



Legislative Fiscal Bureau

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May 27, 2009

Joint Committee on Finance

Paper #376

Economic Nexus Definition (General Fund Taxes -- General Sales and Use Tax)

[LFB 2009-11 Budget Summary: Page 277, #3]

CURRENT LAW

Under federal law and U.S. Supreme Court decisions, a state may not require a seller to collect and remit sales and use taxes unless the seller has a sufficient business connection (or "nexus") with the state, which is generally established by the seller having a physical presence in the state. In Wisconsin, a seller has nexus if it does any of the following: (a) owns real property in the state; (b) leases or rents out tangible personal property located in this state; (c) maintains, occupies, or uses a place of business in this state; (d) has any representative or solicitor operating in this state under the authority of the retailer or its subsidiary for the purpose of selling, delivering, or taking orders for any tangible personal property or taxable services; (e) services, repairs, or installs equipment or other tangible personal property in Wisconsin; (f) delivers goods into this state in company operated vehicles; or (g) performs construction activities in this state.

The Department of Revenue (DOR) reports that, under current law, certain separate affiliates of brick and mortar businesses in this state do not collect and remit the sales and use tax on their Internet sales to Wisconsin residents, even if the purchase is made from a computer located at the Wisconsin store. Certain businesses provide in-store kiosks for the purchase of online sales from a store's out-of-state affiliate. These brick-and-mortar businesses accept returned merchandise on the affiliate's behalf, and provide in-store credit for the dollar amount of the returned affiliate's merchandise. Current law provides that an Internet retailer is engaged in business in this state if an affiliate who has nexus with Wisconsin performs specified services on its behalf [item (d) above]; however, current law does not clearly subject these types of transactions by an online affiliate to the sales and use tax.

Under current law as enacted in 2009 Act 2, a retailer engaged in business in this state will include any retailer selling tangible personal property, items, property, digital goods, or taxable

services for storage, use, or consumption in this state, unless otherwise limited by federal law. This provision will become first effective October 1, 2009.

GOVERNOR

Expand the definition of nexus for purposes of the sales and use tax to include certain businesses that have affiliates in this state. Under the Governor's proposal, nexus would be extended to specifically include any person who has an affiliate in this state, if the person is related to the affiliate and if the affiliate uses facilities or employees in this state to advertise, promote, or facilitate the establishment of or market for sales of items by the related person to purchasers in this state or for providing services to the related person's purchasers in this state, including accepting returns of purchases or resolving customer complaints. For purposes of this provision, two persons would be "related" if any of the following apply:

a. One person, or each person, is a corporation and one person and any person related to that person in a manner that would require a stock attribution from the corporation to the person or from the person to the corporation, as defined under federal law, owns directly, indirectly, beneficially, or constructively at least 50% of the corporation's outstanding stock value.

b. One person, or each person, is a partnership, estate, or trust and any partner or beneficiary; and the partnership, estate, or trust and its partners or beneficiaries; own directly, indirectly, beneficially, or constructively, in the aggregate, at least 50% of the profits, capital, stock, or value of the other person or both persons.

c. An individual stockholder and the members of the stockholder's family, as defined under federal law, owns directly, indirectly, beneficially, or constructively, in the aggregate, at least 50% of both persons' outstanding stock value.

The Governor's proposal would become effective on the day following publication of the budget bill. Based on the administration's estimates and assuming an effective date of July 1, 2009, the proposal would increase use tax revenue by \$1,500,000 in 2009-10 and in 2010-11.

DISCUSSION POINTS

1. Under current law, a multistate business maintaining a store location in this state has nexus and is required to collect Wisconsin's sales and use tax on all sales into this state, including internet sales. To avoid sales and use tax collections for internet sales, multistate businesses have established separate entities with a physical presence in only one state. Each separate internet affiliate registers to collect and remit tax only in the state in which it resides, while the brick-and-mortar affiliate continues to collect tax in every state. DOR reports that internet retailers generally allow purchasers to return merchandise to the brick-and-mortar affiliate, exchange merchandise for sales at the affiliate's store, and some brick-and-mortar stores have set up kiosks so that customers can purchase items through the online affiliate.

2. Under current state law, nexus is extended to a retailer engaged in business in this state, including any retailer having any representative, agent, salesperson, canvasser, or solicitor operating in this state under the authority of the retailer or its subsidiary for the purpose of selling, delivering, or taking orders for any tangible personal property, items, property, goods, or taxable services. DOR argues that internet affiliates engaged in the activities described in point 1 are under the authority of the retailer as an authorized representative and must collect the sales tax; however, current law does not specifically extend nexus to such affiliated entities. Certain internet affiliates engaged in business in this state as described in point 1 argue that current law does not clearly define them as retailers engaged in business in this state and have not registered to collect and remit the sales and use tax for online purchases with nexus in Wisconsin.

3. The Governor's proposal would clarify the definition of a retailer engaged in business in this state and clearly place responsibility for collecting and remitting the use tax owed on internet purchases on the seller rather than the buyer if the seller is an affiliate of a brick-and-mortar store in this state and if the owner holds a 50% stake in both companies.

4. Under current law, sales by online retailers without nexus in Wisconsin are subject to the use tax. The use tax is imposed on consumers for the storage, use, or other consumption of the property or services purchased from out-of-state retailers if the sale would have been taxable if the property or services had been purchased in the state. The use tax is imposed as a complement to the sales tax in order to prevent consumers from avoiding tax by purchasing taxable goods in other states, and to allow state merchants to compete on an equal basis with sellers in other states that may have a lower sales tax rate or no sales tax at all. An enforceable use tax assures the equal taxation of all purchases by state residents and gives no competitive advantage to either resident or nonresident sellers. A credit against the use tax is allowed for the amount of sales tax paid in other states. Few consumers pay use tax because consumers are generally unaware that a use tax is owed on purchases where the retailer does not collect a tax.

5. In the 1967 U.S. Supreme Court case *National Bellas Hess v. Department of Revenue*, the State of Illinois attempted to impose the responsibility of collecting and remitting the use tax on the proceeds of a Missouri company's sales to Illinois residents. National Bellas Hess was a mail order company that owned no tangible personal property, sales outlets, representatives, telephone listing, or solicitors in Illinois. The company mailed catalogues twice a year to customers across the United States and did not advertise in Illinois by radio, television, billboards, or newspapers. The Supreme Court ruled that the commerce clause of the U.S. Constitution prohibited a state from imposing use tax liability on a seller whose only connection with customers in the state was through common or contract carrier or U.S. mail. The Bellas Hess decision established the precedent that a company was not liable for use tax collections if the company did not have a physical presence in that state.

6. The U.S. Supreme Court's 1992 decision in the case *Quill Corp. v North Dakota* established the applicable tests for analyzing a sales or use tax obligation as provided under the due process clause and the commerce clause. The due process clause concerns the fundamental fairness of governmental activity and requires that a seller have only a minimum contact in the state for the purpose of availing itself to the benefits of an economic market in the state for nexus to exist. The

interpretation of the commerce clause established the precedent that a seller has substantial nexus with the state if the seller maintains a physical presence in the state. In the case of *Quill*, the vendor was the sixth largest vendor of office supplies in North Dakota and solicited sales through catalogs, flyers, advertisements, and phone calls; however, the out-of-state corporation had no employees, no real property, and no tangible personal property in the state. *Quill* was determined to have nexus with the state under the due process clause, but was not determined to have substantial nexus with the state under the commerce clause. The court indicated that requiring an out-of-state retailer without substantial nexus to properly collect the estimated 7,500 different sales tax rates in the United States would excessively burden interstate commerce. Under the commerce clause, Congress has the sole authority to regulate interstate commerce. Congress has not authorized states to collect sales and use tax from out-of-state retailers.

7. The 2005 decision *Borders Online LLC v. California State Board of Equalization* extended state use tax obligations to certain out-of-state affiliates of brick-and-mortar companies located within the state. *Borders Online* was a separate legal entity from *Borders Inc.* *Borders Online*, a Delaware company, did not maintain any physical presence in California and did not collect or remit the California use tax for sales to California residents. *Borders Inc.*'s brick-and-mortar stores accepted returns and provided a refund, store credit, or exchanged the online affiliate's merchandise, encouraged its store employees to refer customers to the affiliate's web site, and advertised on sales receipts "Visit us online at www.Borders.com." The state court determined that *Borders Inc.*'s practices were consistent with that of an authorized agent or representative of the online affiliate, and the court ruled that *Borders Online* had substantial nexus and was required to collect and remit the use tax for sales to California residents.

8. Based on the outcome of this court case and current Wisconsin law, DOR has contacted several internet retailers (which are affiliate companies to brick-and-mortar stores in this state) to inform them that they are considered to be engaged in business in Wisconsin under current law. The Department indicates that several internet retailers have responded by registering to collect the tax; however, not all internet retailers have registered. DOR indicates that the Governor's proposal would clarify the definition of a retailer engaged in business in this state, and would encourage other internet retailers to voluntarily collect and remit the tax. The Department claims that a clear definition of a retailer engaged in business in this state to specifically include affiliated entities with at least a 50% ownership in each entity would encourage more internet retailers to voluntarily register with the state and would minimize potential litigation costs for each case.

9. Several states have attempted to address sales and use tax collections by online retailers affiliated with brick-and-mortar businesses in their state through similar legislation. Minnesota, Kentucky, and Arkansas have enacted legislation requiring Internet affiliates of brick-and-mortar entities to collect and remit the sales and use tax for sales in their states. Several other states, such as California, Louisiana, and Michigan, have proposed similar legislation to specifically address this issue.

10. According to the Legislative Reference Bureau (LRB), the ruling of a California state court has no value as precedent for any Wisconsin (or federal) court. In the *Borders* case, the affiliate had real property in the state. Under the budget bill, an affiliate having no real property, but

maintaining employees in this state, would be sufficient to establish nexus. In the two federal cases, *Bellas Hess* and *Quill*, the states lost both cases and were unable to collect the sales and use tax from out-of-state retailers. In both federal cases, the retailers had no employees or property in the state. The LRB reports that it is unclear whether a Wisconsin or federal court would uphold that an affiliate with either employees or property in this state would create enough substantial nexus necessary for the state to impose the collection of the sales and use tax on internet retailers under this provision.

11. DOR argues that clarifying the current law definition of a retailer engaged in business in this state, as proposed by the Governor, would encourage internet affiliates to voluntarily register with the state, reduce the Department's costs of contacting these affiliated retailers currently not collecting the tax, and reduce potential litigation costs in pursuing these retailers. A counter-argument could be made that a clarification of current law is not required if the proposed change would not affect the application of current law.

12. It should be noted that the Governor's proposal would not extend nexus to the types of companies affected by New York's "Amazon Tax" following the 2008 case *Amazon.com LLC v New York State Department of Taxation and Finance*. This case permits the extension of sales tax nexus to remote retailers maintaining no physical presence in the state which enter into an agreement with New York residents in which the resident representative, for a commission, directly or indirectly refers potential customers to the remote retailer, whether by link on a web site or otherwise. Nexus is established only if the cumulative gross receipts from sales by a remote retailer to customers in New York as a result of referrals to the remote retailer by all of its resident representatives under the agreement are more than \$10,000 during the preceding four quarterly sales tax periods. In light of this decision, California, Connecticut, Hawaii, North Carolina, Minnesota, and Tennessee are considering similar state legislation. It is unclear whether the Supreme Court will uphold, overturn, or address this decision, and Congress is currently considering legislation to address the taxation of interstate commerce sales for the types of arrangements affected by the Amazon Tax.

ALTERNATIVES

1. Adopt the Governor's proposal.
2. Delete provision.

ALT 2	Change to Bill
	Revenue
GPR	- \$3,000,000

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