BY MATTHEW BOCH AND LAUREN FERRANTE

American Business USA and the Difficulty of Transactional Nexus Arguments

In the world of sales, use, and other transaction taxes, there must be some fundamental connection between the taxing state and what it seeks to tax. Law on this subject, however, can be confusing and potentially inconsistent. The Supreme Court of Florida's opinion earlier this year, in *American Business USA Corp.*,[1] demonstrates this difficulty and, if the constitutional analysis is correct, raises a number of questions. Practitioners considering transactional nexus arguments should weigh their options carefully.

***American Business USA* allowed Florida to tax sales of flowers delivered to out-of-state customers.** *American Business USA* allowed Florida to impose its sales tax on the worldwide sales of flowers by an online florist located in the state. The taxpayer operated the website 1vende.com, which sold flowers and gifts to customers, primarily targeting Spanish-speaking markets in the United States, Spain and Latin America. An order for flowers would be fulfilled by a local florist near the requested delivery destination. The taxpayer collected Florida tax on sales for delivery in Florida; it did not collect tax on sales of flowers for delivery outside of Florida.

MATTHEW BOCH is an attorney with Dover Dixon Horne in Little Rock, Arkansas. LAUREN FERRANTE is an associate with McDermott Will & Emery in Chicago, Illinois.

The taxpayer's approach conflicted with special origin-based sourcing rules for florists. Like most state sales taxes, Florida requires in-state florists to pay tax on retail sales regardless of where or how the delivery will be made.[2] This rule was a special industry concession for administrative convenience that has had widespread adoption. (One can understand the rationale in light of the attributional nexus risks from fulfillment by in-state florists, together with the administrative burden on smaller florists if they had to collect tax in a number of states on one-off sales. On the other hand, under an origin-based sourcing regime, presumably most online florists are in states without sales taxes.)

Florida audited and assessed the taxpayer for tax on its out-of-state sales. The taxpayer's administrative appeal was unavailing. However, on appeal from the Department of Revenue to the District Court of Appeals, the court granted relief to the taxpayer on its out-of-state sales based on the substantial nexus requirement of the four-part *Complete Auto* test for a tax to be valid under the dormant Commerce Clause of the United States Constitution.[3]

The appellate court's nexus analysis relied on both the remote use tax collection cases of *Quill*[4] and *National Bellas Hess*,[5] as well as the *Jefferson Lines*[6] transactional nexus/fair apportionment case, finding that the customer and delivery destination were out-of-state, and the taxpayer did not maintain an inventory of, store or grow product in-state.[7] The analysis did not distinguish the nexus concepts of whether a tax could be imposed based on the taxable event occurring in the state (transactional nexus) and whether a third party could be obligated to collect the tax (physical presence use tax collection nexus).

The Supreme Court of Florida has now reversed the decision, determining that the Florida statute requiring home-office sourcing complies with the requirements of the dormant Commerce Clause. The court's nexus analysis focused solely on *Quill*-type physical presence nexus. Instead of looking at whether the state has nexus with the specific activity or transaction it seeks to tax, the court simply looked to see whether the taxpayer had more than a slight physical presence nexus with the state.[8] The case law discussion focused on three U.S. Supreme Court remote use tax collection cases: *Quill*, *National Bellas Hess*, and *National Geographic*,[9] as well as a prior Florida Supreme Court case[10] on use tax collection nexus.[11] Given this framework, the court easily determined that the taxpayer had nexus. After all, it was headquartered in the state.[12]

The Supreme Court of Florida also addressed the other three prongs of the *Complete Auto* test. For the fair apportionment requirement, the court applied both the internal and external consistency tests. Internal consistency focuses on the hypothetical result if every state were to adopt the tax policy at issue. Clearly the Florida florist origin-based sourcing was internally consistent: while Florida is taxing in-state florists on sales that they originate, it is not taxing out-of-state florists on sales fulfilled in Florida.[13]

External consistency is more interesting. This aspect of the fair apportionment requirement considers the real-world application of the tax and the relation of the tax to the economic activity within the taxing state. The Supreme Court of Florida agreed with the Department of Revenue that this test was met because of the taxpayer's business activities: "We agree with the Department that because the statute taxes the transaction that occurs in Florida

by the business engaging in business here, and not on the items sold or the activities occurring out of state, prong two of the *Complete Auto* test is met."[14]

The challenges of transactional nexus arguments. The Supreme Court of Florida's complete disregard of transactional nexus authority highlights the risks of making transactional nexus arguments. For generalist judges, trying to distinguish between two lines of constitutional sales and use tax nexus cases may be asking too much. While the U.S. Supreme Court's transactional nexus cases remain good law, confused discussion in a case like *American Business USA* is making transactional nexus more challenging for subsequent cases. Indeed, there is a risk that transactional nexus could simply merge into the external consistency subpart of the fair apportionment requirement.

A starting point for understanding transactional nexus is a pair of 1944 cases that set up the dichotomy between sales taxes and use taxes: In *McLeod v. J.E. Dilworth Co.*,[15] the U.S. Supreme Court prohibited Arkansas from imposing its sales tax on Tennessee businesses soliciting in the state and shipping orders into the state. The Court reasoned that the "sale," i.e., "the transfer of ownership," was made outside of the state.[16]

In contrast, the Court upheld imposition of Iowa use tax requiring retailer collection in *General Trading Co. v. State Tax Commission*.[17] The tax was imposed on an in-state activity, the use of property in Iowa.[18] And while the tax was imposed on "the ultimate consumer," "[t]o make the distributor the tax collector for the State is a familiar and sanctioned device."[19] These two cases thus confirmed the basic framework for state systems of sales and use taxes.[20]

While *McLeod* is over 70 years old now, subsequent case law suggests its continued relevance. Indeed, *Complete Auto* itself specifies that a tax must apply "to an *activity* with a substantial nexus with the taxing state,"[21] not simply a taxpayer with nexus with the state. *Jefferson Lines*, in particular, discussed *McLeod* in the context of the "settled treatment" of the taxation of sales of goods based on the location where the seller's own delivery occurs.

Jefferson Lines involved a taxpayer's fair apportionment challenge to an Oklahoma sales tax on 100% of the ticket purchase price for an interstate bus ticket. The taxpayer in that case already conceded that the ticket sale transaction had transactional nexus, and the Supreme Court agreed.[22] For the fair apportionment challenge, the Supreme Court essentially held that the state that has transactional nexus with the sale of a service can tax 100% of the value of the transaction because the taxable event of the sale is unique to a particular state, much like the situation of a sale of goods.[23]

The other significant Supreme Court transactional nexus sales tax case is *Goldberg v. Sweet*.[24] Much like the subsequent *Jefferson Lines* case, the taxpayer in *Goldberg* challenged on fair apportionment

1 *Fla. Dep't of Revenue v. Am. Bus. USA Corp.*, 191 So. 3d 906 (Fla. 2016), *rev'g* 151 So. 3d 67 (Fla. Dist. Ct. App. 2014).

2 Fla. Stat. § 212.05(1)(l); Fla. Admin. Code Ann. r. 12A-1.047(1).

3 151 So. 3d at 71-73. The opinion directly quoted the four-part test provided in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977). 151 So. 3d at 71.

4 *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

5 *National Bellas Hess, Inc. v. Dep't of Revenue*, 386 U.S. 753, 754 (1967).

6 *Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175, 184 (1995).

7 151 So. 3d at 72-74.

8 191 So. 3d at 913-14.

9 *Nat'l Geographic Soc'y v. Cal. State Bd. of Equalization*, 430 U.S. 551 (1977) (allowing California to require collection of use tax on catalog sales because of National Geographic's physical presence from an advertising office unrelated to catalog sales business).

10 *Dept of Revenue v. Share International, Inc.*, 676 So. 2d 1362 (Fla. 1996).

11 191 So. 3d at 913-14.

12 191 So. 3d at 914. The court also reasoned that "[f]rom its Florida location," the taxpayer "accepts internet orders and arranges for delivery of out-of-state flowers and tangible personal property." *Id.*

13 191 So. 3d at 914-15.

14 191 So. 3d at 915-16. An argument can be made that there is a real risk of multiple taxation for the taxpayer in circumstances in which the taxpayer makes an out-of-state sale to a customer located in a state in which the taxpayer is determined to have a physical presence. In that instance, allowing credit for the tax previously paid to Florida permits the multiple taxation to pass constitutional muster. *See, e.g.*, 514 U.S. at 194 ("These credit provisions create a national system under which the first state of purchase or use imposes the tax. Thereafter, no other state taxes the transaction unless there has been no prior tax imposed . . . or if the tax rate of the prior taxing state is less, in which case the subsequent taxing state imposes a tax measured only by the differential rate.") (citation and quotations omitted).

15 322 U.S. 327 (1944).

16 322 U.S. at 330.

17 322 U.S. 335 (1944).

18 322 U.S. at 338.

19 *Id.*

20 The tax at issue in *American Business USA* is a sales tax, explained *infra* in greater detail.

21 430 U.S. at 279 (emphasis added).

22 514 U.S. at 184.

23 *See* 514 U.S. at 196.

24 488 U.S. 252 (1989).

25 *See* Hellerstein & Hellerstein, State Taxation (3d ed.) ¶ 12.01.

26 Fla. Stat. § 212.05.

27 191 So. 3d at 915-16.

grounds the sales taxation of an interstate service, an Illinois tax on long distance telephone calls. The court framed its holding in terms of nexus: "We believe that only two States have a nexus substantial enough to tax a consumer's purchase of an interstate telephone call. The first is a State . . . which taxes the origination or termination of an interstate telephone call charged to a service address within that State. The second is a State which taxes the origination or termination of an interstate telephone call billed or paid within that State."

The bottom line is that since *Complete Auto*, we have not had a pure sales/use tax transactional nexus case. A difficulty with *Jefferson Lines* and *Goldberg* is that they were basically fair apportionment challenges to sales and use taxation of interstate services based on the entirety of the transaction price. The Court upheld the taxation of the entirety of a transaction by reference to transactional nexus: only a state having nexus with the transaction can tax the sale.

An alternative to the concept of transactional nexus is reading transactional nexus case law into the fair apportionment external consistency requirement. After all, both *Jefferson Lines* and *Goldberg* were fair apportionment challenges. External consistency's consideration of the real-world economic activity of a transaction overlaps with the transactional nexus inquiry into where the taxable transaction occurs. External consistency, however, is more flexible in looking at the value of economic activity rather than the specific situs of the transaction.

In *American Business USA*, for example, the Supreme Court of Florida's opinion is inconsistent with historical transactional nexus authority allowing sales tax only in the jurisdiction where the seller delivers the property to the buyer or a common carrier. External consistency, however, is more flexible and arguably could accommodate sourcing a sale of flowers to the home office despite the flowers never being in that state, particularly where most states have adopted the practice.

Would a different result have occurred in a state imposing sales tax on the consumer? The Supreme Court of Florida's external consistency analysis turned on a technical analysis of the incidence of the sales tax. Query the result if the court had been applying a state sales tax imposed on the consumer rather than the seller.

The technical incidence of state sales taxes varies. Some are imposed on sellers, some are imposed on consumers, and some are imposed on both.[25] Florida's tax is imposed on the seller's exercise of the taxable privilege of selling tangible personal property at retail in the state.[26] The Supreme Court of Florida, in *American Business USA*, took this technical incidence of the tax as justification for the tax satisfying the external consistency requirement: While the flowers might have been elsewhere, the taxpayer's own business activity was in the state.[27] That reasoning would not apply to a sales tax where the incidence is on the consumer.

Implications of *American Business USA*. *American Business USA* highlights the difficulty of prevailing on transactional nexus arguments, particularly when the concept of physical presence use tax collection nexus is more widely known and can confuse courts. While the situation of florists and their sourcing rules is unique and the impact limited, it is nonetheless troubling to have a court decouple the physical location of property from the taxable situs of the transaction for sales tax purposes.

In particular, the weakening or elimination of transactional nexus could support several jurisdictions' attempts to tax cloud-based services under remote use of leased property theories. These jurisdictions seek to impose tax in a state other that where the taxable software and/or hardware is physically located. The transactional nexus limitation on taxation to the location where the property is being sold or used is a potential bulwark against such efforts. ■