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Nexus and Multistate Sales Taxes:

Challenges for Business Services Providers

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Managing sales tax is a complicated task, especially for those who do business across state lines. Since state laws vary regarding which out-of-state businesses must collect sales tax, companies that operate in multiple states find it a challenge to remain in compliance.

For business services companies, which increasingly operate in multiple states or even nationwide, accurately managing sales tax collection requires knowledge and vigilance. Services have eclipsed goods as the engine of the U.S. economy, and now make up 80 percent of revenue. To capture more tax revenue from this expanding sector, states are taxing more and more types of services. They are also expanding laws that dictate which business activities are considered to give companies a substantial presence in their states – a principle called "nexus."

"To capture more revenue from this expanding sector, states are taxing more types of services."

Business services companies can find it a challenge to understand and track changes in laws concerning nexus. Data provided by Bloomberg Tax's *2017 Survey of State Tax Departments* highlights some of the trickier issues such companies should be paying attention to when it comes to nexus and sales tax.

What Is Nexus?

In the context of sales tax, nexus is a business's involvement in a given state that rises to a level at which the state can justify requiring it to register in the state, collect sales taxes on all eligible transactions there, and remit those taxes to the state. The rules dictating nexus vary by state, with nexus-creating activities including but not limited to things like advertising in another state, selling services online, and sending workers to perform services in another state.[2]

The U.S. Constitution provides states with the legal basis to tax out-of- state businesses.[3] Sales tax rules in the U.S. originated in the 1930s,[4] an era when it was most common for a seller to provide tangible personal property (TPP) or services to a local buyer. By the end of that decade it was clear that taxation when selling across state lines was a topic in need of discussion; legislation concerning the principles of nexus dates back to at least 1939. Nexus entered use as a legal term in 1967,[5] and the U.S. Supreme Court clarified in 1977 that there must be "substantial nexus" between the taxing state and the taxed entity.[6] The exact definition of nexus remained somewhat vague until 1992, when the Court found that nexus constitutes a "physical presence" in the taxing state.[7]

Starting in 2008, nexus has gained increasing prominence as states have certified more nexus-creating activities as a way of capturing sales tax revenue from out-of- state companies. The growth of the service industry, especially in business services that lend themselves to remote implementation, is central to this robust conversation over the laws governing nexus. Some legal authorities believe that states' recent efforts to expand nexus to out-of- state retailers is a direct challenge to the Supreme Court's definition of nexus.

Judging Presence

The judgment about which companies have nexus in a given state is generally governed by standards of physical presence or economic presence, and in some cases by a combination of the two – known across states as "factor presence."

Physical Presence: On-the- ground business activities like maintaining employees or property in a state are the most straightforward triggers for nexus. According to Bloomberg BNA's 2017 Survey of State Tax Departments, nine states base their sales tax nexus policy, either as a whole or in part, on the physical presence standard: Delaware, Hawaii, Michigan, Nebraska, New Mexico, Oklahoma, Pennsylvania, Rhode Island, and Texas. New York City also follows this standard.

Economic Presence: A business can also create a substantial connection to a state without setting foot in it. The economic presence standard has historically been applied to nexus for state income tax, but many states have expanded it to sales tax laws in recent years. This standard is based on a business's engagement in regular, systematic sales into a state that total above a certain threshold, such as $100,000 in a 12-month period. Vermont, Washington, Alabama, Maine, and Massachusetts have these types of laws.

Some states, like Ohio and Rhode Island, have tied economic nexus to consumers' use of an out-of- state retailer's software – a move that reflects the dominance of large online retailers like Amazon that offer their own apps for mobile devices. Five other states with economic nexus legislation that is being challenged or delayed are Indiana, North Dakota, South Dakota, Tennessee, and Wyoming.

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1 Avalara, "Competitive Advantages of Sales Tax Automation for Services Companies."
2 Diana Dibello and Sylvia Dion, CPA, "Navigating Nexus," Journal of Accountancy, October 31, 2010, https://www.journalofaccountancy.com/issues/2010/nov/20102904.html
3 Sales Tax Institute, "What Is Nexus?" http://www.salestaxinstitute.com/Sales_Tax_FAQs/What_is_nexus
4 Ronald Snell, National Conference of State Legislatures, "State Finance in the Great Depression," March 2009, http://www.ncsl.org/print/fiscal/statefinancegreatdepression.pdf
5 June Summers Haas, "Due Process, Economic Presence, Nexus and Electronic Commerce," Weekly State Tax Report, Bloomberg BNA, April 22, 2016, https://www.bna.com/due-process- economic-n57982070221/
6 Supreme Court of the United States, "Complete Auto Transit, Inc. v. Brady. 430 U.S. 274 (1977)," https://supreme.justia.com/cases/federal/us/430/274/case.html
7 Supreme Court of the United States, "Quill Corp. v. North Dakota (91-0194), 504 U.S. 298 (1992)," https://supreme.justia.com/cases/federal/us/504/298/case.html

Factor Presence: This standard combines physical and economic presence requirements, setting out sets of thresholds that businesses must meet in order to trigger nexus. This formula is based on the Multistate Tax Commission's model statute, Factor Presence Nexus Standard for Business Activity Taxes:[8] $50,000 of property, $50,000 of payroll, and $500,000 of sales, or 25 percent of total property, total payroll, or total sales. Thirteen states base their nexus policy, as a whole or in part, on the factor presence standard: Alabama, California, Colorado, Connecticut, Kentucky, Maryland, Massachusetts, Minnesota, Nebraska, Oklahoma, Tennessee, Virginia, and West Virginia.

"Remote services push companies into complicated territory with regard to sales tax."

Business Services, Nexus, and Sales Tax

As the U.S. moves toward a more service-driven economy, companies that provide services are using technology to differentiate themselves and broaden their reach. Offering remote services is an excellent way to expand a business services venture, but it pushes companies into complicated territory with regard to managing sales tax.

As the internet enables businesses to sell promote and sell their services from afar, things are getting increasingly complex: States are finding more and more ways to tax services to increase revenue, as well as broadening the rules for how out-of- state businesses might create nexus.

Bloomberg Tax's *2017 Survey of State Tax Departments* highlights that the rules governing sales tax and nexus for business services provided by out-of- state companies vary substantially across states. Today, 18 states currently tax some business services,[9] and each of those states has unique laws that companies doing business there must track. Advertising services, for example, are taxable in Connecticut but exempt from sales tax in New York.

Topics of particular concern to business services purveyors involve the sourcing of service transactions, sales tax on services provided in conjunction with physical goods, and business services-related activities that create nexus – an issue on which states disagree widely.

Sourcing Business Services Transactions

When imposing sales and use taxes, states follow sourcing rules that specify the location of a sale and which jurisdiction should collect tax on the sale. Prior to intensive interstate commerce, local jurisdictions argued over this question, but with the explosion of online sales, the issue of sourcing is increasingly an interstate concern. Which state – that of the buyer or the seller – should be deemed the source (or location) of the sale, allowing that state to collect sales tax on the transaction? Usually, the state in which the goods are to be consumed or used is seen as the source, but rules vary by state and account for many factors, such as the object of the transaction, the type of transaction, and mode of delivery.

Sourcing is especially complicated for business services, considering that such services may involve the provision of digital materials, require employees to visit other states to perform portions of the service, or deliver goods associated with the service. Since some business services result in a product, such as a report, video, or digital presentation that is delivered via electronic download, there are questions about whether the sale should be taxed as a good instead of a service.

Whether something is a good or a service may affect the sourcing determination for a transaction. Additionally, if its output is considered "digital content," its download by residents of certain states may create nexus for the seller. Five states have such a rule, and three states hold that nexus is created when customers access but don't download digital content.

"Sourcing is especially complicated for business services"

Sample Sourcing Use Case

"HR Whiz," a fictional Oregon human resource services company, works with one client in Hawaii and another in Iowa to recruit top executives for those firms. HR Whiz happens to have nexus in both of these states. Since it has nexus in Hawaii, at first its accountants assume it will have to charge sales tax on the service there, since Hawaii is one of four states that broadly tax most services. However, when accounting for Hawaii's rule that sourcing for services is based on the place where the services are performed, the company doesn't have to charge taxes on the transaction after all – the services were performed in Oregon, which has no sales tax. The other transaction produces the opposite conclusion: Iowa rules that as long as the services are taxable and are received in Iowa for the benefit of the customer in Iowa, then the service will be sourced to Iowa and tax must be charged. Employment and executive search is one service that is taxed in Iowa,[10] so HR Whiz is on the hook to charge and remit sales tax on its transaction there.

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8 Multistate Tax Commission, "Factor Presence Nexus Standard for Business Activity Taxes," October 17, 2001, http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/FactorPresenceNexusStandardBusinessActTaxes.pdf

9 Avalara, "Business Services Industry Battlecard."

10 Iowa Department of Revenue, "Iowa Sales and Use Tax: Taxable Services," https://tax.iowa.gov/iowa-sales-and-use-tax-taxable-services-0

Business Services and the True Object Test

Whether a "mixed transaction" that includes business services as well as the provision of a product should be taxed as a good or a service can be determined via the True Object Test.[11] States use the test to figure out the "true object" of a transaction: If the transaction's central purpose is the purchase of a good, with the service only needed to support the provision of that good, then the whole transaction should be taxed as TPP. If the central purpose is the service, and the physical good is secondary or incidental, then the entire transaction should be taxed as a service.

> **The True Object Test**
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> If a transaction's central purpose is the purchase of a good, with the service only needed to support the provision of that good, then the whole transaction should be taxed as tangible personal property. If the central purpose is the service, and the physical good is secondary or incidental, then the entire transaction should be taxed as a service.

This test is a subjective measure, and the transaction's true object is not always clear. However, many business services that involve the provision of a product – such as a business analysis service that results in a physical report delivered to the client – will have the service as their true object.

Those trying to judge the object of business services can look to a landmark 2010 case in the Missouri Supreme Court, Western Blue Print Co. v Director of Revenue,[12] in which the court applied the true object test to the service of scanning customers' paper documents into digital form and delivering them to customers on CDs. The central question was whether the customers' true object was the CD itself or the digital information on the CD. The court decided that the true object was the information, not the physical CD, setting an important precedent in determining the taxability of business services that result in physical or digital products that convey information or analysis.[13]

Creating Nexus with Business Services

Bloomberg Tax's *2017 Survey of State Tax Departments* found that most states rule that performing services from out of state for the benefit of in-state customers does not usually create nexus. It's more likely for states to find that nexus is created if the performance of a service by an out-of- state company involves a company employee visiting the state occasionally or regularly, or involves storing TPP with a third party in the state. This holds true regardless of whether or not TPP is transferred as part of the service, whether physically by common carrier or digitally.

Of those surveyed, only four states hold that the service of repairing TPP and delivering it to the in-state customers by common carrier creates nexus, while nine states hold that providing a taxable service for an in-state customer in which no part is physically transferred creates nexus, and 11 hold that providing a taxable service in which TPP is physically transferred creates nexus. Eight states hold that transferring documents digitally in the provision of a service is enough to create nexus.

It's more likely for states to find that nexus is created if the performance of a service by an out-of- state company involves a company employee visiting the state occasionally or regularly, or involves storing TPP with a third party in the state. The overwhelming majority of those surveyed – 36 states – hold that out-of- state service providers whose employees regularly or occasionally visit the state to deliver TPP create nexus Additionally, 35 of the surveyed states hold that storing TPP with a third party in the state in provision of a service creates nexus.

> **"Performing services from out of state for in-state customers does not usually create nexus."**

> **Sample Nexus Use Case**
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> "Biz Brains," a fictional Arizona marketing and advertising company, gains two new orders from customers in New Mexico, where most services are taxable. It does not have nexus in New Mexico prior to these customers' orders. The first customer wants Biz Brains to design a 'Brainiac' hat with the company logo and deliver a prototype to the company's New Mexico headquarters. Biz Brains does not acquire nexus in New Mexico when doing this, as the state has ruled that providing a taxable service in which TPP is physically transferred does not create nexus there. The second customer wants business analysis done, with the resulting report sent over email. As soon as Biz Brains hits send on the email with the report attached, the company has created nexus in New Mexico, since the state rules that nexus occurs when an out-of- state corporation transfers to an in-state customer, only by electronic means, documents that are incidental to the performance of a taxable service.

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11 Deloitte, "What Am I Selling? Properly Characterizing Technology," https://www2.deloitte.com/content/dam/Deloitte/us/Documents/Tax/us-tax-mts-inside-deloitte-what-am-i-selling-properly-characterizing-technology.pdf

12 Supreme Court of Missouri, "Western Blue Print Co. v Director of Revenue," April 20, 2010, http://caselaw.findlaw.com/mo-supreme-court/1520397.html

13 Jones Day, "The 'True Object' Text vs. Technology," Lexology, June 30, 2010, https://www.lexology.com/library/detail.aspx?g=157510fc-9329-486a-9346-2c3bb841fe08

Conclusion

As Bloomberg Tax's *2017 Survey of State Tax Departments* makes clear, business services companies must be increasingly vigilant about states' sourcing and nexus rules, and must understand the True Object Test to determine whether their transactions must be taxed as goods or services.

Since state laws on nexus are not uniform and are constantly changing – and in particular expanding to apply to more service-related commerce – business services companies should keep accurate records of their activities to ensure that receipts are sourced properly and all entities are registered to file and report taxes in the correct states.

Business services companies will benefit from automating the tracking and reporting of sales tax. Up-to- date SaaS products can track rules and regulations that apply to the sector's activities, maintain up-to- date paperwork, and assist with filing accurate and timely returns. Automating sales tax management allows business services providers to concentrate on delivering top-notch service to their customers while remaining compliant instead of wrangling red tape.

This white paper cites results of Bloomberg Tax's 2017 Survey of State Tax Departments.[14] *Now in its 17th year, this survey clarifies each state's position on the gray areas related to the income taxation of corporations and pass-through entities, as well as to the sales and use taxation, with an emphasis on nexus policies. For more information about the survey, contact the editors at tax-productmanagement@bna.com.*

For information about automating your transactional tax compliance process, visit www.avalara.com.

14 2017 Survey of State Tax Departments, Bloomberg BNA, Vol. 24, No. 4, 2017, http://about.bna.com/2017-state-tax-survey/

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