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# The Dance Continues: States and Multi-State Corporations Dance in and out of Real Space and Cyberspace

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Departments of revenue in cash-strapped states continue to wrestle with multi-state corporations which are equally determined to escape sales and income taxes. Corporations have become increasingly inventive in their configurations of affiliated businesses, making sales in-state but avoiding sales and income taxes. Combined with Internet transactions, the ability of states to collect sales or income taxes has gradually become murkier, though some recent court decisions have allowed greater discretion by state Departments of Revenue. At one time, a state's jurisdiction to compel a foreign corporation to collect sales or use taxes from its customers was based on physical presence and seemed clearer. The volume of online sales has continued to metastasize, consequently eroding the Physical Presence Test. Attempts by corporations to extend the Physical Presence Test to the collection of income taxes have, so far, been generally unsuccessful.

## I. INTRODUCTION

As the Internet has, and continues to, become more ubiquitous, it is useful to review how courts have analyzed the increasingly convoluted factual scenarios devised by corporations seeking to avoid paying income and sales taxes. In this article, we initially examine state income tax battles between corporations and state Departments of Revenue. We then turn our analysis to the battle of sales taxes. Among the combatants in this contest, there seems to be a "take no prisoners" attitude. Corporations configure their affiliates in ways to entirely avoid these taxes, while the states seek to have the entire configurations of affiliated companies declared a sham.

## II. STATE INCOME TAXES

Corporations have found that two configurations are particularly useful to avoid paying state income tax: (1) Trademark holding companies, and (2) Real Estate Investment Trusts (REITs). On the other hand, recent state courts have empowered Departments of Revenue by refusing to extend physical presence limits to the collection of taxes other than sales and use tax, and have permitted Departments of Revenue to compel combined or consolidated tax filings.

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### A. Trademark Holding Companies

Trademark holding companies are an effective means of avoiding in-state income tax if the holding company is located in a state that does not tax corporate income for out-of-state activity, such as Delaware. In this configuration, the trademark holding company is often a wholly owned subsidiary of the parent company. The trademark holding company generally has no employees or other business operations, other than holding and licensing the trademark. The trademark is generally acquired from the parent company for a nominal fee. The trademark holding company charges the in-state affiliate of the parent company a “reasonable” license fee for the privilege of using the trademark. The trademark licensing fee is a business expense, an eligible deduction, for the in-state affiliate and, in some cases, equals the exact amount of reportable in-state income. In addition, the trademark holding company may lend money to in-state retailers owned by the parent company, which will generate interest that is also deductible for income tax purposes.

Trademark holding companies were at the center of a tax decision in North Carolina that involved nine major retailers, including Abercrombie & Fitch (A&F), Limtoo, and Victoria’s Secret.<sup>1</sup> All of these trademark holding companies (“Taxpayers”) were incorporated in Delaware, which does not have corporate income tax.<sup>2</sup> Each Taxpayer entered into a licensing agreement with an affiliate of the parent company that made sales in the state of North Carolina.<sup>3</sup> The licensing agreement called for royalties paid to the trademark holding companies to be between 5% and 6% of gross revenue from the in-state operating units.<sup>4</sup> The Taxpayers had no employees, equipment, or supplies and shared office space at the primary office address in Delaware with 670 other unrelated companies.<sup>5</sup> For the years in question, the royalties charged by the trademark holding companies effectively eliminated the income tax liabilities of A&F in North Carolina.<sup>6</sup> At the time, the Taxpayers licensed stores from over 130 locations in North Carolina.<sup>7</sup>

The Limited, the parent company, developed and cultivated intangible intellectual property in the form of trademarks, trade names, service marks and goodwill.<sup>8</sup> Related expenditures reduced federal and state income taxes

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1. See *A&F Trademark, Inc. v. Tolson*, 605 S.E.2d 187 (N.C. Ct. App. 2004). David L. Baumer was hired by A&F Trademark, Inc. and Victoria Secret Stores, Inc. as an expert witness for the Taxpayers.
  2. *Id.* at 188–89. Each of the nine retailers was a wholly-owned, non-domiciliary subsidiary of The Limited, an Ohio corporation. *Id.*
  3. *Id.*
  4. *Id.* at 189.
  5. *Id.* at 189–90.
  6. *Id.*
  7. *A&F Trademark*, 605 S.E.2d at 189.
  8. *Id.*

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of the parent company.<sup>9</sup> For example, The Limited incurred in-house legal counsel expenses that protected its marks until it incorporated the trademark holding companies in Delaware.<sup>10</sup> The marks owned by The Limited companies were assigned to the Taxpayers by the operating units located in various states at nominal or zero consideration.<sup>11</sup> Although a third party did not value the assigned marks, on appeal the Taxpayers contended the marks were worth \$1.2 billion.<sup>12</sup>

Essentially, the Taxpayers contended they did not do business in North Carolina and, therefore, their profits, nearly equal to their revenue, were not taxable income in North Carolina.<sup>13</sup> When the licensing fees (5% to 6% of gross revenue) were imposed on the operating units located within North Carolina, nothing changed in the day-to-day retail operations of the related retail companies, no actual checks were sent, and no funds were physically transferred.<sup>14</sup> Some overages received by the Taxpayers were loaned back to the retail units in the form of notes, allegedly, charging market interest rates.<sup>15</sup> No attempts were made to collect any of these notes and, indeed, they were marked on company records as “Do Not Collect.”<sup>16</sup> Combined payments by the retail stores to Taxpayers in 1994 exceeded \$301 million in royalties and \$122 million in interest.<sup>17</sup> Royalty and interest charges accounted for 100% of the taxable incomes of the affiliated retailers.<sup>18</sup> Since no tax return was filed for 1994, the Secretary gave notice to the Taxpayers of its proposed assessment of corporate franchise and income tax.<sup>19</sup> At an administrative hearing in 2000, the Secretary issued a final decision of the proposed assessments against the Taxpayers, but assessed no penalties.<sup>20</sup> The Tax Review Board decision was affirmed in its entirety in Wake County Superior Court.<sup>21</sup>

Taxpayers raised two issues on appeal to the North Carolina Court of Appeals: (1) Taxpayers were not “doing business” as required under the rele-

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9. *Id.*

10. *Id.*

11. *Id.*

12. *Id.*

13. *A&F Trademark*, 605 S.E.2d at 189.

14. *Id.*

15. *Id.*

16. *Id.*

17. *Id.*

18. *Id.*

19. *A&F Trademark*, 605 S.E.2d at 190.

20. *Id.*

21. *Id.*

vant statutory provisions;<sup>22</sup> and (2) the North Carolina Department of Revenue's tax assessment was unconstitutional under the Commerce Clause of the United States Constitution.<sup>23</sup>

### 1. Doing Business

Taxpayers contended they were not doing business in North Carolina because they did not transact business in the state.<sup>24</sup> Nevertheless, the court referred to the Administrative Code's adopted definition of "doing business," which encompassed "owning, renting, or operating business or income-producing property in North Carolina including . . . trademarks and trade names."<sup>25</sup> According to the North Carolina Supreme Court, "construction adopted by administrators who execute and administer a law in question is one consideration where an issue of statutory construction arises."<sup>26</sup> Despite this, the Taxpayers contended the Administrative Code had improperly interpreted section 105-130.3.<sup>27</sup> In short, the North Carolina Court of Appeals noted the true intent and purpose of the statute overwhelmingly negated, and made implausible, the Taxpayers' statutory construction.<sup>28</sup>

### 2. Commerce Clause

The Taxpayers' main contention was that the Commerce Clause of the United States Constitution forbade the imposition of taxes by North Carolina.<sup>29</sup> Essentially, this argument was based on the "dormant Commerce Clause," which is frequently interpreted to limit a state's taxing authority.<sup>30</sup> For taxes challenged under the Commerce Clause, the United States Supreme Court has articulated a four-part test: a challenged tax will be upheld if it "(1) is applied to an activity with a substantial nexus with the taxing state; (2) is fairly apportioned; (3) does not discriminate against interstate commerce; and (4) is fairly related to the services provided by the state."<sup>31</sup> Taxpayers contended no substantial nexus existed with North Carolina because they did not have a physical presence within the state. Citing *Bellas Hess* and *Quill*, Tax-

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22. *Id.*; see also 17 N.C. ADMIN. CODE 5C.0102(a) (2004); N.C. GEN. STAT. § 105-130.3 (2003).

23. *Id.*; see also U.S. CONST. art. I, § 8, cl. 3.

24. *Id.*

25. *A&F Trademark*, 605 S.E.2d at 190 (quoting 17 N.C. ADMIN. CODE 5C.0102(a) (2004)).

26. *Polaroid Corp. v. Offerman*, 507 S.E.2d 284, 293 (N.C. 1998).

27. *A&F Trademark*, 605 S.E.2d at 190.

28. *Id.* at 191.

29. U.S. CONST. art I, § 8, cl. 3.

30. *A&F Trademark*, 605 S.E.2d at 193.

31. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977).

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payers contented that taxes could not be levied upon a corporation without an office, employees, or property located in the taxing state.<sup>32</sup>

The North Carolina Court of Appeals disagreed; *Bellas Hess* and *Quill* both involved the imposition of state use taxes on out-of-state vendors, which had no physical presence in the taxing state. The court distinguished and declined to extend *Bellas Hess* and *Quill* to income tax cases, suggesting the *Quill* decision was suspect.<sup>33</sup> In *Quill*, the Supreme Court indicated the physical-presence test, while it has the advantage of clarity, was “artificial at its edges.”<sup>34</sup> Twice the Supreme Court noted that for other taxes, the physical-presence test had not been universally adopted.<sup>35</sup> The court noted that the income tax levied on the Taxpayers is based on their receipt of income and the location of intangible property, licensed by the operating units, within the state.<sup>36</sup> The nexus requirement for imposing income tax has never been premised on taxpayer activity or physical presence.<sup>37</sup>

There are other distinctions between income tax—levied once per year, based upon the use of the taxpayer’s property, and unrelated to any activity within the state—and sales tax—collected on every sale in the state.<sup>38</sup> In essence, the North Carolina Court of Appeals held that “under the facts such as these where a wholly-owned subsidiary licenses trademarks to a related retail company operating stores located within North Carolina, there exists a substantial nexus with the State sufficient to satisfy the Commerce Clause.”<sup>39</sup> The North Carolina court was cognizant that other state tax courts had ruled to the contrary, declining to follow those rulings that used the physical presence test as a constraint on the imposition of income tax.<sup>40</sup>

Reviewing the events that took place in *A&F Trademark*, the court’s analysis and decision was brilliantly prescient. The recent trend regarding state sales and use taxes has been chipping away at *Quill*, rather than extending and adopting the physical presence constraints of state income taxes. Had the Taxpayers in *A&F Trademark* prevailed, corporate income tax col-

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32. See *Nat’l Bellas Hess, Inc. v. Dep’t of Revenue*, 386 U.S. 753, 765 (1967); *Quill Corp. v. North Dakota*, 504 U.S. 298, 311 (1992).

33. *A&F Trademark*, 605 S.E.2d at 194.

34. *Quill*, 504 U.S. 298 at 315.

35. *Id.* at 314, 317.

36. *A&F Trademark*, 605 S.E.2d at 194.

37. *Id.*

38. *Id.* (citing Jerome Hellerstein, *Geoffrey and the Physical Presence Nexus Requirement of Quill*, 8 ST. TAX NOTES 671, 676 (1995)) (“[T]here are important distinctions between sales and use taxes and income and franchise taxes ‘that make the physical presence test of the vendor use collection cases inappropriate as a nexus test.’”).

39. *Id.* at 195.

40. *Lanco, Inc. v. Dir. Tax’n*, 21 N.J. Tax 200, 214 (N.J. Tax Ct. 2003).

lection would have been effectively eliminated for any corporation capable of incorporation in Delaware.

## B. Real Estate Investment Trusts

Real Estate Investment Trusts (“REITs”), established by Congress in the 1960s, are unique entities in that the dividends paid to investors are not subject to income taxes.<sup>41</sup> REITs have been attractive to chain retailers because “captive” REITs—wholly-owned by the parent company—own and rent the land and buildings that house the chain’s retail stores. The rents paid to the REITs by the individual stores are profits that can be distributed to the parent company as non-taxable distributions, while the rent is a deductible expense for the retail stores. The rent that is deductible from the in-state chain’s taxable income never leaves the company. REITs often reside in states, such as Delaware, that do not tax corporate income. REITs have become so commonly used by large chains that a number of accounting firms advertise their knowledge and use of REITs in their tax minimization offerings.<sup>42</sup>

Many of the largest chain retailers—The Limited, Kmart, The Gap and others—make use of both trademark holding companies and REITs.<sup>43</sup> These companies have been able to extract millions, and in some cases billions, of dollars from states, resulting in fewer state services.<sup>44</sup> Anecdotes abound with claims that the largest retailers, such as Wal-Mart, have been able to half the tax paid to the State of North Carolina.<sup>45</sup>

On the other hand, states have become increasingly bold in their challenges to corporate configurations designed to avoid income tax.<sup>46</sup> States have attacked REITs as a means of evading payment of income taxes through their power to order consolidation of corporate returns, often called com-

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41. *Real Estate Investment Trusts (REITs)*, U.S. SECURITIES AND EXCHANGE COMMISSION, <http://www.sec.gov/answers/reits.htm> (last visited Nov. 17, 2013).

42. *Closing State Corporate Tax Loopholes: Combined Reporting*, ILSR (June 2, 2010), <http://www.newrules.org/retail/rules/level-playing-field-taxation/combined-reporting> (“Several accounting firms market the service to their clients. PricewaterhouseCoopers, for example, provides its clients with a comprehensive plan entitled, ‘Utilization of an Investment Holding Company to Minimize State and Local Income Taxes.’”).

43. *Id.* at 2.

44. *Id.*

45. *Id.* (“A report by Citizens for Tax Justice, a Washington-based nonpartisan group, and Change to Win, a labor coalition that represents six million workers, estimated that Wal-Mart’s tax avoidance schemes helped cut its payments to state governments almost in half between 1999 and 2005.”).

46. See Sarah McGahan & Ann Holley, *The House Always Wins – At Least in North Carolina*, 53 ST. TAX NOTES 231, 233–34 (2009).

bined reporting.<sup>47</sup> Combined reporting requires the corporate taxpayer to combine its profits from related subsidiaries, including REITs and trademark holding companies, as a first step in determining the taxable income potentially subject to state income taxes.<sup>48</sup> For multi-state corporations, the second step is apportioning the aggregated taxable income to in-state activity, based on some combination of property, payroll and sales. About half of all states have enacted some version of combined reporting legislation.<sup>49</sup>

Among states yet to enact combined reporting, some have granted their department of revenue discretionary power to order combined reporting. In a North Carolina case involving Wal-Mart, the parent company reorganized in 1996 and created eight subsidiaries, two of which were a property company ("PC") and a REIT 99% owned by said property company.<sup>50</sup> At the time of the reorganization, Wal-Mart transferred real property to the PC and then to the REIT via a master deed.<sup>51</sup> The master deed did not identify the real estate by metes and bounds and was never recorded in any state recording office.<sup>52</sup>

Property "owned" by the REIT was leased to the operating units (Wal-Mart stores) based on a percentage of sales; despite Wal-Mart stores typically did not sign such leases from third-party lessors.<sup>53</sup> The operating units paid rent to the REIT, which distributed its dividends quarterly via wire transfers to the PC. The REIT received the actual funds for the dividends from the PC. The net effects of these transactions were:

Rent paid to the REIT by the operating unit was deductible as an expense;

REIT income was distributed to the PC as a dividend, thus enabling it to reduce its taxable income;

As a Delaware company, the PC did not file a North Carolina income tax return;

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47. See *Wal-Mart Stores E., Inc. v. Hinton*, 676 S.E.2d 634, 650 (N.C. Ct. App. 2009).

48. A distinction must be recognized between *consolidated* tax reports to the state, which is a report of the entire operations of a parent corporation and its subsidiaries and affiliates, and a *combined* report, which is a report that includes only those entities having a nexus within the state. See McGahan & Holley, *supra* note 46, at 236 n.3.

49. *Combined Reporting of State Corporate Income Taxes: A Primer*, INST. TAX'N & ECON. POL'Y at 1 (2011), available at <http://itepnet.org/pdf/pb24comb.pdf>.

50. McGahan & Holley, *supra* note 46, at 231.

51. *Id.* at 231–32.

52. *Id.* at 232.

53. *Id.*

Operating units treated monies received from the PC as non-business income, not allocable to North Carolina from 1999 to 2001, and took a dividend-received deduction in 2002.<sup>54</sup>

Following an audit, the Secretary of North Carolina's Department of Revenue combined the revenue of the operating unit, the PC, and the REIT, and assessed the taxpayer approximately \$30 million in taxes, penalties, and interest.<sup>55</sup> A portion of this tax liability was attributable to the 25% under-statement tax penalty.<sup>56</sup> After the lower court (Wake County Superior Court) agreed with the Secretary's assessment, the taxpayer, unsurprisingly, appealed.<sup>57</sup> The taxpayer cited the N.C. Gen. Stat. section 105-130.6, which states in part:

If the secretary finds as a fact that a report filed by a corporation does not disclose the *true earnings* of the corporation on its business carried on in this State, the secretary may require the corporation to file a consolidated return of the entire operations of the parent corporation and its subsidiaries and affiliates, including its own operations and income.<sup>58</sup>

The taxpayer argued the sentence requires the Secretary to find its taxable income would have been different had all of the inter-company transfers been valued as if charged by unrelated, third-party firms.<sup>59</sup> In other words, the taxpayer contended the Secretary must find income distortions due to transfers that would not have occurred but-for the affiliation. At issue is the meaning of the term "true earnings." Essentially, the North Carolina Court of Appeals held that inter-company payments in excess of fair market value were merely one of several events triggering the Secretary's power to order a consolidated return.<sup>60</sup> According to the court, if the taxpayer attempted to reclassify income as non-business or non-apportionable, such reclassification could potentially distort true earnings in North Carolina.<sup>61</sup> Essentially, true

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54. *Id.*

55. McGahan & Holley, *supra* note 46, at 232.

56. *Id.*

57. Wal-Mart Stores E., Inc. v. Hinton, 676 S.E.2d 634, 638 (N.C. Ct. App. 2009).

58. N.C. GEN. STAT. § 105-130.6 (2011) (emphasis added), *repealed by* N.C. GEN. STAT. § 105-130.5A (2012). Under the earlier statute at force in this case, a consolidated return generally included only entities having a nexus in the State, while a combined return was based on the unitary relationship of the affiliated entities and may not have included all affiliated entities. *See* McGahan & Holley, *supra* note 46, at 231.

59. McGahan & Holley, *supra* note 46, at 232.

60. *Id.*

61. *Hinton*, 676 S.E.2d at 643.

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earnings were equated to the amount of income that the state could constitutionally tax under the unitary principles used in prior cases.<sup>62</sup>

This apparent new grant of state power should alarm taxpayers. Following this analysis, a corporation with affiliates would calculate its taxable income using a *combined* tax return, without requiring the state to show distortions—that is, transactions that do not comport with arms-length dealings.<sup>63</sup> Prior to legislative action, this court ruling effectively transformed North Carolina into a combined reporting state.<sup>64</sup> In this case, when the taxpayer attempted to classify income as “nonbusiness or nonapportionable,” it triggered the combined reporting of income, setting off a comparison of tax liability—with and without combined returns.<sup>65</sup>

A retroactive application of this analysis and these, seemingly, new principles could surprise a number of taxpayers.<sup>66</sup> The North Carolina General Assembly has contemplated combined reporting requirements for years,<sup>67</sup> so it is difficult to argue that taxpayers should have filed combined returns in prior years or even anticipated such a ruling.<sup>68</sup> Further, it should be noted section 105-130.14 forbids affiliated corporations from filing consolidated returns unless and until the Secretary so orders.<sup>69</sup>

On paper, North Carolina continues to be listed as a “separate” reporting state; but such a ruling by the North Carolina Court of Appeals made it unclear when combined reporting can or must be used by the taxpayer. On the other hand, had this decision favored the taxpayers, adroit use of REITs could nearly wipe out taxable corporate income because Wal-Mart was able to deduct, from its taxable income, rental payments paid to its wholly-owned subsidiaries. Substantial tax revenue hinged on whether Wal-Mart’s subsidiary configurations would be respected.

### III. SALES AND USE TAX

Jurisdictional conflicts between out-of-state sellers—mainly those online—have erupted on the issue of whether states can compel direct marketers to collect and remit sales or use tax. In early decisions, the courts had continuously ruled that some sort of physical presence was necessary for a company to be deemed doing business in a state for sales and use tax purposes, until

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62. *Id.*

63. McGahan & Holley, *supra* note 46, at 233.

64. *Id.*

65. *Hinton*, 676 S.E.2d at 643.

66. McGahan & Holley, *supra* note 46, at 234.

67. *Id.*

68. *Id.*

69. *Id.*

the ruling in *National Bellas Hess v. Department of Revenue*.<sup>70</sup> Today, direct marketers do business online, through the Internet, and shipments of actual product take place through the U.S. Post Office or a common carrier. The physical-presence test arguably began with *National Bellas Hess*,<sup>71</sup> and was refined in *Quill*.<sup>72</sup> The United States Supreme Court was concerned that without the physical-presence constraint, small mail order firms would be deterred from interstate commerce because of the need to comply with multiple jurisdictions.<sup>73</sup>

The bright-line Physical Presence Test developed by the United States Supreme Court's holding in *Quill* has been muddled through a number of concepts created to deal with corporate brinksmanship.<sup>74</sup> Substitutes for physical presence emerged in later courts' decisions in the form of *indirect presence*. For years, the required physical nexus has been achieved when the direct marketer employs independent sales agents (attributional nexus) who have a physical presence in the taxing state.<sup>75</sup> Following this logic, it would seem that the required physical nexus can be presumed satisfied if independent sales agents are directed by a company to make sales in the taxing state. This form of nexus is achieved when the relationship between the independent agents and the representative company is extensive.<sup>76</sup>

The Internet has created new challenges for state revenue departments and the legal system. In many instances, retailers have stores in their domicile state, but also sell their products online or through mail order outlets that are wholly-owned, but separate subsidiaries that are acting as agents of the retailers, such as the case in *Borders Online*.<sup>77</sup> In effect, corporations want to sell products offline at traditional retail outlets, but escape state taxation of their online outlets that often had contact with their offline affiliates. Some state courts have deemed cooperation between out-of-state, but online, affiliates and traditional stores, enough of a nexus to allow states to collect state sales taxes on these online purchases.<sup>78</sup> In *Borders Online*, both the in-state retail outlets and the online outlet were wholly-owned by the parent com-

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70. See *Nat'l Bellas Hess v. Dep't of Revenue*, 386 U.S. 753, 757–59 (1967).

71. *Id.*

72. *Quill Corp. v. North Dakota*, 504 U.S. 298, 317–18 (1992).

73. Bryan Mayster & Cara Griffith, *Has Quill Run Out of Ink?*, 53 ST. TAX NOTES, 743 (2009).

74. See *id.* (“But in the 17 years since *Quill*, that bright line has faded to the point that many practitioners are questioning whether *Quill* has run out of ink.”).

75. *Scripto Inc. v. Carson*, 362 U.S. 207, 213 (1960).

76. *Tyler Pipe Indus., Inc. v. Wash. Dep't of Revenue*, 483 U.S. 232, 250–51 (1987).

77. See *Borders Online, LLC v. State Bd. of Equalization*, 129 Cal. App. 4th 1179, 1197–1200 (Cal. Ct. App. 2005); see also *Tyler Pipe*, 483 U.S. at 232.

78. See *Borders Online*, 129 Cal. App. 4th at 1201.

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pany, Borders Group, Inc.<sup>79</sup> As evidence of this, dissatisfied customers of Borders Online would return their products to the traditional, offline outlets of Borders, Inc.<sup>80</sup> There was also evidence of cross-marketing activity between the Borders Online website and its offline Borders, Inc. stores.<sup>81</sup> The degree of collaboration between the in-state Borders and its online website resulting in a finding that the in-state stores were agents of the website, and thus a nexus was established.<sup>82</sup>

In *BarnesandNoble.Com* a California Superior Court held that insertion of coupons and use of bag advertising by the in-state and offline stores was not sufficient to create an in-state nexus for the online affiliate.<sup>83</sup> It appears that these cases are being decided on relatively narrow facts, but the *BarnesandNoble.com* holding claimed that the in-state affiliate was passive and thus not an agent of the online affiliate.<sup>84</sup> A similar outcome took place in *St. Tammany Parish Tax Collector* where there was contact between the in-state stores and the online affiliate, but the contact was deemed insubstantial, in spite of the common ownership of the in-state stores and the online vendor.<sup>85</sup> Apparently merely having a common name and ownership is not sufficient to establish an in-state presence for the online seller due to the actions of the in-state affiliate.

It is possible to reconcile the *BarnesandNoble.com* and *Borders* decisions with the physical presence requirement in *Quill* by recognizing that cooperation between the in-state affiliates and out-of-state websites creates an in-state nexus. The in-state nexus or presence can take place if the in-state affiliate is an agent for the out-of-state website or helps create a market for the goods of the online seller.<sup>86</sup> Simply sharing a common name is not enough.<sup>87</sup> States such as Rhode Island and New York have enacted “vendor presumption” legislation aimed at Amazon that have used affiliate marketing programs to drive sales to their websites in order to collect in-state sales taxes.<sup>88</sup> In-state affiliates receive awards or commissions for driving sales to

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79. Mayster & Griffith, *supra* note 73, at 743.

80. *Borders Online*, 129 Cal. App. 4th at 1194.

81. *See id.* at 1184.

82. *Id.* at 1201.

83. *BarnesandNoble.com LLC v. State Bd. of Equalization*, No. CGC-06-456465, 2007 WL 7281569 (Cal. App. Dep’t Super. Ct., Oct. 12, 2007).

84. *See id.*

85. *St. Tammany Parish Tax Collector v. BarnesandNoble.com*, 481 F. Supp. 2d 575, 580–82 (E.D. La. 2007).

86. Mayster & Griffith, *supra* note 73, at 744.

87. *Id.*

88. *Id.*

the website through links on the website of the affiliates.<sup>89</sup> According to these statutes, in-state presence takes place if there is an agreement between the in-state affiliate and the out-of-state vendor to pay commissions to the in-state affiliate for sales that are triggered by clicks on the in-state website.<sup>90</sup> The New York statute is conditioned upon gross revenue over \$10,000 for four or more preceding quarters.<sup>91</sup>

Although a New York Supreme Court held that New York's vendor presumption statute is constitutional, an appeal has been filed.<sup>92</sup> The constitutional challenge by Amazon, Inc. is based on the Commerce Clause and whether the in-state nexus is sufficient.<sup>93</sup> Some have argued that this New York statute and decision represent a serious erosion of the physical presence requirement that was the *raison d'être* of *Quill*.<sup>94</sup> It could be claimed that the act of providing links to the out-of-state website is merely passive and that the out-of-state website may not even control whether it approves the link on the in-state website. This would mean that once a customer clicks the link on the in-state website, the transaction is out of the control of the in-state firm, and that the function of the in-state website could be viewed as simply a passive advertisement. Advertising in a nationally distributed magazine does not create an in-state presence for the vendor, but apparently if there is a link on a website a different result takes place.<sup>95</sup>

It is argued that constitutional law, based on in-state presence, is being undermined by vendor presumption statutes. On the other hand, out-of-state vendors can avoid these conflicts by prohibiting in-state retailers from providing links that make use of the trademarks of the out-of-state vendor. It is disingenuous for the out-of-state vendor to cry "surprise" when they negotiate agreements with in-state companies to establish links and pay commissions to these companies. Fundamentally, this dispute again revolves around companies that seek to sell as much as possible in-state without paying in-state sales tax that is paid by in-state vendors with a physical presence.

#### IV. STREAMLINED SALES AND USE TAX AGREEMENT

A major claim of out-of-state vendors is that complying the state sales and use tax rules in the 44 states, and approximately 7,500 local jurisdictions, that impose sales and use taxes is unreasonable, especially for firms whose

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89. *Id.*

90. *Id.* at 745.

91. *Id.*

92. Mayster & Griffith, *supra* note 73, at 745.

93. *Id.*

94. *Id.* at 746.

95. *Id.* at 743.

sales are de minimus.<sup>96</sup> The impact of requiring all out-of-state sellers to file and pay in-state sales taxes would be a serious interference with interstate commerce. Courts have limited the right of states to impose sales taxes on out-of-state sellers to those companies with a substantial nexus, or in-state presence, partly because state law as to the items that are subject to sales tax varies, as do basic tax definitions.<sup>97</sup>

Recognizing the shortcomings of the current system, a group of states in 2000 joined together to form a Streamlined Sales Tax Project, which is governed by the Streamlined Sales and Use Tax Agreement (SSUTA).<sup>98</sup> The basic premise of the SSUTA is to make it a uniform sourcing rule that a sale takes place where the product is delivered or consumed.<sup>99</sup> To date there are twenty-two members of the SSUTA, and two more states that have achieved substantial compliance.<sup>100</sup> Essentially, SSUTA is designed to remove one of the main arguments that out-of-state vendors have for not complying with state sales and use taxes: state sales and use taxes entail heavy compliance costs. This issue arises because there is no uniformity from state to state as to basic tax law definitions.

Promoting uniformity across state boundaries, SSUTA seeks to gain agreement among member-states as to various, relevant tax definitions. State tax laws are often very complicated, making distinctions among goods subject to tax, such as food products, between prepared food and store bought groceries. Although a goal of SSUTA is reduction in-state tax compliance costs, the SSUTA is over 100 pages long.<sup>101</sup> There are several crucial principles associated with SSUTA including:

*Administration:* Member states have sole responsibility for administration of sales and use tax, which consequently means that local jurisdictions are prohibited from conducting their own individual audits. Also, sellers can register online once and comply with the sales tax laws of all member states.<sup>102</sup>

*Definitions:* SSUTA guarantees uniform definitions of commonly used tax terms, which is certainly one of the aggravating issues businesses face when they must file multiple state returns.<sup>103</sup>

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96. Ralph B. Tower, et. al, *Understanding the New Streamlined Sales Tax*, 21 INTERNAL AUDITING (2006).

97. *Id.*

98. *Id.*

99. *Id.* at 10.

100. *See State Info*, STREAMLINED SALES TAX GOVERNING BOARD, INC., <http://www.streamlinedsalestax.org/index.php?page=state-info> (last visited Oct. 30, 2013) (listing members of SSUTA).

101. Tower, *supra* note 96, at 6.

102. *Id.* at 8.

103. *Id.*

*Uniform Sourcing Rules:* As stated above, perhaps the most overriding concept propelling the SSUTA is that for all products, tangible, digital, and services, the rule is that sales should be taxed where the product is delivered or consumed, i.e. at its destination. Current law is a crazy patchwork that requires a deep understanding of tax law in each state where sales are made.<sup>104</sup>

*Tax Base:* Numerous local jurisdictions are limited to the tax base of the state in which they reside. This requirement should significantly simplify tax law compliance for retailers.<sup>105</sup>

SSUTA is based on several tax law fundamentals: sales tax applies to all in-state sales and use tax applies to sales made in-state by out-of-state firms. Clearly two flaws with the current system are that (1) some sales of out-of-state sellers in-state are not taxed, and thus they have an advantage over in-state sellers and (2) there is massive under-reporting of use tax by in-state purchasers. E-commerce in particular poses challenges for state taxation. The Internet Tax Non Discrimination Act, which prohibits new and discriminatory taxes imposed on the Internet, including state and local access taxes, was extended through 2014.<sup>106</sup> The SSUTA identification of destination as the basis for use tax is directly contrary to position of out-of-state vendor websites that have so far avoided state sales taxes, except when there is in-state cooperation by retailers or websites.

## V. CONCLUSION

Overall, the Internet has accelerated the clash between state attempts to collect taxes, and artificial constructs that provide ever-changing boundaries for state jurisdiction. State and federal courts discuss whether the presence of out-of-state vendors is insubstantial or substantial. Corporations make use of the latest court rulings to configure their arrangements of affiliates, trademark and property companies, parent companies, and real estate investment trusts. If given effect, none of the larger corporations that make use of sophisticated configurations of subsidiaries and affiliates would pay taxes. Lately, state legislatures have enacted new statutes that push jurisdiction farther and farther outward based on intangible and intellectual property. As the *Quill* decision is being undermined by various decisions, it is perhaps time to consider whether SSUTA's definition of sales taxation based on the territory where goods are used or consumed is appropriate. As noted in *Quill*, *Bellas Hess* literally spawned the mail order industry. It may be time to consider overturning both *Quill* and *Bellas Hess*.

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104. *Id.* at 10.

105. *Id.*

106. 47 U.S.C. § 151 (2008).