Quill Has Been Plucked - MTC States Are Slowly Eroding the Substantial Nexus Standard

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I. INTRODUCTION

Sales and use taxes are imposed on the sales of tangible personal property and certain services within a taxing state.[1] The use tax is a corollary to a state's sales tax and is typically imposed on the right to use, store, or consume tangible personal property in the taxing state, but only to the extent that sales tax has not been paid on such property.[2] Additionally, the use tax is normally self-assessed (i.e., voluntarily paid to the state by the purchaser), and the purchaser is primarily responsible for paying the tax.[3] However, when an out-of-state seller makes shipments to an in-state purchaser, the seller may be responsible by law to collect the state use tax if the out-of-state seller has some physical connection, or "nexus," with that state.

This article will focus specifically on use taxes, addressing issues concerning the out-of-state seller's legal obligation for collecting the use tax from the in-state customer. The power of the states to require out-of-state sellers to collect their use taxes is derived from nexus standards created under both the Due Process and Commerce Clauses of the United States Constitution.[4] In *Quill v. North Dakota,*[5] the Supreme

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1. JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, SALES AND USE, PERSONAL INCOME, AND DEATH AND GIFT TAXES ¶ 12.03 (1992).

2. *See* HELLERSTEIN & HELLERSTEIN, *supra* note 1, ¶ 16.03, at 16-3 to 16-29 (describing the use tax statutes in the states and examples of specific uses which may create liability); JOHN F. DUE & JOHN J. MIKESELL, SALES TAX'N, STATE AND LOCAL STRUCTURE AND ADMINISTRATION 247-48 (2d ed. 1995) (discussing the legal nature of use taxes and the basis of liability under use tax statutes).

3. To accomplish the objective of limiting retail sales taxes and use taxes to purchases by the ultimate consumer, sales to wholesalers or retailers or others who resell the goods they purchase are excluded from tax as "sales for resale," or as "wholesale" sales as distinguished from "retail" sales. Similarly, the statutes often exempt from tax certain items purchased for use in manufacturing, fabricating, or processing personal property for sale if the items become an ingredient or component part of the product that is to be sold. *See, e.g.*, N.D. CENT. CODE § 57-39.2-01.7 (1993 & Supp. 1997).

4. *See infra* notes 83-155 and accompanying text.

5. 504 U.S. 298 (1992). *Quill* has been one of the most important cases of the Supreme Court in the area of sales and use taxes; a number of law review articles and notes have tried to explain its import. These articles and notes include: Anna M. Hoti, *Finishing What Quill Started: The Transactional Nexus Test For State Use Tax Collection*, 59 ALB. L. REV. 1449 (1996); James L. Kronenberg, *A New Commerce Clause Nexus Requirement: The Analysis of Nexus in Quill Corp. v. North Dakota,*

Court defined the boundaries of both the Due Process and Commerce Clause nexus requirements. However, in relation to Commerce Clause nexus, as Justice White foresaw in his acclaimed partial dissent, the majority opinion's so-called "bright-line" standard for finding a nexus has since spurred much controversy over what types of activities attributed to an out-of-state company constitute "physical presence" in a given state.[6]

In the six years since *Quill*, several jurisdictions have substantially increased their efforts to assert that nexus exists between out-of-state vendors and the taxing state. Recently, many states have asserted nexus in situations based solely on the presence and activities of third-party representatives who perform services within the taxing state on behalf of these out-of-state vendors, even where these activities involve something other than the solicitation of sales. In contending that the activities of their "non-sales" representatives (for example, warranty repair companies) do not, in and of themselves, cause them to establish a substantial nexus with the taxing state, vendors have generally responded that the recent audit aggression by states flies in the face of *Quill* and the constitutional limitations expressed therein. Member states of the Multistate Tax Commission (MTC)[7] believe, however, that sufficient constitutional authority exists for them to assert jurisdiction over these out-of-state vendors.[8]

1994 ANN. SURV. AM. L. 1 (1994); Michael C. Hamersley, Note, *Will The Bellas Hess Physical Presence Requirement Continue To Protect Out-Of-State Mail-Order Retailers From State Use Taxes In The Quill Era? Quill Corp. v. North Dakota*, 46 TAX LAW. 515 (1993); Shane D. Buntrock, Note, *Quill Corporation v. North Dakota: Spawning The Physical Presence "Nexus" Requirement Under The Commerce Clause*, 38 S.D. L. REV. 130 (1993); Pamela M. Krill, Note, *Quill Corp. V. North Dakota: Tax Nexus Under the Due Process and Commerce Clauses No Longer The Same*, 1993 WIS. L. REV. 1405 (1993); W. Carl Spinning, Note, *Forcing Mail-Order Houses To Collect Use Taxes In The Wake Of Quill Corp. v. North Dakota*, 60 TENN. L. REV. 1021 (1993); Stewart L. Mandell, Note, *Quill Clears The Way For Future State Tax'n Of Interstate Sales*, 71 MICH. B.J. 946 (1992); and John Thomas Below, Comment, *Out-Of-State Catalog Sales And Constitutional Limitations On State Tax'n: Reverse Protectionism And The Quill Corp. v. North Dakota Decision*, 70 U. DET. MERCY L. REV. 67 (1992).

Several articles in trade journals have also attempted to explain the meaning of *Quill*. Some of the most important articles are: Todd Feldbruegge, *Direct Mail Companies (A Use Tax Controversy*, J. ST. TAX'N, Mar. 1995; Rita Marie Cain, *Mail Order Tax'n in the Post-Quill Era*, J. ST. TAX'N, May 1994; and Rose Litvack & Joseph Guardino, *Is Physical Presence Within the State Required?*, J. ST. TAX'N, Jan. 1994.

6. Quill Corp. v. North Dakota, 504 U.S. 298, 330-31 (1992) (White, J., concurring in part and dissenting in part). Justice White stated:

> In my view, the question of Quill's actual physical presence is sufficiently close to cast doubt on the majority's confidence that it is propounding a truly 'bright-line' rule. Reasonable minds surely can, and will, differ over what showing is required to make out a 'physical presence' adequate to justify imposing responsibilities for use tax collection. And given the estimated loss in revenue to States of more than $3.2 billion this year alone . . . it is a sure bet that the vagaries of 'physical presence' will be tested to their fullest in our courts.

Id.

7. *See infra* notes 59, 61, 64, 66, and accompanying text.

8. MULTISTATE TAX COMM'N, NATIONAL NEXUS PROGRAM BULLETIN NO. 95-1, COMPUTER COMPANY'S PROVISION OF IN-STATE REPAIR SERVICES CREATES NEXUS (Dec. 20, 1995) [hereinafter

As MTC affiliated states are continually faced with revenue shortages, certain vendors should expect a flurry of sales and use tax nexus audits that will focus on the vendors' usage of third-party service companies. Because of the potential for tremendous liabilities, interest, or penalties for past taxes uncollected from their customers, as well as potential competitive disadvantages for having to collect such taxes prospectively, these out-of-state vendors must be prepared to address the pertinent issues related to nexus with state (and MTC) auditors as each nexus audit commences.

II. USE TAXATION BY THE STATES: AN OVERVIEW AND HISTORICAL PERSPECTIVE

In recent years, as described above, states have become more aggressive in their collection of use taxes from businesses. Because of a shortage of taxpayer compliance and ever-changing commerce clause nexus standards, use taxes have become a particularly good vehicle for increasing a state's revenue base.

A. THE FUNCTION OF USE TAXES

Use taxes are excise taxes which, as stated above, are normally imposed for the privilege of possessing, storing, or consuming goods in

BULLETIN 95-1]. Initially adopted by 26 states, BULLETIN 95-1 was publicly released as an "information flyer" to advise taxpayers of the states' views of current constitutional law. However, BULLETIN 95-1 appears to expand the borders of current law. The following states have indicated that their sales and use tax law is consistent with BULLETIN 95-1, the standards of which they will enforce: Alabama, Arizona, Arkansas, Colorado, Connecticut, District of Columbia, Florida, Idaho, Kansas, Kentucky, Maine, Maryland, Michigan, Minnesota, Missouri, Nebraska, New Jersey, New Mexico, North Dakota, Texas, Utah, and Washington. In 1996, the California State Board of Equalization (SBE) and Franchise Tax Board (FTB) rescinded their previous adoption of BULLETIN 95-1.

The Multistate Tax Commission (MTC) gives the following example of when BULLETIN 95-1 applies:

> An out-of-state direct marketing computer company ("Computer Co.") solicits sales through advertising in computer magazines, catalogues, and fliers mailed into the taxing State. Computer Co.'s one year warranty provides for repair services in the customer's state. The Computer Co. proclaims to its customers and/or potential customers in the taxing State through advertisements and other means that its warranty covers provision of repair services in the customer's State. The warranty is either included with the purchase of every Computer Co. computer or computer related equipment or is available at an additional fee. Computer Co. sells a computer or related equipment to a customer and end user in the taxing State. When the customer discovers a problem, the terms of the warranty provide that the customer should contact Computer Co. to arrange repair service. The customer is not authorized to call the third-party repair company to arrange for the repair without first calling Computer Co. for authorization. Customer calls Computer Co. which, after determining that the problem is covered by the warranty, may first attempt to solve the problem over the telephone. The Computer Co. determines whether repair is necessary and authorizes the in-state repair. Either Computer Co. or the customer, on Computer Co.'s authorization, contacts a third-party service provider who performs the service in the taxing State either at the customer's location or at a site determined by the third-party service provider.

Id. at 1-2.

the state. The tax is sometimes referred to as a compensating use tax. The use tax is collected on items bought from a location in another state, but used in the taxing state.[9] The tax is complementary to a state's sales tax, which is imposed on the purchase of items from a point within a taxing state.[10]

The use tax serves several functions. The primary purpose, of course, is to raise revenue.[11] Taxing states also want to prevent taxpayer avoidance of a state sales tax.[12] For example, in the absence of the use tax, abuse could occur if a consumer routinely purchased goods in a state that does not impose a sales tax, with the *mens rea* of exporting those goods immediately for ultimate use in another taxing state. A third purpose for the use tax is to make an equitable adjustment between local and interstate businesses.[13] If a local vendor must collect a sales tax, while an out-of-state vendor escapes the tax collection responsibility, then the local vendor will be at a competitive disadvantage because it will be forced to charge a higher total price for the same items.

The use tax is generally levied upon purchases made from vendors located in other states when the purchaser requests that the goods be shipped to its place of business within the taxing state. Typically, the taxation of a sale of tangible personal property depends on its destination.[14] Accordingly, sales taxes are imposed on goods which are purchased for destination within the same state as the seller's place of business.[15] Since sales taxes are often imposed under this destination principle, purchasers usually are excused from the sales tax if they reside in another state and request the seller to deliver the goods to that state.[16] Absent a use tax, such purchases would escape sales taxation in both the state of purchase and the state of destination.[17] The use tax was designed

9. Twenty-three states impose use tax liability on goods "purchased for use" within the state: Illinois, Alabama, California, Colorado, Connecticut, Florida, Idaho, Iowa, Kentucky, Maine, Michigan, Nebraska, Nevada, New Mexico, North Carolina, Ohio, Rhode Island, South Carolina, South Dakota, Utah, Vermont, West Virginia, and Wyoming. DUE & MIKESELL, *supra* note 2, at 247-48. Other states apply the use tax to "any goods brought into the state for use, consumption, or storage in the state and thus regardless of whether or not they were originally bought for use in the state": Arizona, Arkansas, Georgia, Hawaii, Kansas, Louisiana, Maryland, Mississippi, Missouri, New York, North Dakota, Oklahoma, Pennsylvania, Tennessee, Washington, and Wisconsin. *See id.* at 248.

10. PAUL J. HARTMAN, FEDERAL LIMITATION ON STATE AND LOCAL TAX'N ¶10:1, at 579 (1981).

11. *See* Paul J. Hartman, *Collection of the Use Tax on Out-of-State Mail Order Sales*, 39 VAND. L. REV. 993, 994 (1986).

12. *Id.*

13. *Id.*

14. *See* HARTMAN, *supra* note 10, ¶10:1, at 579.

15. *Id.*

16. *Id.* The sales tax will apply, however, where the out-of-state purchaser takes title and possession of the goods in the state of origin and transports the goods back to its home state.

17. ADVISORY COMM'N ON INTERGOVERNMENTAL RELATIONS, NO. SR-12, LOCAL REVENUE DIVERSIFICATION, LOCAL SALES TAXES 33 (1989) [hereinafter LOCAL REVENUE DIVERSIFICATION].

to circumvent this occurrence and to provide a deterrent for in-state companies purchasing goods in border states or by mail order just to avoid the state's sales tax.[18]

B. USE TAX HISTORY

In 1932, Mississippi was the only state in the union to impose a sales tax.[19] The tax produced seven million dollars in revenue, less than one percent of the state's total tax revenues.[20] Later in the 1930s, the use tax emerged to close a sales tax loophole that was present in the taxation of interstate sales.[21]

The use tax was primarily developed by states to deal with purchases made in neighboring states. The validity of the use tax was upheld in 1937 in *Henneford v. Silas Mason Co.*[22] Early Supreme Court decisions also held that a state's use tax may constitutionally have a fairly broad reach over interstate sales. For example, in *Felt and Tarrant Manufacturing Co. v. Gallagher*,[23] third-party agents working out of a company office in the taxing state constituted a nexus sufficient to require collecting and remitting the use tax.[24]

The first case which addressed use tax imposed upon a mail-order seller was *Nelson v. Sears, Roebuck*[25] in 1941. In that case, the Court established that sellers with retail outlets in a state were required to collect and remit use taxes on mail order sales delivered into the state by common carrier rather than through the retail outlet.[26] The Court based its decision on the Commerce Clause.[27]

After the Supreme Court upheld the Washington use tax in 1937, other states gradually passed their own use tax statutes. Since the early 1960s, all states imposing sales taxes have also imposed a use tax.[28] The states view the use tax as a means to protect their revenue bases and local businesses.[29] Local governments have also begun imposing use taxes as

18. *Id.*

19. Jerome R. Hellerstein, *Significant Sales and Use Tax Developments During the Past Half Century*, 39 VAND. L. REV. 961, 962 (1986).

20. *Id.*

21. LOCAL REVENUE DIVERSIFICATION, *supra* note 17, at 33.

22. 300 U.S. 577 (1937). This case involved a Washington use tax statute. Henneford v. Silas Mason Co., 300 U.S. 577, 578 (1937).

23. 306 U.S. 62 (1939).

24. Felt & Tarrant Mfg. Co. v. Gallagher, 306 U.S. 62, 67-8 (1939).

25. 312 U.S. 359 (1941).

26. Nelson v. Sears Roebuck & Co., 312 U.S. 359, 365-66 (1941).

27. *Id.* at 364. The Court relied on two facts to support its decision: (1) Sears enjoyed the protection and services of the state; and (2) the state was justified in assuming that they were related to the overall course of business by Sears in the taxing state. *See id.*

28. DUE & MIKESELL, *supra* note 2, at 245.

29. *See* Hartman, *supra* note 11, at 994; Anna M. Hoti, *Finishing What Quill Started: The Transactional Nexus Test for State Use Tax Collection*, 59 ALB. L. REV. 1449, 1450 (1996).

well.[30] This has created another constitutional wrinkle in the already complex arena of use taxes.[31]

C. THE MULTISTATE TAX COMMISSION (MTC)

1. *Formation of the MTC and Multistate Compact*

In the late 1950s, several business groups became concerned about the increased state power over taxation of interstate sales and income.[32] These groups lobbied Congress to pass federal legislation to reduce the states' power of taxation.[33] Through the lobbying efforts of the business community, Congress enacted Public Law No. 86-272.[34] In that statute and later amendments, Congress provided for investigation of state taxation of multistate income and sales.[35] A subsequent study was conducted by the Subcommittee on State Taxation of Interstate Commerce of the House Judiciary Committee (the Willis Subcommittee).[36]

The report and recommendations of the Willis Subcommittee were published in four volumes in 1964 and 1965.[37] The principle recommendations of the Willis Subcommittee were: (1) sales taxes should be imposed only by the state in which the purchaser received physical delivery; (2) use taxes should be legal, but only if state law provided a credit for such taxes against previously paid sales taxes on the same goods; (3) all taxes should be collected and remitted to the state by the seller and a state could require an out-of-state firm to collect and remit use taxes only if the vendor owned or leased realty in that state, had an employee whose services were performed entirely in the state, or regularly used its own vehicles or a private parcel service to make deliveries to private residences; (4) the IRS should be given a role in the auditing of

30. *See* LOCAL REVENUE DIVERSIFICATION, *supra* note 17, at 33-4; *see also* DUE & MIKESELL, *supra* note 2, at 293-94.

31. *See, e.g.*, Associated Indust. v. Director of Revenue, 918 S.W.2d 780 (Mo. 1996) (challenging local use taxes in Missouri).

32. *See* DUE & MIKESELL, *supra* note 2, at 272.

33. *Id.*

34. Act of Sept. 14, 1959, Pub. L. No. 86-272, 73 Stat. 555 (codified as amended at 15 U.S.C. §§ 381-84 (1997)). Public Law 86-272 restricts a state from imposing a net income tax (or franchise tax measured by net income) if the only business activity within the state is the solicitation of orders for the sale of tangible personal property when the orders are sent outside the state for acceptance or rejection, and, if accepted, are filled by shipment outside the state. *Id.*

35. *See* ADVISORY COMM'N ON INTERGOVERNMENTAL RELATIONS, NO. A-105, STATE AND LOCAL TAX'N OF OUT-OF-STATE MAIL ORDER SALES 58 (1986) [hereinafter MAIL ORDER SALES]. Later the study was broadened to include sales and use taxes. *See* Act of April 1, 1961, Pub. L. No. 87-17, 75 Stat 41.

36. MAIL ORDER SALES, *supra* note 35, at 59.

37. *Special Subcomm. on State Tax'n of Interstate Commerce of the House Comm. on the Judiciary*, 89th Cong., STATE TAX'N OF INTERSTATE COMMERCE, at 59 (June 30, 1965) [hereinafter WILLIS REPORT].

out-of-state sellers on a reimbursement basis; and (5) all out-of-state vendors should be exempt on the first $100 of taxable sales in any reporting period.[38]

In October 1965, the Willis Subcommittee's recommendations were reflected in House Bill 11798.[39] In summary, this bill would have required all states to use a federal income tax base, would have compelled them to allow the use of a two-factor apportionment formula for income taxes, and would have enacted a uniform sales and use tax law with federal oversight by the IRS as suggested by the Willis Subcommittee.[40] House Bill 11798 encountered serious objections from the states, prompting the Willis Subcommittee to develop a substitute bill, House Bill 16491, which was introduced in Congress in 1966.[41] House Bill 16491 eliminated any provision for federal administration of state and local taxes, while still limiting state and local jurisdiction to impose taxes on multistate businesses.[42] The bill was never enacted into law.[43]

In response to the Willis Subcommittee and the resulting congressional bills, state tax officials began to work on an alternative to federal regulation.[44] During 1966, committees representing the National Association of Tax Administrators, the National Association of Attorneys General, and the National Legislative Conference, under the guise of the Council of the State Governments, drafted the "Multistate Tax Compact."[45] The Multistate Tax Compact (Compact) was a uniform statute which, among other things, required states to: (1) give credit for sales tax paid in another state; and (2) honor a vendor's good faith acceptance of exemption certificates to free him or her from future liability should the purchaser use the item for taxable purposes.[46] The Compact also created the MTC, an interstate agency formed to represent the states' interests, with an executive board composed of one person from each member state.[47] To become effective, the Compact required the

38. *See id.*

39. *Id.*

40. *Id.*

41. *Id.* The same bill was essentially introduced in Congress in 1967 as House Bill 2158. These bills were each separately known as "The Willis Bill."

42. *Id.*

43. *See id.* at 59-60.

44. *See id.* at 78.

45. *Id.*

46. Multistate Tax Compact, 2 All States Guide (RIA) ¶731-32, at 755 (Sept. 5, 1995). "Each purchaser liable for a use tax on tangible personal property shall be entitled to full credit for the combined amount or amounts of legally imposed sales or use taxes paid by him with respect to the same property to another State and any subdivision thereof." *Id.* at ¶ 731.

47. *Id.* at ¶ 735 ("[The Multistate Tax Commission] shall be composed of one 'member' from each party State who shall be the head of the state agency charged with the administration of the type of taxes to which this compact applies").

ratification by seven states,[48] which occurred in 1967 when Nevada enacted the uniform statute.

The 1965 Willis Subcommittee Report criticized the lack of uniformity and cooperation among states in both income and sales and use taxes, concluding that the situation created "confusion, uncertainty, and over and under taxation."[49] In response to these criticisms, the MTC set out to create uniformity among state taxation of income and sales in order to prevent the proposal of federal legislation limiting a state's ability to tax out-of-state vendors.[50]

2. *Objectives of the MTC and Current Membership*

The MTC has two primary objectives: (1) encouraging states to adopt uniform tax laws and regulations; and (2) encouraging businesses to comply with state tax laws.[51] To foster uniformity, the MTC engages in a number of initiatives. The goal of these initiatives is creating "[g]reater uniformity in multistate taxation," helping to insure that "interstate commerce is neither undertaxed nor overtaxed," and seeking to "eliminate the danger that Congress will intervene in state taxation."[52] Uniformity initiatives recently adopted by the MTC included regulations apportioning broadcast industry income, the Model S Corporation Income Tax Act, regulations apportioning publishing industry income, and uniform principles governing state transactional taxation of telecommunications.[53] Recent uniformity initiatives being developed by the MTC include, among other proposed initiatives, a uniform post-*Quill* definition of "minimum contacts nexus" and "substantial nexus."[54]

The compliance component of the MTC's objectives is achieved in two principal ways. First, the MTC maintains a Joint Audit Program, which audits businesses across state lines for sales, use, and income taxes.[55] The goals of the Joint Audit Program are: (1) to serve the compliance function of the several states by identifying non-compliance with state tax laws; and (2) to help states learn about new industry conditions and circumstances which, in turn, will help create uniformity

48. *Id.* at ¶ 777.

49. MAIL ORDER SALES, *supra* note 35, at 78.

50. *See id.*

51. Multistate Tax Commission, *About the Multistate Tax Comm'n* (visited Jan. 8, 1998) <http://www.mtc.gov/aboutmtc/Aboutmtc.HTM>.

52. *Id.*

53. MULTISTATE TAX COMM'N, MEMBERSHIP AND CURRENT ACTIVITIES 3 (Jan. 1, 1997) [hereinafter MEMBERSHIP].

54. *Id.* at 5.

55. *Id.* at 6-7.

in taxpayer treatment.[56] Second, the MTC has created the National Nexus Program, which was formed to "help encourage voluntary disclosure and discover businesses that are failing to file returns with the states."[57]

To become a member of the MTC, a state must enact the Compact.[58] There are currently twenty-one Compact member states, including the District of Columbia.[59] One representative from each of these states is allowed to sit on the executive board of the MTC. In turn, the executive board elects the Executive Director of the MTC.[60]

The MTC has sixteen associate members.[61] These members participate in and help finance one or more of the following MTC programs and projects: the Joint Audit Program; the National Nexus Program; the Property Tax Fairness Project; and the Unitary Exchange Project.[62] In addition to the associate members, the MTC also has project members who participate in various projects of the MTC.[63] Current project members are involved in the National Nexus Program, the Joint Audit Program, and the Unitary Exchange Project.[64]

3. *National Nexus Program: A Glimpse of the MTC Initiative*

The MTC's National Nexus Program was founded in December of 1990 and began operating in 1991.[65] Currently, thirty-five states and the District of Columbia participate in the Nexus Program.[66] The Nexus Program's purpose is to "get non-complying multistate businesses to register and pay major state taxes."[67] The Program tries to accomplish

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56. *See id.*

57. *See id.* at 7-8.

58. *See id.* at 1.

59. The Compact member states are: Alabama, Alaska, Arkansas, California, Colorado, District of Columbia, Hawaii, Idaho, Kansas, Michigan, Minnesota, Missouri, Montana, New Mexico, North Dakota, Oregon, South Dakota, Texas, Utah, and Washington. *See id.*

60. Multistate Tax Compact, 2 All States Guide (RIA) ¶ 735 (Sept. 5, 1995). The current MTC Executive Director is Dan R. Bucks.

61. *See* MEMBERSHIP *supra* note 53, at 2. The associate members are: Arizona, Connecticut, Florida, Georgia, Illinois, Louisiana, Maryland, Massachusetts, New Hampshire, New Jersey, North Carolina, Ohio, Pennsylvania, Tennessee, Wisconsin, and West Virginia. *See id.*

62. *See id.*

63. *See id.*

64. *Id.* The current project members are: Iowa, Kentucky, Nebraska, Oklahoma, Rhode Island, and South Carolina. *Id.*

65. *See id.* at 7.

66. MULTISTATE TAX COMM'N, NATIONAL NEXUS PROGRAM, VOLUNTARY DISCLOSURE 3 (August 1, 1997). The states participating in the program are: Alabama, Alaska, Arizona, Arkansas, California, Colorado, Connecticut, District of Columbia, Florida, Hawaii, Idaho, Iowa, Kansas, Kentucky, Maine, Maryland, Massachusetts, Michigan, Minnesota, Missouri, Montana, Nebraska, New Hampshire, New Jersey, New Mexico, North Carolina, North Dakota, Ohio, Rhode Island, South Carolina, South Dakota, Texas, Utah, Washington, West Virginia, and Wisconsin. *Id.*

67. *See* MEMBERSHIP *supra* note 53, at 7.

this purpose through the following activities: (1) voluntary disclosure; (2) a clearinghouse database; (3) nexus investigations; and (4) education, information, and other compliance activities.[68]

The voluntary disclosure process affords companies the opportunity to simultaneously approach multiple states and anonymously offer to resolve potential liabilities resulting from a number of years of non-filing.[69] The states generally dictate the process for voluntary business disclosure, and the Nexus Program processes the disclosures for the states.[70] To date, this program has produced settlements with taxpayers totaling approximately $47.1 million.[71]

The clearinghouse database allows a participating state access to audits relating to a taxpayer's activities in other states.[72] This database provides a means for the participating states to identify and obtain information on companies involved in interstate commerce and information on any nexus-creating activities within a state.[73]

The nexus investigations arm of the Nexus Program examines the activities of a given company to determine whether it has a history of tax compliance problems with any of the participating states.[74] Pertinent information gathered from this process is forwarded to the applicable state or states and the Joint Audit Program to determine whether the company under investigation should be audited to uncover nexus creating activities within a given state.[75]

Finally, the Nexus Program staff aims to educate the member states and multistate businesses on state tax law and compliance requirements.[76] A recent outgrowth of this initiative was Bulletin 95-1.[77] The National Nexus Program released Bulletin 95-1 as an educational flyer concerning the nexus requirement. Many commentators believe that Bulletin 95-1 goes beyond current constitutional restraints imposed on multistate taxation of out-of-state vendors.[78] Additionally, since Bulletin 95-1

68. *See id.* at 6.
69. *See id.*
70. *Id.*
71. *Id.*
72. *See id.* at 8.
73. *Id.*
74. *Id.*
75. *Id.*
76. *Id.*
77. *See supra* note 8 and *infra* notes 159-72 and accompanying text for a complete discussion of Bulletin 95-1.
78. Many organizations and entities do not support the Bulletin. *See, e.g.*, Deal F. Andal, *Franchise Board Member Criticizes Board Actions*, SOFTWARE TAX'N LETTER (May 1996); Kaye K. Caldwell, *Software Industry Coalition Response: 95-1 is Fundamentally Flawed*, SOFTWARE TAX'N LETTER (May 1996); COMMITTEE ON STATE TAX'N, *Cost Opposes MTC Nexus Bulletin 95-1*, STATE TAX NOTES, March 25, 1996, 973, at 973.

was released as an education flyer rather than a regulation, it was not subjected to public comment.[79] The lack of public involvement has created tension between the business community and the MTC.[80]

III. THE CONSTITUTIONAL DEBATE

A state can impose a use tax collection duty on an out-of-state seller only if this obligation does not exceed certain constitutional limits. The Commerce Clause[81] and the Due Process Clause of the Fourteenth Amendment[82] represent the constitutional barriers against the imposition of a use tax collection duty. The Supreme Court has decided many pivotal cases in this area, but *Quill* is the seminal case. *Quill* described the two types of nexus: Due Process nexus and Commerce Clause nexus.

A. THE DUE PROCESS CLAUSE: THE THINNEST STANDARD

The Due Process Clause requires "some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax,"[83] and the income attributed to the state for tax purposes must be rationally related to "values connected with the taxing State."[84] The relevant inquiry to decide whether a Due Process nexus exists is whether an out-of-state vendor has minimum contacts with the jurisdiction such that the imposition of a use tax collection responsibility does not offend "traditional notions of fair play and substantial justice."[85] If the vendor "purposefully avails itself of the benefits of an economic

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79. The MTC repeatedly presents its Bulletin as the existing law, even though the Bulletin was not subject to any type of formal public hearing in the 26 states. The procedural enactment of the Bulletin will not be discussed in this article. However, the following is one author's summary of the lack of formal public hearings related to the Bulletin:

> The opportunity for analysis should have been presented prior to the MTC asking the states to adopt and agree to enforce the Bulletin. Their stealthy methods for getting it adopted in California, their mischaracterization of the nature of the document as well as its content, and their total disregard for state law in asking the states to adopt it have all led to extreme distrust of the organization and its purposes.

Kaye K. Caldwell, '*Dispassionate' Debate on Bulletin 95-1?*, STATE TAX NOTES, Aug. 27, 1996, at 20; *see also* Kaye K. Caldwell, *Software Industry Coalition Response: 95-1 Is Fundamentally Flawed*, SOFTWARE TAX'N LETTER (May 1996).

80. *See* Committee on State Tax'n, *COST Submits Comments On Multistate Tax Commission's Public Participation Policies*, STATE TAX NOTES, Oct. 29, 1996, at 1321 (stating that the "results of the Bulletin. . . have been (1) disruptive of the MTC's legitimate mission and processes and (2) productive of increased mistrust between the MTC and taxpayers").

81. U.S. CONST. art. I, §8, cl. 3 ("The Congress shall have Power to . . . regulate Commerce with foreign Nations, and among the several States").

82. U.S. CONST. amend. XIV, §1 ("No state shall . . . deprive any person of life, liberty or property, without due process of law").

83. *See* Miller Bros. Co. v. Maryland, 347 U.S. 340, 344-45 (1954).

84. *See* Moorman Mfg. Co. v. Bair, 437 U.S. 267, 273 (1978).

85. International Shoe Co. v. Washington, 326 U.S. 310, 316 (1945) (quoting Milliken v. Meyer, 311 U.S. 457, 463 (1940)).

market" in the state where the purchaser is located, it may subject itself to the state's jurisdiction even if it has no physical presence in the state.[86] In *Quill*, the Court concluded that "purposeful availment" is the proper Due Process test to apply to the burden of collecting use taxes, explicitly overruling precedent that required physical presence in a state for the imposition of this burden.[87]

Therefore, for purposes of a Due Process nexus, an out-of-state seller does not have to be physically present in the state; mere economic presence in a state will be sufficient. For instance, an economic presence in a state, such as the hypothetical direct marketing computer software company given as an example in Bulletin 95-1,[88] will produce the minimum contacts necessary for a Due Process Clause nexus.[89] However, as stated in *Quill*, "a corporation may have the 'minimum contacts' with a taxing State as required by the Due Process Clause, and yet lack the 'substantial nexus' with that State as required by the Commerce Clause."[90]

B. THE COMMERCE CLAUSE: A JUDICIAL CONSTRUCTION

The Constitution gives Congress plenary power to regulate interstate commerce.[91] As such, Congress has the authority to supersede any decision of the Supreme Court as it relates to the regulation of interstate commerce.[92] However, in the area of sales and use taxation and nexus, Congress has never exercised its regulatory interstate commerce power, but has instead left the task of establishing such nexus standards to the Supreme Court.

The Commerce Clause restrictions on state taxation are currently embodied in the four-pronged test set forth in *Complete Auto Transit, Inc. v. Brady*.[93] A tax will be sustained against a Commerce Clause challenge as long as the tax: (1) is applied to an activity with a "substantial nexus" with the taxing state; (2) is fairly apportioned; (3) does not discriminate against interstate commerce; and (4) is fairly related to the

86. Quill Corp. v. North Dakota, 504 U.S. 298, 307 (1992) (citing Burger King Corp. v. Rudzewicz, 471 U.S. 462 (1985)).

87. *Id.* at 308. This invalidated the rule in National Bellas Hess v. Illinois Dep't of Rev., 386 U.S. 753, 758 (1967), requiring physical presence in a state before the liability associated with use taxes could be imposed upon an out-of-state seller.

88. *See supra* note 8 and accompanying text.

89. This notion is consistent with the *Burger King* holding. *See* Burger King v. Rudzewicz, 471 U.S. 462, 476 (1985).

90. *Quill*, 504 U.S. at 313.

91. *See* U.S. CONST. art. I, sec. 8, cl. 3.

92. *See Quill*, 504 U.S. at 318.

93. 430 U.S. 274 (1977).

services provided by the state.[94] The first prong has always been the most difficult hurdle for state governments to clear.

1. *Physical Presence*

A substantial nexus for sales and use tax purposes can only exist where the vendor has a physical presence in the taxing state.[95] The Supreme Court, in *National Bellas Hess v. Illinois Dept. of Revenue,* explicitly made some physical presence of the vendor in the taxing state a requirement under the Commerce Clause. In *National Bellas Hess,* Illinois imposed a use tax collection obligation on a mail order company that had its principal place of business in Missouri and its place of incorporation in Delaware.[96] The company (National Bellas Hess) did not maintain any office or other place of business in Illinois, nor did it have an agent, sales person, or other representative in Illinois.[97] The only contact that National Bellas Hess had with Illinois was that it mailed catalogs twice a year to the company's active or recent customers who resided in Illinois, mailed "flyers" occasionally to past and potential customers, received orders through the mail from Illinois customers, filled the orders, and sent the goods via the mail or common carrier back to the particular customers.[98]

The Illinois Department of Revenue imposed a duty to collect use tax on National Bellas Hess because it was deemed to be maintaining a place of business in Illinois.[99] The definition of "retailer maintaining a place of business" in Illinois included the following: "[a retailer] engaging in soliciting orders within this State from users by means of catalogues or other advertising, whether such orders are received or accepted within or without this State."[100] In finding in favor of the taxpayer, the

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94. Complete Auto Transit v. Brady, 430 U.S. 274, 279 (1977).

95. National Bellas Hess v. Illinois Dep't of Rev., 386 U.S. 753, 758 (1967). In addition, such physical presence in a state must be greater than just the "slightest presence." *Quill*, 504 U.S. at 315 n.8; *see also National Bellas Hess*, 386 U.S. at 756; National Geographic Soc'y v. California Bd. of Equalization, 430 U.S. 551, 556 (1977).

96. *National Bellas Hess*, 386 U.S. at 754.

97. *Id.*

> [National] does not maintain in Illinois any office, distribution house, sales house, warehouse or any other place of business; it does not have in Illinois any agent, salesman, canvasser, solicitor or other type of representative to sell or take orders, to deliver merchandise, to accept payments, or to service merchandise it sells; it does not own any tangible property, real or personal, in Illinois; it has no telephone listing in Illinois and it has not advertised its merchandise for sale in newspapers, on billboards, or by radio or television in Illinois.

Id. (quoting the Illinois Supreme Court).

98. *Id.* at 754-55.

99. *See id.*

100. *Id.* at 755 (citing ILL. REV. STAT. ch. 120, § 439.2 (1965)).

Court ruled that the statute burdened National Bellas Hess in violation of the Commerce Clause.[101]

The test for whether a "state exaction" violated the Commerce Clause was whether the taxation falling on interstate commerce could be "justified as designed to make such commerce bear a fair share of the cost of the local government whose protection it enjoys."[102] The Court held that Illinois could not impose the burden of collecting its use tax on National Bellas Hess and rested its decision on two principles. First, the Court drew a distinction between mail order sellers with retail outlets, solicitors, or property within a state and "those who do no more than communicate with customers in the State by mail or common carrier as part of a general interstate business."[103] Second, the Court foresaw that if the tax in Illinois was upheld against National Bellas Hess, there would be impediments on the free conduct of interstate business.[104] The Court simply stated that sustaining Illinois' right to tax National Bellas Hess "could entangle National's interstate business in a virtual welter of complicated obligations to local jurisdictions with no legitimate claim to impose a fair share of the cost of the local government."[105] In summary, *National Bellas Hess* still stands for the proposition that a vendor whose only contacts with a taxing state are by mail or common carrier lacks the "substantial nexus" required by the Commerce Clause.[106]

2. *Sales Force, Plant, or Office*

Beyond the *National Bellas Hess* safe harbor, *Quill* indicates that "the presence in the taxing State of a small sales force, plant, or office" is probably required to compel a vendor to collect a sales or use tax.[107] This proposition originated in *National Geographic Society v. California Board of Equalization*.[108] In *National Geographic*, the Supreme Court was called upon to decide whether an out-of-state seller

101. *Id.* at 760.

102. *Id.* at 756 (quoting Freeman v. Hewit, 329 U.S. 249, 253 (1946)).

103. *Id.* at 758; *see also* General Trading Co. v. Tax Comm'n, 322 U.S. 335 (1944); Nelson v. Montgomery Ward, 312 U.S. 373 (1941); Nelson v. Sears, Roebuck & Co., 312 U.S. 359 (1941); Felt v. Gallagher, 306 U.S. 62 (1939).

104. *National Bellas Hess*, 386 U.S. at 759.

105. *Id.* at 759-60. The Court noted that a decision in favor of Illinois would allow every other state, municipality, school district, and political subdivision in the United States to impose a tax upon National Bellas Hess. *Id.* at 759. It was the many rates of tax, allowable exemptions, and the administrative record-keeping of such taxes that the Court stated would unduly burden National Bellas Hess' interstate business. *Id.*

106. Quill Corp. v. North Dakota, 504 U.S. 298, 311 (1992). In addition, *National Bellas Hess* indicates that physical presence has not been achieved without "retail outlets, solicitors, or property within a state." *National Bellas Hess*, 386 U.S. at 758.

107. *Quill*, 504 U.S. at 315.

108. 430 U.S. 551 (1977).

could constitutionally be required to collect use taxes under the Commerce Clause.[109] The out-of-state seller was the National Geographic Society and the taxing state was California.[110] National Geographic maintained two offices in California that solicited advertising copy for its monthly magazine.[111] These offices did not perform any sales activities related to National Geographic's mail-order business in the District of Columbia, which sold maps, atlases, globes, and books.[112] All orders for these items were mailed directly to National Geographic in Washington, D.C., and deliveries of the magazine were made, via U.S. mail, from National Geographic's Washington, D.C. or Maryland offices.[113]

California maintained that National Geographic was subject to the burden of collecting use tax from the sales of merchandise in that state due to the two offices it maintained in the state.[114] The Supreme Court addressed the issue of whether these offices provided a "sufficient nexus between the out-of-state seller appellant and the State—as required by . . . the Commerce Clause—to support the imposition of a use-tax collection liability"[115]

The Court concluded that National Geographic's "maintenance of two offices in California and the activities there adequately established a relationship or 'nexus' between the Society and the State," rendering the obligation to collect and remit use taxes constitutional.[116] The test the Court used to decide whether National Geographic maintained a sufficient nexus with the state to require liability for use tax collection was whether the facts demonstrated "some definite link, some minimum connection," between the state and the person it sought to tax.[117] The Court stated that there was "no risk of double taxation to the seller," because the out-of-state seller only became liable for the use tax

109. National Geographic Soc'y v. California Bd. of Equalization, 430 U.S. 551, 554 (1977).

110. *Id.* at 552-53.

111. *Id* at 552.

112. *Id.*

113. *Id.*

114. *Id.* at 553. The relevant statute at the time of the case made every "retailer engaged in business in [California] and making sale of tangible personal property for storage, use, or other consumption in [California]" subject to the burden of collecting use tax. CAL. REV. & TAX CODE § 6203 (West 1987). The California Supreme Court had ruled that National Geographic was a "retailer engaged in business in [California]," because its maintenance of the two offices [brought it] within the definition under § 6203(a) that included "[a]ny retailer maintaining . . . an office." National Geographic Soc'y v. California Bd. of Equalization, 547 P.2d 458, 460-61 (1976).

115. *National Geographic Soc'y*, 430 U.S. at 554.

116. *Id.* at 556. In upholding California's right to impose a duty to collect use tax on National Geographic, the court stated that it did not agree with California's use of a "slightest presence" standard to define nexus. *Id.*

117. *Id.* at 561 (quoting *Miller Bros. Co.*, 347 U.S. at 344-45).

by failing or refusing to collect the tax from an in-state resident consumer.[118]

The Court also stated that there was a "sharp distinction . . . between mail order sellers with retail outlets, solicitors, or property within [the taxing] State, and those [like Bellas Hess] who do no more than communicate with customers in the State by mail or common carrier as part of a general interstate business."[119] The Court ruled that National Geographic fell within the "former category."[120] The Court noted that the disassociation between the nexus creating activities of National Geographic (i.e., two offices within the state) and the activities giving rise to the liability for the collection of the use tax (i.e., sale of National Geographic publications in the state) did not "bar the imposition of the use tax collection duty."[121] In the end, the Supreme Court held that National Geographic's "continuous presence in California in offices that solicit advertising for its magazine provide[d] a sufficient nexus to justify that State's imposition upon the Society of the duty" to collect use tax.[122]

The Supreme Court has allowed states to constitutionally impose a use tax collection duty on a retailer in two other general instances, namely where the retailer has: (1) an employee regularly and continuously working in the state;[123] or (2) agents or third-party representatives regularly and continuously present in the state whose activities directly relate to sales of tangible personal property.[124]

3. *Employee: Regular and Continuous Presence*

The Supreme Court has ruled that the regular and continuous presence in a state by an employee of an out-of-state seller can satisfy the nexus requirement of the Commerce Clause. The decision which best illustrates this point is *Standard Pressed Steel Co. v. Washington Department of Revenue*.[125] In *Standard Pressed Steel*, the Court considered

118. *Id.* at 558.

119. *Id.* at 559 (quoting *National Bellas Hess*, 386 U.S. at 758).

120. *Id.* The opinion stipulated that the maintenance of two offices in California and solicitation by employees in those offices in the range of $1 million annually created a substantial presence. *Id.* at 556.

121. *Id.* at 560. The Court also stated that the "Society's two offices, without regard to the nature of their activities, had the advantage of the same municipal services—fire and police protection, and the like—as they would have had if their activities . . . included assistance to the mail order operations that generated the use taxes." *Id.* at 561.

122. *Id.* at 562.

123. *See, e.g.*, Standard Pressed Steel Co. v. Washington Dep't of Rev., 419 U.S. 560 (1975).

124. *See, e.g.*, Scripto, Inc. v. Carson, 362 U.S. 207 (1960); Tyler Pipe Industries, Inc. v. Washington Dep't of Rev., 483 U.S. 232 (1987).

125. 419 U.S. 560 (1975).

whether a gross receipts tax collection responsibility imposed by the State of Washington violated the Due Process Clause.[126] Standard was a manufacturer of industrial and aerospace fasteners with its home office in Pennsylvania, one manufacturing plant there, and another in California.[127] Its principal customer in the State of Washington was the Boeing Company in Seattle.[128] In the years in question, Standard employed one person in Washington to "consult with Boeing regarding its anticipated needs and requirements for aerospace fasteners and to follow up any difficulties in the use of [Standard's] product after delivery."[129] The employee took no orders for Standard and had no office in Washington except in his home.[130] Standard kept an answering service for the employee in the Seattle area, and the bills for this service were sent to Standard.[131] Additionally, once every six weeks the employee was assisted by a group of engineers from Standard on the Boeing account.[132]

The State of Washington assessed a gross receipts tax on Standard resulting from its sales of fasteners to Boeing.[133] Standard argued that imposing the tax collecting duty violated Due Process because its in-state activities were "so thin and inconsequential" as to make the tax on activities occurring beyond the borders of Washington one which had "no reasonable relation to the protection and benefits conferred by the taxing State."[134] The Supreme Court rebuffed this argument. The Court stated that the in-state services provided by the salesman were substantial in "relation to the establishment and maintenance of sales, upon which the tax was measured."[135] Accordingly, the Court held against Standard and upheld the tax imposed by Washington.[136]

126. *See* Standard Pressed Steel Co. v. Washington Dep't of Revenue, 419 U.S. 560, 562 (1975).
127. *Id.* at 561.
128. *Id.*
129. *Id.*
130. *Id.*
131. *Id.*
132. *Id.*
133. *Id.* at 561-62. The State Tax Board found that the activities of the Standard employee:

> were necessary to [Standard] in making it aware of which products Boeing might use, in obtaining the engineering design of those products, in securing the testing of sample products to qualify them for sale to Boeing, in resolving problems of their use after receipt by Boeing, in obtaining and retaining goodwill and rapport with Boeing personnel, and in keeping the invoicing personnel of [Standard] up to date on Boeing's list of purchasing specialists or control buyers.

Id. at 561. Accordingly, the Washington State Board of Tax Appeals assessed a business and occupation tax against Standard under WASH. REV. CODE § 82.04.270 (1995). *Id.* at 561-62.
134. *Id.* at 562.
135. *Id.* at 563 (quoting General Motors Corp. v. Washington, 377 U.S. 436, 447 (1964)).
136. *Id.* at 563-64. The Court also discussed the Commerce Clause and the risk of multiple taxation. The Court noted that the tax in this case was on "gross receipts from sales made to a local consumer," and that the tax was 'apportioned exactly to the activities taxed,' all of which were intrastate." *Id.* at 564. Therefore, the Commerce Clause was not violated by the tax imposed in this

Although *Standard Pressed Steel* was a Due Process Clause case when decided, the principles enunciated in the opinion are equally applicable to a Commerce Clause analysis. The case stands for the proposition that an employee of an out-of-state vendor, who maintains a substantial, continuous, and on-going "relation to the establishment and maintenance of sales" in a particular state, creates a Commerce Clause nexus for the vendor.

4. *Third-Party Representatives: Regular and Continuous Solicitation*

Not only can employees create a Commerce Clause nexus for an out-of-state seller, but third-party representatives (or independent contractors) performing continuous and regular solicitation in the taxing state can create nexus for an out-of-state vendor. This proposition is illustrated in the following two cases: (1) *Scripto, Inc. v. Carson;*[137] and (2) *Tyler Pipe Industries, Inc. v. Washington Department of Revenue.*[138]

Scripto is one of the Supreme Court's most far-reaching decisions concerning use taxes.[139] In the case, a Georgia corporation (Scripto) sold and shipped mechanical writing instruments to Florida customers from its place of business in Georgia.[140] Scripto had entered into contracts with wholesalers in Florida to solicit orders for its product.[141] Each of the wholesalers was furnished catalogs, samples, and advertising material, and was actively engaged in Florida as Scripto's representative for the purpose of attracting, soliciting, and obtaining Florida customers.[142] The wholesalers were considered independent contractors, and Scripto did not: (1) own, lease, or maintain any office, distributing house, warehouse, or other place of business in Florida; or (2) have any regular employee or agent there.[143] The issue before the Court was whether Florida could impose a use tax collection responsibility based on the presence of an independent sales force in Florida.[144]

The Supreme Court held that a nexus had been established by Scripto and the imposition of the use tax was proper.[145] There were a number of factors the Supreme Court cited to support its decision. The

case. *Id.*

137. 362 U.S. 207 (1960).

138. 483 U.S. 232 (1987).

139. *Scripto* has been "the furthest extension of [a state's taxing] power" under the Constitution. Quill Corp. v. North Dakota, 504 U.S. 298, 306 (1992) (alteration in the original).

140. *See* Scripto, Inc. v. Carson, 362 U.S. 207, 207-08 (1960).

141. *Id.* at 209.

142. *Id.*

143. *Id.*

144. *See id.* at 210.

145. *Id.* at 210-11. The Supreme Court based its decision on the test articulated in *Miller Bros. Co.*, 347 U.S. at 344-45, which stated that there must be "some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax." *Id.*

primary factor influencing the Supreme Court was the "systematic and continuous" activities of the wholesalers in Florida.[146] The Court stated that the salesmen conducted "continuous local solicitation in Florida," and the "only incidence of [the] sales transaction" that was not local was the acceptance of the orders by Scripto.[147]

In *Tyler Pipe*, the taxpayer argued that it did not have a substantial nexus with the State of Washington under the Commerce Clause and, therefore, Washington could not impose a gross receipts tax collection responsibility on the taxpayer.[148] Tyler Pipe sold a large volume of case iron, pressure and plastic pipe and fittings, and drainage products in Washington, but all of those products were manufactured in other states.[149] The company had no office, property, or employees residing in Washington.[150] Its solicitation of business in Washington was directed by executives who maintained their offices out-of-state and by an independent contractor located in Seattle.[151] The sales representatives in Washington acted on a daily basis on behalf of Tyler Pipe in calling on its customers and soliciting orders.[152] Through sales contacts, the representatives "maintained and improved the name recognition, market share, goodwill, and individual customer relations of Tyler Pipe."[153]

According to the Court, the "crucial factor governing nexus" was whether the activities performed in Washington on behalf of the taxpayer were "significantly associated with the taxpayer's ability to establish and maintain a market in [Washington] for the sales."[154] Because the independent contractor was necessary for the maintenance and protection of Tyler Pipe's interests in the state, the Court ruled that "the activities of Tyler's sales representatives adequately support[ed] the State's jurisdiction to impose its wholesale tax on Tyler."[155]

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146. *Id.* at 211.

147. *Id.*

148. Tyler Pipe Indus., Inc. v. Washington Dep't of Rev., 483 U.S. 232, 239-40 (1987). There were two appeals before the Court: one dealt with whether the tax imposed by Washington facially discriminated against interstate commerce; the other appeal considered whether a taxpayer had a sufficient nexus with Washington so that a tax could be imposed upon the taxpayer and whether the imposed tax was fairly apportioned. Only the Court's analysis of the nexus issue is discussed herein.

149. *Id.* at 249.

150. *Id.*

151. *Id.*

152. *Id.*

153. *Id.* (quoting Tyler Pipe Indus., Inc. v. Washington Dep't of Rev., 715 P.2d 123, 127 (1985)).

154. *Id.* at 250 (quoting *Tyler Pipe*, 715 P.2d at 126).

155. *Id.* The Court also made clear that the fact that the sales representatives were independent contractors and not agents of Tyler Pipe had no bearing on the analysis for nexus. *Id.*; *see also* Scripto, Inc. v. Carson, 362 U.S. 207, 211 (1960); National Geographic Soc'y v. California Bd. of Equalization, 430 U.S. 551, 556-58 (1977).

C. PUTTING THE CONSTITUTIONAL PIECES TOGETHER

In summary, the Supreme Court has allowed states to constitutionally impose a use tax collection duty on a retailer in only three general instances. The first case is where an out-of-state vendor has an office, place of business, or other significant ownership of property within the taxing state. *National Geographic* stands for this principle. In *National Geographic*, the presence of a large office building in California provided the necessary nexus allowing California to impose a use tax collection duty on National Geographic.[156]

The second instance permitting a collection mandate involves the presence of an employee who is regularly and continuously working within the taxing state, even if the employee's activities do not specifically involve the solicitation of in-state sales. In *Standard Pressed Steel,* the out-of-state vendor's employee performed regular and continuous activities in the state of Washington.[157] This level of activity provided the vendor with the requisite constitutional nexus required for the imposition of a use tax collection duty. There is a general consensus in the business community that either having an office, place of business or other property, or an employee who regularly and continuously works within the taxing state amounts to a substantial nexus.

Finally, a substantial nexus is also established if a vendor's agents or third-party representatives are regularly and continuously present in the taxing state, but only where their activities are directly related to actual sales of tangible personal property. As previously discussed, *Scripto* and *Tyler Pipe* are the leading cases that have established this general rule.[158] Nonetheless, businesses have recently been the target of tremendous pressures from many states who have collectively maintained that the substantial nexus standard outlined in *Quill* extends beyond the limits the Court reached in *Scripto* and *Tyler Pipe.* Specifically, the states have strongly indicated that *any* type of regular presence of such independent representatives working on behalf of the vendor would push the taxpayer beyond the *Quill* safe harbor.

IV. BULLETIN 95-1: PUSHING THE COMMERCE CLAUSE ENVELOPE

Through the issuance of Bulletin 95-1, the MTC has attempted to unilaterally expand the definition of "substantial nexus." By acqui-

156. *See supra* notes 108-22 and accompanying text.
157. *See supra* notes 125-36 and accompanying text.
158. *See supra* notes 137-55 and accompanying text.

escing to Bulletin 95-1, twenty-five states have maintained that their laws are consistent with the Bulletin,[159] and the MTC has stated that Bulletin 95-1 is supported by the current constitutional principles of the Commerce Clause and the Due Process Clause. According to the MTC, Bulletin 95-1 is only a statement of currently existing constitutional standards.[160] In actuality, as discussed below, it is symbolic of the MTC's ever expanding view of Commerce Clause substantial nexus.

A. THE MTC POSITION

In Bulletin 95-1, the MTC genuinely embarks on a quest to educate computer companies concerning voluntary compliance with currently existing federal nexus standards.[161] Bulletin 95-1 mentions that "state tax officials too often find that companies are not complying with existing standards," and that the states are now seeking voluntary compliance through education and information.[162]

To accomplish the states' mission, the MTC chose to announce its expansive position on nexus in a case study fashion through the selection and analysis of a specific industry.[163] Bulletin 95-1 sets forth the nexus consequences of an imaginary direct marketer of computers and related equipment that also provides warranty repair services to its customers through authorized third-party representatives that are located in the same states as the customers.[164] The warranty permits a customer to obtain on-site repair of the computer through a third-party service provider. In order to obtain a repair, the customer must first contact the direct marketer, who, in turn, authorizes and makes arrangements for the third-party to perform the repair work in the taxing state either at the customer's location or at a site determined by the third-party service

159. *See supra* note 8 and accompanying text.

160. *See* BULLETIN 95-1, *supra* note 8, at 2.

161. This computer company education and compliance project is an innovative effort designed to achieve the following purposes:

> Education—informing the public of the nexus standards applicable to specific industry practice;
> Efficiency—saving the public and private sectors time and money by achieving necessary tax compliance in the most efficient means possible—voluntarily;
> Respect for taxpayer rights—recognizing that each business has the right to make informed decisions about their tax compliance responsibilities, including their right to disagree with State taxing authorities;
> Cooperation with taxpayers—offering businesses assistance in determining applicable nexus standards and filing responsibilities and help with voluntary compliance.

BULLETIN 95-1, *supra* note 8, at 1.

162. *Id.* at 5.

163. The MTC has made it clear that the fact pattern for the selected industry is for illustrative purposes only, and it should not be interpreted to exclude other instances involving similar, but not identical, fact patterns. *Id.* at 1.

164. *Id.*

provider. In this instance, the MTC states that the computer company has a constitutional nexus in a state for the purposes of use tax and income, franchise, or comparable tax liability.[165] Bulletin 95-1 contains a legal analysis attempting to support the MTC's position from a constitutional and statutory position.

The analysis indicates that the Due Process Clause and the Commerce Clause of the Constitution support a liberal approach to defining the use tax nexus. According to the MTC, the presence of representatives of the direct marketing computer company providing repair services in the customer's state will generate a constitutional nexus.[166] The MTC proclaims that "the critical test for 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."[167] The MTC later states "[a]s in *Tyler Pipe*, these in-state activities (warranty repair service provided by computer either in standard warranty or by option of purchase) which develop goodwill and increased market share, are no less important or beneficial to the out-of-state direct marketing computer company because they are performed by an independent third-party repair service."[168]

B. THE TRUE MEANING OF BULLETIN 95-1

It is important to recall that the MTC was created by the states to circumvent federal regulation of state taxes and to increase the revenue base of member states. Accordingly, the MTC has aggressively taken the position that in-state warranty repair activities of an out-of-state vendor's independent contractors are "regular and systematic"[169] and are "significantly associated" with the out-of-state vendor's ability to "establish and maintain a market" for computer hardware sales inside the state,[170] thus creating a sufficient nexus for the state to impose on the computer company a use tax collection responsibility on sales to customers in those states. In addition to repair services, Bulletin 95-1 indicates that "other activities conducted by or on behalf of a

165. *Id.* at 2.
166. *Id.* at 4.
167. *Id.* at 3 (citing *Tyler Pipe*, 483 U.S. at 250).
168. *Id.*
169. According to the MTC, activities that are regular or systematic and in furtherance of the seller's business are not trivial; therefore, they are not to be considered *de minimis* activity that does not rise to the level of constitutional nexus. *Id.* at 2.
170. *See* Tyler Pipe Indus. v. Washington Dep't of Rev., 483 U.S. 232, 250 (1987).

computer company in a taxing State may also independently create [a] constitutional . . . nexus."[171]

According to the MTC, the fact that the in-state services are actually performed by a third-party (as opposed to an employee) is of no constitutional significance, because the out-of-state vendor has authorized the in-state service provider to perform the necessary repairs on its behalf.[172] The following section provides suggestions on how to prepare for sales and use tax audits and combat this type of unfounded state aggression.

V. RESPONDING TO STATE (AND MTC) AUDITORS

What level of activity or physical presence constitutes "substantial nexus" necessary to satisfy the Commerce Clause? Due to the *Quill* Court's failure to specifically define that phrase, this issue can only be considered on a case-by-case basis. If a business encounters an out-of-state tax auditor (or MTC auditor) who indicates that the business may owe a tax liability, based on an assertion that Bulletin 95-1 represents an accurate reflection of current constitutional law, the company may respond in one of two ways.

A. THE DUE PROCESS DEFENSE

The best approach, of course, would be to prevent the auditor from visiting the business in the first place. A business can attempt to avoid an audit altogether under a Due Process theory, but continuous sales into a state will likely establish the minimum contacts necessary to override a Due Process argument. Still, an auditor might respect a company's insistence that the state has no right to conduct an audit because it may not be worth the auditor's time or expense to litigate the procedural issue.[173] Assuming the business cannot prevent the auditor from making a visit, a second response is to make several legal arguments that will discourage the auditor from making an assessment. For obvious reasons, company personnel should present these positions to the auditor as early as possible in the audit process.

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171. *See* BULLETIN 95-1, *supra* note 8, at 1.

172. *Id.* at 4.

173. David J. Bradford, *Tips for Handling Corporate Tax Audits*, SOFTWARE TAX'N LETTER, March 1996, at 36.

B. ANTI-NEXUS ARGUMENTS TO DISCOURAGE AN AUDITOR'S ASSESSMENT

1. *Nexus Must be Present as a Matter of State Law*

In Bulletin 95-1, the MTC makes a sweeping assumption that the statutes of all of the endorsing states require use tax collection by the out-of-state vendor in the sample fact pattern situation. This is quite an oversight, as constitutional arguments are meaningless if they are in reference to a principle that is contrary to state law. Therefore, the person assigned to refute the audit should first look for the state taxing statute that implements a use tax collection responsibility.

As a general rule, a retailer that is "engaged in business" or "doing business" in a taxing state is required to collect tax from an in-state purchaser. While each state's interpretation of "engaged in business" or "doing business" may vary, these phrases for sales and use tax collection purposes generally refer to vendors that are physically present in the state. If a retailer is not engaged in or doing business in a state within the meaning of the state's statutes, no constitutional question needs to be addressed because a use tax collection duty cannot be imposed under state law. In other words, an otherwise constitutionally permissible duty to collect use tax is only enforceable against a retailer if state law contains a statute that requires the retailer to collect the tax.

Consider, for example, California law. According to the statutes, "[e]very retailer engaged in business in this state and making sales of tangible personal property for storage, use, or other consumption in this state. . . shall, at the time of making the sales. . . collect [use] tax from the purchaser. . . ."[174] The collection responsibility, therefore, applies only to retailers who are "engaged in business" in California. Based on pure California statutory analysis, the computer company in the Bulletin 95-1 example would not be required to collect use tax on sales to its California customers because the company would not technically be "engaged in business" in California. The statutes would require the computer company to collect tax only if it either: (a) maintained a place of business in California; or (b) engaged an agent or independent contractor in California to sell, deliver, install, assemble, or take orders

174. CAL. REV. & TAX CODE § 6203 (1996).

for tangible personal property.[175] Based on the fact pattern in Bulletin 95-1, the computer company does not meet either of these criteria.

Because the physical presence in California of the third-party service provider is not connected with sales of the computer company's tangible personal property, the computer company is not "engaged in business" in California.[176] Accordingly, the California statutes do not authorize the state to impose a use tax collection duty upon the out-of-state computer company based solely on its use of an in-state third-party repair company.[177] This statutory finding renders moot any additional constitutional analysis.

2. *Some Adopting States May Not Have the Authority to Follow Bulletin 95-1*

Even if the state conducting the audit has signed on to Bulletin 95-1, the state might not have the authority to follow it. Texas is a good example of this; its "engaged in business" statute is quite similar to California's.[178] If a computer vendor's only in-state contact with Texas is through the use of a service company providing warranty repairs, the vendor would technically not be "engaged in business" in Texas according to state law. Because it is not engaged in business in Texas, the vendor would not be subject to a use tax collection responsibility despite the state's adoption of Bulletin 95-1.[179]

Some states have recently handled this type of inconsistency by changing their laws to conform with Bulletin 95-1. Kentucky, for

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175. A retailer engaged in business in California primarily includes:

> (a) Any retailer maintaining, occupying, or using, permanently or temporarily, directly or indirectly, or through a subsidiary, or agent . . . an office, place of distribution, . . . or other place of business," and (b) 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.

CAL. REV. & TAX CODE § 6203(a)-(b) (1996) (emphasis added).

176. Through a final regulation recently released, the State Board of Equalization has now directly addressed this issue. An out-of-state retailer is not "engaged in business" in California based solely on its use of an unrelated representative or independent contractor that performs in-state warranty or repair services with respect to tangible personal property sold by the retailer. Cal. Prop. Reg. Title 18, § 1684 (May 21, 1997) (enacted).

177. This is the reason California withdrew its support for BULLETIN 95-1. *See supra* note 8.

178. A retailer is "engaged in business" in Texas if, among other things, it "has a representative, agent, salesman, canvasser, or solicitor operating in [Texas] under the authority of the retailer or its subsidiary *for the purpose of selling or delivering or the taking of orders* for a taxable item." TEXAS TAX CODE ANN. § 151.107(a)(2) (West 1996) (emphasis added).

179. *See* TEXAS TAX CODE ANN. § 151.103(a) (West 1996).

instance, did this in 1996, although its new law refers to repair services performed by an agent, as opposed to an independent contractor. [180]

3. *Some Adopting States May Have Conflicting Case Law*

If the state auditing the business has signed on to Bulletin 95-1, company personnel should do research to ensure that such adoption does not contradict established state case law. For example, Arizona's adoption of Bulletin 95-1 appears to be in conflict with its recent holding in *Talbot's, Inc. v. Arizona Department of Revenue*.[181] That case involved a clothing retailer and mail order company that was building its first retail store in Arizona.[182] The issue presented in the case concerned whether Talbot's was required to collect use tax on its mail order sales in Arizona during the period of time that the retail store was being constructed.[183] The Board of Tax Appeals held that no substantial nexus existed between Talbot's and the state to require a use tax collection duty, even though Talbot's had engaged an Arizona architect and contractor to construct the retail store within the state.[184]

4. *Establishing and Maintaining a Market is a Due Process Theory*

The primary Supreme Court cases relied upon by the MTC[185] stand for Due Process nexus standards, not Commerce Clause standards.[186] Therefore, they do not justify Bulletin 95-1's assertion that the fact pattern necessarily creates a Commerce Clause substantial nexus. While the Due Process rationale centers on whether the vendor has derived some benefit from the state, the Commerce Clause rationale is based on the protection of interstate commerce from undue state interference.[187]

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180. Added to the statutory list of businesses who are deemed to be "engaged in business" in Kentucky is: "any retailer soliciting orders for tangible personal property from residents of this state on a continuous, regular, systematic basis if the retailer benefits from an agent operating in this state under the authority of the retailer to repair or service tangible personal property sold by the retailer." KY. REV. STAT. ANN. § 139.340(2)(e) (Michie 1996).

181. Talbot's Inc. v. Arizona Dep't of Rev., No. 1255-94-5 (Ariz. B.T.A., Oct. 12, 1995).

182. *Id.*

183. *Id.*

184. *Id.*

185. The MTC relied upon *Scripto*, *Tyler Pipe*, and *Standard Pressed Steel*. *See supra* notes 161-68 and accompanying text. For a discussion of these cases, *see supra* notes 123-55 and accompanying text.

186. In *Scripto*, for instance, the Court's analysis of the company and its sales personnel's activities in Florida concerned the exploitation of Florida's market, the establishment of "some minimum connection," and the sorts of links that make the imposition of a tax collection duty both foreseeable and fair. All of these considerations are rooted in due process, as *Quill* reaffirmed. COMMITTEE ON STATE TAX'N, *COST Opposes MTC Nexus Bulletin 95-1*, STATE TAX NOTES, March 25, 1996, 973, at 974-5.

187. Quill v. North Dakota, 504 U.S. 298, 308-09 (1992).

5. *Only Continuous Local Solicitation by Third-Party Representatives Creates Nexus*

Bulletin 95-1 states that the Supreme Court has "uniformly held" that the "provision of services" by an in-state representative creates a nexus between the state and an out-of-state vendor.[188] Businesses should challenge the auditor to come forth with any case that supports this bold assertion. Not just *any* activity of an out-of-state vendor's in-state representative will create a nexus for the company. Rather, the Supreme Court has attributed a substantial nexus to an out-of-state vendor only where the independent contractor has performed "continuous local solicitation" in the taxing state.[189]

In *Scripto*, because the third-party representatives were conducting "continuous local solicitation" in Florida on behalf of the company, the Court found the requisite nexus.[190] Critical to the Court's finding of nexus was the "nature and extent of the activities" of the sales representatives.[191] The sole nature of their activities was the selling of goods; i.e., the "attracting, soliciting, and obtaining [of] Florida customers."[192] Accordingly, the Supreme Court, having acknowledged in *Quill* that *Scripto* has been "the furthest extension of [a state's taxing] power" under the Constitution,[193] has made no suggestion whatsoever that post-sale services by independent contractors could constitute a nexus.

Nor was any suggestion made in *Tyler Pipe*. Although the sales representatives did "maintain and improve the name recognition, market share, goodwill, and individual customer relations" of Tyler Pipe, this was just an ancillary result of effective salesmanship by representatives protecting the best interests of their client.[194] The same is true for the "information regarding the Washington market" that the representatives accumulated during the course of their sales activity and provided to Tyler Pipe.[195] The ancillary benefits derived by Tyler Pipe cannot change the fact that the core "nature and extent" of the representatives' activities was the selling of goods.

188. *See* BULLETIN 95-1, *supra* note 8, at 2.
189. *See supra* notes 146-47 and accompanying text.
190. Scripto Inc. v. Carson, 362 U.S. 207, 211 (1960).
191. *Id.*
192. *Id.* at 209.
193. *Quill*, 504 U.S. at 306.
194. Tyler Pipe Indus. v. Washington Dep't of Rev., 715 P.2d 123, 127 (1986).
195. Such information included: "product performance; competing products; pricing, market conditions and trends; existing and upcoming construction projects; customer financial liability; and other critical information of a local nature concerning Tyler Pipe's Washington market." *Id.*

Furthermore, recent state cases and rulings involving nexus-creating activities by independent contractors have all involved situations where the representatives have been involved in the *selling* process.[196] Accordingly, several other recent state opinions have found that a "substantial nexus" was not established where the presence of *employees* in a state was not sales-oriented.[197]

6. *Post-Sale Services Create Nexus Only When Performed by Employees*

Bulletin 95-1 indicates that a third-party representative can create a nexus by doing something other than soliciting sales,[198] but this is misleading. The Supreme Court has never ruled that the actions of an independent contractor, other than as a solicitor of sales, can create a nexus for an out-of-state vendor. *Standard Pressed Steel*, which provided the basis for the MTC's assertion, involved the out-of-state

196. *See generally In re* Scholastic Book Clubs, Inc., 920 P.2d 947 (Kan. 1996) (dealing with elementary school teachers acting as retailer's sales agents by soliciting book orders from students); House of Lloyd v. Commonwealth of Pa., 684 A.2d 213 (Pa. 1996) (dealing with a vendor who directed and controlled a very large sales force of home party hostesses dedicated exclusively to promoting and selling its products); Carapace, Inc. v. Limbach, No. 90-R-825 (Ohio B.T.A., May 28, 1993) (dealing with a vendor who engaged a manufacturer's representative to encourage sales in the state and to locate dealers willing to sell vendor's products); Consolidated Fuel Corp. v. Director of Rev., RV-92-0230 (Mo. Admin. Hearing Comm., 1993) (dealing with a wholesale supplier of natural gas who contracted with a Missouri corporation to solicit sales on its behalf in Missouri); Doctor's Assocs., Inc. v. Director of Rev., RV-95-1748 (Mo. Admin. Hearing Comm., 1997) (dealing with "development agents" who advertised and sold Subway franchises within the state); Texas Comptroller Hearing No. 34,113 (Dec. 19, 1995) (dealing with a manufacturer of playground equipment who used Texas-based agents to solicit business and distribute its products in Texas); New York Dep't of Tax'n & Finance, Advisory Opinion TSB-A-97(19)S (March 28, 1997) (dealing with a Canadian mail-order company that used a New York mail forwarding service to collect catalog and merchandise orders, then transported goods into New York in its own trucks); New York Dep't of Tax'n & Finance, Advisory Opinion TSB-A-96(76)S (Dec. 13, 1996) (dealing with independent contractors who made regular visits into New York to enroll people in a Florida company's training program). *Compare* Scholastic Book Clubs v. Dep't of Treasury, 567 N.W.2d 692 (Mich. 1997) (holding that teachers distributing book club catalogs to students and collecting order forms and payments for out-of-state retailer did *not* create nexus).

197. *See, e.g., In re* NADA Services Corp., No. 810592, New York Div. of Tax Appeals (ALJ) (Feb. 1, 1996) (involving employees who made 15 trips into the state to attend educational seminars and five other miscellaneous visits); Virginia Dep't of Tax'n, Ruling of Commissioner, P.D. 96-339 (Nov. 20, 1996) (dealing with an out-of-state vendor who sent employees into the state solely to install and test custom software after a sale); Virginia Dep't of Tax'n, Ruling of Commissioner, P.D. 97-276 (June 18, 1997) (regarding an out-of-state business specializing in the sale of high school and college graduation photographs that sent employees into the state solely to shoot photographs of graduation events); New York State Dep't of Tax'n and Finance, Opinion of Counsel, Doc. 96-27937 (Oct. 3, 1996) and West Virginia Dep't of Tax and Rev., TAA No. 96-003 (June 1996) (dealing with out-of-state vendors who sent employees into the state to review and approve the production of promotional materials).

198. The U.S. Supreme Court has uniformly found that the in-state presence of a representative of an out-of-state seller who conducts regular or systematic activities in furtherance of the seller's business, such as solicitation of sales *or provision of services*, creates nexus." *See* BULLETIN 95-1, *supra* note 8, at 2 (emphasis added).

vendor's *employee* who was stationed inside the taxing state.[199] Recent state cases and rulings finding a nexus between out-of-state vendors and the state based on post-sale services within the state have involved services being performed by the vendor's own *employees*, not independent contractors.[200]

7. *Actual Contact, Not Potential Contact, is the Test*

Bulletin 95-1 asserts that the availability of an in-state warranty repair service is enough to create a nexus, and whether any in-state service is ever performed is of no constitutional consequence.[201] Businesses should argue, though, that mere potential to provide post-sale repairs, without any actual repairs, is insufficient to establish a nexus.[202] However, this argument should only be offered as a last resort, as the company would be, in essence, admitting a nexus exists for those sales that ultimately required an in-state visit from the third-party repair company.

VI. THE SLIPPERY SLOPE RENDERS A WIDER APPLICATION

The arguments discussed in the prior section may also be used to defend against nexus audits that may arise concerning other business activities not contemplated in Bulletin 95-1. Many businesses fear that Bulletin 95-1 has signified the advent of a slippery slope in which states will continue to develop "attributable nexus" positions based on the theory that somewhere along the line of business relationships there is a physical presence in the state that can travel back up the chain of

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199. *See supra* notes 125-36 and accompanying text.

200. *See, e.g.*, *In re* Vermont Info. Processing, Inc. v. Tax Appeals Tribunal et al., 86 N.Y.2d 165 (1995), *cert. denied*, 64 U.S.L.W. 3378 (1995) (dealing with employees of computer software/hardware mail order vendors who visited New York customers to resolve problems and give additional instructions in connection with the use of software programs); Texas Comptroller Hearing No. 32,349 (Jan. 30, 1995) (dealing with employees of a computer hardware/software vendor who entered the state to perform for each customer three post-sale training sessions of two to three days in length); Philip Crosby Associates, Inc. v. Alabama Dep't of Revenue, No. U.96-143 (ALJ) (Dec. 4, 1996) (dealing with employees of a management consulting firm regularly and continuously traveled into Alabama for post-sale consulting and on-site training). *But see* Wisconsin Dep't of Tax'n, Private Letter Ruling No. W9728006 (April 18, 1997) (stating hypothetically that a software retailer with no physical presence in the state "may have" use tax nexus if third-party representatives provided warranty repair, training, installation, or certain other services in the state).

201. *See* BULLETIN 95-1, *supra* note 8, at 4.

202. When an out-of-state vendor handles a customer's problem exclusively over the telephone, or where the vendor merely ships a repair part to the customer through the United States mail, this is within the *National Bellas Hess* safe-harbor, according to Dan Bucks, Executive Director of the Multistate Tax Commission. *Advisory Board Discusses Nexus Developments, Effect of Federal Actions, High Court Trends, and More at April 1996 Roundtable*, CCH STATE TAX REVIEW (CCH State Tax Advisory Board, Chicago Ill.) June 17, 1996, at 14 (comments by Dan Bucks, MTC Executive Director).

businesses to the seller. Several of these areas of concern are discussed below.

A. SHIPMENTS OF GOODS BY CONTRACT CARRIER

An out-of-state vendor should consider the potentially damaging effects of using a contract carrier, rather than a common carrier, to ship goods into a state where it has no other physical presence. The MTC distinguishes between a contract and common carrier by clearly indicating that deliveries to a customer into a state by common carrier[203] fall within the safe harbor of contact afforded by *Quill*.[204] However, the MTC maintains that an out-of-state business making deliveries of goods into a state via *contract* carrier does establish a physical presence triggering a use tax collection responsibility.[205] This MTC position can probably be circumvented, because in very few instances does a true contract carrier deliver goods for a vendor. If a hauler holds itself out as both a common and contract carrier, the law considers it a common carrier.[206] Therefore, an out-of-state vendor using such a carrier would be immune from any use tax collection liability pursuant to *Quill*.

Caution should still be exercised when shipping goods via common carrier. At least one jurisdiction has recently held that shipments via common carrier created a substantial nexus where the vendor had complete control over the product during shipment, the contract's nature was exclusive, the cargo was unique, and the contract terms were F.O.B. destination.[207]

B. TELECOMMUNICATIONS

An out-of-state vendor's relationship with independent contractors performing telephone-related services in a state may subject the vendor to a use tax collection responsibility in that state. Two recent Illinois letter rulings illustrate this point. In one instance, the hiring of an Illinois telephone marketing company to perform phone solicitation of

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203. A common carrier "holds himself out to the public as engaged in business of transportation of persons or property from place to place for compensation." BLACK'S LAW DICTIONARY 249 (5th ed. 1979).

204. MULTISTATE TAX COMMISSION, CONSTITUTIONAL NEXUS GUIDELINE FOR APPLICATION OF A STATE'S SALES AND USE TAX TO AN OUT-OF-STATE BUSINESS (Initial Public Participation Working Group Draft, March 1997) Section II.C.5., Example 2, [hereinafter NEXUS GUIDELINE (3/97)].

205. *Id.*

206. A contract carrier is limited to those carriers "who operate under individual contracts and who render a specialized service which is required by the peculiar needs of a particular shipper *and who do not come within the definition of common carriers*." 86 CONG. REC. 11546 (daily ed. Sept. 5, 1940) (emphasis added).

207. Koch Fuels, Inc. v. Clark, 676 A.2d 330, 334 (R.I. 1996), *cert. denied*, 65 U.S.L.W. 3293 (1996).

customers all over the United States was a sufficient nexus between Illinois and an out-of-state vendor, even though that vendor owned no property in Illinois, maintained no office there, and had no other sales representatives in the state.[208] Hiring the Illinois telemarketer transformed the out-of-state company into a "retailer maintaining a place of business in Illinois."[209]

In another ruling, even though a Virginia-based retailer had no office or traditional sales representatives present in Illinois, the Department of Revenue ruled that it was "maintaining a place of business in Illinois" due exclusively to its relationship with an Illinois answering service.[210] Orders for the retailer's products were taken by telephone through an "800" number, and some of the calls were routed to an answering service located in Chicago.[211] Because the answering service that took orders qualified as a representative operating in Illinois under the vendor's authority, the vendor was required to collect Illinois use taxes on sales to customers located in the state.[212]

An out-of-state business that maintains "local telecommunications access" in a state is also in danger of acquiring a nexus to that state. Suppose the business enters into an agreement with an interexchange carrier, whereby the carrier, by contract with the telecommunications company serving the local exchanges in the state, arranges for "transparent switching" that achieves the out-of-state vendor's objective of allowing in-state customers to contact it through a local telephone call. Arguably, the interexchange carrier, acting on behalf of the out-of-state vendor by providing local access, has created a "physical presence" in the state for the out-of-state vendor.[213]

C. HIRING IN-STATE PROFESSIONALS

Has a company established a nexus to a state merely by interviewing or hiring an attorney in the state to represent it in litigation? Even the MTC would probably decline to assert a nexus exists, given the Executive Director's contention that the "establishment and maintenance of a market" is the key element of what gives rise to a nexus when a company is represented by an independent contractor in a state.[214]

208. Illinois Priv. Ltr. Rul. 95-0519 (December 29, 1995).
209. *Id.*
210. Illinois Priv. Ltr. Rul. 95-0485 (November 1, 1995).
211. *Id.*
212. *Id.*
213. *See* NEXUS GUIDELINE (3/97), *supra* note 204, at Section II.C.8., Ex. 1.
214. *See Advisory Board Discusses Nexus Developments*, *supra* note 202, at 15; *see also* NEXUS GUIDELINE (3/97), *supra* note 204, at Section II.C.1., Ex. 4.

Ordinarily, a company hires a particular law firm for personal reasons; for instance, the company might believe that the law firm employs the most reputable attorney in the country on the specific subject matter at hand. Because this decision-making process does not necessarily deal with the establishment and maintenance of a market in the state where the attorney is located, a nexus most likely would not be established.[215]

D. ADVERTISING

Assume a Missouri direct marketer hires an advertising company located in New York. Does this mere fact establish a nexus between New York and the Missouri vendor? Does this constitute physical presence in New York? Probably not, because the advertising agency's location in New York is not significantly associated with the ability of the Missouri company to establish and maintain a market in New York vis-à-vis other states.

Does the use of an in-state agency that creates promotional products and services give rise to a nexus for an out-of-state vendor that has no other physical contacts with the state? What if the vendor sends an employee into the state to assist the agency with the production of the materials? What if the vendor furnishes raw materials to the agency to be used in producing the promotional items? The MTC contends that this vendor has a "physical presence" in the state;[216] however, some states have passed legislation directly contrary to the MTC position.[217]

Can advertisement in the local media constitute a physical presence? In *Miller Brothers Co. v. Maryland*,[218] the Supreme Court held that an out-of-state company whose connections with a state were limited to general advertising through newspaper, radio, and occasional direct mailing, as well as deliveries into the state, did not even amount to a Due Process nexus.[219] Although the Due Process Clause analysis in *Miller*

215. *See also* New York Dep't of Tax'n & Finance, Advisory Opinion, TSB-A-96(17)C, (July 24, 1996) (holding that meeting with prospective accountants, bankers, lawyers, or securities underwriters in New York does not constitute doing business in the state).

216. *See* NEXUS GUIDELINE (3/97), *supra* note 204, at Section II.C.1., Ex. 1.

217. *See, e.g.*, CONN. GEN. STAT. § 12-213(a)(20) (1996).

218. 347 U.S. 340 (1954).

219. Miller Bros. Co. v. Maryland, 347 U.S. 340, 341-45 (1954). Due process requires "some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax." *Id.* at 344-45.

Brothers has been overruled by *Quill*,[220] advertising of this type is still protected under the Commerce Clause.

Consistent with *Miller Brothers*, a California appellate court recently held that a vendor did not establish a nexus where its only contact with the state was through televised advertising. In *JS&A Group Inc. v. California Bd. of Equalization*,[221] the court ruled that a portion of the California tax code subjecting out-of-state retailers to sales and use taxes based solely upon contracts with local broadcasters or publishers, or upon the solicitation of orders through in-state advertising, violated the Commerce Clause and was invalid.[222] Basing its decision on *Quill*,[223] the court ruled that the airing of a commercial that promotes a product does not convert a broadcaster or cable operator into an agent or sales representative and, therefore, cannot alone give rise to the "physical presence" required for a finding of nexus under the Commerce Clause.[224]

A few states, however, have expanded their definitions of nexus to capture out-of-state vendors whose sole presence in the state is through a representative that provides advertising services. For example, in 1996 the Massachusetts Department of Revenue announced its intent to prospectively enforce a dormant nexus statute enacted in 1988 that defines "engaged in business" to include "exploiting the retail sales market in the commonwealth through any means whatsoever," such as advertising or soliciting in newspapers, magazines, radio or television broadcasts, computer networks, or in any other communications medium."[225]

Could nexus be established merely by advertising on the Internet? Courts have split on this issue. However, to date, litigation involving this issue has been limited to civil procedure disputes, in which the presence of a nexus has been examined only from a Due Process perspective.[226]

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220. Quill v. North Dakota, 504 U.S. 298, 312 (1992).

> In 'modern commercial life' it matters little that such solicitation is accomplished by a deluge of catalogs rather than a phalanx of drummers: the requirements of due process are met irrespective of a corporation's lack of physical presence in the taxing State. Thus, to the extent that our decisions have indicated that the Due Process Clause requires physical presence in a State for the imposition of duty to collect a use tax, we overrule those holdings as superseded by developments in the law of due process.

Id. at 308.

221. No. 969816 (Cal. Ct. App. Feb. 10, 1997).

222. JS&A Group Inc. v. California Bd. of Equalization, No. 969816, slip op. at 5 (Cal. Ct. App. Feb. 10, 1997).

223. The *JS&A* court declared: "We can find no qualitative difference between the methods of solicitation in *Quill* and advertisement on broadcast and cable television." *Id.* at 5.

224. *Id.*

225. *See* MASS. GEN. LAWS ANN. ch. 64H, § 1 (West 1996); MASSACHUSETTS DEP'T OF REV., TECHNICAL INFO. RELEASE 96-8 (Oct. 16, 1996).

226. World-Wide Volkswagen Corp. v. Woodson, 444 U.S. 286 (1980). The limitations of the Due Process clause require that a nonresident corporate defendant have "minimum contacts" with the

A recent non-tax, federal court of appeals decision is on point. In *Bensusan Restaurant Corp. v. King*,[227] the plaintiff commenced a trademark protection action against King, a Missouri resident who had established a home page for his jazz club on the World Wide Web.[228] The server for the web page was not located in New York.[229] The defendant's motion to dismiss was granted because the mere establishment of a web site was insufficient to permit the court to find that King had purposefully directed activities into the New York market.[230] In other words, a Due Process nexus did not exist.[231]

Other federal district court cases, such as *Inset Systems, Inc. v. Instruction Set, Inc.*,[232] have held that vendors who use the Internet to attempt to conduct business within a state have, in fact, established the minimum contacts necessary to comport with Due Process.[233] Yet, it is unknown how these courts would rule on the same set of facts in terms of whether this level of contact would exceed Commerce Clause nexus.

As evidenced by its recently issued regulation, the California State Board of Equalization (SBE) either agrees with *Bensusan* or, if not, maintains that advertising on the Internet does not amount to "substantial nexus" under the Commerce Clause. According to the SBE, a retailer would not be "engaged in business" in California if its sole contact with the state is the use of a computer server on the Internet to create or maintain a World Wide Web page or site. The regulation makes clear that no Internet service provider (ISP) or similar provider shall be considered an agent or representative of an out-of-state vendor using its services, regardless of the server's physical location.[234]

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forum state such that it would reasonably anticipate being haled into court there. *Id.* at 297. The essence of the "minimum contacts" test is whether a company has "purposefully avail[ed] itself of the privilege of conducting activities within the forum State, thus invoking the benefits and protections of its laws." Hanson v. Denckla, 357 U.S. 235, 253 (1958) (citing International Shoe Co. v. Washington, 326 U.S. 310, 319 (1945)).

227. 937 F. Supp. 295 (S.D.N.Y. 1996).

228. Bensusan Restaurant Corp. v. King, 937 F. Supp. 295, 298 (S.D.N.Y. 1996), *aff'd*, 127 F.3d 35 (2d Cir. 1997).

229. *Id.* at 297.

230. *See id.* at 301.

231. *Id.* at 297. The court noted that "[c]reating a site, like placing a product into the stream of commerce, may be felt nationwide—or even worldwide—but, without more, it is not an act purposefully directed toward the forum state." *Id.* at 301; *see also* McDonough v. Fallon McElligott, Inc., 40 U.S.P.Q.2d 1826 (S.D. Cal. 1996); Hearst Corp. v. Goldberger, 1997 WL 97097 (S.D.N.Y. 1997) (holding a lack of personal jurisdiction where defendant's only contact with a state was that residents of the state had access to defendant's web site).

232. 937 F. Supp. 161, 165 (D. Conn. 1996).

233. *See* Maritz, Inc. v. Cybergold, Inc., 947 F. Supp. 1338 (E.D. Mo. 1996); Zippo Mfg. Co. v. Zippo Dot Com, Inc., 952 F. Supp. 1119 (W.D. Pa. 1997).

234. Cal. Reg. Title 18, § 1684 (May 21, 1997) (enacted).

E. ELECTRONIC COMMERCE

There are an infinite number of complex sales and use tax issues arising out of the electronic commerce industry, a small sample of which is contained in this subsection.[235] It is foreseeable that states will attempt to retain jurisdiction over out-of-state Internet "on-line" vendors by attributing the in-state physical presence of other parties (as "agents") to these vendors. For example, in a typical transaction, an ISP enters into a business agreement with a telecommunications provider (e.g., AT&T) that owns telephone equipment in a state. Delivery of the ISP's service is impossible, of course, without the telecommunications mechanism. An Internet vendor then enters into an agreement with the ISP to link its web page onto a host computer (the use of which the ISP will license).[236]

The MTC might assert that the on-line vendor has a physical presence in the state in which the host computer is located.[237] There are several problems with this position: (1) a vendor's decision concerning where to place the host computer has nothing to do with establishing and maintaining a market in the state of choice; (2) ISPs and on-line vendors often do not know where the server they are using is located; and (3) when they find out where it is located, they can easily move it to a "tax-haven" state (e.g., Alaska, Delaware, Montana, New Hampshire, or Oregon) or out of the United States altogether.[238] Some states have even suggested that AT&T's nexus, arising from the physical presence of its equipment in a state, flows through to the on-line vendor, bestowing on it a use tax collection duty wherever AT&T has a nexus.[239]

While there are currently no cases applying *Quill's* safe harbor to on-line vendors, it appears that *Quill's* rationale would apply just the same. There seems to be no cause for a legal distinction between ordering a product via a computer and ordering the same product over

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235. For more information, see two White Papers on state and local Internet and on-line taxation recently released by the Treasury Department: *Logging on to Cyberspace Tax Policy*, and *Straight Talk: Internet, Tax and Interstate Commerce*. Interactive Service Association, *Logging on to Cyberspace Tax Policy* (visited Jan. 8, 1998) <http://www.isa.net/about/releases/taxwhpap.html>; Information Technology Association of America, *Straight Talk: Internet, Tax and Interstate Commerce* (visited Jan. 8, 1998) <http://www.ita.org>.

236. In a typical on-line sale, a potential customer who is "surfing the Net" enters a vendor's "home page," which resides in a server and is that vendor's presence on the Internet.

237. MULTISTATE TAX COMM'N, CONSTITUTIONAL NEXUS GUIDELINE FOR APPLICATION OF A STATE'S SALES AND USE TAX TO AN OUT-OF-STATE BUSINESS (Preliminary Staff Working Draft, Jan. 1996), Section II.C.5., Example 1. Note that this principle was temporarily deferred from subsequent drafts of the guidelines (Nov. 1996 and March 1997), because the MTC hopes to reach a consensus as soon as possible on the remainder of the draft without having to address this controversial issue.

238. Information Technology Association of America, *Straight Talk: Internet, Tax and Interstate Commerce* (visited Jan. 8, 1998) <http://www.ita.org>.

239. *Id.*

the telephone or through the mail. When using the mail for making orders and deliveries, a vendor is not considered to have entered into an agency relationship with the United States Postal Service and, therefore, does not establish nexus in every state as a result of this relationship. Products ordered or delivered via a different medium, such as the Internet, should render the same result.[240]

Other than its use of telephone lines, the Internet does not create any physical presence by sellers in a taxing state. Without question, it creates less of a physical presence than that generated by out-of-state mail-order companies that physically send their materials into a state.

VII. CONCLUSION

Several decades ago, it appeared that the Supreme Court wanted to exempt all interstate commerce from state taxation.[241] In the 1930s, this philosophy was abandoned when the Court upheld the constitutionality of use taxes in *Henneford*.[242] Over the years, the Court has given states broader authority to recover use taxes from out-of-state vendors, and this discretionary posture was refined in *Quill*. Today, one of the few remaining protections for businesses from interstate taxation is the Commerce Clause limitation placed on a state's ability to mandate the collection of use taxes by out-of-state vendors.

In an effort to tax telephone, mail-order, and Internet sales, states are moving to expand the concept of substantial nexus to encompass many contacts within a state that appear to be constitutionally insignificant. Bulletin 95-1 is a primary example of the states' expansive efforts to tax interstate sales. Although it purports to be based on current constitutional standards, Bulletin 95-1 exceeds the current jurisprudence on Commerce Clause nexus found in *Quill* and related cases.

Nonetheless, facing increasing pressures to derive additional revenues from new sources, state departments of revenue will continue their audit efforts through the implementation of Bulletin 95-1 type theory. Accordingly, businesses must become better acquainted with areas of exposure that have not traditionally caused much concern. When a sales and use tax nexus audit inevitably occurs, advanced preparation concerning the company's constitutional protections will be a key factor in reducing or eliminating potential assessments.

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240. *Id.*

241. *See generally* Sonneborn Bros. v. Cureton, 262 U.S. 506, 507-21 (1923); Robbins v. Shelby County Dist., 120 U.S. 489, 490-99 (1887).

242. *See supra* note 22 and accompanying text.