

Texas Comptroller Defies the Laws of Physics

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In this article, the authors examine a recent Texas administrative law judge's opinion that says an out-of-state company has nexus with Texas through downloaded software that it licenses to Texas customers. They argue that the state comptroller's adoption of the decision allows sales and use tax liability to be based on economic nexus instead of physical nexus and is unconstitutional.

In a recent opinion that stretches the meaning of the phrase "physical presence" beyond the point of absurdity,¹ the Texas comptroller adopted the proposed decision of an administrative law judge who had concluded that an out-of-state company had substantial nexus with the state of Texas when it licensed software to Texas customers through Internet downloads.² This opinion defies the rule set forth by the U.S. Supreme Court in *Quill v. North Dakota*,³ which unequivocally holds that an out-of-state entity must have physical presence in a state before that state may constitutionally subject the entity to the state's sales and use tax laws.

The company, headquartered in Utah, had no offices or employees in Texas, although twice during the audit period sent one to three employees to Texas to attend software education conferences. The employees did not set up exhibition booths at either conference, and did nothing to solicit orders or otherwise promote sales of the company's products; they were present solely to learn about developments in the soft-

ware industry. Aside from these limited, non-sales-related contacts with Texas, the company's only other Texas connection was its customers in Texas that licensed software and digital content from the company via Internet downloads.

As is common in the digital goods industry, the company did not — as a technical matter — make an outright sale of its software or digital content to its customers. Rather, the software programs and content were licensed to the end users. Under the license, customers received a limited right to use the software, with the company retaining all rights in, title to, and ownership of the licensed products.

In rendering his decision, the ALJ first set forth the statutory and constitutional framework governing the imposition of Texas sales and use taxes on out-of-state companies. The ALJ recognized that while the Texas statute provides, quite broadly, that any out-of-state retailer that "otherwise does business in [Texas]" is required to collect use tax on the sale of a taxable item for storage, use, or consumption in Texas, the imposition of sales and use tax collection requirements on foreign companies is subject to constitutional constraints — namely, those set forth in cases such as *Quill*, *National Bellas Hess v. Dep't of Rev. of State of Illinois*,⁴ and *Tyler Pipe Indus. v. Washington State Dep't of Rev.*⁵ Because of these constitutional constraints, only foreign companies with physical presence in Texas can be required to collect use tax from Texas customers.

The ALJ correctly concluded that the presence of a small number of employees at two software conventions held in Texas during the audit period did not create nexus for sales and use tax purposes. The employees were in Texas solely to educate themselves about developments in the software industry.⁶ The ALJ determined that the employees' presence in Texas was not sufficient to establish nexus for the company in Texas, explaining that "their presence in the state for such a professional educational experience cannot be considered to be significantly associated with [the company's] ability to establish and maintain a market in Texas."

¹Vinny Gambini might comment, on hearing the outcome of this case, that "perhaps the laws of physics cease to exist" in the Texas comptroller's office.

²SOAH Docket No. 304-13-5657.26/CPA Hearing No. 106,632 (Sept. 19, 2014).

³504 U.S. 298 (1992).

⁴386 U.S. 753 (1967).

⁵482 U.S. 232 (1987).

⁶See *Helicopteros Nacionales v. Hall*, 466 U.S. 408 (1984) (holding in part that, in the personal jurisdiction context, the sending of company personnel to a manufacturer's facilities in Texas for training purposes was an insufficient basis on which Texas could exercise jurisdiction over that company).

Despite this apparent recognition of the appropriate constitutional limitation at play in the sales and use tax context, the ALJ nevertheless proceeded to find that the licensing of software and digital downloads to Texas users did create substantial nexus for the company in Texas. The ALJ explained that the determination of whether the company had physical presence in Texas depended on the character of the rights and interest that the company retained in the software and digital content downloaded by users located in Texas. Software is, by the Texas statute, defined as tangible personal property for sales and use tax purposes.⁷ The ALJ found conclusive the fact that the company did not challenge this characterization. Because the company apparently conceded that software is tangible personal property,⁸ and the software license agreements provided that the company retained “all property rights” to its products, the ALJ held that the company owned tangible personal property in Texas and was thereby physically present in Texas.

The ALJ went a step further and explained that under *Quill*,⁹ an entity must have more than the “slightest presence” in a state to be subject to its sales and use tax laws. To come to the conclusion that the company’s presence in Texas was substantial, the ALJ examined the fees that were generated by the licensing of software and digital content in Texas during the audit period. While the precise numbers are not provided in the ruling, the ALJ ultimately concluded that these fees established the company had a substantial presence in Texas.

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The comptroller’s staff should be embarrassed by the reasoning reflected in this decision. The decision blatantly contradicts the clear mandate of *Quill*.¹⁰ Quite simply, *Quill* used the words “physical presence” when setting forth what is required before a state can, consistent with the commerce clause, impose its sales and use tax laws on an out-of-state company.¹¹ Physical presence, irrespective of a state’s specific statutory terms — a state, of course, cannot bootstrap itself out of federal constitutional constraints — must mean having an ownership or possessory interest in something

that has mass. Electronic information is merely the result of the orientation of subatomic particles that are already in the state.

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The fact that software is classified as tangible personal property by the Texas statute cannot change its inherent nature as an intangible good. States have begun classifying items such as software and digital goods as tangible personal property so that the items will be taxed under the states’ sales and use tax laws. Classifying those intangible items as tangible personal property stems from a recognition that in the world of modern technology, items traditionally transferred in physical form are increasingly available digitally, and a policy decision that states should not lose out on tax revenue merely because of advances in technology. Rather than rewriting the tax code to provide that sales and use tax is imposed on the sale and use of tangible personal property, software, digital downloads, and any number of other items that may become transferable by other than physical means, states (non-streamlined states) often find it more manageable (that is, politically expedient) to define specific types of digital items as tangible personal property — something that has always been taxed. However, despite the statutory characterization, software is not actually “tangible” — and the ownership of software (or, even more clearly, mere limited rights to software) — does not establish physical presence in a state.

Furthermore, the ALJ’s comments regarding the amount of business done in Texas to show that the *Quill* requirement is met is wrong for two reasons. First, “volume of business” is not the *Quill* test — physical presence is.¹² Without establishing a baseline level of physical presence, a state cannot look to the amount of business done in the state by an out-of-state company to find that its presence in the state is substantial. In *Quill*, the out-of-state company held title to a few (tangible) floppy diskettes in North Dakota.¹³ The Court held that this minimal level of physical presence was insufficient to support a finding of substantial nexus. Here, the out-of-state company owned *no* tangible property in Texas. Thus, there could be no opportunity to find that the company had more than the slightest presence in Texas. Instead, the ALJ substituted the amount of business that the company generated in Texas as a proxy for physical presence

⁷Tex. Tax Code Ann. section 151.009.

⁸It is unclear from the opinion whether the company conceded that software is tangible personal property for sales tax purposes only or for all purposes, including implementing the federal *Quill* standard; it is unclear, in fact, whether the *true* nature of software as tangible or intangible property (in contrast to its statutory classification) was ever discussed at the hearing.

⁹504 U.S. 298.

¹⁰*Id.*

¹¹*Id.*

¹²*Id.*

¹³*Id.*

and found that this amount of business was substantial. This conclusion violates the commerce clause requirements set forth in *Quill*.¹⁴

Second, if volume of business were the *Quill* test, the outcome of *Quill* would have been different; the amount of business that the Quill Corp. had in North Dakota was huge — the company made almost \$1 million of sales to about 3,000 customers in North Dakota, and it was the sixth largest vendor of office supplies in the entire state.¹⁵ Adjusted for population, it is likely that Quill's business in North Dakota was larger than the software company's business in Texas. Nevertheless, the Court held that Quill could not be subject to North Dakota's sales and use tax laws because Quill's only connection to its North Dakota customers was by common carrier or the U.S. Postal Service.

By agreeing with the ALJ that the ownership of software rights creates substantial nexus for a company in Texas such that the company can be subject to the state's sales and use tax laws, the comptroller has completely misconstrued the meaning of the phrase "physical presence." Further, by upholding the ALJ's finding that the amount of income derived from the state can transform any presence into "substantial nexus," the comptroller has effectively allowed sales and use tax liability to be based on economic nexus. This clearly does not comport with Court precedent interpreting the commerce clause. Unless *Quill* is overturned by the Court or by congressional mandate, the analysis and holding set forth in the comptroller's decision should not — and constitutionally cannot — be followed. ☆

¹⁴*Id.*

¹⁵*Id.*

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