Nexus: It's all about physical presence. Or is it?

Nexus. It's a fairly simple five-letter word that the Merriam-Webster dictionary defines as a connection or link. At first glance the word doesn't appear very scary, mystical, or confusing, but when used in the context of taxes it is often one of the most misunderstood, misinterpreted, and underestimated issues; making it a very common cause of tax problems.

Why does this seemingly non-threatening word generate such heartburn in multi-state businesses? Start with the U.S. Constitution, add a couple of federal laws and Supreme Court cases, multiply that by the laws passed in each of the 50 states, then apply that to different categories of taxes, factor in states hungry for revenue, and top it off with an ever-evolving economy, and you have your answer. Nexus is not static. States are constantly pushing the nexus envelope trying to increase their tax base. So even if you are a nexus expert (a Nexpert?), nexus is a topic that requires continuous monitoring and updating of knowledge.

Nexus: Expanding the Simple Definition

A generic definition I like to use is: the minimum connection or link necessary, that allows a state to tax you or force you to collect taxes on it's behalf.

This minimum link can vary from state to state as well as from tax to tax. Perhaps the best way to delve into nexus is by examining it within the context of the three different major types of state taxes and some of the primary legal influences affecting nexus for those taxes:

+ Sales and Use Tax (SUT)
+ Corporate Income Tax (CIT)
+ Neither/Nor Taxes (NNT)

NNT consists of taxes like the Washington Business & Occupation Tax (B & O), the Ohio Commercial Activities Tax (CAT), the Michigan Business Tax (MBT) and the Texas Franchise Tax among others.

Sales and Use Tax

To understand the evolution of nexus for sales and use tax, it is important to start with the U.S. Constitution: more specifically, the Due Process and Commerce Clauses. The Due Process Clause states that no state shall deprive anyone of life, liberty, or property, without due process of law and the Commerce Clause states that Congress shall have the right to regulate commerce among the several states.

The combination of the Due Process and the Commerce Clause has evolved to mean that before a state can subject you to its laws, you must have a link or nexus with that state. The Supreme Court has held that when it comes to the Due Process Clause, there must be a "minimal connection" (nexus) before a state can tax you. However, when it comes to the Commerce Clause, the Supremes have declared that there must be a "substantial connection" (nexus). Because creating the minimal connection required by the Due Process Clause is fairly easy to do, we will concentrate on the Commerce Clause and its substantial nexus.

Commerce Clause and Nexus – How Did We Get Here?

It has been a little more than 70 years since the Supreme Court, in *Nelson v. Sears Roebuck* and *Wisconsin v. J.C. Penney*, broadly addressed the concept of "substantial nexus." Since that time, it has been widely accepted that substantial nexus requires more than the slightest physical presence. What has not been as clear is exactly what constitutes physical presence and exactly at what point does one cross the line from "slightest" to "more than the slightest" physical presence to create substantial nexus.

The Court visited this issue again in the 1967 case *Tyler Pipe Industries, Inc. v. Washington Dept. of Revenue.* The Court held that even one part-time employee or independent agent can create nexus. It went on to add that the critical test was to see if the activities performed on behalf of a taxpayer are significantly associated with the taxpayer's ability to establish and maintain a market in that state. Following this line of reasoning you can see how installation, maintenance, warranty services, etc., are just as important to establishing and maintaining a market as sales, and therefore can also create nexus even if performed by third parties.

Until Congress decides to exercise its powers under the Commerce Clause, nexus will continue to be a complex grey area where states will continue to push the envelope.

Although the Supreme Court has decided a number of cases over the last 50 years providing some guidance, it can only rule on the facts in the instant case. No definitive, all-inclusive answer can come from them. They have (properly) deferred the matter to Congress instead. So until Congress decides to exercise its powers under the Commerce Clause, nexus will continue to be a complex gray area where states will continue to push the envelope. In the meantime we will have to rely on what little guidance the Supreme Court has provided. Even if Congress does act, that does not mean nexus issues will all of a sudden have clarity.

One of the earliest cases to expand the scope of physical presence is the 1960 case, *Scripto, Inc. v. Carson*. In this case the Court decided that independent sales representatives, even if they are not exclusive to a company, create substantial nexus. The Court stated that it was not important what these representatives were called, but rather what they did for the company.

Sales and Use Tax Critical Cases

1. *Wisconsin v. J.C. Penny* – 1940
   - Broad concept of substantial nexus
2. *Nelson v. Sears Roebuck* - 1941
   - Broad concept of substantial nexus
3. *Northwestern Cement* – 1959
   - Led to the introduction of P.L. 86-272
4. *Scripto, Inc. v. Carson* – 1960
   - Non-exclusive independent contractors create nexus
5. *Tyler Pipe Industries, Inc. v. Washington DOR* - 1967
   - Establishing & maintaining a marketplace creates nexus
6. *National Bellas Hess v. DOR Illinois* - 1967
   - Catalogs sent by USPS - not enough physical presence
7. *Quill Corp V. North Dakota - 1992*
   - More than the slightest physical presence required
   - Focus on SUT emboldened pursuit of "economic nexus"

Perhaps two of the most important Supreme Court cases are *National Bellas Hess, Inc. v. Department of Revenue of Illinois* (1967) and *Quill Corp. v. North Dakota* (1992). In Bellas Hess, the Court decided that sending catalogs into a state by U.S. mail did not constitute enough of a physical presence to constitute nexus. In Quill, the State argued that three diskettes were enough of a physical presence to create nexus for Quill's catalog business. The Court decided for Quill, stating that a taxpayer must have more than the slightest physical presence in a state in order to require the collection of sales or use tax. The Court's reasoning was partially based on the fact that, due to the immense number of sales tax jurisdictions, imposing an obligation to collect sales tax would create a burden that could be said to effectively restrict interstate commerce.

This brings us to where we are today. We know that third parties performing activities that help establish and maintain a market can create nexus. We also know that it takes more than the slightest physical presence to create nexus. It's safe to assume that offices, warehouses, and employees all exceed the slightest physical presence. But where is the line drawn? In Quill, three diskettes was not sufficient; but could four, five, or six be enough? Because the Court decided not to quantify, we will remain in this complex gray area reacting to the pushing of the envelope by states until Congress decides to act.

10 Nexus-Creating Activities for Sales & Use Tax

1. Ownership of real property (stores, warehouses, offices, etc.).
2. Ownership of personal property (machinery, equipment, etc.).
3. Leasing of real property (stores, warehouses, offices, etc.).
4. Leasing of personal property (machinery, equipment, etc.).
5. Maintaining of an inventory, whether consigned, stored, or carried by sales representatives.
6. Travel of employees into a state to conduct sales, training, deliveries, installations, repairs, etc.
7. Use of independent sales or manufacture's reps, even if they are not exclusive.
8. Use of sub-contractors for repairs, maintenance, installations, etc.
9. Allowing employees to telecommute or use a home office.
10. Advertising in local media or phone directories.

In its opinion, the Court affirmed a state's power to tax income generated from interstate activities.

Corporate Income Tax

When it comes to CIT, the role of physical presence has become somewhat less paramount. In some instances the state's authority has been limited, while in others, increased. Sometimes these results are by design and sometimes they are the result of the law of unintended consequences. Let's take a look at two of the biggest influences: *Northwestern Cement v. Minnesota* and *Quill v. North Dakota.*

Northwestern Cement v. Minnesota and Interstate Activities

In February 1959, the U.S. Supreme Court decided *Northwestern Cement v. Minnesota.* In its opinion, the Court affirmed a state's power to tax income generated from interstate activities. They went on to say that such a tax is valid if it does not discriminate against interstate commerce and is properly apportioned to activities within the state that create nexus.

Congress began to worry that unclear nexus guidelines and complex compliance issues could cause some companies, particularly smaller ones, to limit their interstate activities. Congress moved quickly to pass legislation, Public Law (PL) 86-272, seven months after the Supreme Court decided the Northwestern Cement case. The major thrust of PL 86-272 is that a state is prohibited from imposing a net income tax if a company's only activities in a state are the solicitation of orders for sales of tangible personal property that are sent outside the state for approval or rejection and are filled from outside the state. The Senate noted that the legislation was not a permanent solution and was intended to be a temporary fix while further studies were made of the problem.

Fifty-two years later, here we are with no further action and an even more confusing environment. Companies have broadened their offerings to sell services and intangibles as well, sometimes even combined with tangible personal property. This law is now one of the factors confusing the nexus situation even more. The protection of PL 86-272 applies to independent agents as well as employees. However, when relying on these protections it is important to remember the narrow confines of the activities covered.

Quill v. North Dakota and Economic Nexus

Another influence on CIT comes from the unintended consequences of the Quill decision. In Quill, the Court expressly talks of physical presence in the context of SUT. Many states have taken the position that the Court's narrow language in Quill referencing SUT means that the requirement for physical presence is superfluous when referencing other taxes. This opened the door for a concept called "economic nexus." This concept, basically defined, is that states have jurisdictional authority to tax any company that takes advantage of the state's markets without regard to physical presence and can be measured in ways such as receipts generated from the state or numbers of customers within the state. To date, there have been many lower court and state supreme court cases affirming the concept of economic nexus with the U.S. Supreme Court refusing to take sides. The result is a confusing mix of nexus rules with some states requiring physical presence and others not.

Neither/Nor Taxes

These taxes are neither SUT nor CIT, but closer to a mix of the two. The NNT group consists of taxes like the Washington Business & Occupation Tax (B & O), the Ohio Commercial Activities Tax (CAT), the Michigan Business Tax (MBT) and the Texas Franchise Tax. Because NNT are not income taxes, they are not afforded the protections of PL 86-272. Conversely, since they are not SUT, the states perceive they are not subject to the physical presence requirements of Quill. Of the four taxes mentioned above, only Texas does not have an economic nexus provision.

Conclusion

Physical presence has and does play a role in nexus. How big that role is depends on the type of tax and the state in question. What qualifies as physical presence also varies widely as states continue pushing the envelope looking to increase their tax base. It's a situation that promises to get more confusing as time goes by. The ultimate solution probably rests with Congress and its ability to regulate interstate commerce. However, since they have been reviewing the situation for 52 years, a congressional solution does not seem to be on the near-term horizon. For now, we are on our own.

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