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Spotlight on Multistate Taxation: Does the Wider Adoption of "Affiliate Nexus" Statutes Expand State Sales and Use Taxing Jurisdiction Beyond Constitutional Boundaries?

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When it comes to state and local taxation, states regularly push the envelope when asserting taxing jurisdiction or "nexus" over out-of-state taxpayers. One such position that is becoming widespread in state statutes is that of "affiliate nexus," a branch of the "attributional nexus" concept. At its annual meeting this July, the Multistate Tax Commission announced the formation of a working group to draft a model affiliate nexus statute.

Not only must internet and other remote/mail order sellers be cognizant of these state laws, this latest state tax trend also applies to franchisors, financial services businesses, health care and other service providers, lessors and affiliated manufacturing and distribution operations, among others.

What is "Attributional Nexus"?

"Attributional nexus" has long been a means by which states have asserted their taxing jurisdiction over an out-of-state company based on the physical presence of an in-state actor. Although similar, so-called "click-through nexus" is distinguishable as that nexus concept relies on an in-state person, related or unrelated to the seller, providing an internet hyperlink on the person's website to a remote seller's website. Attributional nexus can be traced to the 1961 U. S. Supreme Court decision in *Scripto, Inc. v. Carson*. *Scripto* sustained Florida's imposition of a use tax collection obligation over an out-of-state seller based on the presence in Florida of independent contractors soliciting sales for the seller. Although *Scripto* was characterized by the Supreme Court in *Quill Corp. v. North Dakota* as the "furthest extension" of state taxing power, the real test of whether the physical presence of one person could be attributed to an out-of-state company to compel a tax collection or payment was established by the Supreme Court in *Tyler Pipe Industries, Inc. v. Washington* . Again, the presence of independent contractors was at issue, and the court upheld the state of Washington's tax on an out-of-state company because the independent contractors' activities were "significantly associated with the taxpayer's ability to establish and maintain a market in this state for sales."

From independent contractors and school teachers to retailers, loan originators, distributors, installers and warranty service providers, states have routinely sought to establish the requisite relationship between in-state persons and entities with out-of-state taxpayers to confer or attribute the in-stater's physical presence to the out-of-state taxpayer. While the usual target of these state efforts is the out-of-state mail order or internet seller, any out-of-state taxpayer is susceptible depending on the nature of its arrangements and activities of in-state persons, whether or not they are related by common ownership.

Until more recently, most states have solely relied on their interpretations of case law when asserting attributional nexus over out-of-state taxpayers. Now, however, an increasing number of states have enacted "affiliate nexus" statutes that establish a presumption of nexus when an in-state entity and out-of-state entity are related or commonly owned or controlled (affiliated) and share certain business attributes. The attributes relied on by the affiliate nexus statutes aggressively push the envelope of attributional nexus and are constitutionally suspect -- but nevertheless present compliance dilemmas for taxpayers.

Affiliate Nexus: The Case Law

Historically, out-of-state taxpayers typically fared well when a state asserted taxing jurisdiction based on the presence in the state of an affiliated entity. Even when an in-state affiliated retailer carried on some activities that benefited an out-of-state mail order seller, states often met with limited success when attempting to assert attributional nexus over the mail order seller. However, states have recently secured some troubling victories. Although largely a sales and use tax trend, "affiliate nexus" also can impact corporate income taxes, as evidenced by the California Superior Court decision in *Harley Davidson, Inc. v. Franchise Tax Board* that upheld the assertion of income tax nexus over affiliated out-of-state securitization entities based on the in-state presence of a dealer network and affiliated member loan origination.

The New Mexico Supreme Court in *N.M. Tax'n & Revenue Dep't v. Barnesandnoble.com, LLC* , and a California Court of Appeal in *Borders Online, LLC v. State Bd. of Equalization* , held that in-state affiliates operating retail stores aided affiliated internet sellers in establishing and maintaining markets in New Mexico and California. In *Barnesandnoble.com, LLC*, the affiliated retail entity sold gift cards that were also redeemable on the internet seller's website, the retailer had a policy of sharing customer e-mail addresses with the affiliated internet seller, both affiliated entities shared a customer loyalty program, the retailer had a policy of accepting returns of merchandise purchased by customers from the internet seller, and the retailer and internet seller used common logos and trademarks. The New Mexico Supreme Court found that these facts all contributed to the court's decision that the internet seller had nexus with New Mexico. Likewise, in *Borders Online, LLC*, the California Court of Appeal held that because the affiliated retailer had a policy of accepting returns of merchandise purchased from the affiliated internet seller, the internet seller had nexus with California for purposes of the sales and use tax.

Conversely, a federal district court in *St. Tammany Parish Tax Collector v. Barnesandnoble.com* rejected shared customer loyalty programs, gift cards and in-state retailer acceptance of merchandise returns, among other factors, as sufficient to attribute an in-state affiliated retailer's Louisiana nexus to an out-of-state affiliated internet seller. The federal court rejected a finding of nexus because the in-state retailer did not act as a sales presence for the internet seller and, although the internet seller benefited from the retailer's activities, the activities and shared programs were not shown to generate revenue for the internet seller directly as a result of the in-state retailer's activities.

Affiliate Nexus: The Statutes

Affiliate nexus statutes are not a recent phenomenon. For example, California has long had an affiliate nexus statute, which it expanded in 2012. New York, although perhaps better known for having ushered in "click-through nexus," in 2009 enacted an affiliate nexus statute asserting nexus based on the use of common trademarks and trade names by affiliates. Merely being a member of an affiliated group filing a federal consolidated return that includes a member that has nexus in the taxing state has been sufficient to impose sales and use taxes under some of the state statutes.

Beginning in 2012 and spreading considerably during the 2013 state legislative sessions, a number of states expanded existing affiliate nexus statutes or enacted new such statutes, including Alabama, California, Georgia, Iowa, Kansas, Maine, Missouri, Texas, Utah and West Virginia. Some of these statutes share two troubling similarities.

First, a number establish statutory nexus presumptions. That is, if the in-state affiliate performs certain services or activities, maintains certain facilities or the affiliates share certain common business attributes, then the out-of-state company is presumed to have nexus with the state. The burden is then on the out-of-state taxpayer to rebut the presumption by proving that the in-state affiliate's services, activities, facilities and/or common business attributes are not "significantly associated with establishing and maintaining a market in this state."

Second, the statutes employ controversial factors as presumptive alternative grounds to assert nexus. Some such controversial factors are:

1. the in-state and out-of-state affiliates share similar trademarks, trade names or logos; or
2. the out-of-state company has a franchisee or licensee operating in the state; or
3. the affiliates sell a similar line of products or have common business plans.

These presumptions are constitutionally suspect under various factual circumstances. For instance, if an in-state company displays a similar trademark or sells a similar line of products as an out-of-state affiliate, that fact, without more, should only show that the in-state company is promoting its business and not that of the out-of-state company. That in-state company is promoting its own market and selling its own products. It is not promoting the market of an out-of-state affiliate nor is it selling products for or on the account of the out-of-state affiliate simply because it displays a common trademark or sells the same products itself. Although the New Mexico Supreme Court in *Barnesandnoble.com, LLC* thought that it was a "reasonable inference" that affiliates sharing common trademarks made the in-state retailer and out-of-state internet seller indistinguishable, that similarity should not have nexus significance.

In addition, as substantive business entities carrying on economic activities, it is an axiom of the common law of taxation that the affiliates are entitled to be respected as separate entities. Thus, at a minimum, the test should be whether the use of an asset (such as a trademark) by one in-state company to promote and attract customers to its business intentionally serves as an activity that is "significantly associated with the [out-of-state company's] ability to establish and maintain a market in this state for sales." While consumers may find it difficult to distinguish between two business entities, that should be irrelevant to whether the out-of-state affiliate has nexus with the taxing state. Business activities and assets used by the in-state company to promote or enhance its business in the state should not have nexus significance for the out-of-state affiliate even if such activities or assets favorably impact the out-of-state affiliate's business.

Summary

The expansion of affiliate nexus statutes will likely increase state tax nexus controversies and increase compliance burdens for out-of-state businesses. Business planning, therefore, is essential to defending against attributional nexus challenges.

If you have any questions about how the expansion of affiliate nexus statutes may affect your business, or questions about other multistate taxation issues, please contact one of the attorneys in the Firm's Tax Department.