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Reflections on the Current State of "Attributional Nexus": When May a State Use the Presence of an In-State Entity to Claim Jurisdiction over an Out-of-State Seller

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The downturn in the national economy has triggered a budgetary crisis for many state governments. Undoubtedly, legislatures will seek increased revenues as part of the solution to the budgetary shortfalls. One politically easy solution is to expand the reach of the state's taxes to sweep in companies that earn income or enjoy other benefits that can be viewed as occurring within the state's boundaries, i.e., by expanding the state's jurisdiction to tax to more out-of-state entities.

In this article, we review controversies involving the limits of "attributional nexus," with an eye toward plotting the lines that currently govern a state's reach to impose its use taxes on an out-of-state seller that has customers but no employees or property within the state. Seventeen years ago, the United States Supreme Court established a "bright-line" standard that required, quite simply, that a taxpayer be physically present (beyond a *de minimis* presence) within the state as a condition for being subject to its taxing regime.[1] Notwithstanding the "bright-line" rule, the battles continue to this day and there is little reason to believe they will be resolved soon.[2]

The question in the cases decided under *Quill* and *Bellas Hess* is: What constitutes physical presence under *Quill*? And in the current world, the particular issue is often: Can the physical presence of a party other than the remote seller be attributed to the remote seller to provide the necessary nexus, and, if so, under what circumstances?

To begin to answer these questions, we first explore the ways in which courts have applied two factors drawn from United States Supreme Court decisions to support the theory of attributional nexus, namely: i) whether an in-state entity is acting "on behalf of" an out-of-state seller, and ii) whether the in-state entity is performing activities in support of the marketing or sales activities of that out-of-state entity.[3] We then outline a list of principles intended to provide guidance in evaluating whether an out-of-state entity

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may be viewed as physically present within a state by reason of the activities of a third party that is plainly present in the state.

The Attributional Nexus Test

Courts have relied on the United States Supreme Court's decisions in *Scripto, Inc. v. Carson* ("*Scripto*") and *Tyler Pipe Industries, Inc. v. Washington State Department of Revenue* ("*Tyler Pipe*") for the proposition that an out-of-state seller will have nexus by attribution of a third party's in-state activities when: 1) the third party is acting "on behalf of" the out-of-state seller, and 2) the third party's activities are "significantly associated with the taxpayer's ability to establish and maintain a market in this state for the sales."[4]

While this attributional nexus test is clear in theory, application of the test by the courts has yielded less than fully predictable results. Courts have tended to interpret both factors expansively and have implicitly situated the parts in an inverse relationship to one another. Thus, where the court finds that the in-state entity has a close relationship with the out-of-state seller, either because their business operations are extensively integrated or the in-state entity's actions are substantially controlled by the out-of-state entity, then the court will likely place less emphasis on the degree to which the in-state entity's activities are associated with establishing and maintaining the out-of-state seller's market. On the other hand, where a court determines that the in-state entity's activities are very significantly associated with establishing and maintaining a market for the remote seller, the question regarding the extent to which the in-state entity is acting "on behalf of" the remote seller will be less critical. As a consequence, the court opinions considering nexus often have a certain gestalt quality reflecting a test that apparently turns on all the facts and circumstances rather than a surgical examination of two independent factors. Nonetheless, taking each of the factors in turn provides a useful discipline for making judgments as to the risk that certain activities will result in nexus.

A court's examination of "whether substantial business activities have been carried on in the taxing state *on the taxpayer's behalf*" is likely to begin with a determination as to whether the two entities are under common ownership, on the theory that an in-state entity is more likely to represent the interests of its out-of-state affiliate if the two entities are commonly owned.[5]. However, it is clear that common ownership does not by itself result in attributional nexus.[6] As a corollary, the absence of common ownership is not sufficient to prevent nexus, particularly if the in-state entity is acting on behalf of the out-of-state entity.[7]

Likewise, it does not appear that the in-state entity must actually be viewed as a formal agent of the out-of-state entity under state law to support a finding of attributional nexus.[8] Rather, where the court finds that the out-of-state seller "retained control over many of the significant aspects of the services to be provided by [the in-state entity]," or that the remote seller "relies heavily" on an in-state company to perform critical functions in support of the sale, including, for example, accepting and depositing payment, a court is likely to find that the in-state entity is acting on behalf of the out-of-state entity.[9]

As to the second factor, the courts have found that a wide variety of activities are "significantly associated with the taxpayer's ability to *establish and maintain a market* in this state for the *sales*."[10] For example, the Tennessee Court of Appeals concluded that the various functions performed by an in-state manufacturer for an out-of-state vendor, ranging from "the preparation of price quotes[,] to drawing up blueprints[,] to fabricating the product[,] to arranging for shipment of the product[,] to accepting final payment from the customer," satisfied that standard.[11] Two courts examining Dell's business model have determined that in-state warranty repair services sold by Dell in connection with its remote mail order sales of computers, and provided by a third-party contractor, should be viewed as supporting Dell's efforts to obtain sales in the markets where the warranty repair services are provided.[12]

Application of These Principles to the Bookseller Cases

Three cases involving Borders and Barnes & Noble, two booksellers with apparently similar business models, provide a useful opportunity to examine how the courts have determined whether the in-state entity is acting on behalf of the out-of-state entity and whether in-state activities should be viewed as creating or maintaining a market. In those cases, the fundamental facts were the same: each involved stores operating within the state (so-called "brick & mortar" operations) owned by one corporation, and a separately incorporated operation that provided sales over the Internet (and that was not physically

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present in the state seeking to impose the tax) (the "Internet seller"). In each case, the taxing authorities sought to impose use tax collection over the remote Internet sales operation based upon activities of the brick & mortar stores in the state.[13]

In the *Borders* case, decided by the California Court of Appeal, the in-state retailer: 1) accepted returns from, and provided refunds and exchanges to, the remote seller's customers; 2) issued receipts to its customers with the message "Visit us online at www.Borders.com"; and 3) encouraged its employees to refer customers to the remote seller's website.[14] The court concluded that the in-state operation acted on behalf of the out-of-state operation and that these activities were significantly associated with the remote seller's "ability to establish and maintain a market" in California and so created nexus with the out-of-state seller.[15]

In contrast, in the first Barnes & Noble case, *B&N (Cal.)*, the trial court concluded that the brick & mortar store did not act on behalf of the Internet seller. The court focused upon the fact that the brick & mortar company did not control the remote seller.[16] The court also noted that, unlike in the Borders case, the sole activity that the brick & mortar store performed for the Internet seller was to distribute coupons for purchases from the Internet seller that had been inserted into the store's shopping bags by a third-party vendor.[17] The court found that this activity was not enough to create an agency relationship, so that the Internet seller did not have nexus with California.[18]

In the second Barnes & Noble case, a U.S. District Court in Louisiana decided that the in-state activities of the brick & mortar store did not establish and maintain a market for the sales of the remote seller.[19] There, the brick & mortar operation and the Internet seller participated in a "membership program," and a gift card program, whereby customers could receive certain discounts and redeem gift cards at the brick & mortar store, with the Internet seller, or at any other participating retailer.[20] However, the court found that these activities did not "produce[] revenue to Online by virtue of sales made or orders taken by the entity that is physically present in the Parish," since the revenue from the programs was simply divided among participating entities on a pro rata basis.[21] The court did not see that it was justified in "treat[ing] Booksellers as acting as a marketing presence for Online," merely because the brick & mortar store filled orders for merchandise from the Internet seller's distribution center, since the brick & mortar store also filled orders from many wholesalers and did not treat the remote Internet seller any differently from those other wholesalers.[22]

Unlike in the *Borders* case, the brick & mortar stores did not refer customers to the remote Internet seller or otherwise promote that entity's business, except in connection with the membership and gift card programs.[23] However, similar to the brick & mortar retailers in *Borders*, Barnes & Noble stores accepted returns of merchandise purchased from the remote Internet seller, treated that merchandise "as if it were its own," and gave it preferential treatment over merchandise purchased from third parties.[24] The court nonetheless distinguished the *Borders* case on this point, on the grounds that the Barnes & Noble stores "initiated the return policy to generate goodwill and to serve the convenience of its customers," implying that the activity was associated with establishing and maintaining the store's own market, not that of the remote Internet seller.[25]

Thus, these cases provide a pointed example of the variety of conclusions courts can reach when deciding attributional nexus questions, even in the face of seemingly parallel facts.

Guidelines for Avoiding Attributional Nexus

Because the battle lines continue to shift and because the cases that have recently considered this issue often turn on specific facts, it is difficult to develop any practical rules for avoiding attributional nexus based solely on corporate structure or even operational limits. However, notwithstanding the variation among individual cases, we believe it is possible to establish at least four guidelines that can be used to analyze the risk that an in-state business operation may produce nexus for an out-of-state sales operation.

First, common ownership of a remote seller and an in-state entity, by itself, should not result in attributional nexus.[26] The absence of common ownership may go a long way to establishing that the in-state entity is acting in its own interest and not on behalf of the out-of-state entity and, thus, may be very helpful in avoiding attributional nexus.

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Second, contracting with an entity that is plainly not involved in the success of the marketing and sales activity of the out-of-state entity should not result in attributional nexus.[27] This principle will be strongest where the in-state entity is engaged in an obviously unrelated business, for example, where the in-state entity is a professional service provider (*e.g.*, lawyer or accountant),[28] or where the in-state activities provide no meaningful assistance or are, in fact, detrimental to the out-of-state seller's sales.[29]

Third, as a corollary to this principle, merely placing an advertisement in a local newspaper or other media should not result in nexus over the out-of-state entity that places the advertisement.[30]

Fourth, using a common carrier or similar entity to provide delivery in the state (and even accept payment for the product) should not result in nexus over the out-of-state entity.[31]

Undoubtedly, the operations of many taxpayers will not fit neatly within these guidelines. And, while it is useful to think of these guidelines as providing "safe harbors," the law is probably not yet sufficiently developed to ensure that all courts will adhere to these principles. As a result, at least until the United States Supreme Court weighs in to fully reconcile the holdings of its decisions in *Quill*, *Bellas Hess*, *Scripto*, and *Tyler Pipe*, there will always be a measure of risk that the tax authorities, at least, will construe any substantial relationship with an in-state entity as providing attributional nexus over a remote seller.

Footnotes

[1] *See Quill Corp. v. North Dakota*, 504 U.S. 298 (1992) ("*Quill*") (citing *Nat'l Bellas Hess, Inc. v. Illinois Dep't of Revenue*, 386 U.S. 753 (1967) ("*Bellas Hess*")).

[2] Indeed, Dell's recent petition for writ of certiorari with the United States Supreme Court to obtain the Court's guidance on the very issues addressed by this article was denied. *Dell Catalog Sales L.P. v. Taxation & Revenue Dep't*, 199 P.3d 863 (N.M. Ct. App.), *cert. denied*, 189 P.3d 1215 (N.M. 2008), *cert. denied*,129 S. Ct. 1616 (U.S. Mar. 23, 2009) (No. 08-770) ("*Dell (NM)*").

[3] It is worth noting that judicial decisions concerning whether a state has jurisdiction to tax a remote seller often begin by determining whether jurisdiction exists under the state's statutes or regulations. Often the statutory analysis will closely mirror, and effectively substitute for, the constitutional analysis since many state statutes extend the state's jurisdiction to tax to the full limits permitted by the U.S. Constitution or articulate their limit using logic articulated in the court cases discussing the constitutional standards. *Compare*Me. Rev. Stat. Ann. tit. 36 § 1754-B.1.G, *and*Ohio Rev. Code Ann. § 5741.01(I), *with* N.M. Stat. Ann. § 7-9-10.A. Where the constitutional and statutory standards are not identical, and if the state statute is satisfied, the court must then determine whether the constitutional standard is also met because the Commerce Clause and the Due Process Clause requirements must be met in every instance. *See generally Borders Online, LLC v. State Bd. of Equalization*, 129 Cal. App. 4th 1179 (2005). (evaluating the constitutional requirements after determining that the statutory requirements were met).

[4] *Tyler Pipe*, 483 U.S. 232, 250 (1987) (quoting the Washington Supreme Court decision on appeal, 715 P.2d 123, 126 (Wash. 1986)); *Scripto*, 362 U.S. 207, 211 (1960). Although the Court in *Tyler Pipe* found that the out-of-state seller had nexus, the Court nevertheless struck down the tax at issue because it failed the internal consistency standard of the Commerce Clause. *Tyler Pipe*, 483 U.S. at 247-48.

[5] *Arco Bldg. Sys., Inc. v. Chumley, 209 S.W.3d 63, 74* (Tenn. Ct. App.), *appeal denied*, No. M2004-01872-SC-R11-CV, 2006 Tenn. LEXIS 1002 (Oct. 30, 2006) ("*Arco*") (internal quotation marks omitted; emphasis original); *see generally St. Tammany Parish Tax Collector v. Barnesandnoble.com*, 481 F. Supp. 2d 575, 580-81 (E.D. La. 2007) ("*B&N (La.)*")

[6] *See, e.g.*, *Current, Inc. v. State Bd. of Equalization*, 24 Cal. App. 4th 382 (1994) ("*Current, Inc.*"); *see also SFA Folio Collections, Inc. v. Tracy*, 652 N.E.2d 693 (Ohio 1995); *SFA Folio Collections, Inc. v. Bannon*, 585 A.2d 666 (Conn.), *cert. denied*, 501 U.S. 1223 (1991).

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[7] *See State v. Dell Int'l, Inc.*, 922 So. 2d 1257, 1266 (La. Ct. App.), *reh'g denied*, No. 2004 CA 1702, 2006 La. App. LEXIS 867 (2006) ("*Dell (La.)*").

[8] *Dell (La.)*, 922 So. 2d at 1264.

[9] *Dell (La.)*, 922 So. 2d at 1264, 1266; *Arco*, 209 S.W.3d at 74.

[10] *Tyler Pipe*, 483 U.S. at 250 (emphasis added). The authors are unaware of any decision in which the Supreme Court has articulated a rationale for why the third party's activities must be related to support for sales and marketing activities as opposed to support for other, more general activities of the remote seller in order for those activities to create attributional nexus for sales tax purposes. Nonetheless, as a common-sense matter, this limitation makes sense, given that jurisdictional issues that arise in the context of sales and use taxes are ultimately triggered by sales to the in-state consumer.

[11] *Arco*, 209 S.W.3d at 74.

[12] *Dell (La.)*, 922 So. 2d 1257; *Dell (NM)*, 199 P.3d at 872. State tax administrators predictably have taken an even more expansive view of the definition of activities in support of obtaining or maintaining a market. The Kansas Department of Revenue, for example, has concluded local third-party contractors that installed security locks and related equipment sold by an out-of-state seller should be viewed as creating and maintaining the market for the remote seller. Kan. Dep't of Revenue Priv. Ltr. Rul. P-2005-016 (June 20, 2005); *see also, e.g.*,Hearing No. 46,541, Texas Comptroller of Public Accounts (May 10, 2006) (concluding that in-state independent contractors that "perform maintenance and repair services" result in attributional nexus with an out-of-state seller).

[13] *See Borders*, 129 Cal. App. 4th 1179; *Barnesandnoble.com LLC v. State Bd. of Equalization* ("*B&N (Cal.)*"), Cal. Tax Rep. (CCH) ¶ 404-488 (Cal. Super. Ct. Oct. 12, 2007); *B&N (La.)*, 481 F. Supp. 2d at 578-79.

[14] *Borders*, Cal. App. 4th at 1199.

[15] *See Borders*, 129 Cal. App. 4th at 1184, 1190-92, 1199 (citation omitted).

[16] Cal. Tax Rep. (CCH) ¶ 404-488, § III(a).

[17] *Id.* § II.

[18] *Id.* § III(a), (b).

[19] The record in the Louisiana Barnes & Noble case appears to differ slightly from the facts relied upon by the California Superior Court case, discussed above, although both courts reached the same conclusion. The differences in the factual record apparently may be traced to the different years at issue in each decision.

[20] *B&N (La.)*, 481 F. Supp. 2d at 578-79.

[21] *Id.*at 581.

[22] *Id.*

[23] *Id.*at 580.

[24] *Id.*at 582.

[25] *Id.*

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[26] *See, e.g.*, *Current, Inc.*, 24 Cal. App. 4th at 385; *see also* Hellerstein & Hellerstein, *Cases and Materials on State and Local Taxation* ¶ 19.02(8)(e) (8th ed. 2005).

[27] *See, e.g.*, Tax Determination No. 08-0128, Wash. Dep't of Revenue (May 14, 2008, released Jan. 28, 2009) (concluding the presence of an in-state entity did not result in attributional nexus, in part because the in-state entity's promotions of sales of products to retailers may have, in fact, reduced the market share of the out-of-state seller by allowing local retailers to compete with the out-of-state entity's sales over the Internet and telephone).

[28] Michigan Dep't of Treasury, Revenue Administrative Bulletin 1999-1, *Use Tax Nexus Standards* ¶ I.6(c) (May 12, 1999).

[29] *See, e.g.*, Tax Determination No. 08-0128, Wash. Dep't of Revenue (May 14, 2008, released Jan. 28, 2009) (finding no attributional nexus in part because the in-state entity's promotions of sales of products to retailers may have, in fact, reduced the market share of the out-of-state seller).

[30] *Current, Inc.*, 24 Cal. App. 4th at 386, 391; *see also In re Laptops Etc. Corp.*, 164 B.R. 506, 521 (Bankr. D. Md. 1993).

[31] *AT&T Commc'ns of Md., Inc. v. Comptroller of the Treasury*, 950 A.2d 86 (Md. 2008) (finding no attributional nexus where common carrier accepted payment from customer for charges by remote information service providers).

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