Hot Issues in State and Local Taxation Nationwide

Arthur R. Rosen
McDermott Will & Emery LLP
New York, NY

Hayes R. Holderness
McDermott Will & Emery LLP
New York, NY

I. Due Process Clause

> **The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people.**

U.S. Const. amend. X.

> **[Nor] shall any state deprive any person of life, liberty, or property, without due process of law….**

U.S. Const., amend. XIV, §1.

A. Fundamental Principles

1. *Exxon Corp. v. Wisconsin Dep't of Rev.*, 447 U.S. 207, 219–220 (1980). According to the U.S. Supreme Court's decision in *Exxon Corp. v. Wisconsin Dep't of Rev.*, 447 U.S. 207, 219–220 (1980):

   > 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 Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980)).

2. *Wisconsin v. J.C. Penney Co.,* 311 U.S. 435, 444 (1940). In *Wisconsin v. J.C. Penney Co.,* 311 U.S. 435, 444 (1940), the U.S. Supreme Court stated:

> 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.

B. Nexus Standards

1. Transactional Nexus

   a. *Allied-Signal Inc. v. Dir., Div. of Taxn.*, 504 U.S. 768 (1992). Petitioner corporation disputed liability of a gain realized on the sale of its stock interest to a New Jersey corporation. The two corporations were unrelated business enterprises, and petitioner's investment was passive rather than an integral operational one. The Supreme Court reversed the inclusion of the gain in petitioner's tax base, finding that 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.

   b. *Connecticut General Life Insurance Co. v. Johnson, Treasurer of California*, 303 U.S. 77 (1938). Appellant insurer claimed that a tax on its receipt in its home state, Connecticut, of reinsurance premiums from insurance companies operating in California on policies reinsuring them against loss on policies they issued in California to California residents violated the due process clause. Apart from the fact that appellant was privileged to do business in California, and that risks reinsured were originally insured against in that state by companies also authorized to do business there, California had no relationship to appellant or the contracts. The Supreme Court reversed the dismissal of appellant insurer's actions to recover state taxes paid under protest, finding a due process violation and noting that California had no relationship to appellant or to reinsurance contracts.

2. Presence Nexus

   a. *Bridges v. Autozone*, 900 So.2d 784 (March 24, 2005), reh'g denied (May 13, 2005). The Louisiana Supreme Court provided an unusual twist to Due Process case law in *Bridges v. Autozone*, 900 So.2d 784 (March 24, 2005), reh'g denied (May 13, 2005). In *Autozone*, all seven of the court's justices held that due process protections did not prevent the state from taxing an out of state entity that owned intangible property arguably used in the state (an interest in an affiliated real estate investment trust). The taxpayer filed a petition for rehearing, which the court declined to hear due to procedural issues. However, the court's Chief Justice filed a concurring opinion arguing strenuously that in the *Autozone* decision the court misunderstood the issue. He argued that the due process personal jurisdiction issue involved principles distinct from the question of a state's ability to impose an income tax on an out of state business. In his Autozone concurrence, the Chief Justice was not joined by any of his colleagues. However, less than two months later, he was joined by two other justices in voting to accept a case that might have overturned *Autozone*. That is, three of the state's seven justices apparently are willing to reconsider *Autozone's* due process holding.

b. *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

   i. The Due Process Clause requires only that a corporation have "minimum contacts" with the taxing state. The intent of the Due Process Clause is to ensure fairness and notice to the corporation that its contacts with the State cause it to be subject to tax.

   ii. The presence in a state necessary to satisfy the Due Process Clause is comparable to that needed to support a state court's jurisdiction over a defendant in a civil matter. As articulated in cases such as *Burger King Corp. v. Rudzewicz*, 471 U.S. 462 (1985), that standard is met if the entity purposefully directs its activity into a jurisdiction. The Due Process Clause does not require physical presence in the taxing state.

c. *Burger King Corp. v. Rudzewicz*, 471 U.S. 462 (1985). The civil in personam standard is met if the entity purposefully directs its activity into a jurisdiction.

d. *World-Wide Volkswagen Corp. v. Woodson*, 444 U.S. 286, 298 (1980). A corporation can be sued in a state, under the Due Process Clause, when the corporation "delivers its products into the stream of commerce with the expectation that they will be purchased by consumers in the forum state," because the defendant's conduct and connection with the forum state are such that it should "reasonably anticipate being hauled into court there."

e. *Asahi Metal Industry Co. v. Superior Court of California*, 480 U.S. 102, 112 (1987). "The placement of a product into the stream of commerce, without more, is not an act of the defendant purposefully directed toward the forum State…. [A] defendant's awareness that the stream of commerce may or will sweep the product into the forum State does not convert the mere act of placing the product into the stream into an act purposefully directed toward the forum State."

f. *International Harvester Co. v. Department of Treasury*, 322 U.S. 435 (1944). "We think that Wisconsin may constitutionally tax the Wisconsin earnings distributed as dividends to the stockholders. It has afforded protection and benefits to appellants' corporate activities and transactions within the state. These activities have given rise to the dividend income of appellants' stockholders and this income fairly measures the benefits they have derived from these Wisconsin activities."

g. *Geoffrey, Inc. v. South Carolina Tax Commission*, 313 S.C. 15, 437 S.E.2d 13 (S.C. Sup. Ct. 1993), *cert. denied*, 510 U.S. 992 (1993). Delaware holding company that licensed its trademarks and trade names for use by its parent corporation, Toys 'R Us, in South Carolina was determined to have sufficient nexus under the Due Process Clause to subject it to the state's corporate income tax and corporate license fee.

h. *Associated Electric & Gas Insurance Services, Ltd. v. Clark*, 676 A.2d 1357 (R.I. Sup. Ct. 1996).

   i. The taxpayer collected premiums from four natural gas companies located in Rhode Island. The taxpayer had no physical presence in the state and received all insurance contracts directly from the insured by mail. The taxpayer was assessed Rhode Island's gross insurance premiums tax. The taxpayer argued that subjecting it to the tax violated the Due Process Clause of the U.S. Constitution.

ii. The Rhode Island Supreme Court upheld imposition of the tax. Based on *Quill*, the court determined that the taxpayer had "purposefully availed" itself of the benefits of an economic market in Rhode Island and, thus, was subject to tax in Rhode Island.

iii. *Town Crier, Inc. v. Dep't of Revenue*, 315 Ill. App. 3d 286, 733 N.E. 2d 780 (Ill. App. Ct., 1st Dist. June 30, 2000). An out-of-state retailer, whose only physical contact with Illinois during a 26 month audit period were 30 deliveries into the state using its own vehicles, and installation of window dressings on five occasions, was determined to have nexus. Taxpayer argued it did not "purposefully avail" itself of the Illinois market because it did not actively solicit customers from Illinois and that all contacts with the state were at the request of customers in the state. The Court found that although the taxpayer's contacts did not rise to the level of contacts in the Illinois Supreme Court's decision in *Brown's Furniture, Inc. v. Wagner*, 171 Ill. 2d 410, 665 N.E. 2d 795 (Ill. Sup. Ct. 1996), the number of deliveries would have satisfied the statutes cited in that decision and the frequency of the taxpayer's presence in Illinois was approximately equal to that of the taxpayer in the New York Court of Appeals' decision in *Orvis Co., Inc. v. Tax Appeals Tribunal*, 86 N.Y. 2d 165, 654 N.E. 2d 954, 630 N.Y.S. 2d 680 (N.Y. Ct. App. 1995), *cert. denied*, 516 U.S. 989 (1995).

i. *Gordon v. Holder*, 632 F.3d 722 (D.C. Cir. Feb. 18, 2011), remanded to 2011 U.S. Dist. LEXIS 139201 (D.D.C. Dec. 5, 2011) ("Although Quill did not deal with excise taxes, there remains an open question whether a national authorization of disparate state levies on e-commerce renders concerns about presence and burden obsolete.")

j. *J. McIntyre Machinery, Ltd. v. Nicastro*, 131 S.Ct. 2780 (2011) (plurality opinion). Machinery manufacturer that never revealed an intent to invoke or benefit from the protection of the state's laws was not subject to jurisdiction in New Jersey under the Due Process Clause. Decision clarified that *Asahi* meant that when a defendant places goods into the stream of commerce "with the expectation that they will be purchased by consumers within the forum state…" that might indicate the type of purposeful availment that supports jurisdiction.

k. *Goodyear Dunlop Tires, SA v. Brown*, 131 S. Ct. 2846 (2011). A foreign corporation could not be sued in North Carolina in a case not arising out of North Carolina activities just because other entities distributed its products in the state. "[Taxpayers'] attenuated connections to the state fall far short of the 'the continuous and systematic general business contacts' necessary to empower [the state] to entertain suit against them on claims unrelated to anything that connects them to the state."

II. Interstate Commerce Clause

> **The Congress shall have the power…to regulate commerce…among the several States….**

U.S. Const., Art. I, §8, cl. 2.

A. Fundamental Principles

1. The U.S. Supreme Court has held that the Commerce Clause not only gives the authority to Congress to regulate interstate commerce, but also prohibits the states from enacting laws that discriminate against or interfere with interstate commerce. *Gibbons v. Ogden*, 9 Wheat. 1 (1894).
2. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977).
    a. The Supreme Court 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 its earlier decision in *Spector Motor Service, Inc. v. O'Connor*, 340 U.S. 602 (1951), which had stood for that rule.

    b. The Supreme Court articulated a four-part test that must be satisfied for a tax not to violate the interstate Commerce Clause:

        i. The tax must be applied to an activity with a substantial nexus with the taxing state;

        ii. The tax must be fairly apportioned;

        iii. The tax must not discriminate against interstate commerce; and

        iv. The tax must be fairly related to the services provided by the state.

            (1) The states frequently argue, and courts have accepted, that the "fairly related" prong is satisfied by a showing that a business benefited from general state services such as police and fire protection, public roads and schooling. However, in a 2004 case a court held that the imposition of a state use tax violated this prong. *See Am. River Transp. Co. v. Glen Bower*, 813 N.E.2d 1090, 351 Ill. App. 3d 208 (Ill. App. Ct., 2nd Dist. July 21, 2004), in which the Illinois Appellate Court ruled that the imposition of Illinois use tax on a company that operated tugboats on the Mississippi, Illinois and Ohio rivers was unconstitutional. Although the company's boats were on Illinois waters more than 50% of their time, the court concluded that "Illinois provided no services to those tugboats. The waters are all navigable waters of the United States and are maintained by the United States, not Illinois." The court analogized its decision to the treatment of an aircraft flying over Illinois.

B. Substantial Nexus

1. Background

   a. U.S. Supreme Court

      i. According to the Supreme Court's decision in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992):

         (1) The Interstate Commerce Clause requires that a corporate taxpayer (or tax collector, in the case of use taxes) have "substantial nexus" with the taxing state;
         (2) 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";
         (3) In the area of use tax collection, a corporation must be physically present in a state for that state constitutionally to impose collection responsibilities upon the corporation. The degree of presence in a state necessary to satisfy the Commerce Clause is uncertain with respect to the imposition of gross receipts, income, and franchise taxes. (*See Nat'l Geographic Society v. California Bd. of Equalization*, 430 U.S. 551 (1977) and *Felt & Tarrant Mfg. Co. v. Gallagher*, 306 U.S. 62 (1939) regarding support for the argument that a greater nexus standard is appropriate when a tax is being imposed, rather than merely a tax collection responsibility.)

      ii. *Nat'l Geographic Society v. California Bd. of Equalization*, 430 U.S. 551 (1977).

         (1) The taxpayer was held to have use tax collection responsibility on its interstate mail order sales of maps because of the physical presence of its advertising sales offices for its magazine division in the taxing state.
         (2) The Court held it to be irrelevant that the mail order sales activity being taxed did not have a physical presence in-state where taxpayer had otherwise established physical presence in the state through its magazine publication activity.
         (3) The Court noted that an activity only of the "slightest presence" in the state would not be sufficient to establish taxable nexus in the state.

   b. The test is substantial nexus, not substantial physical presence.

      i. *Orvis Company, Inc. v. Tax Appeals Tribunal*, 86 N.Y. 2d 165, 654 N.E. 2d 954, 630 N.Y.S. 2d 680 (N.Y. Ct. App. 1995), *cert. denied*, 516 U.S. 989 (1995).

         (1) "We do not read *Quill Corp. v. North Dakota* to make a substantial physical presence of an out-of-state vendor in New York a prerequisite to imposing the duty upon the vendor to collect the use tax

from its New York clientele." *Orvis,* 86 N.Y. 2d at 70, 654 N.E. 2d at 956 (1995) (emphasis added).

ii. "[A]cceptance of the thesis urged by Orvis…that *Quill* made the substantial nexus prong of the *Complete Auto* test an in-State substantial physical presence requirement—would destroy the bright-line rule the Supreme Court in *Quill* thought it was preserving in declining completely to overrule *Bellas Hess.*[1] Inevitably, a substantial physical presence test would require a 'case-by-case, evaluation of the actual burden imposed' on the individual vendor involving a weighing of factors such as number of local visits, size of local sales offices, intensity of direct solicitations, etc., rather than the clear-cut line of demarcation the Supreme Court sought to keep intact by its decision in *Quill*." *Orvis*, 86 N.Y. 2d at 177 (internal citations omitted).

iii. *Dep't of Revenue v. Share Int'l Inc.*, 676 So. 2d 1362 (Fla. Sup. Ct. 1996), *cert. denied,* 519 U.S. 1056 (1997).

(1) The taxpayer manufactured and distributed chiropractic supplies and sold its product through direct mail. For three days every year, the taxpayer's president and vice president were speakers and coordinators at a national seminar in Florida. During the seminar, the taxpayer's products were displayed and sold. The taxpayer collected and remitted sales tax on these sales. The Department of Revenue determined that the taxpayer should be collecting sales tax on all sales, including mail order sales, to Florida.

(2) The Florida Supreme Court determined that the taxpayer did not have substantial nexus with Florida for other sales and, thus, could not be compelled to collect and remit use tax on mail order sales to Florida residents.

(3) *Share* provides guidance on the issue of the duration of tax presence. In *Share*, the court did not require the company to collect tax on sales occurring after it quit the state. In contrast, sales tax rule 3.286(b)(2) of the Texas Comptroller of Public Accounts, requires "out-of-state seller who has been engaged in business in Texas continues to be responsible for collection of Texas use tax on sales made into Texas for 12 months after the seller ceases to be engaged in business in Texas."

iv. *General Motors Corp. v. City of Seattle*, 25 P.3d 1022 (Wash. Ct. App. 2001). The appellate court determined that two manufacturers and dealers of automobiles, GMC and Chrysler, with independent dealers in Seattle, but no offices there, had nexus for purposes of the city's business and occupation (B & O) tax. The court based its decision on the facts that both GMC and Chrysler directed national advertising to Seattle; sent sales, service, and parts managers there on a regular basis; and employed Seattle dealers to market warranties that serve an important marketing function. The companies' in-city advertising, marketing,

1. Nat'l Bellas Hess v. Dep't of Revenue, 356 U.S. 753 (1967).

sales, service calls, and service of warranties significantly impacted their ability to maintain a market in Seattle, and thereby justified a conclusion of nexus.

v. *In the Matter of Intercard, Inc.*, 270 Kan. 346, 14 P.3d 1111 (Kan. Sup. Ct. 2000). Eleven installations of card readers did not create nexus because such contacts were isolated and sporadic.

vi. *Lamtec Corp. v. Washington Dep't of Revenue*, 246 P.3d 788 (Wash. 2011), cert. denied 132 S. Ct. 95 (2011). 2–3 annual visits to the state by representatives was enough to create nexus with Washington for B&O tax purposes.

c. State Registration and Substantial Nexus

i. *Arco Building Systems, Inc. v. Chumley*, M2004-01872-COA-R3-CV (Tenn. Ct. App. June 12, 2006). The taxpayer did not have property or employees in Tennessee but registered with the state so as to be able to issue resale certificates to its Tennessee vendors. Despite issuing resale certificates, the taxpayer argued that it did not have Tennessee tax presence and was not required to collect sales tax. The court rejected the argument, stating that "Whatever the merits of this argument, it is irrelevant here, for Arco did not simply register as a Tennessee dealer and file annual sales tax returns reporting no tax liability. Arco relied on its Tennessee registration to issue blanket certificates of resale" to prevent its vendors from charging Tennessee sales or use taxes.

ii. *Buehner Block Co. v. Wyoming Dep't of Revenue*, 139 P.3d 1150, 2006 Wyo. 90 (Wyo. July 27, 2006). The taxpayer was a manufacturer in Utah. It made sales to Wyoming customers, with delivery via common carrier. It had no physical presence in Wyoming but held a Wyoming sales and use tax vendor's license. The Wyoming Supreme Court held that the taxpayer's voluntary sales tax registration in combination with its delivery of goods by common carrier created substantial nexus for sales and use tax purposes.

iii. *Rylander v. Bandag Licensing Corp.*, 18 S.W. 3d 296 (Tex. App. Ct. 3d Dist. 2000). Appellee corporation held a certificate of authority to do business in Texas. Appellee licensed intangible property to its parent corporation, and the Comptroller argued that the licensing activity was taxable due to appellee's possession of a certificate of authority to do business. The court held that the mere possession of a license to do business did not create a substantial nexus, and further held that the holding of a passive interest in intangible property was not an "activity" within the meaning of the tax.

iv. *In the Matter of New Milford Tractor Co., Inc.*, DTA No. 808563 (N.Y.S. Tax App. Trib. Sept. 1, 1994). Holding that a taxpayer's voluntary registration for sales and use taxes, allowing it to issue resale certificates on goods purchased in New York, did not create substantial nexus.

C. Presence Nexus

1. Economic Nexus

   a. Economic Nexus—Intangible Assets

      i. *Geoffrey, Inc. v. South Carolina Tax Comm'n*, 313 S.C. 15, 437 S.E.2d 13 (S.C. Sup. Ct.), *cert. denied*, 510 U.S. 992 (1993). Delaware holding company that licenses its trademarks and trade names for use by its parent corporation, Toys 'R Us, in South Carolina has sufficient nexus under the Commerce Clause to subject it to the state's corporate income tax and corporate license fee.

      ii. *Rylander v. Bandag Licensing Corp.*, 18 S.W. 3d 296 (Tex. App. Ct., 3rd Dist., 2000). The Texas Court of Appeals rejected the Comptroller's *Geoffrey* type approach to nexus by holding that the possession of a certificate of authority and receipt of royalties without any physical presence, does not give rise to substantial nexus.

      iii. *K-Mart Properties, Inc. v. Tax'n and Revenue Dep't*, 139 N.M. 172, 131 P.3d 172 (Dec. 29, 2005). The New Mexico Supreme Court let stand a New Mexico Appellate Court decision allowing New Mexico to impose gross receipts tax and corporate income tax on Kmart Properties, Incorporated (KPI), a Michigan affiliate holding trademarks developed by the Kmart Corporation. KPI received royalty income calculated at 1.1 % of gross sales from all Kmart stores, including twenty-two in New Mexico. For Due Process purposes, the appellate court said that allowing the marks to be used in New Mexico was purposeful availment of the economic market in the state. In its Commerce Clause analysis, the appellate court determined that the *Quill* physical presence requirement does not apply to the state income tax. In any event, the appellate court determined that a trademark has a "physical presence" where it is put to tangible use, i.e., where the stores are located, and that Kmart employees in New Mexico were essentially representing KPI's interests.

      iv. *Acme Royalty Co. v. Dir. of Revenue*, (consolidated with) *Gore Enter. Holdings, Inc. v. Dir. of Revenue*, Nos. SC84225 and SC84226 (Mo. Sup. Ct. Nov. 26, 2002). In a 4-3 decision, the Missouri Supreme Court reversed two Administrative Hearing Commission (AHC) rulings that had adopted the nexus conclusions espoused in *Geoffrey*, and held that two intangible holding companies, while related to corporations that had nexus with the state, were separate legal entities that did not have property, payroll or sales in Missouri and thus were not subject to the state's corporate income tax. In order for a taxpayer to be liable for Missouri corporate income taxes, the taxpayer must have had some activity in the state. "The basic requirement for there to be Missouri source income is that there is some activity by the *taxpayer* in Missouri that justifies imposing tax. Although corporate activities can be immeasurably diverse, for multi-state income purposes they fall into three succinct categories: property, payroll and sales."

v. *Lanco, Inc. v. Dir., Div. of Taxation*, 980 A.2d 176 (N.J. 2006), aff'g, 2005 N.J. Super. LEXIS 268 (N.J. Super. Ct. App. Div., Aug. 24, 2005), rev'g, N.J. Tax Ct., No. 005329-97 (Oct. 23, 2003), *cert. denied*, 127 S. Ct. 2974 (June 18, 2007).

Lanco is a Delaware corporation that owns and licenses intangible property (trademarks, trade names, and service marks) to its affiliate, Lane Bryant Inc. for use in its New Jersey retail business. Lanco had no officers, employees, or real or tangible personal property in New Jersey.

The New Jersey Tax Court held that New Jersey's corporation business tax ("CBT") does not apply to an out-of-state corporation that does not have a physical presence in the New Jersey but that has New Jersey-source income from a licensing agreement with a New Jersey retail business.

The New Jersey Tax Court determined that the Commerce Clause requires substantial nexus, which is not satisfied unless the business has a physical presence in the state. Citing *Quill Corp. v. North Dakota* (1992) and reviewing cases in other states that addressed the issue, the court determined that the difference between use tax liabilities and income tax liabilities are not significant enough to justify a different rule for physical presence and that U.S. Supreme Court decisions decided before *Quill* strongly suggested that physical presence was a necessary element of nexus for taxing income.

Reversing the decision of the New Jersey Tax Court, the Appellate Division of the Superior Court held that that *Quill*'s physical presence nexus requirement is not applicable to income tax and that the New Jersey Corporation Business Tax may be constitutionally applied to income derived by plaintiff from licensing fees attributable to New Jersey.

On appeal, the Director of Taxation argued that the Commerce Clause does not require a corporation's physical presence to justify state taxation, provided that the state can establish that the corporation derives significant benefits from continued and deliberate in-state economic activity.

The Director also argued that, unlike the vendors in *Quill* (whose only connection with customers was by common carrier or the U.S. mail), Lanco had a long-term contractual relationship with a related corporation that operated outlets throughout New Jersey and Lanco and Lane Bryant enjoyed numerous benefits provided by New Jersey, including judicial protection, highway maintenance, and police and fire protection.

Reversing the decision of the New Jersey Tax Court, the Appellate Division of the Superior Court held that that *Quill*'s physical presence nexus requirement is not applicable to income tax and that the New Jersey Corporation Business Tax may be constitutionally applied to income derived by plaintiff from licensing fees attributable to New Jersey

In reversing the Tax Court, the Appellate Division looked to recent state cases adopting the holding of the South Carolina Supreme Court in *Geoffrey*, namely North Carolina in its *A&F Trademark* decision and Louisiana in its *Gap (Apparel)* decision (see below). After examining these cases, Appellate Division was "satisfied" that the physical presence requirement applicable to sales and use taxes is not applicable to income tax. As a result, it concluded that New Jersey corporation business tax may be constitutionally applied to income derived by Lanco from licensing fees attributable to New Jersey.

The New Jersey Supreme Court upheld the Appellate Division's decision and referred readers to that decision for a substantive analysis of the issue instead of issuing its own detailed analysis. The Court briefly analyzed the *Quill* decision and ruled that *Quill*'s nexus application was limited to sales tax.

vi. *KFC Corp. v. Iowa Dep't of Rev.*, 792 N.W.2d 308 (Iowa 2010), cert. denied 132 S. Ct. 97 (2011). A franchisor had nexus with Iowa for corporate income tax purposes because it was directing economic activity at the state by entering into licensing agreements with franchisees.

vii. *In the Matter of Scioto Insurance Co.*, Dkt. No. 108943 (Okla. May 1, 2012). An insurance company was not subject to Oklahoma's corporate income tax as a result of receiving royalty payments made under a licensing contract. Scioto was capitalized with intellectual property. It then licensed the intellectual property to an affiliated entity (Wendy's), which then sublicensed the intellectual property to franchisees.

viii. *Griffith v. ConAgra Brands, Inc.*, Dkt. No. 11-0252 (W. Va. May 24, 2012). Foreign licensor with no physical presence was not subject to the state's corporate income or business franchise taxes as a result of receiving royalty payments from the license of intellectual property related to food product brands. The Court noted that the licensees did not operate any retail stores in West Virginia, and all manufacturing by licensees took place outside of West Virginia. Furthermore, the licensor did not dictate how licensees distributed products bearing the licensed trademarks. The Court determined that the licensor did not have nexus because it satisfied neither the "purposeful direction" due process test nor did it have "significant economic presence" under the Commerce Clause. The Court also found that the taxpayer did not engage in the solicitation activities found in *MBNA.*

ix. *In re Washington Mutual, Inc.*, Case No. 08-12229-MFW (U.S. Bankruptcy Del. Dist. Dec. 19, 2012). The United States Bankruptcy Court for the District of Delaware found that a holding company did not have the minimum contacts necessary for nexus under the Due Process Clause or the substantial nexus necessary for nexus under the Commerce Clause with Oregon where its only connection to Oregon was the free use of its intellectual property by its subsidiaries.

x. *In the Matter of Jack Daniels Props., Inc. and Southern Comfort Props., Inc. v. Iowa Dep't of Revenue*, Dkt. No. 09 DORFC 002; 004 (Iowa Dep't of Inspection and Appeals, July 28, 2011) (released Mar. 7, 2012).

(1) An administrative hearing officer upheld corporate income tax assessments issued to two out-of-state intangible holding companies ("IHC") on royalty income from the in-state sale of whiskey by independent retailers.
(2) The mere sale of a trademarked good in the state by an out-of-state licensee is enough to sustain a tax on royalty revenue, even though the licensee did not have any retail stores, outlets or other selling location in the state.

b. Economic Nexus—Customers in the states

i. *Tax Comm'r of West Virginia v. MBNA Am. Bank, N.A.*, 2006 W. Va. LEXIS 132 (2006), aff'g, No. 04-AA-157 (W. Va. Cir. Ct. June 27, 2005), rev'g, W.V. Office of Tax App. File No. 510331454001 (Oct. 22, 2004), No. 06-1228, *cert. denied* June 18, 2007. Please see subsection (d) below for an in-depth discussion.

ii. Multistate Tax Commission's factor based nexus proposal. Under the MTC draft proposal, a company would be subject to a state's income or franchise tax if it (aggregated with its affiliates) had more than $50,000 in property in a state, or $50,000 in payroll in a state, or $500,000 in sales in a state, or 25% of total property, total payroll or total sales. *See* MTC Policy Statement 02-02, amended Oct. 17, 2002.

iii. Oregon Nexus Statute, S.B. 177, 74th Or. Leg. Assem., Reg. Sess, (2007) generally follows the MTC approach. This bill specifies that nonresident individuals and business entities will have substantial nexus with Oregon if certain levels of payroll, property, or sales are exceeded in state. These levels are as follows:

(1) $50,000 in payroll
(2) $50,000 in real and tangible personal property owned or rented in state.
(3) $500,000 in gross sales in state.

Alternatively, if persons or entities have more than 25% of payroll, property, or sales in the state, that person or entity has substantial nexus with Oregon even though its total figures do not exceed those listed above.

This statute also provides for an aggregation approach for commonly owned enterprises. This aggregation approach calls for the aggregation of all commonly-held enterprises whose payroll, property, *and* sales exceed $5,000 in Oregon. Enterprises that independently meet the nexus tests are included in this aggregate determination.

iv. *A&F Trademark Inc. v. Sec'y of Revenue*, No. COA03-1203 (N.C. Ct. App. Dec. 7, 2004), *reviewed denied*, NOC0A03-1203 (N.C. Sup. Ct March 3, 2005). The North Carolina Court of Appeals held that Delaware intangible holding companies were doing business in the state and, therefore, were subject to corporate income and franchise taxes. Further, the Commerce Clause of the U.S. Constitution does not forbid the state from imposing the taxes at issue. Specifically, the court held that administrative Rule 17 NCAC 5C.0102 provides that the term "doing business" means the operation of any business in the state for economic gain, including owning or renting income producing property such as trademarks and trade names in the state. The holding companies argued that Rule 17 NCAC 5C.0102 "is of no consequence" because year 2001 amendments to the income tax statutes[2] indicate "that the agency's rule [improperly] expanded the income tax statute" instead of interpreting it, and that the only possible purpose for the 2001 amendments was to "cover the receipt of royalty income from the in-state use of licensed trademarks." In rejecting this argument, the court found that the 2001 amendments endorsed rather than changed the scope of the income tax statute, stating that "the [2001] bill clearly denotes that its function was to enhance compliance 'with the State tax on income generated from using trademarks in [manufacturing and retailing] activities'… [and] the stated purpose was merely to add a reporting option to the income tax statute, not to modify or change what constituted taxable income."

The court also held that the imposition of franchise taxes by the revenue department does not exceed the department's statutory authority. The state's franchise tax is imposed on every corporation doing business in the state for the opportunity and privilege of transacting business in the state. The court held the "[i]t is beyond dispute that North Carolina has provided privileges and benefits that fostered and promoted the related retail companies. By affording these benefits to the related retail companies, additional benefits have inured to the [holding companies]." Further, the court agreed with the broad rationale accepted by the South Carolina Supreme Court in *Geoffrey, Inc. v. South Carolina Tax Comm'n*, 437 S.E.2d 13 (1993), that by providing an orderly society in which the related retail companies conduct business, North Carolina has made it possible for the taxpayers to earn income pursuant to the licensing agreements.

The court also disagreed with the holding companies' argument that the presence of their intangible property in North Carolina is irrelevant in light of the lack of physical presence of offices, facilities, employees, and real or tangible property, and that *Nat'l Bellas Hess, Inc. v. Dep't of*

2. N.C. Gen. Stat. §105-130.7A, as amended by 2001 N.C. Sess. Laws 327.

Revenue, 386 U.S. 753 (1967) and *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992)[3] mandate that the court find the imposition of tax violates the Commerce Clause. In rejecting the holding companies contention, the court refused to expand the scope of the physical presence test of Quill beyond sales and use taxes, stating that "there are important distinctions between sales and use taxes and income and franchise taxes 'that makes the physical presence test of the vendor use tax collection cases inappropriate as a nexus test.'" Ultimately, the court rejected the contention that physical presence is the *sine qua non* of a state's jurisdiction to tax under the Commerce Clause for purposes of income and franchise taxes. Rather, the court held that "under facts such as these where a wholly owned subsidiary licenses trademarks to a related retail company operating stores located within North Carolina, there exists a substantial nexus with the State sufficient to satisfy the Commerce Clause."

v. *Tax Comm'r of West Virginia v. MBNA Am. Bank, N.A.*, 640 S.E.2d 226 (W.V. 2006), *cert. denied*, 551 U.S. 1141 (2007).

(1) West Virginia's statute imposes tax on financial institutions based on the amount of the financial institutions' economic activity with respect to West Virginia customers.

(2) The Administrative Law Judge for the West Virginia Office of Tax Appeals determined that to meet the "substantial nexus" requirement of the Commerce Clause, there must be "a finding of a physical presence in the taxing state, not merely an economic exploitation of the market."

(3) The ALJ then ruled that MBNA's use of the services of in-state lawyers and West Virginia courts for a *de minimis* number of credit card debt collection actions (three actions over a two year period) was insufficient to create nexus in West Virginia because it was merely the "slightest presence" and was not significantly associated with MBNA's ability to establish and maintain a market in West Virginia.

(4) The Circuit Court reversed the decision of the Office of Tax of Appeals and held that the corporate net income and business franchise taxes had been properly imposed on MBNA.

(a) The Court found that MBNA's gross receipts attributable to a West Virginia source far exceeded the statutory threshold for nexus and concluded that MBNA had substantial nexus with the state for the years in question such that imposition of the corporate income and business franchise taxes was proper.

(b) The Court rejected the "bright-line physical presence test" established in *Bellas Hess* and adhered to in *Quill* because the taxes at issue in this case were not sales and use taxes. Specifically, the Court found as a matter of law that physical

3. Both *Bellas Hess* and *Quill* involved attempts by a state to require out-of-state mail-order vendors to collect and pay use taxes on goods purchased within the state despite the fact that the vendors had no outlets or sales representatives in the state.

presence was not required to establish substantial nexus to satisfy the Commerce Clause when imposing corporate net income and business franchise taxes.

(c) In reaching its decision, the Court focused on the many benefits MBNA was deemed to receive from the state, such as the banking and consumer credit laws and access to the state's courts, all of which enabled MBNA to generate income from West Virginia customers. The Court noted in particular that because MBNA extends substantial unsecured credit to citizens of West Virginia, the fact that MBNA had access to West Virginia courts was essential to its business operations.

(d) The West Virginia Supreme Court affirmed the circuit court decision and introduced a "significant economic presence test" to hold MBNA liable for business franchise and corporate income taxes.

(i) The court began its analysis by determining that *Quill* applies only to sales and use taxes. It based this conclusion on four grounds. First, the *Quill* decision was primarily based on *stare decisis* and the need for a continuing bright-line standard for sales tax imposition. The court pointed to language in *Quill* stating that "contemporary Commerce Clause jurisprudence might not dictate the same result were the issue to arise for the first time today." Second, the West Virginia court read *Quill* so as to limit its decision to sales and use taxes. Third, the court cited *Quill's* foundation that without the *Quill* rule, compliance with the myriad of state and local sales tax rules and rates would be unduly difficult and burdensome on business. The court felt that because income taxes are remitted less frequently and to fewer jurisdictions, the compliance burden for income taxes was not as significant. Finally, the court cited changes in communication technology and electronic commerce leading to the declining viability of *Quill's* physical presence test in today's world.

(ii) After refusing to apply *Quill* to income taxes, the court introduced a "significant economic presence test" as an indicator of whether businesses have nexus for Commerce Clause purposes. The court described the test as one that incorporates the due process requirements of purposeful direction towards a state while at the same time examining the degree of those directed contacts. That degree is measured by "the frequency, quantity, and systematic nature of a taxpayer's economic contacts with a state." In applying this standard to MBNA, the court pointed to the systematic and continuous nature of the direct mail and telephone solicitation performed in West Virginia. Furthermore, MBNA's gross receipts of over $8,000,000 and $10,000,000 in 1998 and 1999 respectively were sizable and "attributable" to West Virginia, thus satisfying the significant economic presence test.

(iii) In his dissenting opinion, Justice Benjamin argued that the majority opinion missed the mark by analyzing what type of tax this was rather than the effects imposition of the tax would have on interstate commerce. "Absent precedential support for differentiating 'substantial nexus' standards based upon tax types, this Court should resist the State's invitation for us to speculate based on semantics and, instead, focus on the effect which the state tax has on interstate commerce—here, attempting to levy an income tax on an out-of-state corporation with no property, tangible or intangible, in West Virginia where the income in question was generated from credit accounts held outside of this state." Justice Benjamin contended that policy considerations such as undue burden on companies and the need for a bright-line standard are equally as valid for income taxes as for sales taxes. Under this framework, he concluded that for the same reasons that sale tax imposition requires physical presence, imposition of an income tax also should require physical presence.

vi. Capital One Bank v. Massachusetts Comm'r of Rev., 899 N.E.2d 76 (Mass. 2009).

(1) The highest court in Massachusetts affirmed the Appellate Tax Board's conclusion that credit card issuer Capital One Bank had substantial nexus with Massachusetts and that imposition of the Massachusetts financial institution excise tax ("FIET") on Capital One was not unconstitutional.

(2) The FIET presumed that financial institutions are engaged in business in Massachusetts, and hence are subject to the FIET, if there are transactions involving intangible property with "one hundred or more residents of the Commonwealth during any taxable year or if the taxpayer has ten million dollars or more of assets attributable to sources within the Commonwealth."

(3) In its decision, the Massachusetts Supreme Judicial Court wrote that "[i]n addition to their consumer lending activities, the Capital banks were soliciting and conducting significant credit card business in the Commonwealth with hundreds of thousands of Massachusetts residents, generating millions of dollars in income for the Capital banks. In essence, the Capital banks were providing valuable financial services to Massachusetts consumers, for which the Capital banks were compensated in the form of interest payments, interchange fees, and finance charges."

2. Attributional Nexus

The states have generally been unsuccessful in their attempts to use an "attributional nexus" theory to establish sales/use tax nexus over taxpayers, but *Matter of Borders Online Inc.*, No. A105488 (Cal. Ct. App., 1st App. Dist., May 31, 2005) (see below) and *Matter of Barnes & Noble.com*, No. 89872 (Cal. St. Bd. Equal. Sept. 12, 2002) cases are recent exceptions.

a. *Scripto Inc. v. Carson*, 362 U.S. 207 (1960).

i. The United States Supreme Court decision sustaining the power of a state to require an out-of state seller that made sales through independent contractors to collect the State's use tax on sales.

ii. Georgia company used independent contractors to solicit orders in Florida. The independent contractors forwarded any resulting orders to the home office for shipment of the ordered goods. The Supreme Court held that the company's relationship with a fleet of sales persons continually soliciting on its behalf within the state, taking orders and receiving commissions based on their sales, acted as the functional equivalent of a local sales force. The use of the salesmen to solicit orders for the sale of goods was to be attributed to the principal for purposes of determining the obligation to collect use tax.

b. *Tyler Pipe Indus., Inc. v. Washington Dep't of Revenue*, 482 U.S. 232 (1987).

i. 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."

c. *SFA Folio Collections Inc. v. Comm'r*, 73 Ohio St. 3d 119, 652 N.E. 2d 693 (Oh. Sup. Ct. 1995).

i. The taxpayer sold clothes to Ohio customers through catalogs. An affiliate of the taxpayer, Saks Fifth Avenue of Ohio ("Saks-Ohio") operated stores in Ohio. Saks-Ohio stores received copies of the taxpayer's mail order catalogs and made copies available for store customers to review. Saks-Ohio stores also accepted returns of the taxpayer's mail order merchandise.

ii. The Ohio Tax Commissioner assessed the taxpayer use tax on its Ohio sales claiming that the taxpayer had substantial nexus with Ohio through its unitary relationship with Saks-Ohio.

iii. The Ohio Supreme Court determined that under *Quill*, the vendor itself must have physical presence in Ohio. Inasmuch as the taxpayer and Saks-Ohio were different legal entities and the retail stores did not conduct activities in Ohio on behalf of the taxpayer, the stores' physical presence in Ohio did not establish nexus. For the taxpayer.

d. *In re Scholastic Book Clubs Inc.*, 260 Kan. 529, 920 P. 2d 947 (1996).

i. The taxpayer was a mail-order seller of children's books. The taxpayer sent catalogs to schoolteachers who distributed the catalogs to their students and collected and submitted the orders to the taxpayer. Teachers received bonus merchandise in proportion to student purchases. Kansas asserted that the taxpayer was subject to use tax liability in Kansas because the teachers were acting as sales agents of the taxpayer and, thus, created physical presence for the taxpayer in the state.

ii. The Kansas Supreme Court determined that the teachers were the taxpayer's implied agents because the teachers acted under the taxpayer's authority once they chose to sell the books. The court determined that the taxpayer's use of the teachers created substantial nexus with Kansas and, thus, the taxpayer was required to collect sales tax on the book orders.

iii. This Kansas case is the latest in a series of state decisions addressing the same issue with a similar fact pattern. The state courts that have addressed the issue have come to widely divergent results. *Cf. Scholastic Book Clubs, Inc. v. State Bd. of Equalization*, 207 Cal. App. 3d 734, 255 Cal. Rptr. 77 (Cal. Ct. App. 1989) (once publisher accepted an order from a teacher, publisher ratified teacher's authority to act on its behalf, thus creating an agency relationship); *Pledger v. Troll Book Clubs, Inc.*, 316 Ark. 195, 871 S.W.2d 389 (Ark. Sup. Ct. 1994) (no agency relationship existed because of lack of requisite control, thus, no nexus); *Troll Book Clubs v. Tracy*, Case No. 92-Z-590, 1994 Ohio Tax LEXIS 1374 (Ohio Bd. Tax App. Aug. 19, 1994) (Ohio teachers not controlled by publishing company, thus, no nexus); *Scholastic Book Clubs, Inc. v. Farr*, 373 S.W.3d 558 (Tenn. S. Ct. 2012), *cert. denied* 568 U.S. ____ (Nov. 26, 2012) (Scholastic created a "de facto marketing and distribution mechanism."); *Scholastic Book Clubs, Inc. v. Conn. Comm'r. of Rev. Servs.*, 38 A.3d 1183 (Conn. S. Ct. 2012), *cert. denied* 568 U.S. ____ (Oct. 9, 2012) ("Because the teachers who participate in the program serve as the only means through which the plaintiff communicates with Connecticut school children, they provide the substantial nexus required to permit the imposition of sales and use taxes under the bright-line physical presence rules established in *Bellas Hess* and *Quill*.").

e. *Bloomingdale's By Mail, Ltd. v. Penn. Dep't of Rev.*, 130 Pa. Commw. 190 at 198, 567 A.2d 773 at 778 (Pa. Commw. Ct. 1989) *aff'd*, 527 Pa. 347, 591 A. 2d 1047 (Pa. Sup. Ct. 1991).

i. A corporation whose only connection with Pennsylvania was the solicitation of sales through catalogs mailed into Pennsylvania from outside of the state and the shipment of goods into Pennsylvania from outside of the state did not have an obligation to collect use tax on shipments of goods into Pennsylvania. Substantial nexus was not established through the presence of an affiliate's retail stores in Pennsylvania because the stores "do not solicit orders on [the catalog company's] behalf nor act as its agents in any fashion and [the catalog company] does not solicit orders for [the instate stores].”

ii. The only connections between the catalog company and the stores were two documented instances where a catalog item was returned to a store in Pennsylvania—even though the catalog specified that items should be returned only by mail—and the fact that the catalogs and the stores used the same advertising themes.

f. *Current, Inc. v. Cal. State Bd. of Equalization*, 24 Cal. App. 4th 382, (Cal. Ct. App. 1994). A corporation did not have sufficient nexus with California such that it was forced to collect California’s use tax on sales of goods shipped into California merely because a corporation that did have nexus with California acquired it.

g. *Comm’r of Revenue v. Jafra Cosmetics*, 433 Mass. 255, 742 NE2d 54 (Mass. Sup. Jud. Ct. Jan. 25, 2001). Company with in-state consultants demonstrating and selling its cosmetics line had representatives in the state and, thus, had substantial nexus for sales and use tax purposes. Taxpayer had argued that consultants were representing their own, independent business, and were not acting on behalf of the out-of-state company. *Cf. Shaklee Corp. v. Comm’r of Revenue*, Nos. F245496, F24597 (Mass. App. Tax Bd. Feb. 7, 2000). A manufacturer of household products was not subject to Massachusetts excise tax or sales and use tax collection based on the sales activities of local independent contractors or a single sales convention in the state. The board found the local sales representatives operated independent businesses, and thus did not create nexus subjection Shaklee to sales/use tax collection obligations in the state.

h. *State of Louisiana v. Quantex Microsystems, Inc.*, 809 So. 2d 246 (La. Ct. App. July 3, 2001). The First Circuit Court of Appeal reversed and remanded a nexus case involving sales & use taxes. The trial court, citing *Quill*, had granted summary judgment in favor of the taxpayer, a foreign corporation that sells computer products into Louisiana by mail, telephone, and the Internet. The appellate court stated that Quantex’s discovery responses gave inconsistent answers regarding whether Quantex itself provided onsite warranty service to customers in Louisiana or whether it was provided by the manufacturer. The court indicated that additional discovery was necessary to determine whether (or how much) on-site service performed by independent contractors would create nexus for Quantex. One judge dissented, finding no inconsistency and supporting the physical presence standard of *Quill.* Gateway, Inc. had filed an amicus curiae brief in the case.

i. *Matter of Borders Online Inc.*, No. A105488 (Cal. Ct. App., 1st App. Dist., May 31, 2005). The California Court of Appeal, First Appellate District, held that an out-of-state online retailer has nexus with California through the activities of its “authorized representative,” a brick-and-mortar affiliate that sells products similar to those sold by the online retailer, and therefore, is liable for use tax collection on goods purchased by customers in California. In reaching this decision, the California Court of Appeal concluded that the in-state retailer's activities on behalf of the online retailer were "for the purpose of selling" the online retailer's goods.

j. *St. Tammany Parish v. Barnesandnoble.com*, No. 05-5695 (E.D. La. 2007). A federal case involving facts similar to *Borders Online.* An Internet seller was alleged to have sales and use tax presence in Louisiana due to its affiliation with an entity owning bookstores in the state. The companies had separate management, employees and offices. However, they participated in gift card and membership programs operated by their parent, and benefited by advertising of the programs as well as certain other cross promotional activities. The brick and mortar stores also accepted returns of merchandise sold by the Internet seller, but also accepted returns of unrelated sellers' products. The Internet site listed store locations.

The federal court refused to attribute tax presence from brick and mortar stores to the Internet seller. The court stated that the contacts were not "of the order of magnitude necessary to establish that" the brick and mortar stores marketed the Internet company's sales in Louisiana. The sharing of a common name, brand identity and the joint marketing described did not establish nexus. This case has been appealed.

k. *Barnesandnoble.com v. State Bd. of Equalization*, No. CGC-06-456465, (Superior Court, San Francisco County, Sept. 7, 2007). An out-of-state corporation that sells books, music, and movies in the state via the Internet does not engage in business in the state, for *use tax* collection purposes, even though limited marketing was done through brick-and-mortar stores in the state. The California Rev. & Tax. Cd. §6203 definition of a retailer engaged in business in the state includes a retailer having an agent within the state. The Superior Court ruled that Barnes & Noble, which owned brick-and-mortar stores in California, was not the agent of Barnesandnoble.com when the brick-and-mortar stores inserted the online retailer's coupons into its shopping bags and printed the name of the online retailer on one side of its shopping bags. The Superior Court distinguished the present case from that in the previous *Borders* case in that Barnesandnoble.com was not fully controlled by Barnes & Noble. Also, Barnes & Noble had no authority to bind Barnesandnoble.com, and Barnes & Noble owned only 40% of Barnesandnoble.com, whereas in *Borders*, the subsidiary was wholly owned by the parent.

l. *N.M. Tax & Rev. Dep't v. Barnesandnoble.com LLC*, No. 31,231 (N.M. Ct. App., April 18, 2012). The court concluded that the "[t]axpayer's use of shared marketing, name recognition, and trademarks, and logos created and established a market in New Mexico," and thus, the hearing officer's determination was not "in accordance with the law." The court ultimately concluded that it was permissible to impute the in-state activities of one licensee (affiliated retail stores) to another licensee (taxpayer) who used the trademarks to make internet sales to residents of New Mexico.

m. *Comptr. of the Treas. v. W.L. Gore*, Nos. 1696, 1697 (Md. Ct. Spec. App., Jan. 24, 2013). The Maryland Court of Special Appeals ruled that two subsidiaries of Gore, one holding its intangible assets and one holding its financial assets, had royalty and loan interest income apportionable to Maryland based upon a unitary relationship with the parent company, which generated income in Maryland. Nexus sufficient to justify taxation arises from the economic reality that a parent's business in the taxing state produces a subsidiary's income. The subsidiaries' income was entirely the product of expenses that the parent deducted in Maryland, so the subsidiaries' income was earned in Maryland.

n. Pennsylvania Department of Revenue Letter dated Aug. 29, 2012 (Pennsylvania based online marketers do not create nexus for out-of-state sellers unless the marketers are paid on a commission basis for their services).

o. Hawaii Letter Ruling 2012-10 (July 10, 2012) (The establishment of a shopping rewards program and return policy with an affiliated retailer that maintains physical locations within Hawaii creates sufficient nexus for the general excise tax.).

p. Utah Private Letter Ruling 12-009 (Feb. 8, 2013).

   i. Taxpayer did not establish sales and use tax nexus or corporate income tax nexus based on its presence in the state at a film festival.

   ii. Taxpayer's presence in the state at a film festival did not create sales and use tax nexus for taxpayer's affiliate.

3. Attributional Nexus—"Amazon Laws"

States have adopted a number of legislative approaches aimed at requiring out-of-state Internet sellers to collect use tax. These efforts have been supported by bricks-and-mortar retailers.

a. Some states have adopted statutes providing that an out-of-state retailer has nexus, or is presumed to have nexus (subject to rebuttal), if it has in-state affiliates who provide links to the retailer's website and sales to in-state customers exceed certain levels.

   i. Examples: Arkansas, California, Connecticut, Illinois, New York, North Carolina, Rhode Island.

   ii. *Amazon.com, LLC v. New York State Dep't of Taxation and Fin.* (Mar. 28, 2013).

      (1) The New York Court of Appeals upheld the New York Amazon Law as facially constitutional.
      (2) The Court found that although physical presence is generally necessary for sales tax nexus, it need not be substantial, and can be met if economic activities are performed in the state by a seller on behalf of the taxpayer.
      (3) "Active, in-state solicitation that produces a significant amount of revenue qualifies as 'demonstrably more than a slightest presence…. The bottom line is that if a vendor is paying New York residents to actively solicit business in this State, there is no rea-

son why that vendor should not shoulder the appropriate tax burden.'"

iii. *Performance Marketing Ass'n v. Hamer*, No. 2011 CH 26333 (Ill. Cir. Ct., Final Order, May 7, 2012).

(1) The Performance Marketing Association filed a suit in federal district court challenging the constitutionality of the Illinois click-through nexus law.
(2) The case was re-filed in state court to avoid challenge of the Tax Injunction Act.
(3) The law was held unconstitutional by Circuit Court Judge.

b. Some states have adopted statutes requiring out-of-state retailers to report in-state purchasers.

i. Examples: Colorado, Oklahoma, South Dakota, Vermont.

ii. *The Direct Marketing Ass'n v. Huber*, 2012 U.S. Dist. LEXIS 44468 (U.S. Dist. Ct. D. Colo., March 30, 2012).

(1) The DMA asked the court to enjoin the Colorado DOR from enforcing the notice and reporting obligations under 39-21-112(3.5). The DMA argued that the requirements violate the Commerce Clause of the U.S. Constitution.
(2) The Court granted the injunction and, on March 30, 2012, declared the law unconstitutional because: (1) it directly regulated and impermissibly discriminated against out-of-state retailers and interstate commerce, and (2) imposed undue burdens on interstate commerce in violation of *Quill*.

D. Transactional Nexus

1. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977). Appellant corporation challenged back taxes for the sales of transportation services. Appellant engaged in business of transporting motor vehicles from Jackson, Mississippi to dealers within the state of Mississippi. The Supreme Court in affirming the decision of the Mississippi Supreme Court, fashioned a four prong test to determine the constitutionality of state taxes on an out of state business. The first prong is whether the tax is applied to an activity with a substantial nexus with the taxing state.

2. *Goldberg v. Sweet*, 488 U.S. 252 (1989). Appellant individuals and corporation challenged the constitutionality of an Illinois telecommunications Tax Act. Appellant individuals are residents of Illinois who are subject and have paid the tax through their retailers, long distance telephone carriers. Appellant corporation is a long distance telephone carrier that does business in Illinois. Appellants conceded before the Supreme Court that interstate communications reached by the Tax Act constitute a sufficient nexus with Illinois.

3. *Conn. Gen. Life Ins. Co. v. Johnson, Treasurer of Cal.*, 303 U.S. 77 (1938). Appellant insurer claimed that a tax on its receipt in its home state, Connecticut, of reinsurance premiums from insurance companies operating in California on

policies reinsuring them against loss on policies they issued in California to California residents violated the due process clause. Apart from the fact that appellant was privileged to do business in California, and that risks reinsured were originally insured against in that state by companies also authorized to do business there, California had no relationship to appellant or the contracts. The Supreme Court reversed the dismissal of appellant insurer's actions to recover state taxes paid under protest, finding a due process violation and that California had no relationship to appellant or to reinsurance contracts.

E. The Direct Aspect of the Commerce Clause

The Commerce Clause explicitly provides that Congress has the power to directly regulate commerce among the several states. Although Public Law 86-272 (discussed below) is the broadest and most general federal legislation restricting state taxation of interstate commerce, there are other federal statutes that either broaden or narrow state taxing powers affecting multistate businesses.

1. The Internet Tax Freedom Act (ITFA), P.L. 105-277, signed into law on October 21, 1998, imposed a three-year moratorium on state taxes on Internet access and multiple or discriminatory taxes on electronic commerce. An exception to the moratorium was provided for Internet access charges that were generally imposed and actually enforced by any state prior to October 1, 1998. On November 28, 2001, President Bush signed H.R.1552 into law and thereby extended the Internet Tax Freedom Act, as originally enacted, for two more years. The moratorium expired on November 28, 2003, but was extended in 2004 and again in 2007.
2. Telecommunications Act of 1996, Public Law 104-104 (S. 652), signed February 8, 1996, which substantially rewrote the 1935 Communications Act, exempts providers of direct-to-home satellite services from the collection and/or remittance of any tax or fee imposed by any local, but not state, taxing jurisdiction on direct-to-home satellite services, also known as direct broadcast satellite (DBS) services.
3. Public Law 104-95 (H.R. 394) (1996) (codified at 4 U.S.C. §114) limits the states' ability to subject retirement income received by a former resident after 1995 to income taxation. The law specifically provides that states may not tax several types of retirement income of non-residents and non-domiciliaries, including income from IRC §403 annuities, §408(k) plans and §7701(a)(37) individual retirement plans. The new law is effective for payments received after December 31, 1995. H.R. 4019 amends Pub. L. 104-95, which prohibits states from taxing the retirement income of nonresidents, to clarify that retirement income of all retirees, regardless of whether they were employees, partners or self-employed prior to retirement, is treated the same for state tax purposes. This amendment applies to amounts received after December 31, 1995. Pub. L. No. 109-264 (H.R. 4019), enacted August 3, 2006.
4. Federal Aviation Administration Authorization Act of 1994, Public Law 103-305, 108 Stat. 1569, broadened the preemption of state authority to tax nonresident wages of airline employees to include in the definition of "compensation" those wages earned while performing union duties.

5. Aviation Safety and Capacity Expansion Act of 1990, Public Law 101-508, 104 Stat. 1388 (codified at 49 U.S.C. §1513(f)), prohibits states and their political subdivisions from imposing "any tax on or with respect to any flight of a commercial aircraft or any activity or service on board such aircraft unless such aircraft takes off or lands in such state or political subdivision as part of such flight. This legislation reversed the results of *Republic Airlines, Inc. v. Wis. Dep't of Revenue*, No. 89CV2916 (Wis. Cir. Ct. Dane County February 12, 1990) and, apparently, the Oregon Supreme Court's decision in *Alaska Airlines, Inc. v. Dep't of Revenue*, 769 P.2d 193 (Ore. 1989), *cert. denied*, No. 89-346 (U.S. Jan. 8, 1990) (use of overflight miles upheld in apportioning the system value of an airline for property tax purposes). *See also* Ruling of Virginia Commissioner, P.D. 91-41, Mar. 19, 1991 (inclusion of overflight miles in a corporate income tax apportionment formula preempted by federal law).
6. Airline passenger tickets may not be taxed. 49 U.S.C. 1513(a) prohibits a state from taxing people traveling in air commerce or the sale of air transportation or on the gross receipts from air transportation.
    a. Any activity or service provided during airline overflights may not be taxed unless the aircraft takes off or lands in the taxing state or subdivision as part of such flight. 49 U.S.C. §1513(f)
7. Federal Interstate Commerce Commission (ICC) Termination Act of 1995, Public Law 104-88, 109 Stat. 803 (codified at 49 U.S.C. 14505), prohibits a state or its political subdivisions from collecting or levying a tax, fee, head charge, or other charge on (1) a passenger traveling in interstate commerce by motor carrier; (2) the transportation of a passenger traveling in interstate commerce by motor carrier; (3) the sale of passenger transportation in interstate commerce by motor carrier; or (4) the gross receipts derived from such transportation. The law, which became effective January 1, 1996, was apparently in response to the U.S. Supreme Court's decision in *Jefferson Lines, Inc.*, 115 S. Ct. 1331 (1995) that Oklahoma's unapportioned tax on the purchase price of interstate bus tickets bought in state did not violate the Commerce Clause.
8. Railroad property may not be taxed more heavily than other commercial and industrial properties. Railroad Revitalization and Regulatory Reform Act of 1976 (4-R Act), P.L. 94-210, 49 U.S.C. §1503 (1978).
    a. Interstate railroad employees may not be subject to state and local taxes, except in their resident state. 49 U.S.C. §11504
9. Generation or transmission of electricity may not be taxed in a manner that discriminates against out-of-state manufacturers, producers, wholesalers, retailers, or consumers of that electricity. 15 U.S.C. §391.
10. Employee Retirement Income Security Act of 1974 (ERISA), §514(a) provides that the provisions of ERISA "shall supersede any and all State laws insofar as they may now or hereafter relate to any employee benefit plan." 29 U.S.C. §1144(a)
    a. New York real property transfer gains tax imposed on gains derived by a qualified employee benefit plan from the sale of property was preempted by

ERISA. *Morgan Guaranty Trust Co. v. Tax Appeals Tribunal of Dep't of Taxation & Fin.*, 599 N.E.2d 656 (N.Y. 1992).

11. McCarran-Ferguson Act, 15 U.S.C. §§1011–1015 (1982), removed all Commerce Clause limitations on the authority of the States to regulate and tax the business of insurance. The purpose of the McCarran-Ferguson Act is to allow the States to regulate, directly or indirectly, interstate commerce between insurance companies of one state and the customers of another state. *See S.E.C. v. National Secs., Inc.*, 393 U.S. 453 (1969), *Feldman v. State*, 615 P.2d 238 (Nev. 1980).

III. Alternative Apportionment

A. Discretionary Adjustments

1. Most statutory schemes provide the Tax Department with discretionary authority to adjust an apportionment formula under certain circumstances for a particular taxpayer. *See, e.g.*, UDITPA Section 18.
    a. For example, many statutes provide authority to exclude one or more of the factors or to include additional factors if the apportionment provisions do not fairly represent the extent of the taxpayer's business activity in the state.
    b. These statutory adjustment powers typically also provide the options of using separate accounting or any other method that will effectuate an equitable apportionment of the tax base.
2. *U.S. Bancorp v. Dep't of Revenue*, 103 P.3d 85 (Or. 2004), *cert. denied*, 126 S. Ct. 48 (U.S. 2005).
    a. The U.S. Supreme Court declined to review an Oregon Supreme Court decision that held that the Oregon Department of Revenue had the authority to depart from the standard three-factor apportionment formula for financial organizations to require the inclusion of intangible personal property in the property factor of its apportionment formula for tax years 1984 through 1992.
3. *Irving Pulp & Paper, Ltd. v. State Tax Assessor*, 879 A.2d 15 (Me. 2005).
    a. Irving Pulp & Paper, a Canadian corporation engaged in forestry with timberland preserves in Maine but no payroll in the state or anywhere else in the U.S., attempted to use worldwide property, payroll, and sales in the denominators of the apportionment factors.
    b. Finding the relevant statute ambiguous, the Supreme Judicial Court of Maine looked beyond the plain language of the statute and adopted the Assessor's interpretation of the terms "all" and "everywhere" to be understood contextually as all and everywhere in the United States.
    c. The appellate court determined that the figures used were properly limited to property, payroll, and sales within the United States.
4. *Microsoft Corp. v. Franchise Tax Bd.*, Dkt. No. 5133343 (Cal. Aug. 17, 2006), *aff'g Microsoft Corp. v. Franchise Tax Bd.*, No.A105312 (Cal. 1st App. Dist. 2005), *rev. granted*, No. S133343 (Cal. S.Ct. June 8, 2005).

a. The California Supreme Court recently affirmed the decision by the Court of Appeals for the First District, which had determined that the California Franchise Tax Board did not abuse its discretionary authority by employing an equitable apportionment method to omit the returned principal from the gross receipts element of the sales factor.

b. The court determined that the standard apportionment formula did not fairly represent the extent of the corporation's business activity in California.

c. The stipulated facts established beyond question that including returned principal in the corporation's gross receipts seriously distorted the representation of its worldwide business activity, including its California business activity.

5. *General Mills, Inc. v. Franchise Tax Bd.*, Dkt. No. CGC05-439929 (Ca. Super. Ct., San Francisco County 2010).

    a. The use of gross receipts for hedging transactions was held to be distortive.

    b. The FTB was reasonable in concluding that the taxpayer's hedging transactions were qualitatively different from its principal business and had to be treated separately.

6. *Miami Corp. v. Dep't of Revenue*, 2005 Ore. Tax LEXIS 23 (Or. Tax Court, Magistrate Div. Feb. 17, 2005).

    a. The Oregon Tax Court determined that a Delaware corporation that owned a tree farm in Oregon was subject to the Oregon excise tax apportionment formula because the taxpayer was a unitary business.

    b. The taxpayer conducted business in four states.

        i. Its real estate department managed timberland in Florida, a tree farm in Oregon, and land and associated oil and gas reserves in Louisiana.

        ii. Its securities department managed its securities portfolio from the corporate head office in Illinois. The securities portfolio managed in Illinois and the oil and gas reserves in Louisiana represented the greatest part of the taxpayer's income-producing assets.

    c. The court determined that the property factor of the apportionment formula should be adjusted to include intangibles for one of the tax years because application of the statutory formula produced an unfair result.

    d. The court also determined that the sales factor should be modified for all the relevant tax years to include the gross receipts, rather than net gain, from the taxpayer's sale of intangibles, including securities, because these receipts were derived from the taxpayer's primary business activity.

7. *Matter of Barclays Group, Inc. (USA) & Affiliates*, New York Division of Tax Appeals, Tax Appeals Tribunal, DTA No. 818789 (Jan. 27, 2005).

    a. The Tax Appeals Tribunal upheld the determination of the Administrative Law Judge that Barclays improperly amended its returns to report, on a net basis, the assets of a wholly-owned subsidiary/member of its combined group that was engaged in business as a primary dealer of U.S. securities, for purposes of the state tax on assets of financial corporations.

b. Barclays claimed that calculating taxable assets in accordance with N.Y. Tax Law §1455(b)(1) distorted the subsidiary's asset picture because its business of purchasing long positions in securities increased the subsidiary's taxable assets with each transaction but did not increase its wealth or otherwise improve its financial condition.

c. The taxpayer argued that netting of the subsidiary's assets would result in a better measure of the subsidiary's taxable assets within the state.

d. The Commissioner of Taxation and Finance declined to make this discretionary adjustment because the group's assets were neither inaccurately nor improperly reflected on the combined returns as originally filed.

e. The Tax Appeals Tribunal also upheld the ALJ's determination that the Commissioner properly declined to exercise the discretion to make the proposed adjustment because the taxpayer's assets were neither inaccurately nor improperly reflected on the combined returns as originally filed.

8. *Union Pacific Corp. v. Idaho State Tax Comm'n,* 83 P.3d 116 (Idaho 2004).

   a. The taxpayer included in its sales factor both receipts from freight sales and the money received from the sale of the freight sale accounts receivable. The state tax department asserted that this double-counted the receipts and sought to include only the freight sales in the apportionment formula.

   b. The Idaho Supreme Court found that both transactions were "sales" under the statute and thus ordinarily includable in the sales factor.

   c. However, the court determined that, because of the "unusual" accounting practice of using an accrual method for the freight sales and a cash method for the sale of accounts receivable, it was appropriate to use an alternative apportionment formula to more accurately reflect the taxpayer's income in the state.

   d. The court also found that the statute was clear as to what the rules were for imposing an alternative formula and that there was no need to include the higher federal constitutional standard of "gross distortion"/"out of all appropriate proportion."

9. *In the Matter of Magella Healthcare Corp.*, Alaska Office of Tax Appeals No. OTA-2003-01 (Jan. 2, 2004).

   a. The Alaska Office of Tax Appeals held that an out-of-state parent corporation of an in-state neonatal medical care provider was entitled to relief from the statutory three-factor apportionment formula and a refund of tax paid on a combined reporting basis. The parent was not required to prove an unconstitutional distortion in apportioned income to obtain factor relief.

   b. The Office determined that the taxpayer had met its burden of proof by showing that the standard formula resulted in a substantial distortion in the income of its Alaska subsidiary by failing to include the payroll and property factors of out-of-state non-subsidiary medical practices, which the corporation controlled through practice management agreements and which generated most of the total income of the multi-state business.

c. Because the out-of-state corporation met its statutory requirements and burden of proof, the denial of the factor relief under the discretionary adjustment was unreasonable and arbitrary.

10. *Infosys Technologies Limited,* Dkt. No. 820669, N.Y. Div. of Tax Appeals (Feb. 2007).

    a. Having determined that Infosys was required to include foreign source income in its computation of its entire net income for purposes of the New York State corporation franchise tax, the ALJ further determined that equity requires an adjustment to the payroll factor to reflect the vast wage differences between employees working in New York and those working in India. He supported his ruling by showing that the payroll factor as computed by the auditor did not properly reflect the amount of business done within New York.

11. *CarMax Auto Superstores West Coast Inc. v. S.C. Dep't of Rev.* (S.C. Ct. App. 2012).

    a. The court held that the Department of Revenue has the burden of proving that its alternative apportionment methodology more accurately reflected income than did the statutory formula.

    b. The court said, in dictum, that the burden could be met by a "preponderance of evidence," rejecting the "clear and convincing evidence" standard urged on it by the taxpayer.

12. *Ind. Dept. of Rev. v. Rent-A-Center East, Inc.*, No. 49510-1112-TA-683 (Ind. Mar. 9, 2012).

    a. Tax Court held that the Department could force combination only if the Department could first show that other alternatives did not fairly reflect income.

    b. Indiana Supreme Court reversed and remanded.

        i. The Department's notice of proposed assessment served as *prima facie* evidence that its claim for the unpaid tax was valid.

        ii. The burden then shifts to the taxpayer to show that an alternative apportionment method would more properly reflect its income.

        iii. Pending the Tax Court's decision on remand, the Indiana Supreme Court's decision now means taxpayers can no longer argue that the Department must first show that use of other alternatives did not fairly reflect the taxpayer's Indiana income before forcing combination.

13. Indiana Letter of Findings 02-20110473 (Mar. 27, 2013).

    a. In approving the use of an "audience factor" to apportion the income of a television producer and broadcaster, the Department notes that "[c]learly, the alternative apportionment regulation strikes a cautionary note against the Department implementing its remedial powers broadly. However, the statute's language of limitation suggests a tolerance for 'limited and unusual' circumstances which are only ordinarily unique and non-recurring; i.e., the circumstances may also be non-unique and recurring."

b. The Department finds that the burden of proving a proposed assessment (including a proposed alternative apportionment method) wrong rests with the person against whom the proposed assessment is made.

B. Multistate Tax Compact Election

Article III of the Multistate Tax Compact ("MTC") provides a taxpayer option to elect to use the MTC allocation and apportionment provisions, which is the equally weighted three factor property, payroll, and sales formula of UDITPA.

1. *Gillette Co. v. Franchise Tax Board*, No. A130803 (Cal. Ct. App. July 24, 2012).
   a. California, as an MTC member state, had entered into a binding agreement that, absent explicit repeal of the entire MTC, required California to offer the option of using the MTC allocation and apportionment provisions.
   b. California Update (Oct. 2, 2012). Upon rehearing, California appellate court affirmed its original finding in favor of taxpayers.
2. *Int'l Bus. Machines Corp. v. Dept. of Treas.*, Dkt. No. 306618 (Mich. Ct. App., Nov. 20, 2012). Taxpayer may not use the MTC election because the Business Tax Act implicitly repealed the MTC election.
3. Comptroller of Public Accounts, Hearing Nos. 106,298, 106,299, 106,300 (Sept. 6, 2012); Comptroller of Public Accounts, Hearing No. 106,503 (Aug. 10, 2012). Texas margin tax requires the use of single-factor sales apportionment formula, taxpayers may not use the MTC election.
4. Utah S.B. 247. Utah withdraws from the Multistate Tax Compact effective July 1, 2013.

IV. Cloud Computing and Digital Goods

A. Cloud Computing

1. Cloud computing generally refers to the delivery of computing as a service provided over the internet. There are three basic models of cloud computing:
   a. SaaS = Software as a Service (incl. ASP)
   b. PaaS = Platform as a Service
   c. IaaS = Infrastructure as a Service
2. Some states take the position that the provision of a service in which a customer uses the Internet to access the services provider's platform is a taxable license of the provider's software; while other states take the position that no such license is created.

a. New Mexico: Tax and Rev. Dept. Ruling 401-13-1 (Jan. 31, 2013) (subscription fees for access to web-based tools which compile and analyze specific data sets are subject to gross receipts tax as licenses to use the tools).

b. New York: Advisory Opinion Nos., TSB-A-09(19)S (May 21, 2009); TSB-A-10(2)S (Jan. 20, 2010); TSB-A-10(44)S (Sept. 22, 2010); TSB-A-11(17)S (June 1, 2011) (online services taxable as sale of pre-written software).

    i. *But see* TSB-A-13(1)S (Jan. 8, 2013) (charges for access to an online driver's education course not subject to sales tax because, although the course entailed the employment of software, the use of this software was ancillary to the provision of an exempt educational service).

c. Colorado: *Ball Aerospace & Techs. Corp. v. City of Boulder*, 2012 COA 153 (Ct. App. Sept. 13, 2012) (remote access to online service providers' software is taxable use of computer software under the City of Boulder Code).

d. Utah: Private Letter Ruling 10-012 (Dec. 7, 2012) (subscription fees for remote access to databases are not taxable because the primary purpose of the transaction is access to databases, however, workflow add-ons are taxable as licenses to use prewritten software because the primary purpose is to access the software); Private Letter Ruling 12-002 (Dec. 7, 2012) (subscription fees for remote access to database are not taxable because the primary purpose of the transaction is access to a database); Private Letter Ruling 10-001 (Feb. 24, 2012) (fees for remotely accessed pre-written software taxable if purchased software is used by the customer in Utah).

e. Pennsylvania: Sales and Use Tax Ruling No. SUT-12-001 (May 31, 2012) (fees for remote access to software taxable if purchased software is used by in-state customer).

f. Texas: Comptroller Letter No. 201212650H (Dec. 20, 2012) (For purposes of the sales tax resale exemption, the Comptroller found that Company's provision of basic, self-managed web hosting services involved the transfer of care, custody, and control of the underlying software.).

g. Kansas: Opinion Letter No. O-2012-001 (Feb. 6, 2012) (charges for hosted software services are not taxable as sales of prewritten computer software).

h. Missouri: Priv. Ltr. Ruling No. 6991 (Jan. 27, 2012) (access to non-downloadable software housed on vendor's website on servers out-of-state not taxable).

i. Iowa: Policy Ltr. 12300002 (Jan. 11, 2012) (hosted software and related training services were not taxable).

j. Tennessee: Rev. Rul. 13-03 (Jan. 14, 2013) (charges for online banner advertising, for advertising on an online database, for set up fees for utilizing the online database, and for providing access to the online database applications and related ASP services are not taxable because they are not for the sale of TPP or enumerated services); Rev. Rul. No. 11-22 (June 10, 2011) (fee for access to software ASP not taxable); Priv. Ltr. Rul. 11-58 (Oct. 10, 2011) (fee for access to software housed outside of state not taxable; no transfer of possession or control).

k. Virginia: Ruling of the Tax Comm'r No. 12-191 (Nov. 29, 2012) (subscription fees for access to a web-based portal are not subject to tax because there is no exchange of tangible personal property).

3. Some states take the position that the provision of a service in which a customer uses the Internet to access the services provider's platform is a taxable information or data processing service.

   a. Texas: Texas Policy Letter Ruling No. 201207533L (July 31, 2012) (various cloud computing services taxable as data processing services).

   b. South Carolina: Rev. Rul. 03-5 (Dec. 9, 2003) (reinstated by Rev. Rul. 11-2) ("charges by the [ASP] are similar to charges by database access services and are therefore subject to [tax].").

4. Some states take the position that the provision of a service in which a customer uses the Internet to access the services provider's platform is not taxable.

   a. Missouri: Priv. Ltr. Rul. No. 6941 (Oct. 20, 2011) (subscription to online educational website not a taxable enumerated service).

   b. Virginia: Pub. Doc. Rul. No. 12-2 (Jan. 19, 2012) (digital certificate authentication and resolution services not taxable because no tangible personal property is transferred).

   c. Rhode Island: Ruling Request No. 2011-01 (March 4, 2012) (digital certificate authentication and resolution services not taxable because no tangible personal property is transferred).

   d. Colorado: Private Letter Ruling 11-007 (Dec. 20, 2011) (charges for digital filing services using a hosted software application not taxable).

5. At least one state has legislatively determined that the provision of a service in which a customer uses the Internet to access the services provider's platform is taxable.

   a. Washington: Wash. Rev. Code §82.08.020(1)(b) (sales tax on "digital automated service"). Which is "any service transferred electronically that uses one or more software applications." Wash. Rev. Code §82.04.192(3)(a).

   b. Vermont: Vermont H 782 temporarily suspends (until July 1, 2013) taxation of remotely accessed pre-written software and allows for refunds of taxes already paid.

6. Idaho has passed legislation that exempts the provision of a service in which a customer uses the Internet to access the services provider's platform from taxation. (H. 243, signed Apr. 4, 2013).

B. Digital Goods

1. Streamlined Sales and Use Tax Approach

   a. "Specified digital products"—are taxable. "Specified digital products" include:

      i. "Digital Audio-Visual Works"—a series of related images that when shown in succession, impart an impression of motion, together with accompanying sounds, if any.

      ii. "Digital Audio Works"—works that result from the fixation of a series of musical, spoken, or other sounds, including ringtones.

      iii. "Digital Books"—works that are generally recognized in the ordinary and usual sense as books.

2. Tex. Tax Code Ann. §151.010 ("The sale and use of a taxable item in electronic form instead of on physical media does not alter the item's taxable status.").

3. Administrative Taxability

   a. Louisiana: La. Admin. Code 61:I.4301 ("Examples of tangible personal property include…digital or electronic products such as "canned" computer software, electronic files, and 'on demand' audio and video downloads.")

   b. New Mexico: Taxation and Revenue Dept. Ruling No. 401-97-6 (Nov. 20, 1997) (The downloading of information that is transmitted electronically from one computer to another is taxable so long as the seller had nexus in New Mexico. The sale takes place when the downloads appear on the customer's computer located in New Mexico.)

4. Administrative Nontaxability (in specific instances)

   a. New York: TSB-M-11(5)S (Apr. 7, 2011): Digital books are exempt from taxation if the following conditions are met:

      i. The purchase of the product does not entitle the customer to additional goods and services and any revisions done to the e-book are for the limited purpose of correcting errors;

      ii. The product is provided as a single download;

      iii. The product is advertised or marketed as an e-book or a similar term;

      iv. If the intended or customary use of the product requires that the product be updated or that a new or revised edition of the product be issued from time to time (e.g., an almanac);

      v. The updates or the new or revised editions are not issued more frequently than annually; and

      vi. The product is not designed to work with software other than the software necessary to make the e-book legible on a reading device (e.g., Kindle, Nook, iPad, iPhone or personal computer).

b. New York: TSB-A-12(23)S (Sept. 20, 2012) (receipts from sales of design images delivered electronically to customers are not subject to sales tax because they are not delivered in a tangible format.).

c. Indiana: Rev. Rul. No. 2011-04-ST (Sept. 2, 2011) (access to online social network games not taxable because not specified digital products, ancillary services, or pre-written software).

d. Missouri: Letter Ruling No. 6991 (Jan. 27, 2012) (purchases of canned and customized software programs delivered electronically were not subject to tax).

e. South Carolina: Rev. Rul. No. 12-1 (Mar. 20, 2012) (purchases of canned and customized software programs delivered electronically were not subject to tax).

f. Colorado: PLR 12-007 (Dec. 31, 2012) (sales tax does not apply to subscription fees for access to online newspaper or online proprietary stock screens and comparative performance ratings.).

5. P.L. 86-272 Issues

   a. P.L. 86-272 prevents a state from imposing income tax on an out-of-state seller whose only activity in the state is related to the solicitation of orders for tangible personal property that are accepted and shipped from outside the state.

   b. *AccuZip, Inc. v. Dir., Div. of Tax'n*, No. 5744-2003 (N.J. Tax Ct. 2009) (following federal income tax classification and treating software as tangible personal property such that P.L. 86-272 applied).

6. Apportionment Issues

   a. Whether a digital product is considered tangible personal property or a service or an intangible affects how it should be sourced.

      i. *Fingerhut Products Co. v. Comm'r*, 258 N.W.2d 606 (Minn. 1977) (cost of performance or market-based sourcing for services or intangibles).

      ii. *American Bus. Info. Inc. v. Egr*, 650 N.W.2d 251 (Neb. 2002) (destination-based sourcing for tangible personal property).

      iii. *Microsoft Corp. v. Franchise Tax Bd.*, No. CGC-08-471260 (Cal. Sup. Ct. Feb. 17, 2011) (destination-based sourcing for license of tangible personal property).

   b. Tangible personal property is generally included in the property factor; intangibles are generally excluded.

      i. Arizona: Corporate Tax Rul. 01-2 (May 5, 2001) (follow federal income tax treatment in determining whether tangible personal property).

ii. Florida: Admin. Code Ann. 12C-1.0153 (canned software is tangible personal property for property factor).

iii. California: *Microsoft Corp. v. Franchise Tax Bd.*, No. CGC-08-471260 (Cal. Sup. Ct. Feb. 17, 2011) (failure to include intangible property in the company's property factor did not distort its apportioned income).

Exhibit A
PowerPoint Presentation

McDermott Will & Emery

Hot Issues in State and Local Taxation Nationwide

ICLE's 26th Annual Tax Conference, Plymouth, MI

May 23, 2013

Arthur R. Rosen
McDermott Will & Emery LLP
ARosen@mwe.com

333 Avenue of the Americas
Miami, Florida 33131
(305) 347-6512

340 Madison Avenue
New York, New York 10173
(212) 547-5596

www.mwe.com

Boston Brussels Chicago Düsseldorf Frankfurt Houston London Los Angeles Miami Milan Munich New York Orange County Paris Rome Seoul Silicon Valley Washington, D.C.

Strategic alliance with MWE China Law Offices (Shanghai)

Agenda

McDermott Will & Emery

- Nexus
  - Analytical Framework
  - Due Process Clause
  - Commerce Clause
  - Attributional Nexus
- Alternative Apportionment
- Cloud Computing and Digital Goods
- Federal Legislation
- Questions/Comments

www.mwe.com

Agenda

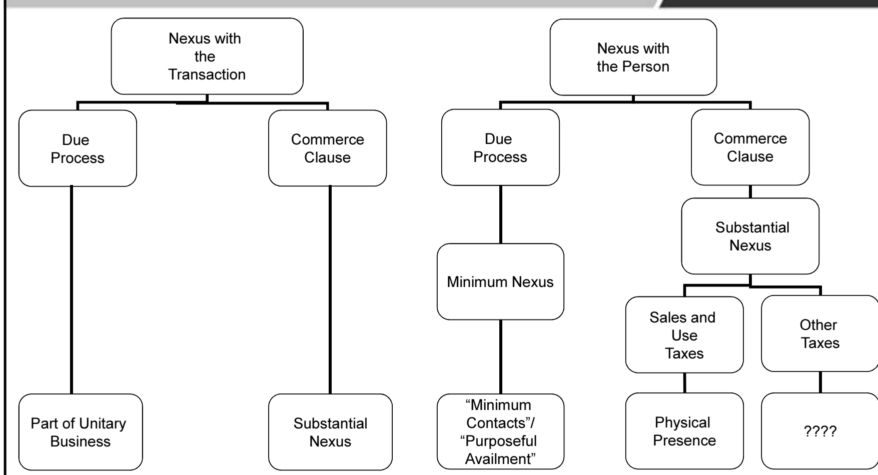
McDermott Will & Emery

- **Nexus**
  - Analytical Framework
  - Due Process Clause
  - Commerce Clause
  - Attributional Nexus
- Alternative Apportionment
- Cloud Computing and Digital Goods
- Federal Legislation
- Questions/Comments

www.mwe.com

Nexus Analytical Framework

McDermott Will & Emery



www.mwe.com

Due Process Clause

McDermott Will&Emery

- Due Process Clause & Taxpayer's Right—U.S. Const. amend. XIV, § 1
  - "[N]or shall any State deprive any person of life, liberty, or property, without due process of law"
  - Similar to the U.S. Const. amend. V

www.mwe.com

Due Process Clause Nexus with the Transaction

McDermott Will&Emery

- *Allied Signal v. Dir., Div. of Tax.*, 504 U.S. 768 (1992)
  - ". . . there must be a connection to the activity itself [nexus with the transaction], rather than a connection only to the actor the State seeks to tax [nexus with the person] . . . . The constitutional question in a case such as *Quill Corp.* is whether the State has the authority to tax the corporation at all [nexus with the person]."

www.mwe.com

Due Process Clause
Nexus with the Person

McDermott Will & Emery

- *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992)
  - "The connection to a state that is needed to support tax jurisdiction is comparable to that need to support general *in personam* jurisdiction."
- *Burger King v. Rudzewicz*, 471 U.S. 462 (1985)
  - "The connection to a state that is necessary to support *in personam* jurisdiction is purposeful direction of activities into state."

www.mwe.com

Due Process Clause
Nexus with the Person

McDermott Will & Emery

- *World-Wide Volkswagen Corp. v. Woodson*, 444 U.S. 286 (1980)
  - The requisite contacts with a state must come as a result of defendant's (i.e., taxpayer's) own activities.

www.mwe.com

Due Process Clause
Nexus with the Person

McDermott Will & Emery

- *Goodyear Dunlop Tires Operations, S.A. v. Brown*, 131 S.Ct. 2846 (2011)
  - "[Taxpayers'] attenuated connections to the state fall far short of the "the continuous and systematic general business contacts" necessary to empower [the state] to entertain suit against them on claims unrelated to anything that connects them to the state."
- *J. McIntyre Machinery, Ltd. v. Nicastro*, 131 S.Ct. 2780 (2011)
  - "As a general rule, the exercise of judicial power is not lawful unless the defendant 'purposefully avails itself of the privilege of conducting activities within the forum State, thus invoking the benefits and protections of its laws.' *Hanson v. Denckla*, 357 U.S. 235, 253 (1958). … [T]he general rule is applicable in this products-liability case, and the so-called 'stream-of-commerce" doctrine cannot displace it."

www.mwe.com

Due Process Clause
Nexus with the Person

McDermott Will & Emery

- *Gordon v. Holder*, 632 F.3d 722 (D.C. Cir. Feb. 18, 2011), *remanded to* 2011 U.S. Dist. LEXIS 139201 (D.D.C. Dec. 5, 2011)
  - "Although *Quill* did not deal with excise taxes, there remains an open question whether a national authorization of disparate state levies on e-commerce renders concerns about presence and burden obsolete."
- *See also Red Earth LLC v. U.S.,* 728 F.Supp.2d 238 (W.D.N.Y. 2010), *aff'd* 657 F.3d 128 (2d Cir. 2011)

www.mwe.com

Due Process Clause
Nexus with the Person

McDermott Will & Emery

- *In the Matter of Scioto Insurance Co.,* Dkt. No. 108943 (Okla. May 1, 2012)
  - Taxpayer, a Vermont corporation, received payments from a restaurant chain for use of its intellectual property in Oklahoma. The licensing contract was not entered into in Oklahoma and no part of the contract was to be performed in Oklahoma.
  - The Court of Appeals ruled that the taxpayer had nexus with Oklahoma.
  - The Oklahoma Supreme Court overruled.
  - Held: the sum paid by the restaurant chain under the licensing agreement with the taxpayer was a bona fide obligation, and the payments received by the taxpayer were a source of income for its insurance business.
  - The Commission could not summarily disregard the licensing agreement simply because it produced a deduction that the Commission did not like.

www.mwe.com

Due Process Clause
Nexus with the Person

McDermott Will & Emery

- *Griffith v. ConAgra Brands, Inc.*, Dkt. No. 11-0252 (W. Va. May 24, 2012).
  - Foreign licensor with no physical presence was not subject to the state’s corporate income or business franchise taxes as a result of receiving royalty payments from the license of intellectual property related to food product brands.
  - Licensees did not operate any retail stores in West Virginia, and all manufacturing by licensees took place outside of West Virginia.

www.mwe.com

Due Process Clause
Nexus with the Person

McDermott Will&Emery

- *In re Washington Mutual, Inc.*, Case No. 08-12229-MFW (U.S. Bankruptcy Del. Dist. Dec. 19, 2012)
  - The United States Bankruptcy Court for the District of Delaware found that a holding company did not have the minimum contacts necessary for nexus under the Due Process Clause or the substantial nexus necessary for nexus under the Commerce Clause with Oregon where its only connection to Oregon was the free use of its intellectual property by its subsidiaries.

www.mwe.com

Due Process Clause
Nexus with the Person

McDermott Will&Emery

- *In the Matter of Jack Daniels Properties, Inc. and Southern Comfort Properties, Inc. v. Iowa Dep't of Revenue,* Dkt. No. 09 DORFC 002; 004 (Iowa Dep't of Inspection and Appeals, July 28, 2011) (released March 7, 2012).
  - An administrative hearing officer upheld corporate income tax assessments issued to two out-of-state intangible holding companies ("IHC") on royalty income from the in-state sale of whiskey by independent retailers.
  - The mere sale of a trademarked good in the state by an out-of-state licensee is enough to sustain a tax on royalty revenue, even though the licensee did not have any retail stores, outlets or other selling location in the state.

www.mwe.com

Due Process Clause
Nexus with the Person

McDermott Will&Emery

- Tenn. Ltr. Rul. 12-27 (Nov. 14, 2012)
  - Company was not subject to Tennessee franchise and excise taxes based solely on its licensing of patents, the use of which gave rise to Tennessee sales by a related licensee, as the licensing activity did not rise to the level of "doing business" in Tennessee.

www.mwe.com

Commerce Clause
Nexus Overview

McDermott Will&Emery

- U.S. Const., art. I, § 8, cl. 3
  - "The Congress shall have the power . . . to regulate commerce . . . among the several states."
  - Has a direct and an implied aspect
    - Direct aspect comes from the language: "Congress shall have the power"
    - Implied aspect derives from a judicial interpretation that the CC "of its own force" limits state taxes where Congress has been silent. Also know as:
      - Negative implications clause, or
      - Dormant commerce clause

www.mwe.com

Commerce Clause
Nexus with the Transaction

McDermott Will & Emery

- *Complete Auto Transit, Inc. v. Brady,* 430 U.S. 274 (1977)
  - The Court's contemporary standard
  - Tax on interstate commerce valid if:
    - Tax applied to an activity having a substantial nexus with the taxing state;
    - Is fairly apportioned;
    - Does not discriminate against interstate commerce; and,
    - Is fairly related to the services provided by the state.

www.mwe.com

Commerce Clause
Nexus with the Transaction

McDermott Will & Emery

- *Goldberg v. Sweet,* 488 U.S. 252 (1989)
  - "We doubt that States through which the telephone call's electronic signals merely pass have a sufficient nexus to tax that call. . . . We believe that only two States have a nexus substantial enough to tax a consumer's purchase of an interstate telephone call."

www.mwe.com

Commerce Clause
Nexus with the Person

McDermott Will & Emery

- *Quill Corp. v. North Dakota,* 504 U.S. 298 (1992)
  - For a state to have taxing jurisdiction over a person under dormant Commerce Clause principles, the person must have substantial nexus with the state, which for sales and use tax purposes, equates with physical presence in the state.
  - "Although we have not, in our review of other types of taxes, articulated the same physical-presence requirement that Bellas Hess established for sales and use taxes, that silence does not imply repudiation of the Bellas Hess rule."

www.mwe.com

Economic Nexus

McDermott Will & Emery

- *Geoffrey, Inc. v. South Carolina Tax Comm'r.*, 437 S.E.2d 13 (1993), *cert. denied*, 510 U.S. 992 (1993)
  - "…by licensing intangibles for use in this state and deriving income from their use here, Geoffrey has a 'substantial nexus' with South Carolina [for purposes of the state's income tax]."
- Other Intangible Property Companies Cases
  - *Geoffrey, Inc. v. Comm'r of Rev.*, 899 N.E.2d 87 (Mass. 2009), *cert. denied*, 129 S. Ct. 2853 (2009)
  - *Geoffrey, Inc. v. Oklahoma Tax Comm'n*, 132 P.3d 632 (Okla. Ct. App. 2005)
  - *A & F Trademark, Inc. v. Tolson*, 605 S.E.2d 187 (N.C. Ct. App. 2004), *cert. denied*, 126 S. Ct. 353 (2005)
  - *Lanco, Inc. v. Dir., Div. of Tax.*, 908 A.2d 176 (N.J. 2006), *cert. denied*, 127 S. Ct. 2974 (2007)
  - *ACME Royalty Co. & Brick Investment Co. v. Director of Rev.*, 96 S.W.3d 72 (Mo. 2002)

www.mwe.com

Economic Nexus

McDermott Will & Emery

- Franchisors
  - *American Dairy Queen Corp. v. Taxation and Revenue Dep't*, 605 P.2d 251 (N.M. Ct. App. 1979)
    - A foreign corporate taxpayer, whose trade name, trademark, and related intangibles were used in New Mexico franchisees, was "engaged in business' in New Mexico so as to permit imposition of gross receipts tax on franchise fees paid by the franchisees, despite the fact that the taxpayer never owned any of such stores.
  - *KFC Corp. v. Iowa Dep't of Rev.*, 792 N.W.2d 308 (Iowa 2010), *cert. denied* 132 S. Ct. 97 (2011)
    - A franchisor had nexus with Iowa for corporate income tax purposes because it was directing economic activity at the state by entering into licensing agreements with franchisees.

www.mwe.com

Economic Nexus

McDermott Will & Emery

- Statutes in 1990s
  - Minnesota
  - West Virginia
  - Tennessee
  - Massachusetts
  - Indiana

www.mwe.com

Economic Nexus

McDermott Will & Emery

- *Tax Comm'r v. MBNA America Bank, N.A.,* 640 S.E.2d 226 (W.V. 2006), *cert. denied*, 551 U.S. 1141 (2007)
  - An out-of-state bank that issued credit cards to West Virginia customers had income tax nexus based on its "significant economic presence" in the state.
- *Capital One Bank v. Comm'r of Rev.*, 899 N.E.2d 76 (Mass. 2009), *cert. denied*, 129 S. Ct. 2827 (2009)
  - "While the concept of 'substantial nexus' is more elastic than 'physical presence,' it plainly means a greater presence, both qualitatively and quantitatively, than the minimum connection between a State and a taxpayer that would satisfy a due process inquiry."
  - Capital One's credit card business, generating millions of dollars in income, established substantial nexus with Massachusetts despite a lack of physical presence.

www.mwe.com

Economic Nexus

McDermott Will & Emery

- Quantitative Statutes
  - MTC Factor Presence ($500K in sales)
  - Cal. Rev. & Tax Code § 23101 ($500K in sales)
  - Mich. Comp. Laws Ann. § 206.621(1) ($350K in sales)
  - Ohio Rev. Code Ann. § 5751.01 ($500K in sales)
  - Wash. Rev. Code Ann. § 82.04.067 ($250K in sales)
- Constitutional Challenges
  - The Ohio Tax Commissioner ruled that an out-of-state mail order company had substantial nexus with Ohio for purposes of the commercial activity tax because its gross receipts in the state satisfied the bright line presence standard (over $500,000 in receipts). *In re L.L. Bean, Inc.,* (Ohio Dep't of Taxation, Final Determination, August 10, 2010).

www.mwe.com

Economic Nexus

McDermott Will & Emery

- Qualitative Statutes
  - Connecticut
    - Conn. Gen. Stat. § 12-216a ("Any company that derives income from sources within this state and that has a substantial economic presence within this state, evidenced by a purposeful direction of business toward this state")
    - $500,000 quantitative threshold adopted by informal publication. Connecticut Informational Publication No. 2010(29.1) (Dec. 28, 2010)
  - New Hampshire
    - N.H. Rev. Stat. Ann. § 77-A:1(XII) ("substantial economic presence")
  - Wisconsin
    - Wisc. Stat. § 71.22(1r) ("regularly selling products or services of any kind or nature to customers in [Wisconsin]")

www.mwe.com

Attributional Nexus

McDermott Will & Emery

- Representative approach
  - *Bloomingdale's By Mail, Ltd. v. Commonwealth*, 567 A.2d 773 (Pa. Commw. Ct. 1989)
  - *SFA Folio Collections, Inc. v. Bannon*, 585 A.2d 666 (Conn. 1991)
- Alter ego approach
  - *Pearle Health Serv., Inc. v. Taylor*, 799 S.W.2d 655 (Tenn. 1990)
- Unitary/affiliate approach
  - *Comptroller v. Armco Export Sales Corp.,* 572 A.2d 562 (Md. App. 1990)
  - *SYL, Inc. Comptroller of the Treasury*, 825 A.2d 399 (Md. Ct. App. 2003)
  - California Assembly Bill 155
  - Alabama Admin. Code 810-6-2-.90.01 (effective Aug. 24, 2012)

www.mwe.com

Attributional Nexus
Representative Approach

McDermott Will & Emery

- *Scripto Inc. v. Carson*, 362 U.S. 207 (1960)
  - "True, the 'salesmen' are not regular employees of appellant devoting full time to its service, but we conclude that such a fine distinction is without constitutional significance. <u>The formal shift in the contractual tagging of the salesman as 'independent' neither results in changing his local function of solicitation</u> . . ."
- *Tyler Pipe Indus., Inc. v. Washington Dep't of Rev.*, 482 U.S. 232 (1987)
  - The "crucial factor governing nexus" is whether the activities performed by the independent contractor on behalf of the out-of-state company are "<u>significantly associated with the taxpayer's ability to establish and maintain a market in [the] state for the sales</u>."

www.mwe.com

Attributional Nexus
Recent Developments

McDermott Will & Emery

- Representative Approach
  - Pennsylvania
    - Department of Revenue Letter Dated Aug. 29, 2012 (Pennsylvania based online marketers do not create nexus for out-of-state sellers unless the marketers are paid on a commission basis for their services)
  - Hawaii
    - Letter Ruling 2012-10 (July 10, 2012) (The establishment of a shopping rewards program and return policy with an affiliated retailer that maintains physical locations within Hawaii creates sufficient nexus for the general excise tax)

www.mwe.com

Attributional Nexus
Recent Developments

McDermott Will&Emery

- Representative Approach
  - New Mexico
    - *N.M. Tax. & Rev. Dep't v. Barnesandnoble.com LLC*, Dkt. No. 31,231 (N.M. Ct. App. Apr. 18, 2012) (finding that "goodwill developed both directly, by in-store activities promoting Taxpayer's website, and indirectly, by consumers' increased awareness of Barnes & Noble due to the presence of in-state stores, helped to establish and maintain a market in New Mexico" and thus created "substantial nexus")
  - Washington
    - Det. No. 11-0292 (Oct. 12, 2011) (out-of-state continuing education provider has sufficient nexus when its independent contractor representatives provide live seminars to local customers)

www.mwe.com

Attributional Nexus
Recent Developments

McDermott Will&Emery

- Representative Approach – Scholastic Book Clubs Cases
  - *Scholastic Book Clubs, Inc. v. Comm'r of Rev. Servs.*, 38 A.3d 1183 (Conn. S. Ct. 2012), *cert. denied* 568 U.S. __ (Oct. 9, 2012)
    - The Connecticut Supreme Court held that teachers were representatives of the taxpayer because their principal function was to serve as the exclusive vehicle for selling the taxpayer's products to students. No formal agency or employment relationship was required under the Connecticut statute.
  - *Scholastic Book Clubs v. Farr,* 373 S.W.3d 558 (Tenn. S. Ct. 2012), *cert. denied* 568 U.S. __ (Nov. 26, 2012)
    - Similar facts as Connecticut case.
    - The Tennessee Supreme Court noted that the utilization of Tennessee teachers created *a de facto* marketing and distribution mechanism within Tennessee schools, and that the taxpayer utilized public services in Tennessee by using school facilities, funded by tax dollars, to facilitate the sale of its books.

www.mwe.com

Attributional Nexus

McDermott Will & Emery

- Click Through Nexus Statutes

State	Effective Date	Affiliate Threshold	Statute
Arkansas (rebuttable presumption)	Oct. 24, 2011	More than $10,000	Ark. Code Ann. § 26-52-117
California (rebuttable presumption)	Sept. 15, 2012	More than $10,000 and (and more than $1,000,000 in annual in-state sales whether a result of click-through referrals or otherwise)	Cal. Rev. & Tax. § 6203(c)
Connecticut (irrebuttable presumption)	July 1, 2011	More than $2,000	Conn. Gen. Stat. § 12-407(a)(12)(L)
Georgia (rebuttable presumption)	October 1, 2012	More than $50,000	Ga. Stat. Ann. § 48-8-2(8)(K)
Illinois (irrebuttable presumption)	July 1, 2011	More than $10,000	35 ILCS 105/2 and 110/2
New York (rebuttable presumption)	June 1, 2008	More than $10,000	N.Y. Tax Law § 1101(b)(8)(vi)
North Carolina (rebuttable presumption)	Aug. 7, 2009	More than $10,000	N.C. Gen. Stat. § 105-164.8
Rhode Island (rebuttable presumption)	July 1, 2009	More than $5,000	R.I. Gen. Laws § 44-18-15
Vermont (rebuttable presumption)	When adopted in 15 other states.	More than $10,000	Vt. Stat. Ann. tit. 32, § 9701(9)(I) (H.B. 436)

- A number of states are considering click through legislation (e.g., Kansas, Massachusetts, Pennsylvania)

www.mwe.com

Attributional Nexus Recent Developments

McDermott Will & Emery

- Click Through Challenges
  - New York
    - *Amazon.com, LLC v. New York State Department of Taxation and Finance* (Mar. 28, 2013)
      - The New York Court of Appeals upheld the New York Amazon Law as facially constitutional.
      - The Court found that although physical presence is generally necessary for sales tax nexus, it need not be substantial, and can be met if economic activities are performed in the state by a seller on behalf of the taxpayer.
      - "Active, in-state solicitation that produces a significant amount of revenue qualifies as 'demonstrably more than a slightest presence . . . . The bottom line is that if a vendor is paying New York residents to actively solicit business in this State, there is no reason why that vendor should not shoulder the appropriate tax burden.'"
  - Illinois
    - *Performance Marketing Ass'n v. Hamer*, No. 2011 CH 26333 (Ill. Cir. Ct., Final Order, May 7, 2012)
      - The Performance Marketing Association filed a suit in federal district court challenging the constitutionality of the Illinois click-through nexus law.
      - Re-filed in state court to avoid challenge of the Tax Injunction Act.
      - Held unconstitutional by Circuit Court Judge.

www.mwe.com

Attributional Nexus
Recent Developments

McDermott Will&Emery

- Unitary/Affiliate Approach
  - Utah
    - Private Letter Ruling 12-009 (Feb. 8, 2013)
      - Taxpayer did not establish sales and use tax nexus or corporate income tax nexus based on its presence in the state at a film festival.
      - Taxpayer's presence in the state at a film festival did not create sales and use tax nexus for taxpayer's affiliate.
  - Maryland
    - *Comptr. of the Treas. v. W.L. Gore*, Nos. 1696, 1697 (Md. Ct. Spec. App., Jan. 24, 2013)
      - The Maryland Court of Special Appeals ruled that two subsidiaries of Gore, one holding its intangible assets and one holding its financial assets, had royalty and loan interest income apportionable to Maryland based upon a unitary relationship with the parent company, which generated income in Maryland. Nexus sufficient to justify taxation arises from the economic reality that a parent's business in the taxing state produces a subsidiary's income. The subsidiaries' income was entirely the product of expenses that the parent deducted in Maryland, so the subsidiaries' income was earned in Maryland.

www.mwe.com

Attributional Nexus
Recent Developments

McDermott Will&Emery

- Unitary/Affiliate Approach
  - California
    - CA imposes new use tax collection requirements, Sept. 15, 2012. (includes members of a commonly-controlled group and combined reporting with a member performing services for the retail in the state that help the retailer establish or maintain a CA market for sales)
  - West Virginia
    - HB 2754 was been approved by the state legislature on April 13, 2013.
    - The bill would apply the state's sales tax to online retailers if "they or a subsidiary have a physical presence in the state."
  - Multistate Tax Commission
    - Memo regarding Model Sales and Use Tax Nexus Statute – Research and Draft Policy Checklist (Apr. 16, 2013) (considering whether the unitary approach should apply to sales and use tax nexus)

www.mwe.com

Agenda

McDermott Will&Emery

- Nexus
  - Analytical Framework
  - Due Process Clause
  - Commerce Clause
  - Attributional Nexus
- **Alternative Apportionment**
- Cloud Computing and Digital Goods
- Federal Legislation
- Questions/Comments

www.mwe.com

Alternative Apportionment

McDermott Will&Emery

- *Indiana Dept. of Rev. v. Rent-A-Center East, Inc.,* No. 49510-1112-TA-683 (Ind. Mar. 9, 2012)
  - Tax Court held that the Department could force combination only if the Department could first show that other alternatives did not fairly reflect income.
  - Indiana Supreme Court reversed and remanded.
    - The Department's notice of proposed assessment served as *prima facie* evidence that its claim for the unpaid tax was valid.
    - The burden then shifts to the taxpayer to show that an alternative apportionment method would more properly reflect its income.
    - Pending the Tax Court's decision on remand, the Indiana Supreme Court's decision now means taxpayers can no longer argue that the Department must first show that use of other alternatives did not fairly reflect the taxpayer's Indiana income before forcing combination.

www.mwe.com

Alternative Apportionment

McDermott Will&Emery

- *CarMax Auto Superstores West Coast, Inc. v. South Carolina Dept. of Rev*., No. 4953 (S.C. Ct. App. Mar. 14, 2012)
  - The Department, as the party seeking to deviate from the standard formula, must satisfy two burdens:
    - (1) standard statutory formula did not fairly represent CarMax West's in-state business activity; and
    - (2) alternative formula is appropriate, and it is more appropriate than any other competing method.
  - "It is only logical that a party seeking to override the legislatively determined apportionment method bears the burden of proving that method is not appropriate and an alternative method more accurately reflects the taxpayer's business activity within the state."
- Significance of standard statutory approach.
  - Legislative intent should be paramount.

www.mwe.com

Alternative Apportionment

McDermott Will&Emery

- Indiana Letter of Findings 02-20110473 (Mar. 27, 2013)
  - In approving the use of an "audience factor" to apportion the income of a television producer and broadcaster, the Department notes that "[c]learly, the alternative apportionment regulation strikes a cautionary note against the Department implementing its remedial powers broadly. However, the statute's language of limitation suggests a tolerance for 'limited and unusual' circumstances which are only ordinarily unique and non-recurring; i.e., the circumstances may also be non-unique and recurring."
  - The Department finds that the burden of proving a proposed assessment (including a proposed alternative apportionment method) wrong rests with the person against whom the proposed assessment is made.

www.mwe.com

Alternative Apportionment MTC Election (*Gillette*)

McDermott Will&Emery

- *The Gillette Co. v. Franchise Tax Board*, No. A130803 (Cal. Ct. App. July 24, 2012)
  - In *Gillette*, the Court found that California, as an MTC member state, had entered into a binding agreement that, absent explicit repeal of the entire MTC, required California to offer the option of using the MTC allocation and apportionment provisions.
- California Update (Oct. 2, 2012)
  - Upon rehearing, California appellate court affirmed its original finding in favor of taxpayers.

www.mwe.com

Alternative Apportionment MTC Election (*Gillette*)

McDermott Will&Emery

- Michigan
  - *International Business Machines Corp. v. Dept. of Treas.,* Dkt. No. 306618 (Mich. Ct. App., Nov. 20, 2012) (taxpayer many not use the MTC election because the Business Tax Act implicitly repealed the MTC election)
- Texas
  - Comptroller of Public Accounts, Hearing Nos. 106,298, 106,299, 106,300 (Sept. 6, 2012) (Texas margin tax requires the use of single-factor sales apportionment formula, taxpayers may not use the MTC election)
  - Comptroller of Public Accounts, Hearing No. 106,503 (Aug. 10, 2012) (Texas margin tax requires the use of single-factor sales apportionment formula, taxpayers may not use the MTC election)
- Utah
  - S.B. 247
    - Utah withdraws from the Multistate Tax Compact effective July 1, 2013.

www.mwe.com

Agenda

McDermott Will&Emery

- Nexus
  - Analytical Framework
  - Due Process Clause
  - Commerce Clause
  - Attributional Nexus
- Alternative Apportionment
- **Cloud Computing and Digital Goods**
- Federal Legislation
- Questions/Comments

www.mwe.com

Cloud Computing Background

McDermott Will&Emery

- Delivery of computing as a service provided over the internet.
  - SaaS = Software as Services (incl. ASP)
  - PaaS = Platform as Services
  - IaaS = Infrastructure as Services
- Subscription fee or pay according to usage.

www.mwe.com

Cloud Computing Background

McDermott Will&Emery

- Is it a taxable sale or license of software?
  - What is the definition of a license? Transfer of control?
- Is the service taxable as an information service or data processing service?
- Does the state tax cloud computing services as a digital product or enumerated digital service?
- How are equivalent off-line services or products taxed?
- How does the state treat bundled transactions?

www.mwe.com

Cloud Computing Background

McDermott Will&Emery

- Prewritten Software Approach - Taxable Examples:
  - New York: *See* Advisory Opinion Nos., TSB-A-09(19)S (May 21, 2009); TSB-A-10(2)S (January 20, 2010); TSB-A-10(44)S (Sept. 22, 2010); TSB-A-11(17)S (June 1, 2011) (online services taxable as sale of pre-written software)
  - Colorado: Ball Aerospace & Technologies Corp. v. City of Boulder, 2012 COA 153 (Ct. App. Sept. 13, 2012) (remote access to online service providers' software is taxable use of computer software under the City of Boulder Code)
  - Utah: Private Letter Ruling 10-001 (Feb. 24, 2012) (fees for remotely accessed pre-written software taxable if purchased software is used by the customer in Utah)
  - Pennsylvania: Sales And Use Tax Ruling No. SUT-12-001 (May 31, 2012) (fees for remote access to software taxable if purchased software is used by in-state customer)

www.mwe.com

Cloud Computing Background

McDermott Will&Emery

- Prewritten Software Approach - Nontaxable Examples:
  - Kansas: Opinion Letter No. O-2012-001 (Feb. 6, 2012) (charges for hosted software services are not taxable as sales of prewritten computer software)
  - Missouri: Priv. Ltr. Ruling No. 6991 (Jan. 27, 2012) (access to non-downloadable software housed on vendor's website on servers out-of-state not taxable)
  - Iowa: Policy Ltr. 12300002 (Jan. 11, 2012) (hosted software and related training services were not taxable)
  - Tennessee: Rev. Rul. No. 11-22 (June 10, 2011) (fee for access to software ASP not taxable); Priv. Ltr. Rul. 11-58 (Oct. 10, 2011) (fee for access to software housed outside of state not taxable; no transfer of possession or control)

www.mwe.com

Cloud Computing Background

McDermott Will&Emery

- Service Approach - Taxable Examples:
  - Texas: Texas Policy Letter Ruling No. 201207533L (July 31, 2012) (various cloud computing services taxable as data processing services)
  - South Carolina: Rev. Rul. 03-5 (Dec. 9, 2003) (reinstated by Rev. Rul. 11-2) ("charges by the [ASP] are similar to charges by database access services and are therefore subject to [tax].")

www.mwe.com

Cloud Computing Background

McDermott Will & Emery

- Service Approach - Nontaxable Examples:
  - Missouri: Priv. Ltr. Rul. No. 6941 (Oct. 20, 2011) (subscription to online educational website not a taxable enumerated service)
  - Virginia: Pub. Doc. Rul. No. 12-2 (Jan. 19, 2012) (digital certificate authentication and resolution services not taxable because no tangible personal property is transferred)
  - Rhode Island: Ruling Request No. 2011-01 (March 4, 2012) (digital certificate authentication and resolution services not taxable because no tangible personal property is transferred)
  - Colorado: Private Letter Ruling 11-007 (Dec. 20, 2011) (charges for digital filing services using a hosted software application not taxable)

www.mwe.com

Cloud Computing Background

McDermott Will & Emery

- Service Approach – Legislation:
  - Wash. Rev. Code § 82.08.020(1)(b) (sales tax on ‘‘digital automated service’’). Which is ‘‘any service transferred electronically that uses one or more software applications.’’ Wash. Rev. Code § 82.04.192(3)(a).
    - Discriminatory tax under ITFA?
  - Vermont H 782 temporarily suspends (until July 1, 2013) taxation of remotely accessed pre-written software and allows for refunds of taxes already paid.

www.mwe.com

Cloud Computing
Recent Developments

McDermott Will & Emery

- Idaho
  - H. 243
    - Provides a sales tax exemption for online software, signed Apr. 4, 2013.
- A number of other states have legislative proposals regarding the taxation of cloud computing.
  - E.g., Kansas, Maine, Massachusetts, Michigan, Minnesota, Ohio, Utah, and Vermont

www.mwe.com

Cloud Computing
Recent Developments

McDermott Will & Emery

- New Mexico
  - Tax and Rev. Dept. Ruling 401-13-1 (Jan. 31, 2013) (subscription fees for access to web-based tools which compile and analyze specific data sets are subject to gross receipts tax as licenses to use the tools)
- Tennessee
  - Rev. Rul. 13-03 (Jan. 14, 2013) (charges for online banner advertising, for advertising on an online database, for set up fees for utilizing the online database, and for providing access to the online database applications and related ASP services are not taxable because they are not for the sale of TPP or enumerated services)
    - Explicitly states that no transfer of "title, possession, or control of the applications" occurs when customers access the online database applications.
- New York
  - TSB-A-13(1)S (Jan. 8, 2013) (charges for access to an online driver education course not subject to sales tax because, although the course entailed the employment of software, the use of this software was ancillary to the provision of an exempt educational service)

www.mwe.com

Cloud Computing
Recent Developments

McDermott Will & Emery

- Massachusetts
  - Working Draft Directive 13-XX (Feb. 7, 2013): Outlines criteria which indicate that a transaction constitutes a taxable transfer of prewritten software, and includes the following:
    - contract or written agreement provides for a transfer by license, sale, subscription, lease, or other means, of prewritten software for consideration
    - A customer can access a seller's prewritten software on its own or the seller's or a third party server, and can enter its own information, manipulate that information, and/or run reports. (Mere search queries in a seller's database are not considered "entering information.")
    - The seller provides the customer with the use of software that functions with little or no personal intervention by the seller or seller's employees other than "help desk" assistance for customers having difficulty using the software.
    - The seller refers to itself as an Application Service Provider (ASP) or its product as Software as a Service (SaaS) or in a similar manner, although the seller's characterization of a product is not ultimately determinative of its treatment for tax purposes.
    - The seller provides access to software, including operating system software or application software, even if no software is transferred to the customer; this may be referred to as "cloud computing."
    - The software provides an organizational tool or function that is used by customer, *e.g.*, screen sharing.
    - Pre-written software is bundled with a non-taxable service and sold for a single price, but only where the software constitutes the predominant value of the sale.
    - The seller provides an application that is downloaded to any device, including but not limited to a Smart-phone, PC or Tablet, and there is a charge for the application.

www.mwe.com

Cloud Computing
Recent Developments

McDermott Will & Emery

- Massachusetts
  - Working Draft Directive 13-XX (Feb. 7, 2013): Outlines criteria which indicate that a transaction should be characterized as the performance of a non-taxable service, and includes the following:
    - The seller's employees are providing data processing, creating and running reports for customer and providing them in any form (assuming that they are unique to the customer).
    - The seller is providing additional, different or restructured information to the customer (*e.g.*, credit card or check verification services, ATM terminal driving services, database access).
    - The customer does not interface with the pre-written software either on its own or on seller's or third-party servers or enter information that will be further manipulated by the software. (Search queries by the customer in the seller's database are not considered entering the customer's own information or interfacing with the software.)
    - A personal or professional service is provided (*e.g.*, legal, accounting, data management, data storage).
    - The transaction is for an optional maintenance contract that does not include software updates or upgrades.
    - The seller is providing custom software.
    - The seller is providing data storage and back-up.
    - The customer is running its own software, which was not obtained from the seller, on seller's hardware in a "cloud computing" environment.
    - The seller is providing customized reports to the customer that are personal and individual to that customer and not shared with or sold to others.
    - Substantial personal or professional services are performed by seller's employees and are bundled with the use of software and sold for a single price, and such services constitute the predominant value of the sale.

www.mwe.com

Cloud Computing
Recent Developments

McDermott Will&Emery

- Utah
  - Private Letter Ruling 10-012 (Dec. 7, 2012) (subscription fees for remote access to databases are not taxable because the primary purpose of the transaction is access to databases, however, workflow add-ons are taxable as licenses to use prewritten software because the primary purpose is to access the software)
  - Private Letter Ruling 12-002 (Dec. 7, 2012) (subscription fees for remote access to database are not taxable because the primary purpose of the transaction is access to a database)
- Virginia
  - Ruling of the Tax Commissioner No. 12-191 (Nov. 29, 2012) (subscription fees for access to a web-based portal are not subject to tax because there is no exchange of tangible personal property)
- Texas
  - Comptroller Letter No. 201212650H (Dec. 20, 2012)
    - For purposes of the sales tax resale exemption, the Comptroller found that Company's provision of basic, self-managed web hosting services involved the transfer of care, custody, and control of the underlying software.

www.mwe.com

Digital Products and Services
Background

McDermott Will&Emery

- Streamlined Sales and Use Tax Approach
  - SST – "Specified digital products"
    - "Digital Audio-Visual Works"
    - "Digital Audio Works"
    - "Digital Books"
  - Adopted in Indiana, Kentucky, Nebraska, New Jersey, North Carolina, South Dakota, Tennessee, Utah, Vermont, Washington, Wisconsin, Wyoming
- Texas Statute – "the sale and use of a taxable item in electronic form instead of on physical media does not alter the item's taxable status"
- Administrative Taxability
  - Louisiana, Maine, Mississippi, New Mexico

www.mwe.com

Digital Products and Services Background

McDermott Will&Emery

- P.L. 86-272 Issues
  - P.L. 86-272 prevents a state from imposing income tax on an out-of-state seller whose only activity in the state is related to the solicitation of orders for TPP that are accepted and shipped from outside the state.
  - *AccuZip, Inc. v. Dir., Div. of Tax'n*, No. 5744-2003 (N.J. Tax Ct. 2009) (following federal income tax classification and treating software as TPP such that P.L. 86-272 applied)
  - Business Activity Tax Simplification Act, H.R. 1439 112th Cong. (2011)

www.mwe.com

Digital Products and Services Background

McDermott Will&Emery

- Apportionment – Sales Factor
  - If a service or an intangible, cost of performance or market-based sourcing.
    - *E.g. Fingerhut Products Co. v. Comm'r,* 258 N.W.2d 606 (Minn. 1977).
  - If TPP, destination-based sourcing.
    - *American Bus. Info. Inc. v. Egr*, 650 N.W.2d 251 (Neb. 2002).
    - *Microsoft Corp. v. Franchise Tax Bd.*, No. CGC-08-471260 (Cal. Sup. Ct. Feb. 17, 2011) (license of TPP).
  - What about throw-out and throw-back rules?

www.mwe.com

Digital Products and Services
Background

McDermott Will & Emery

- Apportionment – Property Factor
  - TPP generally included in property factor; intangibles generally excluded:
    - Arizona: Corporate Tax Rul. 01-2 (May 5, 2001) (follow federal income tax treatment in determining whether TPP).
    - Florida: Admin. Code Ann. 12C-1.0153 (canned software is TPP for property factor).
    - California: *Microsoft Corp. v. Franchise Tax Bd.*, No. CGC-08-471260 (Cal. Sup. Ct. Feb. 17, 2011) (Failure to include intangible property in the company's property factor did not distort its apportioned income).

www.mwe.com

Digital Products and Services
Recent Developments

McDermott Will & Emery

- New York
  - TSB-A-12(23)S (Sept. 20, 2012)
    - Receipts from sales of design images delivered electronically to customers are not subject to sales tax because they are not delivered in a tangible format.
- Colorado
  - PLR 12-007 (Dec. 31, 2012)
    - Sales tax does not apply to subscription fees for access to online newspaper or online proprietary stock screens and comparative performance ratings.

www.mwe.com

Agenda

McDermott Will&Emery

- Nexus
  - Analytical Framework
  - Due Process Clause
  - Commerce Clause
  - Attributional Nexus
- Alternative Apportionment
- Cloud Computing and Digital Goods
- **Federal Legislation**
- Questions/Comments

www.mwe.com

Federal Legislation

McDermott Will&Emery

- The Business Activity Tax Simplification Act ("BATSA") [H.R. 1439] [112th Congress]
  - Introduced: April 8, 2011.
  - Reported favorably out of House Judiciary Committee: October 21, 2011.
  - Would modernize P.L. 86-272.
    - All business activity taxes (not just net income taxes).
    - All sellers (not just sellers of tangible personal property).
    - Other qualitative *de minimis* activities (not just solicitation).
  - Physical presence.
    - Economic nexus would be outlawed.
    - Tangible property or employees in a jurisdiction for more than 14 days during the tax year.

www.mwe.com

Federal Legislation

McDermott Will&Emery

- Digital Goods and Services Tax Fairness Act [H.R. 1860] [S. 971] [112th Congress]
  - Introduced: May 5, 2011.
  - Referred to House Judiciary Subcommittee on Courts, Commercial and Administrative Law: May 23, 2011.
  - The act provides a sourcing regime based on a customer's "tax address;"
  - No state or local jurisdiction may impose a sales or use tax on digital goods or services unless it gives credit for comparable taxes paid to other states for the same transaction;
  - Digital goods cannot be taxed at a higher rate than the rate for comparable tangible personal property or services that is not delivered electronically.

www.mwe.com

Federal Legislation

McDermott Will&Emery

- Marketplace Fairness Act [S. 743] [113th Congress]
  - Introduced Apr. 17, 2013
  - Passed by the Senate May 6, 2013
  - Referred to the House Committee on the Judiciary May 20, 2013
  - This bill provides a state two options for gaining the Congressional authorization to require remote sellers to collect sales tax:
    - SSUTA member states have to provide 90 days notice that they will exercise authority under the Act;
    - Non-SSUTA members may exercise authority by complying with the minimum simplification requirements under the Act by enacting legislation that
      - specifies the taxes to which the authority applies; and
      - Identifies products and services that will be excluded from the authority.
  - The MFA only applies to remote sales and remote sellers.

www.mwe.com

Agenda

McDermott Will & Emery

- Nexus
  - Analytical Framework
  - Due Process Clause
  - Commerce Clause
  - Attributional Nexus
- Alternative Apportionment
- Cloud Computing and Digital Goods
- Federal Legislation
- **Questions/Comments**

www.mwe.com

Questions/Comments

McDermott Will & Emery

Arthur R. Rosen
McDermott Will & Emery LLP
ARosen@mwe.com

333 Avenue of the Americas
Miami, Florida 33131
(305) 347-6512

340 Madison Avenue
New York, New York 10173
(212) 547-5596

www.mwe.com