market of Borders Online, and that Borders did so as the representative of Borders Online in this state. The Board further held that this is a selling activity coming within subdivision (c)(2) of section 6203, and that imposing a use tax collection duty under that provision satisfied the requirements of the United States Constitution. The Board regarded this case as sufficiently important and precedential so as to justify its issuance on September 26, 2001 of a memorandum opinion. A copy is attached.

V. CONCLUSION

Ten years ago, there were many questions as to just what constituted sufficient nexus to impose a use tax collection duty, and there was great anticipation that the Court's ruling in *Quill* that would answer all those questions. The Court has long since made its decision. Has anything changed?

BEFORE THE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Petition for Redetermination
Under the Sales and Use Tax Law of:

B & D Litho, Inc.
SC OH 30-690550
Case ID 89000871770

Appearances:

For Petitioner:	Steven Gaynor, President
For Sales and Use Tax Department:	Warren Astleford, Supervising Tax Counsel
For Appeals Section:	John Abbott, Tax Counsel IV

MEMORANDUM OPINION

This opinion considers the merits of a petition for redetermination for the period July 1, 1993 through June 30, 1996. At the Board hearing, petitioner protested a portion of a determination related to its sales to California customers.

Petitioner, an out-of-state corporation, manufactured and sold customer business forms. Petitioner reported its sales at retail to California customers and paid its use tax collections from those customers pursuant to its Certificate of Registration- Use Tax. It had applied for and received its certificate before the audit period, and its certificate was active during the entire audit period. Among other things, petitioner contends that it did not have sufficient activities in this state to be engaged in business (nexus) for purposes of use tax collection during the audit period.

OPINION

California Code of Regulations, title 18 (Regulation), section 1684, Collection of Use Tax by Retailers, sets out the requirements for out-of-state retailers to collect use tax on their retail sales to California customers. Subdivision (a) of that regulation describes some of the activities that will constitute being engaged in business in this state for purposes of use tax collection, pursuant to Revenue and Taxation Code section 6203.

Subdivision (b) of Regulation 1684 provides:

> "(b) RETAILERS NOT ENGAGED IN BUSINESS IN STATE. Retailers who are not engaged in business in this state may apply for a Certificate of Registration- Use Tax. Holders of such certificates are required to collect tax from purchasers, give receipts therefor, and pay the tax to the board in the same manner as retailers engaged in business in this state…."

Since petitioner had a Certificate of Registration- Use Tax issued by the Board during the entire audit period, it is irrelevant whether petitioner had sufficient activities in this state to be engaged in business during the audit period. Having voluntarily registered to collect the use tax on its California sales, it was obligated to do so until it both cancelled its certificate and did not engage in activities constituting nexus. The petition should be denied as to this issue.

Adopted at Sacramento, California, on May 31, 2001.

Claude Parrish, Chairman

John Chiang, Member

Johan Klehs, Member

Dean Andal, Member

Marcy Jo Mandel, Member*

*For Dr. Kathleen Connell, pursuant to Government Code section 7.9.

BEFORE THE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Petition for Redetermination under the Sales and Use Tax Law of

Borders Online, Inc.
SC OHA 97-638364
56270

Appearances:

For Petitioner:	Scott L. Brandman Attorney at Law
	Douglas D'Agostino Associate Director, Tax
For Sales and Use Tax Department:	David H. Levine Tax Counsel IV
For Appeals Section:	Jeffrey G. Angeja Tax Counsel III

MEMORANDUM OPINION

This opinion considers the merits of a petition for redetermination for the period April 1, 1998, through September 30, 1999. At the Board hearing, petitioner protested a determination related to petitioner's sales to California purchasers.

Petitioner, an out-of-state corporation, makes online retail sales of tangible personal property (e.g., primarily books, videos, music and gift items) via the Internet. The goods petitioner sells to California purchasers are delivered by common carrier from outside California. Petitioner alleges that it is a separate and distinct legal entity from Borders, Inc. (hereafter Borders), an affiliated corporation that sells similar goods in "brick-and-mortar" stores throughout California. Petitioner further alleges that it did not maintain, occupy or use any place of business in California during the period in question. (See Rev. & Tax. Code, § 6203, subd. (c)(1).)

In a letter dated July 29, 1999, the Sales and Use Tax Department (hereafter the Department) informed petitioner that the Department had concluded that petitioner was a retailer engaged in business in California and was obligated to collect use tax from petitioner's California customers. (See Rev. & Tax. Code, § 6203, subd. (a).) The Department based its conclusion, at least in part, on the significance of a paragraph, which petitioner had posted on petitioner's web site under the heading of "RETURNS." The record of this matter reflects that this paragraph stated, in pertinent part, that:

> "You may return items purchased at borders.com to any Borders Books and Music store within 30 days of the date the item was shipped. All returns must be accompanied by a valid packing slip (your online receipt and shipping notification are not valid substitutes for a packing slip on returns to stores). Gift items may be returned or exchanged if they are accompanied by a valid gift packing slip. You may not return opened music or video items, unless they are defective."

Petitioner alleges that this paragraph first appeared on petitioner's web site some time in June of 1999. Petitioner further alleges that petitioner's internal records reflect that this paragraph was removed from petitioner's web site on or around August 11, 1999. Thus, petitioner apparently removed the paragraph in question shortly after petitioner received notice that the Department considered this paragraph to be evidence that petitioner had a use tax collection obligation under California law. Petitioner has not presented any evidence that would establish that petitioner ever expressly disavowed, either publicly or internally, the policy reflected by the paragraph in question.

Petitioner contends that, notwithstanding the restrictions stated in the posted paragraph, petitioner's customers could return merchandise at a Borders store without a valid packing slip and receive a store credit. Additionally, petitioner admits that, throughout the period in question, petitioner's California customers could obtain cash refunds by returning merchandise purchased from petitioner, together with a valid packing slip, to a Borders store. In other words, petitioner's customers' ability to obtain such cash refunds from Borders was not dependent on whether the paragraph at issue was posted on petitioner's web site. According to petitioner, Borders also provided return services to individuals who had purchased merchandise from one of Borders's or petitioner's competitors; however, Borders did not, and would not, provide cash refunds to customers of Borders's or petitioner's competitors.

Petitioner alleges that any merchandise petitioner's customers returned to Borders was not sent back to petitioner but, instead, was added to Borders's inventory. Petitioner claims that Borders did not charge petitioner for return and exchange services. Finally, petitioner further claims that Borders absorbed any losses associated with accepting returns of defective merchandise from petitioner's customers.

OPINION

With certain exceptions that are not relevant to this matter, Revenue and Taxation Code section (hereafter Section) 6203 imposes a use tax collection obligation on ". . . every retailer engaged in business in this state and making sales of tangible personal property for storage, use, or other consumption in this state . . . ." Under subdivision (c)(2) of Section 6203, the meaning of "retailer engaged in business in this state" includes:

> "[a]ny retailer having any representative, agent, salesperson, canvasser, independent contractor, or solicitor operating in this state under the authority of the retailer or its subsidiary for the purpose of selling, delivering, installing, assembling, or the taking of orders for any tangible personal property."

When, as here, no dispute exists with respect to an out-of-state seller's status as a retailer, three additional requirements must be satisfied for the seller to be a "retailer engaged in business in this state" under Section 6203, subdivision (c)(2).

First, the out-of-state retailer must have a representative, agent, salesperson, canvasser, independent contractor or solicitor (hereafter, collectively, representative). Second, this representative must be operating in California under the authority of the out-of-state retailer or its subsidiary (i.e., the in-state representative must be authorized to act on the out-of-state retailer's behalf). Third, the out-of-state retailer's authorized representative's operations in California must include one of the following activities: selling, delivering, installing, assembling or taking orders for tangible personal property. Applying this analysis to the instant matter, these three requirements are met if: (1) Borders was petitioner's authorized representative in this state for purposes of taking returns from petitioner's California customers; and (2) the taking of such returns constitutes "selling."[1] The first issue is a matter of fact, the second is a matter of law.

As to the first issue, the greater weight of the available evidence establishes that, for the period in question, Borders was petitioner's authorized representative in this state for the purpose of accepting returns from petitioner's California customers. As indicated above, petitioner expressly stated on its web site that Borders was petitioner's authorized representative for this purpose. Petitioner has submitted no evidence showing that Borders ever objected to being designated as petitioner's authorized representative or that petitioner ever revoked this designation. Rather, the evidence shows that petitioner removed the web site declaration of this designation in response to the Department's July 29, 1999, letter, not because Borders's status as petitioner's authorized representative had changed.

Although petitioner's express web site declaration is sufficient to establish that Borders was petitioner's authorized representative for returns, in addition to this direct evidence, circumstantial evidence sufficient to establish this fact also exists. Specifically, by petitioner's own admission, Borders provided unique and preferential return services to petitioner's customers. As discussed above, Borders purportedly would allow anyone to exchange for store credit any merchandise Borders stocked, regardless of whether that merchandise was purchased from Borders or petitioner or from one of their competitors. Such exchange transactions presumably would result in little, if any, net loss for Borders and would promote good will. However, even if petitioner were to establish, which petitioner has not, that Borders's practice of

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[1] The Department has not alleged that Borders, during the period at issue, engaged in any activities on petitioner's behalf in California that would constitute "delivering, installing, assembling, or the taking of orders for any tangible personal property" as these terms are used under subdivision (c)(2) of Section 6203.

accepting returns from petitioner's customers was wholly independent of petitioner's published return policy, Borders's willingness to provide cash refunds to petitioner's customers, when Borders refused to do this for customers of Borders's or petitioner's competitors, indicates that Borders made such refunds because Borders was petitioner's authorized representative. While not exhaustive of the circumstantial evidence indicating that Borders was petitioner's authorized representative for returns in California, Borders's preferential treatment of petitioner's customers suffices to establish this fact.

As to the legal issue that remains, we conclude that, when accomplished through an authorized representative, the taking of returns constitutes "selling" under subdivision (c)(2) of Section 6203. Because neither the Sales and Use Tax Law in general, nor Section 6203 in specific, contains a definition of "selling," following the accepted canons of statutory construction, we construe this term according to its common usage. In other words, "selling" is inclusive of all activities that are an integral part of making sales.

When out-of-state retailers that make offers of sale to potential customers in California authorize in-state representatives to take returns, these retailers acknowledge that the taking of returns is an integral part of their selling efforts. Such an acknowledgement comports with common sense because the provision of convenient and trustworthy return procedures can be crucial to an out-of-state retailer's ability to make sales. This is especially evident in the realm of e-commerce.

For example, in this case, petitioner identified Borders as petitioner's authorized in-state representative for effecting the generous, convenient return policy petitioner published on its web site. It is apparent that petitioner announced this favorable return policy to induce potential customers, who might otherwise be wary of making purchases from a remote seller, to place orders. Indeed, many potential online customers would not place an order with an online retailer whose return policy was not worthy of confidence. An online retailer's ability to offer these potential customers convenient returns and exchanges at nearby reputable "brick-and-mortar" stores, as petitioner did, would assuredly help promote such confidence. Moreover, some online purchasers will not be satisfied with their purchases. An online retailer that offers convenient, local return and exchange options is much more likely to obtain repeat business from such purchasers. The important role that an online retailer's return policy plays in obtaining repeat business further underscores how integral the taking of returns is to selling in e-commerce transactions.

In *Quill Corp. v. North Dakota* (1992) 504 U.S. 298 [hereafter *Quill*], the United States Supreme Court held that, pursuant to the Commerce Clause of the United States Constitution, a state cannot impose a use tax collection obligation on out-of-state retailers unless those retailers have "substantial nexus" with that state. The *Quill* court explained that, to establish commerce-clause nexus, a state must show that the out-of-state retailer, or a representative of the out-of-state retailer, has a sufficiently substantial physical presence in the state to justify the imposition of a use tax collection obligation. (*Ibid.*) In this case, petitioner had a substantial physical presence in California through the many places of business and employees of Borders,

petitioner's authorized representative in this state for the purpose of selling tangible personal property. Petitioner's substantial physical presence in this state more than suffices to establish that petitioner had commerce-clause nexus with California during the period in question. (See *ibid.*)

In sum, both the direct and circumstantial evidence are sufficient to establish that Borders, acting as petitioner's authorized representative, performed return and exchange activities in California. Such activities, when performed through an authorized representative, are an integral part of selling tangible personal property. Thus, due to Borders's actions in California on petitioner's behalf, petitioner was a "retailer engaged in business in this state" during the period in question. Accordingly, the petition should be denied as to these issues because petitioner was obligated to collect, and remit, use tax from petitioner's California customers. (Rev. & Tax. Code, §§ 6203, subds. (a) & (c)(2), 6204.)

Adopted at Sacramento, California, on September 26, 2001.

Claude Parrish, Chairman

John Chiang, Member

Johan Klehs, Member

Dean Andal, Member

Marcy Jo Mandel, Member*
*For Dr. Kathleen Connell, pursuant to Government Code section 7.9.

Nexus - *Just Passing Through*

2001 California Tax Policy Conference
Beverly Hills, California
November 7-9, 2001

Presented by:

Ira Rubinoff – Tax Counsel, Multistate Tax Bureau
California Franchise Tax Board
Sacramento, California

Nexus - *Just Passing Through*

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Nexus - *Just Passing Through*

Presented by:

Ira Rubinoff[1] – Tax Counsel, Multistate Tax Bureau[2]
California Franchise Tax Board[3]
Sacramento, California

In Remembrance

Condolences are extended to all who sustained loss on September 11, 2001, at the New York World Trade Center, the Pentagon, and Western Pennsylvania.

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[1] Mr. Rubinoff is a tax counsel with the Franchise Tax Board Legal Division, Multistate Tax Bureau. In the interest of full disclosure, these materials draw liberally from contributions of a variety of individuals, authors and references to which full credit must be given. Best efforts have been made to identify the principle author(s)/source(s). To whatever extent a citation is incomplete or credit not properly advanced, sincerest regret is offered in advance and upon request, an acknowledgement of credit due will be provided. A listing of material consulted appears as an addendum.

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Nexus Legislation

States in their capacity as sovereigns possess the inherent power to tax. However, the extent of that power is limited by federal constraints arising from the due process and commerce clauses of the U.S. Constitution.

Quill [4] is the seminal case of the modern age addressing constitutional limitations with respect to imposing sales and use tax collection responsibilities upon entities operating in interstate commerce. Therein, the U.S. Supreme Court expressly invited Congress to act in accordance with its constitutional responsibility over interstate commerce and provide guidance in nexus matters.

In the near decade since *Quill*, Congress has for the most part remained on the sidelines seemingly content to let the courts sort out the problems. However, it would be error to suppose that Congress is unwilling to engage the subject. Witness, for example, exercise of their legislative authority resulting in enactment of P.L. 87-272[5] in response to the U.S. Supreme Court decision in *Northwestern States Portland Cement Co.*[6]

Since that time, Congress has found itself drawn into the study of business taxation arising from complex problems associated with business conducted electronically, or over the Internet.

In 1998, Congress responded to business and government lobbying by instituting a three-year moratorium on Internet taxation.[7] This state tax "time out" served multiple purposes: It allowed the evolving E-commerce industry to get a commercial footing; it afforded tax agencies and practitioners an opportunity to work towards non-legislated solutions; and it provided Congress with time to study the nature and problems of business in the 21st Century.

The three-year legislative moratorium enacted in 1998 expires on October 21, 2001, and as the date nears, as of the time of this writing, there has been a flurry of activity. The initial inquiry was whether the moratorium would be extended. However, those with special interests used the opportunity presented by the central question of whether and to what extent to tax E-commerce as a springboard from which to seek federal legislation to address a variety of nexus questions that have perplexed tax practitioners and tax administrators since *Quill.* Examples include: Is the nexus standard the same for sales and use taxes and income and franchise taxes?; how much contact with a state is required before a state can tax a nonresident?; in order to have tax nexus, must an entity be physically present in the state and, if so, to what extent?; will intangibles in

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[4] *Quill Corp v. North Dakota* (1992) 504 U.S. 298 [112 S.Ct. 1904, 119 L.Ed.2d 91].
[5] 15 U.S.C. section 381.
[6] *Northwestern States Portland Cement Co. v. Minnesota and Williams v. Stockham Valves and Fittings, Inc.* (1959) 358 U.S. 450 [79 S. Ct. 357, 3 L.Ed.2d 421].
[7] The Internet Tax Freedom Act.

the state or conducting electronic business instate give rise to tax nexus?; and to what extent, if at all, will activities of employees, agents, independent contractors, business affiliates, or representatives, be attributed to a non-present entity for the purpose of establishing tax nexus?

As of September 10, 2001, advocates took positions, lobbying intensified, debate raged, Congress studied the issues, and various remedial proposals were formulated.

On the morning of Tuesday, September 11, hearings were being conducted on H.R. 2526 legislation that would continue the Internet tax moratorium and address a good number of nexus issues.

At a time during the testimony there occurred a series of horrific terrorist attacks which everyone is now all too familiar with. As a nation, we have bifurcated our attention between the attack and the continuing need to attend to business as usual. With respect to the latter as it concerns tax nexus, author Doug Sheppard focused on the business question that concerns the audience reviewing this paper, *Where Do Terrorist Attacks Leave Congress on Internet Taxation*?[8]

In answer to the question he posed, Mr. Shepard collected a variety of opinions. Frank Julian, operating vice president and tax counsel for Federated Department Stores, Inc., noted that, "Congress was attending to nexus business on the eleventh. Several pending bills were in Committee. At the hour of the attacks, one committee chair ended the hearing noting that, "Issues relating to Internet taxation, … paled in comparison to the plane that had just struck the Pentagon and the resulting evacuations. Obviously, it puts things in perspective that there are issues of much greater National concern now than the Internet tax issue."

"From a timing standpoint, … obviously any deliberations that Congress was going to have on [these] issue[s] will be delayed, and that will delay it closer to the October 21 deadline," said Julian. "I think it's a function of whether or not there's enough time to debate the … issues when they get to it, so it might increase the likelihood that they just do a stand-alone extension of the moratorium."

Neal Osten, Committee Director for Commerce and Communications for the National Conference of State Legislatures, noted that prior to the eleventh, Congress was considering a variety of complicated nexus questions. "Even before this happened, I did not think we had enough time to really discuss the … issues that need to be settled, so the fact that [the attacks] could shorten the amount of time that's available for committee discussion or floor discussion probably would work toward that conclusion, that there's probably less ability to deal with all of the issues that need to be settled."

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[8] Sheppard, *Where Do Terrorist Attacks Leave Congress on Internet Taxation*? Tax Analysts, State Tax Today, 2001 STT 179-27, September 14, 2001.

Those interviewed by Mr. Sheppard express what one could argue is a reasonable outcome. Given that there was not much time to completely address the issues presented to begin with, it is not unreasonable to believe that in light of the events of the eleventh, as an interim measure, Congress would find it expedient to maintain the status quo by extending the moratorium and continue to defer tax issues to the courts, at least for the foreseeable future, leaving tax questions to be resolved on a case-by-case basis.

But, looking to the future, "The Internet is here. E-commerce is here to stay. The Internet is a marketplace that will only grow. As such, issues concerning state taxation are unavoidable and sooner or later, they will need to be addressed."[9] With that in mind, an overview of significant pending legislation is warranted.

Significant Pending Legislation[10]

Significant federal legislation includes: The Internet Tax Freedom Act (ITFA); the Internet Tax Fairness Act (ITFA) of 2001(H.R. 2526); and the New Economy Tax Fairness Act (NET FAIR). Significant California legislation includes: the Internet Tax Fairness Act (ITFA) and the California Internet Freedom Bill, (S.B. 394).

The Internet Tax Freedom Act

The ITFA was enacted on October 21, 1998. It is significant for three items: It imposed a three-year moratorium to expire October 21, 2001, on state and local government assessment of Internet access taxes; it exempted nondiscriminatory income, sales, telecommunications, or other taxes imposed prior to October 1998; and it established the Advisory Commission on Electronic Commerce (ACEC) to study federal, state, local, and international taxation and tariff treatment of transactions using the Internet, Internet access and comparable intrastate, interstate or international sales activities.[11]

ACEC presented its report to Congress on April 12, 2000, proposing: (1) the moratorium on E-commerce sales and use taxes be extended five years, (2) prohibit sales and use taxes on sales of digitized goods, (3) permanently exempt transaction taxes on the sale of Internet access, and (4) support the World Trade Organization's international tax moratorium on tariffs and duties for electronic transmissions.[12]

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[9] Reuters, *Wyoming Gov. Jim Geringer,* Gevirtz, *Nation's Governors are Seeking Internet Tax*, , August 6, 2001.

[10] Quirk, Does Congress Put Federalism at Risk When It Limits the States' Power to Tax? Tax Analysts, State Tax Today, 2001 STT 166-27, August 27, 2001. For a review of five House bills and nine Senate bills now pending, see Noto, *Congressional Research Service Reports on Internet Tax Bills in the 107th Congress*, Tax Analysts, State Tax Today, 2001 STT 202-33, October 18, 2001.

[11] Anderson & Monzingo, *Taxing Electronic Commerce*, Tax Analysts, State Tax Notes, Vol. 20, No. 7, February 12, 2001, p. 521. And, see Legislative Analyst's Office, *California Tax Policy and the Internet*, January 31, 2000.

[12] Tax Analysts, Tax Notes Today, *E-commerce Advisory Commission Releases Final Report 2000* TNT 77-25, April 20, 2000.

The Internet Tax Fairness Act of 2001(H.R. 2526)

The ITFA of 2001, H.R. 2526, introduced by Representatives Bob Goodlatte, R-VA., and Rick Boucher, D-VA., on July 17, 2001 is significant for a number of reasons.

First, it would permanently exempt Internet access from taxation.

Second, its provisions extended to sales and use *and* income and franchise taxes.

Third, it establishes, "substantial physical presence" as the standard for determining nexus for business activity taxes.

Fourth, the bill sets forth the following list of activities as nexus "carve outs," (occurrences that would *not* give rise to taxable nexus): (1) The in-state presence of intangible personal property; (2) use of the Internet to create or maintain a Web site; (3) use of the Internet via a Web page or site on a computer present in a state to maintain, take or process orders; (4) lease or own property in-state for less than 30 days; (5) the solicitation of orders or contracts for the sales of tangible or intangible personal property or services by the out-of-state entity; (6) the solicitation of orders or contracts for a prospective customer; (7) the affiliation with another person located in-state unless the person is an "agent" or participating in an activity that constitutes "substantial physical presence;" (8) assigning employees, representatives, or agents in-state for less than 30 days for the purpose of purchasing goods or services, gathering news and covering events, meeting with government officials, attending conferences, seminars and similar functions, and participating in charitable activities; (9) the use of an unaffiliated representative or independent contractor in-state to perform warranty or repair services with respect to tangible or intangible personal property sold outside the state; and (10) the use of any service provider for the transmission of communications, whether by cable, satellite, radio, telecommunications, or similar systems.[13]

Fifth, P.L. 86-272, which presently provides federal immunity from state taxation for transactions that includes the solicitation of sales of tangible goods, would be expanded to include the solicitation of services and intangible property.

If the legislation were enacted, the items enumerated as nexus carve outs, would effectively reverse a number of Supreme Court decisions. For example, *Quill's* current limited application to sales and use taxes would be extended to include income and franchise taxes. It would reverse *Tyler Pipe*[14], which found tax nexus arose from business solicited on the taxpayer's behalf by an independent contractor. It would reverse *Scripto*[15] in that it sets a higher bar as to what would constitute attributional

[13] Tax Analysts, State Tax Today, *U.S. Rep. Goodlatte To Introduce Internet Tax Bill,* 2001 STT 137-32, July 17, 2001.
[14] *Tyler Pipe Industries, Inc. v. Washington Department of Revenue* (1987) 483 U.S. 232 [107 S.Ct.2810, 97 L.Ed.2d 199.
[15] *Scripto, Inc. v. Carson* (1960) 362 U.S. 207 [80 S.Ct. 619, 4 L.Ed. 660].

nexus from what may be called representation to what is thought to be a higher common law agency relationship. It would reverse the South Carolina State Supreme Court decision in *Geoffrey*[16] precluding the presence of intangibles from giving rise to tax nexus. For the first time, a bright-line test requiring substantial physical presence would be required for taxable nexus. The scope of federal tax immunity would be vastly expanded.

There is some disagreement on the likely outcome of the proposed legislation. One writer expressed the belief, that the prospects for passage are not good believing that congressional sentiment favors state and local government and brick-and-mortar retailers. [17] An opposing view is based on the belief that the proposed legislation is sound because it is predicated upon the fundamental constitutional principle that a state cannot justify the taxation of an out-of-state company that has no property or people in the state because the state has not provided anything for which it has a right to ask for a tax in return.[18]

The New Economy Tax Fairness Act (NET FAIR) (S. 664)

This bill was first introduced last year, entitled, The New Economy Tax Simplification Act. It was reintroduced and renamed this year.

In a March 29, 2001 summary of their Act, the sponsors indicated that their legislation would "codify nexus standards across the board" to insure that intangible sales, Web pages and servers do not cause nexus, that specified enumerated acts would not be deemed physical presence so as to not justify state taxation under the U.S. Supreme Court's decision in *Quill,* and eliminate attributional nexus arising from the use of agents and independent contractors to perform warranty and repair services, unless they have a substantial physical presence. NET FAIR extends *Quill*, which currently governs catalogue sales to include the Internet. "Kohl added: Our bill … restates the principle [that] state and local taxing authorities do not have jurisdiction over businesses that are not physically located in their borders."[19]

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[16] *Geoffrery , Inc. v. South* Carolina (1993) 437 S.E.2d 13, (cert.den.Nov.29, 1993) 510 U.S. 992 [114 S.Ct. 550, 126 L.Ed.2d 451].

[17] Sheppard, *Gregg, Kohl Reintroduce Bill to "'Codify" Nexus Standards*, Tax Analysts, Tax Notes Today, 2001 TNT 66-10, April 5, 2001. And, see Gregg, *U.S. Senators Gregg, Kohl Write Letter Urging Support For Net Fair Bill*, Tax Analysts, Tax Notes Today, 2001 TNT 69-58, April 10, 2001.

[18] William J. Quirk, *Does Congress Put Federalism at Risk When It Limits the States' Power to Tax?*, Tax Analysts, State Tax Today, 2001 STT 166-27, August 27, 2001.

[19] Gregg, U.S. Senators Gregg, Kohl Write Letter Urging Support for Net Fair Bill, Tax Analysts, Tax Notes Today, 2001 TNT 69-58, April 10, 2001. William J. Quirk, Does Congress Put Federalism At Risk When It Limits the States' Power to Tax?, August 27, 2001, Tax Analysts, State Tax Today, 2001 STT 166-27.

Related Bills

S. 288, sponsored by Wyden, D-OR, would extend the ITFA five years, permanently eliminate Internet access tax, eliminate the grandfather clause for existing taxes and encourages states to simplify their sales and use taxes.

S.1481, sponsored by McCain, R-AZ, Lyden, D-OR, and Leahy, D-VT, introduced October 2, 2001, attempts to find consensus, and to do so moderates the provisions of S.288 by extending the ITFA for two years, retains the grandfather clause allowing existing access taxes and use what is regarded as more congenial language to encourage the states and industry to forge solutions, "it is the sense of the Congress that state governments and interested business organizations should expedite efforts to develop a streamlined simplified plan for protecting state revenues affected by Internet use without unnecessarily burdening interstate commerce."[20]

S. 512, sponsored by Dorgan, D-ND, entitled "The Internet Tax Moratorium and Equity Act" extends the ITFA to 2005, but takes the opposite view of NET FAIR, and seeks a multistate sales compact.

H.R. 1410, entitled "The Internet Tax Moratorium and Equity Act" is similar to S. 512 extending the ITFA to 2005, and seeks to simplify sales and use taxes.

H.R. 1552 and H.R. 1675 sponsored by Cox, R-CA, would permanently ban taxes on Internet access service and repeal the grandfather clause protecting current state taxes on charges for Internet access.

H.R. 3709 provides for uniform and simplified rules for attributing E-commerce transactions to a given taxing jurisdiction.[21]

Where Does the Administration Stand?

On May 8, 2001, President Bush stated that his administration supported a permanent ban on Internet access taxes as a way to encourage growth of the online economy.[22]

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[20] Tax Analysts, State Tax Today, *Internet* Moratorium *Extension Bill Introduced In Senate,* 2001 STT 193-24, October 4, 2001.
[21] Sheppard, *Gregg, Kohl Reintroduce Bill to 'Codify' Nexus Standards*, Tax Analysts, Tax Notes Today, 2001 TNT 66-10, April 5, 2001.
[22] Mauro, *Nexus Revisited: Current Domestic and International Tax Issues Relevant to Electronic Commerce*, Tax Analysts, State Tax Today, 2001 STT 141-25, July 23, 2001. a paper by associate director, tax practice presented at the inaugural meeting of the Conference Board's Council for Tax Executives, May 16, in New York City.

California Legislation

The California Internet Freedom Bill, S.B. 394

This bill (sponsored by Sen. Byron Sher (D)) would become effective on January 1, 2002, and extend the State's present moratorium on taxation of Internet access, online computer services, and bits or bandwidth to either January 1, 2003, or January 1, 2004, and then it would be repealed. The length of the moratorium is a function of the submission of a report by the California Commission on Tax Policy in the New Economy to the governor and Legislature prior to December 1, 2002. The California ITFA would remain in effect until January 1, 2004, unless the Commission fails to submit the report in which case the California ITFA would be repealed on January 1, 2003.[23] The bill has been enacted into law as Stats. 2001, Chap. 343.

Selected Arguments In Support of Congressional Action[24]

Proponents urge that Congress exercise its constitutional authority over interstate commerce and implement a bright-line substantial physical presence standard based upon equity, case law, and common sense, and to bring a halt to claims of overreaching by states seeking to tax extraterritorial values.

Supporters argue that physical presence was required in *Quill* and, although it was a sales and use tax case, no lesser standard should apply to business and activity taxes because the tax falls directly upon the putative taxpayer. In addition, nexus predicated upon economic, or the purported presence of, intangibles, is not a theory supported by the majority of state courts, is inconsistent with *Quill's* physical presence standard, and would result in a "parade of horrors," where if not prohibited would allow states to tax all manner of insubstantial activity. Substantial contact with the state is the current standard evidenced, in part, by the fact that the Supreme Court declined to follow California in *National Geographic*[25]*,* which attempted to asserted that an insignificant presence would pass constitutional muster.

Supporters of federal legislation advance the argument that where a taxpayer is not substantially physically present, and the only contact with the taxing state is that it is the place of sale, then the state has provided no benefits for which it can ask a return. The point is highlighted by the question, what benefits and protections does a state provide a business that merely has customers in that state; has the state given anything for which it can ask a return? Since a state must govern, acts directed to that end confer no special privilege on out-of-state vendors that lack substantial physical presence in the state. Absent a substantial physical presence, taxation would be unfair particularly

[23] Tax Analysts, State Tax Today*,* California Exemptions, Reductions Smooth Way for Budget Approval, 2001 STT 144-H, July 26, 2001.

[24] A variety of arguments exist which this writer believes exceed the scope of this presentation and will not be addressed. By way of example, a good deal of discussion concerns "federalism at risk," "lost revenues," and the possibility that changes sought would open up opportunities for "tax planning."

[25] *National Geographic Society v. California Board of Equalization* (1977) 430 U.S. 551, [97 S.Ct. 1386, 51 L.Ed.2d 631].

since non-residents would be taxed without a corresponding right to vote in violation of a basic tenet of our republic.

Selected Arguments In Support of State Taxation of Interstate Commerce

Opponents of state taxation seem to advance a lingering insistence that a safe harbor exists for entities engaged in interstate commerce. One may argue that, to whatever extent the notion exists that the states cannot tax interstate commerce, it must be laid to rest; "it was not the purpose of the commerce clause to relieve those engaged in interstate commerce from their just share of the state tax burden even though it increases the cost of doing the business." (*Western Live Stock* at 254[26]/) "Even interstate business must pay its way." (*Postal Telegraph-Cable Co*. at 259.)[27] "It is too late in the day to find offense to that [Commerce] Clause because a state tax is imposed on corporate net income of an interstate enterprise which is attributable to earnings within the taxing state . . . ." (*Northwestern States Portland Cement Co.*[28]*)*

Out-of-State Vendors Receive State Benefits

Proponents of H.R. 2526 insist that when putative taxpayers are not physically present in a substantial way, they receive nothing from the market state that attempts to tax them, or what may be received is nothing more than what a state must provide consistent with its inherent obligation to govern. With no property or employees in the state, those entities that are not present do not receive benefits afforded citizens who avail themselves of police, fire, education and other government services. "The ultimate question predicated upon common sense, fairness, and legal reasons is whether the state has provided the putative taxpayer with sufficient benefits and protections to justify its exacting a tax from that person."[29]

At least one writer disagrees, stating in candid language, "… not a week has gone by in Congress in the current session that someone, either someone testifying at a hearing or a lobbyist going to a Congressional office or a member of Congress or United States senator, someone somewhere hasn't said we've got to stop states from taxing businesses that don't have a substantial physical presence because they don't provide any benefits to these folks. Those statements are patently ridiculous."[30]

The courts do not express agreement that no benefits are received by an entity which enters or allows itself to enter a state and engage in business activity, particularly in those activities where the activity is intended to generate business income.

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[26] *Western Live Stock v. Bureau of Revenue* (1938) 303 U.S. 250.
[27] *Postal Telegraph Cable Co. v. Richmond* (1919) 249 U.S. 252.
[28] *Northwestern States Portland Cement Co. v. Minnesota* and *Williams v. Stockham Valves and Fittings, Inc.* (1959) 358 U.S. 450 [79 S.Ct. 357, 3 L.Ed.2d 421].
[29] Rosen, *The Invalidity of the 'Economic Nexus' Principle is Clear*, 2001 STT 83-20, Tax Analysts, State Tax Today, April 30, 2001.
[30] A special report by Charles E. McLure, Jr. of the Hoover Institution at Stanford University with respect to collection of taxes on remote sales. McLure, Jr., *Legitimacy, Fairness, and Equity of State and Local Taxes on Interstate Commerce*, Tax Analysts, State Tax Today, 2001 STT 190-39, October 1, 2001.

The state's power to tax an individual's or a corporation's activities is justified by the protection, opportunities and benefits the state confers on those activities. (*Allied Signal, Inc.* at 778.)[31] The state confers benefits by the fact of being an orderly, civilized society. (*J.C. Penny Co*. at 444.)[32]

Where the corporate entity elects to enter the state, and engages in a "bundle of corporate activity," [and enmeshed itself] "in local connection" with its operations … we cannot say that the [state] erred in holding that these local incidents were sufficient to form the basis for the levy of a tax that would not run contrary to the Constitution. (*Norton.)*[33]

"Petitioner has not established that such services as were rendered . . . [through instate activity] were not decisive factors in establishing and holding this market. Although mere entry into a state does not take from a corporation the right to continue to do an interstate business with tax immunity, it does not follow that the corporation can channel its operations through … a maze of local connections . . . , and take advantage of its gain on domesticity, and still maintain that same degree of immunity." (*General Motors Corp.)*[34]

The taxes imposed are levied only on that portion of the taxpayer's net income, which arises from its activities within the taxing state. These activities form a sufficient "nexus between such a tax and transactions within a state for which the tax is an exaction." (*J.C. Penney Co*.[35] at 445.) It strains reality to say, in terms of our decisions, that each of the corporations here was not sufficiently involved in local events to forge "some definite link, some minimum connection" sufficient to satisfy due process requirements. (*Miller Bros. Co.* at 344-345.)[36] See also *Ott v. Miss. Valley Barge Lines* (1949) 336 U.S. 169; *International Shoe Co. v. Washington* (1945) 326 U.S. 310; and *West Publishing Co. v. McColgan* (1946) 27 Cal.2d 705, 166 P.2d 861 (1946), aff'd, 328 U.S. 823 [66 S.Ct. 1378, 90 L. Ed. 1603].) The record is without conflict that [the] corporations engage[d] in substantial income-producing activity in the taxing states. In fact … almost half of the corporation's income is derived from the taxing state's sales, which are shown to be promoted by vigorous and continuous sales campaigns run through a central office located in the state. As was said in *Wisconsin v. J.C. Penny Co., supra*, the "controlling question is whether the state has given anything for which it can ask return." Since by "the practical operation of [the] tax the state has exerted its power in relation to opportunities which it has given, to protection which it has afforded, to benefits which it has conferred . . ." it "is free to pursue its own fiscal policies, unembarrassed by the Constitution . . . ." *Id*., at 444 (*Northwestern Cement Co. v. Minnesota* (1959) 358 U.S. 450).

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[31] *Allied Signal, Inc. v. Dir., Div. of Taxation* (1992) 504 U.S. 768.
[32] *Wisconsin v. J.C. Penny Co*. (1940) 311 U.S. 435.
[33] *Norton v. Department of Revenue* (1951) 340 U.S. 534 [71 S.Ct. 377, 95 L.Ed. 517].
[34] *General Motors Corp. v. Washington* (1964) 377 U.S. 436 [84 S.Ct. 1564, 12 L.Ed.2d 430].
[35] *Wisconsin v. J.C. Penney Co*. (1940) 311 U.S. 435.
[36] *Miller Bros. Co. v. Maryland* (1954) 347 U.S. 340.

Some writers express what seems to be a contradiction presented by the proponents of a business activity tax substantial physical presence test which is the seeming irony that, on the one hand, advocates point to unwarranted tax susceptibility arising from the unique nature of business in the new century, yet the only viable solution to new age questions is resorting to last century's yardsticks or, in effect, dealing with modern problems by "turning back the clock." These writers note that it simply is impossible to compare our present business world with the one that existed at the time of horse and buggy. At a time when so much is capable by electronic means, it simply is a modern reality of life that much less emphasis is needed on face-to-face contact, i.e., sales accomplished by means resulting in physical presence; today, results are measured modernly by economic consequences of activities and contact with the state.

Mr. Peter Faber, a partner with McDermott, Will & Emory, New York, seems to agree that new problems require new solutions when he notes that, "… practitioners today face issues that did not exist 10 years ago. The most obvious set of these new issues arises out of the "brave new world" of electronic commerce. If you had referred to "electronic commerce" 10 years ago, it would have been assumed that you were talking about the taxation of light bulbs and extension cords." … "Unfortunately, state and local tax statutes have changed little over … time …. The result is that … practitioners have to advise clients on the way in which judges will apply outmoded tax laws to a modern economy." " … no serious thinker in the field believes that electronic commerce should not pay its fair share of tax."[37]

One could argue that comments such as these express agreement that we cannot look at business the same way, which is what a substantial physical presence test would require. Because business isn't the same, the way we view and measure business must evolve. Nothing in all of the jurisprudence involving nexus suggests that changes would be forever barred. Nothing in all of the jurisprudence suggests that changes cannot be implemented to address the ever-changing social needs and problems of modern civilization.

The court has made adjustments over the years as deemed necessary to accommodate changes in our world. Consider by way of a single example, the advent of automobiles, which increased the incidence of individuals causing injury in states where they were not subject to in personam actions, as one reason for modification of the territorial limits on jurisdictional power. (See *Shaffer v. Heitner* (1977) 433 U.S. 186, 20.) In *Complete Auto*[38], the court found that the "Spector rule" had no relationship to economic realities, and was unsatisfactory in its operation in modern cases. (C*omplete Auto* at 279, 185.) The court overruled the rule of *Spector Motor Service*[39] that a state tax on the "privilege of doing business" is per se unconstitutional when it is applied to interstate commerce,

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[37] Tax Analysts, State Tax Today, *State of Practice*, *The Changing World of State and Local Tax Practice*, 2001 STT 171-19, September 3, 2001.

[38] *Complete Auto Transit, Inc. v. Brady* (1977) 430 U.S. 274 [97 S.Ct. 1076, 51 L.Ed.2d 326].

[39] *Spector Motor Service, Inc. v. O'Connor* (1951) 349 U.S. 602.

and the case was overruled. (*Id*. at 288-89.) In *Quill*, the court noted that due process jurisprudence has evolved in the 25 years since *Bellas Hess.*[40] *Id*. at 306-07. The court looked to "modern commercial life" and modified its holding in *Bellas Hess* because of developments affecting the law of due process. (*Id*. at 308.)

In the end, it may be argued that, the situation is no more complicated than coming to accept that the old world rules have been superseded by new developments. Business in the 21st century illustrates how concepts need to be flexible and adjusted as the world changes, not forever fixed in one spot, which is what a substantial physical presence test would entail.

An owner of property should give appropriate support to the government that protects that property. (See *Virginia v. Imperial Coal Sales Co*. (1934) 293 U.S. 15, 20.) The duty owed to the government is not less when the property is intangible than when it is tangible. (*Id*.) One could argue that great weight must be given to the consequences of the contractual obligations that arise/exist in the state where the E-commerce/ intangibles appear. The state is inextricably involved in seeing that those obligations are faithfully carried out.

If business in the 21st Century must also pay its fair share of tax, one may argue that if we must adapt our view of modern business consistent with how modern business evolves, then it follows that intangibles have value and when in a nexus context they are inextricably intertwined in systematically seeking out, establishing or maintaining a market or generating income in a state, this should equate with a taxable presence in the state.

There is nothing in the Constitution that identifies what benefits must be conferred to justify state taxation. The Constitution is not a formulary. It does not demand of states strict observance of rigid categories nor precision of technical phrasing in their exercise of the most basic power of government, that of taxation. For constitutional purposes the decisive issue turns on the operating incidence of a challenged tax. A state is free to pursue its own fiscal policies, unembarrassed by the Constitution, if by the practical operation of a tax the state has exerted its power in relation to opportunities which it has given, to protection which it has afforded, to benefits which it has conferred by the fact of being an orderly, civilized society. (*Wisconsin v. J.C. Penney Co*. (1940) 311 U.S. 435, 444.)

The incidence of the tax as well as its measure is tied to the earnings which the state … has made possible, insofar as government is the prerequisite for the fruits of civilization for which, as Mr. Justice Holmes was fond of saying, we pay taxes. (See, for instance, his dissent *Compania de Tobaco v. Collector* (1927) 275 U.S. 87 [948 S.Ct. 100, 72 L.Ed.177], *Wisconsin v. J.C. Penney Co*. (1940) 311 U.S. 435, 444.)

The argument that the use tax is not fairly related to the services provided … is without merit. [The state] provides services which facilitate [the] sale[s] … within the state. [The

[40] *National Bellas Hess* (1967) 386 U.S. 753, [87 S.Ct. 1389, 18 L.Ed.2d 505].

vendor] benefits from public roads, police protection, a judicial system and all the other "usual and usually forgotten advantages conferred by the state's maintenance of a civilized society ***." *Jefferson Lines,* 514 U.S. at , 131 L. Ed.2d at 281, 115 S. Ct. at 1346. These benefits … are "justification … enough for the collection of a tax." *Oklahoma Tax Commission v. Jefferson Lines, Inc*. (1994) 514 U.S. 175 [115 S. Ct. 1331, 1346, 131 L. Ed. 2d 261, 281]; *D.H. Holmes Co. v. McNamara* (1988) 486 U.S. 24, 31-32 [108 S.Ct. 1619, 1623-24, 100 L.Ed.2d 21, 28]. (*Brown's Furniture, Inc. v. Wagner* (1996) 171 Ill. 2d 410; 665 N.E.2d 795; 1996 Ill.)

"… the fair relation prong does not require a detailed accounting of the services provided to the taxpayer on account of the activity being taxed ***." *Jefferson Lines,* 514 U.S. at ___, 131 L. Ed. 2d at 281, 115 S. Ct. at 1345. Indeed, interstate commerce may be made to "'contribute to the cost of providing *all* governmental services, including those services from which it arguably receives no direct "benefit'" (Emphasis in original.) *Goldberg* v. *Sweet* (1989) 488 U.S. 252 at 267 [109 S. Ct. 582 at 592; 102 L. Ed. 2d 607 at 620-21], quoting *Commonwealth Edison Co. v. Montana,* 453 U.S. 609, 627 n.16, 69 L.Ed.2d 884, 900 n.16, 101 S.Ct. 2946, 2958 n.16 (1981).

State Benefits Do Not Have to be Used to Have Constitutional Significance

Some proponents in support of H.R. 2526 argue that no benefits are received for which a tax can be exacted if the benefit is not actually used. Simply because an out-of-state entity, "… may someday use the state courts … against an in-state customer … this is a hypothetical possibility … but, [one] which state courts have recognized [as] a de minimus … connection with the state."

In reply, one could argue that proponents have not cited to any case, by way of example, that holds that a citizen receives no benefit from the local fire department unless it is called upon. It may be said that, simply having the resource close at hand or the mere knowledge that the resource is available is itself of immeasurable benefit. Turning to the hypothetical possible use of the state courts, it may be argued that the existence of the state court system makes or breaks any transaction. Imagine, the impact on sales if customers with buyer's remorse could excuse themselves from sales contracts whenever so moved. Without the force of law and the courts there would be no commercial certainty to any transaction. Having the courts available has as much value as having a local fire department. And, so it may be argued, that simply because a vendor does not actually avail itself of certain benefits, that does not diminish the inherent value of those benefits or the value those benefits combined have which give rise to the orderly society and valuable market in which the out-of-state vendor earns a return for its shareholders.

Benefits Are Not Already Paid for by Instate Residents

Proponents of H.R. 2526 admit that certain benefits provided to in-state entities such as truckers and telecommunications companies help out-of-state business earn income. However, these services have been paid for and recaptured by being included in the costs in-state vendors recover from its customers.

If understood correctly, proponents contend that if there is a benefit, it has already been paid for and therefore there is no justification upon which to seek further recompense from out-of-state vendors.

One may argue in reply, that this is tantamount to an argument that the benefits should be provided free of charge to those engaged in interstate commerce. However, the Supreme Court has time and again said what amounts to, there is no free lunch for interstate commerce. Taxes received for, "fighting fires, keep[ing] the streets clean, … provide businesses and consumers with an environment where commerce can be safely and effectively conducted."[41] Nonresidents can fairly be expected to pay their fair share for the benefits they receive.

Taxation of Out-of-State Vendors Is Constitutional Even Without Voting Representation

Proponents of H.R. 2526 argue that requiring an out-of-state business to pay tax without a corresponding right to vote is inconsistent with fundamental tenets of our republic.

In reply, one could argue that proponents have not cited to any case that supports the notion that the inability to vote shields out-of-state vendors engaged in interstate commerce from paying for the benefits they derive from the market in which they earn their income.

The U.S. Constitution addressed this matter in *International Harvester*, where the Court stated unambiguously, "… the fact that the stockholder-taxpayers never enter [the state] and are not represented in the [state] legislature cannot deprive it of its jurisdiction to tax."[42]

Tax Should Be Paid to the State Where Income Is Earned

Opponents of business activity tax argue that a business really earns its income where it employs its capital (i.e. property) and labor (i.e. employees), not where its customers happen to be located. Therefore, attempting to tax out-of-state businesses, which earn money in states where their customers are located, is wrong on the basis that the market state does not provide any benefits to the seller.

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[41] Mauro, *Nexus Revisited: Current Domestic and International Tax Issues Relevant to Electronic Commerce*, Tax Analysts, State Tax Today, 2001 STT 141-25, July 23, 2001.
[42] Tax Analysts, State Tax Today, *Multistate Tax Commission Responds to Business Activity Nexus Standards Article*, 2001 STT 183-32, September 20, 2001.

"[I]t was not the purpose of the commerce clause to relieve those engaged in interstate commerce from their just share of state tax burden even though it increases the cost of doing the business." *Western Live Stock v. Bureau of Revenue* (1938) 303 U.S. 250, 254 "… interstate business must pay its way." (*Postal Telegraph-Cable Co. v. Richmond* (1919) 249 U.S. 252, 259.)

One could argue that the notion that the market state or the state of sale has no commercial significance was referenced in *Bass, Ratcliff & Gretton, Ltd., v. State Tax Comm'n* (1924) 266 U.S. 271 where with respect to a case examining profits of a unitary business …, "the process of manufacturing [results] in no profits until it ends in sales,"; (See *General Motors Corp. v. Washington* (1964) 377 U.S. 436 [84 S.Ct. 1564, 12 L.Ed.2d 430].) (Emphasis added.)

"The taxing statutes are not sought to be applied to … net income … *because* … the source of that income [is] interstate commerce -- but rather *despite* that source. The thrust of these statutes is … [to seek] some compensation for facilities and benefits afforded by the taxing States to income-producing activities therein, whether those activities be altogether local or in furtherance of interstate commerce." (*Northwestern Cement Co. v. Minnesota* (1959) 358 U.S. 450.

At least one writer has replied to the proponents' contention candidly, "To maintain that a remote seller receives no benefits from that state where making the sale makes no sense ... If the seller derived no benefit from the making of the sale, it would not make that sale. The resulting profit is a benefit. The state provides a market for the seller's wares. Those are benefits enough to justify the seller's having to collect applicable use tax for the state." [43]

One could argue that, if it were true that the marketing state has no utility, then why would corporate activity occur there. Without the prospect of realizing some economic return on the activity, the undertaking would be an empty act, an ultra vires act, an act of misfeasance. In-state activity is undertaken for the purpose of realizing a fundamental economic benefit; consummating a sale.

In response to the contention that the state has done nothing to create the market or expended its resources to maintain it, one could argue that benefits accorded by the government of the market state foster the market. The assurances, backed by the laws and courts of the buyer's state, that the seller will be paid for its market transaction is a very real and direct benefit. In addition, one could also argue that the out-of-state seller also benefits indirectly from the very fact that the economy of the market state, supported by the infrastructure of the state also supplies its customers with the economic wherewithal to make the purchase the benefits of which the seller enjoys.

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[43] Corrigan, *'Letter To The Editor': Level The Playing Field ,* Tax Analysts, State Tax Today, 2001 STT 182-38, September 19, 2001.

Those Who Derive Benefit from State Action Should Pay Tax

One of the arguments provided in support of the contention that not all state benefits can or should be paid for is made by postulating the question whether a U.S. high-tech company which hires people educated in Pakistan should pay Pakistan taxes for the benefit they receive and if so then it follows that every business would automatically be obligated to pay taxes to all 50 states.

In reply, one could argue that the example, fails to take the out-of-state vendor knowingly seeks out benefits, which are the fruit of a bountiful tree provided by government. Government effort it may be argued results in the establishment and maintenance of a market, which is a valuable place to expend limited corporate resources in the conduct of its business affairs. In exchange for the privilege of accessing the market and receiving income arising from the exercise of that privilege, as a means to insure that an environment continues to exist which sustains the market to be accessed on another day, a tax is laid.

Advocates opposing a business activity tax without substantial physical presence seem to take refuge in commentary such as "taxable event," "jurisdiction to tax," "business situs," "extraterritoriality," which labels *are not instruments of adjudication* but *statements of result* in applying the sole constitutional test ... That test is whether property was taken without due process of law, or, whether the taxing power exerted by the state bears fiscal relation to protection, opportunities and benefits given by the state. "We must be on guard against imprisoning the taxing power of the states within formulas that are not compelled by the Constitution but merely represent judicial generatlizations exceeding the concrete circumstances which they profess to summarize." (*Wisconsin v. J.C. Penney Co.* (11940) 311 U.S. 435, 445.)

One may argue that there is a cornucopia of value, which the market state provides notwithstanding hypothetical postulations. The substantial privilege of carrying on business in [the state] …, clearly supports the tax, and the state has not given the less merely because it has conditioned the demand of the exaction upon happenings outside its own borders. The fact that a tax is contingent upon events brought to pass without a state does not destroy the nexus between such a tax and transactions within a state for which the tax is an exaction. See *Continental Assurance Co*. v. *Tennessee,* (1940) 311 U.S. 5 [61 S. Ct. 1, 85 L. Ed. 5]. See also *Equitable Life Society v. Pennsylvania* (1915) 238 U.S. 143 [35 S. Ct. 829, 59 L. Ed. 1239]; *Maxwell v. Bugbee* (1919) 250 U.S. 525 [40 S. Ct. 2, 63 L. Ed. 1124]; *Compania de Tobaco v. Collector* (1927) 275 U.S. 87, 98 [948 S.Ct. 100, 72 L.Ed.177]; *New York ex rel. Cohn v. Graves* (1937) 300 U.S. 308 [57 S. Ct. 466, 81 L. Ed. 666]; *Atlantic & Pacific Tea Co. v. Grosjean* (1937) 301 U.S. 412 [57 S. Ct. 772, 81 L. Ed. 1193]; *Atlantic Refining Co. v. Virginia* (1937) 302 U.S. 22 [58 S. Ct. 75; 82 L. Ed. 24]; *Curry v. McCanless* (1939) 307 U.S. 357 [59 S. Ct. 900,83 L. Ed. 1339]; *Wisconsin v. J.C. Penny Co*. (1940) 311 U.S. 435.

The U.S. Supreme Court Does Not Require Substantial Physical Presence to Sustain a Business Activity Tax

The proponents of H.R. 2526 have not cited any U.S. Supreme Court case which requires substantial physical presence to constitutionally sustain a business activity tax.

A variety of cases, most notably, *International Harvester*, have consistently allowed taxation without physical presence. Cases involving the taxation of non-residents in pass-through entities have uniformly allowed taxation even though the putative taxpayer is not present

It is suggested that a higher threshold of activity is required for business activity tax above and beyond sales and use tax citing as authority, *National Geographic. National Geographic* is a 1977 case or some 24 years old. It was decided at a time when computers were still in their infancy. *Quill* was decided in 1992 at a time when it was sensitive to evolving business trends and nothing in *Quill* calls for substantial physical presence to sustain a business activity tax.

While admittedly, case outcomes vary, there are cases which demonstrate that a relatively nominal amount of activity is all that is required.

In *National Geographic*, there were only two offices in the State and solicitation by employees in the range of $1 million annually. The requisite nexus was held to be shown when out-of-state sales were arranged by the seller's local agents working in the taxing state. *Felt & Tarrant Co. v. Gallagher* (1939) 306 U.S. 62; *General Trading Co. v. Tax Comm'n* (1944) 322 U.S. 335. In *Scripto, Inc. v. Carson* (1960) 362 U.S. 207, the necessary basis was found in the case of a Georgia-based company that had "10 wholesalers, jobbers, or 'salesmen' conducting continuous local solicitation in Florida and forwarding the resulting orders from that State to Atlanta for shipment of the ordered goods," (*id*., at 211) although maintaining no office or place of business in Florida, and having no property or regular full-time employees there. In *Standard Pressed Steel Co. v. Washington Rev. Dept.* (1975) 419 U.S. 560, a case involving a direct tax upon gross receipts, the Court held that maintenance in the taxing State of a *single* employee, an engineer whose office was in his Washington home and whose primary responsibility was to *consult* with the Washington-based customer regarding its anticipated needs for the out-of-state supplier's product, established a sufficient relation to activities within the State producing the gross receipts as to support imposition of the tax. The Court characterized as, "frivolous" the argument that the seller's in-state activities were so thin and inconsequential that the tax had no reasonable relation to the protection and benefits conferred by the taxing State, for the employee "made possible the realization and continuance of valuable contractual relations between [the seller and its Washington customer]." (419 U.S. at 562.)

For consideration as to how much is enough, consider a recent case in Kansas involving a company that manufactures and sells electronic data card readers. The Kansas Supreme Court found that 11 visits to the state over a four-year period

amounting to 44 hours worth of presence was insufficient physical presence to constitute substantial use for use tax collection purposes. (*Appeal of Intercard*, Inc., 14 P.3d 1111 (Kan. 2000).) [44]

As noted by June Summers Haas, in her September 11, 2001 testimony before the House Committee on the Judiciary and Subcommittee on Commercial and Administrative Law on H.R. 2526, [45] the crux of the problem concerning state taxation is merely, "when [is] a corporation … present enough in the state that the state may tax it." "When is an entity that has no single physical embodiment, present enough in the state to bring it within the state's taxing jurisdiction?"

Stanley S. Sokul on behalf of the 4700 members of the Direct Marketing Association in his congressional testimony advises in reply, that it is excessive for a state to tax based upon economic nexus where merely making a sale into a state provides sufficient jurisdiction to tax out of state sellers. [46] Mr. Sokul expressed the opinion that, "a physical presence standard is the only one that makes sense in the modern economy, even in the 'borderless' Internet environment."

Those who disagree with Mr. Sokul believe that that physical presence is "archaic" [47] because it does not reflect commercial reality associated with 21st Century business. Keeping the standard is convenient, yes, familiar, yes, but it is not a standard that keeps step with circumstances it is designed to address. The U.S. Supreme Court has a long history of embracing change. In *Quill*, the Court noted, "we have abandoned more formalistic tests that focused on a defendant's 'presence' within a state in favor of a more flexible inquiry into ... a defendants contacts with the forum." [48] The Court appears to adapted to commercial realities with respect to its due process analysis. Why would the Court need to revert to archaic physical presence standards when judging the commercial realities associated with E-commerce or intangibles or any activity purposefully undertaken in a market state. It may be argued that we cannot go forward, by reaching back in time for old world tools.

Elizabeth Harchenko, Chair of the Multistate Tax Commission, in her testimony before the Senate Committee on Commerce, Science, and Transportation, argued that economic nexus as the standard is sound economic policy. Fred H. Montgomery of the Sara Lee Corporation disagrees claiming that, "If this low of a threshold for tax

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[44] As cited in Frankel, *Perspective, Hot Topics in State Taxation: The List for 2001,* Tax Management, Multistate Tax Report, Vol. 8, No. 8, August 24, 2001.
[45] Tax Analysts, State Tax Today*, Michigan Revenue Commissioner Testifies on H.B. 2526*, 2001 STT 181-21, September 18, 2001.
[46] Tax Analysts, State Tax Today, *Testimony on H.R. 2526 Supports Direct Marketing Association*, 2001 STT 181-19, September 18, 2001.
[47] Corrigan, *'Letter To The Editor': Level The Playing Field ,* Tax Analysts, State Tax Today, 2001 STT 182-38, September 19, 2001
[48] Tax Analysts, State Tax Today, *Multistate Tax Commission Responds to Business Activity Nexus Standards Article*, 2001 STT 183-32, September 20, 2001.

jurisdiction where to apply, no one could ascertain what economic nexus is … is it were you have a customer, a Website an account receivable? [49]

Mr. Fank D. Katz, Deputy General Counsel of the Multistate Tax Commission offers answers to questions raised by Mr. Montgomery and others. [50] Certainly continual and systematic electronic contact with customers living in a state would give rise to tax nexus, as would continual and systematic contact through licensing of intangibles employed in another state. Yet, it would not be contact that requires the establishment and maintenance of a market in the state. [51]

One may argue that a substantial physical presence test would in the end only add clutter to the "tangled underbrush." *Wisconsin v. J.C. Penny Co*. (1940) 311 U.S. 435. No one has yet defined "substantial" to a constitutional certainty. And now, if adopted as the standard, we would interject uncertainty arising from the additional element of "physical." What is "physical" is no certainty. In *Pavlovich* [52], the court found instantaneous Web activity "tantamount" to a physical presence for purposes of due process. If the individual components of substantial, physical and presence have been and are thought to still be illusive, what realistic hope have we of any clarity when the three terms are combined. Some writers have asked that if in truth, proponents of H.R. 2526 seek a nexus carve out, if they are in the pursuit of what one author has labeled, "tax-haven status," [53] then in the interest of intellectual honesty, it should be stated as such.

As noted by Ms. Summers Haas, [54] "the U.S. Supreme Court has unequivocally stated that nexus is not based on physical presence. "The fact that the stockholder-taxpayers never enter Wisconsin and are not represented in the Wisconsin legislature cannot deprive it of its jurisdiction to tax. It has never been thought that residence within a State or country is a sene qua non of the power to tax." *International Harvester v. Wisconsin Dept. of Taxation*, (1944) 322 U.S. 435.

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[49] Tax Analysts, State Tax Today, *Sara Lee Tax Director Testifies on Jurisdiction to Tax Business Activity*, 2001, STT 181-20, September 18, 2001.

[50] Tax Analysts, State Tax Today, *Multistate Tax Commission Responds to Business Activity Nexus Standards Article*, 2001 STT 183-32, September 20, 2001.

[51] When writers refer to the "establish *and* maintenance" of a market, the reference is to the U.S. Supreme Court's ruling in *Tyler Pipe*. However, the reference and its innuendo of a dual requirement is erroneous. The U.S. Supreme Court never required both as a constitutional principle. The Court in its ruling cited to the Michigan Division Manual; it was the state manual that required both. The U.S. Supreme Court never said that the elements of the Division Manual were a critical element of constitutional nexus and misconstruing the lower court does amount to a constitutional imperative. Supreme Court was not announcing a dual prong test, but examining the Washington statute which spoke to both.

[52] *Matthew Pavlovich, Petitioner, v. The Superior Court of Santa Clara County, Respondent; DVD Copy Control Association, Inc., Real Party in Interest* (2001) 109 Cal. Rptr. 2d 909.

[53] Stross, *Digital Domain, A gift for the Internet, Why Should Mallgoers Foot the Bill for Web Shoppers?* U.S. News & World Report, December 18, 2000, p. 49.

[54] Tax Analysts, State Tax Today*, Michigan Revenue Commissioner Testifies on H.B. 2526*, 2001 STT 181-21, September 18, 2001.

While advocates insist that substantial physical presence is the only meaningful and equitable test, in actuality, physical presence in the taxing state is *not* the fundamental basis upon which nexus to tax lies. Instead, the focus is on *activities* in-state, and income from those activities. As noted by Mr. Katz in his article responding to arguments set out by the Internet Tax Fairness Coalition's document, *Business Activity Taxes: Myth vs. Fact*, [55] In *Exxon Corp. v. Wisconsin Dept. of Revenue* [56], the Court recognized the simple proposition that 'nexus is established if the corporation avails itself of the "substantial privilege of carrying on business" within the State."'

Mr. Faber suggests that tax administrators attempt to challenge transactions that purport to be something that they are not, illustrated by our respective borrowing and adapting for purposes of explanation, the Gilbert and Sullivan, "H.M.S. Pinafore," notable line, "[tax administrators] … have realized that skim milk that masquerades as cream should be treated as skim milk." [57] In reply, it may be argued that the sale of the great American novel by a brick and mortar establishment, ordered on line, shipped by common carrier or digitized and downloaded from the Web remains the same [58]and should be taxed the same; this is not a case where in one scenario we deal with skim milk, and in the other cream. "Nexus is an archaic concept in this time of globalization. … Goodbye nexus. Hello fairness. Remote sellers are welcome to exploit in-state markets. All that is needed is for them to shoulder the same burden of in-state sellers …" [59]

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[55] Tax Analysts, State Tax Today*, Multistate Tax Commission Responds to ITFC 'Myth vs. Fact' Document*, 2001 STT 183-33, September 20, 2001.
[56] *Exxon Corp. v. Wisconsin Dept of Rev.* (1980) 447 U.S. 207.
[57] Tax Analysts, State Tax Today, *State of Practice*, *The Changing World of State and Local Tax Practice*, 2001 STT 171-19, September 3, 2001.
[58] Comments are directed to the matter of nexus alone. They are not intended to address unitary apportionment, sourcing, etc.
[59] Corrigan, *'Letter To The Editor': Level The Playing Field ,* Tax Analysts, State Tax Today, 2001 STT 182-38, September 19, 2001.

Nexus Standards

With respect to state taxation, we are all engaged in a search of clear, established standards for both sales and use tax and business activity taxes such as income and franchise taxes. Whether by regulation, ruling, technical advice memorandum, case law, constitutional edict, we all seek out the state's understanding of the constitutional limits of nexus. [60]

In terms of the most recent jurisprudence regarding nexus, little has occurred since the hallmark decision of *Quill* by the U.S. Supreme Court in 1992. Since then, we confront the same questions and hypothecate answers. Those questions, and their significance as "hot topic" nexus questions continue to be:

- What is substantial nexus?
- Is substantial nexus a matter that is resolved quantitatively or qualitatively?
- Does the U.S. Supreme Court's call for physical presence in the case of sales and use taxes also apply to business activity taxes?
- If physical presence is required to establish tax nexus, what is "physical" what is "presence" and how much is required to pass constitutional muster?
- Do intangibles establish presence for state taxation purposes and can they satisfy substantial nexus?
- Are non-resident owners of in-state pass-through operating entities sufficiently present to be taxed?
- Can nexus be attributed to entities not in-state and if so under what circumstances?
- Can commerce conducted electronically establish sufficient nexus with a state to justify its taxation consistent with constitutional limitations?

State Taxation of Interstate Commerce

The first step in the analytical process of evaluating whether and to what extent California may exert its taxing authority is to determine whether there is constitutional nexus to tax under the due process and commerce clause. If so, and if interstate commerce is involved, then the second step is to determine whether the activities of the putative taxpayer are immune from state taxation by the provisions of P.L. 86-272. If the corporation is determined to be taxable in California after the first two steps, then the third step is to determine whether the taxpayer is doing business within the state in the context of §23101 [61]. If so, then the taxpayer will be subject to the California franchise tax under Chapter 2 of the Bank & Corporation Tax Law. If the taxpayer is not doing business in California as defined by statute, but nevertheless derives income from

[60] Adapted from a question recently propounded by Frank Katz, Deputy General Counsel, Multistate Tax Commission.
[61] All such references are to the California Revenue and Taxation Code unless indicated otherwise.

sources within the state, then the putative taxpayer is liable for the California corporation income tax under Chapter 3 of the Bank & Corporation Tax Law.

"State and local governments' broad authority to tax individuals and businesses is a fundamental attribute of sovereignty in our federalist system and the foundation of state power." [62] The taxing power of the State is not derived from, but exists in the States independently of, the United States Constitution and may be exercised to an unlimited extent, upon all property, trades, business and avocations carried on within the territorial boundaries of the State except so far as it has been surrendered to the Federal Government, either expressly or by necessary implication. [63]

Substantial Nexus

The term, "nexus" in a general sense refers to a connection or relationship between things. With respect to state taxation, nexus refers to the connection level of activity or presence required between a state and a taxpayer before the state has the legal authority to impose and/or require the collection of a tax by a taxpayer. [64] A finding of tax nexus then is the determination that a certain minimum connection exists of a type or kind consistent with the due process and commerce clauses of the U.S. Constitution so as to result in what is deemed a taxable presence in the state." [65]

In *National Bellas Hess* (1967) 386 U.S. 753, [87 S. Ct. 1389, 18 L. Ed. 2d 505], a case decided prior to *Quill*, the state of Illinois attempted to impose a use tax collection obligation on the Illinois sales of an out-of-state mail order house whose only contacts with the state were via the mail or common carrier. Catalogues and advertising flyers were mailed to customers in Illinois. The customers mailed merchandise orders to the Missouri headquarters, and the goods were then sent to the customers either by mail or common carrier. The Supreme Court found that the mail order house did not have sufficient nexus in Illinois, and requiring it to collect and pay Illinois use tax violated the due process and commerce clauses.

In *Quill* the Supreme Court considered whether a mail order sales corporation could constitutionally be obligated to collect use tax on behalf of its customers where its only connection with the state was the solicitation of sales by catalogues sent through the mail and the shipment of goods from outside of the state by common carrier into the taxing state.

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[62] Anderson & Monzingo, *Taxing Electronic Commerce*, Tax Analysts, State Tax Notes, Vol. 20, No. 7, February 12, 2001, p. 521.
[63] *Union Pacific R.R. Co. v. Peniston*, 18 Wall.5: *McCulloch v. State*, 4 Wheat. 316, 428; *Picard v. East Tennessee* (1889) 130 U.S. 637 [9 S. Ct. 640, 32 L. Ed. 1051]. See also *Michigan Central Railroad Company v. Powers* (1906) 201 U.S. 245 [26 S. Ct. 45, 50 L. Ed. 744].
[64] Legislative Analyst's Office, *California Tax Policy And the Internet*, January 31, 2000.
[65] KMPG, *Attention LLC Members: Is Nexus a Foregone Conclusion?* Perspectives in State and Local Taxation, Vol. 2001-02, Spring 2001.

Quill is noteworthy for at least two propositions: (1) For the first time, the U.S. Supreme Court distinguished constitutional tax nexus analysis between due process and commerce clause, and (2) it overruled *National Bellas Hess* to the extent that it required physical presence for the due process clause.

In distinguishing constitutional tax nexus analysis between the due process and the commerce clause, the Court explained that the differing analysis arose from the different interests that the two provisions addressed.

The Court explained that the due process clause is concerned with the fundamental fairness of government and is addressed by a two prong test: The first prong, is whether there is some definite link, some minimal connection between a state seeking to assert its taxing jurisdiction and the person, property or transaction which it seeks to tax. The second prong is whether the income attributed to the state for tax purposes is rationally related to values connected with the taxing state.

The test requiring a minimum connection is satisfied where the out-of-state corporation purposefully avails itself of the benefits of an economic market in the taxing state and the required minimum connection will be satisfied even though there is no physical presence in the state. Evidence that the out-of-state corporation purposefully availed itself of the benefits of the economic market in the taxing state arises from the fact that the out-of-state taxpayer purposefully directed a substantial amount of its activities at in-state residents. Because the taxpayer has purposely availe[d] itself of the benefits of an economic market in the forum state, the Supreme Court found that the solicitation of sales by mail was sufficient to establish nexus with the state under the due process clause. (See *Burger King .*[66])

The Court agreed that under contemporary due process analysis, *Quill* had directed its solicitation and operational activities at North Dakota residents and therefore could be compelled, even in the absence of a physical presence, to collect the state's use tax. The Court therefore found that North Dakota's use tax did not violate the due process clause of the U.S. Constitution. Accordingly, the Supreme Court overruled *National Bellas Hess* to the extent that it previously required a physical presence nexus under the due process clause.

With respect to the commerce clause, the Supreme Court noted that the due process clause and the commerce clause are "analytically distinct:" " While due process is centered on principles of fundamental fairness to individuals, the commerce clause focuses on "the effects of state regulation on the national economy." *Quill*, 504 U.S. at 312 [112 S.Ct. at 1913, 119 L.Ed.2d at 106] Hence, "a corporation may have the 'minimum contacts' with a taxing State as required by the Due Process Clause, and yet lack the 'substantial nexus' with that State as required by the Commerce Clause." *Quill*, 504 U.S. at 313 [112 S.Ct. at 1913-14, 119 L.Ed.2d at 107].

[66] *Burger King Corp. v. Rudzewicz* (1985) 471 U.S. 462 [105 S. Ct. 2174, 85 L. Ed. 2d 528].

For purposes of commerce clause analysis, the Court reaffirmed the *Bellas Hess* rule forbidding the imposition of use tax collection duties upon an out-of-state vendor whose only contacts with a taxing state are via the mail or common carrier. That is that with respect to the mail order solicitation of sales, the absence of a physical presence within the state, was insufficient to meet the "substantial nexus" requirement of the commerce clause under *Complete Auto Transit*. The Court noted that the *Bellas Hess* rule should be retained because:

1. A "bright-line" physical presence requirement furthers the objectives of the commerce clause by creating a "safe harbor" to avoid case-by-case evaluation of the burdens of tax compliance in an area wrought with "controversy and confusion."
2. The bright-line test encourages "settled expectations," and "fosters investment by businesses and individuals." The stare decisis effect of the *Bellas Hess* case had "engendered substantial reliance … and become part of the basic framework of a sizable [mail order] industry."
3. Congress has the ultimate power to resolve issues raised under the commerce clause, given its power under the constitution to regulate foreign and domestic commerce. Thus, the commerce clause issue was one which the "Congress may be better qualified to resolve."

Quill thus established that where a state attempts to impose a sales and use tax collection obligation upon an out-of-state mail order vendor, it must be physically present within the state in order to meet the substantial nexus requirement of the *Complete Auto* test. *Quill* also expressly affirmed that the "slightest" physical presence within a state will not establish substantial nexus. *Quill,* 504 U.S. at 315 n.8 [119 L. Ed. 2d at 108 n.8, 112 S. Ct. at 1914 n.8] (Quill's title to the contents of "'a few floppy diskettes'" in North Dakota did not meet substantial nexus requirement); see also *National Geographic Society v. California Board of Equalization* (1977) 430 U.S. 551, [97 S. Ct. 1386, 51 L.Ed.2d 631], (rejecting slightest physical presence standard of nexus).

<u>How Much Presence is Required?</u>

Left unclear after *Quill,* is the extent of physical presence in a state needed to establish more than a "slight" physical presence.

In *Orvis and Vermont Information Processing, Inc.* [67] the state of New York attempted to impose a use tax collection obligation upon two Vermont firms, neither of which had a permanent physical presence in New York: One of the firms sent its personnel into New York on visits to as many as 19 wholesale customers on the average of four times a year, and the other sent employees into New York on 41 occasions during three years. (*Orvis* 86 N.Y.2d 180 [654 N.E.2d at 962, 630 N.Y.S.2d at 688].) The issue in *Orvis* for the New York Court of Appeals was whether *Quill* mandated a substantial physical presence within the taxing state.

[67] *Orvis Co. v. Commissioner* and *Vermont Information Processing v. Commissioner* (1995) 86 N.Y.2d 165 [654 N.E.2d 954, 630 N.Y.S.2d 680.

The court stated that the "substantial nexus" that is required in order for a state to have jurisdiction to tax under the commerce clause does not necessarily mean "substantial physical presence." The Vermont corporations marketed products to a substantial New York customer base through mail order. Although visits by employees of the corporations to New York were described as sporadic and occasional, the court believed that those visits significantly enhanced sales and benefited the business. Therefore, there was substantial economic presence in New York, the fact that the level of physical presence was "more than a slightest presence" was considered enough to establish nexus.

The New York Court of Appeal held that, for purposes of use tax nexus, it was not necessary to establish substantial physical presence in a state to establish nexus to tax; it was only necessary to establish more than a de minimis physical presence to meet the "bright line" physical presence requirement of *Quill*, where the taxpayer had substantial economic presence in the state.

The *Orvis* court noted that neither the Supreme Court's prior precedents nor the language of *Quill* itself supported the position that a substantial physical presence is required. The *Orvis* court also noted that the adoption of a substantial physical presence requirement would necessarily mean case-by-case evaluations of factors involved with each out-of-state vendor, thereby undermining the principles of clarity and repose which *Quill* had offered as justification for retention of the bright-line, *Bellas Hess* rule.

While a physical presence of the vendor is required, it need not be substantial. Rather, it must be demonstrably more than a 'slightest presence' [citation]. And it may be manifested by the presence in the taxing State of the vendor's property or the conduct of economic activities in the taxing State performed by the vendor's personnel or on its behalf." (*Orvis ,* 86 N.Y.2d 178 [654 N.E.2d 960-61, 630 N.Y.S.2d 686-87).

To illustrate that not all reasonable minds agree, consider the Supreme Court of Florida decision in *Share International, Inc.* [68] In this case, the presence of employees at a three-day trade show in Florida and their sale of chiropractic devices, did not subject the taxpayer to an obligation to collect use tax on its mail order sales into the state, because the trade show connection did not amount to "substantial nexus" under *Quill*.

Will the Presence of Intangibles Establish Nexus?

In *Geoffrery* [69], an income tax case, the South Carolina Supreme Court examined whether consistent with *Quill*, the presence of intangibles would establish substantial nexus. Geoffery Inc. was a subsidiary of Toys R Us, incorporated in, and with principal offices, in Delaware. It had no offices, employees or tangible property in South

[68] *Florida Department of Revenue v. Share International, Inc.*, (1995) 667 So. 2d 226, 20 Fla.L.Weekly 1911 (Fla.App. August 21, 1995), appeal docketed No. 86481 (Fla. September 18, 1995).
[69] *Geoffrery , Inc. v. South Carolina* (1993) 437 S.E.2d 13, (cert.den.Nov.29, 1993) 510 U.S. 992 [114 S.Ct. 550, 126 L.Ed. 2d 451]

Carolina. Toys R Us transferred trademarks and trade names to Geoffery, Inc. Geoffery received a fee from Toys R Us for the use of those rights based on one percent of net sales. A portion of those sales were in South Carolina. As such, the out-of-state corporation's sole contact with the taxing state was that it licensed its trademarks to a retailer operating within in the state resulting in certain accounts receivables. South Carolina held that the mere presence of intangible property in the state subjects an out-of-state corporation to the state's taxing jurisdiction. [70]

With respect to due process, the South Carolina Supreme Court found that Geoffery had "purposely directed" its business activities to South Carolina because it had given consent to and had control over the use of the trade rights in the state. In addition, the court found certain intangibles (the trade rights and the accounts receivable from the exercise of those rights) had acquired a "business situs" [71] in the state and therefore contributed to its finding of nexus.

According to *Quill*, due process requires that the putative taxpayer must have a minimum connection with the taxing state. That minimum connection exists when the putative taxpayer purposefully avails itself of the benefits of an economic market in the taxing state. Evidence that the putative taxpayer has purposefully availed itself of the benefits of an economic market in the taxing state occurred when it purposefully directs its activities at the in-state residents.

With respect to the existence of nexus for purposes of the due process clause, the court found evidence of a minimum connection sufficient to satisfy the requirements of the due process clause. First, the court felt that when Geoffrey licensed its trademarks for use by Toys R Us and received income in exchange for their use, Geoffrey thereby contemplated and purposefully sought the benefit of economic contact with the states. And in so doing, purposefully availed itself of the benefits of South Carolina's economic market, which the court found, constituted the requisite minimum contacts. Second, additional evidence of the requisite minimum contacts arose from the in-state presence of Geoffrey's intangible property; i.e., its license agreement which amounts to an in-state franchise and accounts receivable which arose in Geoffrey's favor each time Toys R Us made sales. Geoffrey, the court found, "ha[d] not been unwillingly brought into contact with South Carolina.[72]"

With respect to the existence of nexus for purposes of the commerce clause, the *Geoffrey* court found that *Quill* was decided in the context of sales and use tax. The U.S. Supreme Court specifically left open the question whether the "bright-line, physical-presence requirement" (504 U.S. at 317, 112 S.Ct. at 1916) is applicable to other state taxes, such as income. (*Geoffrey*, 437 S.E.2d at p. 14, citing *Quill*, supra, 199 L.Ed.2d 91, 108.)

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[70] William J. Quirk, *Does Congress Put Federalism At Risk When It Limits The States' Power to Tax?*, August 27, 2001, Tax Analysts, State Tax Today, 2001 STT 166-27.
[71] Relying on *Southern Express Co. v. Spigener* (1920) 188 S.C. 413.
[72] William J. Quirk, *Does Congress Put Federalism At Risk When It Limits The States' Power to Tax?*, August 27, 2001, Tax Analysts, State Tax Today, 2001 STT 166-27.

In that this case involved a corporate income tax, the *Geoffrey* court felt that the *Quill* physical presence standard did not apply. Applying the "substantial nexus" standard of *Complete Auto Transit* citing *American Dairy Queen* [73] and *International Harvester* the court determined that Geoffrey had substantial nexus with South Carolina by licensing intangibles for use in the state and deriving income there from.

Geoffrey's petition for certiorari was denied in 1993.

Geoffrey stands for the proposition that substantial nexus can be satisfied by the presence of intangibles, it may be argued alternatively, that *Geoffrey* has application to matters involving economic nexus where economic nexus is defined as being that case where a taxing jurisdiction can assert a connection based on the amount of business done in the taxing state. [74] Viewed from this perspective, the South Carolina Supreme Court could be said to also stand for the proposition that *Geoffrey's* economic activity in South Carolina was enough to assert nexus for purposes of income tax.

The practical effect of the *Geoffrey* case in California is limited. The "business situs" concept (§23040) has been substantially supplanted by The Uniform Division of Income for Tax Purposes Act (UDITPA) for corporate taxpayers (*Appeal of Pacific Telephone* [75]*)* Thus, the "presence" of intangibles in California under a business situs concept will not, by itself, result in California source income. Intangibles are not in the property factors, and the sales factor assignment rules for intangibles are not based on "situs" but are instead based on the state where the greater cost of performance lies. (§ 25136).

Federal Immunity from State Taxation

Even if the facts establish that a vendor has constitutional nexus in a state, the state cannot impose an income or franchise tax on the seller if the activities of the vendor or its representative come within the protections of P.L. 86-272.

In accordance with the provisions of P.L. 86-272, a state is precluded by federal law from assessing tax upon vendors of tangible personal property where the vendor's activity within the state is limited to the solicitation of orders which orders are filled by shipment from a location outside of the state.

While a vendor loses its protections if it, or its agent, operates from an office in the state, or conducts other activity in the state not related to solicitation (See, e.g. *Wrigley* [76] *Brown Group Retail* [77]) it retains its immunity from state taxation if it operates via an

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[73] *American Dairy Queen v. Taxation and Revenue Dept*. (1979) 93 N.M. 743.
[74] Mauro, *Nexus Revisited: Current Domestic and International Tax Issues Relevant to Electronic Commerce*, Tax Analysts, State Tax Today, 2001 STT 141-25, July 23, 2001 a paper by associate director, tax practice presented at the inaugural meeting of The Conference Board's Council for Tax Executives, May 16, in New York City.
[75] *Appeal of Pacific Telephone*, Cal.St. Bd. of Equal., May 4, 1978.
[76] *Wisconsin Department of Revenue v. William Wrigley Jr., Co*. (1992) 505 U.S. 214 [112 S.Ct. 2447, 120 L.Ed.2d 174].

independent contractor which solicits sales from an office in the state, so long as it acts as an independent contractor for two or more sellers. [78]

For a similar decision based on the relationship between entities, consider the May 23, 2000, of a Sacramento trial court decision which held that The Reader's Digest Association (RDA) was not exempt from California state taxation under U.S. Public Law 86-272.

RDA is a Delaware corporation headquartered in New York. It publishes and sells magazines such as *Reader's Digest* through direct mail solicitation of California residents. A wholly owned subsidiary of RDA, Reader's Digest Sales & Services, Inc. (RDS&S) solicited sales of advertising pages in domestic and foreign editions of *Reader's Digest*. RDS&S maintained two offices in California with less than 10 employees. RDS&S sold advertising pages on behalf of RDA pursuant to a contract with RDA. There was no evidence that RDS&S solicited advertising pages on behalf of any publication other than various editions of *Reader's Digest*.

In issue was whether RDS&S qualified as an "independent contractor" under P.L. 86-272 so as to shield RDA from California taxation. The trial court held that RDS&S was not an independent contractor because it was not sufficiently independent of its parent, RDA. Its operations are "tightly interwoven" with those of RDA, and RDA treated its operations and employees "as an integral part of its business," the trial court said. Of particular note were the facts that RDA, in its accounting practices, did not treat RDS&S as an independent entity, nor did RDS&S ever act as an advertising broker for any publication other than *Reader's Digest*. Consequently, RDA was more than a mere mail-order seller or an out-of-state seller soliciting orders through an independent party and was not entitled to protection from California taxation under P.L. 86-272, the trial court held. The case is now on appeal. [79]
The provisions of P.L. 86-272 are currently limited to vendors involved in the sale of tangible personal property. Immunity does not extend to vendors of services, or intangibles including the sale of digitized information.

<u>"Doing Business" and the Franchise Tax</u>

Revenue and Taxation Code section 23101 defines "doing business" to mean "actively engaging in any transaction for the purpose of financial or pecuniary gain or profit." The key inquiry for tax purposes is whether or not the goal or aim of the California activities if financial or pecuniary gain. (*Hise* at 151[80], [81].)

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[77] *Brown Group Retail v. Franchise Tax Board* (1966) 44 Cal.App.4th 823.
[78] 15 U.S.C. §381 (c), (d).

[79] *The Reader's Digest Association, Inc. v. Franchise Tax Board,* Cal Ct of Appeal, 3d App Dist No. 98A503483. As of the date of this writing, briefing has been completed and a hearing date is pending.

[80] *Hise v. McColgan* (1944) 24 Cal.2d 147.
[81] A very limited exception to this standard is provided by §23101.5 if a corporation's only activities within the state are either: (1) the purchase of personal property or services solely for its own use (or the use by

Prior to *Complete Auto* the U.S. Supreme Court held that states had no power to impose a franchise tax on a corporation for the privilege of doing business if the activities of the corporation with respect to a state were conducted exclusively in interstate commerce. However, a franchise tax could be imposed on an apportioned share of all of a corporation's income, if at least some portion of its business was conducted in intrastate commerce. (*See, e.g., Spector Motor Service, Inc.* [82]) In *Complete Auto*, the U.S. Supreme Court eliminated the distinction between the conduct of a business in purely interstate commerce and conduct of a business partly engaged in intrastate commerce for purposes of the imposition of a franchise tax. Thus, there is no longer a constitutional prohibition against imposing a franchise tax measured by income from sources within this state of a corporation conducting its business exclusively in interstate commerce. [83]

If a partnership is doing business within the state, then all of the general partners of that partnership are also considered doing business within the state. However, in the *Appeal of Amman & Schmid Finanz* [84], the SBE held that a limited partner would not be

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its affiliate) outside the state, provided that certain restrictions regarding the presence of employees within the state are met; or (2) the presence of employees in the state solely for the purpose of attending a public or private school, college or university. In addition, §23102 provides that a holding company organized to hold stock or bonds will not be considered "doing business" if its only activities are the receipt of dividends or interest, and the disbursement of those receipts to shareholders. To qualify under this exemption, the holding company may not engage in trading the stock, bonds or other securities that it holds.

[82] *Spector Motor Service, Inc. v.. O'Connor* (1951) 349 U.S. 602.

[83] The California State Board of Equalization has expressly held that, in light of *Complete Auto*, the California franchise tax is properly imposed upon corporations doing business exclusively in interstate commerce, notwithstanding the provisions of California Code of Regulations, tit. 18., Reg. §23101. (*Appeal of Atlantic, Gulf, and Pacific Company of Manila*, Cal. St. Bd. of Equal., Nov. 17, 1982, holding that the reach of the Bank and Corporation Franchise Tax Law is coextensive with the state's constitutional power to tax, citing *Butler Bros. v. McColgan* (1941) 17 Cal.2d 664 [111P.2d 334] (1941), *aff'd*., (1942) 315 U.S. 501 [86 L.Ed. 991], *Luchenbach S.S. Co. v. Franchise Tax Board* (1963) 219 Cal.App.2d 710, and *Matson Nav. Co. v. State Bd. of Equal.* (1935) 3 Cal.2d 1. (See also *Appeal of Aqua Aerobics, Inc*., Cal. St. Bd. of Equal., Nov. 6, 1985, to similar effect.) Thus, the distinctions between an interstate activity and an intrastate activity in the regulations above are long obsolete. The applicable statutes (§§ 23101, and 23501), by their terms, did not contain such a limitation; it was only the regulations that supplied the "judicial gloss" of the constitutional law of earlier times. "In light of the above, the department viewed the indicated regulations (as well as similar regulations under §23040,) as being "deadwood," i.e., without legal effect. Accordingly, it proposed adoption of amended regulations, which among other things, removed the distinction between the conduct of an interstate or an intrastate business for purposes of the "doing business" standard, and for purposes of the imposition of the franchise tax. … These amendments were "changes without regulatory effect" because they deleted a regulatory provision that is premised solely upon constitutional authority that had since been overruled (see, e.g., 1 Code of Regs. §100(a)(2)). Thus, the reach of the statutes, no longer constrained by such constitutional law, are coextensive with the modern ambit of constitutional decisions, inclusive of *Complete Auto Transit, supra*." The proposed amendments to the regulations were approved by the Office of Administrative Law, and were filed with the Secretary of State on April 2, 2001, and became final on May 2, 2001. Because the amended portions of former regulations were of no legal effect, their removal is retroactive …" *Appeal of Reitman Atlantic Corp*. 2001-SBE-002 , May 31, 2001, Michael E. Brownell, Respondent's Supplement to Petition for Rehearing.

[84] *Appeal of Amman & Schmid Finanz AG, et. al*., 96-SBE-008, April 11, 1996.

considered to be doing business merely because it owned a limited partnership interest that was doing business within the state. The statute defined doing business as actively engaged in business and a limited partner was considered a passive and therefore not an "active" owner. Nevertheless, a corporate taxpayer that has income from sources in this state would still be subject to Chapter 3 tax. The case is best viewed as a doing business case and is neither a nexus case nor one that exempts tax on source income. The practical effect of *Amman & Schmid Finanz*, is limited to the fact that a minimum tax cannot be imposed on a limited partner. [85]

Outside these limited exceptions, the definition of 'doing business' is very broad. Because the language of §23101 refers to 'any' transaction, it is not necessary that the corporation conduct business or engage in transactions within the state on a regular basis. An isolated transaction during the year may be enough to cause the corporation to be doing business (see *Carson Estate Co.* [86]) Even negotiations that are an integral part of entering into a transaction may be considered to be doing business (*Appeal of Ebee Corp.* [87])

<u>The California Income Tax</u>

Under Chapter 3 of the Bank and Corporation Tax Law, an income tax is imposed on all corporations which, while not "doing business" in California, do "derive income from sources within this state" (§23501).

In most cases, a corporation with sufficient activities to have nexus within the state will also be considered to be "doing business"' within the state, so the franchise tax will be applied.

Both the franchise tax and the income tax are subject to the allocation and apportionment provisions of California law.

The primary differences between the two taxes are that: Corporations subject to the income tax do not have a minimum tax if they are not incorporated or qualified within the state. If a taxpayer is incorporated or qualified within California however, it will be subject to the minimum franchise tax as well as the income tax. In such cases, §23503 allows the minimum franchise tax to be offset against the income tax.

Federal statutes prohibit a direct tax on interest income from U.S. obligations, therefore such interest is not taxable for California Income Tax purposes. [88]

For California franchise tax purposes, gross income includes all interest received from federal, state, municipal or other bonds (§24272). The federal statute prohibition does

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[86] *Carson Estate Co. v. McColgan* (1943) 21 Cal.2d 516 [133 P.2d 636].
[87] *Appeal of Ebee Corp., Taxpayer, and Bacciocco, Assumer and/or Transferee*, Cal St. Bd. of Equal., February 19, 1974.
[88] 31 U.S.C. sec. 3124.

not apply to the California franchise tax however, because the franchise tax is not considered a direct tax on net income, but is only measured by income. It is for that reason, that U.S. government income may be included in the tax base for the franchise tax.

Nexus Hot Topics

Substantial Nexus

H. Beau Baez III, prepared a thoughtful statement of the problem and advanced his position in his article, *Understanding 'Substantial Nexus': The Phrase as a Legal Term of Art.* [89]

When the U.S. Supreme Court speaks of "substantial nexus," does it call for some predetermined, quantitative, metered or measured amount of nexus? In order for the state to lawfully exert is taxing jurisdiction, must the putative taxpayer be physically present in a quantifiable way in the state or is some other manifestation adequate to pass constitutional muster.

Mr. Baez approached the questions this way. Once due process fairness has been determined, then the inquiry shifts to whether an otherwise fairly imposed tax would nonetheless burden interstate commerce. "'[T]he commerce clause and its nexus requirement are … [concerned] about the effects of state regulation on the national economy.'" (*Quill* at 312.) Thus, the commerce clause 'require[s] a substantial nexus … so as to ensure that state taxation does not unduly burden interstate commerce.' (*Quill* at 313.) "The phrase 'substantial nexus' used in *Quill* was intended to address taxing *jurisdiction* and *not to define a level of activity* that will support a finding of commerce clause nexus." "The Supreme Court uses various terms to describe taxing jurisdiction." " …the term "Substantial Nexus" is what he calls, "a term of art." (Emphasis added) [90]

The Court's qualitative analysis began some three decades before *Quill* in *Scripto*, when it spoke specifically of "taxing jurisdiction" and a "level of activity" which it described as a level amounting to "some definite link, some minimum connection, between a state and the person, property, or transaction it seeks to tax." (*Scripto* at 210-211). The same language was used in *National Bellas Hess. (National Bellas Hess* at 756-757)

In *Complete Auto Transit*, the Court changed its language and for the first time used the term, substantial nexus, noting that in order for state and local taxes to "pass constitutional muster:" (1) there must be substantial nexus with the state; (2) the tax must be fairly apportioned; (3) the tax must not discriminate against interstate commerce; and (4) the tax must be fairly related to the services provided by the state. (*Complete Auto Transit* at 279.) With the exception of the prohibition of discrimination, which speaks of consistency in the application of the standard, all of these occurrences are levels of activity, not quantifiable, metered doses of activity. At no time in its opinion did the Court offer a definition of its new language only indicating that nexus exists

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[89] H. Beau Baez III, June 22, 2001, Vol. 8, No. 6, Tax Management, Multistate Tax Report, (TM-MTR) page 382.
[90] *Ibid*.

again, qualitatively when, it is "sufficiently connected." *Complete Auto Transit* at 278, 287.)

One month after *Complete Auto* was decided, the Court had an opportunity to define a quantified sum if it felt that was constitutionally required, in its decision in *National Geographic* [91]. Therein the Court used the language, "requisite nexus," "necessary basis," "sufficient relation," "necessary nexus," and "adequate nexus" (*National Geographic Society* at 556, 557, 558, 561, 562). Again, all terms express a sense of relative value, but nothing evidencing scientific certainty. The Court did not use the term substantial nexus eventhough it found nexus to exist.

One year later the Court used the phrase "substantial nexus," but did so in circumstances where nexus was deemed, "obvious." (*Stevedoring Assn*. at 750 [92].)

Two years later when the Court reused its phrase "substantial nexus" after quoting *Complete Auto Transit,* it spoke again of a conclusion, value or sense when using the language of "necessary nexus" and "clear and sufficient nexus." (*Exxon Corp. at 225, 228.*[93]*)*

Ten years after *Complete Auto Transit* in *Tyler Pipe Industries*, the Court again used the term "substantial nexus." (*Tyler Pipe* at 250). One year later, the Chief Justice used a new term, "nexus aplenty." (*D.H. Holmes* at 33 [94]). In *Barclay's Bank* decided in 1994 the Court used the term, "adequate nexus." (*Barclay's Bank* at 330 [95]). In *Jefferson Lines* decided in 1995, the Court used the terms, "sufficient nexus," "commerce clause nexus," "nexus aplenty," as well as, "substantial nexus." (*Jefferson Lines at* 184.)

With respect to *Quill's* endorsement of *Complete Auto's* substantial nexus requirement Mr. Baez observes that the Court continues to describe taxing jurisdiction in various ways, but never has it set forth a bright-line that any number of employees, amount or kind of equipment, sum of sales or other quantifiable measurement will or will not as a matter of certainty satisfy commerce clause nexus. For the Court, the test is one of degree and its language expresses its feeling by using what Mr. Baez regards as a word of art. Absent federal legislation, the determination as to whether tax nexus exists is a function of whether the circumstances associated with activity in the case at hand if taxed would unduly encumber the national economy. "Because the underlying concern behind the commerce clause nexus test is the desire not to burden interstate commerce, a quantitative test for nexus cannot resolve that issue." [96] The law does not

[91] *National Geographic Society v. California Bd. of Equal*, (1977) 430 U.S. 551.
[92] *Washington Dept. of Rev. v. Stevedoring Assn*. (1978) 435 U.S. 734, 750
[93] *Exxon Corp. v. Wisconsin Dept. of Rev*. (1980) 447 U.S. 207.
[94] *D.H. Holmes v. McNamara* (1988) 486 U.S 24.
[95] *Barclay's Bank, PLC v. Franchise Tax Bd*. (1994) 512 U.S. 298.
[96] H. Beau Baez III, *Understanding 'Substantial Nexus': The Phrase as a Legal Term of Art*, June 22, 2001, Vol. 8, No. 6, Tax Management, Multistate Tax Report, (TM-MTR) page 382.

recognize any quantum of "presence" between a presence that is de minimis, which the law will ignore, and substantial presence to which the law will give significance. [97]

Although proponents insist that a quantitative test would eliminate the "chilling affect" associated with the uncertainty of what type and degree of activity would establish nexus, in actuality, a rule "of numbers" would never be workable illustrated by several examples posed by Mr. Baez.

Suppose a boot manufacturer that conducts business in Texas and Rhode Island sends an equal number of sales personnel into each state to conduct the same number of sales calls. A few visits to Texas might be deemed insufficient to create taxing jurisdiction because the salesmen can visit only a small percentage of the boot dealers in the state (or a small percentage in Fort Worth for that matter). The same number of visits to Rhode Island, however, might be sufficient to create nexus with that state because the company would have saturated the marketplace.

An out-of-state high-tech manufacturer, with a large in-house tax department, makes a few visits to the two nuclear plants in California, resulting in several large multi-million dollar contracts with high profit margins.

Under a quantitative test, those few visits could fall below the bar and go untaxed unless one were to argue that the relevant test involved examining the type, extent, number and size of the contacts.

While we have a series of state decisions that support arguments on each side; in the end, it is a question of degree. When it comes to having interstate commerce pay its own way, we as tax administrators and private practitioners evaluate whether the facts are sufficient to establish a Constitutionally *permissible* burden. [98]

Physical Presence

If physical presence is required, then how much and what kind? Cases de-emphasizing the type, kind or degree of physical presence may be evidence of the courts' recognition of changes in the social and business environments.

Undoubtedly, a significant physical presence within a state will be enough to constitute nexus under both the due process and commerce clauses. "Reasonable minds surely can differ over what showing is required to make out a 'physical presence' adequate to justify imposing responsibilities for use tax collection" *(Quill,* 504 U.S. at 330-31, 119 L. Ed. 2d at 118-19, 112 S.Ct. at 1921 (White, J., concurring in part & dissenting in part).

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[97] Internet Tax Fairness Coalition, August 30, 2001 , *Business Activity Taxes, Myth vs. Fact*, Tax Analysts, State Tax Today STT 169-25.

[98] H. Beau Baez III, *Understanding 'Substantial Nexus': The Phrase as a Legal Term of Art*, June 22, 2001, Vol. 8, No. 6, Tax Management, Multistate Tax Report, (TM-MTR) page 382.

The extent of physical presence in a state needed to establish more than a "slight" physical presence was not addressed by *Quill*. In *Orvis,* the court noted that neither the Supreme Court's prior precedents nor the language of *Quill* itself supported the position that a substantial physical presence is required.

The *Orvis* court also noted that the adoption of a substantial physical presence requirement would necessarily mean case-by-case evaluations of factors involved with each out-of-state vendor, thereby undermining the principles of clarity and repose which *Quill* had offered as justification for retention of the bright-line, *Bellas Hess* rule.

Orvis does set forth an approach not inconsistent with that taken by Mr. Baez in his examination of the term, substantial nexus, in that where the courts speaks of physical presence as it relates to substantial nexus the reference is more a term of art than anything more. As noted in *Orvis*, "While a physical presence of the vendor is required, it need not be substantial. Rather, it must be demonstrably more than a 'slightest presence' [citation]. And it may be manifested by the presence in the taxing State of the vendor's property or the conduct of economic activities in the taxing State performed by the vendor's personnel or on its behalf." *Orvis,* 86 N.Y.2d at 178 [654 N.E.2d 960-961, 630 N.Y.S.2d 686-87.

Not everyone is in accord.[99]

The nexus implications of a Tennessee trial court ruling in *America Online Inc. v. Johnson*, [100] is a case about physical presence that Professor Richard Pomp said " … has spread like wildfire across the country … [and] was on everyone's e-mail nanoseconds after it became public." It has together with Tennessee's holding in *J.C. Penney* [101] made Tennessee, " … one notorious state."

In *American Online*, Tennessee assessed additional tax of approximately $10 million dollars consisting of an assessment of approximately $9 million for uncollected sales and use taxes and additional sums for activity taxes.

The state contended that substantial nexus existed based on the following: AOL's contracts with its members in Tennessee; AOL's services to its members in state; software distributed to AOL customers; AOL's use of local access phone numbers in state by Tennessee members; and AOL's instate use of leased equipment.

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[99] Comments by Sheppard, What the Are The Implications of Tennessee's AOL Decision?, 2001 STT 72-32, April 13, 2001,Tax Analysts, State Tax Today.

[100] *America Online Inc. v. Johnson* 97-3786-III, Mar 13, 2001, Tennessee Chancery Court for Davidson County.

[101] *J.C. Penney National Bank v. Johnson* (1999) (Appeal No. M1998-00497-COA-R3-CV) (Court of Appeals of Tennessee at Nashville.

The Tennessee court held that the foregoing did not establish substantial nexus and the state could not compel America Online to collect or pay taxes arising from Internet access services provided to Tennessee residents.

First, the court did not distinguish between sales and use and activity taxes. Relying on the decision in *J.C. Penny*, the court applied the *Quill* physical presence standard to both the sales tax and business activity taxes.

Second, the court determined that the America Online agreements with its customers were "intangibles" as was the in-state presence of America Online software neither of which were deemed to amount to physical presence consistent with the treatment given to credit cards in the *J.C. Penny* case.

Third, although America Online did lease equipment instate to provide Tennessee residents telephone services, the court found use of the in-state lines insufficient to constitute substantial nexus for it was not considered necessary to AOL's business and thus, too tenuous and remote to give rise to the requisite physical presence.

The court ultimately held that whatever physical presence did exist, it was no more than a "slightest presence," which was inadequate to amount to substantial nexus.

Just like South Carolina's *Geoffrey* decision, Tennessee's *AOL* decision has elicited raves and criticisms.[102]

Attorney Paul Frankel of Morrison & Foerster LLP, New York, stated that "I think physical presence is a bright-line. That I'm a strong believer in: No physical presence, no nexus. " "I think it's consistent with the principle of 'no physical presence, no nexus,' and I think it's one more nail in the coffin of the so-called economic nexus theory."

Doug Lindholm, executive director of the Committee On State Taxation (COST), stated that, "I think that it reaffirms that the commerce clause nexus standard for both sales tax and income tax is and should be physical presence. I think it's simply unfair and unworkable to essentially premise a nexus standard upon the location of customers. …"

There are those who disagree with the court and its supporters.[103]

Professor Richard Pomp of the University of Connecticut stated that, "… the court is basing portions of its logic on a ruling [in *J.C. Penney*] that [is] questionable to begin with …] While the court said that the credit cards in *J.C. Penney* did not constitute physical presence, "… it said that without a whole lot of analysis." and it's a position " …

[102] As reported by, Sheppard, What the Are The Implications of Tennessee's AOL Decision?, 2001 STT 72-32, April 13, 2001,Tax Analysts, State Tax Today.
[103] As reported by, Sheppard, What the Are The Implications of Tennessee's AOL Decision?, 2001 STT 72-32, April 13, 2001,Tax Analysts, State Tax Today.

that deserves more analytical attention than what the court gave. It made very short shrift of what is one of the very burning issues in taxation right now."

Many believe that the court failed to understand the fundamental importance or role of the modems in the taxpayer's instate business. Professor Pomp noted that while " …the presence of the tangible personal property such as the modems constitute physical presence, … it could be that the court deemed it to be de minimis." However, if that is the case, "… then it misunderstands the integral role a modem plays." You have leased property in the state and although not real property, Professor Pomp suggests that *Quill* makes no distinction when it comes to establishing satisfaction of physical presence.

An additional significant aspect of the court's decision is the absence of nexus where an out-of-state company maintains an arm's length relationship with an in-state affiliate.

In the end, while presenting an interesting view as to what is physical presence and what is substantial physical presence, the value of the case in resolving current debate is uncertain at best. As noted by Professor Pomp, "It's always difficult to know how much precedential value another state will give a lower-level decision like this." "The opinion should not be given any more weight than what the logic of it would require, and it is not very logically rigorous – so I wouldn't think it should receive much weight."

For a counter point to *AOL*, consider, *Browns Furniture, Inc.*[104] and *Town Crier, Inc.*[105]

In *Brown's Furniture*, the Illinois Supreme Court specifically rejected the notion that a retailer's physical presence within the taxing state must be "substantial." (*Brown's Furniture* at 423-24). The state supreme court analyzed the substantial nexus requirement in light of *Orvis Co. v. Tax Appeals Tribunal* (1995) 86 N.Y.2d 165, 178 [654 N.E.2d 954, 960-61, 630 N.Y.S.2d 680, 686-87], which stated that a substantial nexus requires a physical presence in the taxing state that "must be demonstrably more than a "slightest presence".'" [citation] *Brown's Furniture*, 171 Ill.2d at 424 quoting *Orvis Co. v. Tax Appeals Tribunal* (1995) 86 N.Y.2d 165, 178 [654 N.E.2d 954, 961, 630 N.Y.S.2d 687. (*Town Crier, Inc., v. The Department Of Revenue* (2000) 315 Ill. App. 3d 286; 733 N.E.2d 780).

Brown's Furniture was located some 15 miles outside Illinois in Missouri. Illinois residents patronized Brown's Furniture to the extent that some 30% of the store's total sales came from Illinois customers. Purchases by Illinois residents were regularly delivered by Brown's Furniture in its own trucks. During a 10-month period Brown's Furniture made 942 deliveries to Illinois valued at more than $675,000.

When Brown's Furniture delivers its merchandise, its employees unload the furniture, placed it inside the customer's residence, and made minor repairs the result of shipping damage. Items suffering major damage, was returned to the Missouri store, repaired

[104] *Brown's Furniture, Inc. v. Wagner* (1996) 171 Ill. 2d 410; 665 N.E.2d 795.
[105] *Town Crier, Inc. v. The Department Of Revenue* (2000) 315 Ill. App. 3d 286; 733 N.E.2d 780.

and reshipped to Illinois. Brown's Furniture also picks up furniture for repairs. Occasionally, its employees would accept payment on delivery.

The Illinois Supreme Court found that Brown's Furniture has traveled well beyond the "safe harbor [created] for vendors 'whose *only* connection with customers in the [taxing] State is by common carrier or the United States mail.'" (Emphasis added.) *Quill*, 504 U.S. at 315 [112 S.Ct. at 1914, 119 L.Ed.2d at 108]. Through its deliveries, Brown's Furniture is physically present in Illinois on an almost continuous basis. The court found that in so doing, Brown's Furniture met the *Complete Auto* substantial nexus requirement. Brown's deliveries in Illinois were not "occasional" or sporadic. This was in contrast to *Florida Department Of Revenue v. Share International, Inc*., (1995) 667 So. 2d 226, 20 Fla.L.Weekly 1911 (Fla.App. August 21, 1995), appeal docketed No. 86481 (Fla. September 18, 1995) (Texas mail-order company employees' attendance at Florida seminars for three days in five different years insufficient to establish substantial nexus); … The court also considered Brown's extensive advertising in Illinois media outlets "incidental." In addition, contrary to the situation in *Miller Brothers,* Brown's directly and actively solicited and procured the consumer market in Illinois. See *Orvis,* 86 N.Y.2d at 184 [654 N.E.2d at 964, 630 N.Y.S.2d at 690 (Bellacosa, J. dissenting, joined by Ciparick, J.) (contending that *Miller Brothers* remains relevant because of its analysis of economic exploitation of consumer markets). Altogether, the court found that Brown's Furniture has sufficient physical presence within Illinois to meet the substantial nexus requirement.

In *Town Crier,* Illinois found that even though the putative taxpayer had no employees, equipment, or property in the state, it made a number of deliveries into the state. During the period in review it made 54 deliveries into the state. Thirty of which were in Town's own trucks, and 24 by common carrier. Town was also physically present in Illinois five times to deliver and install merchandise purchased from its store. The court determined that the due process clause was satisfied because Town satisfied the minimum contact threshold in Illinois and that by making 30 deliveries into the state in its own vehicles and installing its merchandise in on five occasions, Town Crier exploited the Illinois consumer furniture market sufficient to satisfy commerce clause.

The Supreme Court of Kentucky ruled that a retailer's pre-printed newspaper advertising inserts and direct mail catalogs, that were printed out-of-state and distributed to Kentucky residents, were subject to the state's use tax. The newspaper inserts were shipped by the out-of-state printer to Kentucky newspapers for distribution according to the taxpayer's instructions; the catalogs were mailed by out-of-state printers to potential customers in Kentucky. The court found that *the newspaper inserts belonged to the taxpayer until they were distributed* to the newspaper subscribers free of charge. Once a subscriber had possession of an insert, the taxpayer had made a taxable use of the insert. As to the catalogs, the court concluded that, because *the inserts and catalogs were "virtually the same thing*, apart from their means of distribution, there is *no logical basis to distinguish the two*." *Revenue Cabinet v. Lazarus, Inc., et al.*, No. 1999-SC-1070-DG (Ky., 5/24/01).

Does *National Bellas Hess* and *Quill* Commerce Clause Physical Presence Requirement for Out-of-State Mail Order Vendors Does Apply To Business Activity Taxes

While authors continue to speculate whether or not *Quill* will be limited in its application to use taxes, the U.S. Supreme Court expressly stated that its *Quill* holding did not apply to any other taxes (*Quill*, supra, 119 L.Ed.2d at 108, and 110). When the Court decides to revisit the issue, the grounds upon which the Court might distinguish *Quill* from an income based tax could include:

(1) The actual tax is imposed on the user (consumer) and merely required to be collected by the seller. The seller is not being taxed for its own commercial exploitation of the market for which under *Complete Auto Transit*, at 289 the taxpayer is obliged to "pay its own way."
(2) The U.S. Supreme Court admits that it was influenced by the fact that the then evolving mail order industry had grown upon the physical presence notion expressed in *National Bellas Hess*. Because the Supreme Court has never considered the issue of physical presence nexus in an income or franchise tax test case, there is no reliance concern.
(3) It has been argued that sales and use taxes present burdensome tax compliance burdens described as 'welter of complicated obligations to local jurisdictions' [106] *National Bellas Hess*, at 760 arising from varied assessments by state and local jurisdictions. By comparison, income and franchise taxes are essentially uniformly determined by reference to rules for determining federal taxable income, and apportioned by reference to the standardized rules under UDITPA.

Attributional Nexus[107]/ Representative Nexus

The common law has long recognized that one may act or be deemed to have acted by the actions or deeds of another. The means by which this is accomplished are numerous. It might be by virtue of a power of attorney or authorized by any number of variations on legal themes that give rise to some form of a connection or relationship, arising from actual, ostensible, or apparent authority. In the context of tax nexus,

[106] As an aside, with respect to the modern significance to be placed on the historic view of what has been estimated as 7,500 separate tax jurisdictions deemed to be a complicated compliance task, consider the thoughts expressed by one writer, "Today, … technology makes it possible for Amazon to keep track of manifold details about each of its 28 million products and 25 million customers: what you buy, what your neighbors in the same ZIP code have recently purchased, ….We might ask then, [today] why, then, would it be difficult for Amazon [or any e-retailer] to keep track of a database containing a mere 7,500 tax rules? That would fit in the Palm of my hand. And if Amazon doesn't want to divert … its programmers to the task, it can buy software off the shelf from a number of vendors." "… Target.com collected taxes for all." See Stross, *Digital Domain, A gift for the Internet, Why Should Mallgoers Foot the Bill for Web Shoppers?* U.S. News & World Report, December 18, 2000, p. 49. One writer has expressed a contra view as to the nature of taxation. "The real issue of legitimacy of state and location taxes is whether the taxes are so complex that it is illegitimate to ask a multistate business to pay or collect them." McLure, Jr., *Legitimacy, Fairness, and Equity of State and Local Taxes on Interstate Commerce*, Tax Analysts, State Tax Today, 2001 STT 190-39, October 1, 2001.
[107] It is believed that Mr. Rosen introduced the phrase, "attributional nexus" around 1987.

activities performed within a state may establish nexus where an agent of the taxpayer, instead of by the taxpayer itself, performs those activities. "Agency nexus" thus utilizes principles of common law agency law[108] as well as "independent contractor" nexus as per *Scripto* to ascribe the activities of in-state actor(s) or "agent(s)" to the out-of-state "principal" for purposes of establishing nexus with that principal.[109]

In the case of tax nexus analysis, actions of an entity not in the state may be deemed attributed to be the acts of one outside of the state and in this way give rise to a connection with the taxing state that would satisfy due process and commerce constitutional concerns. The fact that an agent performs activities does not diminish the fact that the taxpayer is realizing benefits from within the state.

The relevant test for determining nexus therefore focuses on the nature and extent of the activities within a state, regardless of whether those activities are performed directly by the taxpayer or by an agent on the taxpayer's behalf. [110]

Expressing what is a less than thrilled acquiescence, one commentator has described these representational or attributional theories to be, "… mutations of nexus."[111]

Analytical precision requires distinguishing attributional nexus from representative nexus. In the former, the out-of-state entity is not itself present, but presence is attributed to the out-of-state putative taxpayer for tax purposes by mere affiliation, ownership, or unitary relationship with an entity the does have nexus. In the latter, the out–of-state entity is deemed present because the acts of a representative are treated as those of the principal itself.

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[108] See In *Appeal of Nardis of Dallas, Inc*., Cal. St. Bd. of Equal, April 22, 1975, a sales man solicited orders in California for a Texas-based company, and maintained a showroom within California for that purpose. The taxpayer argued that the sales man was an independent contractor, therefore the maintenance of the showroom should be a protected activity under P.L. 86-272. The SBE disagreed, stating that the salesman was not an independent contractor under the tests developed at common law. Factors that the SBE found to be significant in determining that an employer/employee relationship existed included the taxpayer's right to discharge the salesman upon notice, and the fact that the parties themselves believed that they had created an employment relationship, as evidenced by the payment of unemployment taxes. As an employee of the taxpayer, maintenance of the showroom went beyond the minimum activities allowed under P.L. 86-272.

[109] Mauro, *Nexus Revisited: Current Domestic and International Tax Issues Relevant to Electronic Commerce*, Tax Analysts, State Tax Today, 2001 STT 141-25, July 23, 2001. a paper by associate director, tax practice presented at the inaugural meeting of The Conference Board's Council for Tax Executives, May 16, in New York City.

[110] *Scripto, Inc. v. Carson* (1960) 362 U.S. 207; *Illinois Commercial Men's Association v. State Board of Equalization* (1983) 34 Cal.3d 839; *Dresser Industries, Inc.,* Cal. St. Bd. of Equal., Opinion on Petiton for Rehearing, October 26, 1983.

[111] Mauro, *Nexus Revisited: Current Domestic and International Tax Issues Relevant to Electronic Commerce*, Tax Analysts, State Tax Today, 2001 STT 141-25, July 23, 2001, a paper by associate director, tax practice presented at the inaugural meeting of The Conference Board's Council for Tax Executives, May 16, in New York City. Also see Fields and McLoughlin, *Special Report, Viewpoint, Attributional Nexus: Have Some States Taken It Too Far?*, Tax Analysts, State Tax Notes, Vol. 19, 23, December 4, 2000, p. 1509.

Attributional or representational nexus can arise under assorted theories such as common law agency, alter ego (arising as a result of the disregard of corporate separateness), or unity (arising from a working relationship with affiliates). [112]

The basic premise upon which tax nexus arises comes from the Supreme Court in its *Scripto* and *Typer Pipe* decisions whereby the representative activities of the in-state actors where attributed to the out-of-state vendor and the corporate form of the in-state actor was deemed to have no constitutional significance.

Most writers base their objections to attributional nexus on claims that evidence must establish acts whereby the in-state actors engaged in activity that both maintained and established a market and that there be a physical presence. [113]

Yet, this fails to take into account that the U.S. Supreme Court did not make both the maintenance and establishment of a market a constitutional requirement. The purported dual requirement comes from language used in *Tyler Pipe*. However, the Court used language that was contained in the Washington state statute. In addition, authors who contend that *Tyler Pipe* and *Scripto* require some form of solicitation to warrant attribution fail to take into account *Standard Pressed Steel* in which the U.S. Supreme Court found tax nexus where there was *no solicitation whatsoever*, and the Court has in numerous cases found tax nexus where no physical presence is required such as in *International Harvester* as have states in finding nexus in cases involving pass-through entities even though the non-resident is not present. Thus, to the critics who argue that attribution requires solicitation, physical presence and acts tantamount to the maintenance and establishment of a market, Supreme Court authority as it now exists is contra.

Not all reasonable minds agree. Consider, Tennessee' decision in *J.C. Penney*.[114] J.C. Penney had retail operations in the state and credit cards were solicited from outside the state by an affiliate. The lower court found tax nexus on three grounds: The in-state presence of credit cards was tangible property giving rise to physical presence, the solicitation of the in-state customers by the out-of-state affiliate created substantial nexus along with the in-state presence of the affiliates' retail stores.

On appeal, the lower court was reversed. The appellate court found the credit cards were essentially intangibles and therefore did not constitute physical presence, the in-state retail stores were not sufficiently affiliated with the out-of-state credit card operations and the out-of-state solicitation did not occur in-state so as to create sufficient nexus.

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[112] Barrie and Iles, *Attributional Nexus: Taxing Corporations that Lack Sufficient In-State Presence,* Journal of Multistate Taxation, March-April 1994.
[113] See for example, Fields and McLoughlin, *Special Report, Viewpoint, Attributional Nexus: Have Some States Taken It Too Far?*, Tax Analysts, State Tax Notes, Vol. 19, 23, December 4, 2000, p. 1509.
[114] *J.C. Penny Nat.'l. Bank v. Johnson* 19 S.W.3d 831 (Tenn.Ct. App. (1999), cert denied, 69 U.S.L.W. 3257 (U.S. Oct 10,2000) (No. 00-205).

In *Borders Online*, is a case just decided,[115] California attempted to require the on-line retailer to collect sales tax.[116]

Borders Online objected on the basis that it did not have constitutional tax nexus in California for two reasons. First, while Borders Online is related to Borders, Inc., its brick and mortars affiliate, the two are not the same and it would be error for California to disregard corporate formalities that has established two very distinct corporate entities. Second, consistent with the holding in the 1992 U.S. Supreme Court decision in *Quill*, there must be "substantial nexus" before a state can assert a requirement upon an out-of-state entity to collect this state's sales tax where the entity's only contact with the state was by way of the mails or common carriers. In this case, Borders Online noted that it had no physical presence in this state including neither property nor employees in the state.

During its initial hearing before the California Board of Equalization, the Board advised that it did not disagree with Borders Online basic premise. However Board member, Mr. Andal, addressed a relationship that existed between Border's, Inc., which accepted returns of books purchased from Borders Online as well as returns of any other book vendor. When a return was accepted from Borders Online, Borders, Inc. would allow an exchange or a cash refund. When a competitor's book was accepted in return, Borders, Inc. allowed a store credit.

This policy caused Mr. Andal to note that the return policy discriminated against vendors other than Borders Online. That being so, Mr. Andal asked, "why would this type of discriminatory return policy exist if Borders Online did not have an agency agreement with Borders Inc.?" That is, Mr. Andal apparently inferred from the different return policy that there was an agency relationship between Borders and Borders Online; the agency agreement was enough to give Borders Online nexus in California. The Board's Chair, Mr. Claude Parrish agreed with Mr. Andal that his vote was based on the return policy.

In its subsequent ruling, the Board concluded that Borders, Inc. was Borders's Online authorized representative in this state for the purpose of accepting returns from California customers. Border's Online expressly stated on its Web site that Borders, Inc. was its authorized representative for this purpose

Its express Web site declaration is sufficient to establish that Borders, Inc. was Border's Online authorized representative for returns, in addition to this direct evidence, circumstantial evidence sufficient to establish this fact also existed in the form of Borders, Inc. preferential policy to Border's Online customers.

"When out-of-state retailers that make offers of sale to potential customers in California authorize in-state representatives to take returns, these retailers acknowledge that the

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[115] *Matter of Borders Online Inc.* ___ SBE ___September 26, 2001.
[116] Alison, *California BOE: Online Bookseller Likely to Have Sales Tax Nexus*, Tax Analysts, State Tax Today, 2001 STT 140-10, July 20, 2001.

taking of returns is an integral part of their selling efforts. Such an acknowledgement comports with common sense because the provision of convenient and trustworthy return procedures can be crucial to an out-of-state retailer's ability to make sales. This is especially evident in the realm of e-commerce." [117]

In *Quill* the United States Supreme Court held that, pursuant to the Commerce Clause of the United States Constitution, a state cannot impose a use tax collection obligation on out-of-state retailers unless those retailers have "substantial nexus" with that state.

In *Border's Online*, "the petitioner had a substantial physical presence in California through the many places of business and employees of Borders, Inc, petitioner's authorized representative in this state for the purpose of selling tangible personal property. Petitioner's substantial physical presence in this state more than suffices to establish that petitioner had commerce clause nexus." [118]

A variety of scenarios give rise to attributional nexus. Border's Online illustrated an agency or affiliate scenario. Consider *Kaiser Optica*l below giving rise to "virtual employees" and *Scholastic Book Clubs* where acts of unpaid non-employee, non-agent, non-independent contractors who facilitated sales were nevertheless attributed to the out-of-state vendor.

In a case involving throwback sales [119], Kaiser Optical operating in Michigan manufactured specialized items for the aerospace industry. The company was owned by Kaiser Aerospace, a Nevada corporation with offices in California. Most of Kaiser Optical's accounting and financial functions were performed by personnel of Kaiser Aerospace's Kaiser Electronics Division in California. All of Kaiser Optical's books and records were maintained and physically kept in offices in California. A monthly use and occupancy charge was exacted from Kaiser Optical for this service. Kaiser Optical's payroll and nonpayroll checks were prepared and processed in California. Kaiser Optical made various sales to Kaiser Aerospace's Kaiser Electronics Division in California. The intercompany sales by Kaiser Optical were eliminated from Kaiser Aerospace's sales because sales by Kaiser Optical, a subsidiary of Kaiser Aerospace, were a cost of sales to Kaiser Aerospace's Kaiser Electronics Division.

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[117] The incidence of large-scale retailers who have electronic kiosks placed in stores is increasing. The kiosks are equipped with computer terminals that let customers among other actions, locate products at affiliates. At Kmart, shoppers can order from Bluelight.com items that might not be available at the brick and mortar site. At Target, customers can familiarize themselves with American Online. Kmart says 20 percent of traffic on Bluelight.com now comes from kiosks inside its stores. Borders has reported that people who use its in-store kiosk name, Title Sleuth, buy more books, make more impulse purchases, and shop more at Borders.com than do non users. Hobson and Brenna, *Business & Technology, Check This Out: New Ways To Cut The Line, Gadgets That Could Change The Way You Shop*, U.S. News & World Report, September 3, 2001, p. 33.

[118] See Tax Analysts, State Tax Today, *California Boe: Borders Online Obligated To Collect Use Tax From California Customers*, 2001 STT 189-11, September 28, 2001.

[119] *Kaiser Optical Systems Inc. v. Department of Treasury*, MTT Docket No. 233475, Mar 30, 2000.

Sales made by Kaiser Optical to California were treated as California sales by Kaiser Aerospace on its unitary California franchise tax return when the electronics division resold the items purchased from Kaiser Optical. Kaiser Optical and its parent, Kaiser Aerospace, did not file consolidated returns in Michigan.

The Department of Treasury determined that the California sales by Kaiser Optical should have been included in Kaiser Optical's Michigan single business tax base under the throwback rule.

If Kaiser Optical had nexus with California, the throwback of Kaiser Optical's California sales to Michigan was improper. Citing *Scripto*, the Administrative Law Judge (ALJ) noted that an office owned, leased, or maintained in a state gives a company nexus with that state. The ALJ determined that Kaiser Optical *in effect* had both an office and employees in California. The tribunal indicated that the activities carried out by employees of the electronics division in the state of California *on Kaiser Optical's behalf* were sufficient to create a nexus with California and therefore concluded that the department was precluded from exercising a throwback to Michigan.

The underlying question was whether or not Kaiser Optical had "nexus" with California. If so, the throwback of California sales to Michigan was improper.

Whether called "agents," "representatives" or "others," those who worked on behalf of Kaiser Optical were, in actuality their, "quasi-employees" evidenced by what was, in effect, "employee-sharing" between the company the Kaiser Electronics Division. Those employees, who worked for their employer, Kaiser Electronics Division, and for Kaiser Optical out of the Division's office in California, were paid in a cost-sharing arrangement between those entities on the basis of "time-spent" ratios.

Based on the *nature and the* extent of the relationship between Kaiser and its parent in California, it was as if Kaiser *itself had employees in the state*. Thus, because Kaiser had what was deemed *"quasi-employees"* in California, the company was taxable in the destination state, precluding invocation of the throwback rule. [120]

It is impossible to argue successfully that those employees of Kaiser Electronics Division who were responsible for most of the accounting and financial functions of Petitioner were not engaged in requisite "business activity," on behalf of Petitioner inasmuch *as they performed those "services" with the object of "gain, benefit, or advantage" to Petitioner*.

The courts have been fairly liberal in finding nexus creating relationships to exist. In *Scholastic Book Clubs, Inc. v. State Board of Equalization* (1989) 207 Cal.App.3d 734, the taxpayer had no property or employees in California. It conducted business by mailing catalogs to teachers and librarians in schools throughout the United States.

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[120] Goodman, *Midwest State Tax Update*. *Tax Analysts, State Tax Today,* 2001 STT 127-19, July 2, 2001.

Each catalog included "offer sheets" for the teachers to distribute to their students, but the teachers were under no obligation to do so. The teachers would consolidate the orders and payments made by their students, and submit them to the taxpayer. Orders were filled and shipped from a Missouri warehouse to the teacher, who then distributed the materials to the students. To encourage teachers to place orders, the taxpayer gave them 'bonus points' based upon the size of their orders. The bonus points could be used to obtain merchandise from a gift catalog. The taxpayer argued that they had no real agency relationship with the teachers, therefore the activities of the teachers should not cause the taxpayer to have nexus within California. The court disagreed, finding the relevant fact to be that the teachers served the function of obtaining sales within California. The court noted that the taxpayer depended on the teachers to act as its conduit to the students. Moreover, the court found an implied contract to exist between the taxpayer and the teachers as evidenced by the fact that the taxpayer rewarded the teachers with bonus points if they obtained and processed orders. The taxpayer attempted to minimize the payment of bonus points by claiming that the teachers could not earn their living though bonus points. The court responded by stating that 'neither the form of the remuneration, the amount thereof, nor the fact that the teachers and librarians were not formally employed by, or dependent upon appellant for the primary income has any legal significance in determining whether they acted as appellant's representatives in soliciting orders for appellant's products in California.' The court held that the taxpayer was exploiting or enjoying the benefit of California's schools and employees to obtain sales, and thus had nexus with the state.

The argument that agency nexus (and representational contacts) are somehow protected from nexus was thoroughly repudiated by *Scripto*. Given the current state of the U.S. Supreme Court decisional law on representative nexus any argument that would attempt to assert forms of corporate organization as having insulating effects would seem nothing short of frivolous. The argument that "corporate formalities" should *not* be overlooked would result in denying common sense in favor of a fiction that the corporate entities are separate.

Warranty Work Subcontracted To Third Parties

California Civil Code §1793.2 provides that every manufacturer of consumer goods sold within California with express warranties must maintain repair facilities reasonably close to the sales location. To comply with this provision, the warranty work can be subcontracted to an independent third party.

Performing warranty work through a subcontractor may be enough to establish taxability within the state. The U.S. Supreme Court has held that the in-state presence of a representative of an out-of-state seller who conducts regular and systematic activities in furtherance of the seller's business, creates nexus. [121]

[121] *Scripto, Inc. v. Carson* (1960) 362 U.S. 207; *General Trading Corp. v. Iowa* (1966) 322 U.S. 327; Tyler *Pipe Industries, Inc. v. Washington Department of Revenue* (1987) 483 U.S. 232.

One could argue that, by logical extension of the *Scripto* and *Standard Pressed Steel* cases, if taxpayer provided warranty services would provide nexus (*Standard Pressed Steel*), then independent contractor warranty activity would be imputed to the out-of-state seller under *Scripto*.[122]

Questions will arise as to what amount of service will satisfy constitutional standards. If the provision of warranty service by a third party gives rise to tax nexus, will the same outcome arise if the third party provides online training or customer assistance? One could argue that it will if physical presence is required. Third party warranty is a physical presence by agency issue. The physical presence of the independent contactor is imputed to the out-of-state seller.[123] If the independent contractor or taxpayer provides warranty service online, one would expect the argument that it doesn't have physical presence.[124]

Representational Nexus and P.L. 86-272

If a corporation is immune from state taxation under P.L. 86-272, nexus will be a moot point. P.L. 86-272 extends protection to certain in-state activities if an independent contractor conducts them, even though immunity would be lost if those same activities were conduced directly by the taxpayer. However, implied in those limited protections is that if an independent contractor does an act other than those described as protected (e.g., warranty), the act is not a protected act.

An Illinois case[125] evaluated whether the acts of an independent contractor should not be attributed to an-out-of state principal in accordance with the provisions of P.L. 86-272.

ABC Manufacturing Co., filed Illinois corporation tax returns on a combined unitary basis including ABC Supply Co., along with others members of its unitary business group. ABC Manufacturing argued that it was immune from state taxation by the provisions of P.L. 86-272 because ABC Supply qualified as an independent contractor under federal law.

According to the provisions of P.L. 86-272, whether an individual is an independent contractor or an employee depends on the existence of a number of factors which address the issue of control.[126]

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[122] Mauro, *Nexus Revisited: Current Domestic and International Tax Issues Relevant to Electronic Commerce*, Tax Analysts, State Tax Today, 2001 STT 141-25, July 23, 2001, a paper by associate director, tax practice presented at the inaugural meeting of The Conference Board's Council for Tax Executives, May 16, in New York City.
[123] Consider *Readers' Digest, supra*.
[124] Mauro, *Nexus Revisited: Current Domestic and International Tax Issues Relevant to Electronic Commerce*, Tax Analysts, State Tax Today, *supra*.
[125] *Department of Revenue v. ABC Manufacturing Co*., No. IT 01-3, Apr 16, 200.
[126] See Ware. v. United States, 850 F. Supp. 602 (W.D. Mich., 1994), aff'd, 67 F.3d 574 (6th Cir. 1995); Rev. Rul. 87-41, 1987-23.

The court explained that in order to qualify as an independent contractor for purposes of P.L. 86-272, the independent contractor must present themselves to the world as an independent contractors and not hide that independent status or masquerade as an employee or division of the principal.

In this case the court found that ABC Supply's sales representatives told customers that they were from ABC or its subsidiaries, the receptionist at ABC Supply answered the phone with the name of ABC Manufacturing and that ABC Supply listed its phone number under the name of ABC Manufacturing.

In *Wisconsin Department of Revenue v. William Wrigley, Jr*., Co. (1992) 505 U.S. 214, the Supreme Court identified the activities protected by P.L. 86-272, as solicitation, those activities entirely ancillary to solicitation and de minimus activities. Because the activities related to customer complaints were neither solicitation nor ancillary to solicitation, the court held that the manner by which ABC Supply's sales representatives handled customer complaints exceeded protection as an independent contractor under P.L. 86-272. [127]

When Does Nexus Start; When Does Nexus End?

What is the effect upon a taxpayer who has nexus in California, but then withdraws or leaves the state in midyear?

Assuming that constitutional nexus exits, and there is no immunity from state taxation afforded by the provisions of P.L. 86-272 then California would assert its right to tax only for the time that tax nexus exists, i.e., California would treat activities occurring outside the nexus period, i.e., pre and post the time of nexus as not constitutionally reachable in accordance with *National Bellas Hess, Complete Auto Transit* and *Quill.*

By way of comparison, with respect to P.L. 86-272, immunity under the federal statute exists, if at all, for the entire taxable year. Thus, if the taxpayer has continuous constitutional nexus, but begins the year engaging only in protected activity, if there is any act later in the year that is not ancillary to solicitation and not de minimus (as per *Wrigley*), which exceeds federal statutory immunity, immunity is lost for the whole year.

While substantial argument might occur on the question of when nexus ends, i.e. as to whether they include closing activities that keep the nexus link intact, the more onerous problem may be as to how to account for income or compute the apportionment factors.

P.L. 86-272 only applies to interstate commerce and does not apply to foreign commerce or to entities incorporated in the state. [128]

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[127] Tax Analysts, State Tax Today, *Illinois DOR Upholds Income Tax Against Corporation With Illinois Subsidiary, Department of Revenue v. ABC Manufacturing Co*., No. IT 01-3, STT 121-6, April 16, 2001.
[128] See *Appeal of Dresser Industries, Inc*. Cal. Std. Bd. of Equal., June 29, 1982.

The loss of P.L. 86-272 immunity in one year does not automatically carry over to a subsequent year. Immunity under P.L. 86-272 only applies to sellers of tangible personal property. Thus, activities related to sales of real estate or intangibles, leasing, renting, or licensing of property, the provision of services, or other transactions, not specifically protected by P.L. 86-272 will cause a loss of immunity.

P.L. 86-272 and Jurisdiction To Tax

For sales between the U.S. and a foreign country, the standard for determining whether a corporation is taxable is constitutional nexus, not P.L. 86-272. Although Regulation 25122(c) states that U.S. jurisdictional standards shall be applied to determine whether a foreign country has jurisdiction to subject a taxpayer to tax, the California State Board of Equalization has held that this refers to U.S. Constitutional nexus; jurisdictional limitations of P.L. 86-272 are not considered. See (*Appeal of Dresser Industries, Inc*., Cal. St. Bd. of Equal., June 29, 1982.)

If sales are made from California to a foreign destination, the relevant question is whether the taxpayer has constitutional nexus in the foreign country. If nexus is determined to be present, the sales may not be thrown back to the California sales factor numerator even if the taxpayer's activities within that country do not go beyond solicitation of orders for sales as per P.L. 86-272.

Conversely, if sales are made from a foreign country to a California destination, the sales will be included in the sales factor numerator as long as the taxpayer has constitutional nexus within California. P.L. 86-272 will not apply, and the taxpayer will be taxable on their California income regardless of whether their California activities exceed solicitation of orders.

Business Conducted Over the Internet

The Nature and Scope of the Internet

The Internet is a global network of computers and connections that use a common communications language. This language provides a common link that enables individual computer systems to interact with one another by way of Internet service providers (ISPs) such as America Online through the use of a combination of wired (telephone, local area network (LAN), or cable) and/or wireless technology. The ISPs, in turn, connect to the Internet "backbone." a large-capacity, high speed, telecommunications network. [129]

In terms of a market force, the Internet is becoming the largest commercial medium in the world. The growth rate of Web users and Internet purchasers far exceeds activity associated with any prior means of business. Today, the number of Internet users worldwide is estimated at 304 million, up from three million in 1994. [130]

Taken as a whole, electronic commerce in the U.S. grew 174.5 percent between 1995-1998, in contrast to an overall global economic growth rate of 3.8 percent.[131] In just five years the Internet economy rivals traditional sectors like energy ($223 billion), automobiles ($350 billion), and telecommunications ($270 billion).[132] Forecasts of business-to-business E-commerce range from $634 billion to $2.8 trillion by the year 2003.[133]

Should E-Commerce Be Taxed?

A vigorous debate is now in progress to ascertain whether states should be able to tax out-of-state Internet sellers.[134] Some, such as California Equalization Board, former chair and current member, the Honorable Dean Andal, contend that Internet commerce should not be taxed. At least one writer has expressed an opposing point of view, "if the Internet is," in Ohio GOP Rep. John Kasich,'s words, "the single largest contributor to

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[129] Legislative Analyst's Office, *California Tax Policy And the Internet*, January 31, 2000.
[130] Anderson & Monzingo, *Taxing Electronic Commerce*, Tax Analysts, State Tax Notes, Vol. 20, No. 7, February 12, 2001, p. 521 citing U.S. Dept. of Commerce, Economics and Statistics Administration, Digital Economy 2000, p.iv, June, 2000.
[131] Anderson & Monzingo, *Taxing Electronic Commerce*, Tax Analysts, State Tax Notes, Vol. 20, No. 7, February 12, 2001, p. 521 citing Barua, Anitest; Jon Pinnell, Jay Shutter, and Andrew B. Whinston, *Measuring the Internet Economy: An Exploratory Study*, pp.3-5, Center for Research in Electronic Commerce, Graduate School of Business, The University of Texas at Austin, June 10, 1999.
[132] *Ibid*.
[133] Anderson & Monzingo, *Taxing Electronic Commerce*, Tax Analysts, State Tax Notes, Vol. 20, No. 7, February 12, 2001, p. 521 citing U.S. Dept. of Commerce, *supra*.
[134] Exemptions relating to the collection of sales and use tax of course is not knew, at it extends back to the exemption of mail order vendors. See Stross, *Digital Domain, A gift for the Internet, Why Should Mallgoers Foot the Bill for Web Shoppers?* U.S. News & World Report, December 18, 2000, p. 49.

our economic prosperity, why is it so delicate that [its taxation] would be a prosperity-threatening drag?"[135] Congress is now studying the matter.

While the regulation of interstate commerce remains within the exclusive domain of congress, the failure to legislate results in varying state tax outcomes. The analysis concerning the taxation of E-commerce begins with the notion that the states' attempt to tax interest commerce is restricted by the due process and commerce clause.

E-Commerce and Due Process

Due process requires some minimum contacts with the state and that in-state activity must be sufficient such that the state can reasonably expect a return by exacting a tax.[136]

The due process clause requires proof of either systematic contact with the state or minimum contacts. With respect to minimum contacts with the state, in the case of electronic commerce, the out-of-state vendor may have no greater association with the state than what arises from a Web site accessible by residents. Would that be sufficient to satisfy the due process test? Additional questions include those raised by Anderson and Monzingo in their article, *Taxing Electronic Commerce.* [137] Does posting an internationally accessible Web site amount to systematic direction into a particular state market? What about a retailer who mails catalogs on request to potential customers who have accessed and researched a manufacturer's Web site? Has the retailer met the due process clause test by mailing the catalogs? Can Internet kiosks in malls that access manufacturers' Web sites and then locate remote retailers who carry the manufacturer's products create due process nexus for the E-commerce seller? [138] Does Internet advertising directed to global consumers, but not to any specific location more than another satisfy the due process clause? [139]

The South Carolina Supreme Court found in *Geoffery* that the taxpayer had "purposely directed" its business activities to South Carolina because it had given consent to and had control over the use of the trade rights in the state. One might argue that a similar occurrence arises from use of a Web site where consent and control arises from

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[135] The quotation concerned use and sales tax collection. See Stross, *Digital Domain, A gift for the Internet, Why Should Mallgoers Foot the Bill for Web Shoppers?* U.S. News & World Report, December 18, 2000, p. 49.

[136] Anderson & Monzingo, *Taxing Electronic Commerce*, Tax Analysts, State Tax Notes, Vol. 20, No. 7, February 12, 2001, p. 521.

[137] *Ibid*.

[138] If physical presence were the standard applicable for income/franchise taxes, one could argue that the kiosk constitutes a satisfactory presence even if rented or leased or provided by a third party (See *Scripto*).

[139] Consider *Good's Furniture House, Inc., v. Iowa* (1986) 382 N.W.2d 145, "We conclude that the *Miller Brothers* nexus test, as refined by … later Supreme Court cases, was satisfied by … showing that Good's Furniture directly solicited a large volume of Iowa sales by intensive television advertising, then regularly serviced its Iowa customers by delivering merchandise in its own trucks with its own employees. "

allowing the electronically posted material to be accessible with the knowledge of where it is reasonable to expect that one would know that it will be accessed by those in-state.

The *Geoffrey* court also found the "presence" of intangibles in South Carolina, on the basis that the intangibles (the trade rights and the accounts receivable from the exercise of those rights) had acquired a "business situs" in the state. In so holding, the court relied upon the principle that an intangible can acquire a business situs in a state if it has become part of a local business conducted within the state. (See *Southern Express Co. v. Spigener* (1920) 188 S.C. 413.) One may argue that *Geoffrey* may therefore support establishment of due process on the basis that E-commerce that involves the sale of intangibles, such as digitized data constitutes an adequate in-state presence for purposes of the due process clause. One may argue that where *Geoffrey* was concerned about in-state presence, the *Pavlovich* case, below, establishes that for due process purposes, maintenance of a Web site gives rise to in-state presence at the point where accessed.

Matthew Pavlovich, Petitioner, v. The Superior Court Of Santa Clara County, Respondent; DVD Copy Control Association, Inc., Real Party in Interest (2001) 109 Cal. Rptr. 2d 909, decided August 7, 2001, presented the question of whether California could, consistent with the due process clause of the U.S. Constitution, assert its personal jurisdiction over an out-of-state provider of Internet services who was not, "physically present" in California.

While it is true that the principal subject of the case dealt with state jurisdiction with respect to the filing a law suit, after *Quill*, the Supreme Court has analyzed the first prong of constitutional tax nexus or analysis of due process, in a way that is consistent with due process analysis in the area of personal jurisdiction. So even though not a tax case, the appellate court's analysis is appropriate with respect to nexus due process. At least to the extent of personal jurisdiction for purposes of filing a law suit, this case addressed the cutting edge issue of whether California's long arm statute can, consistent with the due process clause reach one who's sole contact with the state is the maintenance of a Web site accessible in-state. The California appellate court held that California could assert personal jurisdiction. [140]

Pavlovich was a computer-engineering student and experienced as a computer technician who resided in Texas. He along with others allegedly developed computer programs intended to defeat DVD encryption copy protection systems, used to protect copyrighted motion pictures.

Pavlovich operated a technology firm to allegedly "pirate" copyrighted DVD films in violation of California's state copyright law. Pavlovich also owned and operated a Web site where he posted his program.

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[140] See Giordani, *California Copyright Law Can Apply in Internet Case*, *Appeals Court Rules*, The Recorder, http://www.law.com, as of August 7, 11:02 pm EST.

When sued for copyright infringement, Pavlovich contended that California's personal jurisdiction long arm statutes could not reach him because he was not physically present in the state and so he could not be sued for what was alleged to be trade secret theft and copyright infringement in California.

The California Sixth District Court of Appeals unanimously ruled that, Pavlovich, "*knew, or should have known,* that the DVD republishing and distribution activities he was illegally *doing and allowing to be done through the use of his Web site*, while *benefiting him*, [was additionally] injuriously affecting the motion picture and computer industries in California." (Emphasis added)

The court ruled that the plaintiff's Internet activities subjected him to California jurisdiction because, "**Instant access** provided by the Internet is the **functional equivalent** of **personal presence of the person posting the material on the Web at the place from which the posted material is accessed and appropriated**." "It is as if the poster is instantaneously present in different places at the same time, and simultaneously delivering his material at those different places." (Emphasis added)

The court was not encumbered by the new age nature of Web technology that gave rise to the controversy. In order to resolve the seemingly novel problem presented by cutting age technology, the court noted that, "The Internet, …is new, but the rules governing the protection of property rights, and how that protection may be enforced under the new technology, need not be. There is, for instance, sufficient guidance provided by the United States Supreme Court in *Calder v. Jones* (1984) 465 U.S. 783 [104 S. Ct. 1482, 79 L. Ed. 2d 804].

With respect to due process concerns, the *Calder* court stated: "The Due Process Clause of the Fourteenth Amendment to the United States Constitution permits personal jurisdiction over a defendant in any State with which the defendant has 'certain minimum contacts . . . such that the maintenance of the suit does not offend "traditional notions of fair play and substantial justice." [Citation.]' [Citation.] *In judging minimum contacts, a court properly focuses on 'the relationship among the defendant, the forum, and the litigation*.' [Citations.] *The plaintiff's lack of 'contacts' will not defeat otherwise proper jurisdiction*, [citation], but they may be so manifest as to permit jurisdiction when it would not exist in their absence." (*Calder, supra,* 465 U.S. at p. 788.) " (Emphasis added).

Thus, for purposes of due process analysis and meeting the Supreme Court test of minimum contacts, the focus was upon the *relationship* between the state and the actor and the *effects* of their out-of-state conduct in California, such that maintenance of the suit does not offend traditional notions of fair play and substantial justice.

"*Calder* concluded that California courts had personal jurisdiction over the defendants in Florida because defendants' "intentional conduct in Florida [was] calculated to cause injury to respondent in California." (*Calder, supra,* 465 U.S. at p. 791.)"

"Citing *Burger King Corp. v. Rudzewicz* (1985) 471 U.S. 462 [105 S. Ct. 2174, 85 L. Ed. 2d 528], Vons Companies, Inc. explained that a forum state may exercise specific jurisdiction over a nonresident who *purposefully avails* himself or herself of forum benefits "because the state has 'a "manifest interest" in providing its residents with a convenient forum for redressing injuries inflicted by out-of-state actors. [Citations.] Moreover, where individuals "*purposely derive benefit*" from their interstate activities [citation] it may well be *unfair to allow them to escape having to account* in other States for consequences that arise proximately from such activities.' [Citation.] Further, 'because "modern transportation and communications have made it much less burdensome for a party sued to defend himself in a State *where he engages in economic activity," it usually will not be unfair to subject him to the burdens of litigating in another forum for disputes relating to such activity*.' [Citation.]" (*Vons Companies, Inc*., *supra*, 14 Cal. 4th at p. 447.) " (Emphasis added.)

"Here, the plaintiff was a computer engineering student, a technician in the computer and telecommunications industry, and the founder and president of a start-up technology company, knew that California is commonly known as the center of the motion picture industry, and that the computer industry holds a commanding presence in the state." " Because the plaintiff knew that California is commonly known as the center of the movie industry, and knew that Silicon Valley in California is one of the top three technology "hot spots" in the country, he knew, or should have known, that the DVD republishing and distribution activities he was illegally doing and allowing to be done through the use of his Web site, while benefiting him, were injuriously affecting the motion picture and computer industries in California*. The question is whether the plaintiff's lack of physical and personal presence in California incapacitates California courts from jurisdictionally reaching him through its long-arm statute*. We hold it does not.[141] (Emphasis added.)

"Instant access provided by the Internet is the *functional equivalent of personal presence* of the person posting the material on the Web *at the place from which the posted material is accessed* and appropriated. It is as if the poster is instantaneously present in different places at the same time, and simultaneously delivering his material at those different places. In a sense, therefore, the reach of the Internet is also the reach of the extension of the poster's presence." (Emphasis added.)

"The plaintiff cannot claim innocent intent. As a computer engineering student, a technician in the computer and telecommunications industry, a founder and president of a technology start-up company, and a leader in the "open source" movement, the plaintiff knew, or should have known, that by posting the misappropriated information on the Internet, he was making the information available to a wide range of Internet users and consumers throughout the Internet world, including users and consumers in California."

[141] Some may argue that despite the due process holding, it is difficult to say that the court found actual physical presence in the state, assuming that to be the applicable standard for income/franchise tax.

Admittedly, outcomes vary.[142]

In *Martiz Inc. v. CyberGold*, *Inc*. 947 F. Supp. 1328 (E.D. Mo. 1966), the court found that maintenance of a Web site was sufficient to pass the due process jurisdiction test.

In *Bensusan Restaurant Corp. v. King* 937 F. Supp. 295 (S.D.N.Y. 1966) the court required more than *Martiz*, where merely creating a Web site was deemed no more than simply placing an item in the stream of commerce, and not an act considered purposefully directed toward the forum state.

While most writers would agree that in ordinary course of nexus analysis the due process threshold does not require very much, it may prove to be the lynchpin in state taxation of remote sellers in that while Congress may overrule, modify or amend *Quill's* commerce clause findings, it may not do so with respect to the due process clause. (*Quill* 504 U.S. at 318.)

One could argue that with respect to E-commerce due process, the focus is on the relationship between the taxpayer and the state. The taxpayer has in choosing to use a Web site engaged in substantial, continuous and systematic contact with the state which he knows or should know will result in that in-state contact that the taxpayer will substantially benefit from.

E-Commerce and the Commerce Clause

Currently, some states take the position that economic presence alone is sufficient for tax nexus, on the basis that statements in *Quill* expressly limited its holding requiring physical presence, applied only to use taxes. Or, where some degree of presence is deemed needed, support comes from *Geoffrey* which held that the in-state presence of intangible property, such as accounts receivable or trademark licenses, is sufficient for imposing income taxes under the commerce clause. [143]

For discussion purposes, it could be said that Internet commerce involves three categories of taxpayers each of which engender nexus issues. Those categories include: (1) The primary information or access provider, (2) the secondary information provider, and (3) sellers of tangible personal property whose orders are solicited on line.

Primary information or access providers, are taxpayers who utilize the services of local and interstate telephone companies to provide access to their services or have other direct connection to receiving equipment at the customer's location. They typically own or rent equipment (modem connection points) in the consumer's state. Some primary information providers such as ISPs use local telephone companies for access to subscribers as well as own their own equipment (such as modem connection points or

[142] See White, Crafting A Neutral, Workable E-Commerce Consumption Tax, *Tax Analysts, State Tax Today,* 2001 STT 156-24 August 13, 2001.
[143] Anderson & Monzingo, *Taxing Electronic Commerce*, Tax Analysts, State Tax Notes, Vol. 20, No. 7, February 12, 2001, p. 521.

“nodes”) in the state. Would this arrangement be sufficient to establish nexus? One may argue that the continuous in-state presence of leased or rented property gives rise to the requisite physical presence. In opposition, others may argue that a satellite connection constitutes a nonphysical presence or that nexus may not arise from the third-party relationship.

Secondary information providers include providers of information or data utilizing the Internet or other electronic medium of a third party access provider (such as a cable television company or an Internet access provider) present similar nexus issues. By way of example, newspapers and magazines may be obtained online through primary providers such as America Online. Some subscription services are accessible only on the Internet. Also included in this category may be businesses that sell software. As to providers of information over the Internet through third parties (like cable television companies or ISPs), it may be said that they may not have any physical presence in the state. Many of these businesses would have no direct physical presence and the state would have to rely on more uncertain, nonphysical presence in order to assert nexus. [144]

Once again, one may argue that the presence of dedicated tangible property in the state confers basic tax nexus, because the taxpayer has a continuous physical presence in the state. However, in those cases where the information or access provider connects only through satellite communication, and a third party or the customer owns the receiving equipment, an argument can be made that taxation is predicated upon nonphysical presence or the taxpayer is not present whatsoever.

With respect to sellers of tangible personal property, where orders are solicited through the Internet, and the goods are shipped from a point outside of the state, contact via the Internet through a computer and modem is not dissimilar from contact with a customer by voice telephone or the U.S. Mail. This class of taxpayer would presumably be protected by the provisions of P.L. 86-272, where activity within the state is limited to solicitation. Even if a physical connection could be imputed through the information provider, protection would still lie under the independent contractor "carve out" rule of the federal statute.

Admittedly, not all reasonable minds are in accord. Consider the following.

Universal Music Group digitizes its copyrighted catalog of music and stores the catalog with a third party for distribution over the Internet. This music is delivered electronically in digital form and stored on customers' computer hard drives. Customers play the music on their computers, although they are unable to copy the music onto compact discs. Based upon a previous determination that receipts from the electronic transfer of digital photographic images over the Internet represent receipts from the sale of an intangible, the New York Department of Taxation and Finance has ruled that the sale of

[144] Legislative Analyst's Office, *California Tax Policy And the Internet*, January 31, 2000.

music delivered electronically over the Internet constitutes the sale of intangible property and is not subject to sales or use tax. [145]

[145] New York Tax Department, Internet Music Sales Not Taxable, Tax Analysts, State Tax Today, 2001 STT 114-23, April 18, 2001.

Pass-Through Entities

A state's jurisdiction to tax extends no less than to its own residents, and the property and activities located or arising within its boundaries. [146] May, a state constitutionally tax the income that is received by a non-resident owner of a pass-through-entity which engages in activity within the taxing state.

For the purposes of this discussion, consideration will be given to general and limited partnerships, S corporations and limited liability corporations (LLC).

Partnerships

In *Borden Chemicals and Plastics, L.P., v. Zehnder* (2000) 312 Ill.App.3d 35, the question was whether Illinois could constitutionally tax income earned by an in-state limited partnership operating in the state that was paid to an out-of-state corporate limited partner.

Plaintiff, Borden Chemicals, was a foreign limited partnership, which joined with an affiliated entity to form a limited partnership that operated in Illinois. Borden's only connection with the taxing state was its ownership of its limited partnership interest.

The Illinois court reiterated that there are two prongs to the due process test; there must be a minimum connection between the taxpayer and the taxing state, and the income attributed to the taxing entity must fairly reflect the taxpayer's activities in the taxing entity's jurisdiction.

With respect to the first prong, the court cited to *International Harvester* noting, "[It] has long been established that a state may tax income of a non-resident that is attributable to property or transactions in the forum state. (*International Harvester Co.* v. *Wisconsin Department of Taxation* (1944) 322 U.S. 435, 441-442) … "[p]ersonal presence within the state of the stockholder-taxpayers is not essential to the constitutional level of a tax taken out of so much of the corporation's Wisconsin earnings as it is distributed to them." (*International Harvester Co. v. Wisconsin Department of Taxation*, *supra*, 441). The Illinois court concluded from *International Harvester* that the state could constitutionally impose the tax, even as to nonresident stockholders, because the state had afforded "protections and benefits to appellants' … corporate activities and transactions within the state" and these activities gave "rise to the dividend income of appellants' stockholders." (*International Harvester Co. v. Wisconsin Department of Taxation, supra,* 442).

After the *Borden* court satisfied itself that the income attributed to a taxing body must fairly reflect the taxpayer's activities in the taxing authority's jurisdiction, based upon *International Harvester* and *J.C. Penny*, the court turned to the second prong of the due process test, or whether the plaintiff had the requisite minimum contacts with the taxing state.

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[146] *Shaffer v. Carter* (1920) 252 U.S. 37, 40 S.Ct. 221.

In evaluating the second prong of the due process test, the Illinois court considered the U.S. Supreme Court's ruling in *International Shoe Co. v. Washington* (1945) 326 U.S. 310. In determining whether a state may assert personal jurisdiction over a nonresident defendant, what the minimum contacts standard means depends on whether a state asserts general or specific jurisdiction over a nonresident defendant. While general jurisdiction, for personal jurisdiction purposes, applies to suits neither arising out of nor related to a nonresident defendant's contacts with the forum, and is permitted only where the defendant has continuous and systematic general business contacts with the forum, specific jurisdiction refers to personal jurisdiction in a suit arising out of or related to a defendant's contacts with the forum. (*Borden Chemicals and Plastics L.P., v. Zehnder* (2000) 312 Ill.App.3d 35, 41.)

The Illinois court determined that the issue of taxing a non-resident limited partner to be a question involving specific jurisdiction inasmuch as the tax is an attempt to assert personal jurisdiction related to the plaintiff's contacts with Illinois. In the court's view, the requisite minimum contacts needed to satisfy the second prong of the due process clause arose first from the plaintiff's connection to Illinois which arose from its partnership interest in the entity that availed itself of the laws of Illinois, and the receipt of distributable income that was earned instate. Illinois' assertion of jurisdiction over plaintiff for the sole purpose of taxing this distributive income arises out of plaintiff's contacts. As such, subjecting plaintiff to the replacement tax does not violate the due process clause. (*Borden Chemical and Plastics, L.P. v. Zehnder, supra*. 42.)

To ascertain if Illinois' attempt to tax the non-resident limited partner violated the commerce clause, the Illinois court looked to the test provided in *Complete Auto Transit*. In accordance with *Complete Auto*, in order to pass constitutional muster, the tax must be: (1) applied to an activity with a substantial nexus to the taxing state, (2) fairly apportioned, (3) not discriminate against interstate commerce, and (4) fairly related to the services provided to the state.

Borden agreed that: Illinois afforded protection and benefits to the operating partnership's activities and transactions within Illinois; that the services which the state provided helped give rise to the income distributed to the plaintiff; and that the activities of the operating partnership gave rise to substantial nexus with Illinois. However, citing to *Quill*, the plaintiff argued that *Complete Auto's* substantial nexus requirement must not only exist between the taxing state and the in-state operating partnership, but also the taxing state *and* the *non*-resident partners.

The Illinois court disagreed distinguished *Quill* factually and declined to extend *Quill* to the tax Illinois sought to impose upon partnership income. Plaintiff's characterization of itself as a separate entity, to which substantial nexus between the partnership's activities and Illinois did not apply, for taxation purposes, is "meritless." Plaintiff failed to cite any case that applied the *Complete Auto* test to bar a state from taxing the distributable income of a nonresident limited partner of a partnership that is physically present in Illinois, operates in Illinois, and whose activities undisputedly have a

substantial nexus to the taxing state. The Illinois court held that the tax is valid under the commerce clause. (*Borden Chemicals and Plastics, L.P., v. Zehnder, supra*, 45.)

Limited Partnerships

The California Board of Equalization addressed the matter of the imposition of the Franchise Tax on non-resident partners in the *Appeals of Amman & Schmid Finanz*, 96-SBE-008, April 11, 1996.

This however, was a case involving limited partners. The appellants argued that non-resident corporate limited partners could not be deemed to be "doing business" in California within the meaning of §23151, and thus should not be charged California's minimum franchise tax.

The Board found from the facts presented, that the corporate limited partner's only contact with California was its investment in the limited partnership that conducted business in the state, and that this alone did not constitute "doing business" in California for purposes of imposing the minimum franchise tax. The Board concluded that doing business means actively engaging in any transaction for the purpose of financial or pecuniary gain or profit (§23101.) The Board focused on the word "actively" in the statutory definition of "doing business" and was of the opinion that by definition, a limited partner could not be actively involved in a limited partnership, but would instead be passive.

S Corporations

The question of the taxation of non-resident S corporation shareholders was raised in the case of *Agley, et al. v. Tracy* (1999) 87 Ohio St. 3d 265.

The non-resident shareholders advanced four arguments in support of their contention that as non-residents, the state of Ohio could not constitutionally tax their distributive share of S corporation income. [147]

First, plaintiffs claimed that it was the S corporation operating in Ohio, not the shareholder that earns the income, which the state should tax. Second, the non-resident shareholder plaintiffs did not themselves have substantial nexus with Ohio in violation of their due process rights. Third, provisions of P.L. 86-272 provided the non-resident shareholders immunity from state tax. Fourth, the distributive share of an S corporation's income constitutes nonbusiness income to the shareholder, which should only be subject to tax by the state of residence of the non-resident shareholder.

[147] Nomenclature addressing flow through income varies. In Ohio, S corporation flow through income is labeled as a, "distributive share." For federal income tax purposes, the reference to "distributive share" is used for partnerships and "pro rata share" for S corporations.

The Ohio Supreme Court did not agree that there was a difference in the income earned by the S corporation and that received by the shareholder. An attempt to draw a distinction ignores the flow-through nature of an S corporation. The court noted that it previously dealt with this issue in *Dupee, et al. v. Tracy* (1999) 85 Ohio St. 3d 350. In *Dupee*, the court ruled consistent with the language of Internal Revenue Code section 1366 which provides that the character of any item included in a shareholder's pro rata share shall be determined as if such item were realized directly from the source from which realized by the corporation, or incurred in the same manner as incurred by the corporation. Thus, the court concluded that the shareholder's flow-through income is treated the same as that of the corporation without regard to whether the shareholders are residents or nonresidents.

The court noted that substantial nexus is the test applied with respect to the commerce clause. The plaintiffs' contention that Ohio's attempt to tax them would violate their due process rights because as non-residents, they did not themselves have substantial nexus with Ohio misapplies the requisite test. Due process requires some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax. (*Miller Bros. Co. v. Maryland* (1954) 347 U.S. 340.) Quoting from its decision in *Couchot v. State Lottery Comm*. (1996) 74 Ohio St. 3d 417, 422, the Ohio Supreme court stated: "[T]he determination of state taxing power generally involves the flexible application of several factors, such as the state's power, dominion, or control over that which it seeks to tax; the benefits, protections and opportunities afforded by the state; and the social and governmental costs incurred by the state. (*Agley, et al. v. Tracy* (1999) 87 Ohio St. 3d 265, 266-267.) Since the appellants admitted that their S corporations conducted business in Ohio, the court found that, "… it is evident that the S corporations … utilized the protections and benefits of Ohio by carrying on business here. …Thus, … appellants, through their S corporations have also availed themselves of Ohio's benefits, protections, and opportunities by earning income in Ohio through their respective S corporations. We find that this provides Ohio the 'minimum contacts' with appellants to justify taxing appellants on their distributive share on income. (*Agley, et al. v. Tracy*, supra, 267.)

The court did not agree that the non-resident S corporation shareholders were immune from state taxation by virtue of P.L. 86-272. Although S corporations are pass-through entities for purpose of taxation the corporation is an entity which is separate and apart from the individuals who compose it; it is a legal fiction for the purpose of doing business. Thus, the court held that it is the S corporation's business activity in Ohio that is dispositive as to whether P.L. 86-272, precludes taxation of the S corporation and not the appellants' personal activity. Because the S corporations conducted business activities that exceeded mere solicitation, immunity under P.L. 86-272 was lost. (*Agley et al. v. Commissioner* (1999) 87 Ohio St. 3d 265, 268.)

The court also disagreed that the distributive share of the income should be deemed non-business income and sourced to the state of their domicile. Citing to Section 1366(b), Title 26, U.S. Code, the character of the item distributed to a shareholder is to be determined as if the item were realized from the source from which the corporation

realized the item. Thus, business income generated by an S corporation retains its status as business income as it passes through to the shareholders. (*Agley et al. v. Commissioner*, supra, 268.)

The State Board of Equalization addressed the taxation of a nonresident shareholder of an S corporation that conducted business in California In the *Appeal of John Manter*, 99-SBE-008, December 9, 1999.

The nonresident shareholder claimed that the income passed through from the S corporation was sourced based upon where the owner resided and not to where the corporation conducted business.

Absent California statute addressing the sourcing of S corporation pro rata share income, the Board concluded that it was the intent of our legislature to tax pro rata share income received by nonresidents. The conclusion was based upon various laws such as those relating to the withholding for nonresident shareholders by the S corporation on the California source income and composite returns to be filed by nonresident S corporation shareholders and rules relating to partnerships, which treated pass-through entities similarly. Partnership interests are intangible property just as is the case in an S corporation, yet the pass-through partnership income is sourced under the California regulations based upon the partnership income, not the residence or domicile of the partner. The Board stated that it was "confident that the Legislature intended the same rule to apply in the case of S corporations."

The issue as to whether California could tax California source income of an S corporation, passed through to a nonresident was again raised in California in *Valentino v. Franchise Tax Board*, California Court of Appeal, Fourth Appellate District, Division One, No. D036034, March 23, 2001.

The Valentinos were residents of Florida and owned stock in Cellular 2000, a Delaware corporation that was qualified to do business in California. Cellular 2000 did business in California, was taxed as an S corporation for both federal and California tax purposes and paid California franchise tax on its income derived from sources within this state.

The Valentinos argued that, because they were not California residents, they were not obliged to pay tax on income derived from the stock of a foreign S corporation that did business in the state unless the stock acquired a business situs in California.

The court found that California source income of an S corporation, which passed through to a nonresident shareholder is subject to California tax. The court determined that the California legislature intended that the source of S corporation pass-through income was to be determined by reference to corporate income producing activities and that the law is well settled that there is no constitutional bar to imposing the tax.

The court considered the pass-through nature of an S corporation, comparing it to a partnership, and various statutory provisions evidencing the legislature's intention to tax

non-resident shareholders on flow-through income sourced to California. The court noted that the character of a shareholder's pro rata share of S corporation income is determined as if the income were realized directly from the source from which realized by the corporation. Noting Internal Revenue Code section 1366(b), incorporated by reference into California law by Revenue and Taxation code section 23800, this rule known as the "conduit rule" and "was intended by Congress to be the same as the partnership rule."

Because of the "conduit rule," "[T]he Valentinos are treated as though they conducted business wholly within California in their individual capacitates. This attribution of business activity parallels the treatment of nonresident aliens as being engaged in a trade or business within the United States where the partnership of which such individual is a member is so engaged. Thus, an S corporation shareholder's income is characterized by reference to the corporate income producing activity and, once characterized, the items are then sourced to the particular sourcing rule applicable to each type of income.

The S corporation income as to the shareholder is characterized by reference to its character as to the corporation, not as income from stock. "[S]uch income is corporate income derived directly from corporate activities and passed through and taxed at the shareholder level as if the shareholder earned the income in his or her individual capacity." The shareholders' liability for the tax on their share of the S corporation income derived from California sources is a consequence of the decision to be taxed as an S corporation, rather than a C corporation, for California tax purposes.

Limited Liability Corporations

The Beverly-Killea Limited Liability Company Act of 1994 authorized the formation of Limited Liability Companies (LLCs) in California and recognized out-of-state LLCs doing business in California.

The LLC label is not dispositive of tax classification, which instead is a function of federal and California laws and regulations regarding the tax classification of business entities.

As of January 1, 1997, the tax classification of an LLC is a function of federal "check the box" action.[148] Because California conforms to federal law in this area, any valid election taken for federal purposes will be effective for California. [149]

Absent election as a corporation, a multiple member LLC is treated as a partnership and the separate existence of a single member LLC is disregarded for California franchise and income tax purposes. An LLC election to be classified as a corporation for federal

[148] If the LLC made a federal election to be taxed as a corporation, it may also elect to be treated as an S corporation.

[149] Except in very limited circumstances, the classification of an LLC for California income and franchise tax purposes must be the same as the classification for federal tax purposes.

and California tax purposes (whether a single member or a multiple member) does not alter the identity of the LLC for legal purposes (e.g. limited liability). It merely changes its classification for tax purposes. Thus, whether or not an election is made, the LLC *label or identity* of the entity will not change. It is only the *classification* of the LLC for tax purposes that is whether or not it elects to be treated as a corporation, which determines its tax obligations.

By specific statute, California does apply its Chapter 2 franchise tax to LLCs classified as corporations notwithstanding the fact that the franchise tax normally is only imposed upon traditional corporate entities, not entities such as associations that are otherwise taxed as corporations. The tax, fee and consent regime under California law for LLCs only applies to an LLC that is *not* classified as a corporation. Absent election as a corporation, the LLC has a California $800.00 annual tax if it is doing business in California or has articles of organization accepted, or a certificate of registration issued by the California Office of the Secretary of State. In addition, there is an LLC annual gross receipts type fee based on the LLC's total income from all sources reportable to California without regard to apportionment in an amount up to a maximum of nearly $12,000. [150] Where an entity other than an LLC is classified as an association taxable as a corporation for federal purposes, California imposes its Chapter 3 income tax.

Generally, an LLC is a federal "eligible entity." If the LLC is owned by a single entity, the separate existence of the LLC entity is disregarded in its entirety for California tax purposes (other than the LLC annual tax and fee). In that there is no separate entity of the single member LLC for tax purposes, the income, expenses, and property are treated as the income, expenses, and property of the owner. In the case of a single member that is an individual, the individual owner might reflect the activities of the LLC as a sole proprietorship. If the single member LLC owned property, the individual owner would be treated as the owner of the property for tax purposes. Because the LLC *entity* is disregarded, the individual does *not* receive any flow-through income.

At least one writer has raised several questions regarding state taxation of LLCs. [151] Do non-resident LLC members have a taxable presence in the state, if so, by virtue of what constitutional authority? Does LLC membership alone establish nexus? Is the LLC

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[150] See, Limited Liability Companies, Tax Information and Frequently asked Questions, www.ftb.ca.gov/forms/misc FTB form 3556, Tax Information for Limited Liability Companies (Rev. 3-2000). Governor Davis signed A.B. 898, enacting sections 17942, et al which eliminates annual adjustments in the fee. For taxable years beginning on or after January 1, 1997, an annual fee of $950.00 is payable where total income from all sources reportable to this state for the taxable year is $250,000.00 or more, but less than $500,000.00, $2,500.00 where total income is $500,000.00, but less than $1,000,000.00, $6,000.00 where total income is $1,000,000.00, but less than $5,000,000.00 and $11,790.00 where total income is $5,000,000.00 or more. In addition, for taxable years beginning on or after January 1, 2001, the definition of total income now excludes income paid to an LLC from another LLC that paid this fee. See section 17942 (6)(b)(1).

[151] KMPG, *Attention LLC Members: Is Nexus a Foregone Conclusion?* Perspectives in State and Local Taxation, Volume 2001-02, Spring 2001.

member "deemed present?" Is "presence" unnecessary if income is received from activities conducted within the taxing state?

For California purposes, the default tax treatment for single member LLC is that the LLC's separate existence is disregarded and the owner is treated as paying or incurring the expense, receiving or accruing the receipt, owning the property, etc. If the owner of a single member LLC conducting a trade or business is an individual, the individual is treated as a sole proprietorship. In that the LLC *entity* is *disregarded* it is deemed as though it does not exist and the income and activities are those of the single owner; there is no income to pass-through to the owner. For nexus purposes, the single owner is present and acting and earning California sourced income. In answer to nexus challenges, there is ample authority to find tax nexus based upon the facts that the business activity occurs in this state and the income derives from that in-state activity. There is no known case that would insulate an entity deemed operating in-state. Deemed present, attributional or representative nexus principles are not relevant. (See *Valentino*).

If the LLC is owned by two or more entities the federal and California "default" position is to treat the LLC for tax purposes as a partnership. As a partnership, income is computed at the partnership level and flows-through to the partners. The multiple owner LLC, as a partnership, is considered to act on behalf of its owners. The acts of the LLC classified as a partnership are attributed to its members, including the non-resident members. One could argue that nexus is established according to the partnership principles advanced above. (See *Valentino*).

Does taxing a non-resident LLC member violate provisions of the commerce clause? Can a member with no physical contacts in a state be treated as having substantial nexus merely by virtue of its ownership interest in an LLC?

The court in *Quill* stated unambiguously that the decision was limited to the collection of sales and use taxes; the court expressly provided that it did not review any other type of tax. There is no known case that requires physical presence for the constitutional application of business activity taxes to pass-through entities.

Although physical presence is not required, one could argue that substantial physical presence nexus exists as follows.

In the case of a single member LLC, where the LLC's separate existence is disregarded, the LLC entity is deemed to not exist, and the income and activities are therefore those of the single owner. For commerce clause nexus purposes, the single owner is present and acts and earns California source income sufficient to establish substantial nexus.

In the case were an LLC is owned by two or more entities, the LLC is treated for tax purposes as a partnership. The income flows through to the owner partners, the partnership is considered to act on behalf of and attributed to its owners including those,

which are non-residents. For commerce clause nexus purposes, one could argue that the pass-through convention of S corps and partnerships give rise to an imputation of instate activity which allows taxation of the income sourced here.

In either case, where the LLC conducts business in-state there is a presence sufficient to satisfy the commerce clause substantial presence requirement as a result of in-state income producing activity. There is no constitutional bar on the power of a state to tax income from property located within its borders. (*Shaffer v. Carter* (1920) 252 U.S. 37; 40 S.Ct. 221; 64 L.Ed. 445).

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