Jurisdiction and Nexus for State Tax Purposes
Agenda

- Scope and Goals
- Nexus Background
  - Due Process Clause
  - Commerce Clause
- Due Process Clause Revitalization?
- What Constitutes “Substantial Nexus”?
  - Attributional, “click through” and other
- When Does Nexus End?
- Emerging Trends
- P.L. 86-272
- Federal Legislation?
- Crystal Ball
Introduction

- **Imposition of State and Local Taxes Governed By:**
  - State laws, regulations and case law
    - State law can NEVER trump the U.S. Constitution (Regardless of how hard states try!)
  - U.S. Constitution as interpreted by the U.S. Supreme Court
What is Nexus?

- In the context of state and local tax imposition, it is the threshold relationship between the person and the state that is necessary to pass constitutional muster to support the imposition of a tax.
Federal Constitutional Limits on States’ Power to Tax

- **Due Process Clause, 14th Amendment:**
  - “[N]or shall any State deprive any person of life, liberty, or property, without due process of law…”
  - Requires “definite link” or a “minimum connection” between a state and the person, property or transaction it seeks to tax.
  - Income that is taxed “must be rationally related to values connected with the taxing state.”

- **Procedural vs. Substantive Due Process**
- **General vs. Specific Due Process Jurisdiction**
Federal Constitutional Limits on States’ Power to Tax

- **Due Process Clause – Revitalized?**
    - Foreign corporation is not subject to general personal jurisdiction on actions not arising out of or related to any contacts between it and the forum state, merely because other entities distribute in the forum state products placed in the stream of commerce by the defendant.
    - “The principal inquiry in cases of this sort is whether the defendant’s activities manifest an intention to submit to the power of a sovereign.”
Federal Constitutional Limits on States’ Power to Tax

- **Due Process Clause – Revitalized?**
    - The necessary relationship with the state “must arise out of contacts that the defendant himself creates with the forum”
    - Rejected Ninth Circuit’s agency theory, which would appear to subject foreign corporations to general jurisdiction whenever they have an in-state subsidiary or affiliate, “an outcome that would sweep beyond even the ‘sprawling view of general jurisdiction’ we rejected in Goodyear.”
Due Process Clause - Revitalized

  - Insurance company’s receipts of royalties from the licensing of intellectual property (IP) to its parent, which sublicensed the IP to restaurants nationwide, including Oklahoma, held insufficient to create nexus.
  - “[D]ue process is offended by Oklahoma’s attempt to tax an out of state corporation that has no contact with Oklahoma other than receiving payments from an Oklahoma taxpayer (Wendy’s International) who has a bona fide obligation to do so under a contract not made in Oklahoma.”
Due Process Clause - Revitalized

  - Receipt of royalties from the nationwide licensing of IP held insufficient to satisfy either “purposeful direction” under the Due Process Clause or “significant economic presence” under the Commerce Clause.
Federal Constitutional Limits on States’ Power to Tax

- Commerce Clause, U.S. Const., Article I, Section 8, Clause 3:
  - “The Congress shall have the power...to regulate commerce...among the several States...”

- The “Dormant” Commerce Clause:
  - The Court has interpreted the Commerce Clause to be both a positive grant of authority to Congress enact laws to regulate interstate commerce and a negative (dormant) limitation on states’ power to enact laws that create an undue burden on interstate commerce.
Federal Constitutional Limits on States’ Power to Tax

- **Complete Auto Transit Inc. v. Brady, 430 U.S. 274 (1977)**
  - Sets out a four prong test for determining whether a tax will pass Commerce Clause muster.
  - The tax must:
    - (i) be applied to an activity with a substantial nexus with the taxing State;
    - (ii) be fairly apportioned;
    - (iii) not discriminate against interstate commerce; and
    - (iv) be fairly related to the services provided by the state.
Federal Constitutional Limits on States’ Power to Tax

  - Upheld the physical presence requirement of *National Bellas Hess v. Illinois Department of Revenue*, 386 U.S. 753 (1967); responsibility for use tax collection at issue.
  - Quill solicited business from ND customers by telephone and catalog, delivered merchandise by common carrier, provided merchandise guarantees, held title to floppy diskettes in ND, and licensed computer software to ND customers.
  - Held that “substantial” nexus is required and that Quill’s activities did not meet the physical presence nexus standard. “Substantial nexus” requires that there be a physical presence, and that the presence be more than *de minimis*.
  - Stated that Congress can act if it wants to change the result.
States’ Reactions to *Quill*

- Some states have recognized that they must abide by the U.S. Constitution as interpreted by the U.S. Supreme Court:
    - “If the Taxpayer does not have sufficient nexus for sales and use tax purposes, which it clearly does not have under *Quill*, then it is incongruous that the Taxpayer would have ‘substantial nexus’ to be subject to Alabama’s franchise tax. As a practical matter, the same benefits of a bright-line, physical presence test cited in *Quill* . . . .would also apply equally to other types of taxes.”
States’ Reactions to *Quill*

- Some states have recognized that they must abide by the U.S. Constitution as interpreted by the U.S. Supreme Court (cont.):
Some states have limited *Quill* to sales and use tax and have accepted an “economic nexus” approach, using the following “rationales”:  
- The U.S. Supreme Court did not explicitly approve the same physical presence requirement in reviewing other types of taxes.  
- The world has changed.
States’ Reactions to *Quill*

- Decisions upholding states’ rejection of *Quill*:
    - Licensor of IP to related company was held to have nexus even though it lacked an in-State physical presence.
    - The “presence of intangible property alone is sufficient to establish nexus.”
    - Cited only pre-*Quill* due process cases.
    - Failure to prohibit use of the intellectual property in the state viewed as “purposeful direction.”
    - Economic exploitation of the South Carolina marketplace was enough to support jurisdiction for income tax purposes.
States’ Reactions to *Quill*

- Decisions upholding states’ rejection of Quill (cert. denied by U.S. Supreme Court):
  - *KFC v. Iowa Dep’t of Revenue*, 792 N.W.2d 308 (Iowa 2010)
States’ Reaction to *Quill*

- Possibility of U.S. Supreme Court interest in revisiting *Quill*: “[Quill] should be left in place only if a powerful showing can be made that its rationale is still correct. . . . The legal system should find an appropriate case for this Court to reexamine *Quill.*” *Direct Marketing Ass'n v. Brohl*, 135 S. Ct. 1124, 1135 (2015) (Kennedy, J., concurring).
States’ Reaction to Quill

- South Dakota
  - Enacted SB 106 on March 22, 2016, and effective May 1, 2016, with substantial legislator support, as a direct challenge to Quill.
  - Requires remote sellers to remit tax if either during the previous calendar year or the current calendar year: (i) the seller’s gross revenue from the sale of tangible personal property, any product transferred electronically, or services delivered into South Dakota exceeds $100,000; or (ii) the seller sold tangible personal property, any product transferred electronically, or services delivered into South Dakota in 200 or more separate transactions.
  - Provides for expedited judicial review of constitutionality of the law in the circuit court with direct review by the South Dakota Supreme Court.
  - Enforcement of SB 106 is “stayed” until its constitutionality is “clear established by a binding judgment, including, for example, a decision of the decision from the Supreme Court of the United States abrogating its existing doctrine, or a final judgment applicable to a particular taxpayer.”
  - Filing of a declaratory judgment will act as an injunction during the pendency of an action, and South Dakota will be prohibited from enforcing a sales tax remittance obligation, unless a taxpayer affirmatively consents or otherwise remits the tax voluntarily. No retroactive application of SB 106 is permitted.
State’s Reaction to Quill

- South Dakota (cont.)
  - South Dakota filed a declaratory judgment action in circuit court against Wayfair, Systemax, Overstock.com and Newegg, seeking a determination that SB 106 is constitutional and that it can require sellers to remit sales taxes even if they lack physical presence as long as they meet SB 106’s thresholds. *State of South Dakota v. Wayfair, Inc.*, 32 Civ. 16-__ (S.D. Cir. Ct., 6th Cir., filed Apr. 28, 2016). Complaint cites the “meteoric rise of Internet commerce” and the “absence of federal legislative process,” and Justice Kennedy’s comments in *Direct Marketing Association v. Brohl*, 135 S. Ct. 1124, 1134 (2015).
    - Removed by defendants to federal court; defendants’ motion for summary judgment and plaintiff’s motion to remand pending in federal court.
  - Two trade associations, American Catalog Mailers Association and NetChoice, filed a declaratory judgment action seeking a declaration that SB 106 violates the Commerce and Due Process Clauses of the U.S. Constitution. *American Catalog Mailers Association v. Gerlach*, 32 Civ. 16-__ (S.D. Cir. Ct., 6th Cir., filed Apr. 29, 2016).
State’s Reaction to Quill

- **Alabama**
  - Promulgated regulation 810-6-2-.90.03 imposing sales and use tax reporting and collecting obligations on out-of-state retailers without physical presence in Alabama if such retailer had at least $250,000 in retail sales of tangible personal property the prior calendar year.
  - Alabama Revenue Commissioner has said: “All sorts of things were constitutional or unconstitutional until they weren’t anymore. Sue us.” She also commented that “Why would we continue to work under an antiquated court ruling? Look how old Quill was.”
  - On June 6, 2016, Newegg filed suit in the Alabama Tax Tribunal challenging the regulation.
What Constitutes “Substantial Nexus”

- Multistate Tax Commission’s view (Draft Sales and Use Tax (“Engaging in Business”) Model (MTC July 22, 2015):
  - Cast in terms of “doing business” rather than nexus. Includes retailers that (1) maintain (directly or indirectly) an office, place of distribution, sales or sample room, warehouse or storage place or other place of business; (2) have employees; (3) have representatives, agents, salespersons or independent contractors “for the purpose of selling, delivering, installing, assembling, maintaining or repairing the retailer’s products, or taking orders for or otherwise establishing or maintaining a market [for tangible personal property and/or taxable services sold by the retailer]”; (4) owning or leasing real or tangible personal property; or (5) having a related party acting under an agreement with the retailer that owns or leases real or tangible property or performs services in connection with the solicitation of sales or uses trademarks, service marks or trade names that are similar to those used by the retailer.
  - Contains a “click through” provision, with a presumption that a retailer is doing business if it has commission arrangements generating more than $10,000 in the last 12 months.
  - Contains no de minimis provision and does not address trailing nexus.
What Constitutes “Substantial Nexus”

- National Conference of State Legislatures (NCSL)’s view (Jan. 20, 2016 call to action letter and proposed draft legislation)
  - Proposed legislation with the goal of “revisiting and reversing” Quill; expanding the definition of nexus to capture more businesses that would be required to collect sales tax; expand collection requirements to marketplace providers and expand reporting and registration requirements.
What Constitutes “Substantial Nexus”

- States’ views on what constitutes “substantial nexus” are not always consistent.
  - Remember to consider how “doing business” is defined, and whether there are any state carve outs for particular businesses or activities, e.g., delivery of paper for use by in-state printer, attendance at trade shows.
  - Some states appear to have ignore the concept de minimis non curat lex ("the law cares not for trifles"), which “is part of the established background of legal principles against which all enactments are adopted, and which all enactments (absent contrary indication) are deemed to accept.” Wisconsin Dep’t of Revenue v. William Wrigley Jr. Co., 505 U.S. 214 (1992).
What Constitutes “Substantial Nexus”

- Inconsistencies include:
  - Whether voluntarily registering to do business establishes nexus
  - The number of employee in-state days before nexus will be asserted
  - Whether there is “trailing” nexus
  - Whether driving a leased truck through the state or to make a delivery will constitute nexus
  - Whether a telecommuting employee will establish nexus
Attributional Nexus – Income Tax

  - Ten independent contractors soliciting business in Florida for a Georgia company were found to create nexus.

- **Tyler Pipe Indus., Inc. v. Washington Dep’t of Rev.**, 483 U.S. 232, 250 (1987)
  - The “crucial factor governing nexus” is whether the activities performed by the independent contractor on behalf of the out-of-state company are “significantly associated with the taxpayer’s ability to establish and maintain a market in [the] state for the sales.”
With increasing frequency, states resort to “attributional” nexus to justify their attempts to tax out-of-state entities.

Often used in separate reporting states.

- *Gore Enterprise Holdings, Inc. v. Comptroller of the Treasury*, 87 A.3d 1263 (Md. 2014)
- *Nordstrom, Inc. v. Comptroller of the Treasury*, Nos. 07-IN-00-0317, 07-IN-00-319 (Md. Tax Ct. 2010)
In 2002, the Multistate Tax Commission proposed a uniform state standard for determining corporate income and franchise tax. Under the proposal, “substantial factor presence” is established if any of the following three thresholds are exceeded in a particular state:
- $50,000 of property or 25% of a company’s total property;
- $50,000 of payroll or 25% of a company’s total payroll; or
- $500,000 of sales or 25% of a company’s total sales.

Several states have adopted factor presence nexus statutes.
Challenges to bright-line/factor presence nexus


- Companies are asserting that there is a Commerce Clause violation because neither the companies nor their representatives do any business in Ohio to establish a market in the state.

- Companies focused on Tyler Pipe, rather than Quill.

- Department based its theory of nexus, in part, on customers in Ohio accessing the company’s website from a computer or mobile device in the state, creating a “virtual” presence that was the “functional equivalent” of door-to-door salespeople making sales to Ohio customers.

- Argued before the Ohio Supreme Court on May 3, 2016.
Attributional Nexus – Sales Tax

- **Sales Tax**
  - *Scholastic Book Clubs* and *Troll* cases address whether in-state teachers provide Scholastic Book Clubs with nexus requiring the collection of sales tax.
    - Yes: Alabama, California, Connecticut, Kansas
    - No: Arkansas, Michigan, Ohio
  - *Dell* cases address whether third parties providing in-state warranty services establish sales tax nexus:
    - Yes: Louisiana, New Mexico
    - No: Connecticut
  - *BarnesandNoble.com* and *Borders Online* address whether in-state retail site provides nexus to Internet retail affiliate for sales tax purposes
    - Yes: California (Borders Online)
    - No: California (Barnesandnoble.com), Louisiana
Affiliate Nexus Provisions

- May focus on whether the affiliate contributes to maintaining an in-state market:
  - E.g.: Any person who has an affiliate in this state, if the person is related to the affiliate and if the affiliate uses facilities or employees in this state to advertise, promote, or facilitate the establishment of or market for sales of items by the related person to purchasers in this state or for providing services to the related person’s purchasers in this state, including accepting returns of purchases or resolving customer complaints. Wis. Stat. Ann. § 77.51(13g)(d).

- May focus on commonalities between in-state affiliate and the out-of-state retailer, such as common trademarks or tradenames.

“Click-Through Nexus”

- Presume that remote sellers have established nexus based on their agreements with third-parties resident “affiliate” in the state that refer customers to the remote seller via website link or other means and the “affiliate” receives compensation for the referral.
Other Legislative Attempts to Expand Sales Tax Nexus

- **Use tax notification provisions**
  - Require vendors to notify customers that the customers are required to report use tax

- **Marketplace facilitator provisions**
  - Would deem credit card or other payment facilitators as creating nexus for out-of-state retailers (e.g., E-bay)
    - NY and Washington proposed, but legislation not enacted
Ownership of Partnership or LLC Interests

- Generally, depends on:
  - Type of entity (e.g., general partnership vs. limited partnership);
  - Type of ownership interest held (e.g., general partner vs. limited partner)
  - Nature and degree of control over entity by owner
  - Relationship between the entity and the owner of the interest or other entities affiliated with the owner
When Does Nexus End?

- **Trailing Nexus**
  - Texas: Nexus deemed to continue for one year after ceasing to be engaged in business in Texas. 34 Tex. Admin. Code § 3.286(b)(2) (repealed effective June 3, 2015).
Emerging Trends

- “Unitary” nexus
  - *Gore Enterprises Holding v. Compt. of the Treasury*, 87 A.3d 1263 (Md. 2014)
    - Confirmed that the unitary business principle was not a “jurisdictional principle,” but nonetheless looked to the in-State activities of the parent to determine the nexus of the parent’s subsidiaries.
Public Law 86-272

- Preempts states from imposing a net income tax on persons that otherwise would have nexus if the person’s activities meet certain restrictions. The activities must be limited to:
  - the solicitation of orders of tangible personal property;
  - which orders are sent outside the state for approval or rejection; and
  - if approved, are filled by shipment or delivery from a point outside the state.
Pending Federal Legislation

- **Marketplace Fairness Act of 2015**
  - Would authorize states to compel remote sellers to collect sales tax collection after simplifying their sales tax laws.

- **Remote Transactions Parity Act of 2015**
  - Would authorize states to collect sales tax from remote sellers.
  - Would bar audits of registered remote sellers with under $5 million of annual gross receipts, except if there is a reasonable suspicion of intentional misrepresentation or fraud;
  - Would bar audits of remote sellers by contingency fee auditors; and
  - Would protect against class action refund suits for sales tax over-collection and *qui tam* suits for under-collection.
Pending Federal Legislation

- Online Sales Simplification Act of 2016
  - Would allow states to impose origin-based sourcing on remote sales if the state:
    - is the origin state for the remote sale, and
    - agrees to be a part of a Distribution Agreement that creates a Clearinghouse to collect sales tax on remote sales calculated by the origin state’s tax rate and base
# Summary of Federal Legislation

<table>
<thead>
<tr>
<th></th>
<th>Online Sales Simplification Act</th>
<th>Marketplace Fairness Act</th>
<th>Remote Transactions Parity Act</th>
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</thead>
<tbody>
<tr>
<td><strong>Sourcing</strong></td>
<td>Origin-based sourcing</td>
<td>Destination-based sourcing</td>
<td>Destination-based sourcing</td>
</tr>
<tr>
<td><strong>Small seller exemption</strong></td>
<td>None</td>
<td>$1,000,000</td>
<td>Phase out:</td>
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<td>Year 1: $10,000,000</td>
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<td>Year 2: $5,000,000</td>
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<td>Year 3: $1,000,000</td>
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<td>Year 4: None</td>
</tr>
<tr>
<td><strong>Audit</strong></td>
<td>Remote sellers may be audited by home state.</td>
<td>One audit per state.</td>
<td>Audits conducted through CSPs. Generally no audits for remote sellers with under $5m gross receipts.</td>
</tr>
<tr>
<td><strong>Liability</strong></td>
<td>Remote seller liable for improperly collected tax.</td>
<td>Remote sellers relieved from certain liabilities.</td>
<td>Enhanced liability protection.</td>
</tr>
<tr>
<td><strong>Software</strong></td>
<td>No software assistance to remote sellers</td>
<td>Free software for remote sellers. Integration costs excluded.</td>
<td>Free software. Set-up, installation, and maintenance cost included.</td>
</tr>
</tbody>
</table>
- Are tax jurisdiction constitutional standards dependent on the type of tax involved?
- Should tax jurisdiction constitutional standards change with changing times?
- Are “economic nexus,” “factor presence nexus” and “attributional nexus” constitutional?
- Does the fourth prong of *Complete Auto* (requiring that the tax be fairly related to the services provided by the state) have vitality?
- What does *de minimis* mean in relation to tax nexus?
- Is “attributional” nexus consistent with the constitution?
- How does Public Law 86-272 apply to new business models that do not manufacture or sell tangible personal property?
- Is the multiple taxation due to simultaneous application of economic nexus and expense addback provisions enacted as alternatives to nexus constitutional?
- Do flow-through entities establish nexus for owners?
Questions?

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