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Current issues on Internet sales and nexus

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There has been some (perhaps not enough) media discussion of the future effect of the Internet on taxation, and other geographically based governmental activities. (See especially a series of articles by R. J. Posch in Direct Marketing (US) in March–May 1998, abstracted in New Marketing Directions, Vol. 1, No. 5.) Some of the implications are beginning to surface — inevitably in the first instance in the USA — as this paper shows.

Abstract

The continued growth of sales of tangible personal property and services across the Internet as well as the failure of state revenues to satisfy projections have increased the pressure on state revenue collection agencies to attempt to tax Internet sales. This paper sets forth the legal framework by which states are permitted to tax Internet transactions, developments by which state revenue collection agencies are attempting to expand Internet taxation and methods to avoid taxation on Internet sales.

Nexus requirement

Unlike local jurisdictions in most other countries throughout the world, US states are generally permitted to enact any taxing method they choose. There is no requirement that states enact the same types of taxes, define their tax bases, set rates or administer taxes in any particular manner or do so in a harmonious way with other states. The only true restrictions on a state's taxing power are found in the US Constitution; namely that taxing methods must comply with due process clause requirements and may not interfere with Congress's right to regulate interstate and foreign commerce (the 'commerce clause').

Early Supreme Court history

In *National Bellas Hess, Inc. v Department of Revenue*,¹ the Supreme Court addressed the attempted imposition of Illinois use tax on a Missouri mail-order company that owned no property and had no sales outlets or employees in Illinois. The taxpayer used the US postal system to deliver catalogues to its customers twice a year, and delivered its products using either the postal system or a common carrier. The Supreme Court held that the levy violated the commerce clause because the 'Constitution requires "some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax".'² The court also

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held that the levy violated the due process clause, stating that in order to impose a tax the court must determine ‘whether the state has given anything for which it can ask in return’.³ The court determined that physical presence within a state is necessary for a levy to satisfy the commerce clause and the due process clause.⁴

In *Complete Auto Transit, Inc. v Brady*,⁵ the Supreme Court evaluated a commerce clause challenge to a Mississippi sales tax directed upon automobiles manufactured out of state. The court developed a four-part test to examine the commerce clause dispute which assesses:

- whether the tax is applied to an interstate activity with a substantial nexus with the taxing state;
- whether the tax is fairly apportioned;
- whether it discriminates against interstate commerce;
- whether it is fairly related to the services provided by the state.⁶

Quill Corporation v North Dakota

The *Quill* decision

In 1992, the Supreme Court decided *Quill Corporation v North Dakota*.⁷ Although the court’s decision prohibited North Dakota from imposing a use tax collection duty upon an out-of-state mail-order business, the rationale for its decision dramatically altered the landscape of interstate transaction taxation, and has led to many of the current issues in Internet sales.

Prior to *Quill*, the court acknowledged that its previous decisions addressing interstate sales did not differentiate between the requirements of due process and the commerce clause for the imposition of taxes on out-of-state vendors. However, the court emphasised that the two clauses composed separate and distinct tests. The court stated that the due process clause requires only that the imposition of tax does not offend ‘traditional notions of fair play and substantial justice’.⁸ With respect to mail-order companies that engage in continuous and widespread solicitation of business within a state, the court stated that such a company has fair warning that it could be subject to taxation irrespective of a lack of physical presence in the state. Therefore, the court stated that to the extent its prior decisions, including *National Bellas Hess*, indicated that physical presence was necessary under the due process clause for a state to impose a duty to collect a use tax, such decisions were overruled.⁹

Nonetheless, the court held that *Quill* was not required to collect use tax under the commerce clause. The court noted that the bright-line test requiring physical presence for the imposition of taxation power by a state, established in *National Bellas Hess*, had encouraged certainty to foster investment by businesses and individuals.¹⁰ Therefore, the court upheld the safe harbour constructed by its prior decisions. However, the court expressly noted that, unlike the due process clause, Congress has plenary power to regulate interstate commerce and could thus authorise state actions that burden interstate commerce.¹¹ Thus, the court stated that Congress could decide ‘whether, when, and to what extent the States may burden interstate mail-order concerns with a duty to collect use taxes’ if it disagreed with the court’s conclusion.¹²

**Geoffrey v South
Carolina**

Intangible nexus

The US Supreme Court's splitting of the due process and commerce clauses has encouraged numerous state revenue agencies and state courts to expand the power of states to tax out-of-state vendors. For example, in *Geoffrey v South Carolina*,¹³ the South Carolina Supreme Court held that nexus could be established for income tax purposes by the existence of intangibles such as trade names used in the state even when the owner of such intangibles has no physical presence in the state. In *Geoffrey*, the taxpayer licensed trademarks to an affiliated subsidiary, and the court permitted the imposition of income tax upon the parent. While the South Carolina court noted that *Quill* provided that an out-of-state company does not need physical presence to be subject to tax under the due process clause, it conveniently avoided *Quill* and Congress's inaction thereafter in determining that such taxation did not violate the commerce clause by stating that the *Quill* decision only applied to sales and use taxes, and not to income taxes.¹⁴

The South Carolina court's decision in *Geoffrey* has caused other state taxing authorities to make similar arguments to expand the right to levy taxes. These attempts have been met with mixed success. For example, the Massachusetts Department of Revenue officially adopted the *Geoffrey* rationale in Corporate Excise Directive 96-2 (3 July 1996). On the other hand, in *Cerro Cooper Products, Inc. v Department of Revenue*,¹⁵ an Alabama administrative law judge rejected *Geoffrey* by pointing out the inconsistent nature of reading *Quill* to apply different physical presence rules outside the realm of sales and use taxes. Numerous cases regarding the validity of the *Geoffrey* analysis are currently winding their way through state courts. Internet vendors should monitor such cases in states in which they do business unless and until the US Supreme Court addresses this matter in the future.

De minimis physical presence

**Orvis Company v Tax
Appeals Tribunal**

Other state courts have vastly expanded the reach of the taxing power on out-of-state vendors by diluting the physical presence requirement. In *Orvis Company v Tax Appeals Tribunal*,¹⁶ the Court of Appeals permitted the imposition of use tax upon orders placed through a mail-order catalogue to a company located wholly outside New York. Notwithstanding the US Supreme Court's discussion in *Quill*, the New York court tracked the development of the level of constitutionally required nexus through *National Bellas Hess*, and concluded that the level of nexus required under the due process clause and the commerce clause was 'indistinguishabl[e]'.¹⁷ Thus, the New York court reasoned that the different standards of nexus imposed by *Quill* for the due process clause and the commerce clause were reluctantly adopted.¹⁸

The New York court continued its second-guessing of *Quill* by reasoning that the US Supreme Court's retention of the physical presence requirement for commerce clause nexus was done begrudgingly, and that the evolution of commerce clause jurisprudence did not support its retention. Therefore, the New York court determined that, notwithstanding the clear language of *Quill*, physical presence of a

**Brown's Furniture,
Inc v Wagner**

vendor within a state must only be 'more than the slightest presence. 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.'¹⁹

The New York court is not the only state court that has substantially diluted the US Supreme Court's statements in *Quill*. In *Brown's Furniture, Inc. v Wagner*,²⁰ the Illinois Supreme Court held that the taxpayer had substantial nexus with Illinois for income tax purposes even though it had no property, offices or employees within the state. The taxpayer conducted extensive advertising using television, radio and print media in Illinois and made deliveries to Illinois on a regular basis. The court held that the taxpayer had adequate physical presence because the 'slightest' presence is sufficient to support taxation.

The environment for Internet sales

The willingness of state revenue collection agencies to make broad assertions of jurisdiction to impose taxes, and the complicity in several state courts of last resort to uphold such assertions notwithstanding fairly clear requirements for nexus under the commerce clause set forth in *Quill*, may be at least partially explained by the states' reliance upon transaction taxes for revenue. Forty-five of the 50 states impose statewide sales taxes. The sales tax accounts for at least 20 per cent of state revenues in every state in which a sales tax is imposed, and in several states accounts for more than half of all state revenues.²¹ Because state revenue agencies see out-of-state sales, and particularly Internet sales, as an increased revenue opportunity, the states are becoming more aggressive in attempts to subject such sales to tax.

The impact of taxing Internet sales on state revenues is difficult to ascertain and is subject to overstatement by state revenue authorities for a number of reasons. First, roughly 80 per cent of current Internet sales are business to business, and are therefore either exempt or excluded from sales tax or subject to use tax.²² Second, approximately half of all consumer goods purchases on the Internet, including food, services and prescription drugs, are exempt from tax in numerous states.²³ Finally, even the greatest estimates of state revenue loss due to Internet sales is substantially less than 0.25 of 1 per cent of total state and local tax revenues.

Nevertheless, even though the potential impact for increased state revenues appears small, state revenue collection agencies have been aggressively seeking the ability to tax a larger portion of such sales. Representatives of at least 30 states are participating in the 'Streamlined Sales Tax Project', which seeks, among other things, to increase the ability to tax out-of-state vendors, including Internet vendors. In return for the right to tax remote sellers, the project proposes to create uniformity throughout the states by standardising definitions of what is taxable, establishing uniform sourcing rules, making tax exemptions uniform, ameliorating tax rate disparities and managing sensitive local tax issues. Even though the project has proposed model legislation, the success of the project, and thus Congress's future acquiescence in the

ability to tax out-of-state vendors, may be dependent upon whether the two largest states (California and New York) agree to participate in the project and adopt the model act. To this point they have not done so, and only a handful of states have attempted to adopt the project's model act.

Affiliated company sales

In light of the apparent willingness of state courts to evade the physical presence requirements of the commerce clause in asserting jurisdiction to tax sales by out-of-state vendors as stated by *Quill*, and the spectre of increased aggressiveness by state revenue collection agencies, especially if Congress does not extend the moratorium on Internet taxes, Internet vendors have limited options in maintaining their tax-exempt status for out-of-state sales. One method which has been consistently upheld by courts to this point has been the use of affiliates to make such sales.

For example, in *SFA Folio Collections, Inc. v Bannion*,²⁴ the Connecticut Supreme Court rejected the argument of the state's revenue authorities that an out-of-state corporation that is engaged in a unitary business with an in-state corporation is taxable due to that unitary relationship. Effectively, the Connecticut revenue authorities attempted to attribute the physical presence of the in-state corporation to the affiliated out-of-state vendor. The Connecticut court rejected this attempt to impose taxes and stated that nexus would not be attributed based upon a unitary business theory so long as the transactions between the corporations are conducted at arm's length, and that the out-of-state corporation has substance and is treated as a distinct legal entity.²⁵

Courts in other states have also stated that attributional nexus will not support taxation of out-of-state vendors. For example, in *Bloomington's By Mail v Pennsylvania*,²⁶ the Pennsylvania Commonwealth Court held that a separate mail-order subsidiary did not have nexus based upon its parent's bricks-and-mortar stores in Pennsylvania, even though the stores occasionally accepted returns of sales by the out-of-state subsidiary. Likewise, in *J. C. Penney National Bank v Johnson*,²⁷ the Tennessee Court of Appeals rejected the purported imposition of tax on an out-of-state banking subsidiary which issued credit cards in Tennessee based upon the presence of its parent with nexus in Tennessee.

Practical considerations for Internet sellers

Based on the foregoing, there are a variety of steps that can be taken by Internet sellers to reduce potential sales tax liability. First and foremost, Internet sellers should create affiliated corporations to conduct all Internet sales if there is any possibility that other sales could inadvertently create nexus for various states to impose taxes. In turn, this requires specific knowledge of the following information:

- the location of computer servers;
- the location of fulfilment centres;
- the location of technical employees providing services;
- the location of call centres;
- the criteria in various states for nexus-creating activities.

**SPA Folio
Collections, Inc. v
Bannion**

Further, in light of recent state court decisions which dilute or evade the requirements of the commerce clause as set forth by *Quill*, Internet companies that have been assessed by aggressive state collection agencies should be aware of the continuing development of the law, especially if the US Supreme Court takes another nexus case after *Quill*.

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