

***THE
COMPLEXITIES OF
MULTI-STATE TAXATION***

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Executive Summary

- Presently all the states except Michigan, Nevada, South Dakota, Texas, Washington and Wyoming impose a net income tax. The District of Columbia and various local jurisdictions also impose a net income tax.
- The State of Alabama imposes both an income tax and Business Privilege Tax. The Business Privilege Tax was enacted in 2000.
- The State of Michigan imposed a Single Business Tax (Value-Added Tax) through December 31, 2007. Effective January 1, 2008, the Single Business Tax was replaced by the Michigan Business Tax (Business Income/Modified Gross Receipts Tax).
- The State of Missouri imposes both a net income tax and franchise tax.
- The State of Nevada imposes a Business License Tax.
- The State of New Hampshire imposes a Business Profits Tax and Business Enterprise Tax.
- The State of Ohio imposes both a Corporation Franchise Tax and Commercial Activities Tax (CAT). The CAT became law on July 1, 2005.
- The State of South Dakota does not impose any taxes based on income, net worth, or gross receipts. Effective for all years beginning on or after January
- The State of Texas imposed a Franchise Tax (Privilege Tax) for all reports due on or before January 1, 2008. For all reports due after this date, the “Revised Franchise Tax-Margin Tax” applies.
- The State of Washington imposes a Business & Occupation Tax.
- The State of Wyoming does not impose any taxes based on income, net worth or gross receipts.
- The states have implicit authority to tax. However, their authority is subject to limitations. These limitations include the federal constitutional limitations of the Due Process Clause and Commerce Clause and limitations imposed by federal law (Public Law 86-272) under the federal government’s power to regulate interstate commerce.
- There is pending federal legislation to prohibit states from imposing a net income tax or other business activities tax without physical presence in the state.
- The States of Michigan, Missouri, Pennsylvania and Texas have asserted nexus on all direct selling, multi level marketing and network marketing companies if the company has independent sellers in their state.
- The Multi-State Tax Commission asserted nexus for all states on a direct selling company that charged a fee to their independent sellers. Their position was that the company was selling an intangible and therefore not protected under P.L. 86-272.
- Companies should monitor the States of Alabama, Connecticut, Kentucky, New Mexico, New Jersey, Oregon, Tennessee, Vermont, West Virginia and Wisconsin.

- Companies may file a voluntary disclosure with states where they have a liability due to nexus and are not currently filing.
- From time to time states will offer an amnesty program. These programs generally forego penalties and limit the look-back period. Research the particulars before filing.
- Many states systemically mail nexus questionnaires to companies in an effort to determine if they are subject to any of their taxes. A timely written response should be filed.
- The issue of nexus for state and local taxes is complex. Companies must carefully monitor court cases, rulings, and law changes to develop the appropriate action plan to minimize their overall state and local tax burden.

Introduction

The purpose of article is to inform and give guidance to direct selling, multi level marketing and network marketing entities on multi-state taxation.

One of the more complex challenges facing a company today is to identify those states where it is subject to a tax, whether it is a gross income tax, net income tax, franchise tax measured by net income, franchise tax measured by capital, excise tax, gross receipts tax, value-added tax, business activities tax or other business tax.

Although businesses understand the role of federal income taxes, many overlook the importance of multi-state taxes.

Engaging in multi-state commerce may require the filing and payment of various state and local business taxes.

To better comprehend the multi-state taxation rules you must understand some basic concepts. Once you understand them separately and piece them together, you will better understand the rules behind multi-state taxation.

The Due Process Clause

The Due Process Clause essentially requires some definite link, some minimum connection between the state and entity, property, or transaction it seeks to tax. The most minimal connections will satisfy this requirement. The connection need not include physical presence in the state. Due Process also requires that the income attributed to a taxing jurisdiction for tax purposes must be rationally related to values connected with the taxing state.

With respect to the Due Process Clause, the United States Supreme Court has now repudiated the physical presence test. The current test under the Due Process Clause for deciding if it is fair to tax someone is whether the taxpayer has “purposefully directed sales efforts toward residents of that state.” If so, the Due Process Clause, by itself, will not act to bar the imposition of tax on a company that has no physical presence. Quill Corp. v. North Dakota, 112 S. Ct. 1904 (1992).

The Commerce Clause

The Commerce Clause is the second federal constitutional doctrine involved in nexus determinations. The Commerce Clause prohibits state taxes that interfere with commerce between the states. A state may tax interstate activities so long as: (1) the tax applies to activities that have substantial ties to the taxing state; (2) the tax is fairly apportioned to

reflect the level of activities in the taxing state; (3) the tax does not discriminate against interstate business in favor of purely intrastate business; and (4) the tax is fairly related to services provided by the taxing state.

The Commerce Clause's requirement that there be "substantial" ties to the taxing state is similar to the substantial tie concept under the Due Process Clause but serves a different purpose. Even though it may be "fair" to require a taxpayer to enforce a state's tax laws (a Due Process concept), the impact of requiring such compliance in a large number of states might add up to an undue burden on interstate commerce. Also, the Supreme Court recognizes that it is difficult for a taxpayer operating in a large number of states to determine what level of activity other than having a physical presence is enough to create nexus. Thus, for the Commerce Clause purposes, there is still a requirement that in order to have nexus, a taxpayer must have a physical presence in the taxing state. Quill Corp. v. North Dakota, 112 S. Ct. 1904 (1992).

Nexus (Public Law 86-272)

Public Law 86-272 (P.L. 86-272) restricts a state from imposing a net income tax on an entity if the only business activity of the company within the state consists of the solicitation of orders for sales of tangible personal property, which are sent outside the state for acceptance and shipped from a point outside the state.

P.L. 86-272 only applies to the solicitation for the sale of tangible personal property. Leasing, renting, licensing or other disposition of personal property, or transactions relating to real property or intangibles, such as franchises, patents, copyrights, trademarks, service marks and like, or any other type of property, are not protected activities.

P.L. 86-272 only applies to net income taxes or franchise taxes measured by net income.

The protection of P.L. 86-272 does not apply for the state where an entity is incorporated or domiciled.

The United States Supreme Court established a standard for interpreting the term "solicitation" in Wisconsin Department of Revenue v. William Wrigley, Jr., Co., 505 U.S. 214, 112 S. Ct. 2442, 120 L.Ed.2d 174 (1992).

Solicitation means: (1) speech or conduct that explicitly or implicitly invites an order; and (2) activities that neither explicitly nor implicitly invites an order, but are entirely ancillary to requests for an order.

Ancillary activities are those activities that serve no independent business function for the seller apart from their connection to the solicitation of orders. Activities in which a seller engages, in apart from soliciting orders, are not considered as ancillary to the solicitation of orders. Activities that seek to promote sales are not ancillary, because Public Law 86-272 does not protect activity that facilitates sales; it only protects ancillary activities that facilitate the request for an order.

The conducting of activities not falling within the foregoing definition of solicitation will cause an entity to lose its protection under P.L. 86-272, unless the disqualifying activities are either *de minimis* or otherwise permitted.

De minimis activities are those that, when taken together, establish only a trivial connection to the taxing state. Any activity conducted within a taxing state on a regular or systematic basis or pursuant to company policy shall normally not be considered trivial. Whether or not an activity consists of a trivial or non-trivial connection with the state is to be measured on both a qualitative and quantitative basis. If such activity either qualitatively or quantitatively creates a non-trivial connection with the taxing state, then such activity exceeds the protection of P.L. 86-272.

Establishing that the disqualifying activities only account for a relatively small part of the business conducted within the taxing state is not determinative of whether a *de minimis* level of activity exists. The relative economic importance of the disqualifying in-state activities, as compared to the protected activities, does not determine whether the conduct of the disqualifying activities within the state is inconsistent with the limited protection afforded by P.L. 86-272.

Activities Protected Under P.L. 86-272

The following in-state activities will generally not cause the loss of protection for otherwise protected sales:

- Soliciting orders for sales by any type of advertising.
- Soliciting of orders by an in-state resident employee or representative of the company, so long as such person does not maintain a place of business in the state other than an “in-home” office.
- Carrying samples and promotional materials only for display or distribution without charge or other consideration.
- Furnishing and setting up display racks and advising customers on the display of the company’s products without charge or other consideration.
- Providing automobiles to sales personnel for their use in conducting protected activities.
- Passing orders, inquires and complaints on to the home office.

- Missionary sales activities: i.e. the solicitation of indirect customers for the company's goods. For example, a manufacturer's solicitation of the manufacturer's goods from the manufacturer's wholesale customer would be protected if such solicitation activities were otherwise immune.
- Coordinating shipment or delivery without payment or other consideration and providing information relating thereto either prior or subsequent to the placement of an order.
- Checking of customer's inventories without charge (for re-order, but not for others such as quality control).
- Maintaining a sample or display room for two weeks (14 days) or less at any one location within the state during the tax year.
- Recruiting, training, or evaluating sales personnel, including occasionally using homes, hotels or similar places for meetings with sales personnel.
- Mediating direct customer complaints when the purpose thereof is solely for ingratiating the sales personnel with the customer and facilitating request for orders.
- Owning, leasing, using or maintaining personal property for use in the employee or representative's "in-home" office or automobile that is solely limited to the conducting of protected activities. Therefore, the use of personal property such as cellular phones, facsimile machine, duplicating equipment, personal computer and computer software that is limited to the carrying on of protected solicitation and is entirely ancillary to such solicitation shall not by itself remove the protection under P.L. 86-272.

P.L. 86-272 also provides protection to certain in-state activities if conducted by an independent contractor that would not be afforded if performed by the company or its employees or other representatives. Independent contractors may engage in the following limited activities in the state without the company's loss of immunity:

- Soliciting sales.
- Making sales.
- Maintaining an office.

Sales representatives who represent a single principal are not considered to be independent contractors and are subject to the same limitations as those under P.L. 86-272.

Maintenance of a stock of goods in the state by the independent contractor under consignment or any other type of arrangement with the company, except for purposes of display and solicitation, shall remove the protection.

Activities Not Protected Under P.L. 86-272

The following in-state activities will generally cause the loss of protection for otherwise protected sales:

- Making repairs or providing maintenance or service to the property sold or to be sold.
- Collecting current accounts or delinquent accounts, whether directly or by third parties, through assignment or otherwise.
- Investigating credit worthiness.
- Installation or supervision of installation at or after shipment or delivery.
- Conducting training courses, seminars, or lectures for persons other than personal involved only in solicitation.
- Providing any kind of technical assistance or service, including but not limited to, engineering assistance or design service, when one of the purposes thereof is other than the facilitation of the solicitation of orders.
- Investigating, handling or otherwise assisting in resolving customer complaints, other than mediating direct customer complaints when the sole purpose of such mediation is to ingratiate the sales person with the customer.
- Approving or accepting orders.
- Repossessing property.
- Securing deposits on sales.
- Picking up or replacing damaged or returned property.
- Hiring, training, or supervising personnel, other than the personnel involved, only in solicitation.
- Using agency stock checks or any other instrument or process by which sales are made within the state by sales personnel.
- Maintaining a sample or display room in excess of two weeks (14 days) at any one location within the state during the tax year.
- Carrying samples for sale, exchange or distribution in any manner for consideration of other value.
- Consigning stock of goods or other tangible personal property to any person, including an independent contractor, for sales.
- Owning, leasing, using, or maintaining any of the following facilities or property in-state:
 - Repair shop.
 - Parts department.
 - Any kind of office other than an in-home office.
 - Warehouse.
 - Meeting place for directors, officers, or employees.

- Telephone answering service that is publicly attributed to the company or to employees or agent(s) of the company in their representative status.
 - Mobile stores, i.e., vehicles with drivers who are sales personnel making sales from the vehicles.
 - Real property or fixtures to real property of any kind.
- Maintaining, by an employee or other representative, an office or place of business of any kind (other than an in-home office located with employee or representative that (1) is not publicly attributed to the company or the employee or representative of the company in an employee or representative capacity, and (2) so long as the use of such office is limited to soliciting and receiving orders from customers; for transmitting such orders outside the state for acceptance or rejection by the company; or for such other activities that are protected under P.L. 86-272).
 - A telephone listing or other public listing within the state for the company or for an employee or representative of the company in such capacity or other indications through advertisement or business literature that the company or its employees or its representative can be contacted at a specific address within the state can normally be determined as the company maintaining within the state an office or place of business attributable to the company or to its employee or representative in a representative capacity. However, the normal distribution and use of business cards and stationary identifying the employee's or representative's name, address, telephone and fax numbers and affiliation with the company shall not, by itself, be considered as advertising or otherwise publicly attributing an office to the company or its employee or representative.
 - The maintenance of any office or other place of business in the state that does not strictly qualify as an "in-home" office as described above shall, by itself, cause the loss of protection.
 - Entering into franchising or licensing agreements; selling or otherwise disposing of franchises and licenses; or selling or otherwise transferring property pursuant to such a franchise or license by the franchisor or licensor to its franchisee or licensee within the state.
 - Conducting any activity other than those protected activities, which is not entirely ancillary to requests for orders, even if such activity helps to increase purchases.

The United States Supreme Court

On June 18, 2007 the United States Supreme Court denied the petitions for certiorari to review the decisions of the Supreme Court of West Virginia in MBNA and the Supreme Court of New Jersey in Lanco.

Some believe that the Supreme Court's denial of certiorari should be taken at face value as a denial of certiorari – nothing more, nothing less. It merely means that the holding in Quill is the last holding of the Supreme Court on the issue of substantial nexus. It also means that, at least in West Virginia and New Jersey, the holding in Quill is limited to sales and use tax, and that each court's decision is the law of the land in that state. The denial should not mean that economic nexus is necessarily acceptable under the Commerce Clause of the United States.

Others believe that the denial creates uncertainty and when combined with the aggressive positions of the states and the Multistate Tax Commission (MTC) who will indubitably, view the failure of the Supreme Court to grant certiorari as an opportunity to expand their attempts to impose taxes based on economic nexus.

On the face of it, the implications of these decisions for financial accounting purposes should be limited to those companies doing business in New Jersey and West Virginia with facts similar to those faced by the taxpayers in the instant case. For example, a company with business in West Virginia clearly may no longer have a 'more likely than not' position for not filing a return in West Virginia under a theory that the MBNA decision is unconstitutional. In other situations, the FIN 48 nexus determination is dictated by the facts of the particular case and the analogous authority available from New Jersey and West Virginia, and as a result, companies should consider the ramifications of these decisions in determining the proper application of FIN 48.

Taxpayers should continue to consider income/franchise tax nexus requirements on a state-by-state basis by looking at applicable state statutes, regulations and case law.

Pending Federal Legislation

On April 28, 2005, House Bill H.R. 1956 (The Business Activity Tax Simplification Act of 2005) was reintroduced in the United States House of Representatives. This bill would prohibit states from imposing a net income tax or other business activities tax on an entity without physical presence in the state, including a tax imposed or measured by gross receipts, gross income, or gross profits; a business license tax; a business and occupation tax; a franchise tax; a single business tax or a capital stock tax; and any other tax imposed on a business for the right to do business in a state or measured by the amount or results of business activity conducted in the state. It would not apply to a transaction tax.

On June 28, 2006, The House Judiciary Committee agreed to report out H.R. 1956.

On July 25, 2006, with an assist from other opponents, members of the Washington U.S. congressional delegation were successful in their effort to get H.R. 1956 pulled from the House floor schedule.

Physical presence would also be established by:

1. using a person, other than an employee, in the state on more than 21 days during the taxable year to establish or maintain a market, unless they performed the same function for at least 1 other business during the year; or
2. leasing or owning tangible personal property or real property in a state for more than 21 days during the taxable year.

The presence of property would not count if the property was in the state to be:

1. assembled, manufactured, processed, or tested by another person, or used to furnish a service to the owner or lessee by another person;
2. distributed by mail for marketing or promotional purposes; or
3. used ancillary to an otherwise protected activity.

The “more than 21 days” requirement is replaced by a “1 day” requirement for:

1. sale within a state of tangible personal property, where delivery of the property originates and is completed within the state;
2. performance of services that physically affect real property in the state;
3. a live performance in the state before a live audience of more than 100 individuals; or
4. a live sporting event in the state before more than 100 live spectators.

On June 28, 2007, Senators Charles Schumer (D-N.Y.) and Mike Crapo (R-Idaho) unveiled legislation (S. 1726) that would codify, at the federal level, what states could consider taxable economic activity within their borders. This legislation, if enacted into law, would require physical presence in a State for a business to be subject to income tax.

The action came after the U.S. Supreme Court denied review June 18, 2007 to two cases challenging the constitutionality of state taxation of out-of-state companies that lack a physical presence within the state under the Commerce Clause (*FIA Card Services NA v. West Virginia Tax Commissioner*, U.S., No. 06-1228, cert. denied June 18, 2007, *Lanco Inc. v. Director, New Jersey Division of Taxation*, U.S., No. 06-1236, cert. denied June 18, 2007).

S. 1726 is very similar to last session’s H.R. 1956 “The Business Activity Simplification Act of 2005.”

States Imposing Taxes

Every state except Michigan, Nevada, South Dakota, Texas, Washington and Wyoming impose a net income tax. The District of Columbia also imposes a net income tax.

The State of Michigan imposed a Single Business Tax through December 31, 2007. This tax was a Value-Added Tax and is not an income tax. This tax was replaced by the Michigan Business Tax on January 1, 2008. See additional information under States Currently Asserting Nexus.

The State of Nevada does not impose a corporate income tax. The state does impose a business license tax, which this tax is imposed on most businesses. The current cost is \$100.00 and is renewable annually.

The State of South Dakota does not impose a corporate income tax.

The State of Texas imposed a franchise tax for all reports due on or before January 1, 2008. For all reports due after this date, the Revised Franchise Tax-Margin Tax” applies. See additional information under States Currently Asserting Nexus.

The State of Washington imposes a Business and Occupation (B & O) tax on both the retail and wholesale transactions of tangible personal property and services. See additional information under States Currently Asserting Nexus.

The State of Wyoming does not impose a corporate income tax.

States Currently Asserting Nexus

- **The State of Michigan** The state imposed a Single Business Tax (SBT) through December 31, 2007. The SBT was a Value-Added Tax (VAT) levied on the “Services Consumed” or “Benefits Received” principle.

All entities engaged in a “business activity” in the state were subject to the SBT.

“Business activity” includes: (i) the sale of real or personal property in exchange for a tangible or intangible consideration, (ii) property rental, including both real property and personal property, and (iii) performance of a service for a fee, except services rendered as an employee, or services rendered as the director of a corporation.

The state’s nexus standards are set forth in Revenue Administrative Bulletin 1998-1.

In J.W. Hobbs Corporation v. Michigan Department of Treasury No. 254069 Court of Claims LC No. 02-116-MT (September 1, 2005), the court found that the company was not subject to the Michigan Single Business Tax (SBT) for the years prior to 1998 but was subject to the tax for the years 1998 and thereafter.

Hobbs an Illinois based company contracted with Ziegenbein & Associates a Wisconsin company to act as an independent contractor to sell its products in multiple states including Michigan. Ziegenbein employed George Piper a Michigan resident as a salesman. Piper also sold products for two other companies. Piper sold inventory from a catalog and did not keep any of Hobbs property in the state.

The court's decision that Hobbs had nexus for the years 1998 forward was based on Revenue Administrative Bulletin (RAB) 1998-1. This RAB provides that sufficient nexus for application of the SBT is presumed when a nonresident employee or independent contractor is temporarily present in Michigan for two or more days in any year performing solicitations of sales regardless of whether the company has inventory in the state.

This decision supports the Department's position that all direct selling, multi level marketing and network marketing companies have nexus for this tax if they have independent sellers in the state.

The state has notified many companies in this industry that they are subject to this tax and requested that the company complete and submit a nexus questionnaire and voluntary disclosure request. Upon receipt, the state is notifying the company that it must submit and pay any tax due and applicable interest for the past three or four years and file all future years.

One final note on the SBT. The state has not been consistent in their treatment of companies in this industry. The Discovery and Enforcement Division of the Department has informed some direct selling companies that they had nexus while informing others that they did not. Please be aware of this fact.

The Michigan Business Tax (effective January 1, 2008) is a combined income/gross receipt tax.

- **The State of Missouri** The state has taken the position that all direct selling, multi level marketing and network marketing companies having sales in their state have nexus for their franchise tax. The state's position is that the franchise tax is not an income tax thus P.L. 86-272 does not apply.

In Amway Corporation v. Director of Revenue, 794 S.W.2d 666 (1990) the court held that Amway had nexus for their income tax because its annual fee was the sale of an intangible therefore not protected under P.L. 86-272.

The state has attempted from time to time to use this case to assert nexus against other direct selling, multi level and network marketing companies that charge an annual fee to their independent sellers.

Currently the state is asserting nexus on all direct selling, multi level and networking marketing companies for their franchise tax if the company has one or more independent sellers in the state.

- **The State of Ohio** The state imposes both a corporation franchise tax and a Commercial Activities Tax (CAT).

The corporation tax is computed on both the net worth and net income. A corporation is required to pay on the base that produces the highest tax. This tax applies to all corporations having nexus in the state.

The Commercial Activities Tax became law on July 1, 2005.

This tax is measured by gross receipts on business activities in the state.

The state's position is that this tax is not a net income tax and therefore P.L. 86-272 does not apply. Therefore all direct selling, multi level marketing and network marketing companies that have independent sellers in the state are subject to this tax. For additional information see the state's web site.

- **The State of Pennsylvania** The State of Pennsylvania imposes a corporation income tax and capital stock/foreign franchise tax.

The state is asserting nexus for their capital stock/foreign franchise tax on all direct selling, multi level marketing and networking companies, even if the company is not a domestic corporation and has no property or employees in the state. The state's position is based on Clairol Inc. v. Commonwealth of Pennsylvania, 513 Pa. 74 (1986). Also see Corporate Tax Bulletin 2004-1, Regulation 56.1 and Department of Revenue Tax Update of March 1989 (Number 24).

This tax is currently being phased out and will no longer be in effect starting with tax years beginning after December 31, 2010.

- **The State of Texas** The state imposes a franchise tax. The franchise tax is a privilege tax. Corporations pay the greater of the tax on their net taxable capital or net taxable earned surplus.

The franchise tax is imposed on corporations chartered in Texas and non-Texas corporations doing business in the State.

Franchise Tax Rule §3.546 lists activities considered in determining when a corporation is “doing business in Texas”. This rule sets forth 21 specific activities that constitute doing business in the state.

The state has consistently held that all direct selling, multi level marketing and network marketing companies having 1 or more independent sellers in their state have nexus and must file and pay their franchise tax.

The Franchise Tax is computed on either the “Net Taxable Capital” (Stated Capital and Surplus) or “Net Taxable Earned Surplus” (Federal Taxable Income with adjustments).

For direct selling companies whose only contact with the state is that it has independent sellers in the state are protected under P.L. 86-272 thus, the tax is based on the “Net Taxable Capital”.

See **Franchise Tax Rule** § 3.546, **Publications** 96-114 and 94-108, **Hearings** 44,735 (200504167H), 40,927 (200210640H), 38,070 (200101099H), 32,018 (9502551H), 32,017 (9502551H), 32,016 (9502551H), 31,578 (9502H1372A01), 21,623 (8704H0813B10), 21,028 (8705H0826A08), 20,116 (8705H0826A08), 19,913 (8704H0813B10), and 18,824 (8707H0833F01) and **Rule** of August 20, 1992 (9203R1163D06) and **Letters** of December 22, 1993 (9403T1288G03), April 21, 1993 (9304L1264G11), March 23, 1993 (9303L1263A11) and February 17, 1993 (9302L1266E10).

The current franchise tax has been replaced with a “Revised Franchise Tax-Margin Tax”.

The revised tax applies to reports due on or after January 1, 2008.

The revised tax is computed by determining a taxable entity’s total revenue. From this amount the entity will choose to deduct either its cost of goods sold or total compensation, up to \$300,000 per employee, indexed for inflation. If the entity’s margin is greater than 70 percent of its revenue, the business is taxed only on its total revenue. The business then will apportion to Texas the amount of revenue

from business done in the state and will subtract any other allowable deductions to determine the entity's taxable margin.

Once the business's taxable margin is determined, a rate of 1.0 percent is applied to that margin for all taxable entities that are not statutory defined retailers or wholesalers. For a taxable entity that is statutory defined as a retailer or wholesaler, a rate of 0.5 percent is applicable.

Significant changes were made to the Revised Texas Franchise Tax-Margin Tax during the 79th Third Called Session and the 80th Regular Session of the Texas Legislature.

Changes include the imposition of the tax on most legal entities, a revised tax base and a different tax rate. In addition, there are tax discounts for businesses with less than \$900,000 in total revenue and an EZ filing option for businesses with \$10 million or less in total revenue.

For the text of the changes, see:

- House Bill, which was passed during the 79th 3rd Called Session of the Texas Legislature, and
- House Bill 3928, which was passed during the 80th Regular Session of the Texas Legislature.

The state's publication summarizing the revised franchise tax and their online calculator are being updated to reflect these changes.

All changes are effective for franchise tax reports originally due on or after January 1, 2008, with the exception of the transition final report.

A new provision of the Texas Administrative Code Franchise Tax Interpretative Rule Section 3.586, which became effective January 1, 2008. Under this Rule it would appear that absent a successful constitutional challenge, all direct selling companies would be considered a "taxable entity" under the Rule since one of the "activities" that would subject a company to the tax is "solicitation, having employees, independent contractors, agents or other representatives in Texas, to promote or induce sales of the foreign taxable entity's goods or services...." (subsection 19).

- **The State of Washington** The state imposes a Business and Occupation (B & O) tax on both the retail and wholesale transactions of tangible personal property and services.

The state provides a specific exemption from the B & O tax for direct selling, multi level marketing and network marketing companies under Rule WAC 458-

20-246. There are certain elements in the statute that must be present in order for the company to qualify for this exemption.

A company owning, renting or leasing any property, having employees or inventory or performing services of any nature by an employee or compensated third party in the state is subject to the B & O tax.

These services include maintenance and repairs, training, installation, construction contracts or “services in relation to establishing or maintaining sales in the state”.

The state is presently contacting various companies in this industry requesting that the company complete and return a “Business Activities Questionnaire”. The purpose of this questionnaire is to determine if the company has nexus in the state.

In a determination dated October 9, 2006 in the matter of Melaleuca, Inc., the court determined that the company did not qualify for the exemption under Rule WAC 458-20-246 for direct selling entities because it accepted orders directly from the customers of its independent sellers.

This case is being appealed.

The state’s current position based on the Melaleuca, Inc. decision is as follows:

If a direct selling company is not otherwise subject to the B&O tax and ***only*** makes sales to their “Independent Sellers” and retail customers must purchase product(s) from the “Independent Seller”, the state will regard the company as exempt from the B&O tax.

However, if the company makes sales directly to a retail customer that places and order via the internet, fax, telephone, or mail, the company will be responsible for payment of the B&O as follows:

- **Retailing** The company is responsible for the B&O tax on all retail sales that it had under the retail classification. These are sales made directly to a retail customer regardless of whether an independent seller receives any credit (bonus or profit) on the sale.
- **Wholesaling** The company is responsible for the B&O tax on all its sales to its independent sellers under the wholesale classification. The tax base will be the selling price (generally the wholesale price) to the independent sellers.

- **Membership Fees** If the company makes any sales to a retail customer, the membership fees that it receives will now be subject to the B&O under the services classification.

The above position is based on the company having an Agreement (a No B&O Agreement-there are different Agreements available) with the Department for the collection and payment of the State and Local sales taxes and litter tax.

If the company does not have an Agreement, all of its sales will be subject to the B&O tax under the retailing classification.

- **The Multi-State Tax Commission** The Multi-State Tax Commission recently audited a direct selling company. One of the purposes of the audit was to determine the states in which the company had nexus and was not currently filing.

The commission determined that because the company charged an annual fee to its independent sellers that purchased and sold its products, it has nexus in all states where it is not filing.

The commission's position was that this fee is the sale of an intangible (a license or distributorship) and not covered by Public Law 86-272.

States to Monitor

- **The State of Alabama** The State of Alabama imposes both an income tax and Business Privilege Tax. The Business Privilege Tax was enacted in 2000.

The Business Privilege Tax is based on the net worth of the entity and is imposed on every corporation, limited liability entity, business trust (REIT) that is doing business in the state **or** is registered/qualified to do business in the state.

In 2006, the state notified a direct selling company that it was liable for the Business Privilege Tax for the years 2000 through 2005. The state's position was that the company is "doing business" in the state based solely on the presence of its "independent sellers".

The state does not define what "doing business" means; however, there is some case law.

In an attempt to resolve this matter, additional information was immediately submitted by the taxpayer. No response, additional requests or assessment has been received from the state as of June 1, 2008.

- **The State of Connecticut** amended §12-213(a)(20) which defines their definition of “carrying on or doing business” effective July 13, 2005, for all taxable years commencing on or after January 1, 2005.

A new subsection was added which provides that a company that participates in a trade show or shows at the convention center (as defined in section 32-600(30)) shall not be deemed to be carrying on or doing business in this state, regardless of whether the company has employees or other staff present at such trade show, provided such company’s activity at such trade show is limited to displaying goods or promoting services, no sales are made, any orders received are sent outside the state for acceptance or rejection and are filled from outside this state, and provided that such participation is not more than 14 days in the aggregate during the company’s income year for federal tax purposes.

- **The State of Florida** issued Technical Assistance No. 07C1-007 on October 17, 2007. In this advisement, the Department stated “For nexus purposes, “doing business” in Florida means actively engaging in any transaction for the purpose of financial gain. Following decisions from other state supreme courts, and in light of the fact that the U.S. Supreme Court has declined to review the issue, the Florida Department of Revenue's position is that physical presence is not required to impose the state's corporate income tax.”

All companies having any type of presence in the state should monitor the state’s application of this technical advisement.

- **The State of Kentucky** amended KRS 141.010(25), the nexus standard for their corporate income tax from a physical presence standard to a “doing business” standard. This change is effective for a tax periods beginning on or after January 1, 2005.
- **The State of Maine** explained the Department’s position in their February 2008 issue of the Maine Tax Alert on the nexus standard it will use to determine whether business activity in the state is sufficient to impose corporate income tax.

Maine Revenue Service Rule 808, “Corporate Income Tax Nexus” provides that “the State Tax Assessor construes Maine law to assert the tax jurisdiction of Maine to the full extent permitted by the Constitution and laws of the United States.” Although physical presence nexus and economic nexus often occur together, the MRS considers economic nexus alone to be sufficient to impose Maine’s income tax laws.

- **The State of Massachusetts** In a decision by the Massachusetts Appellate Tax Board, the board held that the physical presence requirement for substantial nexus does not apply to income-based taxes.

The board found that out-of-state banks with no in-state physical presence had substantial nexus with the state based on their exploitation of the market and the in-state presence of intangibles.

All companies having an economic presence in the state should monitor the state's application of this decision.

See Capital One Bank and Capital One F.S.B. v. Commissioner of Revenue, Mass. App. Tax Bd., Nos. C262391 and C262598, 06/22/07.

- **The State of New Hampshire** The State of New Hampshire imposes a Business Profits Tax and Business Enterprise Tax.

In April 2003, the Department of Revenue made a determination based on the Business Activities Questionnaires requested from and submitted by Vector Marketing Corporation and its affiliated companies that the company was subject to both taxes for the years 1994-2002.

The arguments in this case surround New Hampshire Rev. §301.17, which defines independent contractor for purposes of determining nexus in the state, and Public Law 86-272, which protects out of state businesses from the imposition of a state income tax when the activities of the out of state business include only the mere solicitation of orders that are sent outside of the state for acceptance. Vector has argued without success that both of these exclude its business from the tax.

Argument #1

New Hampshire Rev §301.17 "Independent Contractor" means a person who:

- (a) Exercises an independent employment;
- (b) Contracts to do work for multiple business organizations according to his own judgments and methods and without being subject to any employer except as to the results of the work; and
- (c) Has the right to employ and direct the action of other workmen independently of such employer and freed from superior authority to say how specified work shall be done; or
- (d) Has been granted independent contractor status by the Internal Revenue Service for federal income tax purposes.

Vector argued that (d) stands alone and since the Internal Revenue Service recognizes its sellers and recruiters to be independent contractors, it is not subject to the tax.

The state argued that (a), (b), and either (c) or (d) must be satisfied in order for an individual to be recognized by the state as an independent contractor, even though the word “either” does not actually exist in the regulation. This ambiguity was recently addressed by the state when they amended the regulation to clarify that (d) by itself does not grant Independent Contractor status. The amendment was clearly the result of the state’s dealings with Vector and now defines an Independent Contractor as follows:

New Hampshire Rev §301.17 “Independent Contractor” means a person who:

- (a) Exercises an independent employment;
- (b) Contracts to do work for multiple business organizations that are not related parties;
- (c) Holds himself or herself out to the public as an independent contractor in the regular course of business; and
- (d) Meets one of the following criteria:
 - (1) Has been granted independent contractor status by the Internal Revenue Service for federal income tax purposes;
or
 - (2) Works according to his or her own judgments or methods, without being subject to any employer except as to the results of the work and, has the right to employ and direct the action of other workers independently of such employer and freed from any superior authority to say how the specified work will be done.

Argument #2

Vector argued that the activities of its independent representatives in the State of New Hampshire are protected under Public Law 86-272.

The state argues that the activities of Vector’s independent District Managers exceed that protected under P.L. 86-272.

To clarify, the district managers engaged by Vector are similar to the distributor level recognized by many other direct sales companies. Vector District Managers maintain a physical office location from which they recruit and train individuals

to solicit orders for Cutco products. This activity is in addition to the district manager pursuing personal sales. The district managers are solely responsible for all expenses associated with their business and maintaining an office, including lease payments, utilities, equipment, supplies, etc... During the term of their agreement with Vector Marketing Corporation, district managers are authorized to use the name "Vector Marketing" as part of their business trade name or style. All district managers maintain signage, phone listings and business cards with Vector Marketing on them.

At this time, Vector Marketing Corporation and its counsel have focused attention on the argument available under the state regulation. The state of New Hampshire has conceded the point that each state has the authority to set its own nexus standard, provided it does not contravene P.L. 86-272. Accordingly, Vector feels the definition of independent contractor within state regulation, prior to the amendment, is much broader than the definition under P.L. 86-272 because it specifically excludes the activities of all Vector representatives based on the fact they are recognized as such by the IRS. Vector maintains its position that the activity of all its representatives, including its independent district managers, is within the protection granted under P.L. 86-272; however, Vector believes the broader definition available under the state regulation to be the more precise argument.

On June 29, 2007, the governor signed into law H.B. 2. This amends statute RSA 77-a: 1, XII. The provisions are effective July 1, 2007.

The revised law adopts a "substantial economic presence" for purposes of "business activity" conducted within the state that results in a business entity being subject to the business profits tax.

On March 7, 2008, the New Hampshire Supreme Court ruled that the 1998 version of Rule 301.17 requires that independent contractors meet subparts (a) and (b) and either subpart (c) or subpart (d) of Rule 301.17.

- **The State of New Jersey** In a decision handed down on the New Jersey Supreme Court on October 12, 2006, the court ruled that out-of-state companies with no physical presence in the state can be taxed on their licensed goods.

See Lanco Inc. v. N.J. Div. of Taxn., N.J. No A-89, 10/12/06.

This decision is in keeping with a trend among the handful of cases around the nation that have addressed economic versus physical presence.

This decision opens up a very large base of new taxpayers for the state. It is conceivable that all you need to do is derive some economic benefit from the within the state and New Jersey can tax you.

On June 18, 2007 the United States Supreme Court denied the petition for certiorari to review this decision.

Whether the state, as well as other states, will attempt to apply this standard to direct selling, multi level marketing and network marketing companies is not known at this time.

- **The State of New Mexico** Based on the Dart decision, the state will impose both its income tax and franchise tax on direct selling, multi level marketing and network marketing companies that have the same or similar facts to this case. See in The Matter Of The Protest of Dart Industries, Inc. ID No. 02-1522410-00-3, Assessment No. 1972584, 04-03 for full explanation.

On January 1, 2008, the Taxation and Revenue Department updated its guidance on P.L. 86-272 in Administrative Ruling FYI-350.

- **The State of Oregon** On May 1, 2008, the Department of Revenue adopted guidelines for determining substantial nexus for corporate excise and income tax jurisdiction purposes. According to the new guidelines, substantial nexus does not require a taxpayer to have a physical presence in Oregon, and instead, exists where a taxpayer regularly takes advantage of Oregon's economy to produce income for the taxpayer. See Or. Dept. of Rev., Regs. § 150-317.010.
- **The State of Tennessee** The State of Tennessee imposes both an excise tax (based on net income) and a franchise tax (based on net worth). On November 8, 2004, the State Attorney General issued an opinion that Public Law 86-272 applies only to the state excise tax and does not create a safe harbor for the franchise tax. See Attorney General Opinion No. 04-159.

Whether the state asserts nexus to direct selling, multi level marketing and network marketing companies having independent sellers in the state is not known at this time.

- **The State of Vermont** In Steager v. MBNA America Bank, N.A., No. 04-AA-157 (W. Va. Cir. Ct. June 27, 2005) the Court concluded that the lack of physical presence was not determinative. The Court found that MBNA had substantial nexus based on the substantial revenue that MBNA generated from citizens of the state, the extension of credit to citizens of the state who provided payment and

that the state extended substantial benefits to MBNA by providing banking and consumer credit laws as well as access to its courts which supported the generation of income to MBNA.

Based on these factors, Court held that there was substantial nexus for the imposition of corporate net income and business franchise taxes despite the lack of physical presence.

Based on the United States Supreme Court's decision to not review, companies having an economic presence in the state should monitor the state's position going forward.

- **The State of West Virginia** In Tax Commissioner Of The State Of West Virginia v. MBNA America Bank, N.A. No. 33049 (W.V. Supreme Court of Appeals November 21, 2006), the Court determined that MBNA's systematic and continuous solicitation and promotion which produced significant gross receipts indicated a significant presence sufficient to for the imposition of corporate net income and business franchise taxes despite the lack of any physical presence.

This is just another case where the courts focused on economic presence not physical presence to determine if an entity has nexus.

On June 18, 2007 the United States Supreme Court denied the petition for certiorari to review this decision.

Companies having an economic presence in the state should monitor the state's position going forward.

- **The State of Wisconsin** In 2005, 2006 and 2007, the state notified several direct selling companies that they had nexus for its income/franchise tax. The state demanded that the companies file and pay these taxes for the prior 7 years and all future years.

The state's position was based on its opinion that the companies have "control" over their independent sellers based of its rules and procedures as set forth in its independent seller's manual.

In all cases, the only contacts with the state were that the companies had independent sellers in the state and held a voluntary sales and use tax collection agreement to administer sales taxes on behalf the independent sellers. The company had no employees or inventory nor did they own, lease or rent property of any nature or provide any services in the state during the period.

The state recently informed two of these companies that it determined neither had nexus and cancelled their proposed assessment. The other companies have appealed and a decision is pending.

Voluntary Disclosures

Each state has a voluntary disclosure program that allows taxpayers to resolve potential tax liabilities.

Companies may approach the states directly or anonymously through a third party to propose the filing and payment of the prior year's taxes.

Generally, it is in the best interest of the company to have a third party anonymously approach the state.

Amnesty Programs

From time to time, states offer an amnesty program. Generally, these programs offer another opportunity to file and pay prior years' returns and taxes. These programs generally waive penalties and limit the look-back period.

Each state has certain rules, procedures, guidelines and forms that must be used and followed. Research and understand them before you file.

Nexus Questionnaires

Many states systemically mail nexus questionnaires to companies in an effort to determine if they are subject to any of their taxes.

Do not ignore the questionnaire. However, do not fill it out. They want a response from your company. If you fail to respond, some states will make a jeopardy assessment to get your attention. These questionnaires contain questions that regardless of how you answer, your company will be found to have nexus.

Instead, read and review the state's law and regulations on nexus and any pertinent rulings and court decisions. Based on your review, draft a form letter that will be used to respond to nexus questionnaires. This letter should contain all the appropriate facts regarding the company and clearly stating the reasons your company does not have nexus in that state based on their nexus standards.

Respond in a timely manner. Do not lie; you are answering the questions under penalties of perjury.

Recently, a company that ignored a nexus questionnaire received a notice of assessment and demand for payment in excess of \$40,000. The company was then required spend thousands of dollars to appeal.

Summary

The issue of nexus for state and local gross income taxes, net income taxes, franchise taxes measured by net income, franchise taxes measured by capital, excise taxes, gross receipt taxes, value-added taxes, business activities taxes and other business taxes is a complex one.

The large numbers of court cases in this area highlight the fact that there is a tremendous degree of inconsistency among the states and that the interruption of the Commerce Clause, Due Process Clause and Public Law 86-272 are largely dependent on the specific facts and circumstances of each case.

The states are very aggressive about tax collection. Some states are focusing on new impositions and making changes to their laws, while others are expected to narrowly interpret court decisions and their own laws.

Among the state court systems, companies can expect emerging issues such as agency nexus, affiliate nexus, electronic nexus, and economic nexus will evolve in the ever-changing market place.

Companies must carefully review its operations in all states to determine what states it may be legally required to file with and to develop the appropriate action plan to minimize their overall state and local tax burden. Their process should include reviewing and monitoring court cases, rulings, law changes and obtaining professional expertise.

Selected Judicial Decisions

- Alden v. Maine, 98 U.S. 436 (1999)
- Aloha Airlines, Inc. v. Director of Taxation of Hawaii, 464 U.S. 7 (1983)
- American Trucking Associations, Inc. v. Schiener, 483 U.S. 266 (1987)
- American Trucking Associations, Inc. v. Maurice Smith, 496 U.S. 167 (1990)
- Arizona Department of Revenue v. Blaze Construction Co. (97-1536) (1999)
- Arizona Public Service Co. v. Snead, 441 U.S. 141 (1979)
- Armco, Inc. v. Hardesty, 467 U.S. 141 (1979)
- Associated Industries of Missouri v. Lohman, 511 U.S. 641 (1994)
- Barclay's Bank PLC v. Franchise Tax Bd., 512 U.S. 298 (1994)
- Borders Online, LLC v. State Board of Equalization, 2005 Cal App. LEXIS 875 (Cal Ct. App. May 31, 2005)
- Capital One Bank and Capital One F.S.B. v. Commissioner of Revenue, Mass. App. Tax Bd., Nos. C262391 and C262598, 06/22/07.
- Camps Newfound /Owatonna, Inc. v. Town of Harrison et al. 520 U.S. 564 (1997)
- Chevron Oil Co. v. Huson, 404 U.S. 97 (1971)
- Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977)
- Container Corp. v. Franchise Tax Board, 463 U.S. 159 (1983)
- Department of Taxation & Finance of New York v. Milhelm Attea & Bros., 512 U.S. 61 (1994)
- D.H. Holmes Co. v. McNamarra, 486 U.S. 24 (1988)
- Fulton Corp. v. Faulkner, 516 U.S. 325 (1996)
- General Motors Corporation v. Tracy, Tax Commissioner, 519 U.S. 278 (1997)
- General Trading Company v. State Tax Commissioner, 322 U.S. 325 (1944)
- Geoffrey, Inc. v. South Carolina Tax Commission, 437 S.E. 2d 13 (South Carolina Supreme Court, 1993), cert. denied by U.S. Supreme Court, 114 S.Ct. 50 (1993)
- Goldberg et al v. Sweet, Director of Illinois Department of Revenue, 488 U.S. 252 (1989)
- Halliburton Oil Well Cementing Co. v. Reily, 3373 U.S. 64 (1963)
- Itel Containers Int'l v. Huddleston, Commissioner of Revenue of Tennessee, 507 U.S. 60 (1993)
- Jefferson County v. Acker, No. 94-6400 (11th Circuit, 1995)
- J.W. Hobbs Corporation v. Michigan Department of Treasury, No. 254069 Court of Claims LC 02-116-MT (September 1, 2005)
- Lanco, Inc. v. Director, Div. of Taxn., N.J., No. A-89, 10/12/06
- Leathers, Commissioner of Revenue of Arkansas v. Medlock, et al., 499 U.S. 252 (1989)
- Massachusetts v. U.S., 435 U.S. 444 (1978)
- Michelin Tire Corp v. Wages, 423 U.S. 276 (1976)

- Miller Brothers v. Maryland, 347 U.S. 340 (1954)
- Minneapolis Star v. Minnesota Comm’r of Rev., 460 U.S. 575 (1973)
- National Bellas Hess, Inc. v. Illinois Department of Revenue, 386 U.S. 753 (1967)
- National Credit Union Administration v. First National Bank & Trust Co., No. 96-483 (1998)
- National Geographic Society v. California Board of Equalization, 430 U.S. 551 (1977)
- Nelson v. Montgomery Ward, 312 U.S. 373 (1941)
- Nelson v. Sears Roebuck & Co., 312 U.S. 359 (1949)
- New Energy Co. of Indiana v. Limbach, 486 U.S. 269 (1988)
- Nordlinger v. Hahn, 505 U.S. 1 (1992)
- Oklahoma Tax Commission v. Citizen Band Potawatomi Indian Tribe of Oklahoma, Sup. Ct. No. 89-1322 (1991)
- Oklahoma Tax Comm’n v. Jefferson Lines, 514 U.S. 175 (1995)
- Oklahoma Tax Comm’n v. Chickasaw Nation, 514 U.S. 450 (1995)
- Quill Corp. v. North Dakota, 504 U.S. 298 (1992)
- Scripto v. Carson, 362 U.S. 207 (1960)
- Spector Motor Service v. O’Connor, 340 U.S. 602 (1951)
- Steager v. MBNA America Bank, N.A., No. 04-AA-157 (W. Va. Cir. Ct. June 27, 2005)
- Standard Pressed Steel Co. v. Department of Revenue of Washington, 419 U.S. 560 (1975)
- Swaggart Ministries v. Cal. Bd. of Equalization, 493 U.S. 378 (1990)
- Trinova Corp. v. Michigan Department of Revenue, 498 U.S. 358 (1991)
- Tyler Pipe Industries, Inc. v. Washington State Department of Revenue, 483 U.S. 232 (1987)
- U.S. v. New Mexico, 455 U.S. 720 (1982)
- United States Steel Corporation v. Multi-State Tax Commission, 434 U.S. 452 (1978)
- Wardair Canada v. Florida Dept. of Revenue, 477 U.S. 1 (1986)
- Wisconsin Department of Revenue v. William Wrigley Jr., Co., 505 U.S. 214 (1992)