TAX SECTION
State Bar of Texas

December 19, 2014

Via email to Teresa.Bostick@cpa.state.tx.us

Ms. Teresa G. Bostick
Texas Comptroller of Public Accounts
Manager, Tax Policy Division
P. O. Box 13528, Capitol Station
Austin, TX 78711-3528

RE: Comments Pertaining to The Texas Comptroller's Proposed Amended Rule 3.286, Relating to Seller's and Purchaser's Sales and Use Tax Responsibilities and Nexus

Dear Ms. Bostick:

The Tax Section of the State Bar of Texas is providing comments in response to solicitation of comments pertaining to proposed amended Comptroller Rule 3.286 relating to sales and use tax responsibilities and nexus. The proposed amended rule was published in the November 14, 2014 edition of the Texas Register. We appreciate your having agreed to extend the time within which to submit our comments.

THE COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE TAX SECTION OF THE STATE BAR OF TEXAS. THE COMMENTS SHOULD NOT BE CONSTRUED AS REPRESENTING THE POSITION OF THE BOARD OF DIRECTORS, THE EXECUTIVE COMMITTEE OR THE GENERAL MEMBERSHIP OF THE STATE BAR OF TEXAS. THE TAX SECTION OF THE STATE BAR OF TEXAS, WHICH HAS SUBMITTED THIS LETTER, IS A VOLUNTARY SECTION OF MEMBERS COMPOSED OF LAWYERS PRACTICING IN A SPECIFIED AREA OF LAW.

THE COMMENTS ARE SUBMITTED AS A RESULT OF THE APPROVAL OF THE COMMITTEE ON GOVERNMENT SUBMISSIONS OF THE STATE BAR OF TEXAS TAX SECTION, WHICH IS THE GOVERNING BODY OF THAT SECTION. NO APPROVAL OR DISAPPROVAL OF THE GENERAL MEMBERSHIP OF THIS SECTION HAS BEEN OBTAINED AND THE COMMENTS REPRESENT THE VIEWS OF THE TAX SECTION MEMBERS WHO PREPARED THEM.

We greatly appreciate the opportunity to work with your office on these significant tax issues and hope to provide relevant analysis for your review. Thank you for your consideration.

Respectfully submitted,

Andrius R. Kontrimas
Chair, Tax Section
The State Bar of Texas

COMMENTS PERTAINING TO THE TEXAS COMPTROLLER'S PROPOSED AMENDED RULE 3.286

These comments, submitted in response to proposed amended Comptroller Rule 3.286, as published in the Texas Register on November 14, 2014, are presented on behalf of the Tax Section of the State Bar of Texas (the "Section"). The principal drafters of these comments include the Chair and Vice Chair of the Section's Committee on State and Local Taxation, Charolette Noel and Sam Megally, and Section members Alyson Outenreath, Karen Currie and Kirk Lyda. The Section's Committee on Government Submissions ("COGS") has approved these comments. Robert Probasco, Chair of COGS, reviewed these comments. Ira Lipstet also reviewed these comments and made substantive suggestions on behalf of COGS.

Although many of the persons who participated in preparing this letter have clients who would be affected by the state tax principles addressed by this letter or have advised clients on the application of such principles, no such person (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of this letter.

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Date: December 19, 2014

I. INTRODUCTION

This letter provides comments concerning the proposed adoption of 34 Tex. Admin. Code § 3.286, relating to Sales and Use Tax Responsibilities and Nexus ("Proposed Rule 3.286").[1]

We recognize and appreciate the time and thoughtful work invested by the Texas Comptroller of Public Accounts ("Comptroller") in preparing Proposed Rule 3.286 and the descriptions and context provided by the preamble. We also appreciate the efforts of the Comptroller to survey existing authority and update existing Rules, particularly as needed to reflect statutory changes. These efforts are extremely useful to taxpayers and practitioners. It is our intent to present items for consideration that may help and support Comptroller personnel in this endeavor.

While most of our comments focus on modifications in Proposed Rule 3.286 to provisions related to the definition of being engaged in business and the connection between that definition and the definition of having nexus in the state, we have also provided comments on the revised definition of a "taxable item." Following are our comments and suggestions addressing these issues.

II. PROPOSED RULE 3.286 COMMENTS

As an initial matter, we wish to reiterate our appreciation for the helpful descriptions of the proposed amendments provided by the preamble to Proposed Rule 3.286. Based on the initial paragraph of that preamble, we understand that the amendments reflected in Proposed Rule 3.286 are not intended to change longstanding policy, except to incorporate statutory changes made by the Texas Legislature in 2011 and 2013. In general, our comments recommend clarifications consistent with this stated intent.

A. Inconsistent Terminology Between the Tax Code and Proposed Rules

As a general matter, we have concerns that some provisions of Proposed Rule 3.286 incorporate terminology that varies from the terminology used in Chapter 151 of the Texas Tax Code,[2] particularly related to the use of the terms "retailer," "seller" and "person." These terms are sometimes used interchangeably although the terms appear to have distinct and sometimes inconsistent definitions. For example, Proposed Rule 3.286(a)(3) generally uses the term "person" where the corresponding statutory provision in Tax Code § 151.107(a) uses the term "retailer." Also, Proposed Rule 3.286(a)(11) appears to adopt a unique definition of "seller" that varies from the statutory use of the term "seller" as used in Tax Code § 151.008(a).

We suggest that Proposed Rule 3.286 incorporate consistent definitions of statutory terms to limit confusion and avoid potentially inconsistent interpretations of statutory provisions.

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[1] Hereinafter, all references to "Rule" or "Rules" (as appropriate) are to Chapter 34 of the Texas Administrative Code.

[2] Hereinafter, all references to "Tax Code" are to Chapter 151 of the Texas Tax Code.

B. Amendments to the Definition of "Engaged in Business"

According to the preamble:

> Renumbered paragraph (3) [of Proposed Rule 3.286(a)], which defines the term "engaged in business," is amended to more closely follow the language of Tax Code, § 151.107(a). The reference to the term "nexus" in this paragraph is deleted, as the definition of the term "nexus" is revised to state that a person has nexus with this state if the person is engaged in business in this state . . . .

We applaud the Comptroller's goal to more closely follow the language of the Texas Tax Code and understand that it may be helpful to cross reference the definition of "nexus" to clarify that a person has nexus with the state if the person is engaged in business in the state. As drafted, however, Proposed Rule 3.286(a)(3) appears to unintentionally deviate from the language of Tax Code § 151.107(a), which describes when a retailer is engaged in business in this state.

As written, some of the subsections of Proposed Rule 3.286(a)(3) appear to treat a person as doing business "in this state" simply because another affiliated person maintains a location or uses facilities or advertising in the state. The language in the Tax Code, on the other hand, describes the required in-state "nexus" by linking the representatives or affiliates to the retailer's sales. To clarify the terminology and more closely follow the statutory language of Tax Code § 151.107(a), we respectfully suggest that the Comptroller consider revising Proposed Rule 3.286(a)(3). Proposed changes are shown below, with strikethroughs for deleted text and underlines for added text:

> (3) Engaged in business--A person is engaged in business in this state if the person:
>
> (A) maintains, occupies, or uses in this state, permanently or temporarily, directly or indirectly, or through an agent by whatever name called, a kiosk, office, distribution center, sales or sample room or place, warehouse or storage place, or any other physical location where business is conducted;
>
> (B) has any representative, agent, salesperson, canvasser, or solicitor who operates under the authority of the person to conduct business in this state, including selling, delivering, or taking orders for taxable items;
>
> (C) promotes a flea market, arts and crafts show, trade day, festival, or other event in this state that involves sales of taxable items;

(D) uses independent salespersons, who may include, but are not limited to, distributors, representatives, or consultants, in this state to conduct the person's ~~in~~ direct sales of taxable items;

(E) derives receipts from the sale, lease, or rental of tangible personal property that is located in this state or owns or uses tangible personal property that is located in this state, including a computer server or software to solicit orders for taxable items, unless the person uses the software as a purchaser of an Internet hosting service;

(F) allows a franchisee or licensee to operate under its trade name in this state if the franchisee or licensee is required to collect sales or use tax in this state;

(G) otherwise conducts business in this state through employees, agents, or independent contractors;

(H) is formed, organized, or incorporated under the laws of this state and the person's internal affairs are governed by the laws of this state, notwithstanding the fact that the person may not be otherwise engaged in business in this state pursuant to this section; or

(I) holds a substantial ownership interest in, or is owned in whole or substantial part by, another person who:

(i) maintains a distribution center, warehouse, or similar location in this state and delivers property sold by the aforementioned person to purchasers in this state;

(ii) maintains a location in this state from which business is conducted, ~~if both persons sell~~ and sells the same or substantially similar lines of products as the aforementioned out-of-state person (i.e., the person that has no connection with this state other than ownership of or by the in-state seller), and sells such products under a business name that is the same as ~~under the same~~ or substantially similar to the business name~~s~~ of the aforementioned out-of-state person if the in-state seller:

(I) uses its facilities or employees to advertise, promote, or facilitate sales by the aforementioned person to purchasers; or

(II) otherwise performs any activity on behalf of the aforementioned person that is intended to establish or maintain a marketplace for the aforementioned person in this state, including receiving or exchanging returned merchandise; or

(iii) maintains a location in this state from which business is conducted, if the other person with the location in this state:

(I) uses its facilities or employees to advertise, promote, or facilitate sales by the ~~other~~ aforementioned person to purchasers; or

(II) otherwise performs any activity on behalf of the ~~other~~ aforementioned person that is intended to establish or maintain a marketplace for the aforementioned person in this state, including receiving or exchanging returned merchandise.

C. Nexus

The term "nexus" is defined in Proposed Rule 3.286(a)(7). Proposed Rule 3.286(a)(7) begins by defining "nexus" to mean "[s]ufficient contact with or activity within this state, as determined by state and federal law, to require a person to collect and remit sales and use tax." Subpart (A) of Proposed Rule 3.286(a)(7) further provides that "[a] person has nexus with this state if the person is engaged in business in this state."

As described above, Proposed Rule 3.286(a)(3), provides the definition of "engaged in business" and enumerates a list of activities that constitute being engaged in business. The preamble explanation of certain changes to the definition of "engaged in business" seems to indicate an intention to tie "nexus" and "engaged in business" together. It states: "The reference to the term "nexus" in [paragraph (a)(3)] is deleted, as the definition of the term 'nexus' is revised to state that a person has nexus with this state if the person is engaged in business in this state." Because of how the Comptroller defines "nexus" to tie into the "engaged in business" definition, the "engaged in business" definition in Subsection (a)(3) seemingly provides the list of activities that create nexus for sales and use tax collection purposes.

Although not entirely clear, subpart (A) of Proposed Rule 3.286(a)(7) seems to limit "nexus" solely to the defined list of activities deemed to be "engaged in business" under Proposed Rule 3.286(a)(3). The "lead-in" sentence to the nexus definition in Proposed Rule 3.286(a)(7) appears to define nexus more broadly. Thus, Proposed Rule 3.286 might be interpreted as creating two nexus rules -- one based on federal and state law in Proposed Rule 3.286(a)(7) and the other based on the narrower enumerated "engaged in business" list in Proposed Rule 3.286(a)(3).

The narrower interpretation of nexus also seems to be supported by Proposed Rule 3.286(a)(7)(B), which provides that a person does *not* have nexus with this state if (i) the person's only activity in this state is conducted as an unrelated user of an Internet hosting service; or (ii) the person has no connection with this state except the possession of a certificate of authority to do business in this state issued by the Texas Secretary of State. Initially, we suggest that the Comptroller consider expanding this provision to address the statutory language of Tax Code 151.107(b). That language suggests that a person does not have nexus with this state if the

person's only activity in this state is through the dissemination of national advertising that is not intended to be disseminated primarily to consumers in this state and does not appear exclusively in a Texas edition or section of a national publication. Also, similar to the analysis of subpart (A), we note that subpart (B) of Proposed Rule 3.286(a)(7) appears to create two rules, but this time for what does *not* create nexus.

In the end, as currently written, the two sets of nexus rules described above arguably create a disconnect because under the "narrower" rules of Proposed Rule 3.286(a)(3) nexus is deemed to exist only by state law, in defined enumerated situations, *and not also by federal law.* Moreover, some of the situations enumerated in Proposed Rule 3.286(a)(3), to the extent such contacts with the state are *de minimis*, would appear to conflict with the constitutional requirement of "substantial nexus" and the U.S. Supreme Court's rejection of a "slightest presence" standard. *See, e.g., Quill v. North Dakota*, 504 U.S. 298, 315 n.8 (1992) (company's ownership of a few floppy diskettes in the state was a "slender thread" of nexus that failed the "substantial nexus" requirement of the Constitution). Due to these perceived issues, we suggest that the relationship between "nexus" and being "engaged in business" be clarified so that Proposed Rule 3.286(a)(7), in conjunction with Proposed Rule 3.286(a)(3), does not unintentionally create nexus standards that do not comport with state and federal law

D. "Seller" for Sales and Use Tax Purposes

1. Definition of "Seller"

Proposed Rule 3.286(a)(11) begins by defining a "seller" to mean "[e]very retailer, wholesaler, distributor, manufacturer, or any other person *engaged in the business of selling taxable items in this state* who sells, leases, rents, or transfers ownership of tangible personal property or performs taxable services in this state for consideration" (emphasis added). We note that the definition of "seller" in Proposed Rule 3.286(a)(11) differs from the statutory definition in Tax Code § 151.008(b). In particular, the language of Tax Code § 151.008(b) generally does not limit "sellers" to those engaged in the business of selling taxable items *in this state.* We recommend that the definition of "seller" not be limited to someone who is "engaged in ... business ... in this state," so that the definition in Proposed Rule 3.286 of the term "seller" is consistent with that used in the statute. Applying a different, narrower, definition of "seller" in the Proposed Rule compared to the statute may lead to confusion where the statutory provisions refer to out-of-state sellers, such as in Tax Code § 151.007(b).

The term "seller" is further defined by a list of examples that describe certain types of persons to be "a seller responsible for . . . collection and remittance." The grammatical structure of the examples, which include one type of person who is "not considered a seller responsible for . . . collection and remittance" may prove confusing. We recommend providing numbered examples of sellers in a subpart (A) and describing any examples of non-sellers in a separate subpart (B). In addition, it may be helpful for the Comptroller to consider creating a new subpart to describe the responsibilities for collection and remittance separate from the definitional examples in subparts (A), (B), (C), and (D).

2. Permit Requirements

Proposed Rule 3.286(b)(1) provides: "Each seller who *has nexus with* this state must apply to the comptroller and obtain a sales and use tax permit for each place of business operated in this state" (emphasis added). Proposed Rule 3.286(b)(2) begins by stating: "Each out-of-state seller who is *engaged in business* in this state must apply to the comptroller and obtain a sales and use tax permit" (emphasis added).

As a general matter, it would seem appropriate to have a consistent standard for requiring in-state and out-of-state sellers to obtain a sales and use tax permit. Because of how Proposed Rule 3.286(a)(3) and (a)(7) attempt to create a connection between the definitions of "nexus" and "engaged in business," it is unclear whether the emphasized language above in Proposed Rule 3.286(b)(1) and (b)(2) was intended to establish two different standards. To clarify that one standard should apply, it may be appropriate to revise the emphasized language above in Proposed Rule 3.286(b)(2) to state: "Each out-of-state seller who ~~is engaged in business~~ has nexus in this state must apply to the comptroller and obtain a sales and use tax permit..." (strikethrough used for deleted text and underline used for added text.)

E. "Taxable Item" Definition

Proposed Rule 3.286(a)(12) would change the definition of "taxable item" so that it reads:

> Except as otherwise provided in Tax Code, Chapter 151, the term includes tangible personal property and taxable services transferred or used in any electronic form or media now in existence or which may be later devised instead of in or on physical media.

In contrast, Rule 3.286(a)(10), as it currently exists, defines the term "taxable item" to mean "tangible personal property and taxable services."

With respect to this definitional change, the preamble states that the reason for the amendment is to "conform more closely to the statutory definition of the term in Tax Code, § 151.010." Tax Code § 151.010 states:

> "Taxable item" means tangible personal property and taxable services. Except as otherwise provided by this chapter, the sale or use of a taxable item in electronic form instead of on physical media does not alter the item's tax status.

The amended definition in Proposed Rule 3.286(a)(12) appears to exceed the statutory language of Tax Code § 151.010 by use of the phrase "now in existence or which may be later devised instead of in or on physical media." Indeed, Tax Code § 151.010 provides that the sale or use of a taxable item in "electronic form instead of on physical media does not alter the item's tax status," but this is not the language used in Proposed Rule 3.286(a)(12). It is unclear what the phrase "now in existence or which may be later devised instead of in or on physical media" means. Further, the language could be interpreted to mean that a new, *additional* taxable item is created, upon which use tax would be due, if an item is converted in the future to a new medium

by the owner or licensee. This result appears inconsistent with the direct language of Tax Code § 151.010.

Because the new definition of "taxable item" in Proposed Rule 3.286(a)(12) appears to be broader than what is statutorily contained in Texas Tax Code § 151.010, we recommend that the Comptroller revise the proposed new definition so that it reads:

> The term includes tangible personal property and taxable services. Except as otherwise provided in Tax Code, Chapter 151, the sale or use of a taxable item in electronic form instead of physical media does not alter the item's tax status.

F. Cessation of Out-of-State Sellers Responsibility

Similarly, because of how Proposed Rule 3.286(a)(3) and (a)(7) attempt to create a connection between the definitions of "nexus" and "engaged in business," it appears that Proposed Rule 3.286(b)(2) should be revised to delete the term "engaged in business" and replace such term with "nexus." Suggested changes are shown below (with underlines for added text and strikethroughs for deleted text, including language no longer needed when the term "nexus" is used instead of "engaged in business"):

> An out-of-state seller is responsible for the collection and remittance of sales and use tax on all sales of taxable items made in this state until the seller ceases to ~~be engaged in business~~ have nexus in this state. ~~An out-of-state seller ceases to be engaged in business in this state when the seller no longer has nexus with this state and no longer intends to engage in activities that would establish nexus with the state~~. For example, an out-of-state seller who enters the state each year to participate in an annual trade show does not cease to ~~be engaged in business~~ have nexus in this state between one trade show and the next. In contrast, an out-of-state seller who discontinues the product line that it marketed and sold in this state, and who does not anticipate entering the state to solicit new business, has ceased ~~to be engaged in business~~ having nexus in this state. An out-of-state seller is required to maintain, for at least four years after the out-of-state permit holder ceases to ~~be engaged in business~~ have nexus in this state, all records required by subsection (j) of this which the out-of-state permit holder ceased to ~~be engaged in business~~ have nexus in this state.

We also think the foregoing language in Proposed Rule 3.286(b)(2) would be more instructive if the same example were used to explain when an out-of-state seller would and would not continue to have nexus with Texas, as follows (with proposed changes in strikethroughs and underlines):

> For example, an out-of-state seller who enters the state each year to participate in an annual trade show does not cease to have nexus

in this state between one trade show and the next. In contrast, an out-of-state seller who discontinued entering Texas each year to participate in an annual trade show would cease to have nexus in this state beginning the day after the out-of-state seller was last in Texas. ~~s the product line that it marketed and sold in this state, and who does not anticipate entering the state to solicit new business, has ceased having nexus in this state.~~ An out-of-state seller is required to maintain, for at least four years after the out-of-state permit holder ceases to have nexus in this state, all records required by subsection (j) of this which the out-of-state permit holder ceased to have nexus in this state.

III. CONCLUSION

We greatly appreciate the opportunity to work with your office on these significant tax issues and hope these comments provide relevant analysis for your review. Thank you for your consideration.