Sales Tax Affiliate Nexus Stemming From Online Business Presence
Meeting the Challenges of Tough State Laws and Court Rulings

A Live 110-Minute Teleconference/Webinar with Interactive Q&A

Today's panel features:
Diann Smith, Counsel, Sutherland, New York
Elaine Bialczak, Director, Compton & Associates, Atlanta
Patrick Derdenger, Tax Partner, Steptoe & Johnson, Phoenix

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Sales Tax Affiliate Nexus Webinar

Nov. 12, 2009

Legislative Trends

Diann Smith, Sutherland

diann.smith@sutherland.com

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Traditional Sales Tax Statutes

Sales tax nexus based on having physical presence in the state

- Office, warehouse or other business location
- Maintain inventory or property in the state
- Regularly solicit orders in the state
- Deliver property in the state by other than common carrier (company owned trucks); or
- Lease or service property in state

States also have asserted that sales tax nexus may be based on activities by in-state representatives (e.g. solicitation of sales)
What is the difference?

- Affiliate nexus: Existence of common ownership between an in-state taxpayer and an out-of-state company may create nexus for the out-of-state company. Many states have looked to activities that establish that the in-state company is creating or maintaining a market in the state for the out-of-state company (e.g. advertising, accepts returns of product, sales solicitation, marketing, etc.)

- Attributional nexus: A state’s ability to assert nexus on an entity on the basis of that entity’s relationship with another entity doing business in the state – not based on common ownership. The nexus-creating activities of an in-state entity are attributed to an out-of-state entity on the basis of their relationship (agent or representative)
Taxation Of Internet Sales

- States have experienced significant budget deficits and cash shortages
- Internet sales are often perceived as an area that has escaped state taxation
- States, including New York, have attempted to pass legislation that allows for the taxation of sales via the Internet
  - New York’s statutory provision is based on an attributional nexus theory: The activities of in-state associates are attributed to online retailer(s)
New York Internet Tax Statute

• New York was the first state to enact a statutory presumption that out-of-state retailers “solicit business” in New York if:
  ▪ Any in-state entity is compensated for, directly or indirectly, referring customers to the retailer, whether by Web site link or otherwise; and
  ▪ The cumulative gross receipts from New York affiliate referrals exceed $10,000
Why Is the New York statute different?

- Lacks a physical presence requirement
- Presumes out-of-state retailer is soliciting business in the state if any in-state entity is compensated, directly or indirectly, for referring customers to the out-of-state retailer’s Web site
- Fails to meet Commerce Clause substantial nexus requirement
Application of New York’s Law

- New York has issued guidance providing that the aforementioned statute will only be applied where the an in-state associate is compensated for purchases based on clicks – not solely compensation for clicks
- New York’s definition of “resident” is broad, covering any corporation doing business in the state
New York Internet Tax Statute (Cont.)

- Taxpayers have challenged the statute in court, but the cases have been dismissed for failure to state a cause of action (*Amazon* and *Overstock* cases)

- Oral arguments were recently heard in the appeal of the dismissal
The Aftermath Of New York

- After the passage of New York’s Internet tax statute, several states proposed similar legislation
- During the 2009 legislative session, legislation was proposed in California, Connecticut, Hawaii, Illinois, Maryland, Minnesota, North Carolina, Rhode Island and Tennessee
- Rhode Island and North Carolina were the only states to ultimately pass legislation
- Internet retailers have ended their associate programs in the two states
- Threats of termination of associate programs in other states, including Hawaii and California, resulted in vetoes of similar legislation
Rhode Island and North Carolina’s Internet tax statutes are virtually identical to New York’s.

No guidance has been issued though in either state as to how the statutes will be applied – compensation based on clicks only or compensation based on purchased from clicks.

No definition of “resident” in either state.
States have continued to enact affiliate nexus sales tax provisions that create a sales and use tax registration and collection requirement for an out-of-state entity with no physical presence in the state, based on the presence of an in-state affiliate conducting certain activities.

Under these statutes, in-state activities that may create nexus for the out-of-state entity may include:

- Use of similar trademarks, tradenames or other service marks
- Acceptance of returns of tangible personal property
- Activities that constitute establishing and maintaining a market (e.g., solicitation, fulfilling orders, repairs)
- Ownership and control by an in-state entity in the same or similar line of business

New York and Wisconsin recently passed such legislation.
Sales Tax Affiliate Nexus Stemming from Online Business Presence Teleconference

Other Recent Legislative Attempts To Define Nexus For Affiliates

By Pat Derdenger. Steptoe & Johnson LLP
(602) 257-5209
pderdenger@steptoe.com

When Experience Matters®
“Amazon Laws”: Recent Legislative Attempts To Define Nexus For Affiliates

- Response to these laws by Amazon.com and Overstock.com, and similar online vendors
  - Sever ties with affiliates based in New York and other states that have passed similar laws
  - For example, after Hawaii passed its “Amazon tax”, Amazon.com severed ties with all affiliates in the state. Perhaps this motivated the governor to veto the bill!
An out-of-state vendor would have substantial nexus for use tax collection if:

1. Out-of-state vendor and in-state business are “related parties”
2. Out-of-state vendor and in-state business use identical or similar name, trade name, trademark or goodwill to develop, promote or maintain sales. Or, in-state business provides services to or that benefit the out-of-state vendor’s in-state sales
3. Out-of-state vendor must have at least $100,000 of sales in previous year
Relevant Court Decisions

Elaine Bialczak, Compton & Assoc.

ebialczak@comptonllp.com
The United States Supreme Court Nexus Standard

• Quill Corp. v. Heitkamp, 504 U.S. 298 (1992)

• The court affirmed its earlier decision, National Bellas Hess, Inc. v. Department of Revenue of Illinois, 386 U.S. 753 (1967)
  
  – In this earlier decision, the court concluded that the Commerce Clause does not permit a state to require a vendor to collect sales and use tax when the vendor’s only contacts with the state are by mail or common carrier

• A vendor with only these contacts lacks substantial nexus, which the Commerce Clause requires
The United States Supreme Court Nexus Standard (Cont.)

• Quill Corp. (Cont.)

• A company lacking a physical presence in a state does not meet the substantial nexus test

• The court did not discuss the extent of physical presence that creates substantial nexus

• It opined that a state’s ability to require a vendor to collect sales or use tax “may turn on the presence in the taxing State of a small sales force, plant or office …” and decided that the presence of Quill’s licensed software in the state did not create substantial nexus
The United States Supreme Court Nexus Standard (Cont.)

• *Quill Corp.* (Cont.)

• While the court did not discuss affiliate nexus in this decision, state courts have turned to the presence of affiliates in the state to establish physical presence
Connecticut, Ohio And SFA Folio

• Both states decided that SFA Folio did not have nexus by affiliation

  
  – SFA Folio and Saks-Stamford were both subsidiaries of Saks and Company

  – Saks-Stamford operated a retail store in Stamford, Conn. and admitted that it had nexus with Connecticut
Connecticut, Ohio And SFA Folio (Cont.)

• Connecticut (Cont.)
  
  – Commissioner’s assertions

  • SFA Folio had substantial nexus with Connecticut because it was linked to Saks-Stamford through their common paren.

  • The corporations comprised a single enterprise

  • Saks-Stamford’s nexus should be attributed to SFA Folio
Connecticut, Ohio And SFA Folio (Cont.)

- Connecticut Supreme Court decision
  - Rejected the commissioner’s unitary enterprise theory of nexus
  - Refused to disregard the corporations’ separate existence
  - SFA Folio was not a paper entity; it was “a separate and independently functioning corporation”
Connecticut, Ohio And SFA Folio (Cont.)


  - Commissioner’s assertions

    - Same unitary theory of nexus that the Connecticut commissioner espoused

    - SFA Folio was “part of an integrated unitary retail merchandising business,” thereby creating nexus for SFA Folio
Connecticut, Ohio And SFA Folio (Cont.)

- Ohio (Cont.)

  - Ohio Supreme Court decision

    - Imputing nexus to SFA Folio through its sister corporation’s physical presence in the state ran “counter to federal constitutional law and Ohio corporation law”

    - The unitary business principle did not apply when determining whether a state had the authority to tax a corporation initially
California Decisions Split


  - Statute in issue

  - A retailer must collect use tax if it is owned or controlled by the same interests that own or control any retailer engaged in business in the same or similar line of business in this state. [paraphrase of Section 6203(g)]
California Decisions Split (Cont.)

- *Current, Inc. (Cont.)*
  - Current, which did not have nexus, was acquired by Deluxe Corp., which had nexus
  - Current developed, designed, produced and sold through the mail greeting cards, gift wrapping paper and other items, including novelty checks
  - Deluxe engaged primarily in manufacturing and selling checks at wholesale
California Decisions Split (Cont.)

- **Current, Inc. (Cont.)**
  - The two companies did not have integrated operations or management
  - Neither solicited orders for the other, accepted returns of the other’s merchandise or assisted or provided services for the other’s customers
California Decisions Split (Cont.)

- Current, Inc. (Cont.)
  - Courts of Appeals decision
    - Applying Sect. 6203(g) to Current would be unconstitutional
    - Current and Deluxe were not engaged in the same or similar lines of business
    - The companies’ product lines were dissimilar; only 7.9% of Current’s revenue derived from sales of checks, whereas 96.3% of Deluxe’s revenue came from such sales
California Decisions Split (Cont.)


  – Involved Subsect. (c)(2) of Sect. 6203, which provides that a retailer is engaged in business in the state if it has “any representative, agent, salesperson, canvasser, independent contractor, or solicitor operating in the state under the authority of the retailer or its subsidiary for the purpose of selling, delivering, installing, assembling, or the taking of orders for any tangible personal property”
California Decisions Split (Cont.)

• *Borders Online* (Cont.)

  – The board asserted that Borders Online satisfied the statute because the Borders stores acted as its agents when they accepted merchandise returns on its behalf.

  – The court accepted the board’s argument. It also accepted the board’s conclusion that “selling” included “all activities that constitute an integral part of inducing sales.” Accepting the returns, the board reasoned, induced further sales.
California Decisions Split (Cont.)

- Borders Online (Cont.)
  - Substantial nexus was satisfied. The cross-selling synergy between the entities, the use of similar logos, and the store employees’ encouraging customers to visit the Web site established that Borders Online had a representative in the state with activities significantly associated with Online’s ability to establish and maintain a market in the state
California Decisions Split (Cont.)


  - The passive distribution of coupons by Barnes & Noble retail stores allowing a $5 discount on an online purchase from barnesandnoble.com did not by itself create an agency relationship between barnesandnoble.com and Booksellers, the subsidiary of Barnes & Noble, Inc., that operated the bookstores. Neither entity had an ownership interest or operational role in the other; the two entities did not share directors or officers.
California Decisions Split (Cont.)

- Barnesandnoble.com (Cont.)

  - No evidence established that Barnes & Noble, Inc., actually controlled both entities

  - An essential element of agency is that the agent must have the authority to bind the principal. The Barnes & Noble retail stores did not have such authority. Booksellers did not create the coupon program, had no authority to adjust the terms of the coupons or to redeem them, and it could not accept returns of online purchases.
California Decisions Split (Cont.)

- *Barnesandnoble.com* (Cont.)
  
  - Booksellers did not solicit sales or accept orders on behalf of barnesandnoble.com
  
  - To create nexus, selling must be carried out by an agent, and Booksellers was not an agent
Barnesandnoble.com And The Federal District Court

  - The U.S. District Court for the Eastern District of Louisiana decided that barnesandnoble.com did not have nexus for the purpose of collecting local sales and use taxes
  - “The existence of a close corporate relationship between companies and a common corporate name does not mean that the physical presence of one is imputed to the other.”
Barnesandnoble.com And The Federal District Court (Cont.)

- That Booksellers accepted returns of merchandise purchased from barnesandnoble.com did not create nexus, because this was “not comparable to an independent contractor making sales on behalf of the out-of-state retailer”
Drugstore.com And New Jersey

  
  - The New Jersey Tax Court attributed a subsidiary’s sale to the parent, which had nexus
  
  - Drugstore.com provided Web-hosting services and admitted that it had nexus with New Jersey
  
  - Drugstore.com created a subsidiary, DSNP, which sold non-prescription items on the drugstore.com Web site. DSNP did not have nexus with New Jersey
Drugstore.com And New Jersey (Cont.)

- Drugstore.com created another subsidiary, DS Distribution

- Distribution sold items to DSNP for resale

- Distribution leased a building in New Jersey, which it used as a warehouse and distribution facility. Distribution packed and shipped orders from DSNP by common carrier to New Jersey customers
Drugstore.com And New Jersey (Cont.)

- The director argued that drugstore.com should collect New Jersey sales tax on shipments of goods to New Jersey customers from the New Jersey warehouse.

- Drugstore.com argued that DSNP was the vendor, and because it had no nexus with New Jersey, it was not required to collect sales tax.

- Drugstore.com also argued that it was not required to collect the sales tax because it was not the vendor.
Drugstore.com And New Jersey (Cont.)

- The court decided that drugstore.com was the actual vendor, and it made the sales to its New Jersey customers

- The court disregarded the purported sale between Distribution and DSNP

- Because drugstore.com had admitted having nexus, attributing the sales to it made it liable to collect New Jersey sales tax
Amazon.com And New York

• Amazon.com LLC and Amazon Services, LLC v. New York State Department of Taxation and Finance, 877 N.Y.S.2d 842 (Sup. Ct. of N.Y. 2009).

• Applicable statutes
  – A vendor is a person who solicits business by employees, independent contractors, agents or other representatives and thereby makes taxable sales of tangible personal property or services to persons in the state
Amazon.com And New York (Cont.)

- *Amazon.com* (Cont.)

- Applicable statutes
  - A seller is presumed to be soliciting business by an independent contractor or other representative if the seller enters into an agreement with a resident of the state under which the resident indirectly or directly refers potential customers for a consideration, whether by a link on a Web site or otherwise to the seller, if sales exceed $10,000 during the preceding four quarterly periods.
Amazon.com And New York (Cont.)

• Amazon.com (Cont.)
  – Issue
    • Whether the Commerce Clause prevents New York from requiring Amazon to collect use tax with respect to its sales through its “Associates Program”
  – Decision
    • The Commission Agreement Provision is not unconstitutional on its face, because it requires “demonstrably more than a slightest presence” (greater than $10,000 in sales requirement)
Amazon.com And New York (Cont.)

- Amazon.com (Cont.)

  - Decision

  - The provision is not unconstitutional as applied, because Amazon benefits from New York associates who are free to target New Yorkers and encourage Amazon sales while earning money for Amazon and commissions for themselves. Amazon may not escape tax collection indirectly when it could not escape it directly using New York employees for these activities
Drugstore.com And Amazon.com

• Note that neither of these decisions is an affiliate nexus decision

• Drugstore.com admitted that it had nexus; the court attributed sales to drugstore.com, not nexus

• Amazon.com is not an affiliate nexus decision because Amazon.com’s agreements were with individuals and unrelated entities. This is an attributional nexus decision
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“Practical Implications”

Pat Derdenger, Steptoe & Johnson LLP
pderdenger@steptoe.com

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Practical Concerns: An In-State, Unrelated Party Working On Your Behalf - Dell Computer Maintenance Cases

- **Formal maintenance agreements with unaffiliated third-parties to service products may establish nexus**
  - Dell, an online/catalog computer vendor, contracts with a nationwide service company to repair computers in purchaser’s homes; the service contract is sold by Dell to the purchaser at the time of purchase

- **Multistate Tax Commission Bulletin 95-1, revised in 2006, for computer mail order companies, says:**
  - In-state warranty repair services by independent contractor establish nexus
  - Would apply to Internet sales

- Activities of third-party were significantly associated with Dell’s ability to establish and maintain a market in the state
Practical Concerns: An In-State, Unrelated Party Working On Your Behalf - Dell Computer Maintenance Cases (Cont.)

- **No Nexus** *Dell Catalog Sales, L.P. v. Conn. Comm’r of Revenue*, 834 A.2d 812 (2003)
  - Minimal in-state repair service by independent contractor was not sufficient nexus
  - Dell retained 90% of the price of the service contract, and the service provider retained only 10%. So, the court inferred that the service provider’s operations on Dell’s behalf were minimal
  - Isolated and sporadic physical contacts are insufficient to establish substantial nexus
Possible solutions

- Have the customer ship the equipment back to the manufacturer for repairs (eliminate third-party, on-site repairs in state)
  - BUT, customers may prefer on-site repairs
- Have the customer contract directly with the third-party provider and not directly with, or through, Dell
Practical Concerns: An In-State, Unrelated Party Working On Your Behalf – Expedia Case

- *Travelscape, LLC v. South Carolina Dep’t of Revenue*, (08-ALJ-17-0076-CC, Feb. 12, 2009)
  - Administrative Law Court decision
  - Expedia derived its revenue from booking hotel reservations, including some in South Carolina
  - Nexus found: Physical presence established by employees of the in-state hotels, because they were critical to Expedia’s ability to establish and maintain a market in state (i.e. the *Tyler Pipe* test)
Practical Concerns: Location Of Web Servers

- MTC discussion drafts of proposed rules: Nexus established IF
  - Ownership, lease, use or maintenance of computer terminals available for access in the taxing jurisdiction
  - Licensing of proprietary software in the taxing jurisdiction that facilitates use of the online service
MTC discussion drafts of proposed rules (Cont.): Nexus established IF

- Utilization of a “cybermall” with a computer server in the taxing jurisdiction that performs various administrative and financial functions on behalf of the remote seller
  - A “cybermall” is an online retailer, such as Amazon.com, that offers a wide range of goods for sale
- Maintaining a telecommunication linkage by private contract in the taxing jurisdiction that permits the online service to establish and maintain a market in the taxing jurisdiction
Practical Concerns: Location Of Web Servers (Cont.)

- MTC discussion drafts of proposed rules (Cont.): Nexus established IF
  - Performing or rendering *electronic services* in the taxing jurisdiction, such as remote computer diagnostics and technical support
Industry opposition prevented the MTC from finalizing these drafts, but aggressive states may follow them.
Practical Concerns: Location Of Web Servers (Cont.)

- Rulings on servers
  - New Mexico Taxation and Revenue Department Ruling No. 401-97-6 (11/20/1997): *If a taxpayer “owns or leases the server . . . and the server is in New Mexico, that in itself would create nexus for [the taxpayer] with New Mexico.”*
• Va. Department of Taxation Ruling No. 05-128 (08/02/05): “Out-of-state seller whose only presence in Virginia is a computer server [owned by another business] used to create or maintain an Internet website does not have nexus for sales and use tax purpose.”
  o But, if the dealer owns or rents the server, and it is situated in Virginia, then the dealer may have nexus. See Virginia Department of Taxation Ruling No. 04-38 (07/28/2004).
Ill. Department of Revenue General Information Letter No. ST 01-0088-GIL (05/09/01): “Retailer’s use of a server located in Illinois, in and of itself, is generally not sufficient to establish nexus for sales of tangible personal property made through the internet.”

- The retailer did not own or lease the server
- Rather, it paid a fee to a Web-hosting company for use of the server (also used by others)
Practical Concerns: Location Of Web Servers (Cont.)

- Solutions
  - Taxation may turn on whether you own or lease the server, or contract with a third-party for a server service
  - To be safe, use servers that are situated in states in which you already have physical presence – i.e. home state
MTC proposed model affiliate sales tax nexus statute (April 28, 2005): **An out-of-state vendor has substantial nexus for use tax collection if**

1. Out-of-state vendor and in-state business are “related parties”
2. Out-of-state vendor and in-state business use identical or similar name, trade name, trademark or goodwill to develop, promote or maintain sales; or, in-state business provides services to or that benefit the out-of-state vendor’s in-state sales
3. Out-of-state vendor must have at least $100,000 of sales in previous year
Practical Concerns: Business Entity Naming Policies (Cont.)

- Some states have adopted statutes similar to the MTC proposed statute, including:
  - Alabama – Ala. Code § 40-23-190(a)(2)
  - Idaho - Idaho Code § 63-3615A(1)(b)

Practical Concerns: Business Entity Naming Policies (Cont.)

- **Solution**
  - Don’t use the same or a similar name for your in-state and out-of-state affiliates or Internet and bricks-and-mortar affiliates
Practical Concerns: Location Of Distribution And Fulfillment Activities

- States may find nexus established through an affiliate engaging in distribution and fulfillment activities on your behalf
  - *Lyon Metal Products, Inc. v. State Bd. of Equalization*, 58 Cal. App. 4th 906 (Cal. Ct. App. 1997): Nexus established in CA where goods were stored in a warehouse in CA and delivered from there to customers
States may find nexus established through an affiliate engaging in distribution and fulfillment activities on your behalf

Practical Concerns: Location Of Distribution And Fulfillment Activities (Cont.)

- Solution

  • Locate distribution and fulfillment activities in states in which you already have physical presence and nexus