

CORPORATE FRANCHISE AND INCOME TAXES

Hodgson v. Minnesota—A Window into the Future of Economic Nexus

The authors argue that where a taxpayer does not have the requisite physical presence in a foreign state, the receipt from in-state payors of Forms 1099 alone does not, and cannot, form the basis for "substantial nexus."

By CHRIS DOYLE, STEPHEN KELKENBERG AND DAN KELLY

CHRIS DOYLE and STEPHEN KELKENBERG are Partners in the Buffalo, New York, office of Hodgson Russ, LLP, and DAN KELLY is an Associate with that firm.

Constitutional nexus cases are inherently tricky. Both sides usually bring decent arguments to the table, and victory or defeat—often with significant tax implications—rides on razor-thin margins: 10 out-of-state salesmen hawking products in a taxing jurisdiction may create nexus;¹ a series of unrelated, unaffiliated, in-state marketers directing potential customers to your website may create nexus.² Meanwhile, selling millions of dollars of products into a taxing state, delivered by common carrier (along with marketing and promotional materials) may not create nexus (at least for sales tax purposes).³ The inconsistent institutional substantial nexus landscape, in terms of tax codes and case law, can induce pain.⁴

Amongst the plethora of facts and circumstances that can trigger tax nexus, whether it be for sales, income, or some other tax purpose, there's one situation that we're confident should not establish Commerce Clause nexus: the simple issuance of federal Forms 1099 to an out-of-state business by a company using an in-state address. This fact, without more, should never establish substantial nexus between a tax jurisdiction and an out-of-state business. So we were very surprised when our firm, Hodgson Russ LLP, received correspondence from Minnesota demanding that we file tax returns solely based on our receipt of Forms 1099 from payors with Minnesota addresses.

The Controversy

Before we get into the particulars of our situation, it seems appropriate to provide you with a quick tour of the key concepts in the area of institutional tax nexus.

The constitutional standards

The U.S. Constitution offers companies and taxpayers engaged in interstate commerce two distinct protections against unreasonable restraint on their dealings. The first is embedded in the Due Process Clause of the 14th Amendment.

The second is un-written, and is actually a negative presumption divined from the Constitution's Commerce Clause.⁵ Because Congress has the explicit authority to regulate commerce among the several states, the Supreme Court has read a negative inference into the Commerce Clause, called the dormant Commerce Clause, which prevents individual states from unreasonably burdening interstate commerce.⁶

Under current nexus jurisprudence, if a state or local jurisdiction wants to subject an out-of-state taxpayer to its tax jurisdiction, the state must first establish that the imposition of its tax jurisdiction does not violate the out-of-state taxpayer's due process rights. This standard is an admittedly low, but practical, test.

If a business has enough of a connection in a state that it knows or should know it is subject to that state's legal jurisdiction, then the due process test is satisfied. A foreign business that "purposefully avails" itself of the benefits of a state's economic market probably satisfies the due process test.

Physical presence is not required for due process purposes.⁷ So, if the out-of-state taxpayer sells millions of dollars of goods into a state as the result of remote solicitation efforts targeting the state's markets, the due process requirement is likely met.

Second, and what we care most about here, for a state to exercise its taxing jurisdiction over an out-of-state taxpayer, a "substantial nexus" must exist between the state and the out-of-state taxpayer so it does not run afoul of the dormant Commerce Clause. For many years, "substantial nexus" required at least some non-trivial physical presence on the part of the out-of-state taxpayer in the taxing jurisdiction before the standard could be met.

This "physical presence" standard has eroded at the state level over the last several years, especially with regard to income and franchise taxes. Now, even though there has not been congressional action or a

precedential decision by the Supreme Court, many states are taking the position that something considerably less than a physical presence creates nexus.

Minnesota's fateful letter to Hodgson

With the above as background, what exactly happened to us? During the spring of 2014, Hodgson Russ ("Hodgson") received a letter from the Minnesota Department of Revenue ("Minnesota Revenue") that attempted to establish a new low in the constitutional standard required to satisfy substantial nexus with an out-of-state taxpayer.

Hodgson had been identified by Minnesota through an information sharing system, whereby Minnesota Revenue obtained federal Forms 1099 issued to Hodgson by clients who used a Minnesota mailing address on those forms. Acting under the authority of certain provisions of the Minnesota tax code (provisions we think might be unconstitutional),⁸ Minnesota Revenue determined that the issuance of the 1099s—without a floor on the amount of revenue reported to Hodgson over a nine-year period—was enough for Minnesota Revenue to determine that Hodgson had nexus with Minnesota and was in arrears on its Minnesota franchise tax reporting.

Minnesota Revenue wrote Hodgson, stating that it had determined there was substantial nexus between Hodgson and Minnesota. Minnesota Revenue made this determination without an audit, without any inquiries or interrogatories of Hodgson, and with absolutely no constitutional basis.

Minnesota Revenue informed Hodgson that it had exposure dating back to 2004, but it was "willing" to allow Hodgson a free pass on the earlier years, so long as Hodgson filed returns for the 2009-2012 tax years, and apportioned its receipts to Minnesota accordingly.

We've seen a lot of interesting and sometimes troubling things over the years, but this was different. Not only was Minnesota Revenue's letter dramatically off base, but we had reason to believe that Minnesota Revenue was sending similar letters to other out-of-state taxpayers who provided services (from other states) to taxpayers who used Minnesota mailing addresses on Forms 1099.

Indeed, we are aware of other entities forced into a difficult cost-benefit analysis: do we file Minnesota returns, apportion our receipts in Minnesota and pay a small tax, or do we engage in an expensive fight with these guys? Basically, do we incur the substantial expense to fight Minnesota Revenue, or do we surrender to Minnesota's likely illegal demands because the tax cost won't exceed the cost to fight? Most have decided to make the economically prudent decision to simply pay the tax.

While we appreciate business practicalities, we are frustrated when our clients bow to the monumental pressures applied by state tax authorities. Unfortunately (for Minnesota), because Hodgson gets its tax representation at a relatively cheap price, our cost-benefit analysis skewed in favor of fighting the fight. So we welcomed the opportunity to take our frustration out on Minnesota.

The Forum

We didn't go straight to the mattresses here. We would have avoided litigation had it been possible. But when we asked Minnesota Revenue to provide legitimate proof and legal support for its claim of substantial nexus, we were met with the same refrain: "file tax returns for the 2009-2012 tax years, and you'll receive abatement of penalties." Minnesota Revenue's strong-arm tactics were repugnant on multiple levels.

Minnesota Revenue never conducted a formal audit of Hodgson. It also never issued formal assessments to Hodgson. Because of this, Hodgson had no standing to bring a tax appeal through Minnesota's administrative tax appeals system. What's more, Hodgson arguably didn't have the requisite connections with Minnesota for that state to assert long-arm jurisdiction over Hodgson (a due process issue).

Moreover, Hodgson had no desire to give Minnesota Revenue home court advantage or incur the additional expense that would result from having the matter heard before a Minnesota court. So, after going back and forth with Minnesota Revenue on the substantial nexus issue to no avail, Hodgson sued Minnesota Revenue in New York State Supreme Court, seeking relief in several forms.⁹

The Resolution

Several significant issues were at play in this litigation, including: (1) the proper standard for substantial nexus in the age of digital and remote commerce in a service-dominated economy,¹⁰ (2) the constitutionality of Minnesota's statute, and, of course (3) the threshold issue of whether or not Forms 1099 from a payor using a Minnesota address, standing alone, could establish substantial nexus with a foreign taxpayer. Other ancillary, but meaningful, questions—including burden of proof concepts, administrative review requirements, and issues of comity—were also presented and briefed.

Like most litigated controversies, however, Minnesota Revenue chose to resolve this dispute by settling with Hodgson. Neither side formally admitted in the final settlement agreement that the other was right or wrong, but Hodgson didn't file returns or pay anything to Minnesota, so you can draw your own conclusions.

Minnesota Revenue agreed to release Hodgson from any potential tax liability and filing obligations between 2004 and 2012 (the entire period in dispute), and Hodgson agreed to discontinue its case. Hodgson wasn't content, however, leaving the door open to repeated letters from Minnesota Revenue alleging substantial nexus based solely on Forms 1099 in future years, either issued directly to the firm or to the firm's clients. So, as part of the settlement negotiations, an agent for Minnesota Revenue stated on the record in New York Supreme Court that "The Department of Revenue has made some changes to its [] review system, and it will take into consideration 1099s along with other documents and information available to it in making these determinations in the future."

Minnesota Revenue may continue to aggressively enforce its franchise tax economic nexus statute, but we feel confident that future nexus inquiries will be more involved than threatening letters triggered exclusively by the issuance of federal Forms 1099, and if anyone needs proof of Minnesota Revenue's agreement to look beyond Forms 1099 standing alone, they can cite to *Hodgson v. Minnesota*.

The Correct Substantial Nexus Standard in the Age of Economic Nexus

Part of Hodgson's dispute with Minnesota Revenue revolved around the proper standard for establishing substantial nexus under the Commerce Clause for income/franchise tax purposes.¹¹ Hodgson didn't have an office in Minnesota; it didn't have attorneys licensed to practice in Minnesota; it didn't license intangibles in Minnesota; it didn't solicit business in Minnesota—Hodgson really wasn't in Minnesota in any material way. The only connection Minnesota Revenue could point to was the Forms 1099 issued by Minnesota payors, and, assuming Forms 1099 alone wouldn't cut it, what standard would be required in the future?

Minnesota Revenue attributed the Forms 1099 to Hodgson's "doing business" in Minnesota, triggering Hodgson's obligation to file franchise tax reports under Minnesota law. This standard, without more, misses the mark. We think Minnesota Revenue now agrees, especially in light of its adjusted policies and agreement to dig beyond 1099s in the future.

By settling, however, we're left with another question: What activity short of actual physical presence establishes substantial nexus between a tax jurisdiction and an out-of-state taxpayer? This question isn't going away any time soon, and the scope of economic nexus is already being litigated in Ohio.¹²

We believe that the "physical presence" standard—which requires non-de minimis contacts with the taxing state—is the proper standard to apply in all cases. It is the standard that has been regularly applied by the Supreme Court to determine when and if institutional nexus exists.¹³

Some state courts have moved away from requiring physical presence with regards to income/franchise taxes in recent years, distinguishing the Supreme Court decisions as being limited to sales tax, and instead basing their decisions on an alleged overwhelming amount of in-state, non-physical contacts on the part of the foreign taxpayer.¹⁴ On the other hand, at least one state court has continued to demand physical presence before finding substantial nexus for franchise/income tax purposes, even in the face of significant non-physical contacts by the foreign taxpayer.¹⁵

We pushed the New York judge to require physical presence in order to establish substantial nexus in cases like this. We think that requiring a foreign taxpayer to have physical presence in the state seeking to impose its tax provides a minimum, necessary, and clear threshold before a state, or any other tax authority, can subject the out-of-state taxpayer to its tax jurisdiction.

We were willing, however, to accept something less than physical presence, so long as we felt the connections were an actual and legitimate proxy for physical presence. Hodgson's motion papers told the New York judge that in lieu of physical presence, we would be willing to accept a proxy, but only when the non-physical economic connections were truly material—i.e., something far exceeding the issuance of Forms 1099 with Minnesota mailing addresses. In our summary judgment motion papers we dubbed this physical presence proxy as "the material presence" standard.

Under any theory of "economic presence"-based or "material presence"-based nexus, where a taxpayer does not have the requisite physical presence in the foreign state, the receipt of Forms 1099 alone does not, and cannot, form the basis for "substantial nexus." Minnesota Revenue didn't directly acknowledge this fact in settling the controversy with Hodgson (it indirectly made this acknowledgment through its statement on the record), but we're confident Minnesota Revenue knows this to be true. Frankly, we don't think Minnesota Revenue would have settled the case by releasing Hodgson's potential past liability if it didn't believe this to be the case.

Forms 1099 might be valuable evidence of some material presence by a foreign taxpayer in Minnesota when coupled with other relevant evidence gleaned from an audit. But premising nexus on the mailing addresses found on a trace amount of Forms 1099, issued over the course of several years, would far exceed any of the Supreme Court's articulations of the interstate Commerce Clause's "substantial nexus" standard.

Disputes about substantial nexus seem inevitable, especially as states create more franchise/income tax apportionment and filing obligations based on sales and economic activity alone.¹⁶ What Hodgson was sure of this time, and what we'll always be sure of, is that the issuance of Forms 1099 to an out-of-state business

from an in-state address, cannot, without more, establish substantial nexus between the foreign taxpayer and the tax jurisdiction. If you or one of your clients receives one of these letters from Minnesota Revenue in the future, alleging substantial nexus based on 1099s (or on some other basis with questionable constitutionality), you should consider challenging it.

¹ *Scripto v. Carson*, 362 U.S. 207, 208-10 (1960) (Georgia company could constitutionally be subject to Florida's use tax compliance requirements based primarily on the presence of 10 wholesalers in Florida actively soliciting sales on behalf of the company).

² *Amazon.com, LLC v. New York State Dep't of Taxation & Fin.*, 20 N.Y.3d 586 (2013).

³ *National Bellas Hess, Inc. v. Dep't of Revenue*, 386 U.S. 753, 758 (1967) (nexus could be established with an out-of-state mail order retailer for Illinois use tax purposes only if the retailer has an in-state physical presence); *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992) (Commerce Clause substantial nexus could be established in order for North Dakota to subject an out-of-state business to its use tax compliance requirements only with physical presence, even where the mail order company solicited business through catalogs, advertisements, telephone calls, etc., in North Dakota and generated annual revenues from North Dakota customers of approximately \$1,000,000).

⁴ Or at least indigestion. One of the authors, for instance, experiences heartburn every time he reads intentionally vague "constitutional cop-out" statutes that permit the tax jurisdiction to extend the limits of its authority to tax to the boundaries established by the U.S. Constitution, but then makes no effort to describe those limits. See, e.g., New York Tax Law § 1101(b)(8)(C), (E), which extends sales tax nexus to businesses that solicit sales in-state via distribution of catalogs, advertising materials, etc., "if such person has some additional connection with the state which satisfies the nexus requirement of the United States Constitution."

⁵ U.S. Const. art. I, § 8, cl. 3. Some very smart people, the late Justice Scalia for one, have argued that there is no such thing as a "dormant" or "negative" Commerce Clause in the Constitution. With respect, that doesn't seem right to us. If states are, in the absence of an explicit prohibition, permitted to take actions that the Constitution delegates to Congress, then a state, acting alone, can get the country into all manner of mischief. For instance, the authors like most people they've met from Oklahoma, but do they really want Oklahoma to have the power to (1) borrow money on the credit of the United States, (2) coin money and regulate the value thereof, (3) establish federal courts inferior to the Supreme Court, (4) define and punish war crimes, (5) declare war, (6) maintain a navy, etc.? Can't we agree that Congress ought to exercise these powers to the exclusion of the states?

⁶ See *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977). The Supreme Court has generally upheld Commerce Clause challenges to state tax authority if the tax: (1) is applied to activity that has substantial nexus with the taxing state, (2) is fairly apportioned, (3) does not discriminate against interstate commerce, and (4) is fairly related to the services provided by the taxing state.

⁷ *Quill Corp.*, 504 U.S. at 307-08.

⁸ See Minn. Stat. § 290.015.

⁹ Some of the relevant legal briefs and filings are available here:
http://www.hodgsonruss.com/experience-HR_v_Minnesota.html.

¹⁰ This issue is magnified in importance as states shift to single-factor, market-based receipts apportionment.

¹¹ According to Supreme Court precedent, sales tax substantial nexus is only met with physical presence. *Quill Corp.*, 504 U.S. at 314-18.

¹² See, e.g., *Newegg, Inc. v. Testa*, Ohio Board of Tax Appeals, No. 2012-234 (Feb. 26, 2015); *Newegg, Inc. v. Testa*, 2016 Ohio LEXIS 36 Supreme Court of Ohio (Jan. 7, 2016).

¹³ See *Quill Corp.*, 504 U.S. 298; *National Bellas Hess, Inc.*, 386 U.S. at 758; *Tyler Pipe v. Washington*, 483 U.S. 232 (1987) (local independent contractor sales agents, acting on behalf of the taxpayer to establish and maintain an economic market in Washington, established nexus for purposes of Washington's wholesale tax); *Scripto*, 362 U.S. at 208-10.

¹⁴ See *KFC Corp. v. Iowa Dep't of Revenue*, 792 N.W.2d 308 (Iowa 2010); *Tax Comm'r of State v. MBNA Am. Bank, N.A.*, 640 S.E.2d 226 (W. Va. 2006); *MBNA Am. Bank, N.A. & Affiliates v. Indiana Dep't of State Revenue*, 895 N.E.2d 140 (Ind. Tax 2008).

¹⁵ *J.C. Penney Nat'l Bank v. Johnson*, 19 S.W.3d 832 839 , 842 (Tenn. Ct. App. 1999) (finding that the bank at issue did not have substantial nexus to Tennessee even though it had over 11,000 cardholders in Tennessee, its parent company had several J.C. Penney retail stores in Tennessee, and it engaged in significant mail solicitation in Tennessee).

¹⁶ See, e.g., New York Tax Law § 209(1)(b). Effective January 1, 2015, this statutory provision establishes economic nexus with foreign corporations that have \$1,000,000 or more in New York-source receipts.