CBIA Tax Conference

State Tax Nexus - What you need to know

June 28, 2017
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Presentation Agenda

- What Nexus Is and Its Importance
- State’s Right to Taxation
- Physical Presence v. Economic Presence Nexus
- Sales and Use Tax Nexus
- Income and Non-Income Based Tax Nexus
- Federal Legislation
- Nexus May Be A Good Thing
- FIN 48 Implications
- How to Identify Nexus
- How to Respond to Nexus
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- This presentation is intended to provide general information and no tax advice is intended to be given.

- Any written tax content, comments, or advice contained in this presentation is limited to the matters specifically set forth herein. Such content, comments, or advice may be based on tax statues, regulations, and administrative and judicial interpretations thereof and we have no obligation to update any content, comments or advice for retroactive or prospective changes to such authorities. This communication is not intended to address the potential application of penalties and interest, for which the taxpayer is responsible, that may be imposed for non-compliance with tax law.
What Nexus Is and Its Importance

- What is nexus?
  - A business has “contact” within a state
    - Nexus assertions are ever-changing

- Nexus Landscape:
  - Sales and Use Taxation
  - Income Taxation
  - Non-Income Based Taxation

- Implications
  - Tax Return Filing Obligation
  - Sales Tax Collection Obligation
  - Responsible Person Liability
  - Successor Liability
State’s Right to Taxation

The Hierarchy of Nexus

- U.S. Constitutional Nexus
- Federal Law Nexus
- State Tax Law Nexus
United States “Constitutional Nexus”

- U.S. Constitution governs when a State has the right to tax out-of-state persons and businesses.
  - Nexus gives states the right to taxation (not generally a good thing, but sometimes a good thing – to be discussed later).

- A person (business) must have a sufficient degree of Constitutional contact with a State before the State can impose any tax on it.

- What is the degree of Constitutional contact?
  - Due Process Clause (“fundamental fairness”)
  - Commerce Clause (“regulates interstate commerce”)


Due Process Clause: The intent of the due process clause is to ensure fairness and notice to the business that its contacts with the State cause it to be subject to taxation.

Looks to whether the business “purposefully directs efforts toward the market state.”

Need a “minimal connection” or link between a State and the business the State seeks to tax.
U.S. Constitutional Nexus

- **Interstate Commerce Clause:** “Congress shall have the power … to regulate commerce … among the states.”
  - “Negative” or “Dormant Commerce Clause” governs the states’ ability to impede commerce
- Concerned with burdening interstate commerce.
- A business needs a “substantial nexus” with a State in order for the state to seek taxation.
- No “substantial nexus” bright-line test.
Nexus – Substantial Contact

- It has been held via judicial decisions that “substantial nexus” may be achieved in two ways:

1. **Physical Presence** within a State

2. **Economic Presence** within a State
Nexus – Physical Presence

- Substantial Contact Requirement (Physical)
  - Physical Presence (Property, Employees, Attribution)

- Applies to all tax types including:
  - Income Taxes
  - Gross Receipts Taxes
  - Franchise Taxes
  - Net Worth and Capital Based Taxes
  - Sales and Use Taxes
Examples of Physical Presence

- Maintaining any type of facility, office or factory
- Owning fixed assets or inventory
- Leasing Property (as lessor or lessee)
- Conducting any type of service (e.g., consulting, installation, repair, engineering)
- Presence of sales force
- Independent contractors (i.e., third party) doing something on behalf of the business
- Delivery or pick-up of product in business’ vehicles
- Drop-Shipper Nexus
- Attribution (via division, subsidiary, third-party)
- Ownership in a partnership or other pass-through entity
Examples of Physical Presence

By state law or administratively, in order to encourage certain activities within a State, a State may provide nexus carve-outs. For example, the following activities may be determined not to constitute nexus within a *particular* state:

- Attending Trade Shows (e.g., 14 days or less)
- Utilizing Fulfillment Services (inventory in state)
- Commercial Printer Contracts (paper in state)
- Computer Servers (hosting company web site)
- De minimis Presence (qualitative and quantitative)
Nexus – Economic Presence

- Substantial Contact Requirement (Economic based - $)
- Economic Presence (w/o “physical presence”)
  - Application toward taxes *other than sales taxes*
    - Income Taxes
    - Net Worth and Capital Taxes
    - Gross Receipts Taxes
- Industries Most Affected:
  - Financial Services
  - Credit Card Issuers
  - Intangible Licensors
  - Franchisors
  - Service Sector
Examples of Economic Presence

- Economically present in a State by deriving income from a State’s customer market:
  - Deriving revenue from sales of goods to customers within a state.
  - Deriving service (broadly defined) revenue from customers within a state.
  - Deriving royalties from intangible assets (e.g., licensing trademarks, trade names, patents, etc.) located and utilized in a state.
  - Deriving interest and fees from lending to customers within a state.
Nexus – Economic Presence

- Trend is toward an economic presence standard
- Majority of States have held that “economic presence” creates nexus (other than for sales and use tax purposes; although this is changing).
- Connecticut has enacted economic nexus statutes.
Economic Presence Nexus – A Growing Trend

Physical Presence
Economic Presence
Potential Economic Presence
Nexus – Economic Presence

- States *may choose* not to impose an economic nexus standard.

- States may choose to aggressively impose its economic nexus standard only upon certain industries (e.g., financial services and intangible holding companies).

- States may provide economic nexus safe-harbor receipts thresholds (e.g., receipts less than $500,000 or 25% of total business receipts).

- U.S. Supreme Court won’t grant Certiorari (is it Constitutional?)
Sales Tax Nexus

- **Sales Tax Collection Obligation:** In order for a State to require an out-of-state business to collect its sales and use tax, the business must have a “physical presence” within the State that seeks to require the collection (*National Bellas Hess, Inc. v. Illinois* (1967); *Quill Corp. v. North Dakota* (1992)).

- **Physical Presence, not economic presence,** is required in order for a State to assert that a business must collect its sales (use) tax on taxable sales of goods or services within a State.
Sales Tax Nexus

- Attribution Nexus Assertions:
  - Independent Sales Representative (e.g., Mfg. Rep.)
  - Third-Party Installers
  - Third-Party Warrantors
  - E-Commerce:
    - States are becoming increasingly aggressive in asserting the “physical presence” standard, especially as it relates to e-commerce.
      - Brick and Mortar affiliation with dot-com subsidiaries
      - Click-Through Nexus: So called “Amazon.com” attribution nexus legislation has been enacted in Connecticut and New York as well as other States (over 10 states have such statutes).
      - Massachusetts: Cookies are a physical presence
      - Connecticut: Use economic nexus statute and make taxpayer prove lack of physical presence
Economic Nexus

- Justin Anthony Kennedy’s comments in *Direct Marketing Association v. Brohl* opened the door for states to enact statutes, regulations, and administrative releases claiming that economic nexus is enough to require remote vendors to collect sales tax.

  - Alabama, South Dakota, Tennessee, Vermont, and Connecticut are among of the states that have enacted sales tax economic nexus statutes or regulations.

  - Federal Legislation Proposals: “Market Place Fairness Act of 2017” (HR 2193) and “Remote Transactions Parity Act of 2017” (S. 976)
Sales Tax Reporting

- **Colorado**: Effective for Colorado destination sales on and after July 1, 2017, retailers must begin mailing annual purchase summaries to customers on or before January 31, 2018 and submit its report to the Colorado DOR by March 1, 2018. (*Direct Marketing Association v. Brohl*).

- **Other States**: Oklahoma, South Dakota, Vermont
Income Tax Nexus

- Unlike sales tax, according to various state judicial decisions either the Physical Presence or Economic Presence Standards may be asserted by a State to impose its income tax on a business.

- Public Law 86-272 (Federal law limitation):
  - P.L. 86-272 is federal legislation (enacted in 1959) that prohibits States from imposing a tax based on income (income tax) if a business’ only activity in the state is the “solicitation for sales of tangible personal property”, where the order is sent outside the state for acceptance or rejection and the property is shipped from outside the state.
  - Does not apply to services or solicitation thereof
  - Does not apply to non-income based taxes (like gross receipts taxes)
Other Tax Bases

- *Either* the Physical Presence or Economic Presence Standards may be asserted by a State to impose non-income based taxes (other than sales taxes) on a business.

- Federal Law P.L. 86-272 (income tax) protection does not necessarily apply
  - Connecticut – DRS has concluded that PL 86-272 does not apply to capital base
  - New York – DTF has concluded that PL 86-272 applies to franchise tax as a whole, including capital base
Other Tax Bases

Other Tax Bases:
- Tax on Net Worth or Capital
- Gross Receipts Taxes

Examples:
- Kentucky Limited Liability Entity Tax (Gross Receipts)
- Michigan Business Tax (Gross Receipts) (repealed)
- Nevada Commerce Tax (Gross Receipts)
- Ohio Commercial Activity Tax (Gross Receipts)
- Pennsylvania Capital Stock Tax (Net Worth) (repealed)
- Texas Gross Margin Tax (Modified Gross Receipts)
- Washington B&O (Excise) Tax (Gross Receipts)
Potential Federal Legislation

- **Business Activity Tax Simplification Act ("BATSA")**
  - Would create bright line nexus standards
    - De minimis $ and presence thresholds
    - P.L. 86-272 protection provided to service businesses

- **Marketplace Fairness Act**
  - Would allow states to require remote sellers to charge, collect and remit sales tax based on economic nexus (and physical presence)

- **Mobile Workforce Income Tax Simplification Act**
  - Safe harbor for wage tax withholding when working outside resident state (e.g., 30 days)
When Nexus May Be a Good Thing

- Allows “Right to Apportion”
  - E.g., Connecticut Companies paying 100% to CT

- Sales Factor Impact
  - Creates nowhere sales (and nowhere taxation)
  - Avoids Throwback and Throw-out Sales

- Dilutes Apportionment Factor
  - Shift taxable income to a lower or non taxing state

- Impact on Unitary Tax Return
  - May or may not be a good thing

- Sales Tax Collection
  - Nexus is never a good thing
FASB Interpretation No. 48 (ASC 740-10): Accounting for Uncertainty in Income Taxes

- **FIN 48**: Effective January 1, 2009 with respect to “private” businesses (non-public companies).
  - Applies to Corporations; Pass-through Entities and Tax Exempt Entities (i.e., all forms of legal entities)
  - Applied to Public Companies in 2007

- **FIN 48 applies to** entity level income taxes

- Upon adoption, the FIN 48 liability is a cumulative adjustment to an entity’s financial statements as of the beginning of its year and then through P&L
FIN 48 State Income Taxes – Applied to Nexus

- *Pass-through Entity Owners*: Although not considered under FIN 48 or FAS 5, tax liabilities attributable to the owners of pass-through entities should consider their state income tax exposure.

- *FAS 5*: Pursuant to FAS 5 (ASC 450-20), *Accounting for Contingencies*, the business should undertake an analysis of all potential non-income state tax exposures (e.g., sales and use taxes, employment taxes, property taxes) – different standards than FIN 48.
Fin 48 State Income Taxes – Applied to Nexus

- Applies to GAAP Financial Statements
  - Requires *all* businesses and entity types that issue GAAP financial statements utilizing FAS 109, *Accounting for Income Taxes*, to identify “uncertain tax positions” and reserve for such positions on its financials statements as well as provide certain footnote disclosure
  - Does not apply to non-GAAP financial statements (e.g., tax accounting based financial statements)
A tax position includes not filing a state income tax return (where one is required due to nexus)

FIN 48 requires quantification of:
  ◦ Entity Level State *Income* Tax “Exposure”
  ◦ Interest associated with delinquent income tax
  ◦ Penalties associated with delinquent income tax

Look-back/exposure period is to the point where nexus was first created in a State
  ◦ No statute of limitation period if non-filer
  ◦ Consider Department of Taxation administrative practices in such cases (e.g., 6 to 10 years)
How to Identify Nexus

- Discussions and Meetings with Tax Advisors
- Travel and Expense Information
- Nexus Questionnaire/Matrix
  - Company completes and tax advisors reviews and analyzes
  - FIN 48 Analysis
- Apportionment Information
  - Property
    - Where are fixed assets, real property, inventory, rentals
  - Payroll
    - Where are unemployment tax returns filed
  - Sales
    - Where are customers
    - Significant destination sales
How to Respond to Nexus

- Get a SALT person involved (ALWAYS)
- Investigate Nexus Creating Activities
  - Proactive investigation
    - Nexus Study
    - Quantify Potential Tax Exposure
      - Both FIN 48 & FAS 5 Analysis
- Controversies with State Tax Authorities
  - Responding to nexus questionnaires
- Consider Alternative Ways of Doing Business
- Consider Prospective Compliance
- Consider Retroactive Compliance
  - Amnesty Programs
  - Voluntary Disclosure Programs