

**Explanation of changes to
Second Initial Public Participation Working Group Draft of the
Constitutional Nexus Guideline for Application of
a State's Sales and Use Tax to an Out-of-State Business
(D*R*A*F*T—09/97)**

This document explains by line references the reasoning behind the material changes that are reflected in the red-lined version (document *sunxgdf10a_red.doc*) of the *Second Initial Public Participation Working Group Draft of the Constitutional Nexus Guideline for Application of a State's Sales and Use Tax to an Out-of-State Business*. Please do not refer to the clean version (document *sunxgdf10a_clean_nodialogue.doc*) to track the explanations set forth here, because the line references will be different. **Nevertheless, all written comments on the Second Initial Draft submitted by participants of the PPWG should be filed by reference to the *clean* version whose file name has been given above. The red-lined version is intended solely to aid identification of the changes that have been made to the Initial Draft.**

The Warning on the introductory page: The changes emphasize that issuance of the Second Initial Draft does not imply or suggest that anyone participating in the PPWG has approved any portion of the Second Initial Draft.

Line 34: The word “state” was inserted to note that the Second Initial Draft deals with state sales and use taxes and not local taxes.

Line 56-58: This introductory proviso was inserted to ensure that there must be a fairness/substantial justice determination with each of the three alternative statements for when Due Process nexus may be satisfied.

Lines 59-61, 74-76, and 89-90: The language was changed to respond to the observation that the replaced language of the Initial Draft was inartful and imprecise.

Lines 63-73: This example sets forth the drafter's understanding of the constitutional concept of when a sale may be found to exist within a taxing State. See the revised definition of the term “sale”, lines 700-714, that deletes the common state definition of a sale as the “transfer of title or possession” and states in its place the constitutional principle being illustrated by this example.

Lines 79-88: This example illustrates the drafter's understanding of the constitutional concept of when a use may be found to exist within a taxing State. No change to the definition of the term “use” was viewed as necessary.

Lines 92-94: The proviso was deleted, because Due Process nexus has a built-in concept of *de minimis* and all three alternative statements for when Due Process nexus may be satisfied are subject to a fairness/substantial justice determination.

Lines 95-100: The example illustrates that one must refer to the principles of II.C., the statement of what constitutes physical presence in the taxing State, to determine when the taxpayer is present in the taxing State under the Second Initial Draft.

Lines 101-110 and 111-115: Strong sentiment was expressed by several participants that the nexus consequences of purposeful avilment and regular and systematic solicitation were the same. The drafter has *reluctantly* abandoned any attempt to establish rules for state tax jurisdiction that parallel *in personam* jurisdiction concepts (specific and general jurisdiction). Regular and systematic solicitation is now a subset of purposeful avilment. The reference to fairness/substantial justice has been eliminated in favor of the reference to this necessary Due Process determination in the introductory statement. See comment to lines 56-58.

Lines 116-128: The example illustrates the meaning of regular and systematic solicitation in the context of a representative that *occasionally* enters the taxing State.

Lines 134-136, 140-143, 146-147: As was the case with a similar change for the Due Process nexus principles, these changes respond to the observation that the replaced language of the Initial Draft was inartful and imprecise.

Line 139: The reference points to the earlier example under Due Process nexus that illustrates the drafter's understanding of the constitutional concept of when a sale may be found to exist within a taxing State.

Line 145: The reference points to the earlier example under Due Process nexus that illustrates the drafter's understanding of the constitutional concept of when a use may be found to exist within a taxing State.

Lines 158-171: This example illustrates the circumstance of a taxpayer whose connection to the taxing State while not limited to the U.S. Mails and common carrier may still fall short of physical presence. The examples illustrate when these circumstances may still support a finding of nexus. The example analyzes whether the out-of-state business' commercial relationship with the taxing State is significant enough to conclude that the imposition of a use tax collection

duty would not be an unreasonable burden on commerce. If a taxpayer is already sufficiently tied up with the commercial workings of the taxing State, imposition of a use tax collection duty cannot be seen as unreasonably burdensome.

Lines 179-180: The phrase “significantly associated with the ability of the out-of-state business to establish and maintain a market in the taxing State” is now a defined term. It, therefore, became necessary to use the defined term in its exact phraseology in order to invoke the definition. This Explanation will not note similar changes subsequently occurring in the Second Initial Draft.

Lines 212-223: The language of the example was reworked to invoke the now defined term “temporary”.

Lines 238-243 and 260-265: The location of this example that illustrates the *National Geographic Society* case was placed as the initial example in light of the settled, non-controversial nature of the principle being illustrated.

Lines 251-252: The example was refined to state more expressly that no form of sales and use taxes (vendee, vendor, combined) fall within the classification of a direct tax.

Lines 289-296: The example was deleted, because the drafter believes after receiving comments that the acquisition of purchase money security interests better establishes nexus under another principle—the principle that connection with the taxing State that is not limited to U.S. Mails and common carrier may create nexus where imposition of the use tax collection obligation does not create an unreasonable burden on commerce. See comment to lines 158-171.

Lines 283-290: The example illustrates that the holding of security interests purchased from unrelated third-parties does not create physical presence. The example represents the strongly expressed sentiment of several participants in the PPWG.

Lines 323-334: The example provides that the “significantly associated” limiter is not applicable in the circumstances where it is likely that the out-of-state business has replaced one or more of its employees with “leased employees.” This principle is stated in terms of a representative or an employee of a representative operating on a substantially full-time basis for a permanent period and the services are performed under the primary direction or control of the out-of-state business. The concept was pulled from IRC §414(n)(2)(B) and (C), a provision that defines leased employees for qualified plans.

Lines 361-375: The example illustrates activities that would qualify as “significantly associated . . .”, although the activities listed do not involve direct contact with a customer or potential customer.

Lines 376-381: The example illustrates the leased employee concept.

Line 384: The word “property” was added, because the listed categories of “office” or “other establishment” were too limiting to the principle being stated.

Lines 441-443: The note was deleted as surplusage. Even without the statement it is axiomatic that the placement of one example under a particular principle does not mean that another principle could not be used to reach a similar result.

Line 444-445: The reference to representative(s) was deleted, because the principle at II.C.5. already adequately covers this principle for representative(s).

Lines 447-457: The revisions are not intended to change the principle being illustrated but are intended to make the example more readable.

Lines 463-467: The *de minimis* principle is stated more simply. A presence is *de minimis* when the presence does not exceed a slightest presence or is inadvertent. If a presence does not exceed a slightest presence or is inadvertent, then the presence is not *de minimis*.

Lines 468-476: A slightest presence is stated in *quasi* objective terms as a presence that would be a silly premise for finding nexus in the collective judgment of disinterested observers. In the drafter’s view this statement correctly minimize the degree to which the *de minimis* concept would upset the bright line, objective test the U.S. Supreme Court thought it was establishing in *Quill*.

Lines 477-489: Inadvertence means the out-of-state business did not consciously submit itself to the jurisdiction of the taxing State. A contesting taxpayer can show its presence in the taxing State is inadvertent by showing that the presence did not arise from a regular and systematic business practice, pursuit of an established company policy on a continuing basis, an affirmative decision of management, or a step taken to assist in the establishment and maintenance of the market of the taxing State.

Lines 491-507: The example sets forth the facts in the *Quill* case that are reflected in notes 1 and 8 of the U.S. Supreme Court’s decision. It should be recalled in this context that the State in *Quill* conceded in practical terms that the software was unimportant to *Quill*’s establishing and maintaining a market in the taxing State.

Lines 508-515: The example illustrates that storage of the business records of the out-of-state business with a professional service provider in the taxing State as an incident to the provision of these services is a *de minimis* presence. This circumstance would be contrasted from a business records depository in the taxing State that is not addressed in the example,

Lines 516-524: The rationale given for finding a *de minimis* presence in the case of property moved to a jurisdiction in violation of the covenants of a security agreement is now stated in terms of inadvertence as opposed to a slightest presence. This rationale is more appropriate.

Lines 525-540: The example is deleted, because it did not make the distinction the Second Initial Draft now makes between purchase money security interests and other types of security interests. In addition, the drafter sought to avoid further controversy over whether a security interest can properly be characterized as the holding of a property interest in the taxing State. The drafter accepted the suggestion that nexus arising from the existence of purchase money security interests is more properly analyzed under the principle dealing with a connection with the taxing State that is outside the safe harbor of the U.S. Mails and common carrier. See comments to lines 158-171.

Lines 541-554: The example illustrates that an out-of-state business that rents tangible personal property to others can have the property they have rented moved to the taxing State under circumstances where it is appropriate to conclude that the presence of the out-of-state business' property in the taxing State is *de minimis*.

Lines 555-568: Additional facts are stated to demonstrate the sale made by the rogue salesperson clearly does not exceed a slightest presence.

Lines 569-591: The example states more precisely the degree to which the representative occasionally enters the taxing State to solicit orders for the sale of merchandise and a circumstance where these occasional entries will still not be properly classified as *de minimis*. Both rationales for determining the existence of *de minimis* are analyzed in view of these rationales being stated in the alternative in the governing principle.

Lines 592-616: The example states more precisely the degree to which the representative occasionally enters the taxing State to effect warranty service on behalf of the out-of-state business and a circumstance where these occasional entries will still not be properly classified as *de minimis*. Both rationales for determining the existence of *de*

minimis are analyzed in view of these rationales being stated in the alternative in the governing principle.

Lines 617-631: Additional facts are added to indicate clearly that the parcel of real estate is not insignificant, as might be the case in the circumstance of a cemetery plot. Both rationales for determining the existence of *de minimis* are analyzed in view of these rationales being stated in the alternative in the governing principle.

Lines 636-642: Duration of nexus is now stated in terms of proximate cause, a basis that seems more appropriate to a constitutional understanding. The arbitrary time period concept has been deleted with the expectation that this approach may more suitably be included in the phase II document.

Lines 664-668: The definition of a lease has been expanded to reflect use, possession or occupancy of property in return for compensation. Financing leases are now expressly excluded from the defined term “to lease”.

Line 669-674: The definition of the term “maintain” has been eliminated as unnecessary. The deletion eliminates the need for the Editor’s Note.

Line 685: The definition no longer contains the modifier of “accessing the market”, because the modifier is surplusage that potentially creates confusion. The term purposefully is generally used in the text of the Second Initial Draft in contexts that already bring into play the concept of accessing the market.

Line 686-689: Regularly also means “normal”. Limiting “regular” to circumstances involving interval or frequency of occurrence unnecessarily limits the full and complete meaning of the term “regular”.

Lines 693-694: The qualifier of excluding employees of the out-of-state business is necessary, because employees of corporate representatives are still intended to be treated as representatives.

Lines 700-719: The revised definition of the term “sale” reflects the drafter’s understanding of the constitutional concept of when a sale may be found to exist within a taxing State. The drafter does not believe a constitutional sale can be premised solely upon the transfer of title or possession. For this reason, reference to the traditional state definition of a sale has been eliminated. Similarly, the stated rule of when a sale takes place with respect to intangibles or services is stated in constitutional terms without any additional reference to possible state law definitions. When a “sale” takes place in the context

of a lease has also now been stated. Finally, the editor's note has been deleted as now longer necessary in the Second Initial Draft.

Lines 720-734: The term "significantly associated . . ." has now been defined. A note to the definition illustrates that the concept is not limited to circumstances where the contact is directed to customers and potential customers. The note is pulled from *Tyler Pipe* where the U.S. Supreme Court quotes with apparent approval the Washington Supreme Court's rationale in its decision below.

Lines 735-739: The defined term "slightest presence" was deleted, because the meaning of the term is now a substantive part of the *de minimis* rule. As noted elsewhere, a slightest presence is a very low level of presence in the taxing State. This low level mitigates the potential problems that flow from the subjective nature of the slightest presence concept.

Lines 740-745: The defined term "solicitation" was deleted as a term that required no definition in the Second Initial Draft.

Lines 750-751: The term "temporary" is now defined in the negative as something that is not permanent.

Lines 747-754: The placeholder for an alternative definition of the term "use" under the adopting State's own law has been removed. The traditional definition of storage, use or other consumption seems adequate to the job and does not appear to raise any significant constitutional issues. Finally, the editor's note has been deleted as now longer necessary in the Second Initial Draft.