



NRAI WHITEPAPER

Nexus:

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Nexus: It's all about physical presence. Or is it?

Nexus, it's a fairly simple five letter word that the Miriam-Webster dictionary defines as a connection or link. At first glance the word doesn't appear very scary, mystical or confusing, but when used in the context of taxes it is often one of the most misunderstood, misinterpreted and underestimated issues; making it a very common cause of tax problems. Why does this seemingly non-threatening word generate such heart-burn in multistate businesses? Start with the United States Constitution, add a couple federal laws and Supreme Court cases, multiply that by the laws passed in each of the 50 states, then apply that to different categories of taxes, factor in states hungry for revenue and top it off with an ever evolving economy and you have your answer. Nexus is not static; states are constantly pushing the nexus envelope trying to increase their tax base. So even if you are a nexus expert (a Nexpert?), nexus is a topic that requires continuous monitoring and updating of knowledge. The following discussion is intended to provide a glimpse into some of the basics of nexus and the role of physical presence.

Nexus is the the minimum connection or link necessary, that allows a state to tax you or force you to collect taxes on it's behalf

To start off our discussion we should enhance our simple nexus definition to one that best fits our state tax context. A generic definition I like to use is: *the minimum connection or link necessary, that allows a state to tax you or force you to collect taxes on it's behalf*. This minimum link can vary from state to state as well as from tax to tax. Perhaps the best way to delve into nexus is by examining it within the context of the three different major types of state taxes and some of the primary legal influences affecting nexus for those taxes. These taxes are: sales and use tax (SUT), corporate income tax (CIT) and the third group which is neither SUT nor CIT, but closer to a mix of the two. For a lack of a better term we'll call the third group, "Neither/Nor Taxes" (NNT). The third group consists of taxes like the Washington Business and Occupation Tax (B & O), the Ohio Commercial Activities Tax (CAT), the Michigan Business Tax (MBT) and the Texas Franchise Tax among others.

Sales and Use Tax (SUT)

To understand the evolution of nexus for sales and use tax it is important to start with the U.S. Constitution; more specifically the Due Process and Commerce Clauses. The Due Process Clause states that no state shall deprive any one of life, liberty, or property, without due process of law and the Commerce clause states that congress shall have the right to regulate commerce among the several states. What this has evolved to mean is that before a state can subject you to its laws you must have a link or nexus with that state. The Supreme Court has held that when it comes to the Due Process

Clause, there must be a “minimal connection” (nexus) before a state can tax you. However when it comes to the commerce clause, the Supremes have declared that there must be a “substantial connection” (nexus). Since it is fairly easy to create the minimal connection required by the Due Process Clause, we will concentrate on the Commerce Clause and its substantial nexus.

It has been just over 70 years since the Supreme Court, in *Nelson v. Sears Roebuck* and *Wisconsin v. J.C. Penney*, defined the concept of “Substantial Nexus”. Since that time it has been widely accepted that substantial nexus requires *more than the slightest physical presence*. What has not been as clear is exactly what constitutes physical presence and exactly at what point does one cross the line from “slightest” to “more than the slightest” physical presence to create substantial nexus. Although the Supreme Court has decided a number of cases over the last 50 years providing some guidance, since it can only rule on the facts in the instant case, no definitive, all inclusive answer can come from them. They have (properly) deferred the matter to Congress instead. So until Congress decides to exercise its powers under the Commerce Clause, nexus will continue to be a complex grey area where states will continue to push the envelope. In the meantime we will have to rely on what little guidance the Supreme Court has provided. And don’t hold out too much hope that even if Congress does act that all of a sudden things will immediately clarify.

10 Nexus Creating Activities for Sales & Use Tax

1. Ownership of real property (stores, warehouses, offices, etc.).
2. Ownership of personal property (machinery, equipment, etc.).
3. Leasing of real property (stores, warehouses, offices, etc.).
4. Leasing of personal property (machinery, equipment, etc.).
5. Maintaining of an inventory, whether consigned, stored or carried by sales representatives.
6. Travel of employees into a state to conduct sales, training, deliveries, installations, repairs etc.
7. Use of independent sales or manufacture’s reps even if they are not exclusive.
8. Use of sub-contractors for repairs, maintenance, installations, etc.
9. Allowing employees to telecommute or use a home office.
10. Advertising in local media or phone directories.

Third parties performing activities that help establish and maintain a market can create nexus.

One of the earliest cases to expand the scope of physical presence is the 1960 case, *Scripto, Inc. v. Carson*. In this case it was decided that independent sales representatives, even if they are not exclusive to a company, create substantial nexus. The Court stated that it was not important what these representatives were called but rather what they did for the company. This is the first time we see the phrase “establishing and maintaining a marketplace for the company”. The Court revisited this issue again in the 1967 case *Tyler Pipe Industries, Inc. v. Washington Dept. of Revenue*. The Court held that even one part time employee or independent agent can create nexus. It went on to add that the critical test was to see if the activities performed on behalf of a taxpayer are significantly associated with the taxpayer’s ability to establish and maintain a market. Following this line of reasoning you can see how installation, maintenance, warranty services, etc., are just as important to establishing and maintaining a market as sales, and therefore can also create nexus even if performed by third parties.

Perhaps the most important or at least the latest (1992) of the important Supreme Court Cases is *Quill Corp v. North Dakota*. In *Quill* the State argued that three diskettes were enough of a physical presence to create nexus for *Quill*’s catalog business. The Court decided for *Quill*, stating that a taxpayer must have a more than the *slightest physical presence* in a state in order to require the collection of sales or use tax. The Court’s reasoning was partially based on the fact that, due to the immense number of sales tax jurisdictions, imposing an obligation to collect sales tax would create a burden that could be said to effectively restrict interstate commerce.

This brings us to where we are today. We know that third parties performing activities that help establish and maintain a market can create nexus. We also know that it takes more than the slightest physical presence to create nexus. It’s safe to assume that offices, warehouses and employees all exceed the slightest physical presence. But where is the line drawn? In *Quill* three diskettes was not sufficient; but could it be four, five or six? Since the Court decided not to quantify we will remain in this complex grey area reacting to the pushing of the envelope by states until Congress decides to act.

Corporate Income Tax (CIT)

When it comes to corporate income tax the role of physical presence has become somewhat less paramount. In some instances the state’s authority has been limited and in others increased. Sometimes these results are by design and sometimes they are the result of the law of unintended consequences. Let’s take a look at two of the biggest influences.

In February 1959, the U.S. Supreme Court decided *Northwestern Cement v. Minnesota*. In its opinion the Court affirmed a state’s power to tax income generated from interstate activities. They went on to say that such a tax is valid if it does not discriminate

against interstate commerce and is properly apportioned to activities within the state that create nexus. Congress began to worry that unclear nexus guidelines as well as complex compliance issues, could cause some companies, particularly smaller ones, to limit their interstate activities. Congress moved quickly to pass legislation, Public Law 86-272, seven months after the Supreme Court decided the Northwestern Cement case. The major thrust of PL 86-272 is that a state is prohibited from imposing a net income tax if a company's only activities in a state are the solicitation of orders for sales of tangible personal property which are sent outside the state for approval or rejection and are filled from outside the state. The Senate noted that the legislation was not a permanent solution and was intended to be a temporary fix while further studies were made of the problem. Yet here we are 52 years later with no further action and an environment even more confusing than back then. Nowadays, companies sell services and intangibles sometimes even combined with tangible personal property. This law is now one of the factors confusing the nexus situation even more. The protection of PL 86-272 applies to independent agents as well as employees. However when relying on these protections it is important to remember the narrow confines of the activities covered.

Economic Nexus is the concept that states have jurisdictional authority to tax any company that takes advantage of the state's markets without regard to physical presence and can be measured in ways such as receipts generated from the state or numbers of customers within the state.

Another influence on CIT comes from the unintended consequences of the *Quill* decision. In *Quill*, the Court expressly talks of physical presence in the context of SUT. Many states have taken the position that the courts narrow language in *Quill* referencing SUT means that the requirement for physical presence is superfluous when referencing other taxes. This opened the door for a concept called "Economic Nexus." This concept basically defined is that states have jurisdictional authority to tax any company that takes advantage of the state's markets without regard to physical presence and can be measured in ways such as receipts generated from the state or numbers of customers within the state. To date there have been many lower court and state supreme court cases affirming the concept of economic nexus with the U.S. Supreme Court refusing to take sides. The result is a confusing mix of nexus rules with some states requiring physical presence and others not.

Neither/Nor Taxes (NNT)

As mentioned earlier these taxes are neither SUT nor CIT, but closer to a mix of the two. The Neither/Nor group consists of taxes like the Washington Business and Occupation Tax (B & O), the Ohio Commercial Activities Tax (CAT), the Michigan Business Tax (MBT) and the Texas Franchise Tax. Since neither/nor taxes are not income taxes they are not afforded the protections of PL 86-272. Conversely since they are not SUT, they are in the states' minds, not subject to the physical presence requirements of *Quill*. Of the four taxes mentioned above, only Texas does not have an economic nexus provision.

Top Ten Nexus Survival Tips

1. Do not underestimate nexus.

Not knowing about nexus can have a devastating effect on you and your company. If a state determines you have nexus there is generally not a statute of limitations on how far back they can audit you. In theory they can go back to the date you started to do business in the state, although in reality they usually stay in the 7-10 year range. But 7-10 years is still a long time, obviously. Then, not only can you end up paying back taxes but they tack on penalty and interest as well. The dollars can start to add up quickly, especially if the states share information. In some extreme cases criminal penalties may also apply.

2. Educate yourself.

Learn about nexus and see how it applies to your company's operations. Stay abreast of nexus changes as well as changes in your business. There are a number of resources that are available, but free webinars are a good place to start. There are also a handful of firms that can help.

3. Do not assume you are okay.

Just because you have not been contacted by a state yet doesn't mean you are okay. You may be okay or it may mean that the state just hasn't found you yet. Some common ways states find you are through audits of your vendors or customers, disgruntled employees reporting you or your competitors turning you in. There are many other way but these are three of the big ones.

4. Do not assume that your current CPA's fully understand nexus.

CPAs are usually very good at what they do. The problem is that many of them don't focus on state and local taxes and some of those that do only focus on a handful of states. You may be surprised to learn that their knowledge of multi-state nexus issues is no better than yours. Question your CPA about how much of this type of work do they do? How do they stay on top of the evolving issues in each of the states? You may have a great nexus resource in your CPA — then again you may not.

5. Do not assume that your employees are keeping you compliant.

Ask your employees how they stay abreast of nexus changes. Do they monitor operations and see how changes in the way you do business impacts nexus? How do they educate themselves? Who do they go to for answers or clarifications? Are you giving them the tools that they need? If you have doubts consider doing a nexus consultation and analysis; it can be done internally or by a third party.

6. Do not assume that your competitors are approaching nexus correctly.

This is a perfect example of something my father told me over and over, “Just because everyone else is doing it doesn’t make it right.” How true this is. Maybe your competitor has it right, but maybe not. Maybe they just haven’t been discovered yet. This may become a case of the blind leading the blind. How do you know that your competitors are not following you? Where are your competitors getting their information? Perhaps the best question to ask is if the state finds you will your competitor pay the money you owe. I would say no, therefore educate yourself.

7. Do not stick your head in the sand.

If you have nexus do not wait for the state to find you. The longer you wait the greater your liabilities grow as there is no statute of limitations. The second reason is that there is a program called a Voluntary Disclosure Agreement (VDA) that states offer to entice you to come forward. The VDA program usually limits the period a state will look back to three to four years, as well as waiving penalties and/or all or part of the interest. The drawback is that if the state finds you before you come forward, then you are usually not eligible to participate in the program.

8. Do not answer a nexus questionnaire without fully understanding your exposure.

When a state becomes aware of you they will usually send out a questionnaire about your activities in the state. Before you answer the questionnaire you should not only understand what your exposure is but what options are available. Once you return that questionnaire, your options may be limited.

9. Do not just get registered if you find out you have nexus.

This may seem counterintuitive, but remember that there is no statute of limitations if you have not filed the monthly returns. Once you come forward and get registered, you’ve lost the one small advantage and leverage you had. The state now knows who you are and the state can go back and audit you for all the past periods. You will definitely want to look at a VDA or amnesty program.

10. Do not panic.

If you think you might have nexus or have been contacted by a state do not panic. There are programs you can take advantage of and a handful of firms that can help. You are not alone and are not unique. You can rest assured that many before you have had the same problems and have been helped. Just remember not to ignore this issue. Not only does it not go away, it gets worse with time.

Conclusion

Physical presence has and does play a role in nexus. How big that role is depends on the type of tax and the state in question. What qualifies as physical presence also varies widely as states continue pushing the envelope looking to increase their tax base. It's a situation that promises to get more confusing as time goes by. The ultimate solution probably rests with Congress and their ability to regulate interstate commerce. However, since they have been reviewing the situation for 52 years, a congressional solution does not seem to be on the near-term horizon. For now we are on our own.

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About Peisner Johnson & Company

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