



State Tax Nexus – General Concepts

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Agenda

- General Nexus Principles
- Income Tax Nexus
- Sales/Use Tax Nexus
- Taxpayer Responses
- Questions

General Nexus Principles



General Nexus Principles

Why does nexus matter?

- Nexus – the ability to tax (“jurisdiction”)
- Connection required between a state and the activity/entity to be taxed
- Differences between nexus for income tax and sales/use tax purposes



General Nexus Principles

Federal Issues - U.S. Constitution

- Due Process Clause
 - “Minimum connection” required between taxpayer’s interstate activities and a state
- Commerce Clause
 - “Substantial nexus” required between taxpayer’s interstate activities and a state
 - Differing interpretations of “substantial nexus”
- Lower Due Process standard easily met; Commerce Clause analysis more relevant
- Applies to employees or agents working on your behalf

General Nexus Principles

State Nexus Standards

- States often have minimum standards for taxation (e.g., “doing business” statutes)
- De minimis thresholds before taxation
- Specific safe harbors
- Law with regard to nexus differs between tax types



General Nexus Principles

Physical presence standard

Quill Corporation v. North Dakota, 504 U.S. 298 (1992)

- Issue was use tax collection obligation of mail order seller of tangible personal property
 - Solicited orders for sales of tangible personal property through catalogs and phone solicitations
 - Orders received by phone or mail
 - No “physical presence” in the state
- Court’s decision followed earlier case, National Bellas Hess, Inc. v. Department of Revenue of the State of Illinois, 386 U.S. 753 (1967)
 - Seller must have physical presence in the taxing state to be required to collect use tax

General Nexus Principles

Agency nexus

- Nexus created through third parties, e.g., independent contractors
- Third parties hired by out-of-state company
- Their actions might be attributed to the company
- Property used by third parties may also be attributed



General Nexus Principles

Agency nexus

Scripto, Inc. v. Carson, 362 U.S. 207 (1960)

- Georgia corporation's only activity in Florida was independent contractors soliciting sales
 - Did not own, lease or maintain any place of business in Florida
 - No regular employees
- Scripto was required to register as a dealer and collect use tax

Tyler Pipe Industries, Inc. v. Washington Dep't of Revenue, 483 U.S. 232 (1987)

- A single in-state sales representative/independent contractor created nexus for business and occupation tax purposes for out-of-state company
- Formal agency is not required; it is sufficient that there is a party in the state representing the taxpayer and helping the taxpayer to establish and maintain a market.

Income Tax Nexus

Income Tax Nexus

Public Law 86-272, 15 USCS 381

- P.L. 86-272 prohibits the imposition of a net income tax on those who only solicit orders of tangible personal property
- P.L. 86-272 is not applicable to taxes measured by gross receipts or sales
- De minimis activities exception
- Extends to cover in-state presence of independent contractors who
 - Solicit sales
 - Make sales
 - Maintain office

Income Tax Nexus

Examples of unprotected activities

- Sale of services
- Solicitation of the sale of services
- Leasing of tangible personal property
- Sale or license of intangibles
- Install and dismantle
- Customer training
- Engineering, design, and technical assistance
- Warranty, maintenance, and repair
- Credit and collection
- Delivery in seller's vehicle

Income Tax Nexus

Activities that could create income tax nexus

- Owning or renting property
- In-state employees or representatives conducting unprotected activities
 - MTC Nexus Bulletin 95-1: Use of 3rd party independent contractors to perform warranty repairs in-state exceeds protection under P.L. 86-272
- Registration
- Incorporation



Income Tax Nexus

Factor-based nexus standards

- Some states have bright-line tests – nexus created if property, payroll, or sales in the state exceed a certain threshold
 - California
 - Colorado
 - Connecticut
 - Michigan
 - Ohio
 - Virginia
- Multistate Tax Commission
 - Nexus created if during the tax period business exceeds \$50,000 of property, \$50,000 of payroll, \$500,000 of sales, or 25% of total property, total payroll, or total sales.



Income Tax Nexus

Economic nexus

- In some states, receipt of economic benefit from the state creates nexus
- No physical presence required
- Potential exposure for businesses
- Maine's explanation of economic nexus
 - “Economic nexus is a short-hand term for the principle that a taxpayer's purposefully directed business activity in a State (other than solicitation of sales activity protected by P.L. 86-272) may be sufficient to subject that taxpayer to income tax in that State regardless of the level – or absence – of physical presence in that State”



Income Tax Nexus

Economic nexus

- Lanco, Inc. v. Director, New Jersey Division of Taxation, 188 N.J. 380 (2006), cert. den. 551 U.S. 1131 (2007)
 - Licensing intangibles creates nexus for New Jersey Corporate Business Tax purposes
 - Quill only applies to sales tax

- Tax Commissioner of the State of West Virginia v. MBNA America Bank, 220 W. Va. 163 (2006)
 - Adopted “significant economic presence” test
 - Bank had engaged in continuous direct mail, telephone solicitation, and promotion in state
 - Court ruled that Quill only applies to sales and use taxes, not to state business franchise tax



Income Tax Nexus

Economic nexus

- KFC Corporation v. Iowa Department of Revenue, 2010 Iowa Sup. LEXIS 149 (2010)
 - Out-of-state company owned all the intellectual property of Kentucky Fried Chicken (KFC) and licensed this intellectual property to non-affiliated restaurant franchisees nationwide
 - IA Supreme Court ruled that the out-of-state company had corporate income tax nexus with Iowa even though it lacked an in-state physical presence
- Geoffrey, Inc. v. Commissioner, 453 Mass. 17 (2009)
 - MA state corporate excise tax was imposed on royalties earned by an out-of-state trademark company (Geoffrey) under a licensing agreement that based the royalties on in-state affiliate retailers' (Toys 'R' Us, Kids 'R' Us, and Babies 'R' Us) sales.
- U.S. Supreme Court denied review in Lanco, MBNA, KFC, and Geoffrey cases

Income Tax Nexus

Nexus Considerations

Why would a taxpayer/entity intentionally create nexus?

- Ability to apportion income
- Combined reporting
- Create net operating loss carryover
- Throwout/throwback

Sales/Use Tax Nexus

Sales/Use Tax Nexus

All states and the District of Columbia impose sales/use taxes except the following:

- Alaska
- Delaware
- Montana
- New Hampshire
- Oregon



Sales/Use Tax Nexus

Activities that could create sales/use tax nexus

- Property-related activities
 - Ownership of real or personal property in-state (permanent or temporary)
 - Renting real or personal property
 - Property may be unrelated to business at issue
 - CA: National Geographic offices for solicitation of advertising created use tax nexus for mail order business - National Geographic Society v. California Board of Education, 430 U.S. 551 (1977)

- Personnel-related activities
 - Resident employees
 - Occasional state visits by employees
 - Temporary in-state presence of employees
 - Third party or agency nexus (independent contractors)
 - Trade shows and seminars



Sales/Use Tax Nexus

Agency nexus examples

- Texas – Solicitation by Texas-based agents for out-of-state company; also distributed products. Vendor considered engaged in business and had nexus. 1995 Tex. Tax LEXIS 655, 1996 WL 225492 (Tx. Cmpt. Pub. Acct., Dec. 19, 1995).
- Illinois - Out-of-state taxpayers' use of Illinois telemarketing and answering services found sufficient to create nexus. Illinois Department of Revenue Informational Letter, ST 95-0485-GIL (Nov. 1, 1995).



Sales/Use Tax Nexus

Recent developments – “click-through” nexus

- Growth of internet sales has heightened tax collection problems
- Nexus established through customer referrals through website link with commission program
- Click-through nexus legislation passed in various states
 - Arkansas
 - California (delayed)
 - Connecticut
 - District of Columbia (contingent)
 - Illinois
 - New York
 - North Carolina
 - Rhode Island
 - Vermont (contingent)



Sales/Use Tax Nexus

Recent developments - affiliate nexus

Some states have added affiliate nexus provisions for sales and use tax purposes. An attempt to assert nexus through common ownership

- Arkansas
- California (delayed)
- Colorado
- Illinois
- New York
- Oklahoma
- South Dakota
- Texas
- Wisconsin

Other states enforce it through non-legislative means

- For example, Tennessee Attorney General Opinion issued Oct. 3, 2011.



Sales/Use Tax Nexus

Recent developments - notification requirements

- Requires seller to notify purchaser of possible use tax obligation
 - Colorado (injunction currently in place)
 - Oklahoma
 - South Dakota
 - Vermont (until click-through nexus goes into effect)

Sales/Use Tax Nexus

Recent developments – Streamlined Sales Tax

- Streamlined Sales Tax Agreement (SSTA) is an attempt to resolve complexity for vendors and generate new revenue for the states
 - Uniform definitions and sourcing
 - Ultimate objective of requiring all sellers to collect tax in all states
 - Contingent upon act of Congress to compel tax collection

Sales/Use Tax Nexus

Trade shows - factors used by states to determine whether trade show nexus exists:

- Length of time employees or representatives are present in state
 - “Days per year”
- Activities conducted at the show
 - Installing exhibits
 - Renting exhibits
 - Providing show service
- Sales made during show
 - Volume
 - Customers



Sales/Use Tax Nexus

Trade show nexus - examples

- Massachusetts - Vendor selling at trade shows for greater than three days per calendar year creates sales and use nexus. Directive 91-3, Massachusetts Department of Revenue, November 1, 1991.
- California - Under certain circumstances, allows an out-of-state retailer to engage in convention and trade show activities for 15 days (nexus-free) each 12 month period if they derive less than \$100,000 of net income from these activities during the prior calendar year. Cal Rev & Tax Code § 6203(d).
- Ohio - May attend trade show as a consumer without creating nexus.
 - Out-of-state business may participate as an exhibitor if no more than seven instances of nexus-creating activity within a calendar year and gross sales in Ohio of no more than \$25,000 that same calendar year. *Use Tax Information Release ST 2001-01*, Ohio Department of Taxation, September 2001.

Sales/Use Tax Nexus

You have sales/use tax nexus...now what?

- Is the product taxed by state?
 - Generally, all tangible personal property
 - Specified services
 - Trade show services for customer-owned property
 - Software and related services
 - Canned v. custom software
 - Software modification/customization
 - Video production
 - Printed advertising – exemptions available

Sales/Use Tax Nexus

You have sales/use tax nexus...now what?

- What is the taxable sales price?
 - Services related to sale of tangible personal property
 - Installation may be included or specifically excluded
 - Services necessary to complete the sale (e.g., design)
 - Delivery charges
- Sourcing – where does the sale occur?
 - Property – generally where tangible personal property is received by the purchaser or the purchaser's agent
 - Services – generally where performed, but in some cases where the benefit of the service is received (e.g., TX, SD)
 - Possible to have tax from different jurisdictions on the same invoice
- Does an exemption apply?

Sales/Use Tax Nexus

You have sales/use tax nexus...now what?

- If taxpayer has nexus and taxable sales, there is obligation to:
 - Register
 - Collect and remit state sales/use taxes
 - File monthly, quarterly, or annual returns

When Does Nexus End?



When Does Nexus End?

- Company closes physical operations in a state
- How long does nexus remain?
- Texas
 - Administrative one-year rule – continue to collect sales and use tax for 12 months after no longer doing business in Texas. 34 Tex. Admin. Code Sec. 3.286(b)(2).
- Michigan
 - Once nexus established for seller, it exists for remainder of month and the following 11 months
 - Taxpayer may submit proof – longer/shorter period reasonable Revenue Administrative Bulletin No.1999-1, Michigan Department of Treasury, May 12 1999.
- Washington
 - Retail sales tax - trailing nexus period is 4 years, plus the remainder of the year in which business stopped. WAC 458-20-193 (Rule 193).

Taxpayer Responses

Taxpayer Responses

Identification of exposures

- Reserves (ASC 450, 740)
- Nexus study
- Comparison of tax registrations
 - Sales & use
 - Income/franchise
 - Payroll
 - Secretary of State
 - Business license
 - Property tax
- Following Trends
 - Economic nexus
 - Bright-line tests
 - “Click-through”



Taxpayer Responses

Choosing an approach

- Monitor
- Register everywhere you have property or people
- Ruling request
- Middle ground/compromise
- Develop approach to respond to nexus inquiries
 - State-specific questionnaires
 - Multistate Tax Commission



Taxpayer Responses

Considerations

- Reducing Liability
 - Voluntary disclosure agreements
 - Amnesty
 - Audit defense/refund reviews

- Prospective Changes
 - Structural changes
 - Prospective filings/registrations
 - Business decisions
 - Employee changes/sales channels
 - Trade shows
 - Advertising

Questions?

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