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The Contentious Issue of "Nexus"

By: Glenn Newman

Among the most contentious issues in state taxation is the issue of nexus: are there sufficient activities conducted by the person or the corporation in the state to permit the state to require payment of tax New York State and local sales and use tax? The New York State Tax Appeals Tribunal has decided that having independent contractors in New York engaged in promoting wholesale sales is sufficient to make a company liable for tax on retail sales sent to New Yorkers by mail. Also, in the most recent decision on the recurring issue of combined reporting, a New York City Tax Appeals Tribunal Administrative Law Judge reviewed transactions among affiliated corporations including contributions of capital, and payments of royalties and interest and found that affiliates not doing business in the City were not required to be included in a General Corporation Tax combined report.

Sales Tax

In *Matter of The Ohio Table Pad Co., Inc.* (NY State Tribunal decided April 22, 1999), the taxpayer had no office, no employees and no inventory in New York but was held to have "more than the slightest presence" and therefore sufficient nexus to be required to collect New York State and local sales and use tax from New York customers. The taxpayer is in the business of selling table pads, place mats and other items wholesale through independently owned stores and also made retail sales directly to customers by mail order. It has manufacturing plants in Indiana, Nevada and Georgia and its home office in Ohio.

The case is interesting for several reasons. First, it started from an inquiry letter sent to Ohio Table Pad in 1991[1] to which the taxpayer responded that it had no activity in New York. Second, about two years later, the State obtained information from the IRS that the taxpayer had issued Forms 1099 to individuals with New York addresses. Third it highlights the risk of not collecting sales and use tax under questionable circumstances. Here, the taxpayer has been assessed for sales and use tax on retail sales made to New Yorkers which it could have passed on to those purchasers. While the taxpayer had arguments and some hope of success, the risk of failing to collect sales and use tax from purchasers makes the decision not to collect expensive. In some businesses, the marginal price difference represented by the sales tax can be of significance. (Of course, it should be noted that the customer has an obligation to file use tax returns and pay tax on purchases from out-of-state sellers, an obligation that is rarely met and which the tax department is less than rigorous in enforcing except in certain types of purchases, e.g., items shown on U.S. Customs declarations; vehicles, aircraft and vessels registered in New York). In other businesses, the collection of sales tax would have little or no impact on the volume of sales. The decision whether to register as a vendor in New York and collect and remit sales tax or to fight and risk being out-of -pocket for the tax is one that each taxpayer must make based upon his particular facts and circumstances.

Ohio Table Pad's contacts with New York were through individuals known as "referral sources" who work for the taxpayer, as well as other furniture manufacturers. Their job is to identify whether a particular establishment is an appropriate store for the taxpayer's products. When a store is identified, the referral source sends a form to the taxpayer and the taxpayer follows up by sending a formal proposal, samples and brochures. The order form has the addresses of the manufacturing plants and a toll-free telephone number for the store manager to call if interested. The referral sources do not provide display materials or any samples or brochures.

Once a store decides to carry the taxpayer's products, the referral source will check on the displays. The taxpayer does not instruct the referral source as to how to check on displays but if a display is worn, or needs to be replaced, the referral source will send a form to the taxpayer and the taxpayer will send a new display. The referral sources, who also represent other manufacturers of furniture, rarely visit a store strictly on behalf of the taxpayer. Rather, the referral source would propose that a store carry the taxpayer's products as logical accessories to tables carried by the store.

The referral source does not negotiate prices or delivery terms, assemble purchase orders, deliver or distribute products, handle customer service after a sale, have any responsibility for collections, have any contact with the ultimate purchaser of the taxpayer's products or have any other role with respect to the taxpayer's sales. All problems with stores or products are referred to the factory or the home office of the taxpayer.

The referral source gets commissions from wholesale sales made through the stores within his territory. In one year the three referral sources received commissions of $5,900; $4,844 and $2,700.

Slightest Physical Presence

The State also sought to tax the direct sales to customers through mail orders as a result of magazine advertisements. If a customer makes an inquiry after seeing an ad in a nationally distributed magazine, the taxpayer will send an information kit that explains the products and prices. The taxpayer processes, bills and ships the orders from non- New York locations. Shipments are made through common carriers and even in the case of sales made through stores, 70 percent are shipped directly to customers.

No personnel of the taxpayer enter New York to measure or provide customer service. The taxpayer does not mail catalogues into New York and does not have its own retail or other location in New York. The contacts that the tax department relied upon were the contacts with stores making wholesale sales which are exempt from sales tax as resales.[2]

The State Tax Tribunal found that the activities of the taxpayer, acting through its independent contractors (the referral sources) in connection with its nontaxable wholesale sales to be sufficient to subject the retail sales to tax. It found that the taxpayer had more than "the slightest presence" and therefore was subject to the obligation to collect and remit sales and use tax under the precedent of *Matter of Orvis Co. v. Tax Appeals Tribunal*[3].

In *Orvis*, the Court of Appeals decided that sending employees into New York on a regular basis to visit retail outlets at which Orvis products were sold was more than the 'slightest physical presence' required to make the company subject to tax. At its hearing, Orvis submitted affidavits stating that its employees visited stores in New York only to discuss shipping and check on how products were displayed. The

Court of Appeals pointed out that the State Tax Tribunal had discredited the affidavits as being inconsistent with prior responses by Orvis to questionnaires (presumably similar to the nexus questionnaire sent to Ohio Table Pad) . In contrast, Ohio Table Pad had one of its referral sources testify at the hearing and he confirmed that his activities were confined to identification of outlets and checking displays—but the taxpayer fared no better.

In its arguments to the State Tax Tribunal Ohio Table Pad claimed that in order to come within the scope of the *Orvis* decision, there must be solicitation of business by someone in a 'representative capacity' on behalf of the company and that its referral sources lacked that representative capacity. It argued that the referral sources were merely 'bird-dogging' or identifying potential outlets for its products and their activities did not rise to the level of solicitation. Also, the taxpayer argued that subsequent to the *Orvis* decision, the tax department issued Advisory Opinions to the effect that physical presence in New York to attend a trade show in order to promote and demonstrate products was not sufficient to compel collection of sales tax.[4]

The State Tax Tribunal rejected the characterization urged by the taxpayer saying that the referral sources were clearly engaged in solicitation of business on its behalf. It also distinguished the Advisory Opinions issued by the department by noting that each opinion directly stated that one of the factors weighing in that petitioner's favor was that it had no independent contractors in New York soliciting sales.

This case stands for the proposition that in New York you can't have a little nexus (just like you can't be a little pregnant). If a company has nexus, it has nexus for all of its sales. Here, as in *Orvis*, the taxpayer's contacts were exclusively related to its wholesale business but were sufficient to require tax to be collected on retail sales as well. It is likely that the result would have been different if the activities were carried on by separate corporate entities rather than under the same corporate roof. Considering the fact that this taxpayer received a questionnaire in about eight years ago, companies should review their activities and consider seeking Advisory Opinions before assuming the liability for sales and use tax that would otherwise be passed on to the consumer.

Corporate Tax

Although Ohio Table Pad Co., Inc. was determined by the State Tax Tribunal to have sufficient contacts with New York to require it to collect and remit sales and use tax to the State, the company probably is protected from corporate income tax by virtue of P.L 86-272.[5] This is the Federal law which prohibits states from imposing an income tax on a company which merely solicits sales in the jurisdiction with orders accepted and shipped from out-of-state locations. One way for New York State and City to reach the income of corporations that do not have sufficient contacts with the State or City or are protected under Federal law is by requiring inclusion in a combined corporate tax return of a related company that does have nexus to New York. In a recent decision by the Administrative Law Judge ("ALJ") Division of the New York City Tax Appeals Tribunal in the area of combined reporting, the City's Department of Finance was unsuccessful in its attempt to require the inclusion of affiliated corporations not doing business in the City in a combined report of a New York taxpayer.

In *Matter of Toys "R" Us-NYTEX, Inc.* (NY City Tribunal decided August 4, 1999) the well-known retail toy store and its affiliates filed New York City General Corporation Tax ("GCT") returns. After an initial audit and a report of the result of a New York State tax audit, the taxpayer agreed to include certain affiliates in a combined report. The dispute continued however with respect to three other affiliated companies.

As a result of a major corporate reorganization in 1984, these three companies operated as follows: Geoffrey, Inc.[6] owned the trademark and trade names which it licensed to the stores; ABG, Inc. loaned funds and held mortgages on the real estate owned by the taxpayer and the operating companies and TRU, Inc. owned the stock of Geoffrey and ABG, loaned funds to the taxpayer and operating companies and performed cash management and investment activities.

The City GCT (similar to the New York State corporate franchise tax) has a three-part test for combined reporting: 1) there must be common ownership (defined as 80% common ownership directly or indirectly of the voting stock); 2) the companies must be engaged in a unitary business (i.e., in similar or related lines of business and; 3) reporting on a separate basis must distort the taxpayer's income.[7] The taxpayer agreed for the purposes of this case that the stock ownership and unitary business requirements were met by the three companies. Therefore, the dispute centered on the distortion requirement.[8]

The ALJ started out by noting that separate reporting is favored under the GCT law and that the tax department may not require a foreign corporation (i.e., one that is not doing business in New York City) to be included in a combined report unless inclusion is necessary to properly reflect the GCT liability of the taxpayer. The ALJ then found that there were sufficient intercompany transactions to create a presumption of distortion.[9] The intercompany transactions were the royalty payments to Geoffrey from the operating companies for use of the trademark, the mortgage interest paid by the operating companies to ABG and the interest income of TRU from loans to affiliates and investments transferred from its parent.

The ALJ stated the issue to be whether the taxpayer submitted sufficient evidence to overcome the presumption of distortion. In order to overcome the presumption, the taxpayer must establish that the transactions were carried on at arm's length.[10] The taxpayer submitted expert testimony and analysis consistent with the requirements of Internal Revenue Code Search7RH482 (used by the IRS for establishing arm's length pricing—frequently in transactions with foreign affiliates). The ALJ analyzed the expert testimony regarding the royalties paid to Geoffrey, the mortgage interest paid to ABG and the interest income of TRU and found that the royalty payments received by Geoffrey were arm's length. The ALJ also found that except for a de minimis amount representing .38% of the total interest charged by ABG for the tax years, the charges were within the "safe haven" rates under IRS regulations.[11] The ALJ did find distortion in the interest income of TRU, however, the distortion was in the taxpayer paying interest at a *lower* rate than an arm's length charge and therefore the distortion understated the interest deduction of the taxpayer and overstated its GCT. Relying upon State Tribunal precedent,[12] the ALJ said that combination was not a proper remedy in these circumstances.

In a part of the determination that may be of greater interest (if affirmed in the likely event of the Department's appeal to the City Tax Tribunal) , the ALJ addressed the issue of whether the 1984 tax-free reorganizations and contributions of capital to Geoffrey, ABG and TRU were in themselves distortive transactions that could permit the tax department to require a combined report. The ALJ said the factors to be considered in determining whether to respect the corporate transactions that are at the root of this issue are whether the transactions: 1) had a valid business purpose and had economic substance and; 2) were not entered into merely to avoid taxation. After reviewing the history of the transactions and the reasons for entering into them, the ALJ concluded that there were valid business reasons for each of them. Geoffrey was formed to protect trademarks and trade names and had paid its own expenses to protect them; similarly ABG was established to consolidate and manage real estate holdings and; TRU had a legitimate purpose of providing cash management and investment functions to the entire group of corporations. Also, the ALJ found there was economic substance to the transactions and that the independent identities of the corporations and formalities of the transactions had been observed.

Finally, the ALJ quoted from the United States Tax Court on the issue of tax avoidance, "the building may not be constructed entirely from tax advantage, but if the foundation and bricks have economic substance, the economic or financial inducement of the tax advantage can provide the mortar."[13]

Clearly, the issue of combined reports will continue to be a major one in New York State and City corporate taxation. The issue of arm's length pricing is being decided on the basis of the expert testimony and analysis of the particular facts in each instance. It is dangerous to draw broad conclusions in the face of what is clearly a case-by-case analysis. For taxpayers and the tax departments alike, it leaves the area open to great uncertainty knowing that a judge may say about distortion what others have said about pornography—"I can't define it but I know it when I see it".

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[1] The inquiry was entitled "Northeastern States Tax Questionnaire" and consists of a series of questions about activities that states use to determine whether there is a possibility of establishing nexus for tax purposes.

[2] Tax Law Search7RH1105(a) imposes tax on retail sales; sales for resale are excluded. See also, 20 NYCRR Search7RH526.6(c).

[3] 86 NY2d 165 (1995); cert. denied 516 US 989.

[4] TSB-A-96(83)S and TSB-A-96(62)S.

[5] 15 U.S.C. Search7RH381.

[6] Geoffrey was the subject of well-known case in state and local taxation in which South Carolina asserted nexus to tax the company based upon its use of intangibles (i.e., trademarks, trade names and maintenance of accounts receivable) within the state. South Carolina's corporate tax did not permit the filing of a combined or consolidated return. *Geoffrey, Inc. v. Tax Comm'n*., 437 S.E.2d. 13, cert. denied 114 S. Ct. 550 (1993).

[7] 19 Rules of the City of New York Search7RH11-91.

[8] As it did in the recent case discussed in a previous article, *Matter of Tropicana* (NYS Division of Tax Appeals decided November 25, 1998).

[9] 19 Rules of the City of New York Search7RH11-91(f).

[10] Citing *Matter of Standard Manufacturing Co., Inc.* (NY State Tax Tribunal decided February 6, 1992); *Matter of USV Pharmaceutical* (NY State Tax Tribunal decided July 16, 1992).

[11] Treasury Regulations Search7RH1.482-2(a)(2)(iii)(A) and(B).

[12] *Matter of Campbell Sales Co.* (NY State Tax Tribunal decided December 2, 1993).

[13] *Carroll v. Commissioner*, T.C. Memo 1978-173.