

II. Clarifying Nexus Confusion

A. Nexus Background

i. Basic Facts

1. Before a state may force a seller of goods to collect lawfully imposed sales or use taxes, that state must establish that the seller has a sufficient connection to the taxing state.
2. That connection is referred to as “nexus,” and the sufficiency of the nexus between the taxing state and the seller has a constitutional dimension.
3. Generally speaking, nexus is an all or nothing test. Once nexus has been established it is deemed to continue until the taxpayer proves otherwise.
4. The activities that create nexus are different for income taxes than for sales and use taxes.

ii. Primary Constitutional Limitations

1. Under the Constitution, a state may only tax activities within its borders.
2. Therefore, the principal limitations on states’ jurisdiction to tax are federal constitutional limitations and federal statutory law.

3. Due Process Clause

a. US Constitution, Amendment XIV, Section 1

- i. “Nor shall any State deprive any person of life, liberty, or property, without due process of law...”
- ii. It requires a “minimum connection” between the taxing state and the out-of-state taxpayer.

- iii. The relevant inquiry is whether connections with a state are sufficient to enable the state to exercise power over the taxpayer.
- b. *Wisconsin v. J.C. Penney Co.*, 311 US 435 (1940)
 - i. “That test is whether property was taken without due process of law, or, if paraphrase we must, whether the taxing power exerted by the State bears fiscal relation to protection, opportunities and benefits given by the State. The simple but controlling question is whether the State has given anything for which it can ask return.”
- c. *Exxon Corp. v. Wisconsin Dept. of Revenue*, 447 US 207 (1980)
 - i. “The Due Process Clause of the Fourteenth Amendment imposes two requirements for such State taxation: a ‘minimal connection’ or ‘nexus’, between the interstate activities and the taxing State, and ‘a rational relationship between the income attributed to the State and the intrastate values of the enterprise’ ” (citing *Mobile Oil Corp. v. Commissioner of Taxes of Vermont*)
- d. *Allied-Signal, Inc. v. Director, Div. of Taxation*, 112 S. Ct. 2251 (1992)
 - i. “In the case of a tax on an activity, there must be a connection to the activity itself, rather than a connection only to the actor the State seeks to tax.

4. Commerce Clause

a. US Constitution, Art. I, Section 8, Cl. 3

- i. “The Congress shall have the power...To regulate commerce...among the several States...”
- ii. It requires a substantial nexus between the taxing state and the out-of-state taxpayer; the tax must be fairly apportioned; it must not discriminate against interstate commerce; and it must be fairly related to the services provided by the state.
- iii. To pass the discrimination prong, it must not facially discriminate, must not have discriminatory intent, and it must not unduly burden interstate or foreign commerce.

b. *Complete Auto Transit, Inc. v. Brady*, 430 US 274 (1977)

- i. Rejected the rule that a state tax on the “privilege of doing business” is per se unconstitutional when it is applied to interstate commerce and overruled the case that announced that rule, *Spector Motor Service, Inc. v. O'Connor*, 340 US 602 (1951).
- ii. Articulated a four-part test that must be satisfied for a tax not to violate the Interstate Commerce Clause.

1. The tax must be applied to an activity with a substantial nexus with the taxing state
2. The tax must be fairly apportioned
3. The tax must not discriminate against interstate commerce
4. The tax must be fairly related to the services provided by the state

5. Public Law 86-272

- a. Prohibits the imposition of a net income tax on an out-of-state seller of:
 - i. Tangible personal property
 - ii. Solicitation of orders
 - iii. Acceptance outside of state
 - iv. Shipment or delivery from outside of state

(It is therefore inapplicable in the sales tax context.)

iii. Determination of Nexus

1. The only truly protected business: pure mail order sellers that only use mail, telephone and common carriers to communicate with its customers in the state.
2. Separate corporations are usually respected for sales tax purposes as long as:
 - a. Corporate formalities are followed.
 - b. Intercompany transactions are at arm's length.
 - c. In-state corporation does not act as agent for out-of-state corporation.
3. A company is generally required to collect sales/use tax if it:

- a. Owns or leases real property or tangible personal property in the state;
- b. Maintains a business location or inventory in the state;
- c. Has a resident or non-resident employee working in the state, regardless of frequency;
- d. Uses its own trucks and personnel to make regular deliveries to the state;
- e. Uses independent contactors or other agents to perform services or solicit sales on its behalf in the state.

iv. Emerging Nexus Theories

- 1. States are trying to expand their taxing jurisdiction to bring in companies that systematically exploit their market. Some examples include:
 - a. Amazon Nexus
 - b. Affiliate Nexus
 - c. Agent Nexus

B. In *Quill Corp v. North Dakota*, 504 U.S. 298 (1992), the United States Supreme Court clarified the role of nexus in challenging the imposition of a state tax by distinguishing between Due Process and Commerce Clause requirements.

- i. The question presented in *Quill* was whether an out-of-state mail order seller with no physical presence in the taxing state who merely mails catalogs into the state and fills orders by U.S. mail or common carrier is subject to a use tax collection responsibility in the destination state.

1. Quill was a Delaware corporation with offices and warehouses in Illinois, California and Georgia.
 2. None of its employees worked or resided in North Dakota, and its ownership of tangible property in North Dakota was either insignificant or nonexistent.
 3. Quill sold office equipment and supplies; it solicited business through catalogs and flyers, advertisements in national periodicals, and telephone calls.
 4. Its annual national sales exceeded \$200 million, of which almost \$1 million were made to about 3,000 customers in North Dakota.
 5. Quill delivered all of its merchandise to its North Dakota customers by mail or common carrier from out-of-state locations.
- ii. The state argued that the nexus requirements of the Due Process and Commerce Clause were equivalent, and that because the Due Process “minimum connection” test had been met, so too had the Commerce Clause requirements.
 - iii. The Court disagreed, noting that despite the similarity in phrasing, the nexus requirements of the Due Process and Commerce Clauses differ and are “animated by different constitutional concerns and policies.”
 1. In the Court’s view, the Commerce Clause requires a “substantial nexus”, while the Due Process Clause’s “minimum contacts” test requires something less.
 2. The Court explained that Due Process is concerned with the fundamental fairness of governmental activity and looks to whether an individual’s connections with a state are

substantial enough to legitimize the state's exercise of power over him.

3. Unlike the Due Process Clause, however, the Commerce Clause is a means of limiting state burdens on interstate commerce. Therefore, 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.
4. In other words, if an out-of-state corporation purposefully avails itself of the economic market and subjecting the corporation to its taxing jurisdiction does not offend traditional notions of substantial justice, then nexus sufficient to satisfy Due Process exists.
5. However, *Quill's* holding concerning use tax collections was that "substantial nexus" under the Commerce Clause requires something more than "minimum contacts;" it requires "physical presence."

C. In *Geoffrey, Inc. v. Commissioner of Revenue*, South Carolina sought to tax the income of Geoffrey, a company neither located in nor doing business in the state. The only contact with the state was through its royalty license with its affiliate, Toys "R" Us.

i. Background of Geoffrey

1. Geoffrey was a wholly owned subsidiary of Toys "R" Us. Toys "R" Us transferred its trademarks to Geoffrey. Geoffrey licensed the trademarks back to Toys "R" Us in exchange for a royalty. Geoffrey had no employees, offices or tangible personal property in South Carolina. Royalties

were measured by Toys “R” Us’ South Carolina stores’ sales.

ii. Court’s Decision in Geoffrey

1. The court rejected physical presence as a prerequisite for Commerce Clause nexus. Instead, it held that economic exploitation of a marketplace was sufficient to establish nexus.

a. Under the Due Process Clause, purposeful direction is all that is required. Physical presence is not required; presence of intangibles in the state is sufficient.

b. Under the Commerce Clause, the court concluded that it was “well settled that the taxpayer need not have a tangible physical presence in a state for income to be taxable there.”

iii. Reconciling Geoffrey and Quill

1. If Quill is viewed as tax and industry specific, rooted in *stare decisis* and reliance, Geoffrey may very well be consistent with Quill.

2. On the other hand, if Quill is viewed as stating a general rule of physical presence for purposes of taxing jurisdiction under the Commerce Clause, Quill and Geoffrey cannot be reconciled.

3. State judiciaries and taxing authorities are split on whether to follow Geoffrey.

iv. States’ Reactions to Geoffrey

1. *Cerro Copper Products* (Alabama) extended the bright-line physical presence standard to net income taxes.

2. *Guardian Industries* (Michigan) held that “substantial nexus is equated with physical presence, without regard to whether the levy is an excise tax or an income tax.”
3. *J.C. Penney Nat’l Bank* (Tennessee) extended Quill’s bright-line physical presence rule to income taxes. But *American Online* held that *J.C. Penney* should not be read to have adopted “a bright-line test of requiring . . . ‘physical presence’” to have a substantial nexus.
4. *Syl, Inc. v. Comptroller* (Maryland) did not extend Quill’s bright-line physical presence test to other types of taxes.
5. *Bandag Licensing Corp.* (Texas) held the Quill physical presence test applies to all taxes, not just sales and use taxes.
6. *A & F Trademark* (North Carolina) held that Quill’s test does not extend to net income taxes.
7. *Lanco* (New Jersey) held that Quill’s physical presence rule only applies to income taxes.
8. *MBNA America Bank* (West Virginia) held that Quill’s physical presence rule only applies to income taxes.

D. Economic Presence vs. Physical Presence

i. Background on Economic Nexus:

1. Under *Quill*, a business has nexus and is therefore taxable only if it has a physical presence in the state. Businesses that make significant sales in the state without a physical presence are not taxed. This system has several serious consequences: it gives out-of-state businesses a competitive advantage over in-state businesses; the state loses a substantial amount of revenue; and some businesses that

benefit from the state's public structures do not pay for their maintenance.

2. In turn, many states have enacted an economic nexus standard for income tax purposes, meaning that if a business purposefully avails itself or takes advantage of a state's economy to produce income, it will be subject to tax by the state.

ii. States with Economic Nexus Standard For Income Tax

1. As of December 2009, the following states had formally adopted an economic nexus standard (via statute, regulation, or court determination): Alabama, Arizona, Arkansas, California, Connecticut, Florida, Idaho, Indiana, Iowa, Kentucky, Louisiana, Maryland, Massachusetts, Minnesota, New Hampshire, New York, New Jersey, New Mexico, North Carolina, Ohio, Oklahoma, Oregon, Pennsylvania, South Carolina, Tennessee, West Virginia, and Wisconsin.

iii. Affiliate-Nexus

1. Six states have enacted "affiliate-nexus" laws (AR, CA, CO, IL, SD & TX).
2. When does it apply?
 - a. It applies if an online company has an affiliation with a company doing business in the state whereby similar business names or sharing of in-state employees or facilities blur the separation of the two separate and distinct companies so much so that the marketplace is unable to differentiate the two.
3. When does nexus attach?

- a. Nexus attaches to an out-of-state entity if an in-state affiliate acts as an agent, representing the interests of its out-of-state principal/affiliate.
- 4. State Court Rulings in Favor of States Based on Agency Theory:
 - a. *The Readers Digest Association, Inc. v. Mahin*, 44 Ill.2d 354 (Ill. 1970).
 - b. *Scholastic Book Clubs, Inc. v. State Board of Equalization*, 207 Cal. App.3d 734 (1989).
- 5. State Rulings in Favor of Defendants Based on Independence of In-State Entity Argument:
 - a. *Mississippi State Tax Commission v. Bates*, 567 So.2d 190 (Miss. 1990).
 - b. *Pledger v. Troll Book Clubs*, 871 S.W.2d 389 (Ark. 1994)
 - c. *Troll Book Clubs, Inc. v. Tracy*, No. 92-z-590 (Ohio B.T.A. Aug. 19, 1994).
 - d. *Freedom Industries v. Tracy*, No. 92-X-597 (Ohio B.T.A. Dec. 12, 1994).

iv. Sales Tax Nexus Cases

- 1. In *Orvis* (NY 1995) and *Brown's Furniture* (IL 1996) the courts held that "substantial physical presence" was not necessary to establish nexus.
- 2. An in-state office was sufficient to establish nexus in the California case *National Geographic*. The presence of employees and the maintenance of advertising sales offices were sufficient to collect sales taxes on mail-order merchandise sales made in California, even though there

was no relationship between the physical presence and the “sale”.

3. In the Florida case *Share International*, the court ruled that sporadic physical presence was insufficient to establish nexus when a mail-order seller sold products at Florida seminars for three days a year.

E. Independent Contractors Issues

- i. States may be able to impute physical presence to a remote seller by showing that representatives of the seller (independent contractors or agents) operate on behalf of the seller within the taxing state. In such cases, the physical presence of the remote seller’s in-state representative is attributed to the remote seller, allowing the state to impose a sales tax collection obligation on that remote seller for sales into the taxing state.
- ii. Physical Presence by Attribution: Two US Supreme Court cases, *Scripto v. Carson* (1960) 362 U.S. 207, and *Tyler Pipe Industries v. Department of Revenue* (1987) 483 U.S. 232, illustrate the “physical presence by attribution” rule, which means that nexus can be created by the presence of independent contractors.
 1. In *Scripto*, the Court ruled that Florida was entitled to impose its use tax collection obligation on a Georgia retailer with no connection to Florida except for the independent contractors the retailer had hired to solicit sales on its behalf in Florida.
 - a. The Court concluded that although the jobbers were not regular employees, they did conduct continuous local solicitation in Florida on behalf of the

taxpayer, which established a sufficient nexus between the state and the taxpayer.

2. In *Tyler Pipe Line*, the Court ruled that nexus between an out-of-state retailer and the taxing state, Washington, was established by Tyler's use of an in-state sales representative whose in-state activities on behalf of Tyler were "significantly associated with [Tyler's] ability to establish and maintain a market in the state for the sales."

iii. Physical Presence by Delivery: While the Supreme Court (*Miller Bros.* 1954) held that delivery by independent contractors was not sufficient to establish nexus, Illinois courts have held that deliveries can establish nexus.

1. In *Brown's Furniture* (IL 1996), a Missouri store had nexus in Illinois because of the more than 90 deliveries per month by independent contractors into Illinois.
2. In *Town Crier* (Ill. App. Ct. 2000), a Wisconsin store had nexus in Illinois because they delivered one or more deliveries per month into Illinois.

F. Nexus Checklist

i. Holding Real and Tangible Personal Property in State Can Create Nexus

1. Does the company or its employees own, rent, lease, maintain or have the right to use tangible personal property, real property or an office or other establishment permanently or temporarily physically located in the state?
2. Examples which create nexus:
 - a. Repair shop, parts department or warehouse
 - b. Office equipment or fixtures of any kind

- c. Employment office or purchasing office
- d. Mobile office, in-home office or meeting place for directors
- e. Retail outlet
- f. Motor store
- g. Motor vehicles of any kind
- h. Telephone answering service
- i. Stock of goods
- j. Tools and dies at suppliers

ii. Business Activities Can Create Nexus

1. Does the company sell its products or services in the state?
2. Do agents, representatives, independent contractors, brokers or others acting on the company's behalf do any of the following: own, lease, use or maintain an in-state office or other establishment which is significantly associated with the company's ability to establish or maintain a market in the state?
3. Do employees, agents, representatives, independent contractors, or brokers conduct business activity in the state on the company's behalf? If yes, for how many days were the following activities performed in the state during the 12-month taxable year: 0, 1, 2 or more?
 - a. Physical contact with the state soliciting sales through employees, agents, representatives, independent contractors or others acting on their behalf.
 - b. Make repairs or provide maintenance or service to property sold or to be sold to Michigan customers.

- c. Collect on current or delinquent accounts through assignment or otherwise.
 - d. Install or supervise installation at or after shipment or delivery.
 - e. Conduct training for employees, agents, representatives, independent contractors, or brokers acting on the company's behalf.
 - f. Provide customers with any kind of technical assistance or service including, but not limited to, engineering assistance, design service, quality control, product inspections, or similar services.
 - g. Investigate, handle or assist in resolving customer complaints, other than mediating direct customer complaints when the sole purpose of such mediation is to ingratiate the sales personnel with the customer.
 - h. Provide consulting services.
 - i. Solicit, negotiate, or enter into franchising, licensing or similar agreements.
4. How are goods delivered to purchasers in the state?
- a. Common Carrier
 - b. Contract Carrier
 - c. Vehicles owned, leased, used or maintained by the company
 - d. By a Related Party
 - e. By a Representative
5. Examples which create nexus:
- a. Approve or accept purchase orders or credit checks

- b. Inspect dealer inventories, review customer displays and shelving or replace stale product
- c. Provide transportation services or provide shipping information and/or coordinate deliveries
- d. Conduct seminars or participate at a trade show at which orders for goods are taken or sales are made
- e. Perform managerial or research activities, or lease employment or personnel services
- f. Meet with customers to determine user satisfaction, or maintain display room or sample
- g. Pick up or replace damaged, defective or returned property, or repossess property
- h. Sell additional service contracts
- i. Perform computer data processing
- j. Provide private investigation, protection, patrol, watchman, or armored car services
- k. Perform other types of services than those listed