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Determining your Nexus Footprint

(What you're dying to know)

About the Presenter

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- State and local tax (SALT) specialist at TaxOps, helping clients navigate the morass of SALT issues to make it less "Taxing!"
- More than 10 years public accounting experience, focusing on nexus analyses, state tax risk mitigation, structuring and tax controversy work
- Graduate of Quinnipiac University School of Law

Learning objectives

- Define “nexus”
- Examine the history of jurisprudence, landmark cases, and the current law
- List the differences in state income tax vs. state sales tax nexus factors
- Discuss “nexus” collections and internet sales tax
- Describe how to be SALT compliant
- Respond to nexus questionnaires
- Discuss anticipated potential law changes

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What is nexus?

Nexus is the *link* or *connection* between a political jurisdiction and a taxpayer that needs to exist before that jurisdiction can impose a filing requirement for either sales or income tax.

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Nexus principles

- Physical Presence
  - Office building, store, warehouse, employee
- Economic Presence
  - Factor Presence
    - Bright line thresholds of property, payroll, or sales
  - Everything else
- Attributional nexus
  - Agency nexus
  - Alter Ego nexus
- Affiliate nexus
- Click-through nexus

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Nexus principles

Determinations result from the inter-relationships of the following bodies of law:

- Constitutional Principles and Case Law
  - Due Process Clause
  - Commerce Clause
- Federal Law
- State Law
  - Statutes/Regulations/Advisory Opinions
  - Case Law

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Constitutional principles

Due Process Clause

1. Requires *minimum connection*
    - Concerned with concepts of fairness, notice and fair warning.
    - State has authority to tax the benefits enjoyed in the economic market it provides
    - Did taxpayer purposefully direct its activity into the state?
    - Does not require physical presence

2. Rational relationship between income attributed to state and vales of enterprise
    - Fair apportionment

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Constitutional principles

- Commerce Clause
  - Prevents states from imposing laws that restrict interstate commerce
  - Requires taxpayer to have *substantial nexus*
    - *Sales Tax = physical presence*
    - *Income Tax = conflicting results, generally satisfied if company derives economic benefit from jurisdiction*

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Constitutional limitations

- Due process and commerce clause hurdles:
  - *National Bellas Hess v. Department of Revenue*, 386 U.S. 753 (1967)
  - *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992)
    - Physical presence is the bright-line test for *sales and use tax* nexus

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Constitutional principles

Since Quill…the debate wages on

- How much physical presence is needed for physical presence?
  - Is there a "de minimis"? If yes, is it qualitatively or quantitatively evaluated?
  - Occasional visits
  - Trade shows, warehouses (Amazon "FBA")
- Can you have physical presence through agency, affiliation, and attribution?

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Federal law – Public law 86-272 limitation

"No state, or political subdivision thereof, shall have the power to impose…a net income tax on the income…(of) any person from interstate commerce if the only business activities within such State by or on behalf of such person during such taxable year are either, or both, of the following:

1. The solicitation of orders by such person, or his representative, in such state for sales of tangible personal property, which orders are sent outside the State for approval or rejection, and if approved, are filled by shipment or delivery from a point outside the state; and
2. The solicitation of orders by such person, or his representative, in such state in the name of or for the benefit of a prospective customer of such person, if orders by such customer to such person to enable such customer to fill orders resulting from such solicitation are orders described in paragraph (1)

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Federal law – Public law 86-272 limitation (continued)

- Basically, if your only activity in a state is solicitation of sales, the orders are sent, accepted, shipped, maintained, and repaired from a different state, you are protected under Public Law 86-272

- **ONLY APPLIES TO SALES OF TANGIBLE PERSONAL PROPERTY**

- **ONLY APPLIES TO TAXES BASED ON NET INCOME**

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State law

Statute/Regulations/Opinions

- Long Arm Statute
    - Example, Georgia's "doing business" provision:
    - "…entire net income…received by every foreign or domestic corporation owning property within this state, doing business within this state, or deriving income from sources within this state to the extent permitted by the United States Constitution. A corporation shall be deemed to be doing business within this state if it engages within this state in any activities or transactions for the purpose of financial profit or gain…" (Ga. Code Ann. § 48-7-31)

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State law (continued)

Statute/Regulations/Opinions

- Creative ways to extend nexus to out-of-state companies (*bonus question…why focus on out-of-state companies?*)
  - We will discuss the *Scholastic* line of cases a bit later
  - A digital "cookie" as in-state property

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Physical presence

Employee / independent contractor/rep visits

- Washington Tax Determination No. 13-0213, 33 WTD 64 (2014)
- Rent-A-Center, Inc. v. Department of Revenue, No. TC-MD 111031D (Ore. Tax Ct., May 12, 2014)

Physical presence

In-state deliveries

- Texas Comptroller's Decision No. 107,751 (July 23, 2014)
- Colorado GIL No. 14-015 (May 29, 2014)

Physical presence

Trade Shows

- Colorado GIL No. 14-015 (May 29, 2014)
- Washington Tax Determination No. 14-0062, 33 WTD 439 (February 20, 2014)

Ownership/Lease of in-state property

- Real Property
- Tangible Personal Property
- Intangible Property

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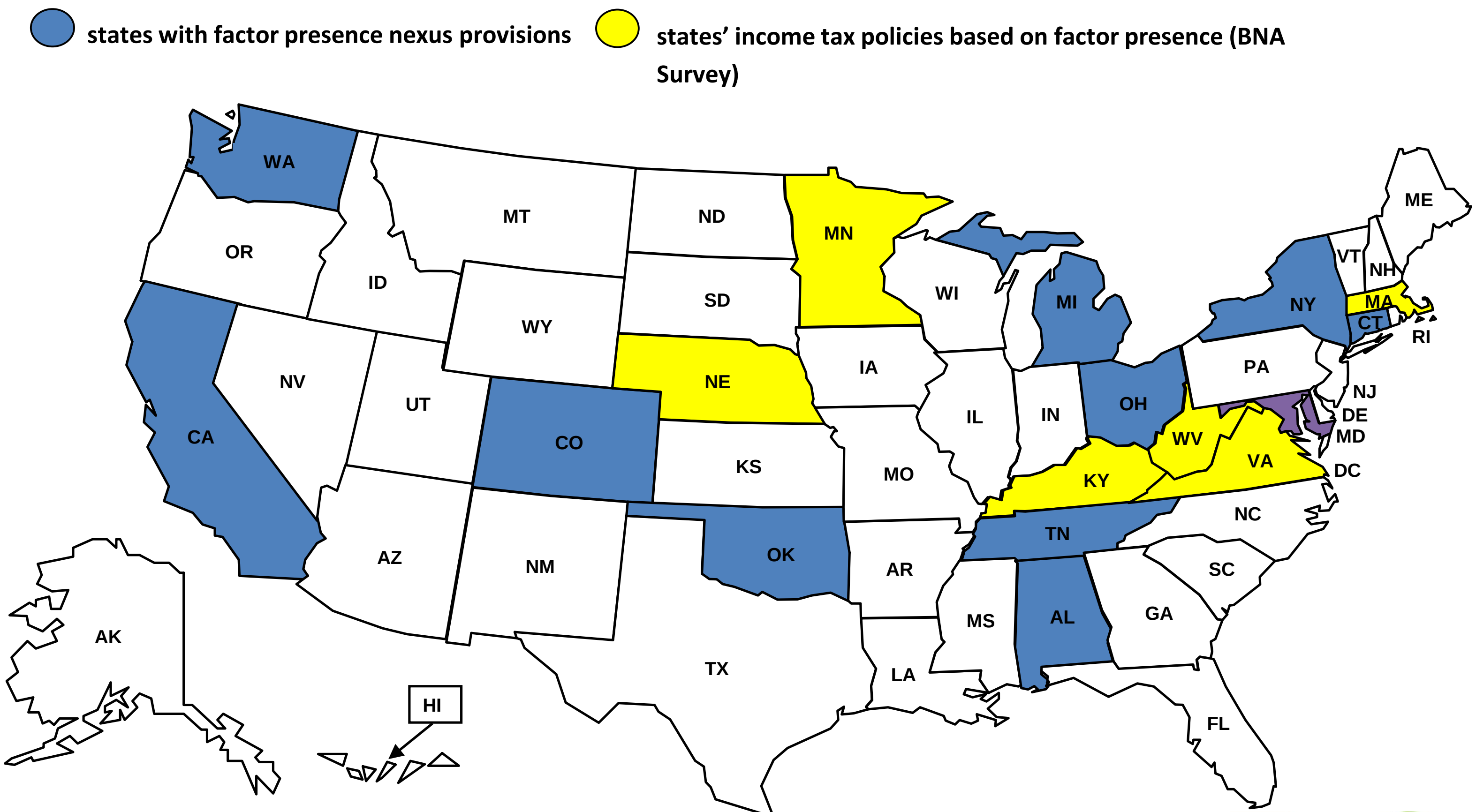
Factor-based presence



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Factor-based presence

- Draws a bright-line and measures economic presence within state
- Model rule as adopted by MTC 10/17/2002
    - More than $50,000 of property in the state, or
    - More than $50,000 of payroll in the state, or
    - More than $500,000 of sales in the state, or
    - More than 25% of total property, payroll, or sales in the state

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Economic presence

Economic presence is nexus without a physical presence

- Generally focused on revenues derived from the exploitation of the state's economic market
- Revenues from the use of intangibles including loans, royalties, patents, copyrights, trademarks, service marks, and franchises, etc.
- Making loans into a state

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Economic presence

- Evaluated based on facts and circumstances on a state-by-state basis
- Examples: intangible licensing (*Geoffrey*), financial institutions (*MBNA*)

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Economic presence

Tax commissioner v. MBNA America Bank, 640 S.E. 2d 226 (WV 2006)

- Principal business was issuing and servicing credit cards; Taxpayer had no real property, TPP, or employees in WV
- Court determined that the proper test for determining whether substantial nexus exists is “significant economic presence”
  - Examines the frequency, quantity, and systematic nature of a taxpayer’s economic contacts with a state”

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Attributional nexus concepts - Agency, Affiliation

- Under the attributional nexus concept, states assert nexus on the basis of a taxpayer's relationship with another entity (e.g., affiliate or subsidiary). That entity, likely, has nexus with the asserting state.

- States have asserted attributional nexus based on *Scripto* (1960) and their "doing business" statutes.
  - *Scripto Inc. v. Carson*, 362 U.S. 207 (1960)
  - *Tyler Pipe Industries Inc. v. Washington*, 483 U.S. 232 (1987)

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Attributional nexus

Pushing the limits - who can be your agent?

- *Scholastic Book Clubs v. State Board of Equalization*, 207 Cal.App.2d 734 (1st Dist. 1989)
- *Pledger v. Troll Book Clubs Inc.* 871 S.W.2d 389 (Ark. 1994)
- *In re Scholastic Book Clubs, Inc.* 920 P.2d 947 (Kan. 1996), *Scholastic Book Clubs v. Michigan Department of Treasury* 567 N.W.2d 692 (Mich. Ct. App. 1997)
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- *Scholastic Book Clubs Inc. v. Connecticut*, 38 A.3d 1183 (Conn. 2012)
- *Scholastic Book Clubs v. Tennessee*, 373 S.W.3d 558 (Tenn. Ct. App. 2012)

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Click-through nexus

- Click-through nexus statutes generally require sales and use tax collection by "out-of-state vendors that compensate residents for sales made via links on their websites"

- New York was first to enact click-through legislation

    - Widely referred to as the "Amazon law"

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Click-through nexus

Amazon.com, LLC v. New York State Department of Taxation and Finance, 20 N.Y.3d 586 (N.Y. 2013)

- The New York Court of Appeals upheld the New York Amazon Law as facially constitutional
- The Court found that although physical presence is generally necessary for sales tax nexus, it need not be substantial, and can be met if economic activities are performed in the state by a seller on behalf of the taxpayer
- The bottom line is that if a vendor is paying New York residents to actively solicit business in this State, "there is no reason why that vendor should not shoulder the appropriate tax burden"
- The United States Supreme Court denied certiorari on December 2, 2013

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States with click-through nexus

1. Arkansas, since October 24, 2011
2. California, since September 15, 2012
3. Connecticut, since July 1, 2011
4. Georgia, since October 1, 2012
5. Illinois, since July 1, 2011 and amended August 26, 2014
6. Kansas, since July 1, 2013
7. Maine, since October 9, 2013
8. Michigan, effective October 1, 2015
9. Minnesota, since July 1, 2013
10. Missouri, since August 28, 2013
11. New Jersey, since June 30, 2014
12. New York, since June 1, 2008
13. North Carolina, since August 7, 2009
14. Pennsylvania, since September 1, 2012
15. Rhode Island, since July 1, 2009

Recent developments

Pushing the limit - Use Tax Reporting Requirement

A prime example is Colorado:

- A remote vendor must do three things:
- Provide the purchaser with notice
  - On invoice
  - Purchase is not exempt and should file
- Annual purchaser notice (January 31)
  - "Important Tax Document Enclosed"
  - (unless purchases were < $500)
- First class letter with date, description, and amount of purchases
- Filing requirement by vendor and purchaser
  - Annual DOR notice (March 1)
- Name and address of each Colorado purchaser
- Total dollar amount of purchases

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Recent developments

- Attempts to Challenge Quill (both legislative and regulatory)
  - Indiana HB 1129
  - North Dakota SB 2298 (contingent on federal authorization)
  - South Dakota SB 106 (appealed to SD Supreme Court)
  - Wyoming HB 19
  - Alabama regulation (challenged in Alabama Tax Tribunal)
  - Tennessee regulation (suspended by HB 261)
  - Massachusetts directive (stretches Quill for internet vendors)
- "Click-through nexus" laws
- "Marketplace provider" laws
  - Minnesota HF 1
  - Potential application in Arizona and Wisconsin
- "Notice and Reporting" requirements
  - Alabama, Colorado, Louisiana, Oklahoma, Vermont

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Recent developments

Pushing the limit - States Challenge Quill: Alabama

- Alabama Sales and Use Tax Rule Number 810-6-2.90.03
- Applies to all sales made on or after Jan. 1, 2016
- Factor-nexus standard with a $250,000/year threshold
- Out-of-state sellers who lack a physical presence but who make sales of tangible personal property into the state have substantial economic presence in Alabama and must collect and remit tax when sales exceed $250,000/year (and engage in an activity listed in 40-23-68)

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Recent developments

Pushing the limit - States Challenge Quill: South Dakota

- Senate Bill 106 (Applies to sales made on or after May 1, 2016)
    - A remote seller has nexus if its annual in-state sales exceed $100,000 or if the seller has 200 or more separate sales into the state

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Recent developments

Crutchfield v. Testa, Ohio Supreme Court Case No. 2015-0794 (Nov. 17, 2016)

- Court also held against *NewEgg* and *Mason Cos. in similar cases* on same day
- Online sellers with no physical presence in Ohio, but over $500,000 in gross receipts found to be subject to CAT.
- Ohio CAT's factor presence meets constitutional requirements for substantial nexus and that *Quill*'s physical presence rule does not apply to gross receipts taxes.
- The court did not address the issue of whether internet cookies create physical presence, an argument the state raised.
- Case settled prior to US Supreme Court cert. petition deadline
- Ohio was the first state to pass the MTC's factor nexus model legislation with its 2005 tax reform.
- At least nine other states have factor nexus provisions (AL, CA, CO, CT, MI, NY, OK, TN and WA)

Other considerations

Qualifying/Registering to do business in a state:

- May create an income/franchise tax filing requirement
- May be required if an entity is doing business in a state
- Applies to corporations and pass-through entities

When does nexus end?

- Lingering/trailing nexus

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Next Steps – Quantify and assess risk

I have nexus, now what…

- Compliance (maybe)
- Sales and Income? Income Only? Sales Only?
- Statute of Limitations considerations

Sales factor: Sales other than TPP

Market / Benefit of Service:

- Revenue is source to place of utilization or the location of the person receiving the benefit

Sales factor: Sales other than TPP

Cost of Performance – MTC Reg. IV.17.(4)

- Receipts (other than from sales of tangible personal property) in respect to a particular income producing activity are in the state if:

  - The income producing activity is performed wholly within this state; or

  - The income producing activity is performed both in and outside this state and a greater proportion of the income producing activity is performed in this state than in any other state, based on costs of performance

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Recap – Nexus watch list

- ✓ All critical changes in corporate structure
- ✓ Adding employees, products, services
- ✓ Mergers and Acquisition activity
- ✓ Know what management, marketing and sales force are doing
- ✓ How are items sold and delivered (sales process)?
- ✓ How are training and warranties handled?
- ✓ Google "nexus questionnaires" to see the extensive list of questions

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The end (really).

Questions

The information contained in this document does not constitute tax advice. Tax rules change frequently. Please contact your tax advisor to get advice tailored to your circumstances.

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