STATE OF ARIZONA

Department of Revenue

Janet Napolitano
Governor

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Director

June 5, 2007

Attached please find a copy of a proposed Arizona Transaction Privilege Tax Ruling addressing the imposition of Arizona transaction privilege tax or the responsibility for use tax collection on sales of tangible personal property by remote vendors. Upon issuance, the final version of this tax ruling will supersede *Arizona Transaction Privilege Tax Ruling* TPR 94-12, which the Department rescinded on March 2, 2004. In an ongoing effort to interact with and inform the public regarding issues relating to taxation, the Department would appreciate your written comments on these drafts.

As you may know, the Department released proposed rulings on this topic for public comment in 2003 and 2005. The attached proposed ruling reflects the Department's efforts to extensively expand the discussion and guidance it provides to taxpayers on remote vendor issues, over and above the information contained in the earlier draft documents.

Please be advised that the deadline for comments is **Friday, July 6, 2007**. Any request for an extension of time for review must also be made by this date. This office will review all comments that are received through this date and make any appropriate revisions before the Department issues the final documents.

Please address your comments to:

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Thank you for your continuing efforts to establish an ongoing line of communication with the Arizona Department of Revenue.

Sincerely,

/s/ Hsin Pai
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Attachment

ARIZONA TRANSACTION PRIVILEGE TAX RULING
TPR 07-__
(This ruling supersedes Arizona Transaction Privilege Tax Ruling TPR 94-12, rescinded March 2, 2004)
DRAFT (6/5/07): FOR REVIEW AND COMMENT PURPOSES ONLY

ISSUE:

Imposition of Arizona transaction privilege tax or responsibility for use tax collection on sales of tangible personal property by out-of-state mail-order or Internet-based ("remote") vendors.

APPLICABLE STATUTES AND RULES:

Arizona Revised Statutes ("A.R.S.") § 42-5061(A) levies the transaction privilege tax under the retail classification. The retail classification is composed of the selling of tangible personal property at retail.

A.R.S. § 42-5001(12) defines a "retailer" as including:

> every person engaged in the business classified under the retail classification . . . and, when in the opinion of the department it is necessary for the efficient administration of this article, includes dealers, distributors, supervisors, employers and salesmen, representatives, peddlers or canvassers as the agents of the dealers, distributors, supervisors or employers under whom they operate or from whom they obtain the tangible personal property sold by them, whether in making sales on their own behalf or on behalf of the dealers, distributors, supervisors or employers.

A.R.S. § 42-5155(A) levies the use tax on the storage, use, or consumption in this state of tangible personal property purchased from a retailer, as a percentage of the sales price.

A.R.S. § 42-5160 provides,

> every retailer and utility business maintaining a place of business in this state and making sales of tangible personal property for storage, use, or other consumption in this state shall collect the tax from the purchaser or user unless the property is exempt under this article or the purchaser or user pays the tax directly to the department as provided by section 42-5167.

A.R.S. § 42-5161 provides:

> except as provided by § 42-5167, every retailer and utility business shall collect from the purchaser the tax imposed by this article and give to such purchaser a receipt for the tax in the manner and form prescribed by the department. The tax required to be collected shall be shown separately on the invoice or other proof of sale. The tax

> required to be collected shall constitute a debt owed by the retailer or utility business to this state.

Arizona Administrative Code ("A.A.C.") R15-5-2302(B) provides:

> A.R.S. § 42-5155 imposes Arizona use tax upon a purchaser that purchases tangible personal property from an out-of-state retailer or utility business if the retailer or utility business's gross receipts from the sale have not already been included in the measure of Arizona transaction privilege tax. Because Arizona transaction privilege tax and Arizona use tax are complementary taxes, only one of the taxes is imposed on a given transaction.

APPLICABLE CASE LAW:

The following federal and state cases are referenced in the Discussion section below:

Federal

Okla. Tax Comm'n v. Jefferson Lines, Inc., 514 U.S. 175 (1995).
Quill Corp. v. North Dakota, 504 U.S. 298 (1992).
Goldberg v. Sweet, 488 U.S. 252 (1989).
Tyler Pipe Indus., Inc. v. Wash. Dep't of Revenue, 483 U.S. 232 (1987).
Moorman Mfg. Co. v. Bair, 437 U.S. 267 (1978).
Nat'l Geographic Soc'y v. Cal. Bd. of Equalization, 430 U.S. 551 (1977).
Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977).
Standard Pressed Steel Co. v. Wash. Dep't of Revenue, 419 U.S. 560 (1975).
Nat'l Bellas Hess, Inc. v. Ill. Dep't of Revenue, 386 U.S. 753 (1967).
Scripto, Inc. v. Carson, 362 U.S. 207 (1960).
Miller Bros. Co. v. Maryland, 347 U.S. 340 (1954).
Wisconsin v. J.C. Penney Co., 311 U.S. 435 (1940).
Felt & Tarrant Mfg. Co. v. Gallagher, 306 U.S. 62 (1939).
In re *Laptops Etc. Corp.*, 164 B.R. 506 (Bankr. D. Md. 1993).

Arizona

Interlott Techs., Inc. v. Ariz. Dep't of Revenue, 72 P.3d 1271 (Ariz. Ct. App. 2003).
Ariz. Dep't of Revenue v. Care Computer Sys., Inc., 4 P.3d 469 (Ariz. Ct. App. 2000).
Ariz. Dep't of Revenue v. O'Connor, Cavanagh, Anderson, Killingsworth & Beshears, P.A., 963 P.2d 279 (Ariz. Ct. App. 1997).

Other States

Current, Inc. v. Cal. Bd. of Equalization, 24 Cal. App. 4th 382 (1994).
Scholastic Book Clubs, Inc. v. State Board of Equalization, 207 Cal. App. 3d 734 (1989).
Fla. Dep't of Revenue v. Share Int'l, Inc., 667 So. 2d 226 (Fla. Dist. Ct. App. 1995), *dec'n approved*, 676 So. 2d 1362 (Fla. 1996).

In re Tax Appeal of Baker & Taylor, Inc. v. Kawafuchi, 82 P.3d 804 (Haw. 2004).
State v. Dell Int'l, Inc., 922 So.2d 1257, *reh'g denied*, 930 So.2d 97 (2006).
Scholastic Book Clubs, Inc. v. State Dep't of Treasury, 567 N.W.2d 692 (Mich. Ct. App. 1997).
Miss. State Tax Comm'n v. Bates, 567 So. 2d 190 (Miss. 1990).
Orvis Co., Inc. v. Tax Appeals Tribunal, 654 N.E.2d 954 (N.Y. Ct. App. 1995).
SFA Folio Collections, Inc. v. Tracy, 652 N.E.2d 693 (Ohio 1995).
Koch Fuels, Inc. v. State ex rel. Okla. Tax Comm'n, 862 P.2d 471 (Okla. 1993).
Koch Fuels, Inc. v. Clark, 676 A.2d 330 (R.I. 1996).

DISCUSSION:

Ascertaining whether a remote vendor is liable for transaction privilege tax, is liable for collecting Arizona use tax, or has no liability for either tax requires a determination of the vendor's nexus with the State of Arizona. The following guidance provides a general discussion of current federal and state nexus jurisprudence for sales and excise tax purposes and the Department's ruling based on these sources.

Federal Jurisprudence

The United States Constitution's limitations on a state's authority to assess or impose tax on the economic activity of an out-of-state business that is engaged in interstate commerce arise from two sources. The first source is the Due Process Clause of the Fourteenth Amendment, which deals with the taxing power or jurisdiction of a state over the business. *See, e.g.*, *Wisconsin v. J.C. Penney Co.,* 311 U.S. 435, 445 (1940). The second source is the so-called "dormant" or "negative" Commerce Clause, which has been interpreted as implicitly prohibiting, even in the absence of Congressional regulation, unduly burdensome or discriminatory state taxation of interstate transactions or entities that are engaged in interstate commerce. *See Okla. Tax Comm'n v. Jefferson Lines, Inc.,* 514 U.S. 175 (1995); *Quill Corp. v. North Dakota,* 504 U.S. 298, 309 (1992).

Due Process Clause

To establish the requisite nexus for a state to validly tax an interstate commercial activity under the Due Process Clause, the facts must simply demonstrate "'some definite link, some minimum connection, between [the taxing State and] the *person* . . . it seeks to tax,' and the required physical presence of the vendor in the taxing state must be more than the 'slightest presence.'" *Nat'l Geog. Soc'y v. Cal. Bd. of Equalization,* 430 U.S. 551, 566 (1977); *Miller Bros. Co. v. Maryland,* 347 U.S. 340, 344-45 (1954); *Moorman Mfg. Co. v. Bair,* 437 U.S. 267, 272 (1978). The burden to meet this "minimum connection" standard is less than that for Commerce Clause purposes, such that a taxation scheme satisfying Due

Process concerns could still be rejected for violating the Commerce Clause. *See, e.g.*, *Quill*, *supra*.

Commerce Clause

Regarding the criteria for determining whether a tax imposed on interstate commerce infringes upon the Commerce Clause, in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), the Court repudiated its former distinction between "direct" and "indirect" taxes on interstate commerce. Instead, the Court explained that a tax on interstate commercial activity would be sustained if it:

1. is applied to an activity with a substantial nexus with the taxing State,

2. is fairly apportioned,

3. does not discriminate against interstate commerce, and

4. is fairly related to the services provided by the State.

430 U.S. at 279. The *Complete Auto* four-pronged standard remains the prevailing test under the Commerce Clause. *See, e.g.*, *Jefferson Lines, supra*.

In a pre-*Complete Auto* case, *National Bellas Hess, Inc. v. Illinois Department of Revenue*, 386 U.S. 753 (1967), the Court established a bright-line rule regarding "substantial nexus." To wit, an out-of-state vendor "whose only contacts with the taxing State are by mail or common carrier lacks the 'substantial nexus' required by the Commerce Clause." *Quill*, 504 U.S. at 315 (referencing *Bellas Hess*, 386 U.S. at 758). Such vendors are free from state-imposed duties to collect sales and use taxes. *Id*. Nevertheless, if a vendor maintains a "physical presence" in the taxing state, the "substantial nexus" requirement is fulfilled. *Id.*

The question of what level of "physical presence" is required to sustain a tax on substantial nexus grounds was left unanswered after *Bellas Hess* and even after *Complete Auto*. Then, in 1987, the Court elaborated on its substantial nexus analysis in *Tyler Pipe Industries, Inc. v. Washington Department of Revenue*, 483 U.S. 232, which involved Washington State's attempt to impose its business and occupation tax on an out-of-state vendor. The Court explained that the "crucial factor" governing nexus is "whether the activities performed in [the] state on behalf of the taxpayer are significantly associated with the taxpayer's ability to establish and maintain a market in [the] state for the sales." *Tyler Pipe*, 483 U.S. at 250 (1987). *Tyler Pipe* involved an out-of-state manufacturer that made wholesale sales to companies within Washington through an independent contractor located in the state and by executives who resided out of state, but that had no office, owned no property, and based no employees in the state. The Court found nexus for

imposition of Washington's tax because the manufacturer maintained and improved, through sales representatives' activities (rather than domicile) in the state, its name recognition, market share, goodwill, and individual customer relations. *Id.* at 249-51.

In 1992, the Court issued *Quill Corp. v. North Dakota*, 504 U.S. 298, in which it struck down North Dakota's attempt to collect use tax from an out-of-state mail order company on products sold to in-state residents. The vendor's only connections with customers of the taxing state were by common carrier or United States mail. The North Dakota Supreme Court had held that social, technological, economic, commercial, and legal changes since *Bellas Hess* had rendered the case obsolete, concluding that physical presence was no longer necessary in the case of a mail-order vendor that systematically directed its marketing efforts at the taxing state.

The Court disagreed with the state supreme court, holding that "physical presence" in the state is still required under the Commerce Clause for a business to have a "substantial nexus" with the taxing state. In its opinion, the Court acknowledged that "contemporary Commerce Clause jurisprudence might not dictate the same result were the issue to arise for the first time today . . . ." 504 U.S. at 311. It overruled *Bellas Hess* to the extent that some physical presence of the vendor is required as a "minimum connection" in the taxing state to support the jurisdiction to tax under the Due Process Clause. *Id.* at 306. Nevertheless, *Quill* follows the *Bellas Hess* precedent requiring some physical presence by an interstate mail-order vendor in the taxing state for a tax to be valid under the Commerce Clause. The Court based its continued reliance on the physical presence test in the realm of sales and use taxes on the rationale that it provides a bright-line rule that encourages the "settled expectations" of the mail-order industry, whose "dramatic growth" over the previous quarter century had likely been because of the test. *Id.* at 316.

Quill does not, however, require a *substantial* physical presence of the vendor in the taxing state to meet the substantial nexus prong of the *Complete Auto* test. This factor is consistent with the fact that none of the Supreme Court cases leading to *Quill* requires that the physical presence of the interstate vendor be substantial for a valid taxation of sales of or imposition of a use tax collection duty upon the vendor. *Bellas Hess*, in requiring the vendor's physical presence, explicitly states that it was applying a definite link or minimum connection requirement, which was then the prevailing nexus standard for *both* Due Process and Commerce Clause analysis in interstate commerce taxation cases. 386 U.S. at 756-57. Furthermore, in several earlier cases that *Quill* did not overrule, the Court did not apply a substantial physical presence requirement in upholding state tax based on the following forms of in-state activities or indicia of interstate vendors:

1. Two nonemployee, commissioned sales solicitors. *Felt & Tarrant Mfg. Co. v. Gallagher*, 306 U.S. 62 (1939).

2. Ten part-time, nonemployee, nonexclusive, commissioned sales brokers. *Scripto, Inc. v. Carson,* 362 U.S. 207 (1960).

3. One engineer-consultant operating an office out of his home. *Standard Pressed Steel Co. v. Wash. Dep't of Revenue*, 419 U.S. 560 (1975).

4. An interstate long-distance telephone carrier's billing to an in-state service address for calls originating or terminating in the taxing state. *Goldberg v. Sweet*, 488 U.S. 252 (1989).

In the Court's post-*Quill* 1995 opinion in *Oklahoma Tax Commission v. Jefferson Lines*, *supra*, the Court did *not* apply a substantial physical presence test, but instead strictly applied the substantial nexus prong of the *Complete Auto* test without referring to the substantiality of the physical presence of the taxpayer, an interstate bus company, in the taxing state. Relying on pre-*Quill* decisions, the Court focused on the in-state *activity* involved in the taxed transaction, such as the site of the origination or consummation of the transaction the state sought to tax.

Taken in context, rather than expanding *Bellas Hess*'s "minimum connection" physical presence requirement, *Quill* is more of a "somewhat begrudging retention of the *Bellas Hess* physical presence requirement," a result the Court remarked may not have found warranted if the issue had been presented for the first time. 504 U.S. at 311.

Arizona Jurisprudence

In *Arizona Department of Revenue v. O'Connor, Cavanagh, Anderson, Killingsworth & Beshears, P.A.*, 963 P.2d 279 (Ariz. Ct. App. 1997), the Court of Appeals held that a manufacturer, on whom state transaction privilege tax was imposed, met the substantial nexus requirement under the Commerce Clause. The court concluded that the manufacturer had nexus sufficient for transaction privilege tax liability although it had no property, business location, or employees in Arizona, because it had one customer in the state and because its activities in performing the contract with that customer were significantly associated with its ability to establish and maintain an Arizona market.

Subsequent to *O'Connor*, in *Arizona Department of Revenue v. Care Computer Systems, Inc.*, 4 P.3d 469 (Ariz. Ct. App. 2000), the Court of Appeals held that an out-of-state corporation was subject to Arizona transaction privilege tax on sales and leases it made to Arizona consumers. 4 P.3d at 471. In the sales transactions at issue, title to the goods passed outside Arizona. Furthermore, the corporation did not own any property, maintain an inventory, have a business address, or hire employees or independent contractors residing in Arizona (the corporation hired a solicitor domiciled in California). Neverthless, applying the *Tyler Pipe* substantial nexus test, the Arizona court observed that the visits by the solicitor with Arizona customers were frequent, the corporation sent trainers to assist

customers in using the computer hardware and software it sold, and these visits were intended to and did create customer satisfaction and additional sales for the corporation. *Id.* at 472. The appellate court determined that the vendor's liability for transaction privilege tax was based on "whether the activities performed on Care's behalf in Arizona were significantly associated with the taxpayer's ability to establish and maintain a market in this state for the sales." *Id.* at 471 (quoting *Tyler Pipe*, 483 U.S. at 250). It explained that "[t]he trips by Care's salesperson to Arizona were intended to, and did, result in additional sales of Care products" and that "[t]he trips by Care trainers to Arizona were in part intended to, and presumably did, increase the satisfaction level of Arizona customers and encourage other members of that nursing home chain to buy Care products." *Id.* at 472.

The court rejected the taxpayer's argument that A.A.C. R15-5-2307, regarding sales and use taxes, limited application of transaction privilege tax to those taxpayers maintaining a business in Arizona, stating that the fact that transaction privilege tax applies to vendors maintaining an Arizona place of business "does not purport to exclude a taxpayer who does not maintain a place of business from the tax." 4 P.3d at 474.

The *Care* court stated that although the taxpayer's business leases "were few in number and duration, . . . they could, and did, develop into outright sales." 4 P.3d at 472. It reasoned that "[a]lthough Care's Arizona activity was of relatively low volume, 'the volume of local activity is less significant than the nature of its function on the out-of-state taxpayer's behalf.'" *Id.* (quoting *O'Connor*, 963 P.2d at 287).

In *Interlott Technologies, Inc. v. Arizona Department of Revenue*, 72 P.3d 1271 (Ariz. Ct. App. 2003), the Department assessed transaction privilege tax under the personal property rental classification on a vendor that leased two hundred machines in Arizona and maintained two employees in the state to respond to service calls, perform preventive maintenance on the machines, train others to use and maintain the machines, and remove and move the machines. 72 P.3d at 1276. Rejecting the argument that Interlott did not maintain a market in Arizona, the court stated that "[p]erforming a contract is maintaining a market." *Id.* (citing *O'Connor*, 963 P.2d at 285). Also, in discussing the taxpayer's argument that no business resulted from contacts by employees in Arizona, the court noted that "an activity need not produce business in order to create a nexus." *Id.*

Nexus Jurisprudence involving Other States' Taxing Schemes

The following list provides summaries of case law in which a court found that a taxpayer's presence or activities in a state were constitutionally sufficient to establish nexus for sales or use tax liability under the Commerce Clause:

1. The United States Supreme Court upheld the assessment of a Washington State gross receipts tax on a foreign vendor's sales to the Boeing Company against Due Process and Commerce Clause challenges. *Standard Pressed Steel Co. v. Wash.*

Dep't of Revenue, 419 U.S. 560 (1975). The Court found a sufficient vendor's physical presence in the state in the form of a single resident engineer-employee who operated out of his home in Washington and whose responsibilities were to consult with the customer on anticipated needs for the vendor's parts and to follow up on problems in using the product. *Id.* at 562-63.

2. The United States Supreme Court upheld a California use tax collection assessment on a foreign corporation that operated two offices in the state. Although the activities in those offices were unrelated to the corporation's mail order activities, the Court held that it was permissible to impose the administrative burden of collecting use taxes on the mail order transactions because the two California offices, regardless of the nature of their activities, had the advantage of the same services (*e.g.*, fire and police protection) as they would have had their activities included assistance to the mail order operations that generated the use tax liability. Hence, there was a definite link between the corporation and the State of California. *Nat'l Geographic Soc'y v. Cal. Bd. of Equalization*, 430 U.S. 551 (1977).

3. The United States Supreme Court upheld Illinois' imposition of a 5 percent excise tax on interstate telephone calls that were required to be collected by long-distance telephone carriers through their billings. *Goldberg v. Sweet*, 488 U.S. 252 (1989). The local nexus requirement was met because the tax was restricted to telephone calls originating or terminating in Illinois and charged to an Illinois service address. *Id.* at 263.

4. The Oklahoma Supreme Court sustained a finding that there was substantial nexus with the state on fuel oil that taxpayer sold to a railroad that then transported it out of the state, because the point of delivery and transfer of title and possession occurred within the state under the terms of the contract and applicable commercial law. *Koch Fuels, Inc. v. State* ex rel*. Okla. Tax Comm'n,* 862 P.2d 471 (Okla. 1993).

5. The New York Court of Appeals upheld New York's imposition of use tax collection duties on two Vermont vendors. In one case, the vendor made retail sales almost entirely through catalog mail-order sales into New York by common carrier or United States mail, and also sold merchandise at wholesale to New York retailers. The vendor's employees visited retailer customers during the tax period. In the second case, a Vermont computer hardware and software marketer made sales through common carrier or United States mail into the state. The vendor's employees made visits to customers to resolve problems, provide training, and occasionally install software; the sales agreements used obligated the company to provide free visits of computer software installers in New York if problems occurred within the first 60 days of installation. The court found that the actions of the vendors established substantial nexus, as they "enhanced sales and significantly contributed to [the

vendor]'s ability to establish and maintain a market . . . in New York." *Orvis Co., Inc. v. Tax Appeals Tribunal*, 654 N.E.2d 954 (N.Y. Ct. App. 1995).

6. The Rhode Island Supreme Court found that Rhode Island's gross earnings tax imposed on an out-of-state fuel oil seller for in-state sales of fuel oil was imposed on an activity with substantial nexus to the state because the out-of-state vendor retained total control of the shipments of the oil throughout delivery; the seller also retained title, possession, and risk of loss of the oil. The court found that the activities of the seller created, in practical effect, a physical presence of the seller within the taxing state. *Koch Fuels, Inc. v. Clark*, 676 A.2d 330 (R.I. 1996).

7. The Hawaii Supreme Court upheld the imposition of Hawaii's general excise tax in In re *Tax Appeal of Baker & Taylor, Inc. v. Kawafuchi*, 82 P.3d 804 (Haw. 2004), which involved an out-of-state corporation that made a series of sales to Hawaii where title passed outside the state, but that was nevertheless assessed for general excise tax and use tax liability. It had no office, real property, or employees based in Hawaii, did not hold a general excise tax license during the tax period, and used common carriers to deliver sales into the state. *Id.* at 803-04. The business sent catalogs to customers in Hawaii, and accepted orders by telephone, fax, and over the Internet, and also provided toll-free numbers for customer assistance and technical support. *Id.* at 807. It also sent employees to Hawaii to meet with customers and potential customers, for sales meetings, trade shows, troubleshoot problems, and hold training meetings for customers. *Id.* at 807-08. It also provided software and training for purchasing and cataloging its materials in the state. *Id.* at 811.

   In referencing *Tyler Pipe*, the Hawaii Supreme Court found that the company's "frequent visits to Hawaii to service" customers were done to "improve [its] name recognition, market share, good will, and individual customer relations[,] . . . the same factors which *Tyler Pipe* determined were adequate to subject Tyler Pipe to Washington's taxing jurisdiction." *Id.* at 813. Next, upon reviewing Arizona's *Care* decision, the court found that "the 'volume' and 'function' of Baker's representatives in Hawaii exceeded that of Care representatives," and were related to its business. *Id.* at 814. Baker furthermore "retained ownership rights with respect to the licensed software" in Hawaii as the vendor retained ownership of property in Arizona in *Care*. *Id.* It concluded that the vendor's situation "did not involve mere solicitation and a sale that was final as the goods were transferred to a common carrier, [but rather], involved . . . an ongoing long term contract with the [customer]." *Id.* at 815. The court concluded that "Baker's presence in Hawaii was a continuous process of sales and service creating substantial legal nexus." *Id.* at 816.

8. The Louisiana Court of Appeal found that evidence in the trial court's record was sufficient to establish a finding of nexus for use tax liability on an out-of-state computer vendor with no offices, bank accounts, direct employees, or other property

in the state that nevertheless contracted with a third-party service provider to provide "on-site" computer repair service to Louisiana purchasers of its computers. *State v. Dell Int'l, Inc*., 922 So.2d 1257, *reh'g denied*, 930 So.2d 97 (2006). To explain its analysis, the Court of Appeal cited the U.S. Supreme Court's opinions in *Tyler Pipe* and a 1960 case, *Scripto, Inc. v. Carson*, 362 U.S. 207, to conclude that "[t]he nature and extent of the activities . . . and whether those activities are significantly associated with the taxpayer's ability to establish and maintain a market in this state . . . are the determinative factors of whether [the vendor's] contractual dealings with [the third-party service provider] constitute a sufficient physical nexus for the purpose of justifying the imposition of a use tax." *Id.* at 1264.

The state appellate court noted numerous facts, including that the out-of-state vendor copyrighted its contracts for service to interested customers, collected and remitted sales tax on behalf of the service provider, marketed, emphasized, and warranted the service in its own advertising, trained the service provider's technicians on what services to provide and how the service should be performed, set the prices on repair service, and reserved the rights to terminate the contracts between its customers and the service provider and to hire another party to perform them if the provider failed to meet performance standards. *Id.* at 1259-60. The court also noted testimony and evidence in the record that demonstrated the computer vendor "foresaw that it would be difficult, if not impossible, to compete with local computer dealers without providing some kind of warranty service," and that "providing on-site service was one of [the vendor]'s primary objectives and that it was a very significant factor in [the vendor]'s ability to establish and maintain a market in other states and led to its subsequent success." *Id.* at 1265. The Court of Appeal concluded that the activities the vendor carried out through its third party service provider was to an extent and of a nature that furthered its ability to establish and maintain a market in the state. Subsequently, it held that the facts were sufficient to find nexus to create the physical presence required for imposing use tax on the vendor's sales to Louisiana customers. *Id.* at 1266.

The following list provides summaries of case law in which a court found that a taxpayer's presence or activities in a state were constitutionally insufficient to establish nexus for sales or use tax liability under the Commerce Clause:

1. An out-of-state company's sales of carpets and subsequent in-state installation of the carpets lacked sufficient nexus to be subject to Mississippi sales tax. Customers could specify particular installers, install themselves, or accept the store's recommendation of one of two local installers. Prices charged by the store did not include installation costs (if the installation fee was paid to the store, it would keep it for the installers to pick up), the store did not own or maintain any installation equipment, installers assumed responsibility over the carpets once they took possession, the store did not pay any compensation to the installers, and the store

did not supervise or maintain control over the installation or final results of the installers' work. State statute provided that sales tax is imposed when title passes, which is usually at the time of performance. The court stated that the Alabama store, which sold carpeting but did not perform the installation in Mississippi, did not avail itself of the substantial privilege of carrying on business within Mississippi, because the local installers were not agents or employees of the store. *Miss. State Tax Comm'n v. Bates,* 567 So. 2d 190 (Miss. 1990).

2. A vendor's activities lacked the substantial nexus required by the Commerce Clause for imposition of sales tax assessments. The taxes were assessed on the purchase of laptops. The seller engaged in occasional advertising in the local newspaper and Yellow Pages and, on a few occasions, an agent of the seller would accompany a common carrier into the state. The court found that the degree of activity was insufficient to satisfy the substantial nexus requirement of the Commerce Clause, although it was sufficient for Due Process requirements. In re *Laptops Etc. Corp*., 164 B.R. 506 (Bankr. D. Md. 1993).

3. Sales of an out-of-state mail-order company with no employees, inventories, or facilities in California and that solicited business through catalog mailings, brochure inserts with products of other interstate mail-order companies, and through newspaper and magazine advertisements were found to have insufficient nexus for purposes of California use tax. Orders were accepted through the mail and filled by shipment from out-of-state through common carrier or United States mail. The vendor never conducted debt collection activities either directly or indirectly, never used the services of any California credit reference agencies, and never collected use tax. The company was a subsidiary of an out-of-state parent corporation that maintained manufacturing plants, field sales representatives, and assorted personnel in California, and engaged in a partially overlapping business as the mail-order subsidiary. Neither was the alter ego or agent of the other, neither solicited orders for the products of the other, and neither accepted merchandise returns of the other or otherwise assisted or provided services for customers of the other—they did not have integrated operations or management. Neither held itself out to customers as being the same as, or an affiliate of, the other, and each had its own trade name, goodwill, marketing practices, and customer lists and marketed products independently of the other. The Court of Appeal found the mail-order subsidiary's physical nexus insufficient to justify the imposition of a use tax. The Board of Equalization's argument that the parent and subsidiary were both "engaged in the printing business" was "too common a denominator." The customer bases, marketing methods, and product lines were dissimilar, and the overlapping check-printing businesses of both entities was not sufficient (it constituted 7.9 percent of the subsidiary's revenue but 96.3 percent of the parent's) to render both in "the same or similar line of business" as required by a statute imposing use tax collection. *Current, Inc. v. Cal. Bd. of Equalization*, 24 Cal. App. 4th 382 (1994).

4. A vendor lacked sufficient nexus with Ohio to impose a use tax collection responsibility on it for direct mail sales that the vendor made through catalog mailings, where a customer placed orders by telephone, mail, or fax, the vendor shipped merchandise to the customer via mail or common carrier, and the vendor had no facility in the taxing state to store or ship merchandise, and returns were only accepted if returned to an out-of-state location. The vendor owned a separate wholly-owned bricks-and-mortar subsidiary in the state that received copies of the catalogs for training and references purposes, but also "left some catalogs on the counter for free distribution to its customers" and kept copies for customers who requested them. Although the bricks-and-mortar subsidiary could search bricks-and-mortar stores in other states for merchandise, it did not search the mail order subsidiary's stock; if the store was unsuccessful in locating the item in its store, however, it "might then refer the customer" to the catalog, but did not place orders with the mail-order subsidiary or assist customers in doing so. The bricks-and-mortar subsidiary did not sell the mail-order subsidiary's merchandise on its behalf. The bricks-and-mortar stores accepted returns of mail-order goods on a discretionary basis but attempted to sell the merchandise itself rather than return the goods to the mail-order subsidiary. The Ohio Supreme Court held that the retailer had no physical presence in the state based on an "affiliated group" or unitary business entity argument. *SFA Folio Collections, Inc. v. Tracy*, 652 N.E.2d 693 (Ohio 1995).

5. A corporation's presence in the taxing state for three days each year to attend seminars was insufficient to impose sales tax under the Commerce Clause. The corporation had no offices, employees, or agents in the state and only sold products in-state during the three-day seminars; the only other contacts with the state were through direct mail sales. This "slightest presence" was insufficient to allow the imposition of the state tax because there was not substantial nexus. *Fla. Dep't of Revenue v. Share Int'l, Inc.,* 667 So. 2d 226 (Fla. Dist. Ct. App. 1995), dec'n approved, 676 So. 2d 1362 (Fla. 1996).

6. An out-of-state company selling merchandise by mailing catalogs to teachers in the taxing state, who ordered on their own behalf or for their students and submitted orders with payment, lacked sufficient nexus with the taxing state to be liable for collecting Michigan use tax. The company's merchandise was delivered to the teachers, who distribute them to students who placed orders. Company did not own or lease real property in the state, and had no employees or independent contractors in the state. The Michigan Court of Appeals found that the teachers were not agents or a substantive "sales force" of the vendor under state law, in that the vendor had no control over the teachers, the teachers had no authority to bind the vendor, and instead, "teachers are invited to be consumers of plaintiff's materials, just as are their students." The court distinguished a California case,

Scholastic Book Clubs, Inc. v. State Board of Equalization, 207 Cal. App. 3d 734 (1989), in that the vendor's "mail contacts with Michigan teachers do not give rise to an agency relationship." *Scholastic Book Clubs, Inc. v. State Dep't of Treasury*, 567 N.W.2d 692 (Mich. Ct. App. 1997).

As can be seen, a common theme across the opinions by courts of various jurisdictions is whether the specific in-state activities directly or indirectly engaged in by a remote vendor enhance the vendor's sales and significantly contribute to the remote vendor's ability to establish and maintain a market in the state. Moreover, a remote vendor that merely creates and operates businesses in a state with separate legal existences from the vendor (*e.g.*, creating and operating separate subsidiaries) or operates its business activity through third parties who are not employees of the vendor may not be successful in avoiding a finding of nexus for state sales or use tax liability.

RULING:

The United States Supreme Court held that "physical presence" with the taxing state is required for a business to have "substantial nexus" with the state and thereby allow it to constitutionally impose a tax collection responsibility. Over the years, the Court has found that physical presence exists if a taxpayer maintains real property or personal property within the state, or when the taxpayer has employees or agents acting on its behalf within the state.

The Court has also held that a salesman's designation as an "independent" contractor does not change his local function or bear upon a retailer's ability to secure its flow of goods into the forum state. Consequently, a remote vendor cannot avoid a finding of nexus through the use of an employee-independent contractor distinction.

The Arizona Court of Appeals has recognized that the crucial factor governing nexus is whether the activities performed in the taxing state on behalf of the taxpayer are significantly associated with the taxpayer's ability to establish and maintain a market in the state for its sales.

Relevant Factors for Arizona Transaction Privilege or Use Tax Liability

Generally, in circumstances involving an out-of-state vendor, certain factors may increase the likelihood that the vendor could be considered a retailer due to substantial nexus with Arizona, such that it becomes subject to Arizona transaction privilege tax liability or a use tax collection responsibility. An overarching attempt to create a "unified face" or singular "brand recognition" among consumers, despite the actual separate corporate existences of subsidiaries, suggests an effort to maintain and improve the name recognition, market share, goodwill, and individual customer relationships of the subsidiaries. The lack of

separation between the retail operations and promotional activities of the bricks-and-mortar store and remote vendor subsidiaries would be distinguishable from cases in which the activities of the in-state and out-of-state entities were more clearly separated.

While neither exhaustive nor intended to suggest that any one factor would necessarily lead to a finding of substantial nexus, the following list provides some guidance at practices that the Department would examine in determining whether any vendor liability or responsibility exists:

1. Cross-promotion and advertising of remote subsidiary (*e.g.*, a "dotcom" or mail-order subsidiary) and in-state subsidiary (*e.g.*, retail) locations, catalogs, and websites by *in-state subsidiaries*, excluding the availability of a remote subsidiary's catalogs at a retail location to use for reference purposes or to provide to a retail customer at the customer's request. Examples include: (a) a in-state retail location's promotion of gift cards that are redeemable through both the dotcom subsidiary and in-state retail locations and (b) an in-state retail location's enrollment of customers in a "member benefits" program that gives its members discounts and benefits through both the dotcom subsidiary and in-state retail locations.

2. The ability to return and exchange merchandise acquired through different subsidiaries at in-state retail store locations and to receive credit for the return or exchange that can be applied to new transactions across subsidiaries.

3. In-state telephone or Internet kiosks that allow customers to access inventories and purchase merchandise from remote subsidiaries.

4. The acceptance of remote subsidiary orders by a retail subsidiary at in-state locations when a product is unavailable at the in-state location.

5. The order fulfillment of merchandise ordered by customers from a remote subsidiary through in-state retail or marketing subsidiaries.

6. Other activities that suggest that that an in-state retail or marketing subsidiary is acting as a salesperson or independent contractor for remote subsidiaries (*e.g.*, in-state subsidiary employees and agents soliciting names and addresses of customers for a remote subsidiary's catalog mailing list, distribution of discount coupons specifically for use with remote subsidiaries).

7. Other in-state sales and marketing efforts that promote the operations of remote subsidiaries to in-state retail customers as part of a single business (*e.g.*, by emphasizing a common company name), although they are actually separately organized business entities.

If no such or similar activities are undertaken by a taxpayer or a related entity of the taxpayer, sufficient taxable nexus would not be established simply by: (a) accepting orders from Arizona customers and (b) making the sales from an out-of-state location to be delivered to Arizona customers by common carrier or U.S. mail. Contrastingly, if the activities of a particular taxpayer include some of the aforementioned factors, they may serve as indicia that there is nexus beyond a level found for an out-of-state vendor "whose only contacts with the taxing State are by mail or common carrier," and thus subject the taxpayer to liability for transaction privilege tax.

Transaction Privilege Tax versus Use Tax Collection Liability

Arizona case law has also held that transaction privilege tax imposed under the retail classification does not require a higher level of nexus with the taxing state than use tax. If a taxpayer maintains the required degree of nexus with Arizona, the taxpayer will be subject to transaction privilege tax rather than a use tax collection obligation, unless otherwise provided by statute.

The requisite nexus for a taxpayer to be subject to transaction privilege tax liability does not require a physical place of business within the state. Moreover, the presence of a vendor's real property within a taxing state need not be related to the activity the state seeks to tax in providing nexus to impose an obligation upon the vendor to collect Arizona use tax.

Arizona use tax functions as a complement to transaction privilege tax: if transaction privilege tax applies, use tax does not. Consequently, if an out-of-state vendor is liable for transaction privilege tax on gross receipts derived from a given transaction, the Department cannot opt to impose use tax instead on the in-state purchaser in the transaction.

Barring the existence of any of the activities described above in the "Relevant Factors for Arizona Transaction Privilege or Use Tax Liability" subsection, it is possible that the remote vendor lacks sufficient nexus with Arizona to be liable for Arizona transaction privilege tax under the retail classification. Nevertheless, the remote vendor would still have sufficient nexus to be subject to Arizona use tax collection requirements for sales to Arizona customers if the vendor maintains a business or otherwise owns real property in Arizona that is *completely disassociated* from its retail sales (*i.e.*, the in-state business or real property does not establish and maintain a market for the taxpayer's retail sales).

Sourcing Transactions

A remote vendor that is liable for Arizona transaction privilege tax or collection of Arizona use tax shall charge, collect, and remit the tax based on the rate in effect at the physical location of the customer. The vendor may rely on the shipping address provided for a transaction to determine the customer's physical location.

The Model City Tax Code ("MCTC") determines the imposition and administration of city privilege and use taxes. Consequently, the sourcing methodology for state and county tax purposes provided above may differ significantly from the methodology used by Arizona cities and towns. An analysis of differences between state and local taxation is beyond the scope of this ruling. Contact the respective cities directly or consult the MCTC (available online at www.modelcitytaxcode.org) for questions regarding city taxation.

Nexus Determinations

Note that the positions and examples stated above are intended to provide general guidance to taxpayers. Determining a taxpayer's nexus for Arizona transaction privilege tax or use tax collection purposes requires a comprehensive evaluation of the particular facts and circumstances surrounding its activities. In some cases, a taxpayer's limited activities within Arizona may be of an inconsequential or de minimis nature such that they do not give rise to such nexus. A taxpayer requesting a nexus determination for tax purposes should contact:

Arizona Department of Revenue
Transaction Privilege and Use Tax Nexus Section
1600 W. Monroe, 5th Fl.
Phoenix, AZ 85007
(602) 716-6533

Explanatory Notice

The purpose of a tax ruling is to provide interpretive guidance to the general public and to department personnel. A tax ruling is intended to encompass issues of law that are not adequately covered in statute, case law or administrative rules. A tax ruling is a position statement that provides interpretation, detail, or supplementary information concerning application of the law. Relevant statute, case law, or administrative rules, as well as a subsequent ruling, may modify or negate any or all of the provisions of any tax ruling. See GTP 96-1 for more detailed information regarding documents issued by the Department of Revenue.