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Texas has codified a rule imposing sales tax collection obligations for companies that merely use a server in the state. Other states have taken the opposite route, specifically providing that the use of a server does not, alone, create nexus for sales tax purposes. These states are looking to attract high-technology businesses, rather than to scare them away.

The Texas Comptroller's Office recently made revisions to its sales tax rules that could ensnare many companies that merely use computer servers ("servers") located in Texas, requiring them to collect the state's sales tax on sales to customers there.

In 1992, the United States Supreme Court ruled in *Quill Corp v. North Dakota* that a state can only require a company to collect its sales tax if the company has a substantial physical presence in the state. This case has set out the basic doctrine on whether an an e-commerce retailer (e-tailer) must collect sales tax on sales to customers in a particular state.

If the e-tailer has a substantial physical presence in a state, then it has nexus with the state, and it must collect sales taxes on sales to customers there. If the e-tailer is required to collect the tax from a customer but fails to do so, then it becomes liable to pay the tax, penalties and interest.

Unfortunately, the Supreme Court has not shed any more light on the question of when a physical presence is substantial enough to create a sales tax collection obligation since *Quill* was decided 18 years ago. This has allowed states to try to set their own rules, where they cast as wide a net as possible to generate sales tax revenues.

For example, New York, North Carolina and Rhode Island have each passed affiliate nexus rules that require e-tailers to collect sales tax if the e-tailer has a certain amount of gross sales from click-through arrangements with affiliates that have a presence in the state. So these states have taken the position that the presence of the affiliate in the state that refers

sales to residents of the state through a click-through arrangement is enough to satisfy the Supreme Court's physical presence test.

Discrimination Against E-Commerce

Texas appears to be on a different track with its recent rule change. It now says that a company is engaged in business in Texas -- and therefore required to collect sales tax -- if it either owns or uses a server located in the state.

If a company owns a server in a state, this is generally considered adequate to satisfy the physical presence test, because the e-tailer would own assets in the state. However, until now, the mere use of a server in a state (without any other presence there) has not been considered adequate to satisfy the physical presence test.

The revision of the Texas rule changes this dynamic. It provides that the mere use of a server in Texas is adequate to establish nexus for sales tax purposes. Prior to this change, no state has taken the position that the mere use of a server located in a state is adequate to establish nexus. This might be because there is a question of whether the mere use of a server would satisfy the federal prohibition against state taxes that discriminate against electronic commerce.

This federal law says that a tax discriminates against electronic commerce when the "sole ability to access a site on a remote seller's out-of-state computer server is considered a factor in determining a remote seller's tax collection obligation." This has been interpreted by commentators as prohibiting a state from imposing a sales tax collection obligation on a company that merely uses a server owned by a third party -- for example, a situation in which an e-tailer enters into a Web-hosting arrangement to use the Web-hosting company's server.

So, it is possible that the revised Texas rule might be trumped by the Internet Tax Freedom Act. However, this rule is presently on the books, and the Texas Comptroller will maintain that this rule is valid. So any such challenge to this rule would have to be resolved in the courts.

It is interesting that Texas has codified this rule imposing sales tax collection obligations for companies that merely use a server in the state. Other states have taken the opposite route, specifically providing that the use of a server in their state does not, alone, create nexus for sales tax purposes. For example, see California Code Regs Section 1684(a) and Virginia Tax Commissioner Ruling 00-53.

These other states are looking to grow their high-technology businesses, rather than to scare away businesses from using servers located in data centers in their state. However, it appears Texas has taken a short-term view in order to enhance sales tax revenues.

Confusion, Not Clarity

It appears that the Texas Comptroller's Office did not thoroughly think through this revision of the rules. It is also possible that the Comptroller's Office did not intend to treat the mere use of a server as adequate to satisfy the physical presence test. This is quite possible since the Nexus Subcommittee of the Texas Tax Policy Working Group organized by the Comptroller's Office concluded in a 1999 report that the mere use of a server is not adequate to create a physical presence.

This report acknowledged that if Texas did impose a sales tax obligation on an e-tailer merely by using a server in the state, that e-tailers would likely abandon Texas Web hosting companies in favor of companies located in states that do not follow such tax policy. However, until the comptroller's office comes out with guidance to clarify the scope of this change, e-tailers should consider the potential impact of this rule on their activities in Texas, and e-tailer trade groups should lobby the comptroller's office for a reversal of this position.

In addition, the preamble to both the proposed and final amendments to Texas Rule §3.286 states the change to "Paragraph (2)(E) clarifies that ownership of tangible personal property in this state, including a computer server, means a person is engaged in business and has nexus in the state." There is a conflict between the Preamble and the Rule, which produces confusion -- not clarification.

Several conversations with the Tax Policy Staff of the Texas Comptroller's Office also failed to provide further enlightenment on its revised definition of nexus. Perhaps the Texas Comptroller has adopted Justice Potter Stewart's famous "I know it when I see it" standard with respect to sales tax nexus. The Texas Comptroller has obfuscated, rather than clarified, its definition of "nexus" with this revised rule, and perhaps has created a tax trap for the unwary.

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