The Paralegal's Perspective and Tax Law: How do I know if I have nexus?

by Michelle Lewis

Towards the end of the year, many businesses start to think about what their tax liabilities are, settling those, and filing tax returns, especially when multiple states are involved. The most common question businesses seem to have is "*Do I owe tax in the state?*" This question can usually lead into, "*Do I have nexus?*" Many may also wonder "*What is nexus and how do I know if I have it?*" These are shared questions that businesses all over the country want answered. The good news is that it is really not that difficult to answer!

Through services offered by the Multistate Tax Commission's National Nexus Program, a state funded agency that offers support to businesses interested in settling tax liabilities, businesses can get their questions answered about nexus. Within this program, one of the primary contact(s) for resolving tax questions is the Paralegal. The Paralegal discusses with the business the activities of the business on an anonymous basis and how the business can proceed with coming into compliance with state tax laws. The Paralegal coordinates the negotiations of a voluntary disclosure contract with states, and facilitates all correspondence between the business and the states involved. The Paralegal is also considered the business's administrative right hand, while undergoing the voluntary disclosure process. This article discusses the Paralegal's perspective on how businesses can determine where they have nexus.

Due Process Clause and Commerce Clause

According to the Bloomberg BNA 2016 2017 Survey of State Tax Departments, "for state tax purposes, nexus generally means the threshold of contact that must exist between a taxpayer and a state before the state has jurisdiction to tax the taxpayer" (p.13). So, we see here that there exist thresholds of contact that the business must reach before it will have nexus.

The U.S. Constitution contains two provisions that courts have used in determining nexus: The Due Process Clause and the Commerce Clause. The Due Process Clause of the U.S. Constitution (U.S. Const. art. I, § 3) requires that there be a minimum connection between a state and the person, property and or operation it seeks to tax, focusing on "fairness." *Miller Bros. Co. v. State of Maryland*, 347 U.S. 340, 344-345 (1954). A state cannot tax a business unless there is a minimum connection between the state and the business it seeks to tax. The Commerce Clause nexus test requires that there be substantial nexus between the taxed entity and the taxing state. The taxing state must be able to establish substantial nexus with the taxpayer sufficient to justify imposing the tax while not unduly burdening interstate commerce *Quill v. North Dakota*, 504 U.S. 298 (1992).

In *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), a Michigan based company, challenged liability for back taxes due as a result of providing transportation services. The state of Mississippi represented that the tax was imposed on transportation companies for the "privilege of doing business". The company transported motor vehicles from Jackson, Mississippi to dealers within the state of Mississippi. This tax was imposed on transportation companies for the privilege of doing business in the state. The Supreme Court responded by affirming the decision of the Mississippi Supreme Court and ruling that a four part test should be used to determine the constitutionality under the Commerce Clause of state taxes on out-of-state businesses. The first part of that test is whether the tax applies to an activity creating substantial nexus within the taxing state.

Additionally, the Florida Supreme court recently upheld as constitutional under the Commerce Clause in *American Business USA Corp v. Florida Department of Revenue* an "origin sourced" sales tax imposed on a florist taking internet orders for flowers in Florida and delivered out of state. The florist did petition for certiorari to the U.S. Supreme Court but it was denied as of February 21, 2017.

Quill v. North Dakota

One question businesses often have is, "How do you know what clause to defer to when trying to determine nexus?" The U.S. Supreme Court ruled in *Quill v. North Dakota* that a retailer's physical presence is required to establish substantial nexus under the Commerce Clause sufficient for a state to legally compel the retailer to collect the state's sales or use tax. This would include agents, employees, or an office or place of business within the state. Such physical presence in the state cannot be *de minimus*. (De minimus means inconsequential.) This could be broken down into how many days the business has been physically present and doing business within the state. Additionally, physical presence can include independent contractors or other representatives acting on behalf of the out-of-state business in the taxing state to establish or maintain the business's market in that state. Don't leave them out the loop! The Supreme Court ruled in *Scripto, Inc. v. Carson*, 362 U.S. 207 (1960) and *Tyler Pipe Industries, Inc. v. Washington*, 483 U.S. 232 (1987) that independent contractors working on behalf of a business or organization create nexus.

For sales and use tax, *Quill* had established a so-called "bright line" physical presence standard, but what about corporate income tax? The *Quill* decision did not spell out whether this standard applied to corporate income tax. That is, it wasn't determined that businesses create corporate income nexus solely through a physical presence. Consequentially, many state appellate courts began to settle the issue themselves. In some states, if the business has an "economic presence" in the state, as determined by the state, that justifies corporate income tax nexus. Therefore, corporate income tax nexus may be established by physical presence or economic presence.

Public Law 86-272

But you should also be aware that a federal statute protects businesses from state net income taxation if the business *only solicits sales of tangible personal property* in that state. So Public Law 86-272 restricts the state's authority to impose income tax on a business if the business is an out-of-state business that sells tangible personal property within the state. To be more clear, if the business only offers sales of tangible personal property or conducts activities ancillary to that solicitation, and the orders are then accepted outside the state, and if the purchased items are shipped by the business into the taxing state from outside the state, the taxpayer's activities are protected by P.L. 86-272 from establishing income tax nexus. Even though Public Law 86-272 provides businesses with some relief, it is important that businesses do their due diligence to settle each income tax nexus determination on a state by state basis. Corporate income tax nexus requirements may vary to some extent.

Online Retailers

Online retailers are becoming more of the norm. The federal, state and local governments are beginning to recognize that retailers are doing business differently. For this reason, Congress has considered proposals granting states the right to impose a sales/use tax collection duty on out of state retailers selling into the state through internet, phone or mail order. This sparked the introduction of The Market Place Fairness Act (2013). The Market Place Fairness Act (2013) was passed by the U.S. Senate authorizing states to require remote sellers without a physical presence in the state to collect sales/use tax from customers under certain circumstances, but it did not pass the House. The Market Place Fairness Act was re-introduced in the U.S. Senate in 2015. The bill has been re-introduced again this year. The Marketplace Fairness Act has been recently re-introduced in the U.S. Senate in 2017.

On a state level, some states have passed nexus legislation applicable to remote sellers. These laws can be referred to as *click-through nexus, affiliate nexus, and attributional nexus*. Click-through nexus requires online retailers to collect sales and use tax if they are out of state vendors that pay residents for sales made through links on their websites. By the way, many of the states that have adopted the click-through nexus legislation include a challenge process where businesses can dispute whether they have sales and use tax nexus.

Affiliate nexus requires out-of-state businesses to remit sales and use tax when they have a subsidiary or other affiliate relationship with an in-state entity that conducts activities helping to establish and maintain the out-of-state business's market in the state. For example, if a visitor clicks on a special link that redirects them to another site that the initial retailer is affiliated with and the visitor buys a product or service, and the initial retailer receives a commission for the referral, affiliate nexus is established.

Attributional nexus is a rule that establishes nexus if continuous local solicitation of multiple salesmen can be attributed to out-of-state sellers for sales and use tax purposes. In *Scripto v. Carson*, 362, U.S. 207 the Court recognized that this was the farthest it had extended nexus in the area of state taxation. In T*yler Pipe Indus. v. Washington State Department of Revenue*, 483 US 232 (1987) independent contractors created attributional nexus by rendering out of state companies liable for tax based on their presence significantly being associated with the business's ability to establish and maintain a market for a sale.

Recent State Legislation

Recent state legislation for remote online retailers has been trending towards incentives to collect tax and sales or revenue thresholds. Alabama enacted legislation effected October 1, 2015 on online retailers called the Simplified Sellers Use Tax Remittance Act. This act permitted online retailers to qualify for a program that allowed them to collect a flat 8% combined state and local sales and use tax rate on remote sales to Alabama customers. In return, the remote retailers could retain a 2% vendor discount from remitted proceeds, and only be subject to state level audits. Additionally, Alabama Department of Revenue published rule 801-6-2-.90.03 stating that remote retailers must collect use tax on remote sales to Alabama customers if sales reach $250,000 per year or more.

South Dakota enacted SB 106, signed by the governor on March 22, 2016, requiring remote retailers with no physical presence within the state and sales to South Dakota customers exceeding $100,000per year, or 200 transactions per year, to commence registration , collecting, reporting and remittance of South Dakota use tax on remote retail sales to South Dakota customers. This statute is currently being challenged in the South Dakota courts.

Mississippi proposed a regulation effective July 1, 2017 that remote retailers with sales of tangible personal property to Mississippi customers exceeding $250,000 per year are required to register and collect sales and use tax. Remote retailers that don't become compliant will be subject to retro-active liability without regard to statute of limitations.

As of March 1, 2017, the Tennessee Department of Revenue proposed in Regulations 1320-05-01-.63 and 1320-05-01-.129 to require remote retailers to register by July 1, 2017 with the state and begin collecting sales-use tax on remote sales to Tennessee customers if their annual gross sales exceeded $500,000. In December, 2016, the Tennessee Senate and House Government Operations Committees provided a 'no recommendation' of Tennessee's remote seller nexus Rule 1320-05-01.129. However, the Tennessee courts have recently stayed enforcement of the regulation, and it is being challenged in litigation.

Beginning April 1, 2017, Amazon.com will be collecting sales/use tax on its remote sales in all states with sales taxes. What's interesting is that many third party vendors selling merchandise on the Amazon.com platform are not collecting sales and use tax on internet retail sales to out-of-state customers. Some states are beginning to consider whether those sellers would have nexus in the states where they may have inventory stored in Amazon warehouses. Right now, legislative proposals have been introduced in Minnesota, Mississippi, New Mexico (SB 264), New York, and Rhode Island that would require market place providers, such as Amazon.com, to collect use tax on behalf of sellers using their marketplace. None of these proposals have been enacted to date.

The Multistate Tax Commission

Collectively, the federal and state guidelines presented should be helpful in establishing whether a business or organization has nexus in the state. It is important to ascertain because tax liabilities, penalties, and interest costs can accumulate and this usually doesn't fare well for the taxpayer. If the business is still unsure of their liabilities they can do one of two things: they can submit the required documents to the legal division of each state in question to get a state ruling determining nexus, or they can contact the Multistate Tax Commission National Nexus Program (MTC NNP) for more information. The advantages to reaching out to the MTC NNP are: (1) it has relationships with state agencies that can quickly answer tax questions involving nexus; (2) it offers a streamlined process for businesses to remit tax liabilities within multiple states; (3) participating member states offer businesses a limited lookback period; (4) member states offer a waiver of penalties; and (5) member states in some cases waive interest.

References:

- *American Business USA Corp v. Florida Department of Revenue*
- *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977)
- *Miller Bros. Co. v. State of Maryland*, 347 U.S. 340, 344-345 (1954).
- State tax policies. (2016). *Bloomberg BNA Survey of State Tax Departments*, 23(4), 13-28.
- Leavy, R. A. (2007). State and local taxation: Entity and Transactional Nexus, Power Point Presentation. Retrieved from https://www.mayerbrown.com/public_docs/presentation_state_local_tax_101607.pdf
- Marketplace Fairness Act of 2015 S.698
- Multistate Voluntary Disclosure Program. (n.d.). Retrieved April 3, 2016, from http://www.mtc.gov/Nexus-Program/Multistate-Voluntary-Disclosure-Program
- Public Law 86-272 15 USC S.381-384
- *Quill v. North Dakota*, 504 U.S. 298, 308 (1992)
- *Scripto, Inc. v. Carson*, 362 U.S. 207, 211 (1960)
- *Tyler Pipe Indus. v. Washington State Department of Revenue*, 483 US 232 (1987)
- U.S. Const. art. I, S.8