

New concepts of “economic nexus” should be a wake-up call to business taxpayers



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State and local governments are facing increasing fiscal pressure due to a faltering economy, the loss of federal money, and diminishing tax revenue. Not surprisingly, this has led to an increasingly aggressive search for new revenue sources.

Dissatisfied with traditional business tax regimes, state legislatures have enacted new, low-rate, broad-based enterprise taxes in a number of states, including Michigan, Ohio, and Texas. In addition, states continue to move away from origin-based tax rules and export their tax burden to out-of-state businesses through allocation formulas based on where customers or economic markets are located, rather than on where a business is located.

Nexus has many facets, with the rules varying by type of tax, industry, and state. For example, nexus dictates whether multistate retailers are liable to collect state and local sales taxes outside their home location. Businesses, legal scholars, taxing authorities, and tax practitioners strongly disagree on the expanded scope of state taxing authorities. This disagreement stems from the fact that there are multiple sources of Federal and State tax authority – including the U.S. Constitution, acts of Congress, state statutes, administrative rules, and state and federal court cases. There are few clearly defined guidelines to help taxpayers apply these legal standards. “Bright line” tests are rare.

Under the U.S. Constitution’s “Commerce Clause,” companies are required to have “substantial nexus” with a state seeking to tax them. “Substantial nexus” has historically and widely been interpreted as “physical presence.”

A nonresident corporation is *physically* present in a state if it has a tangible connection, such as rented warehouse space or visits by employees. It is *economically* present in a state if it derives income from a state’s local market by making sales to in-state customers or receives income from intangible property, such as from a trademark in use in the state. With recent court victories, states have forced a debate on whether a company with only economic presence in a state satisfies the substantial nexus requirement.

All of these trends have business taxpayers and their tax advisors watching closely as the “nexus” debate moves to center stage. “Nexus” is the connection between a business and a state or locality that allows the state or locality to require compliance with its tax laws. It applies to income taxes, sales taxes, and other taxes. Traditional nexus concepts are being redefined by state courts and legislatures as states continue to look for additional tax revenue. The result has been the rise of a legally questionable and potentially hazardous concept – Economic Nexus.

Even as the concept gains momentum, a large share of U.S. businesses remain confused about nexus and face potentially significant tax liabilities. All sizes and types of business entities are potentially affected.

A business with multistate operations is increasingly at risk for being out of compliance with filing obligations for taxes in states where they do business but have otherwise had no physical presence. States like Connecticut, Oregon, and Wisconsin have recently put in place income and franchise tax guidelines that look to activities like direct solicitation and marketing, performing services outside of the state for in-state customers, holding state licenses or regulatory permits, and licensing intangibles as evidence that nexus exists.

This trend is spreading to sales tax as well, which has been historically protected by the landmark 1992 U.S. Supreme Court ruling in *Quill Corp. v. North Dakota*. That case addressed the question of sales tax nexus for an out-of-state mail order company with no physical presence in the taxing state. The Supreme Court ruled that the Commerce Clause requires a physical presence before a state can require an out-of-state seller conducting all transactions over the phone and through the mail to collect sales and use tax. However, it did not specifically state that the physical presence nexus requirement also applied to other types of taxes, resulting in a lack of clarity that has generated uncertainty for taxpayers.

Many states have exploited the apparent nexus opening in the *Quill* decision through legal action or by enacting new statutes and standards to pursue the concept of economic nexus. States have aggressively and successfully asserted nexus against out-of-state financial institutions that only have economic contacts, such as loans made to residents, purchasing loans secured by in-state property, and issuing credit cards to in-state customers.

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New York has taken one of the boldest steps, challenging *Quill* in the enactment of new sales tax rules affecting internet retailers. Under its so-called “Amazon.com” rules, an out-of-state retailer that has a commission arrangement with a company for sales through its website is required to collect state sales tax if the website company has New York nexus. While certain safe harbors apply, New York is imposing its sales tax collection responsibilities on businesses with no in-state physical presence.

The most significant consequence of these developments for a multistate business is that it might find itself subject to income tax in states with which it has few contacts and little or no tangible presence.

A business should have a strategy to manage the potential impact of economic nexus on its tax picture. This means considering the cost of inaction that could later lead to litigation, drains on cash during difficult economic times, and financial statement impairment. If a taxpayer fails to meet statutory filing obligations, the statute of limitations on discovery and assessment by state tax authorities is unlimited. Multistate retailers must be aware that uncollected sales tax is deemed to be the seller’s liability even though most states impose a consumer use tax. It is not a defense to assume that the buyer has taken care of the state and/or local sales tax due.

A company can implement planning and compliance strategies to manage potential exposure arising from aggressive state tax actions:

- > Conduct a nexus review to map its commercial footprint
- > Restructure the business to limit direct activities in economic nexus states
- > Review contracts with third-party representatives and dealers
- > Analyze the company website to determine if it has content or functionalities that either give the appearance of, or establish nexus in, various states
- > Assert the right to apportion income for income tax purposes; rely on “economic nexus” presence to apportion income when traditional nexus is lacking
- > Revisit the financial reporting positions with respect to state nexus, i.e., FAS 109 and FIN 48 (FIN 48 will soon be implemented for privately held companies.)

If significant exposures are discovered, a tax professional can help identify state amnesty programs and voluntary disclosure agreements that may apply. These can limit the “look back” period for prior year tax filings and reduce penalties and interest.

The state and local tax landscape is evolving rapidly. The requirements by which a state can deem a company to be doing business in its state and incurring taxes are quickly expanding. Immediate, proactive planning can help avert an economic nexus “disaster” and allow a company to focus on other key business issues in today’s challenging global economy.

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