Nexus and the Limits of State Taxation

By Steven E. Hollingworth • Wood & Porter • San Francisco

Acquisitions inevitably involve tax disclosures and due diligence. State income taxes, sales and use taxes and even property taxes nearly always must be addressed for multiple jurisdictions. The prospect of audits, notices of tax due, potential successor liability and subsequent state tax fights are often not far in the background.

Nevertheless, both in the acquisition context and with clients increasingly operating or selling in multiple states, it can still be surprising when putative state tax obligations are asserted. In fact, few things come as a more rude surprise than an audit notice from a state in which you do not believe your company is (or ever was) doing business. Let's say you have no offices, stores, property, bank accounts or employees in that state and all your products are delivered by mail.

You might think that the tax authorities of that state have absolutely no right to bother you. After the initial shock wears off, you recall that your company does, in fact, have one connection with the state—an independent contractor who performs warranty work for the widgets you sell. Is that a problem, you wonder? You start feeling nervous after your tax advisor directs your attention to cases like *Louisiana v. Dell*, 922 So.2d 1257 (La. 2006) and *Dell Catalog Sales, L.P. v. Taxation and Revenue Dep't*, 199 P.3d 863 (N.M. App. 2008).

Where, exactly, does a state's taxing authority end? Cash-strapped state governments seem always to be aggressively pursuing revenue. That seems particularly true today, where state budgets have been turned on their heads. Fortunately, the ability of a state to tax interstate transactions is limited, albeit by a myriad of statutory rules and murky legal doctrines.

In a live CCH webinar, *Nexus for State and Local Tax,* presented on December 7, 2010, state tax experts John C. Healy and Bruce M. Nelson provided an informative overview of the history and current state of the law.

Constitutional Limits to State Taxing Authority

Although state tax laws originate by statute, the ultimate limit to a state's taxing authority is the U.S. Constitution. Two key clauses are involved: the Due Process Clause and the Commerce Clause.

Under the Due Process Clause, there must be "some definite link, some minimum connection, between a state and the person, property, or transaction it seeks to tax." [*Miller Brothers Co. v. Maryland*, 347 US 340, 344–45 (1954).] In addition, the "income attributed to the State for tax purposes must be rationally related to 'values connected with the taxing State.'" [*Moorman Mfg. Co. v. Bair*, 437 US 267, 273 (1978).]

Under the Commerce Clause, the tax must relate to an activity that has "substantial nexus" with the taxing state; the tax must be fairly apportioned; the tax must not discriminate against interstate commerce; and the tax must be fairly related to services provided by the taxing state. [*Complete Auto Transit v. Brady*, 430 US 274 (1977).]

How do these general principles apply to business operations? In the seminal case of *Quill Corp. v. North Dakota*, 504 US 298 (1992), the Supreme Court held that North Dakota could not compel an out-of-state mail order house to collect use tax. Because the mail order house had no physical presence in the state, and its only contacts with the taxing state were by mail or common carrier, it lacked the "substantial nexus" required by the Commerce Clause.

Avoiding Physical Presence

What does it mean, then, to have "physical presence" within a state? Healy and Nelson noted that lines can be hard to draw, because the results in cases have varied across the board. Examples of connections that have tripped up taxpayers in the past include delivery of product using the taxpayer's own vehicles; repeated visits to a state, including trade shows (unless within statutory safe harbors); use of printers, warehouses or distribution centers within the state; and employees, agents or affiliates within the state.

Nexus from affiliate and agency relationships can be a particularly contentious issue. Not surprisingly, internet retailers have been a recent focus. For example, the Appellate Division of the New York Supreme Court recently held that Amazon's associates program created a presumption of sales tax nexus where Amazon's in-state associates received fees based on the volume of their referrals. *Amazon.com, LLC v. New York State Dept. of Taxation & Finance*, 2010 N.Y. Slip. Op. 07823 (Nov. 4, 2010).

Nelson cautioned that affiliate nexus is a highly fact-specific issue and a favorite of auditors. Recent cases include efforts to link brick-and-mortar retailers, such as Borders and Barnes & Noble, with their out-of-state internet affiliates. Nelson stressed that maintaining documentation of a taxpayer's activities, as well as establishing procedures in advance to minimize activities that produce nexus, can go a long way in defending an audit.

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Congress Steps into the Fray

In cases such as *Quill*, the Supreme Court has invited Congress to clarify the law through legislation. But to date Congress has acted only in a piecemeal fashion. In 1959, Congress enacted P.L. 86-272 to prohibit states from imposing a net income tax if a taxpayer's only activity in a state is the solicitation of sales of tangible personal property, and if those sales are sent out of state for acceptance and fulfillment.

Unfortunately, P.L. 86-272 does *not* apply to any non–income taxes, such as sales and use taxes, franchise taxes on capital or net worth, or gross receipts taxes such as the Washington Business and Occupation Tax and the Ohio Commercial Activity Tax. Healy pointed out that the interaction of the differing standards under the Constitution and federal law can

result in a taxpayer being subject to a sales tax collection requirement, but not income tax.

Conversely, it is also possible that a taxpayer could be subject to an income tax, but not sales tax.

Example. A manufacturer of widgets located in State A sells its products through employees who work from their homes. The employees solicit sales of the widgets. However, final acceptance of the order occurs in State A and the widgets are shipped from stocks located in State A.

For sales tax purposes, the taxpayer would have nexus in State A and in any other state where it has employees soliciting sales. However, the taxpayer would not be subject to income tax, thanks to P.L. 86-272.

The Future

What can we expect for the future? In the near term, Healy and Nelson believe that federal legislation is unlikely, and that we will continue to see more aggressive state legislation. A recurring challenge, they observed, is that aggressive state taxing authorities often take positions that appear to be unconstitutional. Sometimes the only way to prevail is take your case to court.

However, economic considerations may force taxpayers to concede rather than fight, leaving bad law on the books. Even in cases that are resolved administratively with no precedential effect, it can be more than frustrating for a client to be told by its lawyers that a state's action is probably unconstitutional, but that litigating the issue to conclusion will cost what may to the business be a king's ransom.

Healy and Nelson stressed the importance of education and preparation to head off potential disputes. Listening to their webinar would make a great start to anyone's education on this subject. An audio recording of the two-hour webinar is available from CCH at *http://online.krm.com/iebms/coe/coe_p2_details.aspx?eventid=17467&oc=10&cc=0010300P* for $249.00.