

California's Tax System – Report #2d

Sales and Use Tax Weakness & Possible Remedies: Nexus Uncertainty

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This is one in a series of reports on weaknesses in California's tax system. Report #1 lists several structural weaknesses and policy issues that exist in most of California's taxes and the system overall. Subsequent reports provide further details on each of the weaknesses and issues, along with possible remedies. The purpose of this series of reports is to help promote serious discussion on the need to and the ways to bring California's tax system into the 21st century so it may best promote economic growth, be more equitable, efficiently meet state revenue needs, reduce taxpayer frustration, and be understandable and transparent. Work on this series began through a two-year fellowship with the New America Foundation. A blog accompanies these reports to enable online discussion. To access the reports, articles, and the blog, please visit:

http://www.cob.sjsu.edu/nellen_a/TaxReform/21st_century_taxation.htm

Introduction

Nexus is the connection between a taxpayer and a taxing jurisdiction (for example, a state) that is sufficient to allow the jurisdiction to subject the taxpayer to taxation without violating constitutional principles. The determination as to whether nexus exists can be a subjective one that leads to conflicts between taxpayers, tax collectors and the courts. Much of the subjectiveness can be removed through laws and regulations.

In 1959, Congress enacted legislation to make the nexus determination for state income taxes more objective. While at the time, there had also been discussions about doing the same for sales tax, no legislation was enacted. Without legislation, the U.S. Supreme Court ended up providing the guidance on when nexus exists for sales tax purposes such that a state can require a business to collect sales tax from customers in that state. Since 1992, with the Court's decision in *Quill*,¹ the nexus standard has been that a business must have a physical presence in the state in order for the state to require the business to collect sales tax. However, how much physical presence is a matter of much litigation with results varying from state to state. Thus, businesses may not know whether they have to collect sales tax from California customers. In addition, California-based businesses face similar issues when they sell to customers in other states.

¹ *Quill Corporation v. North Dakota*, 504 U.S. 298 (1992).

This report explains the constitutional standards for nexus and the *Quill* decision, provides examples of confusion that exists today for sales tax nexus, why nexus clarification is needed and how such a result might be achieved.

Weakness: Nexus determinations for sales tax purposes are too subjective and vary from state to state such that businesses may not know when they are required to collect sales tax from California customers.

Remedy: Make State Board of Equalization regulations and publications clearer as to what circumstances cause a business to have sales tax nexus in California. Provide a nexus checklist for businesses that enables them to confidently determine if they have nexus or not. Request those not having nexus to note that on their website or catalogs so California customers know they have a use tax obligation on the purchase. Finally simplify compliance approaches to reduce costs for vendors.

Nexus Basics

Sufficient *nexus* must exist in order for a state to subject a vendor to sales and use tax collection obligations. Nexus may be thought of as a connection between the vendor and state such that subjecting the vendor to the state's sales tax is neither unfair to the vendor nor harmful to interstate commerce. These two requirements of fairness to the vendor and no impediment to interstate commerce stem from the U.S. Constitution—respectively, from the Due Process Clause and the Commerce Clause. Both of these requirements must be satisfied before a state may impose sales and use tax collection responsibilities on a vendor.

Due Process Clause: "No State shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States; nor shall any State deprive any person of life, liberty, or property, without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws" (14th Amendment, clause 1). As further explained by the U.S. Supreme Court, "due process requires some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax" (*Miller Brothers Co. v. Maryland*, 347 U.S. 340, 345 (1954)). "The simple but controlling question is whether the state has given anything for which it can ask return" (*National Bellas Hess, Inc. v. Dept. of Rev.*, 386 U.S. 756 (1967)). Unlike the Commerce Clause, the Due Process Clause does not give Congress any power to enact a law that would modify or violate the due process standard.

Commerce Clause: "The Congress shall have power ... to regulate commerce with foreign nations, and among the several States, and with the Indian tribes" (Article I, Section 8, clause 3). Courts often refer to the "dormant Commerce Clause" because the Commerce Clause does not specifically limit state activities—it just grants power to Congress to regulate commerce. In applying the dormant Commerce Clause, the courts consider the purpose served by the Commerce Clause and "whether action taken by state or local authorities unduly threatens the values the Commerce Clause was intended to serve" (*Wardair Canada v. Florida Dept. of Revenue*, 477 U.S. 1 (1986)).

Quill Corporation v. North Dakota: This case involved Quill, a seller of office equipment and supplies, a Delaware corporation, with offices and warehouses in Illinois, California, and Georgia. Quill did not have any property or employees in North Dakota. Quill sold office supplies and equipment to customers in North Dakota, reaching customers through catalogs mailed to them and ads in national magazines. Under North Dakota law, Quill was required to collect use tax on its sales made to North Dakota customers because Quill was engaged in regular solicitation of customers in the state. Quill challenged the North Dakota law as violating both the Due Process and the Commerce clauses.

The U.S. Supreme Court had previously addressed the "minimum connection" requirement of the Due Process Clause in 1967 in *National Bellas Hess v. Department of Revenue of Illinois* (*supra*). In that case, the Court ruled that some type of minimum contact was necessary for a state to tax an out-of-state

business. The necessary minimum contact existed if the out-of-state company had a sales office or sales personnel in the state.

In *Quill*, North Dakota challenged the 1967 ruling as out of date with modern ways of doing business. Today, a company doesn't need a salesperson in a state to obtain a sale. Instead, a catalog and a mail-order sales system can be just as successful for a company. The taxing authority in North Dakota pointed out that \$1 million of Quill's \$200 million of sales were to 3,000 customers in North Dakota. Quill was also the sixth largest supplier of office supplies in the state. North Dakota argued that it had created an economic climate that helped Quill's sales, that it maintained a legal infrastructure to protect the market, and that it had to dispose of 24 tons of catalogs and other mail that Quill sent into the state each year. Per North Dakota, all of this created the requisite minimum connection to enable it to collect use tax from Quill without violating the due process clause of the U.S. Constitution.

North Dakota was partially successful in its argument that the *Bellas Hess* nexus standards were outdated. The Court called its earlier tests too formalistic and that for due process purposes, it would be more appropriate to not focus on physical presence, but to instead look at whether the company's contacts with the state make it reasonable for the state to require the company to collect use tax. In *Quill*, the Court stated that if an out-of-state business purposefully avails itself of the benefits of an economic market in the state, it need not have a physical presence in the state for tax collection.

Despite the Court's relaxation of the due process physical presence requirement, the Court found North Dakota's enforcement of the tax against Quill an unconstitutional burden on interstate commerce in violation of the Commerce Clause. However, the Court pointed out that because the Constitution gives Congress the right to regulate interstate commerce, Congress could provide a mechanism to allow states to collect sales and use tax from an interstate mail-order business not physically present in the state, without violating the that clause.

Is any tax owed on Quill's sales to North Dakota customers? Yes. When a seller is not required to collect sales tax because it does not have a physical presence in the state, the buyer is required to self-report and pay *use tax*. The use tax is a complement to the sales tax and imposed at the same rate. However, many taxpayers are not aware of their use tax obligations and much of it goes uncollected.

How much physical presence is needed? This is the question that remains after the *Quill* decision. The answer varies from state to state due to conflicting court decisions and because many states have rules that ignore some types of presence. For example, some states exclude presence at trade shows for a limited number of days from creating tax obligations.²

Following are examples of rulings and court decisions where some minimal presence was *not* viewed as sufficient physical presence to create sales and use tax collection obligations. Note the different interpretations in the two cases in the lists below involving BN.com (nexus in California, but not in Louisiana) and Dell Computer (nexus in Louisiana, but not in Connecticut).

- In the *Quill* case, the Court noted that despite the fact that Quill licensed software to some of its customers in North Dakota to aid in placing orders, Quill's interests in the software did not affect the analysis under the due process clause issue nor did it constitute “substantial nexus” as required by the commerce clause.
- California Revenue & Taxation (R&T) §6203(d)(1) provides guidance on whether a website or similar telecommunications arrangement results in a taxpayer having sales tax nexus. Under this provision, “‘engaged in business in this state’ does not include the taking of orders from customers in this state through a computer telecommunications network located in this state which is not directly or indirectly owned by the retailer when the orders result from the electronic display of products on that same network. The exclusion provided by this subdivision shall apply

² For example, CA R&T §6203(e). Many states have these trade show rules to entice trade shows to come to their state without worry about formerly non-present sellers creating sales and use tax collection obligations for themselves.

only to a computer telecommunications network that consists substantially of online communications services other than the displaying and taking of orders for products.”³

- A 2000 ruling by the Virginia Department of Taxation (P.D. 00-53; 4/14/00) held that under Virginia law, a taxpayer did not have nexus in the state if its only presence is the use of computer servers to host web sites. The taxpayer, a dealer of car parts, had a web page that allowed customers to view and order products. The taxpayer had no physical presence in Virginia, but was contemplating using a “managed hosting” service or a “co-location hosting” service that would give the taxpayer server access in Virginia. Under both arrangements, servers would be exclusively dedicated to the taxpayer’s web site. The Tax Department held that the taxpayer met the definition of a “dealer,” but did not find that nexus (physical presence) existed where the only presence was use of a server to create or maintain a web site.
- In 2007, a district court in Louisiana (L) found that BarnesandNoble.com (Online) did not have nexus in the state (*St. Tammany Parish Tax Collector v. BarnesandNoble.com*, 05-5695, ED La, 03/22/2007). Online had no physical presence in L and goods purchased online were delivered to L customers via common carriers. From January 2001 to October 2003, Barnes & Noble, Inc. (BN) owned 40% of Online and then through May 2004, owned 80% of Online through a wholly-owned subsidiary. Thereafter, BN owned 100% of Online through B&N Holding Corp., a wholly-owned subsidiary. Despite being owned by the same parent, BN and Online did not share management, employees, offices or other business elements. BN did operate stores in L including in St. Tammany Parish.

The Tax Collector of St. Tammany Parish, where BN operates a store, sued Online for failure to collect sales and use taxes from its customers in the parish. The court examined the five business relationship factors that L argued proved that Online had substantial nexus for sales tax purposes.

1. Common membership program where customers of BN and Online get a discount on items purchased. Members pay a fee and Online received part of that revenue. BN and Online shared the database generated from the cards.
2. BN sold gift cards that could be used either in a store or with Online. Revenue was earned only by selling gift cards or accepting a gift card as payment. Neither BN nor Online derived revenue from sales made by other retailers participating in the program.
3. Online earned revenue via commissions for merchandise ordered at BN stores but shipped directly to customers.
4. BN and Online engaged in cross-promotional advertising. For example, Online’s website includes a store locator function. BN promoted Online via the gift card and membership programs. BN employees only provided information about Online if asked by customers.
5. BN gave preferential treatment for returns of items purchased from Online. Evidence indicated that BN stores would take returns from other stores including Online and non-BN stores, at the store manager’s discretion.

The court found that Online did not have substantial nexus with Parish. It did not find that BN marketed Online’s products. “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. *See, e.g., SFA Folio Collections, Inc. v. Bannon*, 217 Conn. 220, 229-31 & 233-34 (1991) (refusing to impute nexus from bricks-and-mortar retailer to mail-order retailer when the retailers were separate corporate entities owned by the same parent company, sharing some directors and officers, using the same trademarks and logos, selling similar merchandise, and sharing financial and market information); *Bloomingtondale's By Mail, Ltd. v. Pennsylvania*, 130 Pa. Cmwlth. 190,

³ R&T §6203(d)(2) provides that §6203(d)(1) will no longer apply once Congress authorizes states to collect sales and use tax from remote sellers.

198 (1989) (holding that affiliation alone was insufficient to create nexus); *SFA Folio Collections, Inc. v. Tracy*, 73 Ohio St.3d 119 , 122-23 (Ohio 1995) (rejecting unitary business entity argument that would impute nexus to affiliated, out-of-state retailer); *Current, Inc. v. State Board of Equalization*, 24 Cal.App.4th 382, 391 (Cal. App. 1 Dist. 1994) (holding that nexus could not be imputed between companies that did not have integrated operations or management and were organized as separate and distinct entities). Booksellers and Online were formally separate corporate entities that were wholly owned by the same parent company for only part of the period in issue. The two companies clearly shared a common name and brand identity under the “Barnes & Noble” banner, but there was no overlap between the companies' management or directors. There is no allegation that the companies intermingled assets or that they were underfinanced. And to the extent the companies may have shared financial or market data, that fact is not of independent significance. The companies did not hold themselves out as the same entity. Thus, the Court finds that attributional nexus does not apply merely by virtue of the affiliation between the companies.”

The court also found that BN’s activities performed on behalf of Online were not sufficient to treat BN as serving as a marketing presence for Online in the Parish. Unlike in *Scripto*, BN never took an order for Online and did not provide facilities to enable customers to place an order with Online. In addition, the gift card and membership program did not lead to nexus as they did not produce revenue for Online. “That Online may have derived a benefit from [BN’s] advertising of the program is not sufficient to impute its presence to Online.” The court noted that in *SFA Folio Collections*, the mail-order retailers distributed their catalogs to local stores to be given to customers. The court found that situation to be a stronger case for a showing of nexus than what existed with Online (yet there was no nexus in *SFA Folios*). Finally, the court did not find the return practice to rise to the level of activity that existed in *Scripto* or *Tyler Pipe* where contractors made sales on behalf of the out-of-state retailer. Neither was it comparable to the in-state sales support found in such cases as *Scholastic Book Clubs*, 207 Cal.App.3d 734.

- In *Dell Catalog Sales v. Comm’r., Dept. of Revenue Services*, 834 A2d 812, 48 Conn Supp 170, (2003) Dell Catalog Sales was found not to have nexus in Connecticut from its relationship with BancTec (B) which provided services to Dell’s customers. Dell Catalog had no presence in the state. Its customers could purchase a service contract from B. Dell typically sold the service contract at the time it sold the computer and contracts could not be purchased from Dell without also buying a computer. About 75% of customers purchased a service contract. Dell collected sales tax on the service contract, but not on the computer and remitted the tax to the state. The “the terms of the Service Contract Sales Brokerage Agreements provided that Dell Catalog Sales would act as BancTec's agent and broker in marketing BancTec's service contracts, and Dell entities would provide certain technical assistance to BancTec in connection with BancTec's service contracts, in exchange for the contract commission.” Dell received about 90% of the service contract revenue because it provided the bulk of the services via the phone through Dell Tech Support outside of the state. The court noted that this situation indicated that B’s “effort in going on-site in Connecticut to service the consumer's computer had to be minimal.”

Dell Catalog was registered to do business in Texas, Florida, Kentucky and Nevada, but the Connecticut Tax Commissioner registered Dell (involuntarily) to do business in Connecticut. The Commissioner argued, based on *Scripto* (362 US 207 (1960)), that Dell owed use tax on computer sales in the state because B was its representative in the state.

The court noted that B was an “independent computer service” and it was the only party involved that provided on-site work for Dell customers. Dell had “no right to direct and control the work of” B. Thus the court agreed that B was not an agent for Dell. The court further noted that “Dell is an integral part and a major ingredient in the performance of the contract. Cases dealing with the issue of whether the use of independent service representatives provides the in-state physical contacts required to establish nexus by an out-of state seller focus on the extent of the activities of the in-state independent service representative. In *Scripto*, ten independent service representatives

conducting continuous local solicitation in Florida and forwarding the orders to the out-of-state seller for acceptance of the orders was sufficient nexus for the state of Florida to require the out-of-state seller to collect a state use tax upon the sale of the goods shipped to customers in Florida. *Scripto v. Carson, supra*, 362 U.S. 211-212. In *Tyler Pipe Industries v. Dept. of Revenue*, 483 U.S. 232, 251, 107 S. Ct. 2810 (1987), the U.S. Supreme Court held that having resident sales representatives in the taxing jurisdiction to establish and maintain the seller's market constituted physical contacts that established a nexus sufficient to impose a business and occupation tax on sales upon the out-of-state seller. The Tyler court stated: "[T]he crucial factor governing nexus is whether the activities performed [in Washington] 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." *Id.*, 250-251." The court also discussed *In re the Appeal of InterCard*, 270 Kan. 346, 14 P.3d 1111 (2000), where the court found 11 visits to the state to not create a substantial nexus in the state.

The court found that Dell Catalog had no sales tax nexus in Connecticut. "The missing ingredient in determining whether BancTec's on-site service established nexus in Connecticut as a representative of Dell would be the frequency, if any, of the number of on-site service calls. ... Isolated and sporadic physical contacts are insufficient to establish a substantial nexus to Connecticut."

Following are examples of rulings and court decisions where some presence *was* viewed as sufficient physical presence to create sales tax collection obligations.

- In *National Geographic Society v. Cal. Bd. of Equalization*, 430 U.S. 551 (1977), the Court held that the presence of two advertising offices in California was sufficient to create sales tax nexus for National Geographic, even though the California offices were not involved with the product sales activity. The Court found the "Society's continuous presence in California in offices that solicit advertising for its magazine provides a sufficient nexus to justify that State's imposition upon the Society of the duty to act as collector of the use tax."
- In *Scripto, Inc. v. Carson*, 362 U.S. 207 (1960), a taxpayer located in Georgia had no property or operations in Florida, but did have ten commissioned salespeople (contractors) in Florida. The Court held that such continuous solicitation in Florida was sufficient to constitute "substantial nexus" such that Scripto was obligated to collect Florida use tax on its sales in that state. Also, the Court did not find that the legal distinction between an employee and an independent contractor affected its conclusion. "To permit such formal 'contractual shifts' to make a constitutional difference would open the gates to a stampede of tax avoidance. ... The test is simply the nature and extent of the activities of [Scripto] in Florida." (Also see *Tyler Pipe Industries v. Dept. of Revenue*, 483 U.S. 232 (1987).)
- In *Borders Online, LLC v. BOE*, 29 Cal Rptr 3d 176 (2005), the court found that that Online had sales tax collection obligations in California because of its relationship with Borders (the bricks and mortar stores) and the returns and advertising handled by Borders that benefited Online. Online was formed in 2001 as a Delaware corporation, headquartered in Michigan. Online and Borders were affiliated corporations owned by the same corporation.⁴ Online had no employees or property in California.

In 1998 and 1999, Online sold over \$1.5 million of merchandise over the Internet to California consumers. Its website noted that goods could be returned to any Borders (physical) store. Borders did not charge Online for this service. This note was removed from Online's website on

⁴ Most likely, one of the reasons why Online was set up as a separate corporation was to limit the number of states in which it would have to collect sales tax, based on such precedents as *SFA Folio Collections, Inc. v. Bannon*, 585 A.2d 666 (Conn. 1991), cert. denied, 501 U.S. 1223 (1991), *SFA Folio Collections v. Tracy*, 652 N.E.2d 693 (S.Ct. Ohio 1995), and *Bloomingtondale's v. Dept. of Revenue*, 567 A.2d 773 (1989), aff'd without opinion 591 A.2d 1047 (Penn. 1991), cert. denied, 504 U.S. 955 (1992).

8/11/99. Borders also included a notation on its sales receipts to “visit us online at www.borders.com.”

Issues before the court were (1) whether Border’s activities were “for the purpose of selling” Online’s goods, and (2) whether Online had sufficient presence in the state, through Borders, to require sales and use tax collection.

The court agreed with the BOE that since Borders only handled returns for Online per the terms on Online’s website, it was acting as Online’s authorized agent. A formal arrangement is not needed because an agency relationship can be implied based on conduct and circumstances; no written agreement is needed. The handling of returns for Online caused Borders to be “selling” for purposes of R&T §6203(c)(2), because it was an integral part of getting customers to buy online. The court noted that even if the return policy provided some benefit to Borders (for example, it got a customer into their store), it could still induce Online customers to buy from Online.

Online noted that unlike the situations in *Tyler Pipe* and *Scripto*, Borders was not actually making any sales for Online. The court viewed that perspective as too narrow noting that per *Tyler Pipe* one is to look at whether the activities of the retailer’s in-state people are “significantly associated with [its] ability to establish and maintain a market in [the] state for the sales.” The court did not find the returns policy here similar to *SFA Folios* where the store took returns from the catalog operation under its own policy and for its benefit.⁵

- In *State of Louisiana and Secretary of the Dept. of Revenue and Taxation v. Dell Int’l, Inc., et al*, 922 So 2d 1257 (2006), the appeals court reversed the trial court decision to find that Dell had sufficient connection through a third party acting on its behalf in the state to create physical presence for sales and use tax purposes. Dell itself had no facilities or employees in Louisiana (L). Its customers in L ordered products via the Internet or catalogs with orders accepted in Texas and products shipped from either Texas or Tennessee by common carrier or the U.S. Postal Service. Dell had a contract with BancTec (B) for B to provide on-site service for Dell products in L. B did not work exclusively for Dell, but also had repair contracts with other computer providers.

Dell designed the repair service program and copyrighted it. Customers bought the service contracts at the time they purchased a Dell product or after the purchase. The service was emphasized in Dell’s marketing literature. B employees were trained by Dell and Dell told B, based on calls Dell received from its customers, when to service a customer’s machine. Dell set the service prices and paid B based on the number of on-site service calls it had. Dell also provided all of the service parts to B. However, the service contracts themselves were between a Dell customer and B. Yet, if B did not perform to Dell’s standards, Dell had the right to hire a different third party to handle the service. The court noted: “The record establishes that Dell through BancTec is clearly in control of the on-site computer repairs.”

L’s tax agency sought payment from Dell for use tax and income and franchise taxes, plus interest and penalties. Only the use tax claim survived to trial. L argued that Dell had a physical presence in L through its repair agent, B. Dell countered that B was not an agent, but an independent party performing work under contracts between customers and B and that B was not acting on behalf of

⁵ R&T §6203(a) provides that “every retailer engaged in business in this state and making sales of tangible personal property for storage, use, or other consumption in this state, not exempted ... shall ... collect the tax from the purchaser.” R&T §6203(c)(2) provides that “retailer engaged in business in this state” includes “any retailer having any representative, agent, salesperson, canvasser, independent contractor, or solicitor operating in this 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.” Query: Does “selling” mean offering inducements to sales, or actually making sales, as was done in *Scripto* (independent contractors taking orders) and *Scholastic Book Clubs, Inc. v. State Board of Equalization*, 207 Cal App 3d 734, 255 Cal Rptr 77 (CA Ct App, 1989) (teachers taking orders and collecting payment for the bookseller)?

Dell. To support its case, Dell submitted various affidavits and documents including the decision of a Connecticut court (see earlier summary of the case) that found that the arrangement did not cause Dell to have a physical presence in that state. The L court noted though that the decision states that the “court’s finding was based primarily on the lack of evidence in the record to establish the focus and extent of the activities of BancTec’s independent service representatives in Connecticut, particularly evidence regarding the frequency or number of the on-site services actually performed in Connecticut.”

In finding that Dell did have a physical presence in L through B, the court referred to *Scripto* and *Tyler Pipe*, as well as an L case, *Quantex* (809 So. 2d 246 (2000)). The court noted that unlike *Quantex*, the present case provides “both documentary evidence and deposition testimony detailing the contractual relationship between Dell and BancTec as well as the nature and extent of the services provided by BancTec and most significantly, evidence regarding the significance of BancTec’s services on Dell’s ‘ability to establish and maintain a market in Louisiana.’”

The court questioned the semantics of terms such as “agent,” “broker” and “on behalf of” seeking to look at the substance of the arrangements. The court noted that “the trial court and Dell both ignore the Supreme Court’s admonition in *Scripto*, that the ‘contractual tagging’ of a third party as an independent contractor or salesman is simply insufficient to change the function of the third party ‘nor bears on its effectiveness in securing a substantial flow of goods into [the state].’ 362 U.S. at 211. The nature and extent of the activities (*Scripto*, 362 U.S. at 211) and whether those activities are significantly associated with the taxpayer’s ability to establish and maintain a market in this state (*Tyler Pipe Industries, Inc.*, 483 U.S. at p. 250 ; *Quantex*, 809 So.2d 252) are the determinative factors of whether Dell’s contractual dealings with BancTec constitute a sufficient physical nexus for the purpose of justifying the imposition of a use tax.” The court found Dell’s involvement in all parts of the contractual arrangement to be significant, from writing the contracts, to requiring customers to call Dell first, training B’s employees and providing initial diagnosis and scripts for B’s employees. Also, Dell included the availability of on-site service in its advertising. Dell also hired a third party to determine how satisfied customers were with B and could terminate the arrangement with B if B didn’t meet Dell’s expectations.

Dell argued that it was not legally obligated to provide repair services. Thus, when B provided the services, it was not acting on behalf of Dell. The court noted that the contractual “tag” of being a non-agent to avoid taxation in the state was forbidden by the U.S. Supreme Court per *Scripto* and *Tyler Pipe*. The court also noted that without the arrangement for B to provide services, it would have been difficult for Dell to establish and maintain a market in L. The court refers to the following excerpt from CEO Michael Dell’s book – *Direct from Dell: Strategies that Revolutionized an Industry*:

“Pretty early on in the company’s life, we concluded that we wanted to earn a reputation for providing *great customer service*, as well as great products. ... What was really important was sustaining loyalty among customers and employees, and that could only be derived from *having the highest level of service* and very high-performing products. ...

From the very beginning, we saw a *huge opportunity to provide extraordinary service* where our competitors saw none — and *designated it as one of the company’s early objectives*. In 1986, we offered the *very first program in our industry for on-site service as a kind of “house call” service for sick computers*. If your computer had a problem, you didn’t have to go anywhere; we came to you — to your business, house, or hotel room.... What the competition initially assumed would be a disadvantage for us *turned out to be a massive advantage*.”

The court concluded: “The trier of fact could clearly find for the purpose of taxation that Dell hid behind the fact that it hired a third party to provide this service in state or tag that third party as “independent” to destroy nexus with this state which is contrary to law and to the mandates and admonitions of the Supreme Court of the United States.”

A dissenting judge noted that B did not solicit sales for Dell but instead only provided services to Dell customers who purchased an optional service contract from B. This judge did not find that the optional service contract, Dell's efforts in ensuring quality control, and its insistence that B did not disparage Dell when providing services, rose "to the level of activities sufficient to find that BancTec was acting on behalf of Dell." This judge also did not put much credence in an unsworn statement from a mass marketed book.

- *Arizona Dept. of Revenue v. Care Computer Systems, Inc.*, 1 CA-TX 98-0003, 4 P3d 469, (7/25/00), rev'g. *Dept. of Revenue v. Care Computer Systems*, No. TX 95-00642, 4/8/97 (where the Arizona Superior Court had agreed with the Arizona Board of Tax Appeals (Dkt. No. 1049-93-S (4/4/95)), involved a business that sold and leased computers, licensed software, and provided computer training to nursing homes throughout the U.S. CCS had no offices or regular business presence in Arizona, and none of its employees lived there. CCS had one salesperson visit Arizona during the year, about 21 days of customer training, about 180 transactions totaling approximately \$385,000 of income over a 4-year period, and owned two computers it was leasing to a customer in Arizona. All customer contracts were approved at CCS's home office in Washington and all items were shipped from that location either by common carrier or U.S. mail, with terms F.O.B. origin. The Arizona Board of Tax Appeals and Arizona Superior Court held that CCS did not have a substantial nexus in Arizona and thus, Arizona could not impose the transaction privilege tax on CCS. However, the Court of Appeals reversed these decisions.

The court quoted from the *Tyler Pipe* case: "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." While noting that CCS's activity in Arizona was of "relatively low volume," the court noted it was more than existed in *Arizona Dept. of Revenue v. O'Connor*, 963 P.2d 279 (App. 1997), where the vendor was found to have nexus in Arizona. For example, in the 1997 case, the vendor had only one customer in Arizona and did not own any property in Arizona. In contrast, CCS had many customers and owned the property it was leasing to Arizona customers.

A dissenting judge primarily disagreed with the approach of finding nexus based on similar cases. "The best the court can do is conclude by comparative analysis that, if the attenuated circumstances of *O'Connor* meet that standard, so must the equally attenuated circumstances of this case. And so, validating the taxation of one attenuated transaction after another after another, the courts erode the general standard of substantial nexus into something very insubstantial indeed." The dissenting judge also suggested that the majority did not follow the ADOR regulation because they broadened the meaning of "maintaining a place of business within Arizona" by considering current Commerce Clause cases, which the judge felt made the regulation irrelevant.

Quill Only Applies to Sales Tax: Several state courts have held that the *Quill* physical presence standard only applies for sales and use tax purposes, not for income tax purposes.⁶ These courts note that franchise and income taxes do not pose the same compliance burden as do sales and use taxes. Instead, a significant economic presence test has often been used for income tax purposes.

Nexus Questionnaires: Most state tax departments have some form of a nexus questionnaire to help the state and business determine if the business has nexus in the state. Typically, states mail the questionnaires to businesses they believe have a taxable presence, yet are not filing tax returns. Most of the questionnaires address nexus for all state taxes, a few focus solely on sales tax. The questionnaires tend to have numerous questions that go beyond both physical and economic presence tests. Thus, they

⁶ For example, *Tax Comm'r of the State of West Virginia v. MBNA America Bank*, 640 SE2d 226 (2006). The U.S. Supreme Court denied cert on 6/18/07 (Dkt. 06-1228). On the same day it also denied cert in *Lanco v. Director, NJ Division of Taxation* (Dkt. 06-1236) which had also found that the *Quill* physical presence standard did not apply for income tax purposes.

are not helpful to businesses trying to determine if they have sales and use tax obligations in the state. For example, the sales tax nexus questionnaire for Minnesota is five pages long. Information requested includes the names and contact information for the taxpayer's three largest customers in the state and whether employees have been in the state for certain functions, but doesn't ask for how long they were there.⁷

California provides some nexus guidance in its forms and publications. Publication 77 lists three situations where a business is considered engaged in business in California for sales and use tax purposes. One situation provides: "Your business does not have a physical location in California, but you have a representative in the state who makes sales, takes orders, installs merchandise, trains customers, or makes deliveries."⁸ Clearly, given the court holding in *Borders* (discussed earlier), this explanation is not enough as it would have led Online to conclude that it did not have sales and use tax nexus in California since the physical store (which the court found to be Online's representative) did none of the functions listed in Publication 77.

Why Nexus Uncertainty Should Be Addressed

When a business is not sure if it is required to collect sales tax from customers, it incurs risks and costs. An uncertain business might register and incur costs to collect sales tax that it doesn't need to collect. On the other hand, an uncertain business might not register and later find out it should have been collecting sales tax. When the mistake is discovered, the business will owe back taxes, penalties and interest. Businesses also incur accounting and legal fees in their efforts to remove uncertainty as to whether they have sales tax nexus in any states.

Uncertainty also affects buyers. If a seller is not legally obligated to collect sales tax, the buyer is legally obligated to pay use tax. If a buyer believes that sales tax should have been collected on a sale, it may avoid the use tax and the State of California tax collector is left to resolve the matter (should it have the resources to do so) and the State likely loses out on revenue that should be collected from some party.

Would reversal of the Quill decision eliminate the need for nexus guidance? If states were allowed to collect sales tax from any vendor selling to customers in its states, it would seem that nexus guidance would not be needed. That is, whether a customer is in the state is usually not difficult to determine. Of course, with the sale of digitized items (such as software and music) it may not be clear where the customer is located. Also, services may take place in more than one state making it difficult to determine where the service provider owes sales and use tax. But these issues are not nexus ones, although they are ones that still require a clear set of rules to ensure that the sales tax is properly collected.

Several states have been working together since 2000 to create a uniform sales and use tax act that states can adopt (the Streamlined Sales Tax Project⁹). The purpose of this effort is to greatly reduce the interstate commerce impediment caused by the varied sales tax rules in over 6,000 states and local jurisdictions. Adopting states are banking on Congress exercising its authority under the commerce clause to allow states that have adopted the uniform law to collect sales and use tax from remote (non-physically present) sellers.¹⁰

It is unknown when, if ever, Congress will enact such legislation. Also, even if passed, it will only eliminate nexus issues for states that adopt the Act and it is unlikely that California will be an adopting

⁷ The form is available at <http://www.taxes.state.mn.us/forms/st101.pdf>.

⁸ BOE, *Out-of-State Seller: Do You Need to Register with California?* Pub. 77; available at <http://www.boe.ca.gov/pdf/pub77.pdf>.

⁹ Information on the Streamlined Sales Tax Project can be found at <http://www.streamlinedsalestax.org>. As of June 2007, 15 states had adopted the Streamlined Sales and Use Tax Act and a few more states have pending legislation.

¹⁰ For example, S. 34 (110th Cong.) allows adopting states to collect sales tax from remote vendors that do not fall under the small business exception.

state.¹¹ Thus, California needs to clarify its sales and use tax nexus standards to aid in the proper collection of sales and use tax from vendors and customers.

Challenges

Reluctance by businesses to collect sales and use tax: There are operational and competitive reasons why a business will not want to be a sales tax collector if it doesn't have to be. Governments need to recognize this in creating any remedy to the nexus uncertainty problem.

Compliance costs for businesses include labor, training, software and regular updates to it due to changes in laws and regulations, audits, and costs associated with risk of error. A 1998 study by the State of Washington on compliance costs concluded that costs as a percent of total state and local sales tax collections were as follows:¹²

Small business	6.47%	(gross sales between \$150,000 and \$400,000)
Medium business	3.35%	(gross sales between \$400,000 and \$1,500,000)
Large business	0.97%	(gross sales over \$1,500,000)
Total cost weighted by number	4.23%	
Total cost weighted by dollars	1.42%	

A 1999 study by Ernst & Young concluded that the costs of administering state and local sales taxes were primarily borne by sellers. Their study found that a large remote seller in 15 states had compliance costs of about 8.3% of the sales and use taxes paid.¹³ Very few states provide vendors with any compensation for collecting the sales and use tax.

Given the costs of compliance, there is a natural tendency to employ business strategies to avoid sales and use tax collection. In addition, some industries with strong e-commerce competition have worked to avoid sales and use tax collection for price competition purposes. For example, assume Bookseller B only sells books online and only has a physical presence in State X and Y. Customers living outside of States X and Y may find that buying books from B looks like a good deal because B is not required to collect sales tax (and these customers either don't know of or ignore their use tax payment responsibilities (see Report #2b)). If bricks and mortar Bookseller M with physical stores in most states also wants to sell online, M's books will look more expensive because it would be required to collect sales tax from customers in all of the states in which M has a physical presence. However, if M instead establishes a separate entity with a physical presence in few states, it can be more price competitive with B. This situation has occurred, as evidenced by the cases summarized earlier.

How much presence is needed? As is clear from the just the small set of cases summarized earlier, state laws are not clear and it is not easy to create nexus guidance that will be helpful to all businesses.

¹¹ Aspects of the SSUTA that are not favorable to California: (1) Each member state gets one vote, so California, with its large population and market, will have a small voice in interpreting and changing the model act; and (2) California would need to change local sourcing rules from origin to destination which for many retailers will be a more complicated system and the changes will create winners and losers among local jurisdictions.

¹² Washington State Department of Revenue, *Retailers' Cost of Collecting and Remitting Sales Tax*, December 1998; http://dor.wa.gov/Content/AboutUs/StatisticsAndReports/Retailers_Cost_Study/default.aspx. The report also notes that the costs of collection can be offset somewhat by the float that retailers enjoy due to the lag between collection and remittance of the tax, and the ability to deduct these costs on their income tax returns.

¹³ Robert J. Cline and Thomas S. Neubig, *Masters of Complexity and Bearers of Great Burden: The Sales Tax System and Compliance Costs for Multistate Vendors*, Sept. 1999; available at <http://www.ecommercecommission.org/document/MastersOfComplexity.pdf>.

Recommendations to Eliminate Nexus Uncertainty

The Board of Equalization (BOE) should review the key sales tax nexus cases and make a determination of what the appropriate standard should be in California. If a legislative change is needed, the BOE should pursue one. For example, the BOE should determine what activities fall under “makes sales” (as used in Pub 77) and “selling” (as used in R&T §6203(c)(2)) and be sure the answer is clear and specified in regulations and publications.

The BOE could also provide a checklist for businesses to allow them to determine if they have a physical presence under California law and the *Quill* standards. If the checklist indicates that the business has a physical presence, the BOE should help that vendor with its collection responsibilities, if needed. Simplified compliance approaches should also be provided. For example, if the vendor only sells items online, the BOE should allow the vendor to have a link on its site such that when the California customer’s credit card is charged for the goods purchased, it is also charged to the BOE for the sales tax. This would eliminate filing needs for vendors and reduce their compliance costs and credit card fees. If the checklist indicates that the vendor has no physical presence, the state should provide a safety mechanism that may help ensure that customers self-assess and pay their use tax. The BOE could ask the non-present vendor to note on its website or catalog that it has no sales tax collection obligation in California so California customers know they must self-report the use tax on the purchase. If vendors comply with this request, they would be relieved of liability should a later audit indicate that a non-fraudulent mistake was made on the nexus checklist.¹⁴

Ideally, vendors should be required to file the checklist with the BOE and doing so should not in itself create nexus. If a vendor has not filed a checklist and is found to have nexus, additional penalties should apply to the amount of uncollected tax. Since the state may not have sufficient jurisdiction over a remote vendor, it may not be able to mandate that all vendors file the checklist. Assistance from Congress and working with other states for a uniform checklist (and thus uniform nexus standards) may be needed.

California could perhaps reduce the desire of vendors to take actions to ensure remote vendor status by helping with sales tax compliance and by compensating vendors for collecting the sales tax.

Tax Policy Analysis¹⁵

The following chart explains how the providing clearer and more effective guidance on when a business has sales tax collection obligations would satisfy the principles of good tax policy. The rating in the last column indicates how nexus certainty would improve the current system.

Principle	Application and Analysis	Rating
Fairness		
Equity and Fairness Similarly situated	Clearer nexus guidelines would make it more likely that similarly situated (physically present) vendors would have similar collection	–

¹⁴ A mistake is easy. For example, a company’s tax department might not know that the marketing department leased equipment to a entity in the state for a few months thereby creating a physical presence.

¹⁵ This analysis uses a document prepared by the American Institute of Certified Public Accountants (AICPA) Tax Division and altered to the above format by Joint Venture: Silicon Valley Network. The AICPA document, *Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals* (2001) is available at <http://ftp.aicpa.org/public/download/members/div/tax/3-01.pdf>. The Joint Venture workbook is available at <http://www.jointventure.org/PDF/taxworkbook.pdf>. The principles laid out in these documents are frequently used tax policy analyses ones. For more information see Nellen, Policy Approach to Analyzing Tax Systems; available at http://www.cob.sjsu.edu/facstaff/nellen_a/Policy%20Approach%20to%20Analyzing%20Tax%20Systems.pdf. Note: The author of this report (Annette Nellen) was the lead author for both the AICPA and Joint Venture documents noted here.

taxpayers should be taxed similarly.	obligations and similarly situated customers would have use tax payment obligations.	
Transparency and Visibility Taxpayers should know that a tax exists and how and when it is imposed upon them and others.	Having vendors complete a clear nexus checklist and noting on their website or catalog whether they have nexus in the state will make both sales and use tax obligations clearer to sellers and customers.	+
Operability		
Certainty The tax rules should clearly specify when the tax is to be paid, how it is to be paid, and how the amount to be paid is to be determined.	Clear and objective standards for determining whether a vendor has nexus and providing a mechanism to reduce penalties for honest mistakes should reduce uncertainty.	+
Convenience of Payment A tax should be due at a time or in a manner that is most likely to be convenient for the taxpayer.	If clearer nexus standards and compliance assistance resulted in more vendors collecting sales tax from California customers, convenience of payment would improve for those customers since sales tax would be added on at the time of sale rather than later when they pay their use tax.	+
Economy in Collection The costs to collect a tax should be kept to a minimum for both the government and taxpayers.	Improved guidance eliminates uncertainty and decreases the need for professional tax assistance, thus reducing costs. Also, compensating vendors would reduce their compliance costs.	+
Simplicity The tax law should be simple so that taxpayers can understand the rules and comply with them correctly and in a cost-efficient manner.	Clearer nexus guidance and use of a checklist would make compliance simpler.	+
Minimum Tax Gap A tax should be structured to minimize non-compliance.”	Simplified compliance approaches for vendors and improved nexus guidance may lead to fewer vendors trying to avoid physical presence in California and result in greater sales tax collection (it is the use tax that is toughest to collect).	+
Appropriate Government Revenues The tax system should enable the government to determine how much tax revenue will likely be collected and when.	There is likely little effect although collections could increase.	No effect
Appropriate Purpose and Goals		
Neutrality The effect of the tax law on a taxpayer’s decisions as to how to carry out a particular transaction or whether to engage in a transaction should be	Simplified compliance for vendors may reduce their incentive to avoid physical presence in California.	+

kept to a minimum.		
Economic Growth and Efficiency The tax system should not impede or reduce the productive capacity of the economy.	Likely no appreciable impact.	No effect.