State Taxation of Mail-Order Sales of Computers after Quill: An Evaluation of MTC Bulletin 95-1

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On December 20, 1995, 26 states through the Multistate Tax Commission (MTC) issued National Nexus Program Bulletin 95-1. The bulletin has inspired considerable public commentary. In light of the extensive commentary, the MTC, at its expense, authorized two recognized authorities on state tax matters to evaluate independently the nexus conclusions presented by the bulletin. The following article is the result of that independent evaluation.

At the end of 1995, the Multistate Tax Commission (MTC), working together with 26 states,[1] issued Nexus Program Bulletin 95-1. The bulletin set forth the position that an out-of-state vendor of computers generally has nexus for sales and use tax and income tax purposes with the market state if the vendor contracts with a third party to provide the purchasers with repair services for their computers under the vendor's warranty. (For the full text of the bulletin, see State Tax Notes, Jan. 1, 1996, p. 62, or 95 STN 246- 71.)

The MTC had multiple goals in promulgating Bulletin 95-1. The bulletin is intended to educate the public, to save time and money by achieving uniform enforcement of the tax laws among the states, and to provide businesses with assistance in determining applicable nexus standards and filing responsibilities.[2] The MTC does not view Bulletin 95-1 as a policy statement but rather as an authoritative description of the audit position of the signatory states regarding companies engaged in the cross-border sale of computers.

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[1] The California State Board of Equalization (but not the California Franchise Tax Board) requested that references to it be deleted from Bulletin 95-1. Letter from Ernest J. Dronenburg Jr., member, California Board of Equalization, to Dan R. Bucks, executive director, Multistate Tax Commission (on file with the Multistate Tax Commission). Mr. Dronenburg has been reported as explaining that the vote to take this action "was not a rejection of the bulletin's contents, but a reflection of concerns that the document was being treated as if it had the weight of regulation." "Board of Equalization Official Explains Position on Rejection of MTC Bulletin," 3 Tax Mgmt. Multistate Tax Rep. 120 (April 26, 1996). Mr. Dronenburg was also reported as stating that the Board of Equalization had not taken a position on the issues raised by Bulletin 95-1. Id.

[2] Letter to the Editor from Dan R. Bucks, executive director, MTC, State Tax Notes, Mar. 11, 1996, p. 820.

Bulletin 95-1 is a refinement of the MTC's long-standing position that a mail-order seller has nexus with a state and may be required by a state to collect the use tax if it has a service representative in that state who regularly acts on its behalf. [3]

The question addressed by Bulletin 95-1 is whether an independent enterprise constitutes a service representative of a seller of computers if that enterprise provides repair services for the seller's in-state customers under a contractual arrangement with the seller. Bulletin 95-1 answers that question in the affirmative. For reasons discussed below, we believe that this answer is supported by Supreme Court precedent and cogent legal analysis and is consistent with sound public policy. [4]

Criticism of Bulletin 95-1 has been pointed and immediate. Some of the criticism has been shrill and angry — not entirely surprising because the bulletin puts taxpayers and their advisers on notice that the states are contesting a popular tax avoidance strategy. Other criticism has been more tempered. In reviewing the merits of the legal position taken in Bulletin 95-1, we discuss some of the criticism of the bulletin. [5]

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[3] As long ago as 1968, the MTC issued a Sales and Use Tax Jurisdiction Limitation Statement, providing that

"A vendor is required to pay or collect and remit the tax imposed by this Act if within this state he directly or by any agent or other representative: * * * * 5. Regularly engages in any activity in connection with the leasing or servicing of property located within this state."

Minutes of Meeting, Multistate Tax Commission, Kansas City, Mo., Sales and Use Tax Jurisdictional Standards Committee Report, p. 5 (adopted Nov. 19, 1968) (on file with the Multistate Tax Commission) (emphasis added). This sales and use tax standard remained outstanding until 1984, when it was withdrawn as part of a litigating strategy designed to establish economic presence as the nexus requirement for the imposition of use tax collection responsibilities on out-of-state vendors. The jurisdictional limitation statement was apparently noncontroversial, judging from the lack of taxpayer protest or other reaction from the private sector. The MTC resolution withdrawing the jurisdictional limitation statement in 1984 recited that 36 states had submitted comments indicating they applied the statement in establishing the limits of their assertion of nexus. Minutes of Meeting, Multistate Tax Commission, Denver, Colo., Resolution by the Multistate Tax Commission Regarding Withdrawal of Sales and Use Tax Jurisdiction Standard, p. 2 (adopted July 13, 1984) (on file with the Multistate Tax Commission).

[4] We have not attempted to determine the audit policies, or substantive or procedural laws, of any state, or to determine whether the bulletin should have been published without a prior hearing.

[5] The bulletin has been held out as an example of the kinds of guidance tax administrators should provide to taxpayers. See "New York State Bar Tax Section Report Outlines Nexus Standards for Out-of-State Vendors," State Tax Notes, Mar. 25, 1996, p. 982, p. 984 n. 18 ("The bulletin . . . serve[s] as an example of the kinds of questions that the [New York State Department of Taxation and Finance] should be addressing in promulgating guidance on vendor's responsibilities to collect New York taxes"). Further, the principles set forth by the bulletin (but not the specifics) have been apparently endorsed by professional associations in their sometimes critical comments on other work of the MTC related to nexus issues. See, e.g., New York State Bar Tax Section Report, supra, at 987 (nexus arises from

The Appropriate Standard To Apply in Evaluating Bulletin 95-1

Legal issues worth debating can seldom be resolved conclusively from existing cases and statutes. Indeed, the distinctive function of legal analysis is to obtain the best available answer to a legal question when no precedent is directly on point and the answer cannot be deduced syllogistically from authoritative legal rules. Legal reasoning is a form of practical reasoning, whereby the analyst first establishes the governing legal principles by analyzing applicable precedent and then applies those principles by analogy to the facts of a specific case. [6]

It would defeat the MTC's panoply of objectives in issuing nexus program bulletins if it were to restrict itself to issues that were uncontroverted, that would tolerate only one plausible resolution, or that were based on undisputed Supreme Court precedent. Nonetheless, some of the criticism of 95-1 is based on the view that the MTC should refrain from issuing its nexus bulletins unless it can demonstrate beyond reasonable challenge that its position would be upheld by the courts. [7]

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representative's services when related to a vendor's in-state sales); "AICPA Comments on MTC's Proposed Nexus Guideline," State Tax Notes, June 26, 1995, p. 2545 (in-state presence of independent contractor can establish nexus).

Not all the comments on the bulletin have been negative. For a summary of favorable reaction, see Dan Bucks, June Summers, Paull Mines, and Michael Mazerov, "Why the States Are Right in Issuing Bulletin 95-1," State Tax Notes, Mar. 25, 1996, p. 978.

[6] Much of the criticism of Bulletin 95-1 apparently rejects argument by analogy; critics of 95-1 dismiss cases that support the bulletin by restricting such cases to their facts. For example, critics treat *Standard Pressed Steel v. Washington, 419 U.S. 560 (1975),* which has language supporting 95-1, as irrelevant because the corporation's physical presence in that case was provided through an employee rather than someone acting in a non-employee contractual arrangement, such as an independent agent. See note 37 infra. Although this treatment of Standard Pressed Steel would seem inconsistent with *Scripto v. Carson, 362 U.S. 207 (1960),* which rejects the difference between independent contractors and employees, id. at 621-22, critics read Scripto as applying only to contractors who solicit customers — which are the facts in that case. Because the independent contractors in Bulletin 95-1 provide repair services and do not solicit customers, critics maintain that Scripto has no relevance. See notes 34 and 43 infra.

Critics do not explain why repair services performed on behalf of out-of-state vendors should have a different constitutional impact from the service of solicitation, similarly performed on behalf of out-of-state vendors.

[7] COST would apparently impose the most demanding standard:

"COST believes that the constitutional nexus standards that apply to situations such as the one addressed in the bulletin will continue to evolve . . . and such evolution may well justify the audit positions outlined herein. However, unless and until such irrefutable precedents have been crafted by the U.S. Supreme Court, it is not the province of the MTC or any state to claim otherwise, in the hope that stating a new 'rule' often enough or loudly enough will yield either its validity or its acceptance."

COST, supra note 6, at 977 (emphasis in original). Of course, the law could only

This "beyond-reasonable-challenge" standard is especially inappropriate when the nexus issue involves an interpretation of the Supreme Court's Commerce Clause jurisprudence. As the Court has itself acknowledged on more than one occasion, that jurisprudence "is something of a 'quagmire' and the 'application of constitutional principles to specific state statutes leaves much room for controversy and confusion and little in the way of precise guides to the States in the exercise of their indispensable power of taxation.'"[8] As Justice White warned in *Quill*, "[r]easonable minds surely can, and will, differ over what showing is required to make out a 'physical presence' adequate to justify imposing responsibilities for use tax collection. And given the estimated loss in revenue to States of more than $3.2 billion this year alone . . . it is a sure bet that the vagaries of 'physical presence' will be tested to their fullest in our courts."[9]

Some criticism of 95-1 reduces to nothing more than the observation that the bulletin does not establish its position by citing any case directly on point. Everyone acknowledges, however, that the Court has not directly addressed a case like the one presented in Bulletin 95-1. If it had, there would have been little point in issuing the bulletin.[10] Further, one rule of good tax planning is to structure business practices so that a taxpayer's situation is not on all fours with unhelpful precedent.

Tax administrators, who have the duty to interpret and apply the tax laws, cannot wait until the courts have resolved every conceivable fact pattern before formulating their own positions. They must make a reasonable interpretation of what the law is, recognizing that conflicts will inevitably arise to be resolved by the legislatures, the courts, and perhaps Congress. In appropriate situations, they have an obligation to communicate their interpretation to the public.

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evolve very slowly in favor of the states if they were limited to taking positions based on "irrefutable precedent." Certainly taxpayers only rarely can cite irrefutable Supreme Court precedent in support of the positions they take with state tax administrators.

[8] *Quill Corp. v. North Dakota, 504 U.S. 298, 315-316 (1992),* quoting *Northwestern States Portland Cement Co. v. Minnesota, 358 U.S. 450, 457-58 (1959)*

[9] *Quill, 504 U.S. at 330-31 (1992)* (White, J., concurring in part and dissenting in part). Although Justice Scalia chided Justice White on this point ("Justice White's concern that reaffirmance of Bellas Hess will lead to a flurry of litigation over the meaning of 'physical presence,' . . . seems to me contradicted by 25 years of experience under the decision," *id. at 321),* recent cases have underscored Justice White's warning. See, e.g., *Orvis v. New York, 630 N.Y.S. 2d 680 (1995); Brown's Furniture v. Illinois, 1996 Ill. Lexis 58 (1996).*

[10] The nature of some of the criticism of Bulletin 95-1 is nicely illustrated by the title of the Isaacson and Eisenstein article, supra note 6: "MTC Nexus Bulletin 95-1 Goes Beyond Existing Law." One message of the piece is that the MTC can cite no case directly on point. In that sense, opinion letters often "go beyond existing law" because clients usually don't need tax lawyers if there are precedents directly on point. Similarly, tax administrators are often asked by taxpayers to issue "opinion letters" that also go "beyond existing law."

***The Lessons of* Quill**

Much of the disagreement over the bulletin's legal analysis concerns the interpretation of *Quill* and its effect on the cases that preceded it. We recognize there are various ways of reading *Quill* and that, as Justice White predicted, the courts will be drawn into resolving interpretive conflicts. *Quill* obviously reaffirmed the holding in *Bellas Hess* that a mail-order seller will not have use tax nexus with a state if it does not have a physical presence in that state. Mail-order sellers do not have nexus with a state for purposes of collecting a state use tax if their only contact with the state is through common carriers or the U.S. mail.

The Court, however, appeared reluctant to reaffirm *Bellas Hess*.[11] The case rests primarily on the reliance interests of the mail- order industry and principles of stare decisis. The Court asserted that it perceived an obligation to protect the reliance interests and settled expectations of the direct-marketing industry that had flourished in part as a result of *Bellas Hess*.[12] Reflecting its ambivalence about the wisdom of its decision, the Court extended a clear invitation to Congress to eliminate or modify the *Bellas Hess* rule by legislation.[13]

In the period between *Bellas Hess* and *Quill*, a body of law had developed that had relaxed the due process limitations on personal jurisdiction. This evolution in the Court's due process jurisprudence was widely perceived as offering an alternative

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[11] "While contemporary Commerce Clause jurisprudence might not dictate the same result were the issue to arise for the first time today . . ." *Quill, 504 U.S. at 311.*

[12] "Moreover, a bright-line rule in the area of sales and use taxes also encourages settled expectations and, in doing so, fosters investment by businesses and individuals. (Footnote omitted.) Indeed, it is not unlikely that the mail-order industry's dramatic growth over the last quarter century is due in part to the bright-line exemption from state taxation created in Bellas Hess." *Quill, 504 U.S. at 316.* "[T]he Bellas Hess rule has engendered substantial reliance and has become part of the basic framework of a sizeable industry. The 'interest in stability and orderly development of the law' that undergirds the doctrine of stare decisis . . . counsels adherence to settled precedent." *Id. at 317.* The Court did not discuss whether the growth in the mail-order industry came at the expense of in-state vendors that were obligated to collect sales tax on their sales and thus were placed at a competitive disadvantage by the Court's holding. See *Quill, 504 U.S. at 329* (White, J., concurring in part and dissenting in part).

[13] "This aspect of 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. No matter how we evaluate the burdens that use taxes impose on interstate commerce, Congress remains free to disagree with our conclusions. . . . Indeed, in recent years Congress has considered legislation that would 'overrule' the Bellas Hess rule. Its decision not to take action in this direction may, of course, have been dictated by respect for our holding in Bellas Hess that the Due Process Clause prohibits States from imposing such taxes, but today we have put that problem to rest. Accordingly, Congress is now free to decide whether, when, and to what extent the States may burden interstate mail-order concerns with a duty to collect use taxes" (footnotes and citations omitted). *Quill, 504 U.S. at 318.*

nexus standard — economic presence — to the physical presence test applied in *Bellas Hess*.[14]

Quill provided a harbor from this threatening storm by preserving the common carrier and U.S. mail exception for direct marketers. At the same time, it made clear that the Due Process Clause was not an obstacle to congressional intervention by bifurcating the concept of nexus into a due process component and a Commerce Clause component. Due process nexus was satisfied in *Quill*[15] but not Commerce Clause nexus.

This bifurcation approach was novel, without support in existing case law.[16] The new approach allowed the Court to preserve the *Bellas Hess* result, while paving the way for congressional intervention;[17] in that sense, the Court narrowed *Bellas Hess*.[18]

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[14] See Sandra McCray, "Overturning Bellas Hess: Due Process Considerations," 1985 Brigham Young University Law Review 265; *Quill, 504 U.S. at 307-08*. Justice Scalia apparently feels that even before Bellas Hess precedent existed that would support a theory of economic rather than physical presence. *Quill, 504 U.S. at 319-20* (Scalia, J., concurring in part and concurring in the judgement).

[15] There was no doubt that Quill had "purposefully directed its activities at North Dakota residents, that the magnitude of those contacts is more than sufficient for due process purposes, and that the use tax is related to the benefits Quill receives from access to the State." *Quill, 504 U.S. at 308*.

[16] The Court justified its bifurcation by appealing to the "different constitutional concerns and policies" animating the Due Process and the Commerce clauses. *Quill, 504 U.S. 298, 312*. Unfortunately, the Court cited no cases to support its approach — an approach that was not suggested by either party in the case. We believe the failure to cite any cases is not an oversight because "the Court's discovery that '[d]espite the similarity in phrasing, the nexus requirements of the Due Process and Commerce Clauses are not identical' is not a logical inference to be drawn from a careful reading of its precedents." Jerome Hellerstein and Walter Hellerstein, 1994 Cumulative Supplement, II State Taxation S19-3. Justice White also scolded the majority for its novel approach. "The Court freely acknowledges that there is no authority for this novel interpretation of our cases and that we have never before found, as we do in this case, sufficient contacts for due process purposes but an insufficient nexus under the Commerce Clause." *Quill, 504 U.S. at 325* (White, J., concurring in part and dissenting in part).

Although moving the physical presence requirement for nexus from the Due Process Clause to the Commerce Clause cleared the way for congressional intervention, it is hard to understand how the holding in Quill furthers the policy underpinnings of the Commerce Clause that the Court articulated. See note 20 infra.

[17] Whether Bellas Hess rested on the Due Process Clause or the Commerce Clause was a matter of dispute prior to Quill. If Bellas Hess were viewed as a due process case, questions could be raised about whether Congress had the power to reverse the holding in the case with federal legislation. Quill, of course, puts such questions to rest.

[18] We join other commentators who are troubled by Quill's lack of analytical coherence and rigor. One fundamental problem with the case is that the Court never explains what physical presence in a state has to do with limiting state burdens on interstate

commerce. Quill states that the Commerce Clause and the substantial nexus requirement are informed by structural concerns about the effects of state regulation on the national economy and about limiting state burdens on interstate commerce. *504 U.S. at 312-13.* Yet nowhere does the Court explain why the burden on interstate commerce is a function of physical presence — why, for example, the burden of collecting the use tax is reduced when a mail-order vendor has property in the state, see *National Geographic Society v. California Board of Equalization, 430 U.S. 551 (1977),* or has engaged the services within the state of 10 part-time independent contractors, see *Scripto v. Carson, 362 U.S. 207 (1960).* The fairly apportioned and nondiscriminatory doctrines better address Commerce Clause concerns than does the substantial nexus doctrine.

A second analytical flaw in Quill is its overstatement concerning the evolution of its due process jurisprudence. The Court asserted that "[o]ur due process jurisprudence has evolved substantially in the 25 years since Bellas Hess, particularly in the area of judicial jurisdiction," *504 U.S. at 307.* Yet cases that preceded Bellas Hess had already established the proposition that "state regulatory jurisdiction could be asserted on the basis of contacts with the State through the United States mail. See *Travelers Health Association v. Virginia, ex rel. State Corp. Commission, 339 U.S. 643, 646-650 (1950)* (blue sky laws). It is difficult to discern any principled basis for distinguishing between jurisdiction to regulate and jurisdiction to tax." *Quill, 504 U.S. at 319* (Scalia, J., concurring in part and concurring in the judgment). See also *McGee v. International Life Insurance Co., 355 U.S. 220, 222-24 (1957); Ministers Life & Casualty Union v. Haase, 141 N.W. 2d 287* (Wis.), app. dismissed, *385 U.S. 205 (1966); People v. United National Insurance Co., 427 P.2d 199* (Cal.), app. dismissed, *389 U.S. 330 (1967).*

A third problem is that Quill inappropriately cites Complete Auto's "substantial nexus" language in support of the position that nexus for Commerce Clause purposes is different from nexus for due process purposes. This dubious proposition was not raised by either party in Quill and was not raised in Complete Auto. The issue in Complete Auto was whether a tax on the privilege of doing business violated the Commerce Clause. The issue of nexus was not before the Court because there was no doubt that the taxpayer, which was transporting automobiles within Mississippi on behalf of General Motors, had a physical presence in Mississippi. Although Complete Auto never discussed whether it viewed nexus as a due process issue or a Commerce Clause issue, the cases it cited suggest strongly that the Court viewed the concept as a due process issue. Accord, Charles Rothfeld, "Mail-Order Sales and State Jurisdiction to Tax," Tax Notes, Dec. 23, 1991, p. 1405. This view was also expressed by Justice White in Quill. See *Quill, 504 U.S. at 325-27* (White, J., concurring in part and dissenting in part).

Moreover, the rather cavalier way Complete Auto vacillated in its description of the nexus requirement was inconsistent with a Court that thought it was formulating a new Commerce Clause interpretation of nexus. For example, Complete Auto sometimes referred to "substantial nexus," and sometimes referred to "sufficient nexus" or "sufficiently connected." See, e.g., *430 U.S. at 278, 287.* The cases cited in Complete Auto referred to nexus in its more traditional due process context as a "necessary connection," *430 U.S. at 281* (citing *Freeman v. Hewit, 329 U.S. 249, 271* (Rutledge, J., concurring), or as "sufficient nexus," *430 U.S. at 285,* citing *Northwestern Cement v. Minnesota, 358 U.S. 450 (1959).* The Court in Complete Auto even described the taxpayer as having "sufficient nexus." *430 U.S. at 278.*

That Complete Auto's occasional use of the term "substantial nexus" was without any groundbreaking significance was strongly suggested in a case shortly following. In *National Geographic v. Board of Equalization, 430 U.S. 551 (1977),* the Court said: "The question presented by this case is whether the Society's activities at the offices in California provided

The following quotation nicely summarizes what we take to be the central message of the Court in *Quill*:

> [*Quill* is] essentially . . . a political decision. As both the majority and the concurring opinions made clear, the Court was troubled by the possible practical — and, from the Court's perspective, largely indeterminate — consequences that might follow from overruling *Bellas Hess*. At the same time, however, the Court plainly recognized that *Bellas Hess* stated a questionable rule that stands in considerable tension with more recent decisions. The Court, therefore, split the baby by keeping the physical presence rule in place under the Commerce Clause while, by sweeping away *Bellas Hess*' due process underpinnings, making clear that Congress has the authority to discard the rule. . . . This suggests, perhaps, that the Court did not mean its stated rationale for *Quill* to be taken very seriously.[19]

Obviously, the Court could not candidly admit to the agenda described above without undermining the legitimacy of the decision.

Application of* Quill*: Use Tax

Both Bulletin 95-1 and its critics accept the distinction set forth in *Bellas Hess* and reaffirmed in *Quill* between "mail-order sellers with [a physical presence in the taxing] 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."[20] Further, if a vendor had a repair operation in a state using its own employees, there would be little disagreement that physical presence existed and that use tax would have to be collected on mail- order sales.[21] Accordingly, the controversy over Bulletin 95-1 centers on the meaning of physical presence in a situation in which an out- of-state vendor combines its mail-order sales with the provision of in-state services, not through its own employees, but instead through third parties under a contractual relationship.

A major disagreement that some critics have with the bulletin is the weight that should be given to the Court's pre-*Quill* decisions on nexus. These critics would read such cases very narrowly, essentially limiting them to their facts. But neither the language nor the holding of *Quill* supports a narrow reading of the pre-*Quill* nexus cases.

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sufficient nexus between the out-of-state seller appellant and the State — as required by the Due Process Clause of the Fourteenth Amendment and the Commerce Clause — to support the imposition upon the Society of a use-tax-collection liability. . . ." *Id. at 554.*

[19] Charles Rothfeld, "Quill: Confusing the Commerce Clause," State Tax Notes, July 27, 1992, p. 111.

[20] *Quill, 504 U.S. at 311,* citing *National Geographic Society v. California Board of Equalization, 430 U.S. at 559.*

[21] *National Geographic Society v. California Board of Equalization, 430 U.S. 551 (1977).*

In addition, some critics would reject pre-*Quill* cases decided under the Due Process Clause as not having any relevance in a post- *Quill* world where nexus has been bifurcated and the physical presence requirement moved from the Due Process Clause to the Commerce Clause.[22] Again, they offer no support for this position from the language or the holding of *Quill*.

We disagree sharply with these views of the post-*Quill* world. Those views are logically possible, but they are an improbable reading of the Court's intent in *Quill*. As discussed above, we read *Quill* as adding no new use tax nexus requirements. Nor did *Quill* invigorate the existing physical presence precedents. *Quill* claimed that it was preserving the physical presence test of *Bellas Hess* because of its adherence to *stare decisis*. There is not even a hint in *Quill* that the Court, in doing so, was repudiating all of its many cases that gave content to that test. Indeed, to read *Quill* as some radical decision — a voyage into uncharted waters — is to treat the Court's stated concern for s*tare decisis* as claptrap. A court concerned with preserving existing expectations and providing a bright-line test for nexus should not be read as having discarded existing nexus jurisprudence unless it has made an explicit statement to that effect.

Those who would read *Quill* as breaking new ground regarding use tax nexus are left with the task of examining all prior nexus cases to determine which of those were decided under the Commerce Clause or the Due Process Clause. This task is fundamentally unsound. Prior to *Quill*, the Court never had any reason to specify whether a decision on nexus was grounded on one or the other clause.[23]

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[22] See e.g. COST, supra note 6, at 974, which rejects the bulletin's reliance on Scripto and Tyler Pipe, arguing that those cases stand "for due process nexus principles, not Commerce Clause principles, and thus cannot serve as binding precedent" (emphasis in original). COST acknowledges elsewhere that Tyler Pipe "does not designate the Due Process Clause or the Commerce Clause as grounds for its nexus holding . . .", id. at 975 (emphasis in original), but argues by analogy that Tyler should be characterized as a due process case. Id.

[23] As an illustration of the type of difficulty encountered in determining whether a particular case rested on the Due Process Clause or the Commerce Clause, consider Standard Pressed Steel. COST characterizes the case as interpreting the *Due Process Clause. COST, supra* note 6, at 974. Yet Quill describes the North Dakota Supreme Court in the lower proceedings as "review[ing] our recent Commerce Clause decisions," and includes Standard Pressed Steel in that group. *Quill, 504 U.S. at 314*. Does that mean the Quill Court viewed Standard Pressed Steel as a Commerce Clause case? Or, what is more likely, that the Court did not give much thought to how Standard Pressed Steel was characterized because nothing turned on it?

Similarly, COST characterizes Scripto as a due process case. Quill, however, after stating that Bellas Hess relied on both the Due Process and Commerce clauses, *Quill, 504 U.S. at 305,* cited Scripto as an example of where the physical presence requirement of Bellas Hess was satisfied. *Id. at 306-07, 315*. Does this mean the Court viewed Scripto as an example today of Commerce Clause nexus, or that physical presence under the Due Process Clause in pre-Quill cases constitutes physical presence under the Commerce Clause in post-Quill cases?

Finally, there are cases such as Tyler Pipe, which COST notes "does not designate the Due Process Clause or the Commerce Clause as grounds for its nexus holding . . .," COST,

Accordingly, the Court could be somewhat casual about the grounds of its decisions, even suggesting that nexus was required by both the Due Process Clause and the Commerce Clause.[24] Nothing in *Quill*—or in any other case—suggests that physical presence had a different meaning under the Due Process Clause from its meaning under the Commerce Clause. *Quill* does not define physical presence nor does the Court indicate that it is reexamining, let alone overruling, the definition of physical presence that emerges from those due process cases that found nexus because of a physical presence.

The Meaning of 'Physical Presence'

The term "physical presence" cannot be applied literally to a corporation, which is a legal construct with no physical attributes. Unlike individuals, who can be physically present in a state, a corporation can be physically present only indirectly, through, for example, some person or property with which it has a legal relationship. The ownership or leasing of real property is one way in which a corporation can be present in a state.[25] More relevant to the issues raised by Bulletin 95-1, a corporation can also be physically present in a state through persons acting on its behalf.

Under the case law, a clear example of a corporation that would have physical presence in a state through the actions of some individual is a corporation having an employee on duty in a state.[26] For example, traveling salespersons who are employees of an out- of-state vendor provide nexus for the employer. [27]

The employer-employee relationship is one polar case on a continuum of possible relationships. At the other end of that continuum are the employees of common carriers or of the U.S. Postal Service. As *Quill* held, mail-order sellers "who

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supra note 6, at 975 (emphasis in original).

[24] "As in a number of other cases involving the application of state taxing statutes to out-of-state sellers, our holding in Bellas Hess relied on both the Due Process Clause and the Commerce Clause." *Quill, 504 U.S. at 304.* "The question presented by this case is whether the Society's activities at the offices in California provided sufficient nexus . . . as required by the Due Process Clause of the Fourteenth Amendment and the Commerce Clause. . . ." *National Geographic, 430 U.S. at 554.* Quill describes Bellas Hess as suggesting that physical presence was not only sufficient for jurisdiction under the Due Process Clause, but also necessary. *Quill, 504 U.S. at 307.* Because Quill describes Bellas Hess as relying on both the *Due Process Clause and the Commerce Clause, 504 U.S. at 304,* presumably physical presence was required under both clauses. Indeed, the Court recognized that its recent Commerce Clause cases involved taxpayers who had a physical presence in the taxing state. *Quill, 504 U.S. at 314.*

[25] *National Geographic Society v. California Board of Equalization, 430 U.S. 551 (1977); Nelson v. Sears, Roebuck & Co., 312 U.S. 359 (1941); Nelson v. Montgomery Ward & Co., 312 U.S. 373 (1941).*

[26] See, e.g., *Standard Pressed Steel v. Washington, 419 U.S. 560 (1975).*

[27] See, e.g., *Standard Pressed Steel v. Washington, 419 U.S. 560 (1975).*

do no more than communicate with customers in the State by mail or common carrier"[28] will not have nexus.

Of course, employees are only one category of individuals operating on behalf of a corporation who can provide the corporation with physical presence in the state. The in-state actions of agents and independent contractors can also confer nexus. While the case law does not establish all of the relevant boundary lines, it is clear that an independent contractor does not have to work exclusively for the out-of-state corporation to confer nexus.[29]

The issue addressed in the bulletin is whether independent contractors providing repair services to the customers of an out-of- state computer vendor under the vendor's warranty will confer nexus on that vendor. As we noted above, no case is clearly dispositive of the issue of nexus under the facts addressed in Bulletin 95-1. But analogous precedents abound.

Considering the preference stated in *Quill* for bright-line nexus tests, the Court may be inclined to attempt to fit the warranty contractors into a preexisting category. Those contractors obviously do not fit the common-carrier category — the only category that the Court has held would not result in a finding of nexus. Other preexisting categories, all resulting in a finding of nexus, include a general agent,[30] a sales representative,[31] or a jobber, broker, or independent contractor,[32] at least in

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[28] *Quill, 504 U.S. at 311,* citing *National Geographic Society v. California Board of Equalization, 430 U.S. 551, 559 (1977)*

[29] *Scripto v. Carson, 362 U.S. 207 (1960)*

[30] *Felt & Tarrant Manufacturing Co. v. Gallagher, 306 U.S. 62 (1939).* Besides the presence of two general agents in Felt & Tarrant, the company paid the rent of an office for each of them.

[31] *Tyler Pipe Industries Inc. v. Washington State Department of Revenue, 483 U.S. 232, 249-50 (1987)*

[32] *Scripto v. Carson, 362 U.S. 207 (1960).* Critics have combined Quill's description of Scripto as "the furthest extension of [the Due Process Clause's requirement of some definite link, some minimum connection]," *Quill, 504 U.S. at 306,* with the activities of the independent agents in Scripto, who "conducted continuous local solicitation," *Scripto, 362 U.S. at 211,* to conclude that solicitation is a necessary condition for nexus. See, for example, Isaacson and Eisenstein, supra note 6, at 1169; COST, supra note 6, at 975.

Nothing in Scripto, however, held that the activities at issue were the only activities that could establish nexus. We view the statement in Scripto regarding solicitation as nothing more than an illustration of a sufficient condition for nexus, not as a necessary one. Further, the Court's descriptions in other cases of the activities of the in-state person that constituted a physical presence of the out-of-state vendor are inconsistent with a crabbed reading of Scripto. See notes 36-40 infra, and accompanying text.

We also read Quill's description of Scripto as "[t]he furthest extension" of the law as a neutral descriptive statement. It means what it says — that the case is the furthest extension of the law to date. We see no basis for the position taken by COST that the Court, in making

circumstances where the in-state person in its dealings with the customers of the vendor would be understood as acting on behalf of the vendor.

We have no reason to believe the Court will interpret these categories narrowly. The Court has never suggested that it was using terms such as agent or representative in a narrow, technical sense, or that such terms were to be defined under state law. If anything, the Court has indicated that labels and fine distinctions of nomenclature will have no constitutional significance.[33]

In addition, the Court has described quite broadly the activities of in-state persons that will constitute a physical presence for out-of-state vendors. For example, the Court has held that a corporation has a physical presence if the person acting on its behalf has performed activities significantly associated with the corporation's

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that statement, was "intimating that courts in the intervening 36 years have moved the other way." COST, supra, at 975. COST's interpretation is inconsistent with Quill eliminating the physical presence requirement under the Due Process Clause. That is, Quill extends the law way further than Scripto by holding that no physical presence is needed to provide nexus under the Due Process Clause. If Scripto is a due process case, as COST maintains, why would Quill intimate that courts in the intervening 36 years have moved away from Scripto, when Quill itself reversed this "trend" totally by eliminating the physical presence requirement as a precondition to satisfying due process?

Critics of Bulletin 95-1 have further attempted to limit the scope of Scripto by noting that it does not directly address the case of warranty contractors. See Isaacson and Eisenstein, supra, at 1169. ("[n]othing was said — or even suggested — in Scripto about after-sale repair services by totally independent third parties as constituting nexus"); see also id. ("... the U.S. Supreme Court has never ruled that the actions of an agent or representative, other than a solicitor of sales, can create nexus for an out-of-state vendor").

That Scripto is not on all fours with the fact pattern addressed in the bulletin is of course true. Scripto does establish the important principle, nevertheless, that independent contractors do provide nexus for out-of-state vendors in appropriate circumstances.

We would also quarrel with Isaacson and Eisenstein's characterization of warranty contractors as "after-sale repair services," in that warranty protection is likely to be an important factor in making the sale. We would also suggest that no constitutionally significant distinction exists between "totally independent third parties" and "independent third parties."

Isaacson and Eisenstein attempt to turn what we consider to be an illustrative statement by the Quill Court into a necessary condition for nexus. The authors state that "[a]s the Supreme Court made clear in Quill, what is required to create nexus is a 'physical presence,' and that requires a 'small sales force, plant, or office,'" supra at 1169. The Court in Quill made no such point. The language quoted out of context by Isaacson and Eisenstein simply provides, in our opinion, a brief summary of some of the relevant precedent. It cannot be fairly read as the Court's rejection ahead of time of all of the possible fact patterns that might be sufficient to constitute nexus. If the reading suggested by Isaacson and Eisenstein were correct — that what is required for nexus is limited to a small sales force, plant, or office — then their position would mean that a mine, a television tower, a large sales force, and who knows what else, would not constitute nexus — an untenable view.

[33] *Scripto, 362 U.S. at 211.* See also note 43 infra.

ability to establish and maintain the in-state market, [34]has made possible the realization and continuance of valuable contractual relations between the corporation and its customers,[35] has resolved problems regarding the use of the corporation's product after its receipt by the customer,[36] has obtained or retained the good will of the customer,[37] or has assisted a local service department in repairing the corporation's products.[38]

Bulletin 95-1 posits sufficient facts suggesting that the in- state service repairpersons provide nexus for the out-of-state computer vendors. The in-state repairpersons perform services that are likely to be important to the out-of-state corporation in making its sales within the state. The in-state services are expected to be regular and continuous, the charge for the services is borne by the vendor, the relationship between the contractor and the computer purchaser was established by the vendor, and the in-state contractor and the out-of-state vendor have a contractual relationship with each other that directly relates to the sales made in the state by the vendor. In terms of the holdings in the Court's nexus cases, the in- state service provider can be characterized as performing activities significantly associated with the corporation's ability to establish and maintain the in-state market, as making possible the realization and continuance of valuable contractual relations between the corporation and its customers, as resolving problems regarding the use of the

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[34] *Tyler Pipe, 483 U.S. at 250; General Motors, 377 U.S. at 447.* Isaacson and Eisenstein, supra note 6, at 1169, dismiss the ability to maintain a market "as the applicable test. As the Supreme Court made clear in Quill, what is required to create nexus is a 'physical presence,' and that requires a 'small sales force, plant, or office.'" As we suggested above, see supra note 34, they convert an example of a sufficient condition for nexus into a necessary condition. They also distinguish Tyler Pipe as a case involving a sales representative, supra at 1169, and not a service representative. They do not, however, explain why this difference should have any constitutional significance.

[35] *Standard Pressed Steel, 419 U.S. at 562.* Isaacson and Eisenstein, supra note 6, at 1169, dismiss the relevance of Standard Pressed Steel because it involved an employee and the Court "has never ruled that the actions of an agent or representative, other than a solicitor of sales, can create nexus for an out-of-state vendor." COST rejects Standard Pressed Steel because "the taxpayer paid its employee located within the state to perform a variety of employment- related functions and services — a circumstance we agree creates nexus," COST, supra note 6, at 974 (emphasis in original). Contrary to our interpretation, COST describes Standard Pressed Steel as doing "everything to undermine/destroy the bulletin's premise that the activities of a third-party repair service provider relative to the creation or maintenance of an in-state market must establish Commerce Clause 'substantial nexus.'" COST, supra, at 975 (emphasis in original).

[36] *Standard Pressed Steel, 419 U.S. at 561.*

[37] Id.

[38] *General Motors, 377 U.S. at 444.* The statement in the text referred to a person described in the opinion as a "service representative."

computer after its receipt by the customer, and as thereby obtaining or retaining the goodwill of the customer.[39]

We are bolstered in our views by the Court's concern with substance rather than form in its Commerce Clause cases since its 1977 opinion in Complete Auto.[40] The Court's willingness to treat employees, agents, independent contractors, and representatives as constituting physical presence under appropriate conditions is an example of its pragmatic philosophy of focusing on economic reality and practical effects and not on labels.[41] We believe that the Court will not interpret its prior cases on physical presence in a narrow or wooden manner but will acknowledge that in a world where outsourcing is becoming increasingly common, legal relationships often will not fall into traditional employer-employee categories. The Court has demonstrated an appreciation of and sensitivity to the tax avoidance opportunities that can arise from drawing fine distinctions in contractual arrangements.[42] We do not think that the Court will tolerate a different nexus result if, for example, a corporation eliminates its in-house repair department and then outsources its

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[39] Contrary to our views, COST concludes that the MTC's position "is not in fact dictated by, or even supported by, Supreme Court precedent . . .," COST, supra note 6, at 974 (emphasis in original).

[40] Complete Auto repudiated the formalistic school of interpretation that had once governed Commerce Clause analysis because it bore "no relationship to economic realities." *Complete Auto, 430 U.S. at 279.* In its place, the Court embraced a decisional framework that "considered not the formal language of the tax statute but rather its practical effect. . . ." Id. Subsequent cases reaffirmed that decisions should be grounded in "economic realities," *American Trucking Associations v. Scheiner, 483 U.S. 266, 295,* and eschew "magic words and labels," *Quill, 504 U.S. at 310* (quoting *Railway Express Agency Inc. v. Virginia, 358 U.S. 434, 441 (1959),* avoid "formalism," *Trinova Corp. v. Michigan Department of Treasury, 498 U.S. 358, 373 (1991),* and reflect "pragmatism," *Quill, 504 U.S. at 310.*

[41] See id. The Court's emphasis on substance over form did not start with Complete Auto but can be found in earlier cases. Scripto, for example, expressly recognized that the artificial distinction between "regular employees [of Scripto] devoting full time to its service," and independent contractors is a "fine distinction . . . without constitutional significance." *Scripto, 362 U.S. 211.* The Court was also sensitive to the tax avoidance opportunities that would arise if it were to draw such a distinction. "To permit such formal 'contractual shifts' to make a constitutional difference would open the gates to a stampede of tax avoidance." Id. This same sentiment was expressed in one of the Court's most recent First Amendment cases. In responding to whether First Amendment protection of employees should be extended to independent contractors, the Court stated that "[w]e see no reason, however, why the constitutional claim here should turn on the distinction, which is, in the main, a creature of the common law of agency and torts. Recognizing the distinction in these circumstances would invite manipulation by government, which could avoid constitutional liability simply by attaching different labels to particular jobs." *O'Hare Truck Service Inc. v. City of Northlake, 1996 U.S. Lexis 4263, at 17.*

[42] Id.

warranty work to independent contractors, some of whom may have been its former employees.[43]

We also think that the Court will not for purposes of nexus carve out an exception for repair services. Some critics would dismiss cases cited by the bulletin because they dealt with the solicitation of sales and not the provision of services, such as those of a warranty contractor.[44] Other than noting this factual distinction, these critics do not explain why such a distinction should have a constitutional dimension nor why the solicitation of sales should not be characterized as the performance of a service. In addition, we think the critics have it entirely backwards because the performance of services in a state typically creates nexus.[45] Finally, the Court's recent cases have shown an unwillingness to create special rules for services if the result would be a lapse in a state's sales tax jurisdiction.[46] These cases suggest that the values implicit in the Commerce Clause can be undermined by granting interstate commerce unfair tax advantages.

More significantly, an out-of-state vendor that both sells computers and provides for in-state repairs is raising the degree of market penetration to a new height. Local computer stores compete with the mail-order vendors by offering the kinds of services valued by many purchasers of expensive and complex computers. This edge is eroded when the mail-order vendor starts to compete with its own in- state services. With a product as complicated as computers, for which service and support play a key role in a consumer's decision, the Court is even less likely to place in-state merchants at a disadvantage by carving out an exception for their out-of-state competitors.

Application of Quill*: Income Taxes*[47]

Quill involved only the use tax and not the income tax. There is some disagreement among commentators about the effect of *Quill* on the nexus standard for income taxes. We believe that the nexus standard for income taxes might be more liberal than the standard for use taxes. *Quill*'s reluctant reaffirmation of *Bellas Hess* based on the Court's desire to protect the reliance interests of the mail-order industry would have no relevance to income taxes. There is simply no income tax

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[43] We are not suggesting that this hypothetical represents the facts in Bulletin 95-1 but only that it illustrates the type of tax planning that might be inspired by the position of those who would narrowly read cases such as Scripto, Tyler, General Motors, and Standard Pressed Steel.

[44] See, e.g., COST, supra note 6, at 974; Isaacson and Eisenstein, supra note 6, at 1169.

[45] *Western Live Stock v. Bureau of Revenue, 303 U.S. 250 (1938); Department of Treasury of Indiana v. Ingram-Richardson Manufacturing Co., 313 U.S. 252 (1941).*

[46] See e.g., *Oklahoma State Tax Commission v. Jefferson Lines Inc., 115 S. Ct. 1331 (1995); Goldberg v. Sweet, 488 U.S. 252 (1989).*

[47] We use the term "income taxes" to refer generically to taxes imposed on income, regardless of the name of the tax.

case that provides a counterpart to *Bellas Hess*. Also, the *Quill* Court recognized that it has not required a physical presence test in other cases.[48] At the least, the nexus for income taxes does not require a higher threshold of physical presence than does the nexus for sales or use tax purposes. Consequently, our discussion above regarding physical presence applies equally to the income tax, and we agree with the bulletin's conclusion that nexus for income tax purposes exists.

Unlike sales and use taxes, Congress has intervened with federal legislation for income taxes. Specifically, P.L. 86-272[49] provides that a state may not impose an income tax on an out-of-state corporation if the company does no more than solicit orders for the sale of tangible personal property using either its own employees or independent contractors.[50] The Court has described the activities of repairing and servicing a company's products as falling outside the protection of the statute. [51] Accordingly, P.L. 86-272 offers no protection from the income tax for the out-of-state computer vendor described in the bulletin.

Conclusion

We find Bulletin 95-1 to be a reasonable and sound interpretation of Supreme Court precedent. To the extent the bulletin reflects the audit position of states, taxpayers are now on notice regarding their income tax and use tax obligations. Taxpayers wishing to challenge this audit position are obviously free to pursue whatever remedies are available under state law. Nevertheless, noncompliance with a state's announced audit position carries significant risk.

Risks that a taxpayer assumes in failing to collect the use tax under the facts of Bulletin 95-1 will vary from state-to- state. We have not examined the likelihood of the states imposing negligence or other types of penalties. We suspect, however, that states would be disinclined to grant discretionary relief. For example, a vendor that unsuccessfully challenges a state's position based on Bulletin 95-1 can expect to pay the use taxes that it failed to collect from a customer.

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[48] Quill makes it clear that the nexus requirement for sales and use taxes is stricter than the requirement for other types of taxes. Quill states that "although in our cases subsequent to Bellas Hess and concerning other types of taxes we have not adopted a similar bright-line, physical-presence requirement, our reasoning in those cases does not compel that we now reject the rule that Bellas Hess established in the area of sales and use taxes." *Quill, 504 U.S. at 317.*

[49] Codified at *15 U.S.C. section 381* et seq. (1988).

[50] The workings of P.L. 86-272 are slightly more complicated than what is described in the text, but not in ways that are germane.

[51] *Wisconsin Department of Revenue v. Wrigley, 505 U.S. 214, 228 (1992).* The Court's position on services is entirely consistent with the legislative history of P.L. 86-272. 105 Cong. Record 16377 (1959) (Remarks of Sen. Javits) ("I point out that one of the major things which is not incorporated in this minimal standard is servicing and maintenance, which is a very essential element of operation in a particular State, and which calls upon the use of the State facilities in a way very different from the solicitation of orders").

Not only is the imposition of use tax collection responsibilities under the facts of Bulletin 95-1 a sound interpretation of Supreme Court precedent, but also it is sound public policy. In *Quill*, the Court concluded that the reliance interests of the mail-order industry required the reaffirmation of the *Bellas Hess* rule, subject to congressional intervention. That rule, nonetheless, creates an unfair competitive bias against in- state merchants that collect the sales tax. Extending that rule to out-of-state computer vendors that provide in-state warranty services is likely to be especially harmful to local computer stores that provide similar goods and services.