2013 SURVEY OF STATE TAX DEPARTMENTS
Survey Clarifies Nexus Policies on Web Servers, Telecommuting, and Treatment of Non-U.S. Entities

In Bloomberg BNA’s 13th annual Survey of State Tax Departments, we asked many questions aimed at clarifying each state’s position on the gray areas of corporate income and sales and use tax administration, with an emphasis on nexus policies. Every state participated in the survey.

As emerging technologies, such as cloud computing, continue to proliferate, a growing portion of the U.S. economy is operating independently of state, local, and international borders. This shift has increased the number and complexity of cross-border transactions. It has also allowed companies to reduce the number of locations in which they own property or have employees.

The survey this year focuses on the nexus consequences of internet servers, alternative work arrangements, and transactions involving non-U.S. entities.

Nexus from a Web Server

Income tax nexus results from owning a web server in their jurisdiction, according to 36 states and the District of Columbia. Several of these jurisdictions said they would find nexus even if the corporation did not make sales into the state. Twenty-six jurisdictions would find nexus for an out-of-state corporation that leased space on a third-party’s internet server located within their borders.

Having data on an in-state leased server would trigger nexus in 24 jurisdictions, regardless of whether the data was stored on the server for more or less than six months. Only 12 states and the District of Columbia said nexus would arise from using the services of a web-hosting provider with a web server in their jurisdiction.

Telecommuting

Thirty-six states, plus the District of Columbia and New York City, said income tax nexus would result for an out-of-state corporation with employees that telecommute from homes within their jurisdiction. As in prior years, most of these states said that their position would remain the same even if the corporation had made no sales in the state or the employees telecommuted for only part of their total work time.

This year, 33 jurisdictions said nexus would arise from a single telecommuter who performed back office administrative business functions, such as payroll, as opposed to direct customer service or other activities directly related to the employer’s commercial business activities. Thirty-four jurisdictions said nexus would be triggered by a single telecommuting employee who performs product development functions, such as computer coding.

Treatment of Non-U.S. Entities

At the federal level, a non-U.S. company generally is not subject to U.S. tax on business income derived in the U.S., unless the income is attributable to a permanent establishment in the U.S. The definition of “permanent establishment” varies by treaty, but it is generally defined as a place of management, an office, a construction site, or an agent of the non-U.S. company with authority to enter into contracts. At the state level, whether a non-U.S. entity is subject to tax depends on the entity having nexus with the particular state.

Most states adhere to an economic nexus rationale for income taxes, which does not require a physical presence. As a result, a non-U.S. company can achieve nexus with a state even if it lacks a permanent establishment. Only 18 jurisdictions said that they rely on “permanent establishment” criteria for purposes of making income tax nexus determinations. Another question is whether a state extends the protection afforded under Pub. L. No. 86-272 to non-U.S. entities. Pub. L. No. 86-272 prohibits the imposition of state income-based taxes against businesses engaged in the sale of tangible personal property whose activities in the taxing state are limited to the solicitation of orders. Twenty-four states said that they extend the protection to foreign commerce under Pub. L. No. 86-272 to non-U.S. entities.
2013 SURVEY OF STATE TAX DEPARTMENTS
States Specify Nexus Policies on Web Servers
Non-U.S. Entities; Address Many Other Gray Areas

INTRODUCTION

In Bloomberg BNA's 13th annual Survey of State Tax Departments, we asked many questions aimed at clarifying each state's position on the gray areas of corporate income and sales and use tax administration, with an emphasis on nexus policies. Every state participated in the survey.

New questions answered by the states this year focus on the nexus consequences of internet servers, alternative work arrangements, and transactions involving non-U.S. entities.

As emerging technologies, such as cloud computing, continue to proliferate, a growing portion of the U.S. economy is operating independently of state, local, and international borders. This shift has increased the number and complexity of cross-border transactions. It has also allowed companies to reduce the number of locations in which they own property or have employees.

As in previous years, we asked each state its position on several important trends in state taxation. We quizzed the states about their conformity to I.R.C. §338(h)(10), treatment of income arising from bankruptcy, position regarding intangible holding companies, and application of throwback and throwout rules. We also asked about other areas such as add back requirements and sourcing rules.

The sales tax policy portion of the survey asks about sourcing rules, the treatment of social media coupons, and the extent to which each state conforms with the Streamlined Sales and Use Tax Agreement (SSUTA) as of Jan. 1, 2013.

Nexus

Much of the survey is focused on clarifying each state's position with respect to specific activities that could trigger income tax or sales tax nexus. While it is fairly easy to track new legislation as states enact it, it is far more difficult to gauge how strictly each jurisdiction interprets and enforces those laws.

For state tax purposes, “nexus” generally means the threshold of contact that must exist between a taxpayer and a state before the state has jurisdiction to tax the taxpayer. The Due Process Clause of the U.S. Constitution requires that there be some minimum connection between a state and the person, property, or transaction it seeks to tax. Similarly, the Commerce Clause, which governs the taxation of interstate commerce, requires that there be a “substantial nexus” between the taxed activity and the taxing state.

Corporate Income Tax Nexus

For the Bloomberg BNA survey, we sought to identify each state's general approach to making income tax nexus determinations by asking whether its income tax nexus policy is based on physical presence or economic presence. Those states that adhere to a physical presence standard base nexus on the presence of employees or property within their borders. States that adhere to an economic nexus standard take the position that nexus can be triggered merely by making sales into the state; owning property or maintaining a payroll is not required.

Much of the survey is focused on clarifying each state's position with respect to specific activities that could trigger nexus.

In addition to constitutional protections, a federal law (Pub. L. No. 86-272, 15 U.S.C. §381 (1959)) further limits the states' power to impose net income taxes on an out-of-state business that sells tangible personal property in the state. When the company's only activity is the solicitation of orders, the law prohibits a state from imposing tax on such a business. To receive protection under the law, the out-of-state company must receive orders outside the state and fill those orders from points outside the taxing state. The U.S. Supreme Court specified the activities that constitute protected “solicitation” under U.S. Pub. L. No. 86-272 in Wisconsin Dept. of Rev. v. William Wrigley, Jr., Co., 112 S. Ct. 2447 (1992).

Despite these constitutional and federal nexus standards, states vary greatly in determining what particular activities performed within their borders might trigger income taxation.

A key constitutional question that remains undecided by the U.S. Supreme Court is whether the states

Bloomberg BNA would like to thank the state tax officials who devoted their time and attention to responding to our questionnaire.
making corporate income tax nexus determinations must use the physical presence test established by the high court in Quill v. North Dakota, 504 U.S. 298 (1992) for sales taxes.

A Shifting Standard for Income Tax Nexus

While Quill reiterated the bright-line, physical presence standard of an earlier U.S. Supreme Court decision, it left open the question of whether that standard also applied to corporate income taxes. In the absence of clear guidance from the high court, state appellate courts began providing their own answers. Almost from the time Quill was decided in 1992, the results have been varied and contradictory.

Many state appellate courts have opted to apply an economic presence test for income taxation.¹ The first of these rulings was the South Carolina Supreme Court’s decision in Geoffrey Inc. v. South Carolina Tax Dept., 437 S.E.2d 13 (S.C. 1993), cert. denied, 510 U.S. 992 (1993). In Geoffrey, Toys “R” Us paid royalty fees to Geoffrey, a Delaware holding company, for the right to use certain trademarks, trade names, and franchises in South Carolina. South Carolina assessed income tax on Geoffrey’s royalty income.

While Quill reiterated the bright-line, physical presence standard of an earlier U.S. Supreme Court decision, it left open the question of whether that standard also applied to corporate income taxes.

Protesting the assessment, Geoffrey argued that it did not do business in South Carolina and did not have sufficient nexus with the state for its income to be taxable there. But the South Carolina Supreme Court upheld the assessment. Citing Quill, the court said “the nexus requirement of the Due Process Clause can be satisfied even where the corporation has no physical presence in the taxing state if the corporation has purposefully directed its activity at the state’s economic forum.” The court noted that Geoffrey purposefully directed its activities toward South Carolina’s economic forum by consenting to and benefitting from the use of its trademarks in the state.

Accordingly, the court found that by licensing intangibles for use in South Carolina and receiving income in exchange for their use, Geoffrey had the “minimum connection” with the state that is required by the Due Process Clause.

The court also held that South Carolina’s tax on the income satisfied Commerce Clause requirements. Geoffrey argued that it had not achieved “substantial nexus” with the state as required under Complete Auto Transit v. Brady, 430 U.S. 274 (1977), because it lacked a physical presence there. But the court said that Geoffrey’s reliance on the physical presence requirement under National Bellas Hess v. Illinois Dept. of Rev., 386 U.S. 753 (1967), was misplaced. The court found that while the U.S. Supreme Court in Quill reaffirmed the vitality of the physical presence rule, the high court noted that the physical presence requirement had not been extended to other types of taxes.

Therefore, the court concluded, a taxpayer need not have a physical presence in a state for income to be taxable there.

After the U.S. Supreme Court denied the taxpayer’s petition for certiorari, several other state appellate courts found that the physical presence standard established in Quill is limited to sales and use tax nexus determinations.

While most taxpayer challenges to state nexus determinations are based on the Commerce Clause, two relatively recent U.S. Supreme Court rulings involving tort cases could support arguments based on Due Process grounds. In Goodyear Dunlop Tires Operations S.A. v. Brown, 131 S. Ct. 2846 (2011), North Carolina residents whose sons died in a bus accident outside Paris, France, filed a suit for wrongful death damages in a North Carolina state court. Alleging that the accident was caused by tire failure, they named as defendants Goodyear USA, an Ohio corporation, and three Goodyear USA subsidiaries, organized and operating, respectively, in Luxembourg, Turkey, and France. The defendants filed a motion to dismiss on jurisdictional grounds. However, the North Carolina Court of Appeals held that the state’s courts had general jurisdiction over the defendants because their tires reached the state through “the stream of commerce.” However, the U.S. Supreme Court reversed after finding that the defendants lacked the “kind of continuous and systematic general business contacts” necessary to allow North Carolina to entertain a suit against them unrelated to anything that connects them to the state.

Two relatively recent U.S. Supreme Court cases regarding Due Process may have already influenced subsequent state tax cases regarding income tax nexus.

In *J. McIntyre Mach. LTD v. Nicastro*, 131 S. Ct. 2780 (2011), the plaintiff injured his hand while using a metal-shearing machine manufactured by J. McIntyre Machinery, which was located in England. The plaintiff filed suit in New Jersey, which is the state where the injury occurred, and J. McIntyre Machinery moved to dismiss the suit on jurisdictional grounds. The company argued that no more than four of its machines were located in New Jersey. However, the New Jersey Supreme Court ruled that the company was subject to the state’s jurisdiction even though at no time had the company advertised in, sent goods to, or in any relevant sense targeted the state. The U.S. Supreme Court reversed after finding that imposing New Jersey jurisdiction on J. McIntyre Machinery violated due process because the plaintiff never established that the company directed any purposefully driven activity at the state.

These cases may have already influenced subsequent state tax cases regarding income tax nexus. For example, in *Scioto Ins. Co. v. Okla. Tax Comm.*, 279 P.3d 782 (Okla. 2012), the Oklahoma Supreme Court held that payments received by an out-of-state subsidiary from its parent, Wendy’s International Inc., under a licensing agreement for the use of trademarks and other intellectual property by Wendy’s restaurants in Oklahoma did not create sufficient nexus under the Due Process Clause to impose corporate income tax on the subsidiary.

Similarly, the West Virginia Supreme Court held in *Griffith v. ConAgra Brands*, 728 S.E.2d 74 (W.Va. 2012) that assessments against an out-of-state licensor for West Virginia corporation net income and business franchise tax, based on royalties earned from the nationwide licensing of food industry trademarks and trade names, were prohibited by the Due Process and Commerce Clauses of the U.S. Constitution.

Sales and Use Tax Nexus

In *Quill*, the court declared that for a state tax to satisfy the U.S. Commerce Clause, the potential taxpayer must have a substantial connection with the taxing state, whereas under the Due Process Clause, only “some minimum requirement” is required. In the context of sales and use taxes, the *Quill* court found that “substantial nexus” means that the potential taxpayer/collector must have a physical presence in the state and that such physical presence must be more than de minimis.

Thus, under the *Quill* rule, some direct, in-state presence — either through agents or employees, an office, or other place of business — must be in place to create the nexus that triggers the imposition of a duty to collect sales and use taxes on behalf of the state. In the absence of agents, employees, or physical location, a seller cannot be required to collect sales and use taxes.

Since 2008, several states have enacted legislation modeled on New York’s so-called “Amazon law,” which creates a presumption of nexus for out-of-state sellers that compensate state residents (“associates”) for sales made via links on their websites.

In *Overstock.com v. New York Dept. of Taxn. and Fin.*, Nos. 33 & 34 (N.Y. March 28, 2013), New York’s highest court found that the state’s internet tax requiring online retailers to collect and remit sales and use tax for soliciting business through in-state affiliates satisfies the Commerce Clause’s substantial nexus requirement because when such solicitation produces revenue for the retailer, it also creates a “physical presence” in the state.

The case centers on constitutional challenges to N.Y. Tax Law §1101(b)(8)(vi), which was adopted in 2008. The statute provides that out-of-state sellers of taxable tangible personal property or services are presumed to be New York vendors if they enter into agreements with residents of the state to refer customers to the seller. Under the law, the term “vendor” includes any person who solicits business in the state through employees, independent contractors, agents, or other representatives and, by virtue of that connection, makes sales within the state.

New York’s law extends to internet retailers, such as Amazon, that enter into agreements with in-state operators of websites — referred to as “associates” — to provide links to the retailers’ sites and compensate them on a per-sale basis. When the law was enacted, Amazon and Overstock.com filed suit, charging that it was unconstitutional on its face and as applied. The New York Supreme Court — the state’s trial court — ruled in favor of the state. On appeal, the Supreme Court Appellate Division upheld the statute while recognizing that the record did not contain enough information to allow an examination of whether the law actually discriminated against the retailers as applied.

By the time the case was before the New York Court of Appeals, Amazon and Overstock.com withdrew their “as applied” challenge and proceeded with a “facial” challenge to the statute. To win a facial challenge, the taxpayers would have had to prove that there were no circumstances under which the statute could be constitutionally applied. As a result, the court might have believed it was unnecessary to analyze the nexus effects of specific activities.

New York’s latest “Amazon” decision leaves open whether many types of online activities constitute solicitation. The lower court in *Overstock.com* said newspaper advertisements do not constitute “solicitation,” but can the same be said for Google AdWords, which are targeted to appear for specific types of searches? Adding to the confusion are the multiple ways that online affiliate marketers reach out to potential customers. Common marketing methods include blogs, comparison shopping sites, e-mail newsletters, videos, paid searches, and podcasts.

Perhaps it was this multitude of issues that prompted Colorado to adopt a different approach, which attempted to avoid the substantial nexus requirement. The state enacted a reporting requirement regime in 2010 under which online retailers otherwise lacking nexus must notify in-state customers that use tax may be due to the state, annually report to in-state customers the details of their purchases from the previous...
year, and annually report to the state details on their sales to in-state customers.

But in March 2012, a federal judge for the U.S. District Court for the District of Colorado struck down the reporting requirement as unconstitutional and issued a permanent injunction (Direct Marketing Association v. Huber, No. 1:10-CV-01546-REB-CBS (D. Colo. March 30, 2012)). The federal judge held that the law providing for the reporting requirement amounts to an impermissible discrimination against interstate commerce in violation of the dormant Commerce Clause.

Meanwhile, Congress is weighing proposals to authorize remote collection authority to states that implement minimum simplification requirements to their sales and use tax laws. The most viable of these bills appears to be the Marketplace Fairness Act (S. 336, H.R. 684), which would set a single small-business exemption level of $1 million in online sales.

**Bloomberg BNA Survey**

Bloomberg BNA’s annual survey offers insights for practitioners who must gauge whether a corporation’s activities within a state could result in a tax assessment. Because guidance, in the form of case law or statutes, setting forth the types of activities that trigger nexus and taxability is lacking in many states, this survey fills in essential details.

However, because nexus determinations are fact-specific and subject to interpretation, the states’ answers should not be relied upon as definitive policy statements. Even when a state indicates that the performance of a particular activity, by itself, would not trigger nexus, it is not always clear whether nexus might arise if any additional activity was performed in the state.

For the 13th consecutive year, Bloomberg BNA has sought to clarify each state’s position on nexus by sending questionnaires to senior state tax department officials in the District of Columbia, New York City, and the 45 states that impose a corporate income tax. Bloomberg BNA also sent questionnaires regarding sales and use tax nexus to the 46 states that impose that tax. In addition to nexus, the questionnaire asked the officials questions about their state’s tax treatment of non-U.S. entities, methods of sourcing income arising from services or intangibles, transactions involving intangible holding companies, taxes paid to other jurisdictions, certain merger transactions, and bankruptcy.

The states were also queried about their throwback/throwout rules, combined reporting regimes, and conformity to Streamlined Sales and Use Tax Agreement provisions.

For the income tax portion of the survey, every state (plus the District of Columbia and New York City), participated this year. On the portion of the survey addressing sales and use tax nexus, 39 states and the District of Columbia participated.

Full text of the questionnaire used in the 2013 Bloomberg BNA survey appears on page S-257.

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**Survey Results**

**Income Tax Nexus Policies**

We asked each state to explain its general income tax nexus policy, including whether it applies Quill (i.e., requires that a corporation have a physical presence in the state in order to create nexus) in making nexus determinations.

Thirty-five states said they do not apply Quill for income tax nexus — up from 34 last year. The jurisdictions that do apply Quill for income tax determinations are Delaware, the District of Columbia, Hawaii, Massachusetts, Nebraska, New York City, Pennsylvania, Tennessee, and Texas. But even some of these states (Hawaii, Massachusetts, Nebraska) also said their income tax nexus policy was based on economic presence.

“Quill’s physical-presence standard for substantial nexus provides clearer guidance on when a person is subject to a state’s tax, transactional or income, than a subjective economic-presence standard, said Fred Nicely, senior tax counsel for the Council On State Taxation (COST). “There is no logical reason to justify limiting Quill’s physical-presence requirement for substantial nexus to transactional taxes. Income taxes imposed at the state and local levels, especially with state and local tax laws increasingly requiring taxpayers to make adjustments to its federal income and the state and local governments using differing apportionment methodologies, are just as complicated for taxpayers to comply with.” Nicely added that it concerns him that “even states indicating they use Quill’s physical-presence standard will often stretch what constitutes an ‘agency relationship’ to assert an out-of-state taxpayer has a physical presence in the state.”

**Trailing Nexus**

This year, Bloomberg BNA expanded its questions regarding state nexus enforcement policies to include queries about “trailing nexus,” which is nexus that exists after a corporation begins to cease operating within a jurisdiction’s borders.

“Trailing nexus certainly has become a more visible issue within the state-tax community during the last few years, both among taxpayers and states,” said the MTC’s Shimkin. “Formal issuance of state guidance has increased over the past several years, but the number of states with specific guidance is low,” he added.

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**Thomas Shimkin, Director of the Multistate Tax Commission’s Nexus Program**

Thirty-five states said they would find nexus for the entire taxable year (but no more), for a corporation that stops an activity during the year that once created nexus. Only Indiana said trailing nexus would extend beyond the taxable year. “One year seems reasonable to me as a benchmark for states without specific guid-
ance, but a state may have unique considerations that dictate a different policy," said Shimkin.

But Nicely questioned the fairness of trailing nexus policies. "A determination that a person has substantial nexus for a given tax should be based solely on that tax's measurement period," he said. "While a tax agency may want to audit a taxpayer's records to confirm there was no substantial nexus creating activities during a tax's measurement period, there is no justification for a state to argue it can impute nexus from prior and current activities of a taxpayer for X years in the future."

Many of the states that enforced trailing nexus said that their determination did not depend on the magnitude of the nexus-creating activity (e.g., three salesperson visits resulting in the sale of a used car, versus three CEO visits resulting in the sale of a petroleum super tanker).

The jurisdictions that said they do not enforce trailing nexus were Mississippi, New Jersey, New York City, Texas, and Vermont.

**Income Tax Nexus-Creating Activities**

Much of the survey is devoted to posing questions addressing whether certain activities or relationships would, by themselves, create sufficient nexus to subject a corporation to a state's income-based tax. When determining whether the listed activity or relationship creates nexus for a corporation, states were asked to assume that each item on the list was the only activity or relationship the corporation had in the state, other than activities protected by Pub. L. No. 86-272.

The responses to the survey questions were consistent with those of prior years. As in the past, very few of the activities Bloomberg BNA described drew unanimous agreement from the responding states as to whether they created nexus. While some differences are to be expected, the survey shows a high level of variation among the states.

**Web Server Nexus**

Income tax nexus results from owning a web server in their jurisdiction, according to 36 states and the District of Columbia. It appears that there are differing rationales underlying the states' conclusion. Some states focus on the presence of the out-of-state corporation's data. Others focus on the presence of property. Iowa explained that "physical presence is not required for corporate income tax nexus per [the] Iowa Supreme Court decision in KFC Corporation." But Vermont said "ownership of an internet server creates nexus because its in-state presence requires either ownership or lease of real property."

Georgia, Louisiana, and Maryland were among the several jurisdictions that said nexus would result from the presence of a web server even if the corporation did not make sales into the state.

Twenty-six jurisdictions would find nexus for an out-of-state corporation that leased space on a third-party's internet server located within their borders. Having data on an in-state leased server would trigger nexus in 24 jurisdictions, regardless of whether the data was stored on the server for more or less than six months.

From the perspective of the cloud provider, the states responses that a company would have an income and/or sales and use tax collection obligation by virtue of owning a server in the state is not surprising, said Kendall Houghton, a partner with Alston & Bird in Washington, D.C. "The key issue is whether ownership of the server (and/or licensing of software) creates taxable nexus. Many states have taken this position in formal rulings on the basis that server is tangible property, the presence of which is more than de minimis, and thus satisfies Quill," she said.

The key issue is whether ownership of the server (and/or licensing of software) creates taxable nexus. Many states have taken this position in formal rulings on the basis that server is tangible property, the presence of which is more than de minimis, and thus satisfies Quill.

KENDALL HOUGHTON, A PARTNER WITH ALSTON & BIRD IN WASHINGTON, D.C.

But, from the cloud computing purchaser's perspective, the issues become even more challenging and nuanced, said Matthew Hedstrom, a senior associate with Alston & Bird in New York. "Since most cloud computing services involve software, and hosting of such software on servers, the question becomes whether purchasing cloud-based services results in taxable presence," he explained. "Under Quill, the issue would be whether the purchaser would be deemed to own or lease tangible personal property."

"The states' positions may not withstand challenge by taxpayers when you consider that any nexus inquiry is highly fact-intensive," added Hedstrom. "And despite the various state responses in this regard, taxpayers would have a number of arguments that merely purchasing cloud services does not create substantial nexus. For one, even assuming that the ownership or lease of a server would constitute a taxable presence, whether a purchaser owns/controls/possesses an interest in the software or the server simply by purchasing cloud services is a gray area, subject to considerable debate, and likely, again, a fact-intensive inquiry. Some states have formally acknowledged this point," he said.

Only 12 states and the District of Columbia said nexus would arise from using the services of a webhosting provider with a web server in their jurisdiction. One of these states was Tennessee. It explained "the corporation is conducting business in Tennessee through a web-hosting provider which creates nexus in Tennessee regardless of whether the corporation makes Tennessee sales."

"From an income tax perspective, asserting nexus over an out-of-state company because a company merely possesses data and/or uses the services of a provider with a server located in that state raises constitutional concerns, even from a Due Process perspective," said Houghton. "In many instances the purchaser of the cloud-service has no knowledge of the location of the server and has not purposefully availed itself of the state in which the server is located," she said.
“In light of recent authorities, including *Griffith v. ConAgra Brands*, 728 S.E.2d 74 (W.Va. 2012), *Goodyear Dunlop Tires Operations v. Brown*, 131 S.Ct. 2846 (2011) and *J. McIntyre Machinery, Ltd. v. Nicastro*, 131 S.Ct. 2780 (2011), one has to wonder how a state would defeat a Due Process challenge considering that those cases generally stand for the proposition that lack of purposeful direction will not satisfy Due Process, said Hedstrom. “For example, under *ConAgra*, if licensing trademarks did not establish nexus when the licensor lacked control over the location of the ultimate sale of products bearing that trademark, it would seem bizarre that an expense-producing activity such as the purchase of cloud-based services could create substantial nexus when the company purchasing the cloud-based service lacks control over the ultimate location of the server(s) providing the services. Taken to its logical extreme, a company could be taxable in any state in which a service provider is located or states in which it provides services. The fact pattern would also appear inconsistent with the authorities addressing economic presence under a Commerce Clause analysis.”

The states’ positions [regarding nexus resulting from web servers] may not withstand challenge by taxpayers when you consider that any nexus inquiry is highly fact-intensive.

MATTHEW HEDSTROM, A SENIOR ASSOCIATE WITH ALSTON & BIRD IN NEW YORK.
Cloud Computing or Software as a Service (SaaS) Transactions

The states still appear to be grappling over their positions on the nexus consequences of activities related to cloud computing. As compared with 2012, more jurisdictions said that nexus would arise from cloud computing activities. Providing access to software via the internet to in-state customers and hiring independent contractors to perform set-up or configuration services within their jurisdiction is sufficient to create nexus, 32 states said — up from 30 states in 2012.

Cloud-based service providers would also trigger nexus by allowing employees to solicit services within their jurisdiction, according to 32 states — up from 29 states last year.

Nexus would also result for cloud-based service providers that lacked a physical presence within the jurisdiction, but had a substantial number of customers with billing addresses in the state or earned a substantial amount of revenue from customers in the state, 16 jurisdictions said — up from 14 states in 2012.

A company that offers services via the cloud would achieve nexus by renting space on a server located in the jurisdiction, 27 states said — up from 25 states last year.

Telecommuting

Thirty-six states, plus the District of Columbia and New York City, said income tax nexus would result for an out-of-state corporation with employees who telecommute from homes within their jurisdiction. Joining these states for the first time was Virginia, which had for years taken the position that telecommuting would not trigger nexus. This year, Virginia explained that “nexus requires at least one positive apportionment factor. If the corporation made no sales in Virginia, it would only have nexus if it had a positive property or payroll factor.”

As in prior years, most states said nexus would result from a telecommuting employee even if the corporation had made no sales in the state or the employees telecommuted for only part of their total work time. The states that nexus would not be triggered from telecommuting employees were Indiana, Kentucky, Maryland, Mississippi, and Oklahoma.

This year, Bloomberg BNA expanded its questions to see if the states would alter their positions based on the type of activities being performed by the telecommuting employee. Thirty-three jurisdictions said nexus would arise from a single telecommuter who performed back office administrative business functions such as payroll, as opposed to direct customer service or other activities directly related to the employer’s commercial business activities.

But nexus would not result in Tennessee, which said that “a person living in Tennessee and doing work that does not involve contact with Tennessee customers or direct promotion of business in Tennessee, such as payroll, accounts payable, or planning projects for out-of-state headquarters would not result in nexus if no other Tennessee nexus activities exist.”

Thirty-four jurisdictions said nexus would be triggered by a single telecommuting employee who performs product development functions, such as computer coding.

For Maryland, the determination of nexus based on a telecommuter “depends on whether [a] portion of [the] residence is used exclusively for business, is reimbursed by the corporation, is used to host meetings, or is used to store property of the corporation.”

![Income Tax Nexus from Telecommuting Employees](image)
Nexus Treatment of Non-U.S. Entities

One of the new topics that the survey addresses this year is the state tax treatment of non-U.S. entities. “Even more than their domestic counterparts, foreign companies have a steep learning curve when it comes to state taxes,” said David Fruchtman, who is of counsel with Horwood Marcus & Berk in Chicago. “When a foreign company enters the U.S. market, its U.S. sales volume is small, its state tax liability insignificant and its knowledge of U.S. sub-national taxes essentially nonexistent. At this point, a foreign company’s failure to comply with state tax obligations often will go undetected by state tax agencies.” “Unfortunately,” said Fruchtman, “even after generating meaningful amounts of U.S. sales and state tax liabilities, foreign businesses often remain unaware of their state tax obligations. As a result, these companies may have significant multistate tax exposures before they are genuinely aware of their liability for these taxes.”

At the federal level, a non-U.S. company generally is not subject to U.S. tax on business income derived in the U.S., unless the income is attributable to a permanent establishment in the United States. The definition of “permanent establishment” varies by treaty, but it is generally defined as a place of management, an office, a construction site, or an agent of the non-U.S. company with authority to enter into contracts. At the state level, taxation of a non-U.S. entity depends on if the entity has nexus with the particular state.

Most states adhere to an economic nexus rationale for income taxes, which does not require a physical presence. As a result, a non-U.S. company can achieve nexus with a state even if it lacked a permanent establishment. Only 18 jurisdictions said that they rely on “permanent establishment” criteria for purposes of making income tax nexus determinations.

Another question is whether a state extends the protection afforded under Pub. L. No. 86-272 to non-U.S. entities. Pub. L. No. 86-272 prohibits the imposition of state income-based taxes against businesses engaged in the sale of tangible personal property whose activities in the taxing state are limited to the solicitation of orders. Twenty-four states said that they extend the protection to foreign commerce under Pub. L. No. 86-272 to non-U.S. entities.

Unfortunately, even after generating meaningful amounts of U.S. sales and state tax liabilities, foreign businesses often remain unaware of their state tax obligations. As a result, these companies may have significant multistate tax exposures before they are genuinely aware of their liability for these taxes.

David Fruchtman, of counsel, with Horwood Marcus & Berk in Chicago.

But the protection under Pub. L. No. 86-272 is limited to income-based taxes. A non-U.S. entity could lack a permanent establishment but have some connection with a state that makes it subject to franchise-level taxes, which typically are not based on how much income the entity earns, and could be substantial in some cases, said Jamie Yesnowitz, a principal with Grant Thornton LLP in Washington, D.C. “That result is likely a surprise for entities that summarily determine that the 1120F filing ensures that nothing need be done on the state tax side,” Yesnowitz added. Thirteen states said a franchise tax or other non-income based tax would apply to a non-U.S. entity that is not subject to federal income tax and only files federal form 1120F.

“The survey demonstrates the state income tax hazards confronting foreign-based businesses, too many of which are neither complying with nor planning for state income taxes,” said Fruchtman. “The states have long sought to shift the burden of their income taxes to out-of-state businesses. Now, as borders of all kinds become less significant to both commerce and taxation, the states’ interest in taxing foreign businesses is continually increasing.”
General Activities

Registering to do business is sufficient to trigger nexus in 13 jurisdictions. These jurisdictions are Connecticut, District of Columbia, Florida, Idaho, Kansas, Kentucky, Louisiana, Massachusetts, Missouri, New Jersey, New Mexico, Pennsylvania, and Rhode Island. But COST’s Fred Nicely questions the validity of this position. “A person registered to do business with a state’s secretary of state is not, on its own, a sufficient showing of nexus under either the Due Process Clause or the Commerce Clause,” he said. That is how Texas decided the issue in Rylander v. Bandag Licensing Corporation, 18 S.W.3d 296 (Tex. App. 2000), he noted.

Ownership/Leasing of In-State Property

Only Tennessee said that owning raw land within its borders would not trigger nexus. The state explained that its answer assumes that “no use is made of the land and that it produces no income or loss.”

Minnesota, Oregon, and West Virginia were the only states that said they would not find nexus for an out-of-state corporation that stored inventory within their borders. Iowa said that it generally would find nexus from property located in the state, but has an exemption for property stored at a distribution facility.

The states were less likely to find nexus where company cars were provided to sales representatives than if cars were provided to employees. Thirteen states said nexus would arise from allowing a sales representative to drive a company car within their borders. Forty-two states indicated that nexus would be triggered from allowing an employee to drive a company car within their jurisdiction.

“Federal Pub. L. No. 86-272, does provide some protection for property located in the state used by salespersons to solicit sales of property,” said Nicely. “For example, a business owning or leasing an automobile for use by a sales person in compliance with Pub. L. No. 86-272 may potentially have substantial nexus with a state; however, the federal law prevents that state from subjecting the business to its income tax based on that factor alone.”

Ownership of In-State Pass-Through Entities

Ownership of an interest in most types of pass-through entities is sufficient to create nexus in nearly every state. But Tennessee, Vermont, and West Virginia agreed that nexus would not result from owning an interest in an entity that is disregarded for federal income tax purposes.

Only five states — Connecticut, Georgia, Tennessee, Vermont, and West Virginia — said they would not find nexus from an ownership interest in an investment LLC or partnership. All but six states said nexus could arise from owning a non-management interest in an LLC. Two states — Vermont and West Virginia — said a general partnership interest would not trigger nexus.

“The ownership of a passive investment in a business, such as a limited partnership interest, should not create substantial nexus for the owner,” said Nicely. “It should be treated in the same manner as a person owning common stock in a corporation.” Nicely noted that in BIS LP Inc. v. Director, Div. of Taxation, 26 N.J. Tax 489 (2011), the court found a foreign corporation that owned 99 percent of a limited partnership operating in the state, but owned no other New Jersey assets, was an
investment company that was not liable for the state’s corporation business tax.

The ownership of a passive investment in a business, such as a limited partnership interest, should not create substantial nexus for the owner. It should be treated in the same manner as a person owning common stock in a corporation, Fred Nicely, Senior Tax Counsel for the Council on State Taxation (COST).

Licensing Intangibles

Nearly every state that said nexus would arise from licensing trademarks to related entities also indicated that they would find nexus from licensing trademarks to unrelated entities. The sole exception was Maryland, which said nexus would not result from licensing trademarks to unrelated entities with locations in the state.

Similarly, most states said nexus would result from receiving a management fee from an entity with a location within their borders. For most states, the answer remained the same whether the management fee was paid by a related or unrelated entity. Only Louisiana, Maryland, and Oklahoma said they would find nexus for management fees paid by related entities, but not find nexus for management fees received from unrelated entities.

Licensing canned software to in-state customers would trigger nexus in nearly half the jurisdictions. "Licensing of trademarks or other types of intangibles should not, on their own, create substantial nexus," said Nicely. For example, the West Virginia Supreme Court in Griffith v. ConAgra Brands, 728 S.E.2d 74 (W.Va. 2012), recently affirmed this position, he noted, when it held that the receipt of royalties related to the use of trademarks and trade names, some of which were used in West Virginia, did not give rise to corporate income tax nexus.

Employee Activities—Sales Related

Reimbursing sales staff for the costs of maintaining an in-home office would trigger nexus in 25 states. But it is important to note that federal Pub. L. No. 86-272 protects certain sales solicitation activities that may otherwise create substantial nexus for a person, said Nicely. “The U.S. Supreme Court’s decision in Wisconsin Dept. of Revenue v. William Wrigley, Jr., Co., 505 U.S. 214 (1992), provides the Court’s interpretation of that law and the restrictions it imposes on state income taxation.”

Soliciting services for six or fewer days would trigger nexus in every state but Hawaii, Massachusetts, Oklahoma, Rhode Island, Vermont, and Virginia.

Attending a trade show for 14 or fewer days is enough to trigger nexus in nine states. California, New York City, and Texas each said they had a special exclusion for trade show participants.

Employee Activities—Non-Sales Related

Conducting job fairs, hiring events, or other recruitment activities would trigger nexus in 20 states. Thirty-four states said nexus would arise from having employees hire, supervise, or train other employees within their borders.

“While these non-sales type activities may not be protected by Pub. L. No. 86-272, such activities must still satisfy the Due Process and Commerce Clause nexus bars,” Nicely said. The recent U.S. Supreme Court cases of Goodyear Dunlop Tires Operations v. Brown, 131 S.Ct. 2846 (2011) and J. McIntyre Machinery, Ltd. v. Nicastro, 131 S.Ct. 2780 (2011) demonstrate that for a state to seek general jurisdiction over a person, the person must have continuous and systematic business contacts with the state and the person must purposefully avail itself of the privilege of conducting activities with the forum state, he said. Nicely added that states should refrain from asserting nexus where the activity is not directly related to conducting the business or to establish or maintain a market in the state (e.g., the presence of a telecommuting employee that is only for the benefit of the employee, not the employer).

Some states have provided some quantitative measurements for when the state may assert substantial nexus in these situations; however, overall qualitative factors also must be considered in determining whether a person has substantial nexus with a state, Nicely said.

Activities of Unrelated Parties

The states generally agreed that several types of activities performed by unrelated parties were sufficient to create nexus. These activities included fulfillment services, debt collection, credit checks, and installation services.

The general agreement among the states on this issue appears to highlight the suspicion with which most taxing jurisdictions view third-party arrangements. But it is important that states at least consider whether there is an agency relationship when evaluating the activities of third-parties, said Nicely.

Although the states were asked to assume that the services were being performed by an "unrelated party," at least one state refused to make that assumption. "Although the facts state that the third parties are ‘unrelated,’ it appears that there may be an agency relationship that would create nexus for the principal,” Tennessee said.

Distribution and Delivery

A corporation whose trucks travel through the state no more than six times a year would trigger nexus in California, Florida, Illinois, Iowa, Louisiana, Michigan, Minnesota, Nebraska, Pennsylvania, Texas, and Wisconsin.

Other states said nexus would not result until the trucks travel through their jurisdiction 12 or more times during the year. These states were Missouri, New Mexico, North Dakota, and Utah. Twenty-two states said that driving trucks through their jurisdiction was not sufficient to create nexus.
Financial Activities/Transactions

All but 11 jurisdictions said nexus could result from issuing credit cards to in-state residents. California said nexus would depend on whether the corporation generates receipts in excess of the factor presence threshold it adopted for tax years beginning on or after 2011 (i.e., the lesser of $500,000 or 25 percent of total sales).

“It is important that states carefully consider the Due Process and Commerce Clause restrictions on asserting nexus based on ‘receipts’ and other indicators of economic activity in the state,” said Nicely. He added that an ‘economic presence’ standard provides no clear guidance for businesses, and the sole use of ‘factor presence’ standards are constitutionally suspect.

Transactions With In-State Printers

Most of the states agreed that nexus would arise from leasing personal property or owning raw material located at a printer’s facility. But the states were closely divided over whether quality control visits to a printer would trigger nexus.

Several states provide explicit exceptions or exemptions for a person owning property in a state for use by an in-state printer, said Nicely.

In addition to nexus, the survey addressed several other gray areas regarding state corporate income tax. This year, Bloomberg BNA asked each jurisdiction how it treated non-U.S. entities for corporate income tax purposes. Many of the queries focused on the state compliance obligations of a non-U.S. entity that is exempt from federal tax, but subject to a state’s corporation income tax as a result of meeting substantial nexus requirements.

Tax Computation for Non-U.S. Entities

Sixteen states said they require non-U.S. entities in this situation to compute the state’s tax liability by first completing a “pro forma” federal tax return or computing federal income. California explained that a federal pro forma return is “[n]ot required, but may be helpful.” Utah clarified that a pro forma return would be applicable “where a worldwide combined election is made and the income and apportionment factors of foreign corporations are therefore included in the combination.”

A non-U.S. entity could lack a permanent establishment but have some connection with a state that makes it subject to franchise-level taxes which typically are not based on how much income the entity earns, and could be substantial in some cases. That result is likely a surprise for entities that summarily determine that the 1120F filing ensures that nothing need be done on the state tax side.

JAMIE YESNOWITZ, A PRINCIPAL WITH GRANT THORNTON LLP IN WASHINGTON, D.C.

Only five states said that a non-U.S. entity must use a starting point other than federal taxable income (Mississippi, New Jersey, North Dakota, Oregon, and Pennsylvania).

Ten jurisdictions said that their corporate income tax would apply to the non-U.S. entity’s apportioned worldwide taxable income. Thirteen jurisdictions said they use federal source rules to determine the taxability of nonbusiness income.

Income Taxes: Sourcing Of Services, Intangibles, Cloud Computing

For years, nearly all of the states conformed to §17 of the Uniform Division of Income for Tax Purposes Act (UDITPA) in determining if sales, other than sales of tangible personal property, are taxable within their jurisdiction. The provision provides that such sales are sourced to the state in which the greatest proportion of the income-producing activity is performed. Income-producing activity is determined according to the taxpayer’s costs of performance.
While most states adhere to the cost-of-performance rule, jurisdictions differ in the way that the sourcing method is applied. The majority of these states use an all-or-nothing approach, in which all of the receipts are sourced to the jurisdiction in which most of the cost of performance occurs. Twenty-two jurisdictions said they use a plurality method, which looks to whether income-producing activity is performed in one state more than in any other state. Seven states said they use a proportionate method or pro rata approach, in which receipts are sourced to each state where the cost of activity occurs: Colorado, Delaware, Hawaii, Kentucky, North Dakota, Ohio, and Wisconsin.

Fifteen states said they use a market-based sourcing approach, in which the receipts are sourced to the states according to factors such as where the customer is located or where the services are performed.

### Sourcing Receipts from Cloud Computing

We asked the states how they characterize and source receipts from in-state customers that access an out-of-state corporation’s software via a third-party’s cloud infrastructure. The receipts from such transactions are characterized as “other than tangible personal property” and sourced according to the cost of performance method, 13 jurisdictions said — up from 10 last year. (Arizona, District of Columbia, Kansas, Hawaii, Massachusetts, Missouri, Nebraska, New Mexico, North Dakota, Oregon, Tennessee, Virginia, and West Virginia).

Twelve states — up from 11 last year — said they characterize the receipts as “other than tangible property,” but use a market-based sourcing method in which the in-state customers’ receipts are added to the numerator of the corporation’s sales factor to the extent that the customers used the software within the jurisdiction. These states were Alabama, Florida, Georgia, Iowa, Kentucky, Maine, Massachusetts, Minnesota, North Carolina, Rhode Island, Utah, and Wisconsin.

These 10 jurisdictions said they characterize the receipts from cloud-based transactions as sales arising from “tangible personal property”: Colorado, the District of Columbia, Florida, Indiana, Kentucky, Massachusetts, Michigan, Minnesota, Pennsylvania, and West Virginia.

Fifteen states and the District of Columbia said they would deem the customer’s billing address to be the place of use for purposes of calculating the sales factor when no other information is available. These states were Alabama, Colorado, Florida, Hawaii, Indiana, Iowa, Kentucky, Maine, Maryland, Minnesota, North Carolina, Pennsylvania, Rhode Island, Utah, and Virginia.

Given the uncertainty in this area, Bloomberg BNA also asked the states to cite the guidance taxpayers should refer to in the event that an alternative apportionment methodology is invoked. Twelve states — one more than last year — said they had no written guidance available on alternative apportionment.

This year, Bloomberg BNA asked each jurisdiction to specify the burden of proof the taxpayer must meet to invoke the alternative apportionment formula and the state’s burden of proof to require it. Twelve states said the burden of proof for a taxpayer seeking to invoke alternative apportionment is clear and convincing evidence. Michigan and West Virginia said the taxpayer's burden of proof is preponderance of the evidence. Several of the states said they use both burdens of proof in deciding whether to allow a taxpayer to use an alternative apportionment formula. Other jurisdictions said they adhered to neither standard. Colorado and Maryland explained that allowing the use of alternative apportionment is within the tax department’s discretion. To challenge the department’s denial of the use of an alternative apportionment, a taxpayer would need to prove that the tax agency abused its discretion, Colorado explained.

When the tax agency seeks to require a taxpayer to use an alternative apportionment formula, the agency’s burden of proof is clear and convincing evidence, eight states said. These states were California, Florida, Illinois, Iowa, Kentucky, Pennsylvania, Rhode Island, and Utah. The states that said the tax agency’s burden of proof is a preponderance of evidence were Arkansas, Colorado, Michigan, and West Virginia.

### Combined Reporting

As more states move to adopt combined reporting regimes, some important differences have emerged in the ways that states apply unitary business concepts. Answers to fundamental questions, such as how to determine the combined group, vary from state to state.

Nearly all of the states that permit or require combined reporting said they use a definition of “unitary business” to determine which entities must be included within a combined group. Exceptions include Colorado, Iowa, Kentucky, and New York.

Sixteen jurisdictions said they use an ownership threshold to determine which entities must be included within a combined group.

Water’s-edge reporting is the default method for determining the composition of a combined group, 15 states said. Only California, Idaho, Montana, Nebraska, and North Dakota said they use worldwide reporting as the default method.

Among the jurisdictions that said a combined group must exclude members with 80 percent of business activity outside of the U.S. were Arizona, Colorado, the District of Columbia, Illinois, Indiana, Michigan, North Carolina, and West Virginia.

### State Tax Addbacks

On another portion of the survey, the states identified taxes that they disallow as deductions and require taxpayers to add back to their tax base when calculating the corporate income tax. Nearly every state indicated that they require taxpayers to add back to taxable state level income, income taxes imposed by their own jurisdiction.

All but nine states said they require taxpayers to add back to taxable income, taxes paid to other states. These states were Arkansas, Colorado, Hawaii, Illinois, Iowa, Louisiana, Nebraska, Rhode Island, and Tennessee. Twenty-five states said they require taxpayers to add back taxes paid to other countries. Only nine states said they require the add back of other states’ gross receipts taxes.
I.R.C. § 338(h)(10) Elections

The survey included questions regarding the state tax treatment of I.R.C. §338(h)(10) elections. For federal tax purposes, sellers and purchasers may jointly elect under I.R.C. §338(h)(10) to treat a qualifying stock purchase as a sale of assets by a target subsidiary, followed by a tax-free liquidation of the subsidiary under I.R.C. §332. Federal S corporation shareholders also may make such elections. Bloomberg BNA asked the states to clarify their conformity to the federal rules, the treatment of gain on the deemed sale, the effect on the apportionment formula, and the resulting filing obligations.

Forty-five states said that they conform to the federal treatment of I.R.C. §338(h)(10) elections for C corporations, and 40 states said they conform for S corporations. Only Arkansas and Hawaii said that they require a separate election to be made at the state level.

Bankruptcy Issues

The states were also asked if they conformed to the federal tax treatment of discharge of indebtedness income resulting from bankruptcy. For federal tax purposes, I.R.C. §108 allows debtors in bankruptcy to exclude from income the discharge of indebtedness. If such an exclusion is provided, the taxpayer must reduce specific tax attributes, including adjusted basis of property, to the extent discharge-of- indebtedness income is excluded from gross income. Each state was asked to specify whether it conformed to federal provisions that exclude debt discharge from income, reduce tax attributes, and permit taxpayers to reduce basis. The survey also asked whether federal tax attribute treatment is binding for state tax purposes.

Most of the states indicated that they conform to the federal exclusion of discharge of indebtedness income, reduction of tax attributes, and election to reduce basis. Exceptions were Connecticut, Minnesota, Mississippi, and Montana. Connecticut explained that it does not follow I.R.C. §108(i). Minnesota explained that the deferred income is required to be added back, but the taxpayer is allowed to decrease Minnesota net income for discharge of indebtedness in subsequent years to the extent that the income was included in net income in a prior year.

Intangible Holding Companies

The survey asked the states to indicate their tax treatment of royalty payments made by an in-state corporation to an out-of-state intangible holding company. As in previous years, the Bloomberg BNA survey reveals that the states are attacking these plans with a variety of approaches, including denying the deduction for the royalty payment, requiring unitary reporting, finding that the out-of-state subsidiary had nexus based on the subsidiary’s licensing activities (a Geoffrey-type approach), or finding that the out-of-state subsidiary had nexus as a result of licensing intangible property in the state (i.e., a Geoffrey-type approach). But only seven states — Florida, Maine, Maryland, New Jersey, New Mexico, Oregon, and Wisconsin — said they would find that the out-of-state subsidiary has nexus based on the in-state parent’s activities.

Twenty-two states said they would require unitary reporting.

Throwback/Throwout Rules

Twenty-four states said they would use a throwback rule to tax receipts that are sourced to a destination state with which an in-state corporation lacks nexus. Arizona, Delaware, Iowa, and Virginia are among the states that said they do not have a throwback rule. In these states, sourcing sales to jurisdictions to which the taxpayer lacks nexus could result in nowhere income.

Only Illinois, Maine, New Mexico, and West Virginia said they had a throwout rule (i.e., require multistate corporations to exclude from the denominator of the sales factor sales attributable to a state in which the corporation lacks sufficient nexus to subject it to the state’s income-based tax). Illinois said its throwout rule applied to sales of services.

Sales Tax Policies: Sourcing, Software, and Social Media Coupons

Bloomberg BNA asked the states about the sourcing method they use for interstate and intrastate transactions. Most states said they use destination-based sourcing (i.e., the location where the customer takes delivery is the place of the sale) for both interstate and intrastate transactions involving tangible personal property.

The states were also queried as to whether the method by which canned software is delivered from a remote seller to an in-state purchaser affects whether it is characterized and taxed as tangible personal property. Twenty-six states said the method of delivery does not affect whether the item is taxed as tangible personal property. The 11 jurisdictions that said that the delivery method did affect the classification of an item as tangible personal property were Arkansas, California, the District of Columbia, Florida, Georgia, Iowa, Maryland, Missouri, Nevada, Rhode Island, and Virginia.

Sales Tax Treatment of Cloud Computing

Fifteen states said their sales tax would apply to fees paid by in-state customers to remotely access canned or prewritten software that is hosted on a web server. Included among these states were Arizona, Colorado, Hawaii, Idaho, Indiana, Michigan, New Mexico, New York, Ohio, Pennsylvania, South Dakota, Texas, Utah, Vermont, and Washington.

Sourcing Remotely Accessed Software

Of the 15 states that said remotely accessing software is taxable, most indicated that the sales are sourced to the location where the software is used. But others, such as New Mexico, North Dakota, Rhode Island, and Tennessee, said they source such sales according to the location of the server.
Social Media Coupons

Nearly every state agreed that social media coupon companies, such as Groupon or LivingSocial, would not achieve taxable nexus with its jurisdiction by allowing their coupons to be redeemed at in-state retailers or restaurants. The only exceptions were the District of Columbia and West Virginia.

Taxable Amount of Social Media Coupons

Sixteen jurisdictions — the same as last year — said at the time an item is purchased and the social media coupon is redeemed, the retailer is required to collect tax on the full value of the item purchased (e.g., sales tax would be imposed on a full-purchase price of $100 even though the customer actually paid $50 as a result of the certificate). An equal number of states said they would require the retailer to collect tax on only the discounted value of the item purchased (e.g., sales tax would be imposed on a discounted purchase price of $50 even though the full value of the meal was $100).

Disclosure of Discounted Price

Twenty states — up from 17 last year — said they require retailers to collect sales tax on the full value of an item purchased using a social media coupon if the coupon does not disclose the discounted price.

Sales Tax Nexus-Creating Activities

Unrelated Distribution Center

Twenty-nine states said sales tax nexus would result for a corporation that makes remote sales into the state and stores and ships items from an in-state distribution center. The states reaching the opposite conclusion were Indiana, Maine, Nevada, Vermont, and West Virginia.

Virginia did not answer the question, but explained that it enacted legislation in 2012 that “confers nexus if a commonly controlled person maintains a distribution center in Virginia that facilitates the delivery of TPP sold by the out-of-state dealer.”

Internet Activities

Eighteen states — one less than last year — said a remote vendor that enters into affiliate agreements with one or more residents in the state would trigger nexus if sales attributable to all such arrangements totaled less than $10,000 for the year. Twenty-one states said they would find nexus under these circumstances if annual sales attributable to the affiliate arrangements totaled $10,000 or more. Georgia noted that when referrals from in-state sources exceed $50,000 during a 12-month period and the referral source earns sales commission, the remote seller is a “dealer” and has to collect sales tax.

Eleven states said that an out-of-state internet retailer has nexus with their state if the retailer enters into an agreement with an in-state website operator to host advertisements directing consumers to the retailer’s website, and the website operator is paid each time the ad is displayed (per impression). Fifteen states said the retailer would have nexus if the website operator is paid each time a consumer clicks on the ad and buys a product from the retailer (per conversion).

Activities With Affiliates

Nearly all of the states agreed that nexus would result for a remote retailer that accepted returns or made exchanges of items that were purchased from an affiliate’s in-state stores. Nineteen states said nexus would arise for a corporation that is part of a controlled group with an affiliated entity that was physically located in their state.

Making remote sales into a state and allowing customers to redeem loyalty points for merchandise at an in-state affiliate’s stores will trigger nexus in 30 states, according to the survey results.

Web Servers

Almost all of the states indicated that owning a web server within their borders would result in nexus. Most of the states agreed that nexus would arise regardless of whether the corporation owned or leased the in-state web server. Factors such as whether or not the corporation maintained an exclusive lease of the server or merely shared space on it with other unrelated entities did not alter most of the states' finding of nexus.

Two exceptions were New Jersey and Wisconsin, which both indicated that nexus would arise from an exclusive lease of a server, but not from sharing space on a server with unrelated entities.

Whether the corporation’s data was on the in-state server for more or less than six months did not alter the states’ conclusions.

One strategy a company might consider to avoid a nexus determination would involve a leasing subsidiary. “Many companies have leasing subsidiaries that lease everything from office equipment to fleet vehicles to fork lift trucks,” explained Maryann Gall, a state tax consultant with MB Gall Tax. “I would put the leased server in that sub which has no connection to the retail sales activities and take a ‘no nexus’ position if the retail subsidiary received a nexus questionnaire from a state tax department.”

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**Maryann Gall**, State Tax Consultant with MB Gall Tax

Many companies have leasing subsidiaries that lease everything from office equipment to fleet vehicles to fork lift trucks. I would put the leased server in that sub which has no connection to the retail sales activities and take a “no nexus” position if the retail subsidiary received a nexus questionnaire from a state tax department.

But many states — 23 — said nexus would not be triggered from paying a web hosting provider with a server located in the state to provide web services enabling them to sell products over the internet. Among
the states that said this would not create nexus was Arizona, which explained that ‘‘the key inquiry is whether the Arizona third party is creating or expanding a market in this state for the remote vendor. The more indicia, the more likely the remote vendor will have nexus for the transaction privilege tax.’’

**Access to Remote Software**

Selling remote access to canned software would trigger nexus in six jurisdictions, according to the survey. These jurisdictions are Arizona, the District of Columbia, Hawaii, Massachusetts, Michigan, and North Dakota. Ohio said the question of nexus would depend on whether ‘‘the corporation owns the server that is used and it is located in Ohio.’’

**Conformity to Streamlined Sales And Use Tax Agreement**

The states were also asked questions regarding the extent to which they conform to the SSUTA as of Jan. 1, 2013. Nineteen states said they are fully compliant with Streamlined Sales and Use Tax Agreement provisions (SSUTA). Three states (Nevada, Ohio, and Utah) said they are in compliance with the SSUTA, except for sourcing. Twelve jurisdictions, including California, the District of Columbia, New York, and Pennsylvania, said they had not adopted any SSUTA provisions.

**QUALIFICATIONS**

Some states qualified their responses as follows:

**Alaska**

Alaska’s responses were based on the survey it completed in 2011. As a result, they do not reflect any subsequent policy changes made after that time.

**California**

California noted that answers to questions addressing highly factual areas, specifically relating to nexus, are necessarily general in nature and may change based upon the specific fact pattern presented and the constantly changing nature of the law regarding nexus.

Where appropriate, California said, it provided an explanation in a footnote, instead of a ‘‘yes’’ or ‘‘no’’ response. In addition, California stated that it made no attempt to address the imposition of any fee or license, filing requirements, distinctions between nexus and doing business, withholding responsibilities, or the consequences of unity and foreign commerce.

**Florida**

Florida said that nexus is a very complicated issue and, in many instances, a thorough review of the facts and circumstances of each individual taxpayer’s situation is required in order to make an accurate determination.

**Hawaii**

Hawaii noted that the views expressed in its survey response are informal opinions for general discussion purposes, subject to change without notice, and have no binding effect on the Hawaii Department of Taxation. For more information, see Hawaii Tax Information Release 2009-01.

**Indiana**

Indiana said the conclusions expressed in the survey response are those of the writer and therefore not binding on the Department of Revenue. The advice given in the survey response is based on the facts as presented and understood.

**Iowa**

Iowa noted that its survey response is an informal opinion and only applicable to the factual situation referenced and the statutes in existence at the time of issuance. Because of this the Department of Revenue could, in the future, take a contrary position.

**Louisiana**

Louisiana said that its responses to the portion of the questionnaire addressing nexus-creating activities should be considered to be general guidelines based on the scenario provided. Deviations from those scenarios might alter the determination, the state said.

Additionally, the state said its responses constitute ‘‘informal advice’’ from the Louisiana Department of Revenue, as contemplated by La. Admin. Code tit. 61, §101.D.3, which provides that informal advice does not have the force and effect of law and is not binding on the department.

**Massachusetts**

Massachusetts said that its responses to the questionnaire constituted an ‘‘information letter’’ within the meaning of the Letter Ruling Regulation, 830 Mass. Code Regs. §62C.3.2. The responses, the state said, are intended to provide general information such as the potential applicability of the Massachusetts Department of Revenue’s public written statements or well-established principles of tax law, but are not intended to provide authoritative guidance on the application of the tax laws to a specific set of facts. The responses are not a ‘‘ruling’’ or ‘‘letter ruling’’ that is legally binding on the department, the state said.

**New York**

New York’s 2012 responses were used for the 2013 survey. As a result, the responses do not reflect subsequent policy changes with respect to each answer. The Tax Department routinely publishes new and/or updated guidance on its web site, which tax practitioners can readily access to determine any changes that have occurred since 2012.

**Ohio**

Ohio noted that because the corporate franchise tax was phased out for most taxpayers, the responses now apply to Ohio’s CAT. The state said it did not answer many of the new questions concerning nexus, primarily because it has not set its policy in those areas or its policy is under review.
South Carolina

South Carolina’s 2011 responses were used for the 2013 survey. South Carolina noted that its responses to the questions regarding nexus-creating activities are formally addressed by South Carolina Department of Revenue Ruling No. 03-04 (2003). In addition, the state indicated that its answers to the questions regarding state tax addbacks are contained in Revenue Ruling No. 09-10 (2010). The responses provided to the remaining portions of the survey are the personal opinion of a department employee and should not be construed as the department’s official position regarding the issue, the department stated.

Texas

Texas noted that the Texas franchise tax is the state’s major business tax and is imposed on each taxable entity that is chartered in Texas or that does business in the state. “Taxable entity” includes a corporation, limited liability company, bank, savings and loan association, partnership (general, limited, and limited liability), business trusts, professional associations, business associations, joint ventures, and other legal entities that are organized in Texas or that do business in Texas. However, a general partnership where direct ownership is composed entirely of natural persons is not a taxable entity.

The state explained that it does not impose a corporate income tax, but does impose a franchise tax. The franchise tax is based on a taxable entity’s margin. Margin equals the least of three calculations: total revenue minus cost of goods sold, total revenue minus compensation, or total revenue times 70 percent. A taxable entity with total revenue of $10 million or less may elect to calculate its franchise tax due by multiplying total revenue times the apportionment factor times 0.575 percent.

Texas said that because parts I-X of the survey specifically ask about the state’s “income-based” tax on corporations, its responses are directed at the calculation of “margin” for franchise tax reporting purposes on taxable entities.

Wyoming

Wyoming noted that the state does not have an income tax, and its responses to the portion of the survey addressing sales tax should not be extended to income tax nexus. The state also said that it does not have a de minimis threshold that businesses must meet before nexus or a physical connection is established. “One delivery into our state, one incidence of owned or leased equipment in Wyoming or one agent operating in our state is enough to establish nexus,” the state said.