Multistate Businesses Must Have a Nexus Tax Strategy

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States are looking to increase revenues by more aggressively enforcing income tax nexus laws. The term "nexus" describes the threshold of contact that must exist between a taxpayer and a state before the state has jurisdiction to impose a tax. It is important to understand the various state income tax filing requirements and the exposure to noncompliance penalties. There are 50 states and 50 sets of rules, making state taxation convoluted at best. Accordingly, if you have a multistate business, it is important to develop a tax strategy by working closely with an experienced tax advisor. Below is a general overview of state income tax nexus rules.

Federal Limitations Add an Extra Layer of Complexity to State Taxes

While states have implicit jurisdiction to tax, their authority is subject to three principal limitations. The first limitation is the Due Process Clause of the U.S. Constitution, which requires a "minimum connection" between the activities of the taxpayer and the taxing state. The second restriction stems from the Commerce Clause of the U.S. Constitution, which imposes a higher standard by requiring that there be a "substantial nexus" between the taxed activity and the taxing state. The last limitation, Public Law 86-272, applies only in a limited set of circumstances. Under this federal law, states may not impose an income tax on an out-of-state company if the only intrastate activity is the solicitation of orders for sales and delivery of tangible personal property, and the orders are sent outside of the state for approval and fulfillment. It is important to note that the sale of services or software is not protected by Public Law 86-272.

Physical Presence vs. Economic Presence

Despite these constitutional and statutory protections, neither the Due Process Clause nor the Commerce Clause define or provide guidance regarding nexus. As a result, the courts have defined what constitutes nexus using mostly facts and circumstances. Traditionally nexus was asserted when the taxpayer was physically present in the state. However, the "minimum connection" required by the Due Process Clause gave the states the leeway to legislate nexus through economic presence, even if no physical presence existed. Recently, in South Dakota v. Wayfair, Inc. 138 S. CT. 2080 (2018), the Supreme Court ruled that physical presence is not required and that purely economic presence is sufficient to establish "substantial" nexus as required by the Commerce Clause. While this case dealt exclusively with sales and use tax nexus, it may open the door for economic nexus to be applied to state income tax.

Factor Presence Nexus Standards

In an effort to develop a more equitable standard for the assessment of state business taxes, in 2002 the Multistate Tax Commission (MTC) developed the concept of "factor presence nexus." In general, under factor presence nexus standards, a business is presumed to have nexus with a state if the business has property, payroll, or sales factors in the state that exceed a certain threshold. Under this test, a taxpayer would establish nexus if the taxpayer exceeds any of the following apportionment factor thresholds:

- $50,000 of property;
- $50,000 of payroll;
- $500,000 of sales, or;
- 25% of total property, total payroll, or total sales.

continued

The existence of a property or a payroll factor would indicate physical presence, which is a more traditional indicator of nexus for the Commerce Clause. The sales factor would indicate purely economic presence and has been the source of litigation. In the early litigation of factor presence nexus standards, the courts have sided with the states and against the taxpayers. Currently, the majority of states have not adopted the MTC standard in its entirety. It is likely that more states will set arbitrary sales factor thresholds to claim nexus.

Conclusion: Every Business is Different - Review Sales and Income Tax Strategy

Vague legal standards combined with little or no federal and state guidance regarding the type and level of activity that triggers state income tax, make nexus a high-stakes legal issue for multistate businesses. This is especially true given the absence of a statute of limitations for unfiled returns. If your business delivers products or services outside your home state, it is important to review your sales tax and income tax nexus policies to ensure that your business does not have additional state and local exposure due to these recent changes.

About the Author:

Jill McSpadden, CPA is a Tax Senior at Rivero, Gordimer & Company, P.A. She earned her bachelor's and master's degrees in accounting from the University of Florida. Her areas of concentration include income tax preparation and accounting consultation.

Contact Ms. McSpadden at 813-875-7774 or jmcspadden@rgcocpa.com

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