

STATE AND LOCAL TAXATION: Entity and Transactional Nexus

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NEXUS AND THE POWER TO TAX

- Entity Nexus vs. Transactional Nexus
- Due Process Clause Nexus
- Commerce Clause Nexus
- Attributional Nexus
- Application of the Nexus Principles

NEXUS AND THE POWER TO TAX

- Entity Nexus vs. Transactional Nexus
 - Transaction-Based Taxes
 - Entity-Based Taxes (the unitary issue)

DUE PROCESS CLAUSE NEXUS

- Minimum Connections with the Taxing Jurisdiction
 - For the Transaction (or line of business)
 - For the Taxpayer

DUE PROCESS CLAUSE NEXUS: Minimum Connections with the Taxing Jurisdiction for the Transaction and the Taxpayer

- *Mobil Oil Corp. v Commissioner*, 445 U.S. 425 (1980)
 - Nexus or some minimum connection between the taxing state and the activity from which the income is derived (transactional nexus).
- *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992)
 - The connection to a state that is needed to support tax jurisdiction is comparable to that needed to support general in *personam jurisdiction* (presence nexus).
 - Purposeful direction of economic activities into a state, such as through targeted solicitation, is sufficient. This is referred to as the "purposeful availment" of a state's market.

DUE PROCESS CLAUSE NEXUS:

Transactional Nexus

- *Allied-Signal, Inc. v. Director, Div. of Tax'n*, 504 U.S. 768 (1992)
 - Although the taxpayer, as an entity, clearly had nexus aplenty in New Jersey, its activities relating to the purchase, maintenance, and disposition of the stock of a non-unitary corporation were unrelated to its New Jersey property and activity. Therefore, New Jersey could not tax income and gain generated through the taxpayer's ownership of that stock.
- *Central National-Gottesman, Inc. v. Director, Div. of Tax'n*, 14 N.J. Tax 545 (N.J. Tax Ct. 1995), aff'd, 677 A.2d 265 (N.J. Super. Ct. App. Div. 1996 (1992))
 - While the taxpayer's forest products business was actively conducted in New Jersey, its investment business was separately run in New York and was unrelated to the forest products business. Therefore, New Jersey could not tax the income from the investment activity.

DUE PROCESS CLAUSE NEXUS:

Taxpayer Nexus

- The "purposeful availment" standard
- *Geoffrey, Inc. v. South Carolina Tax Comm'n*, 313 S.C. 15, 437 S.E.2d 13 (1993)
 - Because Geoffrey did not prohibit its licensee, Toys R Us, from taking the intangibles into South Carolina, Geoffrey had purposefully availed itself of the South Carolina market.
- *Associated Electric & Gas Insurance Services, Ltd. v. Clark*, 676 A.2d 1357 (R.I. Sup.Ct. 1996)
 - Even though the taxpayer had done no solicitation in the state, it was found to have purposefully availed itself of the state's market because it communicated with, and received "orphan premiums" from, residents of the state.

DUE PROCESS CLAUSE NEXUS:

Taxpayer Nexus

- The "purposeful availment" standard
- *Town Crier, Inc. v. Dep't of Revenue*, 733 N.E.2d 780 (Ill, Ct. App. 2000)
 - Even though the taxpayer had not actively solicited customers in Illinois and delivered furniture to them only when the customers took the initiative to request such delivery, the court held that the taxpayer had purposefully availed itself of the Illinois market.
- *Bensusan Restaurant Corp. v. King*, 937 F. Supp. 295 (SDNY 1996)
 - Merely maintaining a website that New York residents visited to obtain information about upcoming shows and ticket availability, without more, was not enough to establish that the out-of-state business purposefully availed itself of the New York market; New Yorkers went to the website, the website didn't go to the New Yorkers.

DUE PROCESS CLAUSE NEXUS:

Taxpayer Nexus

- Advertising as "purposeful availment"
- *Montgomery Ward & Co. v. State Board of Equal.*, 272 C.A.2d 728 (Cal. Ct. App. 1969)
 - Television, radio, and print advertising that reached residents of the state (as well as sales and deliveries into the state) did not constitute sufficient due process nexus.
- *Opinion of the Attorney General, Nebraska No. 87020 (1987)*
 - A state statute provided that "doing business" in the state included advertising via broadcast from a transmitter in the state or distributed from a location in the state was unconstitutional, based on U.S. Supreme Court rulings.

DUE PROCESS CLAUSE NEXUS:

Taxpayer Nexus

- Advertising as "purposeful availment"
- *Mallon v. Walt Disney World*, 42 F. Supp. 2d 143 (D. Conn. 1998).
 - A company's systematic print and television advertising for several years aimed to solicit Connecticut residents to visit the company's Florida facility constituted sufficient due process nexus.
- *Divincino v. Polaris Indus. & Central Vermont Motorcycles*, Nebraska No. 87020 (1987)
 - Although internet and newspaper advertisements would not necessarily be sufficient, advertisements specially directed to residents would satisfy due process requirements.

DUE PROCESS CLAUSE NEXUS: Taxpayer Nexus

- Due Process Nexus Means:
 - The state may audit
 - The state may subpoena records:
 - In an audit of the putative taxpayer
 - In an audit of other taxpayers
 - Insurance companies may be taxed
 - The entity may be required to register to do business

COMMERCE CLAUSE NEXUS: Defining the Standard

- Substantial nexus with the taxing jurisdiction
 - For the transaction (or line of business)
 - For the taxpayer
- In application, substantial nexus arises as a result of purposefully directed activity that is:
 - Regular
 - Continuous
 - Substantial (more than de minimis)

COMMERCE CLAUSE NEXUS:

Transactional Nexus and Taxpayer Nexus

- *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977)
 - "[T]he transaction being taxed must have substantial nexus with the state"
- *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992)
 - For a state to have taxing jurisdiction over a person under dormant Commerce Clause principles, the person must have substantial nexus with the state. For sales and use tax purposes, substantial nexus requires physical presence.

COMMERCE CLAUSE NEXUS:

Physical Presence

- {Case involved sales taxes and should be limited to its facts}
- " . . .all of these cases involved taxpayers who had a physical presence . . ." (*Quill*)
- "substantial" means more than "minimal"
- While sales and use tax collection obligations impose only administrative burdens, business activity taxes impose both equivalent administrative burdens AND true economic burdens
- *National Geographic Soc. v. California Bd. of Equal.*, 430 US 551 (1977)
- The Court based its decision on the need for a bright-line physical presence test AND *stari decisis*

COMMERCE CLAUSE NEXUS:

Physical Presence

- Although the Supreme Court made it clear in *Quill* that it was establishing this criterion of "physical presence" only in the context of a state imposing a duty to collect use tax, both logic and Supreme Court authority suggest that the appropriate standard to be used in determining whether a state can impose a tax directly upon an entity (in contrast to imposing a mere duty to collect a tax from customers) should be even greater because the imposition of a tax is obviously more burdensome.[1]
- As was noted by the Supreme Court in *Norton Company v. Department of Revenue of Illinois*, it is easier for a state to prove that "some local incident occurs sufficient to bring the transaction within its taxing power in the case of imposition of a sales and use tax on a local buyer or user than in the case of a tax that falls on an out-of-state vendor." [2]

[1] See *National Geographic Society v. California Board of Equalization*, 430 U.S. 551 (1977).

[2] *Norton Company v. Department of Revenue of Illinois*, 340 U.S. 534, 537 (1951).

COMMERCE CLAUSE NEXUS:

Physical Presence

- Applying the substantial nexus standard, it is generally accepted that the ownership of tangible personal property located in a jurisdiction will give rise to taxable nexus for the owner.
- If the tangible personal property is only in a jurisdiction temporarily or on an occasional, sporadic, irregular basis, the presence may not be sufficient to create a taxable nexus.
- As a guideline, some taxpayers make their nexus decisions on the basis that maintaining property (or employees) in a jurisdiction:
 - For zero to five days annually creates a minimal risk of taxable presence (i.e., *de minimis* presence),
 - Six to twelve days in a jurisdiction annually creates a moderate risk of taxable nexus, and
 - More than twelve days in a jurisdiction annually creates a nearly certain risk of taxable nexus.

COMMERCE CLAUSE NEXUS: Physical Presence

- Factor-Presence Proposal of Multistate Tax Commission
 - Property of \$50,000
 - Payroll of \$50,000
 - Sales of \$500,000
 - Repeal of Public Law 86-272

COMMERCE CLAUSE NEXUS: Ohio Commercial Activity Tax

- Enumerated Nexus Standards
 - Domiciled in Ohio
 - Owns or uses part of its capital in Ohio
 - Holds a certificate of compliance to do business in Ohio
 - Otherwise nexus pursuant to U.S. Constitution
 - Has at least 25% of its total property, payroll, and sales in Ohio
 - Has \$50,000 of property, \$50,000 of payroll, or \$500,000 of sales in Ohio

COMMERCE CLAUSE NEXUS:

Attributional Nexus

- *Scripto v. Carson*, 362 U.S. 207 (1960)
 - Continuous local solicitation by several salesmen could be attributed to out-of-state seller for sales and use tax nexus purposes. The Court recognized that this is the "furthest extension" it had ever condoned in the area of state taxation.
- *Tyler Pipe Indus. v. Washington State Dep't of Revenue*, 483 U.S. 232 (1987)
 - Full time, dedicated sales person within the state, although an independent contractor rather than an employee, rendered the out-of-state company subject to tax because his presence was "*significantly* associated with the taxpayer's ability to establish and maintain a market in the state for the sales."

COMMERCE CLAUSE NEXUS:

Attributional Nexus

- *JS&A Group, Inc. v. SBE* (Cal. Ct. App. 1997) (unpublished opinion)
 - "We see no analogy between Scripto's relationship with a fleet of salespersons continually soliciting on its behalf within the state . . . and JS&A's contractual relationship with broadcasters . . . [who] did not solicit or accept orders on behalf of JS&A."
- *Baker & Taylor, Inc. v. Kawafuchi*, 82 P.3d 804, 813 (Haw. 2004)
 - Explained that the *Tyler Pipe's* attribution analysis emphasizes the involvement of a "sales representative"
- *House of Lloyd v. Commonwealth*, 694 A.2d 375, 377 (Pa. Commw. 1997)
 - Only sales representatives generate attribution

COMMERCE CLAUSE NEXUS:

Attributional Nexus

- *In re Family of Eagles, Ltd.*, 66 P.3d 858, 865 (Kan. 2003)
 - Only sales representatives generate attribution
- *Department of Revenue v. Share International, Inc.*, 676 So.2d 1362 (Fla. 1996)
 - In-state activities did not establish or maintain market
- *Dillard Nat'l Bank v. Johnson*, No. 96-545-III (Tenn. Ch. Ct. June 22, 2004)
 - In-state solicitation permitted attribution

COMMERCE CLAUSE NEXUS:

Economic Nexus

- *Lanco, Inc. v. Director, Div. of Tax'n*, 908 A.2d 176 (N.J. 2006), *cert. denied*, No. 06-1236 (U.S. June 18, 2007);
- *FIA Card Services NA, f/k/a MBNA Am. Bank NA, v. Tax Comm'n*, 640 S.E.2d. 226 (2006), *cert. denied*, No. 06-1228 (June 18, 2007).

Application of the Nexus Principles

- Investment Banking Activities and Nexus Creation
 - Client Pitch
 - Negotiation
 - Due Diligence

Application of the Nexus Principles

- Holding Commodities and Nexus Creation
 - Electricity
 - Gas
 - Oil
 - Coal
 - Metals
 - Agricultural Products

Application of the Nexus Principles

- Broker/Dealer Operations and Nexus Creation
 - Client Solicitation
 - Client Presence
 - Client Meetings

Application of the Nexus Principles

- Investment in Subsidiaries and Nexus Creation
 - Stewardship
 - Management and Control
 - Business Integration
 - Front Office
 - Back Office

Application of the Nexus Principles

- Investment in Funds/Partnerships and Nexus Creation
 - Management vs. Passive Role
 - Active vs. Passive Enterprise

Application of the Nexus Principles

- Investment in Assets and Nexus Creation
 - Debt vs. Equity
 - Trust Ownership