

Constitutional Limitations

Impatient with Congressional inaction on sales tax legislation for remote sellers, states are beginning to design their own rules and challenge the status quo for what can create sales tax nexus. In this article, Sylvia Dion gives an overview of states' expanding sales tax nexus policies, discusses New York's failed proposal and takes an in-depth look at Washington's current proposal.

From Click-Through to Marketplace to Economic Nexus: How Far Will States Push the Nexus Envelope on Remote Sellers?



BY SYLVIA F. DION

Introduction

States have grown weary of waiting for Congress to enact federal legislation that would require remote sellers to collect tax on sales to customers located in their states. As a result, many states have taken matters into their own hands and have enacted legislation that expands the definition of a retailer with substantial

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nexus to their jurisdiction for sales and use tax collection purposes. More than a third of the states that impose a sales tax have enacted laws which focus on the activities of in-state marketing affiliates that refer customers to the online stores of the retailers with whom they contract. In conjunction with enacting "click-through" nexus provisions, many states have enhanced their nexus-expanding laws with affiliate, or related party, nexus provisions. It appears that states are now ready to push the nexus envelope even further as evidenced by New York's recent attempt to enact legislation which would have imposed sales tax collection duties on marketplace providers on behalf of their marketplace sellers. Even though New York's marketplace provision was ultimately rejected, it appears the state may have introduced a novel approach to increase the collection of tax on online sales to in-state customers.

On March 30, 2015, the state of Washington introduced an almost identical marketplace facilitator proposal which would similarly transfer the tax collection

duties to marketplace facilitators. But the Washington proposal goes much further in expanding the definition of what constitutes substantial nexus for sales tax purposes by introducing several ways that substantial nexus can be achieved and expanding the state's economic nexus standard to sales tax nexus. This article begins with an overview of states' nexus-expanding approaches, looks at what New York's proposal would have done and then delves into the current Washington proposal and its attempt to aggressively redefine what constitutes substantial nexus.

Overview of Click-Through And Affiliate Nexus: Which States Have Enacted Nexus-Expanding Laws

Although not intended to be a comprehensive discussion of each state's provision, it's important to begin with an overview of the types of nexus-expanding provisions that states have enacted. Efforts to redefine what constitutes a physical presence in order to achieve substantial nexus for sales tax collection purposes began in 2008, when New York enacted the nation's first click-through nexus law. New York's law focused on the efforts of in-state marketing affiliates, individuals or businesses who post web links on their in-state website that refer their website visitors to the online store of the Internet retailer with whom they contract and are compensated for referred sales, generally via commission. Click-through nexus laws are based on the presumption that in-state marketing affiliates are acting in a similar capacity to in-state agents who solicit sales on behalf of the out-of-state retailer.¹

Despite the possibility that the law would likely be challenged, other states took notice and soon North Carolina and Rhode Island had enacted almost identical click-through laws. However, states' efforts to expand nexus for sales tax purposes based solely on the in-state presence of compensated marketing affiliates were often thwarted when the online retailers at whom these laws were arguably directed terminated their contracts with their marketing affiliates in states that enacted click-through nexus provisions. Seeing that these click-through provisions alone were insufficient, another

trend evolved where states coupled their click-through provisions with affiliate (i.e., related party) provisions. The rationale behind adding an affiliate nexus component to a state's nexus-expanding efforts was that an out-of-state remote retailer who failed to achieve nexus through the state's click-through provision could still be attributed nexus through a corporate affiliate's provision of fulfillment or other services related to the remote retailer's sales of tangible personal property in the state. Thus, even if the remote retailer chose to terminate its marketing affiliate contracts, if an entity related to the online retailer owned a fulfillment center, performed services on behalf of the online retailer or met another criteria established in the affiliate nexus provision, the out-of-state remote retailer would be attributed nexus for tax collection purposes.

Other states took a different approach—enacting notification or notification and reporting laws. These differed from the click-through and affiliate nexus laws in that they did not seek to require remote retailers to collect tax on sales to in-state residents. In fact, notification and/or reporting provisions acknowledge that the remote retailers to whom they apply do not have substantial nexus to their state for tax collection purposes. But as a state cannot require remote retailers who lack substantial nexus to their state to collect their tax, notification only or notification and reporting statutes imposed other requirements on remote retailers which would purportedly assist the state with enforcing its use tax laws and the ultimate collection of tax revenue.²

To emphasize how pervasive states' efforts to enact nexus-expanding legislation have been since New York introduced its click-through nexus provision in 2008, following is a list of the states that have enacted some type of nexus-expanding law and the year enacted: Arkansas (2011), California (enacted 2011, effective 2012), Colorado (2010 notification and reporting, 2014 click-through and affiliate), Connecticut (2011), Georgia (2012), Illinois (2011, challenged then reintroduced and enacted again in 2014), Kansas (2013), Maine (2013), Michigan (2014), Minnesota (2013), Missouri (2013), New York (2008), North Carolina (2009), Rhode Island (2009), Texas (2011), Vermont (2011) and Virginia (2012).³

² There has been attention recently on Colorado's notification and reporting law as a result of the United States Supreme Court's decision in *Direct Marketing Association v. Brohl*, *Supreme Court*, No. 13-1032, March 3, 2015. In a unanimous decision, the court held that the federal Tax Injunction Act (TIA) did not bar a challenge in federal court of Colorado's notification and reporting statute.

³ Ark. Code Ann. §26-52-117(d)-(e); Cal. Rev. & Tax Code §6203(b)(5); Conn. Gen. Stat. §12-407(a)(12)(L); Ga. Code Ann. §48-8-2(8)(M); 35 Ill. Comp. Stat. 105/2 & 110/2; Me. Rev. Stat. Ann. tit. 36, §1754-B(1-A)(C); Minn. Stat. §297A.66(4a); N.Y. Tax Law §1101(b)(8)(vi); N.C. Gen. Stat. §105.164.8(b)(3); R.I. Gen. Laws §44-18-15(a)(2); Tex. Tax Code Ann. §151.107(a)(3) & Tex. Tax Code Ann. §151.107(a)(8); Vt. Stat. Ann. tit. 32, §9783(b)-(c).

¹ See N.Y. Tax. Law §1101(b)(8), which states, "A person making sales of tangible personal property or services taxable under this article ("seller") shall be presumed to be soliciting business through an independent contractor or other representative if the seller enters into an agreement with a resident of this state under which the resident, for a commission or other consideration, directly or indirectly refers potential customers, whether by a link on an Internet website or otherwise, to the seller, if the cumulative gross receipts from sales by the seller to customers in the state who are referred to the seller by all residents with this type of an agreement with the seller is in excess of ten thousand dollars during the preceding four quarterly periods ending on the last day of February, May, August, and November."

New York Fails in Its New Approach

On January 21, 2015, New York Governor Andrew Cuomo introduced his 2015-2016 New York State Executive Budget.⁴ Among the numerous tax provisions included in the budget bill was a provision which would have imposed New York's sales tax collection, reporting and remittance duties on entities that met the legislation's definition of a "marketplace provider," which the proposal defined as "a person who, pursuant to an agreement with a marketplace seller, facilitates a sale occupancy, or admission by such marketplace seller." Facilitating a sale, occupancy or admission would have required that the person, or an affiliated person,⁵ both collect the receipts, rent or amusement charge paid by a customer, occupant or patron to a marketplace seller; and provide the forum in which, or by means of which, the sales take place or the offer of occupancy or admission is accepted, including a shop, store or booth or an Internet website, catalog or similar forum; or arrange for the exchange of information or messages between the customer, occupant or patron as the case may be and the marketplace seller.⁶

The most significant aspect of the proposed legislation was that it would have amended the definition of "persons required to collect tax" to include "every marketplace provider with respect to sales, occupancies or admissions facilitated by" the marketplace provider⁷ and would have alleviated a marketplace seller's responsibility to collect tax on any sale, occupancy or admission that is facilitated by a marketplace provider from whom the seller has received in good faith a completed certificate of collection in a form prescribed by the commissioner certifying that the marketplace provider is registered to collect sales tax and will collect sales tax on all taxable sales, occupancies or admissions by the marketplace seller.⁸

Although New York's "marketplace provider" proposal was rejected and failed to be included in the enacted legislation, it was significant because it introduced the concept that requiring the marketplace provider with substantial nexus to New York to collect the tax on the transactions it facilitated would increase the collection of tax on sales.

Washington Follows and Expands on New York's Lead

While New York failed in its attempt to pass legislation to further expand its remote seller collection re-

quirement, the proposed marketplace provider provision may have been a signal of what is on the horizon in other states.

And indeed, just days before the New York Legislature chose to exclude the marketplace provider provision from the final New York budget bill, the state of Washington introduced an almost identical "marketplace facilitator" provision in H.B. 2224, an omnibus revenue bill.

Introduced on March 30, 2015, H.B. 2224 will provide funding for education and essential public services by modifying and improving the fairness of Washington's excise tax system by enacting an excise tax on capital gains, narrowing or eliminating tax preferences, reinstating a previously expired business and occupation surtax while increasing the small business tax credit and implementing marketplace fairness in Washington. The revenue bill contains 10 parts, each of which details a specific tax provision that would generate the needed revenue components.

Overview of Washington's Nexus-Expanding Provisions

Of particular significance is Part IX, which if enacted, will significantly expand the ways in which an out-of-state remote seller would be deemed to have substantial nexus with Washington for purposes of the state's sales tax and Business and Occupation ("B&O") tax. More specifically, Part IX enumerates five activities which would modify the definition of a seller with substantial nexus. Those activities are as follows:

1) Click-Through Nexus. The revenue bill contains a rebuttable click-through nexus provision similar to the click-through nexus provisions enacted in other states. The click-through provision would create nexus for an out-of-state remote seller who enters into an agreement with a Washington resident or residents who, for a commission or other consideration, refer(s) potential customers to the remote seller whether by a link on an Internet website or otherwise, if such agreements generate more than \$10,000 in gross receipts from sales into Washington in the prior calendar year.⁹

2) Affiliate Nexus. The revenue bill also contains a robust affiliate nexus provision¹⁰ which would create nexus for retail sales tax purposes for an out-of-state remote seller if the seller, a third-party or an affiliated person¹¹ engages in or conducts any of the following in Washington:

- Sells a similar line of products as those sold by the seller and does so under the same or a similar business name as that used by the seller;

⁹ H.B. 2224 Part IX §902 (2)(a).

¹⁰ H.B. 2224 Part IX §902 (2)(b)(ii)(A)-(H).

¹¹ For purposes of the determining affiliation, the proposed legislation provides that two persons are affiliated if one person has a greater than 5 percent direct or indirect ownership interest in the other person, or where a greater than 5 percent direct or indirect interest is held in each of such persons by another person or by a group of persons which are affiliated persons with respect to each other. This 5 percent affiliation threshold is almost identical to what was included in New York's marketplace provider legislation.

⁴ 2015-16 New York State Executive Budget, Revenue Article VII Legislation.

⁵ New York's proposal provided that for purposes of the determining affiliation, the proposed legislation provides that two persons are affiliated if one person has a greater than 5 percent direct or indirect ownership interest in the other person or where a greater than 5 percent direct or indirect interest is held in each of such persons by another person or by a group of persons which are affiliated persons with respect to each other.

⁶ N.Y. State Assembly Bills A. 3009 and S. 2009, Part X §1 (1).

⁷ N.Y. State Assembly Bills A. 3009 and S. 2009, Part X §2 (1).

⁸ N.Y. State Assembly Bills A. 3009 and S. 2009, Part X §3 (2).

- Promotes or facilitates the seller's Washington sales through its employees, agents, representatives or independent contractors;

- Maintains, occupies or uses an office, distribution facility, warehouse, storage place or similar place of business in Washington to facilitate the delivery or sale of tangible personal property to the seller's Washington customers or facilitate the pick-up or return of such property;

- Uses trademarks, service marks or trade names in Washington that are the same or substantially similar to those used by the seller;

- Provides delivery, installation, assembly, maintenance or repair services to the seller's Washington customers;

- Shares management, business systems, business practices or employees with the seller or engages in intercompany activity with an affiliate in order to establish or maintain the seller's Washington market; or

- Conducts any other in-state activities that are significantly associated with the seller's ability to establish or maintain its Washington market.

3) Marketplace Facilitator Nexus. A remote seller that offers its products for sale through one or more marketplaces¹² operated by a "marketplace facilitator" with substantial nexus to Washington¹³ would likewise be deemed to have substantial nexus to the state.

The revenue bill defines a "marketplace facilitator" as a person who enters into a contract with sellers to facilitate, for compensation, the sale of the seller's products through a physical or electronic marketplace and who engages, whether directly or through an affiliated person, in any of the following: 1) transmitting or otherwise communicating the offer or acceptance between the buyer and seller; 2) owning or operating the infrastructure, electronic or physical, or technology that brings buyers and sellers together; 3) providing a virtual currency that buyers are allowed or required to use to purchase products from the seller; or 4) engaging in related software development or research and development activities related to any of the above.¹⁴ Additionally, a marketplace facilitator is also a person who engages, directly or through an affiliated person, in any of the following activities with respect to a seller's products: payment processing, fulfillment or storage services, product listing services, price setting, branding of sales as those of the marketplace facilitator, order taking, advertising or promotion and customer services including accepting or assisting with returns or exchanges.¹⁵

4) Payment Processor Nexus. In addition to achieving nexus through any of the above methods, an out-of-state remote seller will have substantial nexus if the remote seller contracts with a payment processor or

credit card company with substantial nexus to Washington.¹⁶ This would include contracting with a payment processor or merchant bank or accepting credit cards issued either by a financial institution under a license from a credit card association or by an entity that also authorizes purchases and settles with consumers and merchants if the payment processor, merchant bank, credit card association or credit card issuer has a substantial nexus to Washington.

5) Economic Nexus. In addition to the expanding definition of substantial nexus as detailed above, the revenue bill would replace Washington's physical presence nexus standard with its economic nexus standard.¹⁷

Marketplace Facilitator's Rights and Responsibilities

Like New York's rejected marketplace provider provision, the Washington revenue bill would also mandate that a marketplace facilitator assume collection duties of its marketplace sellers. The bill states that "a marketplace facilitator is deemed to be an agent of any marketplace seller making retail sales through the marketplace facilitator's physical or electronic marketplace. A marketplace facilitator must collect the taxes imposed under this chapter on all retail sales made through the marketplace facilitator's marketplace and sourced to Washington whether as principal or as the agent of a marketplace."¹⁸

Limited Liability Relief For Marketplace Providers

As compliance with the proposed legislation would require marketplace facilitators to assume their sellers' sales tax administration responsibilities, the proposal provides liability relief for the failure to collect the correct amount of sales tax. A marketplace facilitator who fails to collect the correct amount of tax would be relieved of liability to the extent that the marketplace facilitator can show to the department's satisfaction that the error was due to incorrect information given to the marketplace facilitator by the marketplace seller, but only if the marketplace provider and seller do not meet the 5 percent or greater affiliation rule.¹⁹

Additionally, as the bill requires a marketplace facilitator with substantial nexus to assume the collection duties, a marketplace seller with Washington substantial nexus is relieved of its obligation to collect the taxes on all taxable retail sales made via a marketplace operated by a marketplace facilitator if the marketplace seller has obtained documentation from the marketplace facilitator indicating that the marketplace facilitator is registered with the department and will collect all applicable taxes due under this chapter on all taxable retail sales made on behalf of the marketplace seller through the marketplace operated by the marketplace facilitator.²⁰

¹² H.B. 2224 Part IX §902 (2)(b)(i).

¹³ H.B. 2224 Part IX §902 (4)(a)(i). A marketplace facilitator is deemed to have substantial nexus in Washington if it or any affiliated person maintains a physical presence in Washington or the marketplace facilitator generated more than \$10,000 of gross receipts in the preceding calendar year from sales made through its physical or electronic marketplace by sellers that are physically located in the states.

¹⁴ H.B. 2224 Part IX §902 (7)(a)(i)(A)-(D).

¹⁵ H.B. 2224 Part IX §902 (7)(a)(ii)(A)-(H).

¹⁶ H.B. 2224 Part IX §902 (2)(c)(i).

¹⁷ H.B. 2224 Part IX §902 (1).

¹⁸ H.B. 2224 Part IX §903 (1).

¹⁹ H.B. 2224 Part IX §903 (2).

²⁰ H.B. 2224 Part IX §903 (3).

If enacted, the legislation would become effective on July 1, 2015.

Concluding Thoughts

States have grown weary of waiting for the U.S. Congress to enact federal legislation which would require remote sellers to collect tax on sales to customers located in their state. As a result, states have taken matters into their own hands and have enacted legislation that expands the definition of a retailer engaged in business in their state for sales tax collection purposes. No longer content to rely on click-through or affiliate nexus provisions as a means to increase the collection of tax by remote online retailers, states such as New York and now Washington are looking at novel approaches to redefining what it means to have substantial nexus in order to require out-of-state remote retailers to collect their tax.

Although New York's proposal was not enacted into final law, it may have introduced the concept that sales tax collection duties of a marketplace seller are best transferred to a marketplace provider with nexus to the state.

And indeed, the Washington Legislature has introduced a revenue bill which contains a marketplace facilitator provision—one which is almost identical to New York's. But Washington has taken an even more aggressive approach by introducing several ways in which a remote seller could be found to have substan-

tial nexus to Washington, including by adopting an economic nexus approach for sales tax collection purposes.

When New York first introduced its marketplace provider legislation, many in the state and local tax community believed that New York might once again change the sales tax landscape by enacting legislation that further expanded its authority to tax remote online sales. But now it appears the state of Washington may assume that role. What seems almost certain is if Washington's proposed legislation is enacted,²¹ other states will take notice and could likely follow with similar legislation in much the same way as they did with click-through laws following New York's 2008 enactment of the nation's first click-through nexus law. Unless Congress enacts federal remote seller legislation,²² it seems clear that states will continue to take matters into their own hands by enacting legislation that expands the nexus envelope—but just how far are they willing to go?

²¹ On April 29, 2015, by resolution, H.B. 2224 was reintroduced in the 2015 1st Special Session and retained in present status.

²² S. 698, The Marketplace Fairness Act of 2015, was introduced in the U. S. Senate on March 10, 2015. This represents the most recent effort by Congress to pass federal legislation which would require remote sellers to collect tax in states which are granted collection authority in accordance with federal law. The U.S. Congress has attempted to enact similar federal remote legislation during several previous Congressional sessions. During the 113th session, S. 743, The Marketplace Fairness Act of 2013, was passed by the Senate on May 6, 2013, but failed to advance any further.