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Third-party service providers

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In this article, the authors consider the state income tax nexus implications of the shift toward the remote delivery of goods and services as states more aggressively assert jurisdiction to tax. They focus on scenarios in which out-of-state companies rely on in-state services provided by third parties as well as the implications it may hold in the context of Public Law 86-272.

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I. Introduction

Long past are the days when companies could reasonably base nexus determinations on the location of property, payroll, and employee travel. Physical presence in a particular state and whether that presence was sufficient to give rise to an income tax filing obligation was a fairly consistent rule of thumb through the end of the 20th century. However, technology and innovation have resulted in rapid changes to the national economy in the past 20 years, and companies can now reach their customers without ever physically setting foot in the state where the customer is located. As a result, many states are seeking to assert their taxing authority over out-of-state companies regardless of whether those companies have a physical presence in the state. Application of what are generally referred to as economic presence nexus standards is increasingly common and may be based on the existence of some types of nonphysical activity in a state, including purposeful direction, active solicitation, and factor-based activity. Equally significant is the scrutiny that states are giving to the in-state services provided by third

parties to a taxpayer's in-state customers that would create nexus if directly engaged in by a taxpayer and to services provided by third parties to the taxpayer itself that may or may not involve the presence of property owned by the taxpayer in the state.

In this article, we consider the state income tax nexus implications resulting from the shift toward the remote delivery of goods and services as states more aggressively assert jurisdiction to tax. We focus on scenarios in which out-of-state companies rely on in-state services provided by third parties, as well as the implications of Public Law 86-272.¹

II. Economic Presence Nexus

Economic presence nexus generally refers to several theories that states have adopted asserting nexus over an out-of-state corporation that has an economic presence in a state, even though the business may lack a physical presence. The latest incarnation of economic presence nexus rules are so-called factor nexus standards, which impose bright-line thresholds that trigger income tax nexus in the state if the taxpayer has a certain amount of in-state property, payroll, or sales, regardless of whether the taxpayer is otherwise present.

Nine states — Alabama, California, Colorado, Connecticut, New York, Ohio, Tennessee, Virginia, and Washington — have adopted factor nexus standards for income or gross receipts tax purposes.² Factor nexus has become a popular trend among states because those standards, relative to the more subjective economic nexus standards (for example, "active solicitation") remove much of the ambiguity over whether a taxpayer must file an income tax return. Those bright-line rules, and specifically the sales element, cast the nexus net ever more broadly but not without

¹15 U.S.C. sections 381-384.

²Ala. Code section 40-18-31.2(b); Cal. Rev. & Tax. Code section 23101(b)-(d); 39 Colo. Code Regs. section 39-22-301.1; Conn. Gen. Stat. section 12-216a; N.Y. Tax Law section 209.1(b); Ohio Rev. Code Ann. section 5751.01(H)-(I); Tenn. Code. Ann. section 67-4-2004(52); and Va. Code. Ann. section 58.1-400.

controversy.³ Most of the states that have adopted a factor nexus standard have based it on the Multistate Tax Commission model statute, which requires \$50,000 of property, \$50,000 of payroll, or \$500,000 of sales in the state.⁴ Notable variations include New York, which has a \$1 million annual sales threshold,⁵ and Virginia, which requires the filing of an income tax return if any positive Virginia apportionment factor exists.⁶

It is important to note that economic presence nexus and market-based sourcing of services and intangibles create an enhanced challenge for taxpayers in states such as California, which have adopted both.⁷ While the sourcing of sales of tangible personal property may be relatively straightforward to determine and apply in the context of an economic presence nexus standard, taxpayers providing services or dealing in intangibles face the initial, additional burden of determining how their sales must be sourced under often-ambiguous market-based sourcing rules.

Another issue that is amplified by the growing economic presence nexus trend is the P.L. 86-272 implications for a company making sales of tangible personal property that also provides, albeit remotely, so-called ancillary services to in-state customers. For example, a company sells software, which is considered a sale of tangible personal property in the state, but also provides access to a 24-hour help desk to troubleshoot any problems with the software. In that situation, are the protections of P.L. 86-272 available in states where otherwise only mere solicitation occurred? Would it make a difference if the activities of the in-state sales force and marketing promoted the ancillary service? What would be the result under a rule as in Michigan, which requires only active solicitation to trigger nexus?⁸

III. Third-Party Services Provided to a Taxpayer's In-State Customers

Advancements in technology and relationships have significantly enhanced the ability of companies to participate in previously inaccessible national and global markets. One of the mechanisms by which states may attempt to assert their taxing jurisdiction over out-of-state companies availing themselves of in-state markets is by looking to the presence of third parties conducting in-state activities on behalf of the out-of-state company. Whether the presence of a third party performing in-state activities for an out-of-state corporation, without more, is enough to subject an out-of-state company to taxation is a difficult question;

³Crutchfield v. Testa, 2015 Ohio Tax LEXIS 1154 (Ohio Bd. of Tax App. Feb. 26, 2015); argued, Case No. 2015-0386 (Ohio 2016).

⁴MTC, Factor Presence Nexus Standard for Business Activity Taxes, Oct. 17, 2002, available at <http://bit.ly/29HoHi3>.

⁵N.Y. Tax Law section 209.1(b).

⁶Va. Code. Ann. section 58.1-400; 23 Va. Admin. Code section 10-120-90; and 23 Va. Admin. Code section 10-120-90.

⁷See Cal. Rev. & Tax. Code sections 23101(b)-(d); 25136.

⁸Mich. Comp. Laws section 206.621(1).

there are no bright lines, and the answer may vary from state to state. This section discusses some increasingly common third-party relationships and considers their potential nexus implications for out-of-state companies contracting with those third parties.

Broadly speaking, third-party representatives may be classified as either independent contractors or agents. The distinctions between an agent and an independent contractor can be murky. As a general rule, independent contractors are not subject to the supervision or control of the contracting party in the performance of their activities; they dictate their own method and manner of work. Independent contractors also generally cannot legally bind the contracting party and are liable for their own negligence in performing their tasks. In contrast, an agency relationship will generally be found to exist in circumstances in which the contracting party has the authority to direct and control the activities of the person or entity, whether exercised or not. The party on whose behalf the agent is acting may be held legally liable for the actions or negligence of the agent. Because the agent is akin to an employee in most material respects, an agent's in-state activity generally establishes nexus for an otherwise out-of-state principal. However, whether an independent contractor's activities are deemed to establish nexus for its principal can depend on numerous factors, including the nature of the activities being performed.

In *Scripto Inc. v. Carson*, the U.S. Supreme Court found that an independent contractor's marketing activities in Florida, performed for an out-of-state company, created nexus for the out-of-state principal for sales and use tax purposes because the activities of the independent contractor were in furtherance of the seller's maintenance of a market in the state.⁹ The Court noted that the distinction between independent contractor and agent was a private contractual matter and that "to permit such formal 'contractual shifts' to make a constitutional difference would open the gates to a stampede of tax avoidance."¹⁰ Another Supreme Court case, *Tyler Pipe Industries Inc. v. Department of Revenue*, largely affirmed *Scripto* in the gross receipts tax context, with the Court concluding that the critical inquiry is whether the independent contractor's activities are "significantly associated" with the ability of the out-of-state principal to establish and maintain a market in the state.¹¹

The provisions of P.L. 86-272 also apply to some types of activities of independent contractors and provide some protection from the establishment of nexus that would not be afforded if those activities were conducted instead by employees or agents.¹² The law generally permits independent contractors to solicit sales of tangible personal property,

⁹362 U.S. 207 (1960).

¹⁰Id. at 211.

¹¹483 U.S. 232, 250 (1987).

¹²For example, an independent contractor may rent an office in a state without creating nexus. 15 U.S.C. section 381(c).

make sales of tangible personal property, and maintain offices instate without establishing nexus for the principal.¹³ However, independent contractors whose activities go beyond those activities, such as performing services unrelated to solicitation, would presumably not be engaging in activities protected by P.L. 86-272 and thus could create nexus for their contracting parties.

As commerce continues to expand and companies reach customers in more jurisdictions where they have no physical presence through property or employee activity, the activities provided on a company's behalf have increasing income tax nexus implications. Several are considered below.

A. Warranty Obligations Serviced by Third Parties

Numerous states take the position that nexus is established with out-of-state taxpayers whose only in-state connection is the performance of warranty servicing activity by third-party contractors. The MTC considered that issue in 1995 with the issuance of Nexus Program Bulletin 95-1, which addressed a computer company's provision of repair and other warranty-related services through third-party service providers. The MTC indicated that the third party's provision of in-state repair services created nexus for the out-of-state computer company because the services were "part of the company's standard warranty or . . . an option that can be separately purchased and as an advertised part of the company's sales contributes significantly to the company's ability to establish and maintain its market for computer hardware sales in the State."¹⁴ About two dozen states and the District of Columbia initially signed on to that analysis.¹⁵ Other states, such as Massachusetts, have taken a different approach, requiring that a company inspect, approve, or otherwise have oversight over the third party's activities in order for those activities to create nexus.¹⁶

B. Third-Party Marketing and Merchandising

P.L. 86-272 provides that a state cannot impose nexus on a taxpayer who uses an independent contractor to solicit sales of tangible personal property, as long as the independent contractor's activities do not exceed the limits imposed by P.L. 86-272, as discussed above.¹⁷ However, if the independent contractor's activities exceed the boundaries of P.L. 86-272, it may result in nexus the same way it would if the taxpayer itself had engaged in those activities. Examples of activities that may exceed those limits include coordinating in-state meetings or promotional events to raise awareness about a product. Whether those types of marketing activi-

ties create nexus for an out-of-state company can vary by state, but some states have taken the view that an in-state company's marketing for another company is a service, to which P.L. 86-272 would not afford protection.¹⁸

Another type of third-party activity that could potentially create nexus for an out-of-state corporation is activity performed for product sellers to place and display merchandise in large retail stores and grocery markets to make the merchandise more appealing to consumers. The Minnesota Tax Court recently examined the case of an out-of-state seller that sold its products through jewelry and retail department stores.¹⁹ While the case examined the activities of employees, rather than independent contractors, it provides at least one state's view on the limits of P.L. 86-272 protections regarding those type of activities. In the case, the product seller employed "merchandisers" in Minnesota — part-time employees who were responsible for visiting retailers' stores in the state and conducting a variety of activities. Among those activities, merchandisers would inspect, rearrange, and refill the cases that displayed the seller's products.²⁰ The court held on summary judgment that all but one of the merchandisers' activities went beyond the mere solicitation of orders in Minnesota. Thus there was no P.L. 86-272 immunity, and there was sufficient nexus to impose the state's corporate franchise tax on the seller.²¹ Large retailers and supermarkets may require vendors to use "merchandising service" providers, whose activities may range from setting up in-store displays and signage, monitoring inventory levels, and moving product from a warehouse onto shelves. It may be a condition of the contract with the retailer, or vendors may employ the services voluntarily to improve in-store presence and sales.

While P.L. 86-272 addresses independent contractors, it does not address the treatment in which an entity solicits sales for an affiliate. That issue was examined by the Pennsylvania Commonwealth Court in *Schering-Plough Healthcare Products Sales Corp. v. Commonwealth of Pennsylvania*.²² There the court found that P.L. 86-272 protected a company from taxation in Pennsylvania when the company's in-state activities were limited to soliciting sales of tangible personal property for another out-of-state company. The court found that P.L. 86-272 does not require the ownership of the underlying tangible personal property for which the sales are solicited in order to provide protection.²³

¹³*Id.*

¹⁴MTC, Nexus Program Bulletin 95-1, Dec. 20, 1995, at 3.

¹⁵See John C. Blasé and John W. Westmoreland, "Guilt by Third Party Association? Contesting Sales and Use Tax Audits Based on 'Attributable Nexus' Theory," *State Tax Notes*, Sept. 29, 1997, p. 827, n. 3.

¹⁶830 CMR 63.39.1(5)(d).

¹⁷15 U.S.C. section 381(c).

¹⁸See, e.g., Idaho Tax Commission Decision, Docket No. 16056 (May 1, 2003); Ind. Department of Findings, Letter Nos. 02-0499 and 02-0500 (Jul. 1, 2004); N.C. Department of Revenue, Dir. No. CD-98-2 (Apr. 27, 1998); and Ill. Department of Revenue, Gen. Info. Ltr. IT 98-0092-GIL (Nov. 24, 1998).

¹⁹*Skagen Designs Ltd. v. Commissioner of Revenue*, 2012 Minn. Tax LEXIS 25 (Apr. 23, 2012).

²⁰*Id.* at 3-5.

²¹*Id.* at 20-21.

²²805 A.2d 1284 (Pa. Commw. 2002), *aff'd*, 580 Pa. 357 (2004).

²³*Id.* at 1289.

IV. Third-Party Services That Involve Taxpayer-Owned Property

The previous section considered the activities performed by third parties designed to maintain a taxpayer's market in a state and the potential income tax nexus that this may create for the taxpayer. The in-state activities of a third party for the benefit of a taxpayer may create income tax nexus when it involves the instate presence of property to which the taxpayer retains title.

Generally, the Supreme Court has interpreted the commerce clause so that an out-of-state company must have substantial nexus to be subject to tax in a state.²⁴ In *Quill Corp. v. North Dakota*, the Court did not find nexus based on ownership of software, which included "a few floppy diskettes" in the state, noting that substantial nexus requires something more than the "slightest presence."²⁵ Also, in *Department of Revenue v. William Wrigley Jr. Co.*, the Court noted that a de minimis amount of activity in-state that is not sales solicitation would not cause the loss of P.L. 86-272 protection.²⁶ However, whether a level of presence exceeds the de minimis standard is fact specific and subject to interpretation in each state.

A. Equipment and Materials Placed at Customer Location

One common question is whether placing equipment with customers to facilitate the use of a product creates nexus in states where there is otherwise no presence. For example, a car paint seller may also provide mechanics with equipment to apply the paint. Most states will treat taxpayer-owned property as creating nexus; however, depending on the facts of the case, it is possible that other states would consider that type of property to be de minimis²⁷ and thus not establishing nexus.

States have grappled with the issue of whether the presence of out-of-state, company-owned containers creates nexus. Broadly, when an out-of-state business's containers are instate because of delivery-related activities, a state may be less likely to assert nexus because of the protections of P.L. 86-272. However, if the presence of containers is ancillary to the use of the goods, as with reusable containers, that presence may exceed P.L. 86-272 protection. For example, in *Olympia Brewing Co. v. Department of Revenue*, the Supreme Court of Oregon held that the presence of beer kegs

used for dispensing draft beer was not a protected activity under P.L. 86-272; therefore, the out-of-state seller was subject to Oregon income tax.²⁸

B. Logistics Service Providers

Third-party logistic service providers may perform logistic or supply chain management functions for an out-of-state company, including integrating operations, warehousing, or transportation services. A few states offer exceptions to the general rule that property in a state will create nexus for inventory held by a third-party logistics provider or a public warehouse.²⁹ However, absent an exemption, to the extent a company retains title to inventory that is not in the process of delivery or transshipment, a company may have nexus in the state where the inventory is held.

C. Contract and Toll Manufacturing

Under a contract manufacturing arrangement, a principal does not generally own the raw materials that are being processed at the manufacturer's location or hold title to the inventory work in progress. A contract manufacturer typically purchases the raw materials themselves, then sells the manufactured products to the company that contracted for the finished product. Contract manufacturing often involves the presence of tooling, dies, molding, or other manufacturing-related property owned by an out-of-state company at the manufacturer's location. The presence of that manufacturing-related property instate when owned by an out-of-state company is generally enough to create nexus for the out-of-state company.³⁰

Toll manufacturing, by contrast, describes an arrangement under which a third party manufactures products for a fee as a service. Under a toll manufacturing arrangement, the principal may continue to own the raw materials being processed at the manufacturer's location and hold title to the inventory work in progress. While rules vary by state, the presence of the raw materials may be treated as owning inventory in the state. Thus toll manufacturing may create nexus for an out-of-state corporation.

At least one state specifically provides that the presence of inventory in a public warehouse will not be considered nexus creating. Massachusetts provides that ownership of tangible personal property stored in a licensed public warehouse would not be enough on its own to subject a foreign corporation to the corporate excise tax.³¹ As such, in evaluating whether the presence of inventory is enough to create

²⁴Complete Auto Transit Inc. v. Brady, 430 U.S. 274 (1977).

²⁵504 U.S. 298, 315 n.8 (1992).

²⁶505 U.S. 214 (1992).

²⁷See, e.g., Tenn. Code section 67-4-2004 (nexus exemption for some de minimis property); and Pennsylvania Department of Revenue Corp. Tax Bull. 2004-02 (May 14, 2004) (equipment, tooling, and inventory on a temporary basis for the purpose of having work or services performed by an in-state provider is de minimis if the activity engaged in is not the pursuit of a market in Pennsylvania, the equipment is not used or held by an affiliated instate entity, and the companies have no control over work done in Pennsylvania by the in-state entity).

²⁸511 P.2d 837 (1973).

²⁹See, e.g., Conn. Code Regs. section 12-214-1; and Ind. Code section 6-3-2-2.1; 830 CMR 63.39.1(7)

³⁰Genentech Inc. v. Commissioner, Mass ATB Docket Nos. C282905, C293424, C298502, and C298891, ATB 2014-918-19 (Nov. 17, 2014).

³¹830 CMR 63.39.1(6)(c), but cf. Wis. Admin. Code Tax section 2.82(4)(a)(3) (indicating that the presence of goods in a public warehouse would create nexus).

nexus for an out-of-state company may require the company to consider the nature of the inventory's presence instate.

D. Clinical Research Organizations

Pharmaceutical companies may employ a third-party clinical research organization (CRO) to conduct independent clinical trials of drugs under development or to seek new medical uses for marketed drugs. Whether that is enough presence to subject an out-of-state company to tax may vary depending on those factors including who is directing the trial, in what types of activities the contract research organization is engaging, and who owns the property (for example, the drugs or infusion devices) being used in the research activities. A taxpayer might argue that actual testing activities cannot be imputed to the drugmaker for nexus purposes as the CRO is truly an independent contractor that performs those services for many unrelated parties. However, while CROs generally operate independently of the pharmaceutical companies that hire them, the pharmaceutical companies generally retain title to the drugs being tested, which some states may consider as nexus creating even if the amount of drugs involved in the clinical trial is arguably insignificant.

In *Genentech Inc. v. Commissioner*, the Massachusetts Appellate Tax Board recently found that taxpayer ownership of tested materials creates nexus when used by CROs in the state.³² The board stated that it did not "adopt a bright line rule that a specified level of property or possession of clinical trial material in and of itself will create nexus in every case" but the taxpayer's "ownership of drugs used in clinical trials was sufficient to create nexus" when taken together with some other tangible property used by employees in Massachusetts.³³ The taxpayer had argued that because the CRO was an independent contractor, the CRO's activity could not be attributed for nexus purposes under Massachusetts rules. The board rejected the argument, noting that it is "not the activities of . . . the CROs that were nexus creating; it was the ownership of the underlying property in Massachusetts itself that created nexus."³⁴

Alternatively, in a letter ruling, the Virginia tax commissioner described several factors that must be considered in

making a determination whether an out-of-state pharmaceutical company has nexus in Virginia, where one of its contacts with the state was the conducting of clinical trials by third parties.³⁵ In evaluating whether the clinical trial activity would be enough to create nexus for the out-of-state company, the commissioner noted that the company retained ownership of the drugs and some equipment used in the clinical trials but focused his analysis on whether the third-party CRO met the requirements for being an independent contractor under P.L. 86-272. The commissioner noted that determining whether the CRO could be considered an independent contractor was a key inquiry in determining whether the out-of-state pharmaceutical company had nexus with Virginia.

E. Software and Cloud Computing

Because of the dramatic expansion of the market for digital products and the ever-increasing use of cloud computing, new issues have developed regarding where nexus is created in connection with those technologies. For example, even if a company does not own or lease servers in a particular state, the mere *use* of a third-party server may raise nexus issues. Texas administrative regulations provide that a company will be deemed to be doing business in the state, for sales and use tax purposes, if it "derives receipts from the sale, lease, or rental of tangible personal property that is located in that state or owns or uses tangible personal property that is located in that state, including a computer server or software to solicit orders for taxable items, unless the seller uses the server or software as a purchaser of an Internet hosting service."³⁶

V. Conclusion

As companies become less physically connected to the marketplace for their products and services, states can be expected to go to greater lengths to assert their jurisdiction to tax. Unless Congress³⁷ or the U.S. Supreme Court acts to clearly restrict the power of states to subject companies to income tax based on physical presence, taxpayers will continue to see states applying or enacting economic presence nexus rules and asserting nexus based on a growing list of third-party activities. ■

³²*Genentech Inc. v. Commissioner*, ATB 2014-918-19 (Nov. 17, 2014). This case is under appeal to the Massachusetts Supreme Judicial Court (transferred *sua sponte* from the appeals court); however, the nexus finding was not appealed.

³³*Id.*

³⁴*Id.*

³⁵Virginia Tax Commissioner, P.D. 14-145 (Aug. 26, 2014).

³⁶34 Tex. Admin. Code section 3.286(a)(3)(E).

³⁷Business Activity Tax Simplification Act of 2015, H.R. 2584, 114th Cong. (2015).