 Grant Thornton

## State Nexus Developments

May 5, 2017  
CTAC Meeting

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Welcome

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## Agenda

- U.S. constitutional limitations on state and local taxation
- Proposed federal legislation
- State approaches to expanding nexus
- Recent significant decisions
- Likely developments for 2017



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## U.S. constitutional limitations on states' ability to tax

- The principal federal constitutional provisions that limit states' powers to tax are:
- **Commerce Clause**
  - Art. I, §8, Cl. 3, of the Constitution of the United States provides that "[T]he Congress shall have the power . . . [t]o regulate commerce with foreign nations, and among the several States and with the Indian Tribes."
- **Due Process Clause**
  - Amendment XIV §1, to the Constitution of the United States provides that . . . "[n]o State shall . . . deprive any person of life, liberty, or property, without due process of law."

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## Multistate nexus concepts Constitutional requirements

- **Nexus is required before a state can impose tax**
- **Constitutional requirements**
  - **Due Process Clause** - requires minimum contacts and exploitation of the market
    - Does not require physical presence
    - Notion of fairness
    - "Some definite link, some minimum connection"
  - **Commerce Clause** - requires "**substantial** nexus with the taxing state"
    - Congress has power to regulate commerce among states
    - Use tax collection – requires a physical presence
    - For income, franchise and other entity-level taxes physical presence may not be required (for other taxes, physical presence may be required)

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## Multistate nexus concepts Landmark cases – Complete Auto

- **Complete Auto Transit v. Brady (1977)**
  - The U.S. Supreme Court established the following four-prong test for constitutionality under the Commerce Clause:
    - Substantial nexus
    - Nondiscrimination
    - Fairly apportioned
    - Fairly related to services received from the state

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Multistate nexus concepts  
Landmark cases – Quill

- **Quill v. North Dakota (1992)**
- Sales tax nexus – Mail order (Internet) sales
- Based on *Quill*, many courts have held that physical presence is not required for income tax nexus, but is required for sales tax nexus
- **Decision** – No collection responsibilities exist without **substantial physical presence** in the state
  - Due Process nexus existed
  - Commerce Clause nexus did not exist; no substantial physical presence existed
- Due Process and Commerce Clauses are not identical (reflect different constitutional concerns)

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Proposed federal legislation

- Two remote seller nexus bills that would expand the universe of taxpayers were introduced during the last Congress:
  - Senate - Marketplace Fairness Act of 2015 (MFA)
  - House - Remote Transactions Parity Act of 2015 (RTPA)
- House Judiciary Chairman Bob Goodlatte (R-Va.) proposed an alternative remote seller nexus solution:
  - Online Sales Simplification Act of 2016 (OSSA) - Not yet formally introduced as a bill (discussion draft)
- Similar legislation is expected to be introduced during the current Congress

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Proposed federal legislation (cont'd)

- Opposition to federal legislation:
  - Constrains Internet commerce
  - Erodes state sovereignty
  - Compliance burden by forcing businesses to track thousands of different tax codes
  - Disproportionate effect on small businesses

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### Proposed federal legislation (cont'd)

- Reasons federal legislation fails:
  - Hard to sell ideas that have been introduced mostly as a component of sweeping tax reforms
  - Opposition from different and unexpected sources
  - Potentially raise too much money
  - Impact of these proposals on business (particularly small businesses)

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### State approaches to expanding nexus

- Click-through nexus
- Affiliate nexus
- Remote retailer notice and reporting requirements
- Anti-Quill / economic nexus

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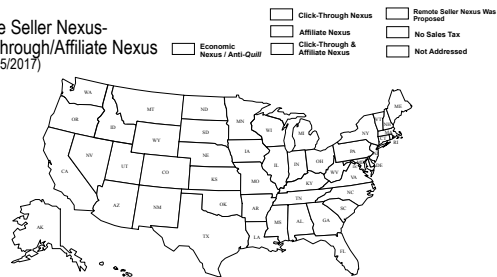
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### Remote Seller Nexus- Click-Through/Affiliate Nexus (as of 3/15/2017)



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### Click-through nexus

- An out-of-state taxpayer may have sales tax nexus if the entity has an agreement to pay an in-state resident a commission for sales made via "clicking-through" a link on the in-state resident's website
- In 2008, New York was first state to enact click-through nexus
- Provisions are fairly consistent in each state
- In many states, a rebuttable presumption of nexus
- Most states have a sales threshold (for example, \$10,000 of sales in the state during the preceding year) that must be satisfied
- States that most recently have adopted click-through nexus:
  - 2015: Michigan, Nevada, Ohio, Tennessee, Vermont and Washington
  - 2016: Louisiana

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### Click-through Nexus – Example (1)

- Company A is an online retailer based in South Carolina which sells antique fishing poles
- Company A has no nexus in New York
- Company B is a large brick and mortar and online sporting goods retailer
- Company B has nexus in New York
- Company A approaches Company B and enters into an agreement with Company B requesting that Company B post/maintain a link on it's website for Company A to generate fishing pole product interest and revenue

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### Click-through Nexus – Example (2)

- The agreement between Company A and Company B is a commission/ revenue sharing agreement where Company B receives compensation when sales are generated by Company A through the referral.
- Nexus in New York is deemed to have been created by Company A when cumulative gross receipts from sales by the seller to customers in New York as a result of referrals by all of the seller's resident representatives under the type of contract or agreement total more than \$10,000 during the preceding four quarterly sales tax periods (ending on the last day of February, May, August, and November)

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### Affiliate nexus

- An out-of-state seller may have sales tax nexus if an in-state affiliate uses trademarks, service marks, or trade names that are the same as those of the out-of-state seller and the in-state affiliate engages in activities in the state that maintain a market for the out-of-state seller
- Statutes vary by state – In some states, the entity operating in the state does not need to be related to the seller
- For each state that has adopted affiliate nexus, must consider the statutory language
- States that most recently have adopted affiliate nexus:
  - 2015: Michigan, Nevada and Ohio
  - 2016: Louisiana and Oklahoma (substantially expanded)

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### Affiliate Nexus – Example (1)

- Borders, Inc. was a brick and mortar retailer with locations in California selling books and digit media products.
- Borders, Inc. has nexus in California and collects and remits sales tax on its products sold at its California stores.
- Borders Online, LLC, an affiliate of Borders, Inc. sold similar products online to customers.
- Borders Online did not own or lease property in California and did not have any employees or bank accounts in the state. Therefore, they did not collect and remit sales tax to items sold to California purchasers. The products were shipped via common carrier.

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### Affiliate Nexus – Example (2)

- Returns of merchandise could be made at Borders stores physically located in CA.
- There was cross-marketing and brand activities between the Borders, Inc. and Border's Online
- Borders store receipts stated "visit us online at [www.borders.com](http://www.borders.com)" and employees of Borders Inc. were encouraged to have customers visit the website.
- Nexus in CA is deemed to be created for Border's Online by virtue of the fact that Border's Online referred its customers to Borders Inc. retail stores in CA for returns. The court held that through the agreement to accept returns of merchandise Borders Inc acted on behalf of Borders Online as its authorized representative in CA.

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## Economic Nexus

Physical Presence  $\iff$  Affiliate/Click-Through Nexus  $\iff$  Economic Nexus

- Adopted by states as a way to collect lost revenue from e-commerce
- Dollar thresholds established on sales made into states by out-of-state retailers
- A challenge to traditional physical presence/anti-Quill
  - Alabama
  - South Dakota
  - Tennessee
  - Vermont
  - Wyoming



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## Anti-Quill developments

- In 2015, Justice Kennedy issued challenge in *Direct Marketing Association v. Brohl* in a concurring opinion
  - "Legal system should find an appropriate case" for the U.S. Supreme Court to reexamine *Quill*
  - "Given these changes in technology and consumer sophistication, it is unwise to delay any longer a reconsideration of the Court's holding in *Quill*. A case questionable even when decided, *Quill* now harms States to a degree far greater than could have been anticipated earlier."
- *Quill* is being challenged in several states



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## Alabama

- Alabama Department of Revenue promulgated a regulation that directly challenges *Quill*
  - Regulation requires out-of-state sellers to collect and remit sales tax in the absence of physical presence in the state
  - Regulation took effect October 22, 2015 and applies to transactions occurring on or after January 1, 2016
- Two conditions must be met in order to be required to collect and remit sales and use tax under the regulation:
  - Prior calendar year retail sales of TPP in the state are greater than \$250,000, based on the previous year's sales; and
  - Seller performs one or more of the activities listed in Alabama Code Sec. 40-23-68(b)

Ala. Admin. Code r. 810-6-2-.90.03



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## South Dakota

- South Dakota governor signed S.B. 106, effective May 1, 2016
  - Automatically enjoined due to litigation being filed
- Institutes economic nexus standard for sales tax
  - Remote sellers are required to collect and remit sales tax on sales of TPP, any product transferred electronically, or services delivered into South Dakota if:
    - Gross revenue exceeds \$100,000; or
    - The seller sold 200 or more separate transactions
- On March 6, 2017, the South Dakota Circuit Court granted a motion for summary judgment and held that South Dakota anti-*Quill* law is unconstitutional (*South Dakota v. Wayfair*).
  - This is the first time that a court has considered the constitutionality of legislation that disregards the physical presence requirement.
  - What will happen now in other states that also have laws or regulations that challenge the physical presence requirement of *Quill*?

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## Tennessee

- Under new rule, out-of-state dealers who engage in the regular or systematic solicitation of consumers in Tennessee through any means and make sales that exceed \$500,000 to consumers in the state during any calendar year have substantial nexus with the state
- By March 1, 2017, these dealers were required to register with the DOR for sales and use tax purposes and affirmatively acknowledge that they will begin to collect and remit tax to the DOR by July 1, 2017
- Tenn. Comp. R. & Regs. 1320-05-02-.129

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## Vermont

- Legislation enacted in 2016 (H. 873) expands remote seller nexus provisions to vendors with a threshold level of sales or transactions within the state
  - Effective on **later** of: (1) July 1, 2017; or (2) first day of first quarter after controlling court decision or federal legislation abrogates physical presence requirement contained in *Quill*
- Definition of “vendor” amended to mean a person making sales of TPP from outside the state to a destination in the state and not maintaining a place of business in Vermont that engages in regular, systematic, or seasonal solicitation of sales of TPP in Vermont **and**
  1. Made sales from outside Vermont to destinations in the state of at least **\$100,000**; or
  2. Totalling **at least 200 individual sales transactions**, during any 12-month period preceding monthly period for which tax liability is determined

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## Wyoming

- On March 1, 2017, Wyoming enacted legislation requiring certain remote sellers that do not have a physical presence in Wyoming to collect sales tax on sales made in state
- Similar to South Dakota legislation
- Remote sellers will be required to collect and remit sales tax once they meet one of two thresholds in either the current calendar year or the immediately preceding calendar year:
  - The seller's gross revenue from the sale of TPP, admissions or services delivered into Wyoming exceeds \$100,000; or
  - The seller sold TPP, admissions or services delivered into Wyoming in 200 or more separate transactions
- Effective July 1, 2017

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## Notice requirements

- Colorado was first state to enact remote seller notice requirements
- Retailers without nexus in Colorado must provide the following:
  - Notice on invoices to Colorado customers that tax is due on non-exempt purchases
  - Annual notification to all Colorado purchasers showing amounts paid by them for Colorado purchases
  - Annual statement for each purchaser filed with Department of Revenue
  - Penalties will be assessed for non-compliance
  - NOTE: SB 238
- *Direct Marketing Association* – U.S. Court of Appeals upheld constitutionality of statute
- Similar types of notice requirements have been enacted by Kentucky, Louisiana, Oklahoma, South Dakota and Vermont
- Will these burdensome notice requirements result in vendors collecting sales tax?

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## Notice requirements (cont'd)

- DMA and Colorado signed a settlement agreement on February 22, 2017 to resolve all of DMA's pending claims in Colorado District Court, as well as other constitutional claims that could be refiled in federal court.
- Agreement provides that the Department will not require compliance with Colorado's notice and reporting requirements until July 1, 2017, and will waive any and all penalties for non-collecting retailers who fail to comply with these rules prior to July 1, 2017.
- The Department has not yet issued any draft forms related to the reporting requirements, but the settlement terms suggest that these requirements will take effect on July 1, 2017.
- Appears that the first required Annual Summary forms will be due to customers by January 31, 2018 and Customer Information Reports will be due to the Department by March 1, 2018.

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## Other notable decisions

### *Crutchfield Corp. v. Testa*

- On Nov. 17, 2016, Ohio Supreme Court became the first state supreme court to issue an opinion addressing the constitutionality of a bright-line presence standard, in lieu of physical presence, to determine nexus for purposes of a corporate-level tax.
- Bright-line presence nexus standard that applies to the Commercial Activity Tax (CAT) satisfies the substantial nexus requirement under the Commerce Clause.
- Case involved an out-of-state retailer which did not have a physical presence in the state, but had nexus with Ohio for purposes of the CAT because its annual gross receipts in Ohio exceeded the state's \$500,000 statutory threshold.
- Although this case concerns a gross receipts tax, it may be relevant to the constitutionality of bright-line nexus standards for purposes of sales taxes.

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## Likely developments for 2017

- Sales tax nexus legislation has been introduced in many states this year
- U.S. Supreme Court's denial of *certiorari* in *DMA* may embolden other states to enact similar notice and reporting requirements
- States are expected to challenge *Quill*'s physical presence requirement through legislation, regulations and litigation, as the U.S. Supreme Court and Congress have failed to act.
  - Alabama: Collect and remit tax beginning 1/1/2016
  - North Dakota: Signed by Governor on 4/10/17, collection and remittance obligations
  - South Dakota: TBD
  - Tennessee: Register by 3/1/2017, collect and remit tax beginning 7/1/2017
  - Vermont: Contingent
  - Wyoming: Collect and remit tax beginning 7/1/2017

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## Likely developments for 2017 (cont'd)

- So far this year, proposed anti-*Quill* legislation has already been passed by at least one house in the following states:
  - Georgia: H.B. 61, passed by House on Feb. 15, 2017; \$250,000
  - Hawaii: S.B. 620, passed by House on March 7, 2017; \$100,000
  - Indiana: S.B. 545, passed by Senate on Feb. 2, 2017; \$100,000
- Similar legislation introduced, and is still active in six more states (Maryland, Nebraska, New Mexico, North Carolina, Utah, and Washington).
- More states likely to jump on board.

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### Likely developments for 2017 (cont'd)

- Other 2017 nexus legislation introduced and active:
  - Click-through nexus: South Carolina
  - Affiliate nexus: Idaho, Mississippi, South Carolina, Utah
  - Remote seller notice requirements: Arkansas, Georgia, Hawaii, Kansas, Nebraska, Utah
  - Expanded Nexus: Minnesota, Mississippi

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### Questions and comments



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