Doing Business in Colorado

- 10/6/2009

October 6, 2009

On October 6, 2009, Tax Executives Institute filed the following comments with the Colorado Depart-ment of Revenue relating to a proposed regulation that would impose the State's corporate income tax on out-of-state corporations with no physical presence in Colorado. TEI's comments, which took the form of a letter from TEI President Neil D. Traubenberg, were prepared under the aegis of its State and Local Tax Committee, whose chair is Cathleen Stevens of Brunswick Corporation. Contributing substantially to the development of TEI's comments was Linda Dickens of Texas Instruments, Inc., who serves as a Vice Chair of the committee. Daniel B. De Jong, TEI Tax Counsel, serves as legal staff liaison to the committee.

On behalf of Tax Executives Institute, I am pleased to submit the following comments on the Department of Revenue's ("Department") Proposed Regulation 39-22-301.1 defining when a corporation is doing business in Colorado for purposes of imposing the State's corporate income tax ("Proposed Regulation"). TEI supports the Department's goal of crafting "a regulation that addresses in a comprehensive fashion what activities of a corporation will create nexus in Colorado." We regret, however, that if the Proposed Regulation is not revised to require some physical presence in the State, it will violate controlling Commerce Clause jurisprudence and subject both taxpayers and the State to months, and even years, of uncertainty and expense.

Background

Tax Executives Institute was founded in 1944 to serve the professional needs of business tax professionals. Today, the organization has 54 chapters in North America, Europe, and Asia, including one in Colorado. Our 7,000 members represent 3,200 of the largest companies in the world, many of which are either resident or do business in Colorado. As the preeminent association of business tax professionals worldwide, TEI has a significant interest in promoting sound tax policy, encouraging the uniform and equitable enforcement of the tax laws, and reducing the cost and burden of administration and compliance to the benefit of taxpayers and government alike. The Institute is committed to maintaining a system that works — one that builds upon the principle of voluntary compliance and is consistent with sound tax policy. We, along with federal, state, and local governments, have the most at stake in crafting a tax system that is administrable and efficient.

Description of the Proposed Regulation

The Proposed Regulation provides a bright-line test for determining when an out-of-state corporation has nexus in Colorado for purposes of the State's corporate income tax. Pursuant to that test, taxpayers exceeding any one of the following three thresholds fall within Colorado's taxing jurisdiction: (1) $50,000 worth of property in the State; (2) $50,000 of payroll in the State; or (3) $500,000 of sales in the State.

The Proposed Regulation goes on to provide that sales are "in the State" if an out-of-state business ships tangible personal property to a purchaser who receives that property in Colorado. Sales of services, and licenses of intangibles and digital products, count toward the sales threshold without regard to whether the seller or licensor has any physical presence in the State or has even directed advertising to residents of the State. Under this standard, a California corporation operating a website through which customers download movies, television shows, and music would have nexus in Colorado simply as a result of having residents of the State purchase more than $500,000 in digital downloads. Likewise, Colorado would impose its corporate income tax on an investment management company in New York managing portfolios for Colorado residents even when the company has no offices in Colorado and all communication between the company and its clients occurs over the Internet or phone.

Comments on the Proposed Regulation

While TEI welcomes the predictability created by a bright-line test, we respectfully submit that the Department's proposal to resolve nexus determinations with these thresholds – without any requirement that an out-of-state business have physical presence in the State – exceeds the restrictions long imposed by the Commerce Clause of the U.S. Constitution on a State's power to tax out-of-state businesses, as well as by controlling federal legislation.

Specifically, the possibility that exceeding a sales-factor threshold in the State would provide the sole basis for asserting tax jurisdiction without a physical presence requirement would violate the substantial nexus prong of the U.S. Supreme Court's opinion in *Complete Auto Transit v. Brady*, 430 U.S. 274 (1977), as well as the teaching of the Court in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), which clearly held that a physical presence was required before a State could impose a sales or use tax obligation on an out-of-state company.

One progenitor of both *Complete Auto Transit* and *Quill* was the Court's decision in *National Bellas Hess, Inc. v. Department of Revenue of Illinois*, 386 U.S. 753 (1967), in which it held that a sales and use tax violated the restrictions imposed by the Commerce Clause to the extent it was imposed on a vendor whose only contacts with the taxing State were through the mail and by common courier.1 The Court explained that permitting the imposition of a use tax collection duty on a business that maintained no physical presence in the State would give rise to "unjustifiable local entanglements" of interstate commerce. *Id*. at 760. Evaluating earlier cases, the Court noted it had "never held that a State may impose the duty of use tax collection and payment upon a seller whose only connection with customers in the State is by common carrier or the United States mail [*i.e.*, without physical presence in the State]." *Id*. at 758. That remains true today.

Twenty-five years after *National Bellas Hess*, the Court in *Quill* again grappled with the question of whether physical presence was required before a State could constitutionally impose a use tax collection obligation on an out-of-state enterprise. The State of North Dakota argued that the physical presence standard had outlived its usefulness — its obsolescence caused by "tremendous social, economic, commercial, and legal innovations" since *National Bellas Hess* was decided in 1967. *North Dakota v. Quill Corp.*, 470 N.W.2d 203, 208 (N.D. 1991). The Court declined, however, North Dakota's invitation to cast aside decades of precedent simply because States found the economic effects of the Commerce Clause not to their suiting. Indeed, *Quill* confirmed the vitality of the *Complete Auto Transit* construct and effectively harmonized that decision with the Court's 1967 decision in *National Bellas Hess*. It also reaffirmed the constitutional prerequisite of the taxpayer's physical presence in the taxing jurisdiction. *Quill Corp.*, 504 U.S. at 317.

States that have moved away from the physical presence nexus standard often defend their departure by pointing to the Court's not expressly addressing the application of its holding in *Quill* to income taxes. Although the Court in *Quill* did not explicitly extend its holding beyond the sales and use tax area, it did caution that its declining to articulate a physical presence test in other areas (*e.g.*, income taxes) "does not imply repudiation of the *[National] Bellas Hess* rule" in those areas. *Quill*, 504 U.S. at 314. Thus, there is no policy basis for distinguishing between the level of nexus required for sales and use tax purposes and that required for income tax purposes. The objectives of the Commerce Clause are the same regardless of the type of tax; that is to say, the focus is not on the form of tax but on the burdens it imposes.

The constitutional overreaching contemplated in the Proposed Regulation will encourage ill-advised assertions of nexus and related income tax liabilities upon out-of-state businesses with no presence in the State. Certainly, in the examples of the California website operator and New York investment manager posited above, the State has not satisfied a key prerequisite for the imposition of its taxing power: It has not "given anything for which it can ask return." *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 444 (1940).

Finally, the Proposed Regulation would undercut the protections accorded interstate business by Public L. No. 86-272, 73 Stat. 555 (codified at 15 U.S.C. § 381 (1988)). That law prohibits States from taxing the income of a corporation whose only business activities within the State consist of "solicitations of orders . . . for sales of tangible personal property," where the orders are sent outside the State for approval and the goods are delivered from out-of-state. *Id*.; *see also Wisconsin Dep't of Revenue v. William Wrigley, Jr., Co.,* 505 U.S. 214 (1992).

The Proposed Regulation purports to adhere to the restrictions on taxation included in Public L. No. 86-272, but it is not difficult to imagine situations where the Proposed Regulation would trespass in areas protected by that federal law. Consider, for example, a computer retailer located in Illinois with no property or employees in Colorado that sells computers to customers in Colorado through its website. Along with the computers, the Illinois retailer offers maintenance agreements under which customers may call a toll-free number to obtain assistance remedying problems with their computers. The retailer's employees provide these services over the phone and over the Internet, but no employee or contractor of the retailer ever enters Colorado. The Proposed Regulation could force the Illinois retailer to file a Colorado tax return and pay Colorado tax even though its presence in the State is less than that contemplated by Public L. No. 86-272 simply because it offers a service to its customers in addition to its computers.

Conclusion

The approach to nexus determinations embodied in the Department's Proposed Regulation would create nexus in circumstances where it constitutionally cannot exist. TEI urges the Department to revise the Proposed Regulation to require physical presence within the State in order to harmonize it with modern Commerce Clause jurisprudence and the limitations established through federal law in Public L. No. 86-272.

TEI appreciates this opportunity to comment on the Proposed Regulation. If you have any questions about the Institute's views or desire additional information regarding the comments contained in this letter, please do not hesitate to contact Cathleen Stevens, Chair of TEI's State and Local Tax Committee, at 847.735.4672 (cathleen.stevens@brunswick.com) or Daniel B. De Jong of TEI's legal staff at 202.638.5601 (ddejong@tei.org).

Respectfully submitted,

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1 The Court also reasoned that the administrative and recordkeeping requirements that could arise in the absence of a physical presence test "could entangle National [Bellas Hess]'s interstate business in a virtual welter of complicated obligations to local jurisdictions . . . . ." *Id*. at 759-60.