Cole Schotz P.C.

Tax, Trusts & Estates Law

A State Nexus Study: Avoiding Imminent Audits by Revenue-Thirsty States

By **Geoffrey Weinstein** & **Juliya Ismailov** on May 16, 2016

POSTED IN CORPORATE TAX, GROSS INCOME TAX, SALES AND USE TAX, SALES TAX

We are seeing an uptick in audit activity by state tax authorities of closely held businesses, particularly in the area of sales and use tax, to generate much needed revenue for meeting budget shortfalls and funding services and entitlement programs. A go-to audit technique is to examine whether a company has "nexus" with its state.

The question of whether your company has "nexus" with other states can lurk in the background of its normal multi-state activities, until all of a sudden it explodes in an audit. A company that has failed to file returns and pay tax where there is nexus may face an audit for the past six to eight years generating substantial tax liability. In the case of a trust fund tax (such as sales tax) there is also personal liability to a company's owners and officers that is not a dischargeable debt in bankruptcy.

Definition of Nexus

An out-of-state ("foreign" or "nonresident") business with significant physical presence in another state will have nexus with this other state. The reason is that such business will be considered to avail itself of the state's benefits and privileges (this assumption is automatic for resident businesses) and, in turn, the state will have jurisdiction to impose "privilege" taxes, of whatever specific kind, on the nonresident business.

Physical contacts in the state, beyond outright ownership or leasing of property, may

include in-state deliveries (other than by common carrier) and banking activities in the state. For sales tax purposes, such contacts also include solicitation of sales, whether by employees, independent contractors or other agents. In addition, states have become increasingly aggressive and have asserted "economic nexus" based on non-physical contacts with the state, such as "click-through" nexus / internet referrals, licensing a trademark, and banking and financial services.

The two most common types of tax imposed by states on out-of-state businesses through nexus are income tax and the obligation to collect sales and use tax from customers.

Income Tax

State income tax is generally imposed on a nonresident business on income sourced within the state. However, income derived from solicitation activities is protected by federal statute, 15 USC § 381 (commonly known by its 1959 enacting legislation, "P.L. 86-272"). Under P.L. 86-272, a state cannot impose corporate tax on a foreign business, even when there is nexus, if the tax is based on, or measured by, the business' gross or net income if: (1) all such income is derived from solicitation of sales of tangible personal property, and (2) orders are approved and shipped from out of state.

Note that P.L. 86-272 does not protect: (a) income derived from solicitations of sales of services, real estate or intangibles, and (b) non-income franchise tax calculated based on gross receipts, apportioned capital, net worth and other non-income measures. For example, Washington State is notorious for targeting out-of-state companies with tenuous business activities in the state for failure to pay its Business and Occupancy Tax. Other types of such non-income taxes that have been known to reach companies "doing business" out of state include Michigan Business Tax, Texas Margin Tax, and Ohio Commercial Activities Tax.

Sales and Use Tax

P.L.86-272 only protects solicitation activities from income tax. For sales tax purposes, solicitation of sales by subsidiaries, agents or affiliates, who are residents of a state, on behalf of a foreign business will create nexus.

In fact, many states have made nexus automatic (and also not purely based on physical nexus), through a rebuttable presumption that a foreign company's in-state referral sources are soliciting sales, by internet or otherwise, to generate their commissions. The burden of proof shifts to a company having to prove the opposite: that a referral arrangement with a resident does not cause such resident to solicit sales, by internet or otherwise, generating a sales tax collection obligation. New York's highest court has upheld this type of statutory presumption (referred to variously as "click-through nexus," "commission-agreement provision" or "Amazon law") against constitutional challenge by online retailers Amazon.com and Overstock.com.

Nexus Study / Diagnostic Check

In light of the potential tax pitfalls facing a business with regular ties to various states—direct or indirect, physical or economic—every multi-state business should periodically perform a state-by-state diagnostic check, or nexus study, of its activities, such as:

- Ownership or leasing of real property (store, warehouse, office) or personal property (machinery or equipment).
- Inventory maintained in a warehouse or by sales representatives.
- In-state deliveries to customers in company-owned vehicles.
- Local media advertising (e.g., phone directory or telemarketing service).
- Employees attending trade shows, or conducting training or seminars.
- Active solicitation of orders for sales (for sales and use tax purposes).
- Solicitation activities beyond the protection of P.L.86-272, such as solicitation of sale of services, real estate or intangibles (for income tax purposes).
- Installation, repair, or maintenance services.
- In-state order approval, receipt of payment, merchandise returns and customer complaint resolution.
- Affiliate referral programs, internet-based or otherwise.
- License, royalty or other fee arrangements.

Once a company completes a nexus study questionnaire, and personnel interviews, regarding its specific activities in various states, this information is analyzed in light of current law by state and area of tax. A confidential attorney-client privileged memo summarizing the nexus study results is then provided to the business. The company can then make informed decisions with its tax counsel on how to minimize its multi-state tax exposure. The business may choose to alter its business practices to eliminate nexus in one or more states. If that is not possible, it may choose to make voluntary disclosures through available state programs to potentially obtain a limited look back period and waiver of penalties.

Conclusion

In the wake of dramatic budget shortfalls and deficits, states are eager to wage nexus audits on out-of-state businesses, generating significant payments of income tax, sales and use tax, interest and penalties. If your company operates in a multi-state market, is not registered to do business in other states and is not paying income tax or collecting sales tax, it is critical that you engage a tax attorney—that has the benefit of a confidential-attorney client relationship—to conduct a state-by-state nexus study. Failing to do so may cause your company to be blindsided by what could be substantial (in some cases multimillion dollar) tax liability that may also be a personal debt for its owners and officers.

Geoffrey Weinstein

Juliya Ismailov

0 Comments Tax, Trusts & Estates Law

Login

Recommend

Share

Sort by Oldest

Start the discussion…

Be the first to comment.

Subscribe

Add Disqus to your site Add Disqus Add

Privacy

NEW JERSEY | NEW YORK | DELAWARE | MARYLAND | TEXAS | FLORIDA

Copyright © 2016, Cole Schotz P.C. All Rights Reserved. Attorney Advertising.