

Nexus News

Nexus and Web-Related Activities

By Maryann Gall and Laura Kulwicki

Introduction

Nearly every company in today's current business environment has a Web site or uses the Internet in some fashion to promote or sell products, communicate with customers, or provide customer service. Due to the inherently interstate nature of Internet communications, these kinds of activities are often overlooked when a company analyzes its nexus risks in any given state. Companies should be aware, however, that states may take the position that Web-related activities could potentially trigger nexus enforcement under certain circumstances. This article discusses how traditional nexus rules are applied against the backdrop of Internet-based activities and highlights some of the potential nexus pitfalls resulting from Web-related activities.

The Nexus Theory

For nexus purposes, the cardinal rule under *Quill*¹ is that an out-of-state business must have some physical presence within the state in order to constitutionally create taxing jurisdiction. The requisite physical presence is often established directly through the company's own property, offices, stores or employees in the state. Physical presence may also be established indirectly through an agent, solicitor or other third party acting on behalf of the seller in the taxing state.²

Some states have specifically addressed the nexus consequences of maintaining a Web site. Not all states adopt the same approach. In general, however, it makes a difference for nexus purposes where the server is located. It also makes a difference who owns it. A state might take the position that a company has "property" in the state for nexus purposes if its Web site is housed on a server located in the



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state, or the company has in-state employees or technological infrastructure within the state. For example, the New Jersey Department of Revenue indicated that it believes that maintaining a Web page on a computer server located in New Jersey will create income tax nexus if the taxpayer has some physical presence in New Jersey connected with the construction, maintenance or operation of the Web site. The Department noted that the computer server and the technicians that kept it functioning are located in New Jersey, and the Web page is accessible in New Jersey by downloading it into computers located in New Jersey. As such, the out-of-state

vendor is considered to have the intention to “exploit the market” in New Jersey and consequently, would be considered doing business in New Jersey. In addition, the vendor is considered to be “employing” or maintaining tangible personal property in the state which also would give rise to nexus.³

Another common Web-based contact involves Web site linking arrangements. E-commerce retailers and other types of businesses often enter into Internet linking arrangements with third parties to promote the sale of goods. Under these types of arrangements, an unrelated company will place a link to the taxpayer’s Web site on their own Internet Web site, typically in exchange for a commission or percentage of each sale that is made to the taxpayer’s customer from the linked site. Basic principles of nexus law suggest that Web site links would create a risk of nexus only if the online affiliate is physically present in the state, and only if the online affiliate uses this in-state presence to solicit or make sales on the taxpayer’s behalf. Although the courts have not specifically addressed this issue, those states that have informally addressed the issue have concluded that something more than just a Web site linking arrangement is required to create nexus.

While there are no court cases specifically addressing these issues, some states have clarified their position in this context by specific statutes or regulations, or in informal departmental rulings or responses. A summary of these authorities is provided below.

Maintaining Web sites Accessible by In-State Residents

Maintaining a Web site that is accessible by in-state residents is not sufficient to create nexus. Indeed, merely communicating with customers in the state through an Internet Web site should be treated no differently than any other form of protected interstate communications

for nexus purposes. Several states have specifically recognized this fundamental concept. For example, the Tennessee Department concluded in Letter Ruling No. 99-09⁴ that maintaining Web sites accessible by Tennessee residents is no different than any other mail order business and

would also, absent all other indicators, fail to rise to the level of nexus for purposes of sales and use taxation.

Similarly, the South Carolina Department of Revenue considered whether an Ohio company had nexus for income tax purposes because its Web site (maintained on an out-of-state server) could be accessed in South Carolina.⁵ The Department held that a Web site which is accessible in, but not located in, South Carolina is viewed as the equivalent of an 800 telephone number and thus does not create nexus.

These rulings reflect the principles established not only by federal constitutional law, but by federal legislation as well. In federal legislation originally adopted in 1998 and extended until at least the end of 2007,⁶ federal, state and local governments may not tax an Internet seller based solely on the fact that it conducts its business *via* a Web site housed on an out-of-state computer. The “Internet Tax Nondiscrimination Act” prohibits multiple or discriminatory taxes on electronic commerce. The law defines a “discriminatory tax” as:

(B) Any tax imposed by a state or political subdivision thereof, if:

- (i) the sole ability to access a site on a remote seller’s out-of-state computer server is considered a factor in determining a remote seller’s tax collection obligation; or
- (ii) a provider of Internet access service or online services is deemed to be the agent of a remote seller for determining tax collection obligations solely as a result of:
 - (I) the display of a remote seller’s information or content on the out-of-state computer

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- server of a provider of Internet access service or online services; or
- (II) the processing of orders through the out-of-state computer server of a provider of Internet access service or online services.

It is clear, therefore, that merely displaying a Web page or Web site accessible by customers in a particular state will not create nexus. Something more is required.

Maintaining a Web site on a Computer Server Located in the State

States are not expressly prohibited, however, from taxing companies that maintain a Web site on a computer server that is physically located in the state. Under this circumstance, the state may argue that the in-state server is “property” sufficient to create physical nexus in the state. Likewise, a state could attempt to argue that an Internet service provider or other third-party provider that hosts a company’s Web site qualifies as an in-state “agent” or “representative” for nexus purposes.

Ownership of In-State Server

Several states have enacted specific safe harbors to clarify their position on using an in-state server. Some states, such as Oklahoma and Vermont, expressly provide by statute or rule that owning or using an in-state server will *not* create nexus. For example, Vermont’s taxing statutes broadly provide that ownership of a server by an out-of-state company in Vermont, by itself, does not establish substantial nexus for either sales and use tax purposes, or income and franchise tax purposes.⁷

Similarly, §710:65-19-156 of the Oklahoma Administrative Code provides that the use of an online service or the establishment of a Web site, whether the server on which the Web site is maintained is located inside or outside Oklahoma, is not a sufficient physical presence in Oklahoma, absent any other connection, to require the Web site owner to register as a business and to collect Oklahoma sales tax on sales of tangible personal property, service to consumers located in Oklahoma, or on sales of goods sold for use in Oklahoma.

Although there is no specific statutory or regulatory safe harbor, the Virginia Department of Revenue has also held that owning an in-state server will not create nexus.⁸

Using an In-State Server

Other states have enacted statutory safe harbors for Web-based activity, but only if the server is owned by a third party. For example, maintaining a Web page on a server located in New York does not, by itself, create nexus for an out-of-state retailer with respect to sales of products delivered in New York. New York’s tax statutes provide that an out-of-state company is not subject to tax if its only connection is advertising stored on a server located in New York, as long as the server or other computer equipment is not owned or leased by the retailer.⁹

Although Texas does not have a specific statutory safe harbor, the Comptroller has concluded in several Comptroller Rulings that maintaining a Web page on a third-party server in Texas does not create nexus for an out-of-state seller unless the seller owns, leases or rents the server.¹⁰ In addition, Maryland, New Jersey and North Carolina have informally indicated that having a Web page on a computer server within the state does not create nexus.¹¹

Finally, California’s regulations specifically address the issue of Web site nexus and dispel any notion that using an in-state service provider creates “agency” nexus. Pursuant to Cal. Code Regs. tit. 18, §1684, an out-of-state retailer whose only contact with California is the use of a computer server on the Internet to create or maintain a Web site does not have “substantial nexus” with the state. The regulation further provides that “[n]o Internet service provider, on-line provider or other similar provider of Internet access services or World Wide Web hosting services shall be deemed the agent or representative of any out-of-state retailer solely as the result of the service provider maintaining a web site on a computer server that is physically located in the state.” In summary, agency nexus is not created when an out-of-state company uses an in-state computer server to either host its Web site or transact e-commerce.

In summary, it is important for out-of-state companies to review the nexus stance taken in the state or states where Internet hosting or Web site infrastructure is located. Owning or using a Web site in some states may inadvertently create nexus for either or both sales/use tax and income/franchise tax purposes.

Web Site Linking Arrangements and Web Malls

No court has directly considered whether a Web site linking arrangement or the use of an online Internet “affiliate” creates nexus in states where the

online affiliate has a physical presence. However, a number of state administrative rulings have addressed the issue in some fashion. Based on these limited rulings and traditional principles of nexus law, Web site linking arrangements in general do not appear to create an undue risk of nexus for out-of-state companies that choose to advertise in this way.

Nevertheless, the law is gray enough that taxpayers have sought guidance from state taxing authorities in this area. Given the uncertainty, aggressive states could attempt to argue that a Web site linking relationship with an in-state company may, either standing alone or in combination with other activities, create the requisite physical presence nexus.

An Illustrative Analysis

In Private Letter Ruling No. ST -6-0073-GIL,¹² the Illinois Department of Revenue (DOR) applied traditional principles of nexus law to conclude that a Web site linking arrangement between two affiliated companies will not create nexus for sales and use tax purposes. The Illinois ruling provides a well-reasoned overview of the applicable analysis in this context.

The company at issue sold footwear over the Internet. It had no traditional physical presence in Illinois and it did not maintain its Web site or server in Illinois. Although most of the footwear it sold was acquired from unrelated third-party vendors, the company also sold private label shoes that were designed, manufactured, marketed and sold by sister companies through affiliated brick-and-mortar retail stores (some of which were in Illinois) and *via* the Internet on their own separately branded Web sites.

The company planned to pay its sister companies to send out e-mails directing their customers to the company's Web site. In addition, the company would pay an arm's-length price to have its link appear on the sister companies' separate Web sites. Although the sister companies operated retail stores in the state of Illinois, no marketing of the company or its Web site was planned at the retail locations.

Before housing Internet infrastructure or contracting with third parties for Internet services in a state in which they would otherwise lack nexus, out-of-state businesses should be certain to consider the particular state's position on Web site nexus.

The Illinois DOR reviewed these facts and concluded that "the link on the Sister Companies [*sic*] Web site to the Company's Web site will not create nexus for sales and use tax purposes in the State of Illinois," primarily because all solicitation was done *via* the Internet. In reaching this result, the DOR applied an analysis that is consistent with fundamental principles of third-party nexus law:

The key issue here is whether the link constitutes solicitation in the state of Illinois on the Company's behalf. ... Contrary to *Tyler Pipe* and *Scripto*, any

'solicitation' on behalf of the Sister Company for the Company is nonlocal—it is all done via the Internet. All technology infrastructure for the Company and the Sister Companies is located entirely in California and Ohio. There is no local element or solicitation whatsoever in this link.¹³

The Illinois DOR also relied on the Internet Tax Freedom Act (ITFA) as further support for its conclusion.¹⁴ The DOR concluded that tax collection obligations based on Web site linking activities would run afoul of the ITFA by discriminating against electronic commerce.

Other States

Authorities in Missouri, New Mexico and New York also conclude that Internet linking arrangements do not create nexus.¹⁵ The only contrary indication is the North Carolina Department of Revenue's informal response to the CCH survey on the sales and use taxation of e-commerce. The state's non-binding response that the state would find nexus if an Internet seller pays for banner exchanges or per-click commission on a third-party Web page displayed in North Carolina. However, no nexus is created if the seller pays for advertising only on such Web page. With specific regard to "Web malls," the Department concluded that nexus does not exist if "the seller has a web-based mall arrangement (a web site comprised of several other commercial web sites) with a mall in your state under which the

mall provides services for the seller such as design, advertising or order processing.”¹⁶

Conclusion

While most traditional Web-based activities should not create nexus, it is important for companies to

be aware that certain activities could lead to nexus enforcement in aggressive states. Before housing Internet infrastructure or contracting with third parties for Internet services in a state in which they would otherwise lack nexus, out-of-state businesses should be certain to consider the particular state’s position on Web site nexus.

ENDNOTES

¹ *Quill Corp. v. North Dakota*, SCt, 504 US 298 (1992).

² See, e.g., *Scripto, Inc. v. Carson*, SCt, 362 US 207 (1960); *Tyler Pipe Industries, Inc. v. Washington Dept. of Revenue*, SCt, 483 US 232 (1987).

³ N.J.A.C. 18:71.6(a).2.v. See also Response to CCH Internet/Electronic Commerce Survey, CCH ¶400-721 (Sept. 12, 2000).

⁴ 1999 Tenn. Rev. Rul. LEXIS 4 (Mar. 17, 1999).

⁵ See, Rev. Rul. #98-3 (S.C. Dept. of Revenue Jan. 21, 1998).

⁶ Federal Internet Tax Freedom Act.

⁷ See, Vt. Stat. Ann. Tit. 32, §§5811(15)(C)(ii), 9701(9)(H)(2003).

⁸ See, P.D. 00-53, 2000 Va. Tax LEXIS 75 (Va. Dept. of Taxation April 14, 2000).

⁹ N.Y. Tax Law §12. See also, Wash. Rev. Code 82.04.424 (Washington does not tax Web site hosting or e-commerce conducted on an in-state computer server for an out-of-state company as long as the company, or an affiliate, does not own the server); Wash. Rev.

Code 83.08.050 (an out-of-state company is not obligated to collect excise tax if the Web site is not owned or operated by the person making sales in the state); N.M. Stat. Ann. §7-9-3.3 (“engaging in business” for gross receipts and compensating use tax purposes in New Mexico does not include “having a worldwide web site as a third party content provider on a computer physically located in New Mexico but owned by another non-affiliated person”).

¹⁰ See, e.g., Hearing No. 44, 127, CCH ¶403-003 (Tex. Cmpt. Pub. Accts. Nov. 22, 2005); Ruling No. 9806518L (Tex. Cmpt. Pub. Accts. June 2, 1998); Ruling No. 9802118L (Tex. Cmpt. Pub. Accts. Feb. 10, 1998); Letter No. 9801365L (Tex. Cmpt. Pub. Accts. Jan. 5, 1998).

¹¹ See, e.g., Responses to CCH Internet/Electronic Commerce Survey, CCH ¶400-665 (N.J. Div. of Tax Sept. 22, 1999); CCH ¶202-142 (N.C. Dept. of Rev. July 11, 2000).

¹² 2006 Ill. PLR LEXIS 81 (April 19, 2006).

¹³ LEXIS op. at 13.

¹⁴ The ITFA was the original federal law that imposed a moratorium on state and local taxes on Internet access as well as “multiple and discriminatory taxes on electronic commerce.” It was signed into law by President Clinton on October 21, 1998 and has twice been extended by Congress since its original enactment. The most recent extension—the “Internet Tax Nondiscrimination Act”—was discussed above and signed into law by President Bush on December 3, 2004. It extended the moratorium until late 2007 and continues to prohibit multiple or discriminatory taxes on electronic commerce.

¹⁵ See, e.g., Letter Ruling LR2257, 2004 Mo. Tax Ltr. Rul. LEXIS 82 (Mo. Dept. of Rev. Dec. 17, 2004); Ruling 400-05-2, CCH ¶401-109 (N.M. Tax. & Rev. Dept. May 18, 2005); N.Y. Tax Law §12 (out-of-state company is not subject to tax if its only connection is advertising “disseminated or displayed on the Internet by an individual or entity subject to tax” in New York).

¹⁶ CCH ¶202-142 (N.C. Dept. of Revenue July 11, 2000).

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