

Minnesota revenue notice, number 96-16

Corporate Franchise & Sales and Use Tax Nexus, In-State Repair Services by Computer Companies.

The Multistate Tax Commission issued a nexus program bulletin (NB 95-1) on December 20, 1995 relating to the provision of in-state repair services by computer companies and how such services will create jurisdiction to tax computer companies.

This nexus program bulletin is consistent with the Minnesota Department of Revenue's position with regard to such activities occurring within the State of Minnesota. The majority of the Multistate Tax Commission's nexus bulletin follows:

COMPUTER COMPANY'S PROVISION OF IN-STATE REPAIR SERVICES CREATES NEXUS

This Bulletin describes the nexus consequences under the U.S. Constitution and Public Law 86-272 to a company selling computer and/or related items through direct marketing (hereafter sometimes called "computer company") where the computer company also provides, directly or indirectly, repair services to its customers in a taxing State. While this Bulletin focuses on the provision of repair services performed in the taxing State, other activities conducted by or on behalf of a computer company in a taxing State may also independently create constitutional or federal statutory nexus.

INDUSTRY PRACTICE

Computer companies selling through direct marketing routinely provide repair services to their customers either on-site or through a business location in the customer's State under the computer company's warranty. A typical fact pattern is described below. This example is for illustrative purposes and should not be interpreted to exclude other instances involving similar, but not identical, fact patterns.

An out-of-state direct marketing computer company ("Computer Co.") solicits sales through advertising in computer magazines, catalogues, and fliers mailed into the taxing State. Computer Co.'s one year warranty provides for repair services in the customer's State. The Computer Co. proclaims to its customers and/or potential customers in the taxing State through advertisements and other means that its warranty covers provision of repair services in the customer's State. The warranty is either included with the purchase of every Computer Co. computer or computer related equipment or is available at an additional fee. Computer Co. sells a computer or related equipment to a customer and end user in the taxing State. When the customer discovers a problem, the terms of the warranty provide that the customer should contact Computer Co. to arrange repair service. The customer is not authorized to call the third party repair company to arrange for the repair without first calling Computer Co. for authorization. Customer calls Computer Co. which, after determining that the problem is covered by the warranty, may first attempt to solve the problem over the telephone. The Computer Co. determines whether repair is necessary and authorizes the in-state repair. Either Computer Co. or the customer, on Computer Co.'s authorization, contacts a third party service provider who performs the service in the taxing State either at the customer's location or at a site determined by the third party service provider.

NEXUS CONSEQUENCES

The industry practice of providing in-state warranty repair services through third party repair service providers, as described above, creates constitutional nexus for imposition of use tax collection responsibility for all sales made to customers in that State and for income, franchise, or comparable tax liability (including but not limited to a gross receipts excise tax) in the taxing State where the warranty services are performed. The repair services performed in the taxing State by the third party representative do not constitute *de minimis* activities in the taxing State. *De minimis* activity that does not rise to the level of constitutional nexus is activity that represents no more than a trivial connection with the State. Activities that are regular or systematic and in furtherance of the seller's business, such as the provision of in-state repairs under the company's warranty in this case, are not trivial.

LEGAL ANALYSIS

1. CONSTITUTIONAL STANDARDS FOR USE TAX NEXUS

The limits of States' taxing authority under the Due Process and Commerce Clauses for imposition of use tax collection responsibility are set forth in *Quill Corp. v. North Dakota*, ___ U. S. ___, 112 S. Ct. 1904 (1992), and in *National Bellas Hess Inc. v. Department of Revenue*, 386 U.S. 753 (1967). In *Quill*, the Court held that the Due Process Clause does not require the in-state physical presence of an out-of-state seller for a State's jurisdiction to impose a use tax collection duty upon the out-of-state seller. Economic presence through purposeful solicitation of business within a State was sufficient. *Quill*, 112 S. Ct. at 1911. In overruling, in part, the holding in *National Bellas Hess*, the Court held that the Due Process concerns of "fairness" were satisfied where the out-of-state seller "purposefully avails itself of the benefits of an economic market in the forum State." *Id.* at 1910. The Court also reaffirmed the "bright line" safe harbor created in *National Bellas Hess* that contacts with a taxing State through U.S. mail or common carrier do not create "substantial nexus" under the Commerce Clause. The Court reaffirmed that in-state presence of, or attributable to, the out-of-state direct marketing seller through retail outlets, property, or personnel satisfies the Commerce Clause requirement. The *Quill* Court drew a bright line between those direct marketing sellers with no connection to the State other than through the U.S. mail or by common carrier and all other direct marketing sellers. Thus, to the extent that a computer company's activities in any State exceeds contacts by U.S. mail or common carrier, nexus may exist. Where a direct marketing company has in-state physical presence through property or personnel in the taxing State, substantial nexus clearly exists.

Under the *Quill* bright line test, repair service provided directly by a direct marketing computer company employee in the customer's State creates in-state physical presence that exceeds contact by U.S. mail or common carrier and constitutes "substantial nexus." Courts have also consistently ruled that out-of-state companies may not circumvent state jurisdiction to impose taxes by contracting with in-state persons to conduct company business that would have otherwise created nexus if the out-of-state company had used their own employees. The U.S. Supreme Court has uniformly found that the in-state presence of a representative of an out-of-state seller who conducts regular or systematic activities in furtherance of the seller's business, such as solicitation of sales or provision of services, creates nexus. *Scripto, Inc. v. Carson*, 362 U.S. 207 (1960); *General Trading Co. v. Iowa*, 322 U.S. 327 (1944); *Felt & Tarrant Mfg. Co. v. Gallagher*, 306 U.S. 62 (1939). See also *Tyler Pipe Industries, Inc. v. Washington Dep't of Revenue*, 483 U.S. 232 (1987); *Standard Pressed Steel vs. Dep't of Revenue*, 419 U.S. 560 (1975). The Court in *Quill* specifically approved this line of cases and recognized that these cases all involve physical presence that creates nexus under *National Bellas Hess*. *Quill*, 112 S.Ct. at 1910. Accordingly, presence of representatives of a direct marketing computer company providing repair services in the customer's State will generate constitutional nexus.

The characterization of the relationship between the out-of-state seller and its in-state representative conducting business on the out-of-state seller's behalf does not effect the nexus determination. *Scripto, Inc. v. Carson*, 362 U.S. 207 (1960). See also *Tyler Pipe Inc. v. Washington Dep't of Revenue*, 483 U.S. 232 (1987); *Standard Pressed Steel v. Dep't of Revenue*, 419 U.S. 560 (1975). In *Scripto*, the Court held that in-state activities on *Scripto's* behalf by ten part-time independent contractors created nexus, even though these independent contractors worked for competing companies. The Court held that the distinction between employees and independent contractors was of no constitutional significance. As the Supreme Court in *Scripto* noted, the important fact is that the in-state activity is effective in creating and maintaining the in-state market. *Scripto*, 362 U.S. at 211-212. Similarly, in *Tyler Pipe Industries, Inc. v. Washington Dep't of Revenue*, 483 U.S. 232 (1987), the activities of one independent contractor residing in the taxing State were sufficient to create a taxable presence in the State on behalf of the company to impose Washington's Business and Occupations tax. In *Tyler Pipe*, the Court held that the critical test was whether the activities performed in this state on behalf of the taxpayer are significantly associated with the taxpayer's ability to establish and maintain a market in this state for the sales.

Tyler Pipe, 483 U.S. at 250. The Court found this standard was satisfied because "Tyler's sales representatives perform any local activities necessary for maintenance of Tyler Pipe's market and

protection of its interests." *Id.* at 251. The important aspect of both decisions is that the Court, without weighing the amount of the in-state activities, noted that in-state activities carried on through an in-state representative associated with the seller's ability to establish and maintain a market in the taxing State satisfies constitutional nexus requirements. *Tyler Pipe*, 483 U.S. at 250; *Standard Pressed Steel*, 419 U.S. at 562. In-state representation can take many forms, such as representation by individuals, corporations, partnerships, or other entities. The different forms of the relationship have no constitutional significance. Hence, an out-of-state company may not circumvent the imposition of nexus in a State where a representative third party company, rather than an in-state individual representative, conducts in-state activities on its behalf. It is the performance of the in-state activities by an in-state entity on the seller's behalf that extends those nexus creating activities and in-state presence to the out-of-state seller.

The provision of warranty repair service in the customer's state is precisely the kind of presence that squarely supports the finding of substantial nexus. The provision of in-state repair services provided by a direct marketing computer company as part of the company's standard warranty or as 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. As in *Tyler Pipe*, these in-state activities, which develop goodwill and increased market share, are no less important or beneficial to the out-of-state direct marketing computer company because they are performed by an independent third party repair service.

2. STANDARDS FOR INCOME AND FRANCHISE TAX NEXUS UNDER THE CONSTITUTION AND P.L. 86-272

There is a question of whether the substantial nexus standard for imposition of use tax collection as preserved in *Quill* or a lower nexus standard applies to income taxes, franchise taxes based upon income, and other comparable taxes. Regardless of the merits of these two positions, there is no question that when a company has sufficient contact with the State to support the constitutional imposition of a use tax collection and reporting obligation with respect to the State into which the company is selling, nexus exists for the application of an income, franchise, or comparable tax as well. The discussion of use tax nexus in the previous section supports the conclusion that constitutional nexus under the Commerce Clause and the Due Process Clause exists with respect to the market State's imposition of a reporting obligation under an income, franchise, or comparable tax.

A State's jurisdiction to impose taxes based on net income is further limited by Public Law 86-272, codified at 15 U.S.C. § 381 *et. seq.* (1988) ("P.L. 86-272"). P.L. 86-272 provides that a State may not impose a net income based tax on an out-of-state company if the company does no more than solicit orders for sales of tangible personal property. The protection extends to solicitation by either employees or independent contractors. However, if the independent contractor engages in activities on behalf of the company that exceed solicitation and sales and such activities are not ancillary to the solicitation of sales, the company is no longer protected.

The provision of warranty repair of computers and computer related equipment exceeds solicitation and is not a protected ancillary activity. Accordingly, P.L. 86-272 does not protect the out-of-state direct marketing computer company's repair activities in the taxing State.

3. DE MINIMIS ACTIVITIES

In *Wisconsin Dep't of Revenue v. William Wrigley, Jr., Co.*, ___ U.S. ___, 112 S.Ct. 2447 (1992), the Supreme Court found that the *de minimis* concept is especially important when a rule operates in a "stark all-or-nothing fashion", such as P. L. 86-272. *Wrigley*, at 2458. The "bright line" nexus rule affirmed by the Court in *Quill* also operates in an all-or-nothing fashion. Accordingly, recognition of a *de minimis* exception is appropriate for use tax collection as well as income tax liability even though the bright line is not statutory as is P. L. 86-272. *De minimis* activities are those that, when taken together, establish only a trivial connection with the taxing State. *Id.* at 2458. An activity conducted within a taxing State on a regular or systematic basis or pursuant to a company policy (whether such policy is written or not) is not considered trivial. *Id.* at 2459 n. 8. Whether or not an activity consists of a trivial or non-trivial connection with the taxing State is to be measured on both a qualitative and quantitative basis. If the disqualifying activity either quantitatively or qualitatively creates a non-trivial connection with the taxing State, then the

de minimis exception to constitutional or statutory nexus is not applicable. Establishing that the disqualifying activities only account for a relatively small part of the business conducted within the taxing State is not determinative of whether a *de minimis* level of activity exists. Because the provision of warranty repairs in the customer's state is a regular and systematic business activity directed to the establishment and maintenance of the in-state market, this activity cannot be considered *de minimis*.

APPLICATION OF THE LAW TO THE DIRECT MARKETING COMPUTER INDUSTRY PRACTICE

There is no issue of Due Process nexus because direct marketing computer companies purposefully direct advertising and catalogue solicitations to taxing State customers. Under applicable case law, in-state presence of independent contractors creates substantial nexus under the Commerce Clause for out-of-state companies that hire them to perform in-state services. Accordingly, the industry practice of direct marketing computer companies arranging for provision of in-state repair service through third parties creates nexus. The fact that the in-state warranty service is actually performed by a third party is of no constitutional consequence. In any event, the out-of-state direct marketing computer company authorizes the in-state warranty repair service provider to perform the necessary repairs on its behalf. The third party service provider merely serves as an extension of the out-of-state direct marketing computer company. Thus, the in-state repair activities benefit the direct marketing computer company and aid in the establishment and maintenance of the in-state market. Indeed, from the end user's point of view, the out-of-state direct marketing computer company is his or her primary contact and the entity that the end user must rely on to obtain repairs under the warranty agreement. Provision of in-state repair service has become more or less a standard practice in the direct marketing computer industry and in many cases is advertised by the direct marketing computer company itself. Provision of in-state warranty repairs is thus tacitly recognized as a necessity to maintain market share in the competitive direct marketing computer industry. The warranty repair activity is a regular, systematic activity undertaken under direct marketing computer company's written warranty. Accordingly, the in-state repair activity does not constitute a *de minimis* activity regardless of the number of times warranty services are actually provided in the customer's state or the amount of time spent in the state to make repairs covered by the warranty agreement.

The following states have indicated that their law is consistent with the constitutional and federal statutory nexus principles described in this Bulletin and that they will enforce these nexus standards with respect to computer companies selling computers and/or related items through direct marketing for purposes of determining, as indicated by parenthetical notation, an obligation to collect, report and remit use taxes on the sale and purchase of a computer and/or related items and/or an obligation to report and pay income taxes, franchise taxes based on income, or comparable taxes: Alabama. . .Minnesota (use tax, net income tax, net income based franchise tax);. . .

(Taxpayers who believe they may have tax compliance issues are encouraged to contact the appropriate state taxing authority.)

For information in Minnesota, please call the Minnesota Department of Revenue:
Minnesota Corporate Franchise Tax Division: (612) 297-7000
Minnesota Sales and Use Tax Division: (612) 296-6181

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