MULTISTATE TAX COMMISSION

To:	Sales and Use Tax Nexus Model Statute Workgroup
From:	Roxanne Bland, MTC Counsel
Date:	April 16, 2013
Subject:	Model Sales and Use Tax Nexus Statute – Research and Draft Policy Checklist

At its March 6, 2013 meeting, the Sales and Use Tax Subcommittee asked the workgroup to:

1. Consider:
   a. whether the Due Process and Commerce Clause nexus standards should be analyzed for a unitary business as a whole, or whether they must be analyzed for each corporate member of that unitary business on a stand-alone basis;
   b. whether the *Tyler Pipe* requirement – that the activities performed in a state on behalf of the taxpayer must be significantly associated with the taxpayer's ability to establish and maintain a market in the state in order to create nexus for the taxpayer – applies for purposes of activities conducted by unitary affiliates or for purposes of sales and use taxes at all (as opposed to the Washington business and occupations tax at issue in *Tyler Pipe.*); and
   c. whether the federal Internet Tax Freedom Act has implications for an associate nexus statute

2. Develop a nexus statute policy checklist.

This memorandum provides an analysis of the first two questions and a draft policy question list for workgroup consideration and discussion.

ANALYSIS

1. "Unitary Nexus": Can sales and use tax nexus be established for a unitary business as a whole? Or must a determination of nexus be made on a corporation by corporation basis within the unitary group?

Some state courts have held that the unitary business principle does not apply in the context of sales and use taxes.[1] The MTC argued to the contrary in *Barnesand,noble.com v. New Mexico Taxation and Revenue Department, No. 33.627 (2013)* -- that a sales and use tax nexus

[1] *SFA Folio Collections, Inc. v. Bannon*, 585 A. 2d 666 (Conn. 1991) and *SFA Folio Collections, Inc. v. Tracy*, 652 N.E. 2d 693 (Ohio 1995)

analysis may be made for the unitary group as a whole. The following is excerpted from the MTC's brief:

The hallmark of a unitary business is that it operates as a single business enterprise. *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425, 438-439 (1980). A unitary business may be carried out by a single legal entity or by multiple affiliated entities operating together. *See, e.g., Mobil Oil Corp., at 439*; *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159 (1983). Each portion of a unitary business contributes to and operates for the benefit of all other portions of the business. In *Container*, the Supreme Court noted that the due process and commerce clauses of the Constitution impose "...the obvious and largely self-executing limitation that a State not tax a purported 'unitary business' unless at least some part of it is conducted in the State." 463 U.S. at 167; *citing to Exxon Corp. v. Department of Revenue of Wisconsin*, 447 U.S. 207, 220 (1980) and *Wisconsin v. J.C. Penney Co*., 311 U.S. 435, 444 (1940).

Here [in *Barnesandnoble.com*], the intra-state and extra-state activities conducted by the Taxpayer and its affiliated in-state bookstores formed part of a single unitary business; the out-of-state activities were not "unrelated business activity" and did not constitute a "discrete business enterprise." *See Allied Signal, Inc. v. Dir. of Taxation*, 504 U.S. 768, 773 (1992), in turn quoting *Mobil Oil Corp v. Commissioner of Taxes of Vermont* at 439. A portion of this unitary business was conducted in New Mexico. It was conducted with the aid of physical property – three brick and mortar bookstores. By definition of the unitary business principle, the activities carried out by this brick and mortar affiliate were carried out for the benefit of the unitary business as a whole, including the Taxpayer's benefit.

Moreover, even had the portion of this unitary business that was conducted in the state not performed activities *directly* related to the establishment or maintenance of Taxpayer's on-line business, the business as a whole nonetheless has a physical presence in the state sufficient to establish nexus for the entire business, including Taxpayer. In *National Geographic Society v. California Bd. of Equalization*, 430 U.S. 551 (1977), the U.S. Supreme Court applied the physical presence test established in *Bellas Hess*¸ later upheld in *Quill*, to hold that two offices in California gave that state nexus to require use tax collection by National Geographic's mail-order business, even though the buildings made *no* contribution to the establishment or maintenance of a market for the mail-order business.

In reaching its holding, the Court in *National Geographic* pointed to *Nelson v. Sears, Roebuck & Co*, 312 U.S. 359 (1941), and made clear that although Sears had argued its mail-order department was separate from its in-state stores, and that the in-state stores had not assisted directly with the mail-order sales, the basis for the Court's holding that the state had nexus to require use tax collection on mail-order sales had nothing to do with whether or not there was direct in-state assistance with respect to those sales. Rather, the holding in *Sears* was simply that "the fact Sears' business was departmentalized[, and] the mail-order and retail stores operations were separately administered[,] did not preclude the finding of sufficient nexus." *National Geographic* at 560. The Court in *Sears* found that:

> Respondent cannot avoid that [tax collection] burden *though its business is departmentalized*. Whatever may be the inspiration for these mail orders, however they may be filled, Iowa may rightly assume that they are not unrelated to respondent's course of business in Iowa. *They are nonetheless a part of that business though none of respondent's agents in Iowa actually solicited or placed them*.

Sears at 364. (emphasis added).

The Court in *Sears* found departmental divisions irrelevant for nexus purposes, which is the essence of the unitary business principle. Indeed, the principle has been applied in the context of corporate income tax to find corporate divisions irrelevant, as well. *See Container,* 463 U.S. 159 (1983)*; Barclays Bank PLC v. Franchise Tax Board of California,* 512 U.S. 298 (1994). In the context of corporate income tax, the concept that a taxpayer's choice of organization along departmental or even corporate lines has no bearing on constitutional nexus is well accepted for purposes of apportionment.

> Superficially, intercorporate division might appear to be a more attractive basis for limiting apportionability. But the form of business organization may have nothing to do with the underlying unity or diversity of business enterprise. Had appellant chosen to operate its foreign subsidiaries as separate divisions of a legally as well as a functionally integrated enterprise, there is little doubt that the income derived from those divisions would meet due process requirements for apportionability. Cf. *General Motors Corp. v. Washington,* 377 U.S. 436, 441 (1964). Transforming the same income into dividends from legally separate entities works no change in the underlying economic realities of a unitary business, and accordingly it ought not to affect the apportionability of income the parent receives.

Mobil at 440-441.

And there is no constitutional reason why this principle – looking past divisional and corporate lines to recognize a single economic enterprise for purposes of state corporate income tax nexus with respect to business activity – should not apply for purposes of other taxes, including taxes on gross receipts from certain activities attributable to a state. In fact, the principle arose in the late 1800's in the context of a capital stock tax, a type of property tax. *See, e.g., State Railroad Tax Cases,* 92 U.S. 575 (1876); *Adams Express v. Ohio State Auditor*,165 U.S. 194 (1897)). It was applied to business net income taxes in the 1920's. *See Underwood Typewriter Co. v. Chamberlain, Treasurer of the State of Conn.,* 254 U.S. 113 (1920); *Bass, Ratcliff & Gretton, Limited v. State Tax Commission,* 266 U.S. 271 (1924). As a constitutional matter, the concept should apply in the context of a gross receipts tax as well. *See, e.g.,* P. Frankel, C. Fields, M. Pearl, R. Coll, *The Unitary Business Principle Applies to More than Net Income Taxes,* Tax Analysts (May 2012)(referencing *Reynolds Metals Co., LLC v. Department of Treasury,* Not Reported in N.W.2d, 2012 WL 954278 (Mich. Ct. App.), and commenting that "[a]lthough the court's decision comes as no surprise, it is significant because it reinforces the fact that the unitary business principle applies to more than corporate net income taxes; for example, it applies to gross receipts taxes or value added taxes as well … the U.S. Supreme Court developed the rationale of a unitary business to ensure that a state did not tax value or activity occurring outside the state. That rationale applies equally to VATs, gross receipts taxes, net worth taxes, or other business activity taxes [at least where apportionment is required].")

Two state court appellate decisions have rejected the unitary business principle in the context of use tax collection nexus involving mail order affiliates of companies operating stores within the taxing state, *SFA Folio Collections, Inc. v. Bannon*, 585 A. 2d 666 (Conn. 1991) and *SFA Folio Collections, Inc. v. Tracy*, 652 N.E. 2d 693 (Ohio 1995). Both cases are wrongly decided.

The Connecticut court in *SFA Folio v. Bannon* disallowed the application of the unitary business principle to use tax collection because Connecticut did not have a statute that explicitly authorized the application of the principle to sales and use tax. 585 A.2d 672-673. A number of state courts have rejected the proposition that the application of the unitary business principle requires specific statutory authorization. *See, e.g., Coca Cola Co. v. Oregon Department of Revenue*, 533 P.2d 788 (Or. 1975); *Montana Department of Revenue v. American Smelting & Refining Co*., 567 P.2d 901 (Mont. 1977); *American Smelting & Refining Co. v. Idaho State Tax Com*., 592 P.2d 39 (Id. 1979); *Caterpillar Tractor Co. v. Lenckos*, 417 N.E.2d 1343 (Ill. 1981); *PMD Investment Co. v. State Dep't of Revenue*, 345 N.W.2d 815 (Neb. 1984); *Pioneer Container Corp. v. Beshears*, 684 P.2d 396 (Kan. 1984).[2] These courts ruled that the unitary business principle is a constitutional construct inherent in the state's corporate income tax apportionment statutes and thus specific statutory recognition of the principle was not a prerequisite in order for the state to apply it and require combined reporting. Likewise, this court may apply the unitary business principle to issues involving the New Mexico gross receipts tax without a specific statute authorizing its application.

The Ohio court in *SFA Folio v. Tracy* rejected the unitary business principle, again as applied to use tax collection, because the court viewed the principle as a limitation on the scope of state authority to tax the amount of business income properly attributable to the state. The court did not view the principle as applicable to the threshold determination of whether the state could tax the business at all. 652 N.E. 2d at 697-698. In doing so, the Ohio misapplied the following language from *Allied Signal, Inc. v. Dir. of Taxation,* 504 U.S. 768, 778 (1992): "The constitutional question in a case such as *Quill Corp*. is whether the State has the authority to tax the corporation at all. [The unitary business principle], by contrast, focuses on the guidelines necessary to circumscribe the reach of the State's legitimate power to tax." An examination of the Supreme Court opinion in *Allied Signal*, however, makes clear that the Court viewed this distinction between the unitary business principle and the *Quill* nexus test as deriving entirely from the due process clause. The Court wrote:

> Although our modern due process jurisprudence rejects a rigid, formalistic definition of minimum connection, we have not abandoned the requirement that, in the case of a tax

[2] But see, *Polaroid Corp. v. Comm. of Rev.*, 472 N.E. 259 (Mass. 1984); *Sears Roebuck & Co. v. State Tax Assessor*, 561 A. 2d 172 (Me. 1989) (Specific statutory authorization required to apply unitary business principle).

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.

Allied Signal, 504 U.S. at 778.

In the instant case, as was true in *SFA Folio v. Tracy* (and in *Quill* itself), there is no question that taxpayer has sufficient minimum contacts with New Mexico to satisfy the due process clause, and taxpayer does not dispute that. The only question is whether New Mexico's imposition of gross receipts tax on taxpayer's receipts from certain of its activities attributable to New Mexico is consistent with the commerce clause. As the Supreme Court explicitly held in *Allied Signal*, *supra* at 786, the unitary business principle is "quite compatible" with the commerce clause. The Supreme Court has never addressed whether the in-state presence of a unitary affiliate using common trademarks and conducting cross-marketing activities (such as joint marketing through gift cards and book clubs) satisfies commerce clause nexus requirements.

To the extent the unitary business principle applies to this case, the entire unitary business would be viewed as a single economic enterprise. That enterprise involves the use of physical property in New Mexico, and the existence of physical property in the state certainly creates sufficient nexus for the state to impose a tax on the gross receipts from certain activities attributable to New Mexico.

2. — "Establishing and Maintaining a Market"

In *Tyler Pipe v. Washington Department of Revenue*, Tyler Pipe was an out-of-state company with an independent contractor representative in Washington, whose activities allowed Tyler Pipe to remain competitive and profitable in that state. The Washington Supreme Court wrote, with respect to nexus and the state's business and occupation tax, that "the crucial factor governing nexus is whether the activities performed in this state on behalf of the taxpayer are significantly associated with the taxpayer's ability to establish and maintain a market in this state for the sales." On appeal, the U.S. Supreme Court agreed, quoting the Washington court's analysis, that "Tyler's 'sales representatives perform any local activities necessary for maintenance of Tyler Pipe's market and protection of its interests....'" and wrote "that the activities of Tyler's sales representatives adequately support the State's jurisdiction to impose its wholesale tax on Tyler."

Since then, state courts have applied that language in the sales and use tax context (see, e.g., *Dell Int'l v. Louisiana*, (unrelated third party service contracts helped out-of-state seller to "establish and maintain a market" in Louisiana so as to subject it to the state's sales and use tax); *BordersOnline v. California State Board of Equalization,* ("Online had a representative with a physical presence in the State and the representative's activities were "'significantly associated with [Online's] ability to establish and maintain a market in [the] state for the sales.'"))

In *National Geographic v. California Board of Equalization,* the Society "maintains two offices in California that solicit advertising copy for the Society's monthly magazine, the National Geographic Magazine. However, the offices perform no activities related to the

Society's operation of a mail-order business for the sale from the District of Columbia of maps, atlases, globes, and books." Court found that "the [the Society's] maintenance of the two offices in California and activities there adequately establish a relationship or 'nexus' between the Society and the State that renders constitutional the obligations imposed upon appellant pursuant to [the California statutes.]" It rejected Geographic's argument "that there must exist a nexus or relationship not only between the seller and the taxing State, but also between the activity of the seller sought to be taxed and the seller's activity within the State." The Court said

> It is true that Sears, Roebuck and Montgomery Ward, relied on by appellant, involved fact patterns that included proof of assistance by local operations of the mail-order business. Sears maintained 12 retail stores in the taxing State and was qualified to do business there. Sears' agents in the States, although not directly involved in the solicitation of the mail-order sales, at times assisted in processing such orders. The holding that Sears could not avoid use-tax liability did not, however, turn on that fact. The holding, rather, was that the fact Sears' business was departmentalized the mail-order and retail stores operations were separately administered did not preclude the finding of sufficient nexus. "[T]he relevant constitutional test to establish the requisite nexus for requiring an out-of-state seller to collect and pay the use tax is not whether the duty to collect the use tax relates to the seller's activities carried on within the State, but simply whether the facts demonstrate 'some definite link, some minimum connection, between 'the State and the person . . . it seeks to tax.'"

National Geographic was cited with approval by the Court in *Quill v. North Dakota* in its discussion of *National Bellas Hess v. Illinois*.

What distinguishes *Tyler Pipe* and *National Geographic* that makes them consistent? How are these two cases reconciled? One possibility is that the business and occupations tax in *Tyler Pipe* was one on the "privilege of engaging in business activities in the State, including manufacturing in the State and making wholesale sales in the State., and involved an independent contractor. In *National Geographic,* the issue was a use tax collection requirement, and the in-state activities in question were performed by a division of the taxpayer itself.

POLICY QUESTIONS

1. How much activity by a third party will rise to the level of "establish[ing] and maintain[ing]" a market in a state so as to confer nexus on an out-of-state retailer?

> If *Tyler Pipe* is applicable to sales and use taxes, should there be a de minimis to the activities performed by a third party in state such that those activities do not help to "establish and maintain a market in the state?"

2. Should the proposal specify that nexus is found in cases of an in-state personunrelated to the out-of-state retailer and with no formal agreement with the retailer, but who acts as a "*de facto* marketing and distribution" channel in the state for the retailer's goods?[3]

3. Should the proposal specify that third-party independent contractors soliciting within a state on behalf of an out-of-state retailer results in nexus with the state??[4]

4. Should the proposal specify that the unitary business may be the basis for analyzing nexus?[5]

5. Should the proposal specify that nexus for an internet retailer arises if an in-state entity, through agreement with the internet retailer, solicits sales on behalf of the retailer?[6]

6. Should the proposal specify that a non-affiliated entity, contracted to perform in-state warranty. "installation, maintenance or repair" services for products sold by an out-of-state retailer, gives rise to nexus in the taxing state?[7]

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[3] **(**GA. CODE ANN. § 48-8-2(8)(L)), *Scholastic Book Clubs v. Commissioner of Revenue Services*, *Scholastic Book Clubs v. Farr.*

[4] *Scripto, Inc. v. Carson*, 362 U.S. 207 (1960)

[5] MTC Brief, *Barnsandnoble.com v. New Mexico Taxation and Revenue Department*; *Borders Online*; State "affiliate nexus" statutes; California Reg. 1684.

[6] N.Y.S. 1101 (b)(8)(vi); *Amazon v. New York State Department of Taxation and Finance*

[7] S.D.C.L. 10-45-2.9 (South Dakota), *Dell Catalog Sales, L.P. v. Commissioner of Revenue Services*, (Connecticut), 4834 A.2d 812 (Conn. Super. Ct. 2003), *Dell Catalog Sales LP v. NM Taxation & Revenue Dept.*,(New Mexico), *State v. Dell Intern., Inc.* (Louisiana)