

## STATES ARE TRYING TO COLLECT MORE TAX FROM RETAILERS

Many states, under pressure to close budget gaps, have become increasingly aggressive in the interpretation, enforcement, and enactment of tax laws as they relate to the retail industry. From a sales tax perspective, some states are increasing the requirements of out-of-state retail companies to collect sales tax as “agents of the state.” Meanwhile from an income tax perspective, states are broadening their definition of “conducting in-state business” to enable them to tax out-of-state retailers. Other states—and their municipalities—have begun exploring different ways to tax internet-based and “remote” businesses.

For retailers, in particular, state and local tax issues continue to evolve and develop into some of the most complicated and risky areas. Although there are Federal laws designed to protect interstate business, the U.S. Congress and the U.S. Supreme Court have taken a rather passive approach to managing the complex interstate tax issues stemming from our 50 states and countless local taxing authorities. As a result, our state and local tax system is difficult for retailers to comply with and for taxing authorities to enforce.

Most states impose an income tax and a sales/use tax based on the selling price of products. The challenge with these taxes begins with the Commerce Clause of the United States Constitution, which limits the states’ ability to tax interstate commerce. The purpose of the Commerce Clause is to ensure a free flow of trade among the state by preventing the discrimination of trade coming into the state.

A state is only allowed to assess its tax (or sales tax collecting requirement) on retailers that have “nexus” (i.e. a connection) with that state. While this nexus notion is

- **An affiliate with physical presence**—Many states consider an out-of-state business with an in-state affiliate (e.g., parent/subsidiary or brother/sister

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well-established law, the concept of what activities give rise to nexus has become an area of great debate, great litigation and sometimes, great headache.

Retailers with the following connection with a state should work with their tax advisor to review that state’s law to determine whether they have a tax filing obligation:

- **State of incorporation**—Retailers have nexus with the state of its incorporation, organization, or formation. Some states, however (e.g. Delaware), provide income tax exemptions for businesses that lack any other in-state activities.
- **Physical presence**—Generally, a business has nexus with a state where it has an in-state physical presence. Physical presence refers to activities such as an employee, office, inventory, other personal or real property, and in some states, an independent agent. However, physical property that remains in transit or employees who travel through the state without performing any other in-state activities do not typically create nexus.

corporate relationship) to establish nexus when both affiliates sell a similar product line. This can prove troublesome for retailers. While many states assert this “affiliate” notion, several states have lost this issue in various state court cases.

- **Economic presence**—Economic presence refers to the in-state presence of an intangible asset (such as a trademark, patent rights, and, potentially, a loan) of an out-of-state business. However, for sales tax purposes, a line of U.S. Supreme Court cases require a physical in-state presence before a sales tax collection requirement may be enforced. Regardless, the states are increasingly trying to do away with this requirement, causing much uncertainty for retailers.

Until recently, e-commerce businesses were able to operate in an environment where they could potentially sell to customers in all 50 states and only file tax returns in their one “home state.” In contrast, if that online retailer was a “bricks and mortar” operation having stores in 50 states, then that retailer would be required to file tax returns in each state a store was located. This area

of the law is continuing to evolve and the changing landscape will be different in the very near future.

Another new taxing area relates to states requiring online travel companies to collect local hotel occupancy taxes. Recently, a number of states (including Florida, North Carolina, South Carolina, and Texas) filed different lawsuits against the online retailer Hotels.com in order to force the company to collect (and remit) local hotel occupancy taxes. There are many other similar cases pending as this becomes a potential area of revenue for local jurisdictions.

There are also enforcement actions against online ticket sales companies. In a recent case, the City of Chicago sued Stubhub.com to force it to collect and remit Chicago's 8 percent "amusement tax" on the portion of its profit realized on ticket sales even though Stubhub.com did not have a physical presence in Chicago. Although Stubhub.com prevailed in that particular case, there will likely be similar litigation against similar "remote" sellers.

One final example, which has had the online retail industry's full attention for about two years, is New York's "Amazon"

legislation. In 2008, the State of New York enacted legislation that broadly defined the term "vendor" for nexus purposes. Nicknamed after Amazon.com, New York specifically included in the definition of "vendor" internet retailers who contract for commission with New York website "link" providers. Until that point, Amazon.com lacked a physical presence in the State of New York and, therefore, had no requirement to collect and remit New York sales tax. However, with New York redefining the term "vendor," Amazon.com was forced to begin collecting and remitting sales tax as it sold items from its website to New York residents.

This case was litigated in the New York Supreme Court (which is not New York's highest court) and that Court upheld the Amazon.com law. As a result, Amazon.com is required to collect sales tax as long as it contracts for commission with website "link" providers. Amazon is currently appealing the decision. Several states have considered enacting similar provisions, with Rhode Island passing such legislation a year later. Connecticut, and Hawaii considered similar legislation, but chose not to enact it. California initially rejected such legislation, but is now reconsidering it.

J.H. Cohn advises retailers to work with their tax and business advisor to diligently review their business operations and state and local tax filing policies. Not complying with a tax in a particular jurisdiction can be very costly, especially when sales taxes are involved or interest and penalties are significant. There are many state and local tax strategies that may help save tax dollars as well as compliance costs. For further information on this, please contact your J.H. Cohn engagement partner. ■

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