

The Impact of the Internet Upon Long-Standing Rules of Taxation

By James F. McDonough, Jr. on October 3rd, 2012

There are certain legal doctrines that have been developed to address state taxation of non-resident businesses. The Supreme Court created a four part test in 1977 in *Complete Auto Transit, Inc.* The first part was that an out-of-state business must have a “connection” or nexus to the state seeking to impose tax. In *Quill v. North Dakota* (1992), the Supreme court held that an out-of-state mail order house without sales outlets or representatives in North Dakota could not be required to collect North Dakota sales tax, upholding *National Bellas Hess (1967) v. Dept of Revenue, the State of Illinois*.

All of us recognize the internet as the single biggest force of change in our lifetime. The Internet’s effect on the traditional notion that physical presence is required before a state may impose income tax and sales tax is a bit less obvious. Internet retailers, without a physical presence, have hurt brick and mortar stores and state tax collections. Today, the traditional apportionment three factor formula, payroll, property and sales in a state, is or has been revised to tax the new paradigm. States have responded to attack revenue lost in other areas or to expand the concept of sufficient contact or nexus.

One business strategy has been defeated in court in New Jersey, South Carolina and other states. It involves shifting income to low or no-tax states from high-tax states using tax deductible payments to siphon the income away. Many large, multi-state businesses would place their Intangibles (trademarks, patents, copyrights and know-how) into subsidiaries in no-tax states and lease the Intangibles for a deductible royalty payment designed to reduce the amount of income subject to taxation in high-tax states.

Until recently, tele-commuting employees did not create a nexus in New Jersey for their employers until the *Tele-Bright* decision. Here, no doubt, the state was interested in expanding its reach to include businesses using remote workforces. Again, the traditional notion of a nexus is being modified in response to the Internet.

In the international arena, the concept of a Permanent Establishment (PE) is expected to be revised. The UN, according to my colleague, Frank Brunetti, Esq., is seriously considering amending its definition to include a server or a remote office. Israel recently ruled that an investment advisor, working from his home in Israel, was performing services in Israel and not in the European office of his employer. Thus, the employer was subject to tax in Israel.

These changes in traditional definitions will eventually permit the collection of state sales taxes and may foreshadow the introduction of a Value Added Tax (VAT) in the U.S. The internet has changed retailing and the workplace forever; however, taxation struggles to

catch up. As our states and the federal government cry out for more revenue, the elimination of the requirement of a physical presence in order to tax is virtually certain.