



September 26, 2006

Establishing Physical Presence: Borders Online Case Reveals Court Disharmony in Applying Physical Presence Rules to State Sales Taxes

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(The following article originally appeared in the September 26, 2006 edition of State Tax Notes.)

Fiscal Fact No. 67

Introduction

The issue of sales and use tax collection on remote sales has plagued policymakers since the proliferation of catalog sales in the 20th century and continues to do so with the expansion of sales made over the Internet. The issue involves competing principles of federalism, state sovereignty, and tax neutrality.

Theoretically, all sales in a state should be taxed equally, regardless of whether the goods are purchased over the Internet or at the local shop. There is a real danger, however, in allowing state governments to make out-of-state retailers their tax collection agents. Should a state's ability to efficiently administer its sales and use tax system trump a retailer's right to freely engage in interstate commerce? Do retailers that sell and ship products from out of state receive sufficient benefits to require them to collect sales or use tax? Those questions have not yet been answered to the satisfaction of state revenue officials or the business community, who are working together on the Streamlined Sales Tax Project to develop a better state sales tax system.

In the 109th Congress, Sens. Michael B. Enzi, R-Wyo., and Byron Dorgan, D-N.D., introduced legislation (S. 2152 and S. 2153) that would give congressional approval to the SSTP system. The Sales Tax Fairness and Simplification Act (STFSA) would approve state participation in the system if a state met specified requirements. Most significantly, the legislation would overturn an important U.S. Supreme Court decision that protects remote sellers.

In the case of *Quill v. North Dakota*,¹ the Supreme Court ruled that a remote seller could not be required to collect a state's use tax if it did not have a physical presence in that state. Last year, in *Borders Online v. State Board of Equalization*,² the California Court of Appeal ruled that Borders Online had to collect California use tax³ on all sales made to

California customers. In *Borders Online*, the California appeals court ruled that Borders Online was physically present in California through its sister organization, Borders Books and Music, which had many locations in California.

Borders Online was an attempt by a state court to apply the *Quill* decision. Different state courts have interpreted *Quill* in different ways, reaching divergent conclusions about physical presence in cases with nearly identical facts. That disharmony makes the *Quill* physical presence rule ripe for clarification by Congress, which has several options in designing legislation to bring much needed clarity to that issue. Even if Congress declines to approve the STFSA, it still should clarify the physical presence rules for remote collection of state sales and use tax.

Overview of *Borders Online*

In May 2005 the California Court of Appeal held that California could constitutionally compel Borders Online to collect use tax on products shipped into California from outside the state. In the opening paragraph of the decision, the court recognized the growing tension between sales and use tax administration and technological innovation: "We face with increasing frequency issues at the junction of Internet technology and constitutional principles. This is another such case."⁴

At dispute in this case was whether Borders Online, which made more than \$1.5 million in sales to California customers over the Internet in 1998-1999, could be required to collect and remit California use tax on those sales. Borders Online was not physically present in California (that is, it had no offices, tangible property, or employees in California). However, Borders Books and Music (a sister corporation of Borders Online) had many locations in California. Borders Inc., the parent corporation of both Borders Online and Borders Books and Music, allowed Borders Online customers to return merchandise and receive cash refunds at Borders Books and Music stores in California, and Borders Books and Music stores promoted the Borders Online Web site through general in-store advertising.

The Commerce Clause requires substantial nexus between a state and a taxpayer for the state to impose its taxing jurisdiction.⁵ In the context of collection of sales and use tax, the U.S. Supreme Court has ruled that retailers with no physical presence in a state do not have the required substantial nexus and are thus shielded from collecting use taxes on the state's behalf.⁶ Thus, Borders Online claimed that California could not constitutionally require it to collect California use tax on its sales to California customers because it had no offices, employees, or property in California.

The California Court of Appeal disagreed. The court principally relied on state law and two Supreme Court rulings on nexus in reaching its decision. Under California law, a retailer is obliged to collect use tax if it is "engaged in business in the state."⁷ California law defines "engaged in business in this state" as "any retailer having any representative, agent . . . or solicitor operating in this state . . . for the purpose of selling, delivering, installing, assembling, or . . . taking of orders for any tangible personal property."⁸ The State Board of Equalization argued that Borders Books and Music, by accepting returns

of Borders Online merchandise and promoting the use of Borders Online services to the customers of Borders Stores, was acting as the agent of Borders Online. The court agreed.

Having found that Borders Books and Music was operating as Borders Online's agent, the court easily dispatched the question of physical presence. The Supreme Court has ruled that sellers that have agents acting on their behalf to establish and maintain a market in a state for sales can be subjected to the state's tax jurisdiction.⁹ Though those cases were decided before *Quill*, they dealt with the separate question of whether businesses could establish nexus through the actions of their agents or salespersons. Reading *Quill* in light of those earlier cases, the court ruled that Borders Online was physically present through the actions performed by Borders Books and Music on its behalf (for example, giving cash refunds for returned merchandise and advertising for Borders Online).¹⁰

Borders Online takes its place in a growing number of state court decisions on state sales and use tax nexus. Some state court decisions have required more substantial physical presence to impose nexus while others have allowed nexus even when the facts showed the slightest amount of physical presence. I will now review those decisions.

Overview of State Court Decisions on Sales and Use Tax Nexus

Several state court decisions have attempted to apply the *Quill* physical presence standard in the context of various factual circumstances, but state courts have not always decided similar cases in similar ways. As Table 1 (next page) shows, state courts have decided that *Quill* dictates a different outcome even when the facts of the case are almost identical.

In one case (*Intercard*), 11 repair visits over four years were deemed insufficient to create nexus, but in another case (*Orvis*), 12 visits over a three-year period were deemed sufficient to create nexus. In neither case were the employees of the retailer actually engaged in the solicitation of sales, an activity that is routinely understood to generate nexus sufficient to warrant sales or use tax collection.¹¹ In fact, in only one of the cases in Table 1 was the retailer engaged in the in-state solicitation of sales (*Care Computer Systems*); in all the other cases the retailer's activities were limited to what we might define as customer service activities.

The courts in those cases struggled with two principal questions: first, the quality of the activities performed; second, the quantity of the activities performed. More often than not, those two questions come into conflict.

On the first question, the quality of activities, all the courts agreed that a slight physical presence (or a mere "toe in the water") is not sufficient to meet the Supreme Court's standard in *Quill*.¹² In other words, the definition of physical presence is not to be taken literally. If that were the case, then a retailer could be forced to collect use tax on all its sales to a state merely on the passage of its delivery truck through a state, or when one of its employees changed planes at an airport in the state. Yes, the retailer would technically

be physically present in those cases, but the physical presence was not at all related to the sales activity.

The question of quality can be clearly seen in *Care Computer Systems*.¹³ In that case, although Care's employees were not frequently present in Arizona, the court nonetheless found that their activities (solicitation, training, and leasing of property) were significant enough to find nexus.

On the second question, the quantity of activities, courts have to ask whether the presence is of sufficient quantity to require the retailer to collect use tax on all sales made to customers in the state. One can imagine a situation in which a retailer sends a technician to install purchased machinery for a customer on only one occasion. It would make no sense to force the retailer to collect use tax on all its future sales into that state simply because of one instance of significant physical presence (a "quick dip in the water").

The question of quantity can be seen in *Share International*.¹⁴ In that case, although Share sold products and collected sales tax at a three-day seminar in Florida, it was at no other time physically present in Florida even though it made many sales to customers in Florida. Despite a significant, one-time example of physical presence, the Florida Supreme Court was uncomfortable in ruling that Florida could force Share to collect use tax on all its sales to Florida customers.

Unfortunately for retailers, even though all state courts agree that more than a mere physical presence is necessary, that's where the agreement ends. Thus, retailers have no idea whether sending technicians or salespersons to a state for 1, 2, or 10 days will trigger nexus. That creates uncertainty and confusion for retailers engaged in interstate commerce and begs for a legislative solution.

The Need for Federal Legislation

The SSTP is a partnership between state lawmakers, revenue officials, and business groups. The goal is to get states to voluntarily simplify their sales and use tax systems so that Congress could be persuaded to legislatively overturn *Quill* and allow states to impose use tax collection responsibility on remote sellers.

The SSTP has made significant progress thus far. More than 20 states have conformed their laws (to varying degrees) to the Streamlined Sales and Use Tax Agreement (SSUTA), which attempts to create a harmonized sales and use tax system among the participating states.

Table 1: State Court Applications of the *Quill* Physical Presence Rule

Case	Issue	Facts	Ruling	Reasoning
<i>Borders Online v. California Board of Equalization</i>	Did Borders Online have to collect use tax on its sales to California customers?	Borders Books and Music, a separate but related company, gave cash refunds for returns of Borders Online merchandise and promoted Borders Online generally	Borders Online can be forced to collect use tax	Borders Stores, which was physically present in California, acted as Borders Online agent in helping it maintain a California market for sales
<i>In re Intercard</i>	Did Intercard have to collect Kansas use tax on sales made to Kinko's stores in Kansas?	Intercard's only presence in Kansas was sending technicians to Kinko's stores (at Kinko's request) to service card-readers 11 times during a 48 month period	Intercard cannot be forced to collect use tax	Intercard's presence in Kansas was isolated, sporadic, and insufficient to establish nexus.
<i>Arizona Department of Revenue v. Care Computer Systems, Inc.</i>	Did Care Computer Systems have to collect Arizona sales tax on its sales to Arizona customers?	Care leased personal property to two Arizona customers, had employees present to train customers approximately 21 days per year, and had one salesperson that made seven trips to Arizona in a seven-year period	Care can be forced to collect sales tax	The volume of Arizona activity was less important than its function; the trips to Arizona by Care's employees resulted in additional sales
<i>Town Crier, Inc. v. Illinois Department of Revenue</i>	Did Town Crier have to collect use taxes on its sales to Illinois residents?	Town Crier made 54 deliveries of furniture to Illinois customers (30 using its own vehicles) and, when specifically requested to do so by its customers, installed window dressings on 5 occasions, all in a 2 1/2 year period	Town Crier can be forced to collect use tax	More than slight but less than substantial physical presence required; Town Crier established a "regular presence" in Illinois
<i>Florida Department of Revenue v. Share International</i>	Did Share International have to collect use tax on its sales to Florida customers?	Share's officers were present for a seminar for three days each year for a five year period; Share collected use tax for sales made on those days to customers in Florida but did not	Share cannot be forced to collect use taxes	The slightest presence of Share was not sufficient to establish nexus to require Share to collect use tax on all Florida mail order sales

		collect on mail order sales made into the state at other times		
<i>In re Orvis Company</i>	Did Orvis have to collect use tax on its sales to New York customers?	Orvis salesmen made 12 trips into New York during a three-year period to communicate with customers and inspect retailers who sold products using the Orvis trademark	Orvis could be forced to collect use tax	Orvis' physical presence does not need to be substantial but it does need to be more than a slightest presence; requirements met by presence in New York of property or the conducting of economic activities on its behalf by its own employees

Source: Tax Foundation

The Enzi and Dorgan bills, S. 2152 and 2153, would give approval to the SSTP system. The bills would:

- overturn *Quill* protections for any remote seller making sales into a state that has adopted the SSUTA;
- impose minimum simplification standards for states that wish to join the system (including a central registration system for sellers, uniform definitions, and so forth);
- specifically exclude state corporate income taxes from the nexus provisions, and;
- create a small-business exemption.

The chief difference between the bills is the small-business exemption. S. 2152 would adopt a \$5 million sales threshold for remote collection; S. 2153 would have the Small Business Administration define small business for purposes of the act.

Table 2: Congressional Options for Clarifying *Quill*

Rule	Details	Activities that Trigger Nexus	Potential Problems
P.L. 86-272 Analogue	Only physical presence in excess of the solicitation of sales, where the sales are filled from out of state, would trigger sales and use tax collection nexus	More than traveling salesman, technicians, customer service activities, etc. Orders approved or filled in-state.	States could circumvent with other types of transaction taxes not technically covered by P.L. 86-272
Permanent Establishment rule	Only those retailers with a permanent establishment would have to collect sales and use tax	Retailers incorporated in a state, or with an office, warehouse, manufacturing	What does permanent mean? How long does a retailer have to be physically present to establish permanency?

		center, or permanent employees in-state.	Many cases could be resolved by resorting to international tax treaties
Nexus for Individual Sales rule	Retailers would have to collect sales or use tax only for those sales in which they have a directly related, even <i>de minimis</i> physical presence	Any physical presence directly associated with a sale (e.g. use of retailer's delivery trucks, customer service activities, or presence of a salesman) would trigger nexus solely for that sale	For some taxpayers with little direct physical presence, the administrative cost of filing a return might exceed the total tax paid; may be more difficult for state revenue departments to administer since each sale must be tracked for nexus generating activities

Source: Tax Foundation

There's a catch, however, with the STFSA: Not every state is moving toward amending its laws to conform to the SSUTA. Some states do not have a sales tax (Alaska, Delaware, Montana, New Hampshire, and Oregon). Others are not amending their laws for economic development reasons (Colorado and Virginia). What happens to the states outside the SSTP system if Congress approves legislation authorizing the system to move forward?

If Congress overturns *Quill* legislatively it will affect retailers in all states, not just those in the SSTP. A retailer located in Virginia that sells into an SSTP state, but has no physical presence there, will not have the protection of *Quill* unless it can claim the small-business exemption. Therefore, the revenue departments in SSTP states will be able to require retailers in non-SSTP states to collect use tax on remote sales.

That will likely be a big point of contention in future congressional debate on SSTP authorization. However Congress decides to answer that question, the thorny issues raised in the state court cases above will remain unanswered in the non-SSTP states. Thus, whether Congress chooses to authorize SSTP or not, it still must clarify and codify *Quill*.

Any legislation that clarifies *Quill* has to give clear guidance to state courts about what types of physical presence are sufficient to trigger nexus for sales and use tax collection. Several options are available, including:

- *An Analogue to Public Law 86-272*: P.L. 86-272 created a corporate income tax safe harbor for corporations whose in-state activities do not exceed the solicitation of sales of tangible personal property if the orders for sale are filled from outside of the state.¹⁵ Extending that requirement to sales and use tax nexus, a remote seller could not be forced to collect if its activities did not exceed solicitation of sales (so long as the orders are filled from out of state) as well as the sending of employees into a state for customer service activities.¹⁶ That standard would have

dictated a taxpayer victory in each case reviewed above, with the possible exception of *Care Computer Systems* (in which the retailer had leased property to customers in Arizona) and *Share* (because Share was actually filling orders inside Florida).

- *Permanent Establishment Rule*: That is the standard used for establishing corporate income tax nexus in international tax treaties. That would require an office, sales force, or other form of permanent presence to trigger tax collection nexus. Thus, occasional trips into the state to engage in nonsales activity (for example, repair, inspection, and so forth) would not constitute a "permanent" physical presence. That standard would dictate taxpayer victory in each case above with the exception of *Care Computer Systems* because the taxpayer leased its own property to Arizona customers.
- *Nexus for Individual Sales Rule*: A law providing that a state can force sales and use tax collection on sales when a retailer has a directly related, even de minimis (that is, insignificant) physical presence. The state could, for example, force collection on those sales when the retailer has an employee present for any reason. Thus, if an employee makes a service call on a piece of merchandise purchased from the employee's out-of-state company, the company would have to charge use tax on the original sale in addition to the service bill. That allows the state to collect use tax on sales when the remote seller legitimately has a physical presence in the state, however de minimis that presence is, but would restrict the state from imposing collection on the bulk of sales when the only presence is through the delivery of goods in the mail. Thus, in the state court cases above, the remote seller could have legitimately been forced to collect on those small number of sales for which they sent technicians or other employees into the state, but not on the larger volume of sales for which the remote seller had no specific physical presence.

Conclusion

The decision in *Borders Online* is the latest attempt by a state court to wrestle with the physical presence rule pronounced by the U.S. Supreme Court in *Quill v. North Dakota*. As this article has shown, state courts have not consistently interpreted *Quill*, requiring sales and use tax collection in some instances and denying it in others. The U.S. Supreme Court will not likely intervene because it explicitly left the ultimate disposition of the physical presence issue to Congress.¹⁷ Congress has several options available if it decides to legislate, regardless of whether it approves the Sales Tax Fairness and Simplification Act. It is up to Congress -- and Congress alone -- to bring some much needed clarity to the issue of sales and use tax nexus.

Footnotes

¹ 504 U.S. 298 (1992).

² 129 Cal. App. 4th 1179 (Cal. Ct. App 2005).

³ A use tax is nearly identical in operation to a sales tax, except the use tax is levied on the purchaser for using the product or service, while the sales tax is levied on the sale of a product or service. The use tax is basically designed to apply in all those situations in which the sales tax would not, that is, purchases made from sellers located in another

state.

⁴ *Borders Online*, *supra* note 2, at 1184.

⁵ See *Complete Auto Transit v. Brady*, 430 U.S. 274, 279 (1977).

⁶ See, e.g., *Quill Corp. v. North Dakota*, 540 U.S. 298, 315 (1992) ("Whether or not a State may compel a vendor to collect a sales or use tax may turn on the presence in the taxing State of a small sales force, plant, or office."); *National Bellas Hess, Inc. v. Department of Revenue*, 386 U.S. 753, 758 (1967) ("In order to uphold the power of Illinois to impose use tax burdens on National in this case, we would have to repudiate totally the sharp distinction which these and other decisions have drawn between mail order sellers with retail outlets, solicitors, or property within a State, and those who do no more than communicate with customers in the State by mail or common carrier as part of a general interstate business.").

⁷ California Revenue and Taxation Code section 6203(a).

⁸ *Id.* at section 6203(c)(2).

⁹ See *Scripto v. Carson*, 362 U.S. 207 (1960).

¹⁰ *Borders Online*, *supra* note 2, at 1199 ("These facts amply support the conclusion that Online had a representative with a physical presence in the State and the representatives activities were significantly associated with Online's ability to establish and maintain a market in the state for the sales.") (internal quotations omitted).

¹¹ See *Scripto*, *supra* note 9.

¹² See *National Geographic v. California Equalization Board*, 430 U.S. 551, 555-556 (1977). (The Supreme Court ruled that the slightest presence in California would not trigger use tax collection nexus.)

¹³ 1 CA-TX 98-0003 (July 25, 2000).

¹⁴ 676 So.2d 1362 (Fla. 1996).

¹⁵ See 15 U.S.C. section 381 (2003). For a more thorough explanation of P.L. 86-272, see Chris Atkins, *A Twentieth Century Tax in the Twenty-First Century: Understanding State Corporate Tax Systems*, Tax Foundation Background Paper #49 (September 2005), available at <http://www.taxfoundation.org>.

¹⁶ The protection of customer service activities is what makes that an "analogue" to P.L. 86-272 and not a pure copy of it. Customer service activities are not uniformly interpreted to be protected by P.L. 86-272.

¹⁷ See *Quill*, *supra* note 1, at 318. ("Our decision is made easier by the fact that the underlying issue is not only one that Congress may be better qualified to resolve, but also one that Congress has the ultimate power to resolve.")

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